Helping People to Save

The Modernisation of Britain's Tax and Benefit System, Number Seven

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1 Introduction and Summary

1.1 The Government is committed to building a strong economy and a fairer and more inclusive society in which everyone can contribute to and benefit from economic prosperity. It has taken steps to tackle poverty and to create employment opportunities for all, and by putting in place a sound fiscal framework and cutting the £28 billion deficit it inherited, the Government has taken steps to promote a higher level of national saving. As well as raising people's living standards day-to-day, the Government wants people to be able to save for their future.

The value of savings

1.2 Savings have a crucial role to play in people's lives. From money saved in an account at a bank or building society, investments on the stock market, wealth built up in a life or pension fund or in equity in a house, savings act as a cushion for people to fall back on if something unexpected happens and a platform for people to build for their future. The Government recognises the importance of savings in providing people with:

- **independence throughout their lives;**
- **security if things go wrong; and**
- **comfort in old age.**

1.3 The Government wants more people to enjoy these benefits. For a long time there has been a concern that too many people have no, or only very low levels of, savings. Recent research has shown that half the adult population has less than £750 in liquid financial savings and that one in ten households has no savings at all[1]. Of course, not everyone will have the money to save all the time and the Government will continue to provide support to those who need it. But the Government wants more people to be able to save and believes there is a role for policy to help them to do this.

The Government's strategy

1.4 The Government's strategy to encourage saving is to:

- **create the right environment for saving;**
- **create the right incentives for people to save; and**
- **provide information and education to help people to make the right saving choices.**

1.5 Since 1997 the Government has put in place a number of reforms to encourage people to save. It has been:

- **extending tax incentives for saving,** particularly to low–income savers, by introducing Individual Savings Accounts (ISAs);
- **ensuring that savers are not unfairly penalised** by raising capital limits for pensioners and setting out plans for a Pension Credit;
- **making savings products more accessible and transparent** by introducing CAT standards as voluntary benchmarks for **c**harges, **a**ccess and **t**erms;
- **reforming pensions** by introducing stakeholder pensions and Individual Pension Accounts (IPAs) from April 2001;
- **tackling financial exclusion** and working with banks to offer basic bank accounts to people who do not have a current account;

[1] Banks, J. and Tanner, S. (1999) *Household wealth in the UK*, Insitute for Fiscal Studies.

- **introducing a single financial regulator**, the Financial Services Authority (FSA), to promote consumer confidence in financial services and secure appropriate consumer protection; and
- working with FSA to **raise financial literacy**, for example by including financial education as part of the National Curriculum from September 2000.

1.6 Since 1997, personal sector net financial wealth has increased by 25 per cent, more than twice the rate of income. The proportion of total financial wealth (excluding pensions) held tax-free in TESSAs, PEPs and ISAs has risen by 50 per cent.

1.7 For the future, the Government will take further steps to encourage saving, particularly among low or moderate earners. It has already announced the introduction of stakeholder pensions in April 2001, which will provide a low-cost, flexible and secure pension, particularly to those without access to a good occupational scheme.

1.8 ISAs are a key element of the Government's strategy to promote saving. They have had a successful start. In the first year 9.3 million accounts were opened and £28.4 billion invested – a third more than was invested in Tax Exempt Special Savings Accounts (TESSAS) and Personal Equity Plans (PEPS) during their last, and most successful, year. A further £9 billion has been invested during the first quarter of 2000–01. ISAs, particularly mini cash ISAs have have also attracted relatively more low-income savers than TESSAs or PEPs. More than a quarter of mini cash ISAs are held by people with household incomes of less than £11,500 per year, compared to around one in five TESSAs and one in six PEPs.

1.9 **Building on ISAs' success, the Government will retain the £7,000 overall ISA contribution limit for a further five years until April 2006. The £3,000 limit for cash will also be retained**, which will benefit the many younger and low-income savers who have chosen to save in mini cash ISAs.

1.10 However, promoting saving through tax relief provides the greatest incentives to those on higher incomes. The Government will continue to look at ways of encouraging people with low or moderate earnings to save.

1.11 The Government will also ensure that savers are not unfairly penalised by the tax and benefit system. **A separate consultation document, to be published by the Department of Social Security on 9 November, will set out plans for a Pension Credit to ensure that people who have saved in a pension are rewarded in retirement.** For people of working age, the next phase of modernisation of the tax and benefit system offers an opportunity for a thorough review of the treatment of income and capital in assessing entitlement to support. The aim is to create a modern system with incentives to work and save.

1.12 This paper presents a framework for Government policy on personal saving. It summarises evidence on saving and wealth in the UK[2]. It establishes the Government's commitment to encourage saving and the role for policy to do this. It sets out the Government's strategy for helping people to save and the priorities for the future.

[2] Throughout this paper, saving is used to refer the flow of money that people save each period. Savings refer to the accumulated stocks of assets that people have saved in the past. The terms savings and wealth are interchangeable.

2 EVIDENCE ON SAVING AND WEALTH

Information on aggregate wealth shows the importance of longer-term saving. Together, life and pension funds and housing account for 62 per cent of household wealth. Cash deposits account for 14 per cent and direct holdings of equities for 13 per cent.

Better survey information is needed to build up a more complete picture of saving and wealth across the population. An ONS working group has been assessing the case for a regular wealth survey and will be consulting on this over the coming months.

Existing evidence, focusing largely on financial savings (cash deposits, stocks and shares and National Savings), shows that a large proportion of the population has no – or only very low levels of – financial savings.

Overall, more than a quarter of households have no financial savings. Among households with incomes of less than £200 a week, more than 40 per cent have none. 9 per cent of adults do not even have access to a current account.

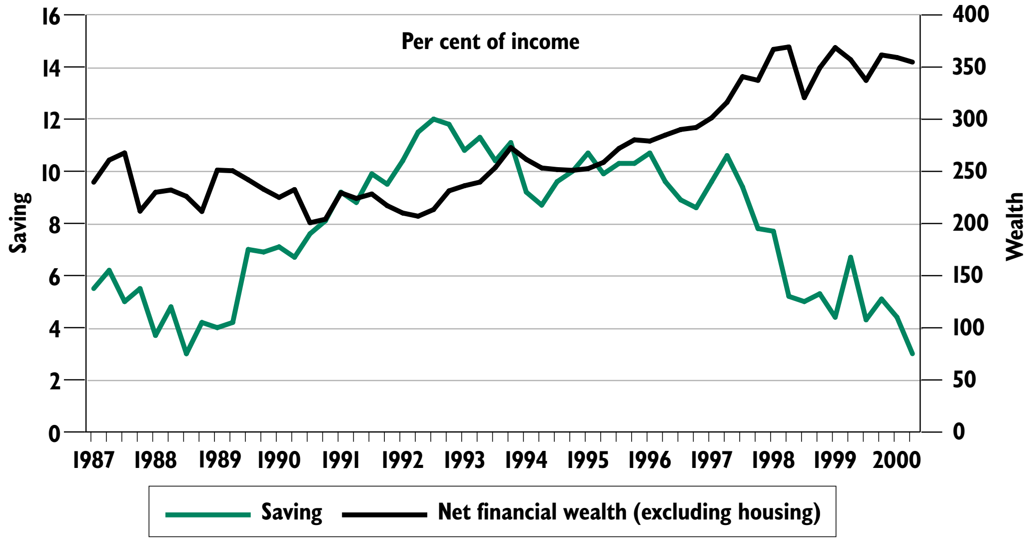
Looking at all forms of saving (including pensions, life assurance and housing) recent research has shown that around one in ten households has no savings at all.

2.1 The Government's objective for personal saving encompasses saving in all possible forms – from putting money into a bank or building society account, investing in stocks and shares, contributing to a pension or life assurance or building up wealth in housing or a business.

The saving ratio

2.2 A commonly used measure of personal saving is the personal sector saving ratio[3]. In effect this is a residual measure of the personal sector's total income minus its total spending and captures the *flow* of net saving out of current income. As shown in Chart 2.1, this has been on a downward trend since 1993, returning to its level of the late 1980s.

Chart 2.1: Personal sector saving and wealth



[3] The personal sector incorporates households and non-profit institutions serving households.

2.3 The personal sector saving ratio measures net saving – i.e. net of any borrowing. Most of the fall in the saving ratio in the 1990s has been driven by an increase in borrowing. Gross saving as a proportion of income has remained robust. Flows of long-term saving into pensions and life funds are particularly healthy and in 1999 were above the average during the 1990s.

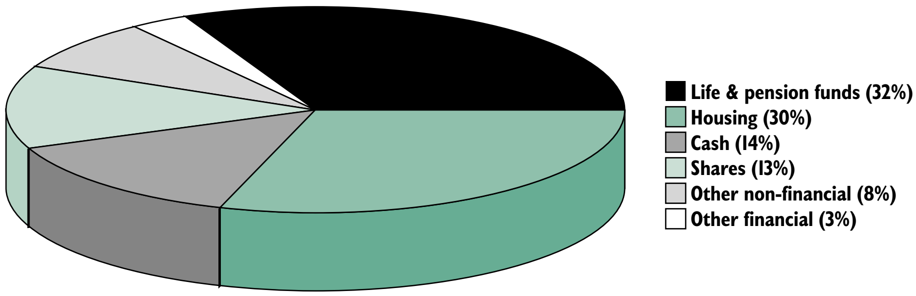
Personal sector wealth

2.4 In any case, the flow of saving out of current income tells only part of the story. Ultimately what matters is the *stock* of wealth that people have saved and what is happening to the value of that stock. As chart 2.1 shows, net financial wealth is close to an historic high and has risen by 25 per cent since 1997 (more than twice the rate of income). In turn this might explain why the saving ratio has fallen. Greater-than-expected increases in the level of wealth might cause people to increase their current spending – and reduce the flow of net saving out of income.

2.5 The total value of net financial wealth[4] held by the personal sector at the end of the second quarter of 2000 was over £2,196 billion. Including the gross value of housing wealth increases the total to over £4,000 billion – over six times the level of income.

2.6 Looking at the composition of net financial and housing wealth reveals the importance of saving for the longer term (see Chart 2.2). Life and pension funds account for nearly one-third of total net wealth and housing (net of loans secured against housing) accounts for 30 per cent. Direct holdings of equities account for 13 per cent and cash deposits for 14 per cent.

Chart 2.2: Composition of personal sector net wealth



2.7 This provides some insight into where people hold their money. But information on the saving and wealth of the entire personal sector may be relatively uninformative about the adequacy of savings of individual households. Wealth is very unevenly distributed. The wealthiest one per cent of the population account for one fifth of the total wealth, while the wealthiest 10 per cent account for over half.[5] This means that the aggregate figures may be dominated by the behaviour of a relatively wealthy few. Any information on the saving or wealth of the entire personal sector therefore needs to be supplemented with information from household or individual surveys on the distribution of saving and wealth across the population.

Survey data on savings

2.8 A recent Cabinet Office report[6] identified a gap in detailed information on saving and wealth throughout the population. Existing public and private sector sources contain information on certain assets but for the moment no single data source brings everything together to provide the whole picture. In July 2000 a working group set up by the Office for National Statistics (ONS) brought together interested Government departments to assess the case for a regular survey of individual wealth and assets to supplement the existing sources of information. Over the coming months, the ONS will be carrying out a process of consultation with the academic and private sectors to establish their requirements.

[4] This excludes the gross value of housing wealth, but is net of all debt, including mortgages.
[5] Inland Revenue Statistics 1999.
[6] Productivity and Innovation Unit (2000) *Adding it up*, Cabinet Office.

Box 2.1: Survey data on savings

Household and individual surveys typically focus on the liquid financial savings that people have – money in bank and building society accounts, investments in stocks and shares and National Savings products. The Department of Social Security's *Family Resources Survey* collects information on the products that people have and their total liquid financial savings. The *Financial Research Survey*, conducted by National Opinion Polls (NOP), also collects information on the products that people have and on the amount of money they hold in each.

The two surveys are broadly consistent, but differences in their design make them difficult to compare directly. One difference is the unit of assessment. The Family Resources Survey carries out interviews with all individuals within the household, but some answers are given at the household or family level. The NOP Financial Research Survey collects information at the individual level – and only interviews one individual per household. Looking at individuals, there will tend to be a higher proportion without any savings, although they may have access to some savings within the family or household (see Table 2.1).

The second main difference lies in how the surveys ask people to give their responses to questions about how much savings they have. The NOP Financial Research Survey asks people to give banded responses to questions about how much savings they have in individual products. The estimate of how much savings they have in total depends on the methodology used to aggregate banded responses. By contrast, the Family Resources Survey asks directly about total savings, but asks for broad banded responses from everyone, and exact amounts from people with between £1,500–20,000 total savings.

2.9 Table 2.1 summarises information from the 1998–99 Family Resources Survey on the types of savings products that people have (note that this is before the introduction of ISAs). The key findings are:

- **bank and building society accounts** are by far the most commonly held form of liquid financial savings. However a high proportion of adults – nearly one in ten – does not even hold a current account. These people tend to be concentrated both geographically and among certain groups of people such as lone parents, those on low wages, ethnic minorities, people with disabilities and the unemployed[7];
- **nearly one in four adults own shares directly** – around half of those own shares only in privatised industries or demutualised building societies[8]; and
- **holdings of National Savings products are widespread.** National Savings offers a range of retail savings and investment products, including a mini cash ISA, some of which are not readily available from the private sector (eg. index-linked bonds). Although National Savings does not have an explicit role to play in encouraging people to save, it is committed to improving quality of service and levels of access, to ensure it is competitive and that all its customers are offered a fair deal.

[7] Financial Services Authority (2000) *In or out? Financial exclusion: a literature and research review.*
[8] *Private Share Ownership in Britain*, research carried out by MORI Financial Services for ProShare.

Table 2.1: Savings products held

	% of households	% of adults
Current account	85	85
Post office account	11	5
TESSA	14	10
Other bank/building society account	64	52
Gilts	1	1
Unit trusts	6	5
Stocks and shares	28	23
Other National Savings products	8	3
Save-as-you-earn	2	1
Premium Bonds	27	19
PEPs	15	12
NONE	8	9

Source: Department of Social Security, Family Resources Survey 1998–99

2.10 Table 2.2 summarises evidence from the 1998–99 Family Resources Survey on the amount of money that people have in liquid financial savings. It shows a high proportion of the population who report that they have none. More than one quarter of households had no savings at all, while a further 22 per cent had less than £1,500. This is broadly consistent with the finding of low levels of liquid financial savings held by *individuals* from the 1997-98 NOP Financial Research Survey. Analysis of these data found that half of the adult population had less than £750 in liquid financial savings[9].

Table 2.2: Levels of liquid financial savings (bank and building society accounts, stocks and shares and National Savings products)

Total liquid financial savings	% of households
None	28
<£1,500	22
£1,500–3,000	8
£3,000–8,000	14
£8,000–10,000	3
£10,000–16,000	7
£16,000–20,000	3
>£20,000	14

Source: Department of Social Security, Family Resources Survey 1998–99

2.11 Households with low incomes tend also to have little savings. The 1998–99 Family Resources Survey found that among households with less than £200 a week gross income, more than 40 per cent do not have any liquid financial savings, while 70 per cent of single parent families have none.

2.12 It should be noted that this represents a snapshot of savings at a single point in time. Detailed research has recently looked at the saving behaviour of people on moderate earnings (roughly £10,000 – £20,000 a year), described in the research as small savers[10]. It found that, although at any point in time small savers may have low levels of savings – or none at all – very few of them will never save.

[9] Banks, J. and Tanner, S. (1999) *Household saving in the UK*, Institute for Fiscal Studies.
[10] Kempson, E. and Whyley, C. (2000) *Understanding Small Savers*, Pearl Assurance.

2.13 Also, the Family Resources Survey and the NOP Financial Research Survey only consider the amount of money in liquid financial savings, but not pensions, housing and life assurance. In addition to liquid financial savings, over two-thirds of households own their own homes[11] and 60 per cent of working-age people have a private (occupational or personal) pension.[12] However, research has shown that by 1997 one in ten households had no forms of savings at all (including housing, pensions and life assurance and all liquid financial savings, but excluding current accounts) and that this proportion had almost doubled since the beginning of the 1980s.[13]

[11] Department of the Environment, Transport and the Regions, *Housing and Construction Statistics*.
[12] Department of Social Security (1998) *A new contract for welfare: partnership in pensions*.
[13] Banks, J. and Tanner, S. (1999) *Household wealth in the UK*, Institute for Fiscal Studies.

3 Why there is a Role for Government Policy on Saving

Given the crucial role of savings for independence, security and comfort, the Government wants more people to be able to save.

There is a role for Government policy to encourage saving. Although the benefits of having some savings create an incentive for people to save without Government intervention, a number of possible factors may have discouraged them in the past, including:

- **poor returns, particularly for smaller savers;**
- **lack of awareness of the future benefits of saving;**
- **the complexity of financial decisions and often inaccessible savings products; and**
- **lack of confidence in financial providers and advisers following pensions mis-selling**

3.1 The Government's objective for saving is for more people to be able to save enough for

- **independence throughout their lives;**
- **security if things go wrong; and**
- **comfort in old age.**

Independence throughout people's lives

3.2 Saving is forward-looking. It requires someone making a sacrifice today because of something they value even more in the future. For many people the motivation to save is to enable them to take control of the future direction of their lives – whether this is settling down, starting a family, moving house or changing jobs. Savings provide the capital for people to invest in their future – financing education, a deposit for a house or a business start-up. Having some savings to fall back on also provides a solid platform for people to take potential risks by starting a new career, embarking on adult education or starting their own business venture.

Security if things go wrong

3.3 Savings cushion the impact of uncertain events – whether a temporary spell of unemployment or a washing machine breaking down. Having even a small amount of money saved allows people to keep their lives running smoothly when things go wrong. It helps ease the transition back into work before the first pay cheque arrives. Having some savings also makes it less likely that people will go into debt when things go wrong and helps them to get back on track more quickly.

3.4 Saving is not the only way that people can protect themselves. Borrowing (whether from financial institutions, friends and family or the Social Fund) and insurance are, broadly, alternatives to saving. But if people do need to draw on their savings when things go wrong then, since they can not predict when this will happen, they need to have at least some of their money where they can get easy access to it.

Comfort in old age

3.5 On average, pensioners' incomes have risen by more than earnings over the past 20 years, largely as a result of the growth of private pensions. The Government wants more pensioners to benefit from this in the future. The basic state pension will be retained as the foundation of the pension system and the state second pension will be introduced from April 2002 to provide better pensions for people on low earnings and carers and disabled people with broken work histories. But the Government also wants to encourage more people to save for their retirement. Private pensions play a key role for people saving for their old age since they require people to lock up their savings for the longer term and provide a stream of income throughout retirement in the form of an annuity. This role is recognised in their favourable tax treatment. But, at the broadest level, wealth accumulated for retirement might encompass ISAs, a house, or a business as well as – or instead of – a pension.

Role for Government policy

3.6 The Government believes that there is a role for policy to help more people to save. Although the benefits of having some savings give people an incentive to save without any Government intervention, a number of factors may discourage saving.

3.7 For many, the return to saving may have been low:

- taxes may have reduced the return to saving. For example, before the introduction of ISAs the return to saving in an ordinary bank and building society account – where people typically start to save – was taxed at a higher rate than almost any other form of saving. People could only save tax-free in a bank or building society account in a TESSA where they were required to hold their savings for five years. This might not have been appropriate for many low-income savers;

- as well as tax, high charges on financial products may also have reduced the return to saving. For example, high up-front charges for personal pensions particularly penalised people who were unable to save regular amounts; and

- the benefit system may have unfairly penalised savers. For example, pensioners deriving an income from modest pension savings have seen their benefit income reduced pound for pound in line with their private pension income. This creates a savings trap which reduces the incentive for some people to save in a pension in the first place.

3.8 A second possible problem is that some people may not be fully aware of the future benefits of saving. If people can be encouraged to start to save and to start investing in their future, they may begin to value the future – and the value of saving for the future – more highly. This suggests a role for the Government in getting people starting to save.

3.9 A third possible problem is that financial decisions may be difficult and hard for people to make. Many lack even basic financial literacy skills, while others may be confused about how much they need to save and where they should be putting their money. This leaves people feeling vulnerable, anxious and insecure when it comes to making decisions about saving.

3.10 If people are unsure about making financial decisions themselves, one option is for them to get advice from others. But they need to be able to trust the people who advise them. This trust was undermined by the experience of pensions mis-selling when some people were wrongly advised to take out personal pensions. People needed to have their confidence in financial service providers and advisers restored.

3.11 These factors may discourage people from saving and they suggest an important role for Government policy to address these problems. The next chapter sets out the Government strategy for encouraging saving.

4 The Government's Strategy for Saving

4.1 To achieve its objective of encouraging more people to save the Government's strategy is to:

- **create the right environment for saving;**
- **create the right incentives for people to save; and**
- **provide information and education to help people make the right saving choices.**

The right environment

- **a stable macro-economy with low inflation;**
- **employment opportunity for all;**
- **a well-regulated and efficient market in financial services;**
- **flexible and accessible savings products; and**
- **an integrated and coherent approach to saving.**

The right incentives

- **a tax system with greater incentives to save, particularly for low–income savers;**
- **a tax and benefit system that does not unfairly penalise savers; and**
- **lower charges on financial products to enhance the rewards to saving.**

Providing information and education

- **clear, impartial information; and**
- **greater financial literacy.**

CREATING THE RIGHT ENVIRONMENT

A stable macro-economy with low inflation

4.2 People need to be able to save without fear that the value of their savings will be eroded by rapidly rising prices. The Government is encouraging people to save with greater confidence than in the past by setting out its clear commitment to low inflation. It has done this by reducing its own borrowing and giving independence to the Bank of England.

Employment opportunity for all

4.3 The first step in encouraging people to save is to raise their incomes. People will only start to save for the future when they have enough income not to worry about living day-to-day. Before people can be encouraged to start saving they need to be helped back into work – and into a job that pays them a reasonable income. Through the New Deal, the Working Families Tax Credit (WFTC) and the minimum wage, Government policies are helping people to move into work and raising in-work incomes, providing people with the necessary means to start saving.

A well-regulated and efficient market in financial services

4.4 In order for people to invest their money for the future, they need to have confidence in the financial services industry and in any financial advice they receive. But confidence in financial services was seriously undermined by pensions mis-selling. To restore trust, the Government is strengthening the regulatory framework for the financial services industry, and setting up clear procedures to prevent mis-selling in the future.

4.5 The Government wants effective competition in the financial services industry. In the past, the presence of a number of different financial providers may have suggested a competitive industry, but an asymmetry of information between consumers and providers often prevented genuine competition. The long-term aim is for consumers to exert greater competitive pressure by making better-informed decisions on the basis of more transparent products and clearer information.

Flexible and accessible savings products

4.6 The Government is committed to making financial products more accessible to a wider number of potential consumers. Too many people do not even have a current account. In the short term they miss out on the day-to-day benefits of a bank account, such as the convenience and potential cost savings associated with direct debits; in the longer term they may not gain access to opportunities for saving.

4.7 By setting standards for the levels of charges and contributions for financial products, the Government is also making a wide range of savings products more accessible. In the past, the needs of people who wanted to save small amounts were often not met by the financial products on offer because of high charges and high minimum contribution levels.

An integrated and coherent approach to saving

4.8 The Government wants people to have access to flexible and secure products to meet their saving needs for the short and long term. ISAs and stakeholder pensions will provide this. Some people will be able to put money into both an ISA (for shorter term saving needs) and a pension (for the longer term). People on low incomes, with more limited funds, may face more difficult decisions about where to save. Although they may want to put money by for the longer term, their short-term priority may be to build up savings in a bank or building society account to provide security. To make savings decisions easier, the Government is making the saving system more integrated by improving transferability between different savings vehicles.

Box 4.1: An integrated and coherent approach to saving

ISAs and stakeholder pensions will meet people's saving needs for the short and longer term. A cash ISA is ideal for someone starting to save. It offers savers instant access to their money, making it perfectly suited to someone wanting their savings to provide security if things go wrong and to build up money for a deposit for a house, or to start a family. An equity ISA provides a vehicle for people to invest for the medium term to take advantage of potentially higher returns.

Stakeholder pensions are designed for long-term saving since they lock up money until retirement. This may not be something that people are willing to do when they first start saving. But the Government is making the savings system more integrated by improving transferability between vehicles. The Government wants people to be able to build up savings in an ISA and transfer them easily into a stakeholder pension when they are ready to save for the longer term. New tax rules for pensions will allow someone to contribute at least £3,600 a year regardless of earnings, allowing them to transfer money from an ISA into a stakeholder pension. To increase flexibility further, the Government is investigating with the pensions industry whether it would be useful in practice to allow certain eligible ISA collective investments to be transferred directly into a stakeholder pension and to be placed in an IPA.

It has been suggested that flexibility should be extended the other way so that people could withdraw money from their pension before retirement in particular circumstances (if they want to buy a house or if they lose their job) as happens in the US. But in the US, there is no vehicle which allows people to hold liquid financial savings tax-free. In the UK, ISAs enable people to build up savings for short-or medium-term needs tax-free, removing the justification for such a pension drawdown facility.

There will also be flexibility between ISAs, stakeholder pensions and the new All-Employee Share Ownership Plans (AESOPs). No flow of funds was allowed directly between PEPs, TESSAs, and the previous employee shares scheme. But now someone will be able to start saving some of their salary in an AESOP scheme and later decide to diversify that shareholding, within the annual subscription limits, by transferring AESOP shares directly into an ISA or a stakeholder pension. Any shares could be cashed in and used for a specific purpose (such as towards a house deposit) but allowing direct transfers reduces, at least to an extent, the temptation to cash the shares in and simply spend the proceeds. This transfer facility is also helpful in allowing someone who is leaving their job, when they would otherwise have to take the AESOP shares out of the tax-favoured plan, to keep those savings in a tax-favoured savings vehicle.

CREATING THE RIGHT INCENTIVES

A tax system with greater incentives to save

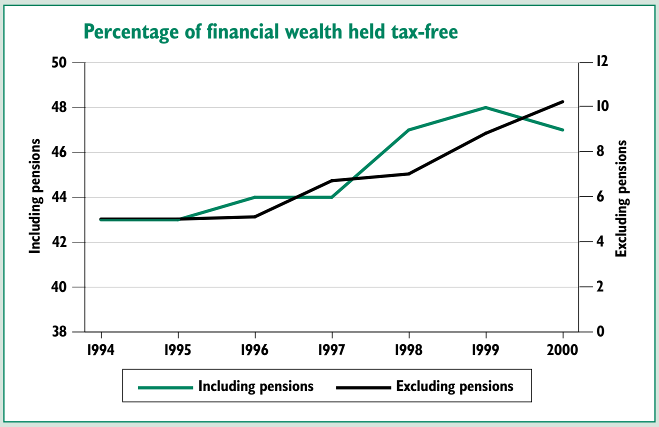
4.9 The Government wants to ensure that the tax system gives incentives to save to all tax payers, not just the relatively wealthy savers who tended to save in PEPs, TESSAs and pensions in the past. The Government is extending opportunities for tax-free saving particularly to low-income and younger savers.

Box 4.2: The tax treatment of saving

Extending tax-free saving

The Government has taken significant steps to make it possible for most savers to do all their saving tax-free. The amount that someone will be able to save each year in an ISA and a pension is above the level of saving of the majority of the population. The returns to owner-occupied housing – the other key element in household portfolios – are also tax-free.

The chart below shows that the proportion of financial wealth held tax-free has increased since 1997. Including pensions, the proportion of financial wealth that is held tax-free increased from 44 per cent in 1997 to 47 per cent in 2000. Much of this has been driven by an increase in the proportion of (non-pension) financial wealth that is held tax-free in TESSAs, PEPs and ISAs, which has increased by 50 per cent since 1997.



Reducing distortions

By providing a single tax-free wrapper for different assets, ISAs reduce the tax distortion to the choice about what form to save in. Without a lock-in period, ISAs mean that anyone can now save tax-free however little they want to save, however long they want to save for and whether they want to save in cash, shares or life insurance. Pensions remain tax-favoured. The Government continues to give favourable tax treatment to pensions because it recognises that an additional incentive is required to encourage people to save for the longer term and in a form that provides a stream of income throughout retirement.

Encouraging saving

A lot of money is typically observed to flow into tax-favoured vehicles, but much of it may simply be transferred from elsewhere rather than representing new saving. Allowing people to save tax-free increases the return to saving and makes it relatively more attractive for people to save. But the final effect on saving is not clear – at least not in theory. If people have a target level of savings then a higher return means that they can reach that level more easily – and afford to spend more (and save less) today.

Evidence on the impact of tax incentives on people's saving suggests that they do have a small positive effect.[a] This effect is typically greater where the tax-favoured vehicle is not a close substitute to existing vehicles (so tax relief on pensions may raise overall saving more than tax relief on ISAs). Recent US evidence has suggested that tax incentives have a bigger effect on saving for people on lower incomes, presumably since they have less wealth to transfer.[b]

[a] For an overview, see Organisation for Economic Co-operation and Development (1994) *Taxation and Household Saving,* Report by Working Party No. 2. For the UK see Blundell, R. (1995) *Tax policy reform: Why we need microeconomics?* Fiscal Studies

[b] Engen, E. and Gale, W. *The effects of 401(K) plans on household wealth,* paper prepared for TAPES conference, Switzerland, May 2000

A tax and benefit system that does not unfairly penalise savers

4.10 The Government wants to target support on those who need it most, while ensuring that people who have some savings are not unfairly penalised. The current system of support allows people to hold some liquid financial savings without their entitlement to benefits and tax credits being affected. It also ignores pension savings for people of working-age, consistent with the Government's aim of encouraging people to save for the longer term. The Government will ensure that the treatment of capital by the tax and benefit system creates the right incentives for people to work and save.

Lower charges to enhance the rewards to saving

4.11 High charges made by financial service providers reduce the return to saving. The Government is reducing charges by regulating where necessary and by promoting more effective competition in the financial market. The wider use of clearer benchmarks and comparative information will help people to shop around and increase competitive pressure on charges.

INFORMATION AND EDUCATION

4.12 Decisions about saving – particularly those about long-term saving for retirement – are inevitably complex. For some people this may be enough to discourage them from saving altogether. For others, it may mean they are not making the right saving choices.

4.13 Information and education have two roles to play. First, in achieving a more competitive financial services industry since better-informed consumers are more likely to shop around. Second, information and education may also have a role to play in encouraging people to save, as evidence from the US suggests (see Box 4.3).

Box 4.3: Evidence from the US

Workplace education

US studies[a] have looked at the impact of providing information and education in the workplace on participation in – and contributions to – private pension plans. Information on 2,000 firms was used to evaluate the impact of different forms of workplace education. The studies found a significant positive effect of a firm running frequent retirement seminars on participation and contribution rates. The effect was even larger for junior employees. However, this positive result was for frequent workplace seminars only. Other channels of information – summary plan descriptions, newletters, etc. – had no significant effect, showing that the medium matters as well as the message.

Education in schools

Mandatory financial education programmes were introduced in several US states between 1957 and 1985. These were found to have a positive and significant effect on saving behaviour in adulthood[b]. People who entered high school five years after the imposition of a financial education mandate in their state had savings rates that were, on average, 1.5 percentage points higher than those of people educated in states with no such mandate. These results control for demographic characteristics as well as any underlying differences in saving rates across states.

a. Bayer, P. Bernheim, D. and Sholz, J. (1996) *The effects of financial education in the workplace* and Bernheim, D. and Garrett, D. (1996) *The determinants and consequences of financial education in the workplace,* both Stanford university mimeos.
b. Bernheim, D. Garrett, D. and Maki, D. (1997) *Education and saving – the long-term effects of financial curriculum mandates,* Stanford University mimeo.

5 Implementing the Strategy

5.1 Since 1997, the Government has been active in reforming the regime for savings and pensions to encourage saving. Its reforms have included:

- **extending tax incentives for saving,** particularly to low-income savers by introducing ISAs;
- **ensuring that savers are not unfairly penalised** by raising capital limits for pensioners and setting out plans for a Pension Credit;
- **making savings products more accessible and transparent** by introducing CAT standards;
- **reforming pensions** by introducing stakeholder pensions and Individual Pension Accounts from April 2001;
- **tackling financial exclusion** and working with banks to offer basic bank accounts to people who do not have a current account;
- **introducing a single financial regulator,** the FSA, to promote consumer confidence in financial services and secure appropriate consumer protection; and
- working with FSA to **raise financial literacy,** for example by including financial education as part of the National Curriculum.

	THE STRATEGY		
THE POLICIES	**The right environment**	**The right incentives**	**Information and education**
ISAs	introducing a more flexible product;	extending opportunities for tax-free saving;	
Higher capital limits and Pension Credit		ensuring savings are rewarded in retirement;	
CAT standards	making products more transparent and accessible;	setting lower charges;	setting clear benchmarks;
Reforming pensions	making pensions more flexible and accessible;	extending opportunities for tax-free saving; setting lower charges;	introducing decision trees to aid retirement planning;
Tackling financial exclusion	increasing access to basic financial products;		
Creating a single regulator	maintaining confidence in the financial system;	ensuring effective competition to lower costs;	promoting consumer understanding;
Financial literacy			helping people making the right savings choices.

Extending tax incentives for saving

5.2 ISAs were introduced in 1999 to encourage tax-free saving, particularly among lower-income savers. In the first year 9.3 million accounts were opened and £28.4 billion invested – a third more than was invested in TESSAs and PEPs during their last, and most successful, year. A further £9 billion has been invested during the first quarter of 2000–01.

5.3 Analysis of the NOP Financial Research Survey for 1999–2000 by Inland Revenue shows that ISAs – particularly mini cash ISAs – have attracted relatively more low-income savers than TESSAs and PEPs. More than a quarter of mini cash ISAs have been taken out by those with household incomes less than £11,500 per year, compared to around one in five TESSAs and one in six PEPs (chart 5.1a).

5.4 More of the savings in mini cash ISAs are also held by low-income savers (chart 5.1b). Only 37 per cent of savings in mini cash ISAs are held by people with household incomes greater than £25,000, compared to 57 per cent of money in PEPs and 44 per cent of money in TESSAS. This means that more of the benefit of tax-free saving is going to low-income savers than was the case with TESSAs and PEPs.

Chart 5.1a: Income profile of tax-free savers

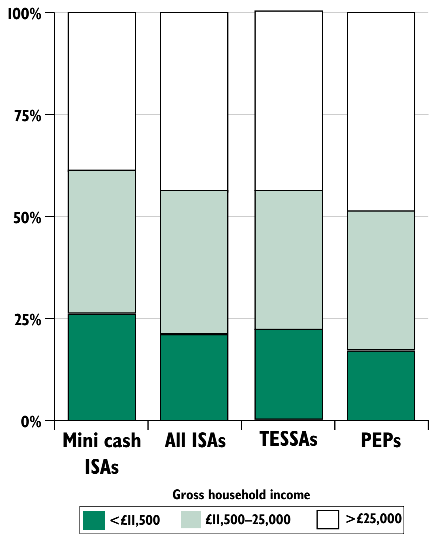
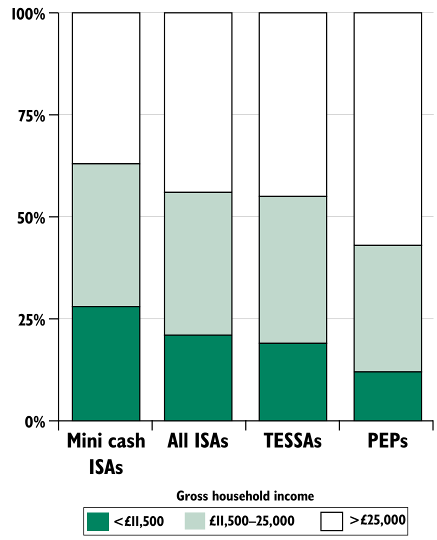


Chart 5.1b: Income breakdown of tax-free savings



5.5 ISAs, particularly mini cash ISAs, have also proved more attractive to younger savers. The absence of a lock-in period makes them well-suited to people who are starting to save and may want access to their savings if something unexpected happens. More than one in five mini cash ISAs have been taken out by people under 35, compared to one in six PEPs and TESSAs (chart 5.2a). Mini cash ISAs have attracted double the proportion of savings from people under 35 than TESSAs or PEPs (chart 5.2b).

Chart 5.2a: Age profile of tax-free savers

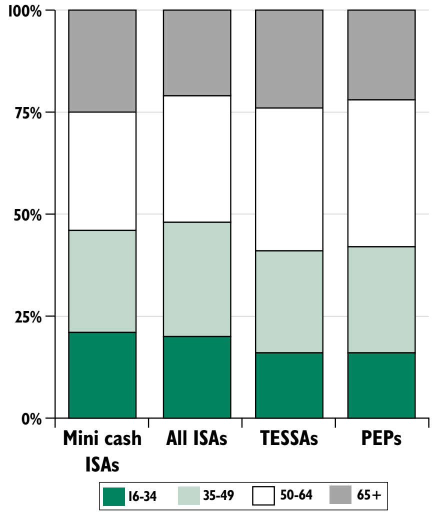
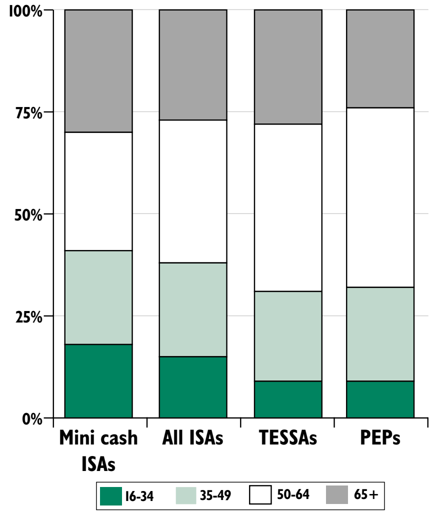


Chart 5.2b: Age breakdown of tax-free savings



5.6 ISAs are a key element of the Government's strategy to promote saving. **Building on ISAs' success, the Government will retain the £7,000 overall contribution limit for a further five years until April 2006. The £3,000 limit for cash will also be retained,** which will benefit low-income savers who have chosen to save in this way. **From April 2001, the Government will allow people to take out an ISA from age 16 rather than 18, as now, to extend the benefit to even younger savers.** There are 100,000 16- and 17-year olds who work and pay tax and could benefit from the opportunity to save tax-free.

5.7 However, promoting saving through tax relief provides the greatest incentives to people with high incomes. It may not be easy for the very poorest to save, but the Government will continue to look at ways of encouraging people with low and moderate earnings to save.

5.8 Individual Development Accounts (IDAs), offering more generous incentives to low-income savers, have been piloted in the US since 1997. People saving for particular purposes – housing, business or education – have limited amounts of saving matched, typically at a rate of $2 for every $1 saved. The schemes are small-scale and locally run and offer a high level of personal involvement. The role of personal advisers and mentors has been a key factor in encouraging people to save, as well as the generous incentives. IDAs have succeeded in attracting regular saving from people with low incomes: one-third of participants had monthly household income less than $1,000 (for further details see Center for Social Development (2000) *Saving patterns in IDA programs*).

5.9 But there has not yet been any rigorous analysis of whether IDAs have encouraged *new* saving. Savings in IDAs may be transferred non-IDA balances (past saving) or saving that IDA participants would have done anyway. In both cases the match money (and the administration costs) represents a deadweight loss if the aim is to promote saving. Given that each dollar saved in an IDA costs at least two dollars this is a serious issue. There may be more efficient ways for the Government to promote saving – or to subsidise house purchase, business start-ups or education.

5.10 Also, the fact that IDAs require people to save for particular purposes runs counter to the spirit of ISAs which is that low income savers should have easy access to their savings. The experience with mini cash ISAs suggests that this has been important in encouraging low-income savers to take them out. The benefits of offering more generous incentives would need to be carefully balanced against any additional constraints on people's saving this might require.

5.11 The Government is following the IDA pilots closely and will consider the possible lessons for the development of ISAs in the UK.

Ensuring that savers are not unfairly penalised

5.12 From April 2001 the Government is raising the capital limit for pensioners to £6,000 (from £3,000) to allow them to hold more savings without affecting their entitlement to benefit. **A separate consultation document, to be published on 9 November by the Department of Social Security, will set out details for a new Pension Credit.** This will ensure that people with modest savings will be rewarded in retirement. Currently those with small pensions are caught in a savings trap as they have their benefits withdrawn pound for pound in line with their pension income. They are no better off as a result of having saved than if they had saved nothing at all. The Pension Credit will also replace the capital limits for pensioners with a fairer system based on the income people derive from their savings.

5.13 **By October 2001 the Government will abolish the capital limits in the Sure Start Maternity Grant and Funeral Payments** so that families on low incomes with small amounts of savings will receive support from the Government to help cover the additional costs associated with the birth of a baby or the death of a close relative. More generally, for people of working age, the development of the new integrated system of support for children and the employment tax credit offers an opportunity to review the treatment of income and capital in assessing a person's or family's entitlement to support. The current rules applied in income support and those inherited from Family Credit by the WFTC have developed over a considerable period of time and reflect a process of incremental change. The aim is to create a modern system which creates incentives to work and save.

Making products more transparent and accessible – CAT standards

5.14 To give people confidence to take out ISAs and other financial products, the Government developed CAT standards as voluntary benchmarks for charges access and terms. CAT standards help people identify straightforward products that should offer a reasonable deal – and to make financial choices that they should not later regret. More widely, the existence of a set of benchmark standards should help people to make better-informed comparisons between products, increasing competitive pressure in the marketplace.

5.15 A study of the ISA market, carried out for the Treasury by McKinsey's, has found that CAT standards have helped ISA savers achieve value for money. They have set an interest rate floor for cash ISAs and set a one per cent cap on charges in CAT equity ISAs. As a result, a typical saver investing £3,000 a year in a CAT equity ISA would pay £35 a year less in charges than someone investing in a non-CAT ISA.

5.16 CAT standards have also made ISAs more accessible. The CAT-standard limits on contributions mean that people can start to save from as little as £10 a month. In practice, some ISA providers allow people to save as little as £1 a month.

5.17 The Chancellor of the Exchequer announced in his response to Don Cruickshank's report on Competition in UK Banking that the Government intends to consult consumers and providers on the wider use of CAT standards. The consultation will begin shortly.

Reforming pensions

5.18 Stakeholder pensions will be introduced from April 2001. They will be defined contribution pensions with:

- a cap on charges of one per cent of fund value;
- an upper limit on minimum contribution levels;
- greater flexibility and portability; and
- workplace access.

5.19 They will provide the option of a low-cost, flexible and secure way to save for retirement, particularly for those without access to a good occupational pension scheme.

5.20 Individual Pension Accounts (IPAs) will also be available from April 2001. These are not a new type of pension, but a new pension investment vehicle. IPAs will therefore complement – not substitute for – other forms of pension, such as stakeholder pensions. IPAs will mean greater flexibility in pension provision by making it easier for people to invest in collective investments such as unit trusts and they will be easily transferable between different schemes at relatively low cost. IPAs will also be more transparent investment vehicles. People will be readily able to see what the value of their IPA is, giving them a greater degree of control and increasing effective competition.

Tackling financial exclusion

5.21 The Prime Minister established the Social Exclusion Unit in 1997 to develop integrated and sustainable approaches to the problems of the most deprived neighbourhoods, including financial exclusion. The Policy Action Team on financial exclusion (PAT 14) reported 44 recommendations at the end of last year. These are now being taken forward (see Box 5.1).

Box 5.1: Action on financial exclusion

Credit Unions

In future, Credit Union members will have similar protection to that enjoyed by depositors in banks and building societies after the Financial Services and Markets Act 2000 brought credit unions within the FSA's rule-making powers. The FSA will be consulting widely with the sector about the details of the new regulatory regime before it comes into effect. The Association of British Credit Unions has published a draft business plan for a central services organisation (CSO) which has the potential to relieve credit unions of the burdens – in terms of time, training and money – of back office processing. These burdens were identified as a major obstacle to growth of the sector. Specific details on progress the CSO are likely to be available in the next few months.

Banking Services

The British Bankers Association published its report *Promoting Financial Inclusion* in April 2000, highlighting measures that the banks have been taking in response to the PAT 14 recommendations. These include the establishment of basic bank accounts, which allow people with no or a poor credit history to obtain an account without the danger of an unauthorised overdraft. The banks were set a target of October 2000 for availability of these accounts, and most have achieved this. Measures also include developing partnerships with the Post Office and supermarkets to provide better access to banking facilities; a range of support for credit unions, including free banking, premises, secondees, equipment, training and help with developing the business plan for the central services organisation; and grants and joint initiatives with organisations providing financial advice.

5.22 It is not just Government that is taking the initiative to make financial products more accessible. Local save-as-you rent schemes such as that set up by Cambridge Housing Society are encouraging saving among low income savers (see Box 5.2). This form of partnership is capable of being replicated between registered social landlords and banks or building societies everywhere.

Box 5.2: Save-as-you-rent schemes

Cambridge Housing Society is a 70-year old registered housing association with charitable status, which has launched an innovative saving and loan scheme (New Horizons) in conjunction with Cambridge Building Society. The aim is to give the housing association tenants access to competitively priced loans and to encourage regular savings which will attract enhanced rates of interest.

New Horizons is not a credit union and was considerably simpler to establish. The housing association has deposited a lump sum with the building society to act as a guarantee fund. This attracts a standard interest rate. All the housing association tenants, their partners and their children are eligible to open a savings account through the scheme, with the money being deposited with the building society. There is no requirement for a minimum opening balance. The overall effect is a sort of joint account, with individual savers obtaining the benefits of an enhanced savings interest rate. This is because all the savings are aggregated with the lump sum guarantee fund for the purposes of calculating the tiered interest rate due.

Tenants with amounts saved are able to apply for a loan, as a multiple of their savings up to a specified maximum amount. Individual borrowers will have no need to offer any security, and there are no additional credit checks. The building society will be making loans direct to tenants, secure in the knowledge that the guarantee fund is available in event of any default on loan repayments. For a trial period, the scheme is to offer a small loan facility of £150 to members, even if they have no savings in their account. The aim is to meet a key need, which has come out of research, which is that people require immediate access to a small loan facility to meet unforeseen crisis expenditure. The interest rate differential between the saving and loan rates makes a contribution to the administrative cost of running the scheme, apportioned between the housing association and the building society.

Establishing a single regulator – the FSA

5.23 In the light of pensions mis-selling and low consumer confidence in financial services, one of the Government's first announcements in 1997 was that it would strengthen the regulatory framework by creating a single regulator for financial services, the FSA, with responsibility for:

- maintaining confidence in the UK financial system;
- promoting public understanding of the financial system;
- securing an appropriate degree of protection for consumers; and
- contributing to reducing financial crime.

5.24 The Government has recently endorsed proposals from the FSA to work towards modernising the regulations on how retail investments are distributed to open up the way for more real choice for investors (see Box 5.3)

Box 5.3: Polarisation

Since 1988, the market for retail investments has been polarised. That is, FSA rules have insisted that retail sales firms must either offer the products of only one group of firms, or be fully independent and offer their customers access to the whole market.

The Director-General of Fair Trading reported in 1999 that aspects of these rules were significantly anti-competitive and should be reformed. Independent research for the FSA, published in July 2000, foresaw that liberalisation of the rules would improve market competition, with scope for lower prices and greater variety of choice for consumers, without undermining the role of independent financial advisers.

The FSA is now planning proposals to update polarisation in two stages. Subject to consultation, the first phase, aimed for spring 2001, will reform the rules covering investment in stakeholder pensions, potentially CAT-standard ISAs, and direct sales offers including new developments such as internet fund supermarkets. These are all areas where consumers often feel confident to select for themselves.

The second phase will extend reform to the full range of retail investment products, with scope for radical change, drawing on work the FSA plans on improving disclosure arrangements for a wide range of retail investments. This stage of reform will take longer to bring into effect but could have a significant effect on the structure of the market for retail investments. The aim is to deliver a better choice for consumers through more effective competition and enhanced transparency.

Providing information and education

5.25 The provision of clear, impartial information has an important role to play in ensuring that people make the right saving decisions and in promoting genuine competition between financial providers. Information and education can also play a role in encouraging people to save.

5.26 Recognising this, the FSA has a statutory responsibility for financial education as part of its regulatory role – the first time a financial regulator has had such as responsibility. The FSA provides people with authoritative, independent general information and advice that they can trust. For example, it has been developing stakeholder pension decision trees to guide people through decisions about saving for retirement.

5.27 After consultation, the FSA is moving closer to launching published tables of information about several ranges of retail financial products. Those to be published first, in early 2001, will cover endowment policies, investment bonds, mortgages, personal pensions and pooled fund ISAs. The tables will be accurate, authoritative and kept continuously up to date on the FSA website.

5.28 Supporting the work of the FSA, the Government also has a role to play in promoting financial education. It has introduced financial education onto the National Curriculum from September 2000 to raise financial literacy among future savers. The FSA has developed a range of materials which can be used to develop financial capability among schoolchildren. A working group set up by the Department for Education and Employment has produced a report recommending ways to improve adults' financial understanding and awareness. In order to help achieve this the Government is considering providing participants on New Deal 50 plus with a signposting service to direct them to appropriate sources of financial information. This will help those in their fifties who are thinking about saving as a way of improving their standard of living in retirement. Good, impartial information is now more widely available than before; the Government working with FSA, will consider ways of increasing access to that information for low-income savers.

6 CONCLUSION

The Government is helping people into work, raising in-work incomes and helping people to save. Savings have a crucial role to play in people's lives – providing them with independence, security and comfort.

These benefits create an incentive for people to save. But the Government has a role to play too. The Government has been tackling some of the factors that may have discouraged people to save in the past, such as low rates of return, inaccessible and complex financial products and a lack of confidence in financial providers and advisers.

The Government has a clear strategy for promoting saving by creating the right environment and the right incentives and by providing information and education to help people make the right saving choices. In the future, the Government will take further steps to help savers, particularly those on low or moderate earnings.

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