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THE SAVING GATEWAY AND THE CHILD TRUST FUND: IS ASSET-BASED WELFARE ‘WELL FAIR’?

Carl Emmerson
Matthew Wakefield

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COMMENTARY 85

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Preface

This study is part of the research programme ‘The Changing Distribution of Consumption, Economic Resources and the Welfare of Households’ at the Institute for Fiscal Studies, funded by the Leverhulme Trust. Data from the British Household Panel Survey were supplied by the ESRC Data Archive; data from the Family Resources Survey were made available by the Department for Work and Pensions. The authors would like to thank colleagues at IFS, in particular James Banks, Mike Brewer, Tom Clark and Andrew Dilnot, for advice and assistance with this research. Any errors are the authors’ own.

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Executive summary

In April 2001, the government announced a consultation on ‘policies designed to increase rates of saving and asset-ownership, both among the lower-income households of today, and in generations of families to come’. Two reforms were discussed and the 2001 Labour Party election manifesto has committed the government to introduce both in the current parliament. The policies are:

1. A Child Trust Fund, which is a lump-sum payment made for every child at birth. Children from lower-income families will receive a larger payment and the funds will be locked away until adulthood.
2. A Saving Gateway, which is a savings account for those on lower incomes. The government will match individuals’ contributions in order to provide an incentive for account holders to place funds in these accounts.

To justify these policies, the government has focused on the benefits to individuals of a ‘saving habit’ and of holding financial assets. It has pointed to the fact that ‘people without assets are much more likely to have lower earnings and higher unemployment, and are less likely to start a business or enter higher education’. While it may be true that individuals who are able to plan ahead and save are more likely subsequently to experience better outcomes, it does not necessarily follow that providing assets or financial incentives to save is the best way to help individuals who are not currently saving. An alternative would be to provide low-income individuals with greater incomes and allow them to decide how much to consume today and how much to save for consumption in the future.

That is not to say that all individuals are necessarily making optimal saving decisions and that there is no justification for government intervention. There is evidence from the USA that the provision of financial education can increase individuals’ rates of saving. Given the likely cost of the Child Trust Fund and the Saving Gateway, it should be considered whether extensions in the provision of financial education would represent a better-value alternative. If it is believed that individuals will only learn from financial education if they are currently holding a financial asset, then it is possible that the Saving Gateway will lead to some individuals making better decisions.

The government’s consultation document lacks clarity in discussing the specific aims of the Child Trust Fund. One justification is that ‘all young people should be able to embark on their adult lives with a financial asset to invest in their future’. If this is the sole purpose, then a more obvious policy would be to give financial assets to young adults rather than to children at birth. Targeting resources on the basis of family income at birth, or teaching children about finances and the benefits of forward planning, are possible arguments for providing the asset at a younger age. If these benefits apply to newborns, it seems strange to believe that they would not also be felt by other young children who would not be helped by the policy as currently proposed. The lack of clarity regarding the specific policy objectives and how these relate to the policy design make it hard to discuss important issues such as whether the choice of how matured funds can be spent should be restricted to uses such as funding education. If the aim of the policy

is to improve opportunities for higher education among lower-income groups, then a better-focused reform is likely to be the reintroduction of maintenance grants. The provision by the government of a clearer set of aims would be beneficial in enabling necessary further consultation to consider many detailed design issues.

A central aim of the Saving Gateway is to ‘increase rates of saving and asset-ownership’ among lower-income households. One potential problem with targeting the Saving Gateway on the basis of income alone is that many individuals who are already making sensible saving decisions would be eligible for an account. Evidence from the British Household Panel Survey shows that, were a Saving Gateway to be targeted solely on the poorest fifth of the population, then less than a third of this group look like individuals who do not have an obvious reason for not saving. Those remaining have already been able to save more than £500, or are retired, unemployed or in full-time education. These individuals are unlikely to benefit fully from the policy in the ways that the government hopes. This might also apply to those who live in owner-occupied housing or who are making savings in the form of a pension. Excluding these groups leaves just one-in-eight of the poorest fifth of the population.

Among those eligible for the Saving Gateway, those who already have financial assets will be able to benefit financially from the government match simply by switching their savings into the new account. This could make the policy very costly. The government should consider whether a small-scale Saving Gateway targeted at those who are more likely to benefit from the scheme should be introduced. One possible target group would be those who have just moved into paid employment, since it might be a good time for them to reappraise their saving decisions. Such a scheme could be evaluated in order to assess the size of any beneficial effects and, in the light of this evidence, could be extended to other groups, left unchanged or abolished without creating many losers. Further consultation on these details would be of use if the government wants to ensure that the policy delivers as many benefits as possible for the minimum exchequer cost.

The government has claimed that ‘the right environment for saving involves a stable macroeconomy’. The microeconomic stability provided by a stable and simple savings environment would also help individuals to make appropriate saving decisions. New reforms proposed by the government come at the cost of complexity and uncertainty. Individuals, such as those in the stakeholder pension target group, may want to re-evaluate whether they should be saving in a pension scheme, since, if they save in a liquid form and become eligible for a Saving Gateway, then these savings might receive a government match. With the Child Trust Fund, the government has a manifesto pledge to ‘provide incentives for extended family and friends as well as parents to contribute’. The consultation document suggests Individual Savings Account (ISA)-style tax relief. The main beneficiaries of this would be those who contribute up to the annual ISA limit. If the government decides to provide a more generous incentive than this, it would severely reduce the attractiveness of saving in an ISA for families with children.

Issues of targeting and interactions with other savings instruments are crucial to the design of the Child Trust Fund and the Saving Gateway. The provision by the government of a clearer set of aims for these policies would help to enable further consultation to be of maximum benefit to the reform process.

1. Introduction

When it was elected to government in 1997, the Labour Party promised reforms to ‘promote saving’ (Labour Party, 1997). The introduction of Individual Savings Accounts (ISAs) and stakeholder pensions can be seen as reforms intended, at least in part, to further this aim. The 2001 election manifesto committed the government to endeavour to ‘boost the savings habit’ (Labour Party, 2001, p. 10) amongst individuals.

The latest announced policies intended to further this aim are proposals to introduce a new ‘Saving Gateway’ and ‘Child Trust Fund’ (HM Treasury, 2001a). These represent something of a new departure in terms of the means by which they will affect incentives to save and hold assets. Stakeholder pensions give people a positive incentive to lock up some savings until retirement. ISAs are intended to ensure that taxpayers do not have a disincentive to save some of their current income in a more liquid form.¹ In contrast, the Saving Gateway will provide those from lower-income households with a strong financial incentive to save in a relatively liquid form. The Child Trust Fund will simply present a financial asset to children which can be spent when they reach adulthood.

In this Commentary, we consider some potential arguments for the introduction of these new policies and discuss certain issues that might be important in deciding the details of how the policies are designed. Chapter 2 examines what exactly we mean by the term ‘asset-based welfare’ and leads into the discussion of potential rationales for introducing asset-based policies that is contained in Chapter 3. Having looked at what the aims of the policies might be, we are in a position to consider what the best design for the policies would be if these aims are to be achieved. Chapter 4 begins the process of discussing this issue by describing what we already know about the form that the policies will take and what remains to be decided. Chapter 5 provides analysis of some issues that will be important in determining how the policies should be designed, how much they might cost and which groups might benefit. Chapter 6 concludes.

¹ The dividend tax credit does provide an incentive to save in UK equities held in an ISA, over and above smoothing-out of tax disincentives.

2. What is asset-based welfare?

Since the term was first coined 10 years ago (Sherraden, 1991), it has become relatively common in policy debate in the USA to discuss ‘asset-based’ policy. ‘Asset-based’ policies are now also being discussed in other countries, such as Australia, Canada, Singapore and Sweden. Following proposals to introduce a Child Trust Fund and a Saving Gateway in the UK, the term is now also gaining currency in policy discussions here. Before considering the details of the policy debate in the UK, it is helpful to consider what is new about an ‘asset-based’ approach and what the rationale for employing it might be. We begin this task in this chapter with a discussion of what we mean by the term ‘asset-based welfare’ in the UK context.

Broadly speaking, asset-based policies are all public policies that involve encouraging or forcing individuals to hold assets. Typically, the assets will be financial, although the policies might be intended as part of a strategy to encourage people to invest in assets such as education, a home or their own business. Under this broad definition, a move from a state-financed pay-as-you-go pension system to a funded system with individual accounts might be seen as an asset-based policy. In Sweden, the option of using personal savings accounts has been discussed as a means of organising a wide range of social insurance systems, including adult education, unemployment insurance, support for families and health insurance (see Fölster in Regan and Paxton (2001)).

In the UK (and in most other countries), the term has been used to describe a much narrower range of policies than this. The policies involved are intended ‘to increase rates of saving and asset-ownership, both among the lower-income households of today, and in generations of families to come’ (HM Treasury, 2001a, abstract). What the Child Trust Fund and the Saving Gateway have in common is that they both provide financial assistance, targeted towards lower-income households, in the form of assets. This is in contrast to the standard approach of providing welfare benefits in the form of income supplements. The fact that the assistance is targeted towards lower-income households perhaps also explains why these asset-based policies are sometimes described as asset-based *welfare* policies.

The government does not see asset-based welfare as a new way of organising large parts of the Welfare State. Rather, it is seen as an additional, ‘complementary, strand of welfare policy’ (HM Treasury, 2001a). Nonetheless, the proponent of these policies needs to explain why some of the financial support that is directed towards lower-income families is better provided in the form of assets rather than income. Providing individuals and families with greater income allows them to decide how much of it to consume and how much to save. Providing the same groups with assets may not help them have higher consumption today, while providing them with strong incentives to save may actually reduce their consumption in the current period. A justification of the policies must explain why it is good to constrain or distort the choices that these groups make concerning how they use their resources. Income supplements are also relatively easily targeted at those on low incomes, which is not necessarily the case with the targeting of asset-based policies since many lower-income individuals may be only temporarily poor. We consider some potential rationales for an asset-based approach in the next chapter.

3. Why might we want to have asset-based welfare?

A sound rationale for asset-based welfare must show that there is more value in providing financial assistance to families in the form of assets than there is in spending the same amount on transfer payments, such as the integrated child credit and the employment tax credit, or on improving public services or cutting taxes.² In this chapter, we consider several economic arguments that might favour the asset-based approach, and discuss whether or not they are likely to be sufficient to justify some form of asset-based policy. This consideration of the best justifications for the policies is interesting in itself, and it will also help to focus our subsequent discussions of whether or not the government's proposed policies can achieve their likely aims.

3.1 A desire to redistribute wealth?

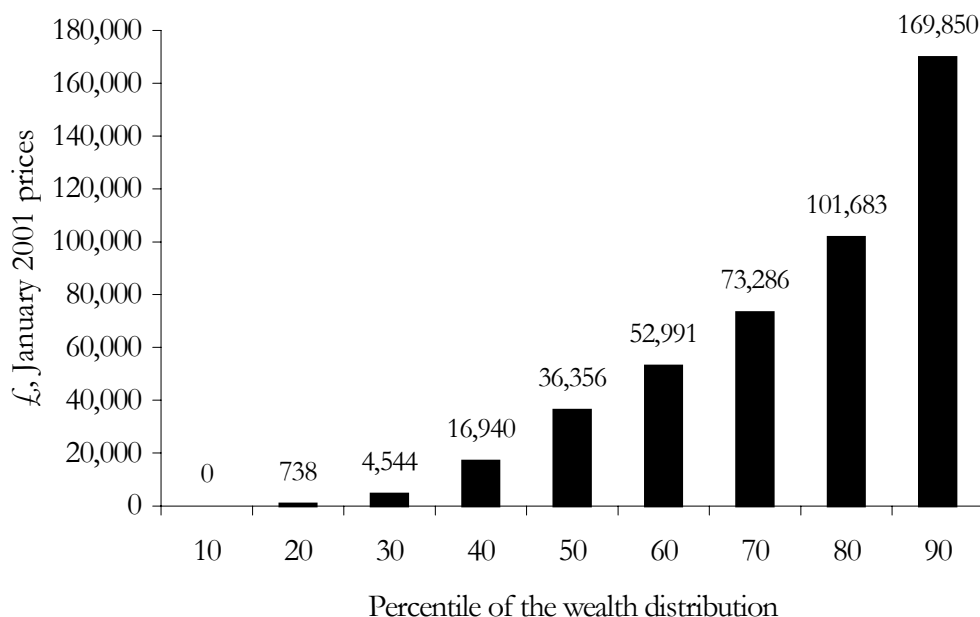
A desire to influence the overall wealth distribution?

One potential outcome of asset-based welfare is that it achieves a more even distribution of wealth, which in itself could be seen as a justification. Banks and Tanner (1999), using data from the NOP Financial Resources Survey for individuals in 1997–98, show that, due to the uneven distribution of financial wealth, mean wealth of £7,136 was almost 10 times larger than the median holding of just £750. In contrast, mean financial wealth among the wealthiest 10 per cent of the population was found to be in excess of £50,000. Research by Banks, Blundell and Smith (2000) uses data from the British Household Panel Survey to look at household rather than individual wealth, and includes tangible assets such as houses and cars alongside financial wealth. Using this research, Goodman (2001) shows that, to be in the wealthiest 10 per cent of the population, a household needs wealth of almost £170,000, compared with median household wealth of just over £36,000, as shown in Figure 3.1. It should be noted that this measure of wealth excludes occupational, personal and state pension wealth, which is often an individual's largest asset.

Further evidence on the distribution of wealth is provided by Inland Revenue statistics from data on inheritance tax returns. These state that, in 1998, the wealthiest 10 per cent of individuals held more than half of total wealth, as shown in Figure 3.2. This graph also shows how the concentration of personal wealth has changed between 1976 and 1998. Wealth inequality, as measured by the Gini coefficient, changed very little over the period from 1976 to 1995, although there is some evidence that inequality has increased in the last few years of data. For example, the Gini coefficient has increased from 0.65 in 1995 to 0.69 in 1997 and 1998. It should be remembered that changes in these aggregate figures could reflect a range of factors that are not necessarily related to why we might care about the distribution of wealth. For example, changes in birth rates in the past will lead to changes in the proportion of individuals who, at any one time, are just before retirement. Since this is the point in the life cycle when individuals might be expected to

² One argument for providing people with assets is that they may be able to obtain rates of return from investing in equities that are greater than the rate of return at which the government borrows. The government has not made this argument. In any case, arguments of this type are complicated by a number of issues – for a discussion in the context of pensions policy, see, for example, Appendix A of Clark and Dilnot (2001).

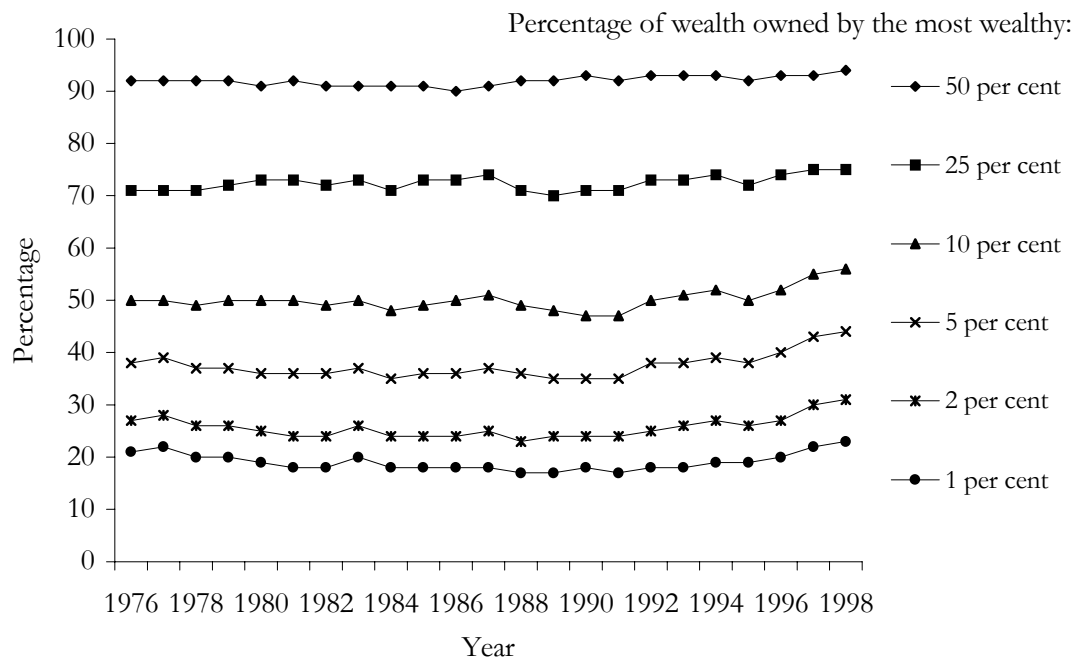
Figure 3.1. Distribution of wealth in Great Britain



Notes: Wealth is measured including both financial assets and tangible assets such as housing and cars, but excluding pension assets and business equity. Upper bounds for each measure of wealth are used. Figures in January 2001 prices.

Source: Goodman (2001) using research by Banks, Blundell and Smith (2000).

Figure 3.2. Concentration of personal wealth in the UK



Note: Personal wealth here refers to the value of individuals' marketable assets, such as houses, stocks and shares and other saleable assets, less any amounts owed due to debts and mortgages. The value of occupational and state pensions is not included since they cannot be immediately realised.

Source: *Inland Revenue Statistics 1990*, Table 10.4; *Inland Revenue Statistics 2000*, Table 13.5 (www.inlandrevenue.gov.uk/stats/distribution2000.pdf).

hold the most wealth, changes in the proportion near retirement will affect aggregate measures of the concentration of wealth.

These Inland Revenue figures suggest that, in 1998, total personal wealth was £2,543 billion, which is almost exactly three times the UK's total national income in that year. Even though this wealth is very unevenly distributed, this does not justify government intervention in the form of asset-based welfare. This is because it is apparent that even a relatively large asset-based welfare package would be unlikely to have much effect on the distribution of wealth in the short and medium terms. Any reform package wishing to achieve a more equal distribution of wealth in the short or medium term would probably need to consider other policies, such as reforms to inheritance tax and the possibility of a capital transfer tax.

A desire to influence the wealth distribution among certain groups?

The government has not, so far, used arguments about the overall distribution of wealth to justify asset-based welfare. One aim that it has suggested is 'promoting inter-generational mobility – extending to the children of lower-income families the opportunities that might be taken for granted higher up the income ladder' (HM Treasury, 2001a, para. 1.5). Evidence on UK intergenerational mobility from Dearden, Machin and Reed (1997), using data from the National Child Development Survey, shows that there is a clear correlation between the earnings of a father and the subsequent earnings of their children. For example, of the sons whose fathers were in the bottom earnings quartile, only 12.8 per cent were in the top earnings quartile. Even less downwards mobility from the top earnings quartile was found.

It is possible to imagine targeted reform packages that could influence the distribution of wealth among young adults quite significantly – for example, mean financial wealth among 22- to 29-year-olds in 1997–98 was £1,746 (Banks and Tanner, 1999, p. 72), with levels of financial wealth among younger adults likely to be even lower. A policy giving assets to individuals in young adulthood is likely to reduce wealth inequality at that point, and, at the very least, will increase asset holding among low-wealth individuals. If it is the case that access to a stock of assets among young adults is one of the transmission mechanisms of intergenerational mobility, then asset-based welfare packages that provided assets to young adults could increase intergenerational mobility. This could potentially benefit the economy as a whole, as talented individuals became less constrained by their childhood family circumstances. Policies that did lead to an increase in intergenerational mobility could, in the long run, reduce overall wealth inequality. However, it is not necessarily the case that asset-based welfare packages are the best way to promote intergenerational mobility. An alternative policy would be to improve the education opportunities for children from lower-income families through increases in education spending focused specifically at these groups.

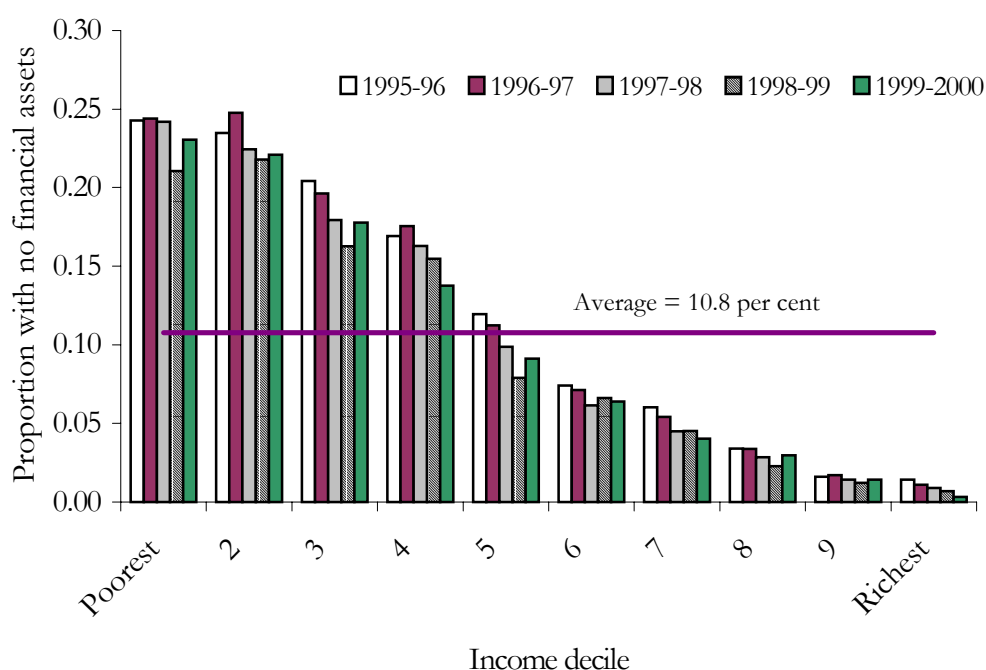
3.2 Other potential justifications for asset-based welfare?

The government has argued that asset holding has many beneficial effects on an individual's life and that government intervention can work effectively to spread these benefits more widely. This section looks at evidence on how many people are not

holding any financial assets, before addressing several possible arguments for asset-based welfare in turn.

Evidence on asset holding is provided by the annual Family Resources Survey (FRS) from 1995–96 to 1999–2000.³ On average across the five years of data, 10.8 per cent of families are found not to hold any form of financial asset, including a current account. Those with no financial assets are, unsurprisingly, found to be more concentrated towards the lower end of the income distribution. Nearly one in four of those in the bottom income decile do not report having any financial assets, compared with one in 10 of those in the fifth decile and less than 1 per cent of those in the richest 10 per cent of the population. There is some evidence in Figure 3.3 that, over the five years covered by the FRS, there has been a slight fall in the proportion with no financial assets.

Figure 3.3. Proportion of families with no financial assets, by income and year



Note: Income is that of the family before housing costs and is adjusted for family size using a simple equivalence scale of 1 for the first adult, 0.7 for any second adult and 0.5 for each child.

Sources: Disney, Emmerson and Wakefield (2001) using data from the Family Resources Survey updated using figures from 1999–2000; authors’ calculations.

Over the longer run, evidence from Banks and Tanner (1999) using the Family Expenditure Survey shows that the proportion of households reporting to have no financial assets and no housing wealth was 4.7 per cent at the beginning of the 1980s and reached 10.2 per cent in 1996. This increase was particularly large amongst those households with a head aged under 35. It must, though, be noted that the decision of whether or not to hold assets is a complicated one and individuals may have good reasons to choose not to hold interest-bearing assets. As stressed by Kempson and

³ For further details of asset holding from the 1998–99 FRS, see Section 2 of HM Treasury (2000).

Whyley (1999), many of those who do not possess a financial asset at any particular moment will have done so in the past and may do so again in the future.

We now turn to assess arguments that suggest that an asset-based approach to welfare might be beneficial to those individuals who have little or no savings. These arguments include the fact that access to financial assets may improve an individual's opportunities to study or start a business, whether holding financial assets leads to other beneficial effects on an individual's well-being, such as their subsequent health or employment prospects, and whether there is evidence that some individuals are simply not saving enough. In addition to these possible factors, we consider whether any other government interventions are likely to offer better value for money than support through a package of asset-based welfare.

Individuals are prevented from borrowing to purchase certain goods?

Under normal circumstances, individuals would be expected to purchase a good or make an investment if the expected benefits outweighed the expected costs. In the absence of any market failures, governments could simply allow these transactions to take place and concentrate on achieving their distributional objectives. One argument that has been used to justify asset-based welfare is that people on low incomes find it difficult to obtain credit and often can only borrow at high rates of interest. One problem with this argument is that it might be the case that the higher rates of interest are justifiable on the basis that these individuals have higher risk of default. There are, however, two types of activity that individuals may have difficulty financing due to identifiable market failures: education and self-employment. We assess each of these in turn.

Education

Individuals may be unable to borrow in order to undertake education because they might not be able to use any increased earnings potential as collateral. This does not necessarily imply that asset-based welfare would be the best policy, since it will also go to individuals who do not wish to undertake education. In 2001–02, the government is planning to spend £47.7 billion on education (HM Treasury, 2001b). If the government wants to improve education outcomes further, then a better use of any increased expenditure may be to increase this amount rather than to opt for some form of asset-based welfare. These additional funds could be targeted at individuals living in deprived areas, perhaps along the lines of the government's 'Sure Start' or 'Excellence in Cities' initiatives. An alternative policy also focused towards those on lower incomes would be to provide support with living costs for those in further and higher education. The government is also currently piloting the education maintenance allowance (EMA), which is a means-tested payment to those deciding to remain in full-time education between 16 and 18. Early evidence suggests that this is increasing participation in further education among low-income groups (Ashworth et al., 2001). The government has also stated that 'Our aim is to get more children from less privileged backgrounds into higher education and we hope to better achieve this by changing the combination of family, student and state

contributions'.⁴ Subsidising the maintenance costs of young adults from lower-income families seems a much-better-targeted policy for increasing their participation rates in higher education than any package of asset-based welfare.

Self-employment

Individuals trying to borrow money in order to finance a business venture may find it particularly difficult to raise capital if they lack any collateral of their own. Normally, the market response to an excess of demand over supply is for prices to rise – in the case of the demand for loans, this would lead to an increase in the rate of interest charged by the lender. There are economic models that suggest that financial institutions may decide not to increase interest rates, but instead to ration credit and, in particular, to insist on individuals putting financial collateral of their own into any new venture (Stiglitz and Weiss, 1981).⁵ This is supported, for example, by evidence from the National Child Development Study showing that individuals who have received an inheritance are more likely to become self-employed (Blanchflower and Oswald, 1998).⁶ While this is a genuine market failure, it is difficult to think of a well-targeted government intervention that will lead to a better allocation of resources. Asset-based welfare packages are likely to be poorly targeted since they will be received by many individuals who would not have applied for finance to start a business. Many applications for loans that are rejected by banks will be rejected on the grounds that the project does not appear to be economically viable – obvious reasons include the applicant not being considered to have the appropriate skills or experience. This is particularly likely to be the case with young adults.

Holding assets improves people's life chances?

In order to support the claim that asset-based welfare will help those on lower incomes by more than simply spending equivalent amounts on further increases in benefits such as income support, the integrated child credit and the minimum income guarantee, the government has argued that holding assets has an 'independent effect on individuals' life chances and attitudes, above and beyond such factors as their social class background or educational achievement'.⁷ This is similar to the case made by Sherraden (1991), who argued that having assets and engaging in the process of saving could be associated with a range of beneficial effects, including household stability, risk taking, participation in education and improved health. The relationship between having assets and outcomes was stressed in the government's election manifesto, which stated that 'people without

⁴ Estelle Morris, Secretary of State for Education, DfES Press Release, 4 October 2001 (http://www.dfes.gov.uk/mediamonitor/DisplayRB.cgi?pn_id=0128).

⁵ This is because the lender is unable to assess perfectly either the proposed venture or the subsequent effort of the person borrowing the money. Increasing interest rates might simply lead to only individuals with relatively riskier projects approaching the lender for finance. The solution is to increase the amount of monitoring of projects and to increase risk sharing by insisting that the borrower also puts some collateral into the venture.

⁶ Although, as stated by the authors, it is possible that 'perhaps wealth makes people less risk-averse and thus more prone to go into business, or self-employment allows wealthier individuals to consume leisure more easily'.

⁷ Speech by David Blunkett, then Secretary of State for Education, to the Institute for Public Policy Research, 7 June 2000.

assets are much more likely to have lower earnings and higher unemployment, and are less likely to start a business or enter higher education' (Labour Party, 2001, p. 27).

Evidence from the UK on these beneficial effects has been cited by the Treasury as a potential justification for asset-based welfare.⁸ This comes from a study by Bynner and Despotidou (2001) that uses data from the National Child Development Survey (NCDS). This survey contains information on over 12,000 people who were born in March 1958 and were interviewed at various ages in their life. The study looks at the correlation of having savings, holding investments and receiving inheritances at age 23 with various outcomes at age 33, once other background characteristics have been controlled for.

In the NCDS data, 82 per cent of the sample reported having savings, 11 per cent having an investment and 12 per cent receiving a gift or an inheritance worth more than £500. Table 3.1 gives the results for a selection of the outcome variables that were analysed. For example, it shows that, for men, holding savings at age 23 was positively correlated with years in full-time employment between 23 and 33 and with general health at age 33. The significant correlations reported in the table are all found to be robust to adding numerous background variables, including whether the individual owns a house between the ages of 23 and 33 and what the individual earns at age 33. While a number of significant correlations were found between having savings and subsequent outcomes, very few were found between holding investments and subsequent outcomes. This is potentially of concern, given that an extremely high proportion (82 per cent) of the 23-year-olds in the sample reported having savings, making it unclear whether they were actually saving in an active way or if, for example, they simply had a small amount of money in a current account. Rather than interpreting the findings as saying that having savings at age 23 improves subsequent outcomes, we might prefer to say that those who were likely to be without any savings account at age 23 were also those who were more likely to experience 'bad' life outcomes subsequently.

Table 3.1. Correlation of having savings and investments at age 23 with various outcomes at age 33^a

	Men		Women	
	Savings	Investments	Savings	Investments
Labour market experience between 23 and 33:				
Years in education	ns	ns	–	ns
Years in full-time employment	+	ns	ns	ns
Years spent unemployed	–	–	–	ns
Marital breakdown	–	ns	–	ns
Smoking	–	ns	–	ns
General health	+	ns	ns	ns

^a + denotes a positive and significant correlation, – a negative and significant correlation and ns no significant correlation. Other correlations – for example, years spent in self-employment, individuals' attitudes and potential indicators of parenting ability – are also contained in the study.

Source: Bynner and Despotidou, 2001.

⁸ HM Treasury, 2001a, Box 3.3, pp. 12–13. For a survey of some other evidence, from the USA and elsewhere, on the economic, social and psychological benefits of holding assets, see Kelly and Lissauer (2000, pp. 8–10).

As the authors themselves acknowledge, ‘placing causal interpretations on statistical relationships in non-experimental data of the kind reported here is always problematic. It is possible that another control variable could be found that would eliminate the observed effects of assets’. With this particular study, the concern is that holding savings at age 23 is correlated with something else that has an effect on the outcomes that are observed at age 33 but that has not been adequately controlled for. The most obvious factor would be that individuals who save are those who are more able and/or willing to plan ahead, which is also likely to affect many other outcomes.

If the correlations observed in this study are causal as opposed to reflecting other unobserved factors, the true cause is still not clear. It could be either that individuals who have had a financial asset are also more likely to experience a ‘good’ life event subsequently, or that it is individuals who have gone through the process of saving who are also more likely to experience a ‘good’ outcome. The process of saving would be the important factor if it were individuals’ ability to constrain consumption and plan ahead, rather than the holding of a financial asset per se, that mattered for subsequent life outcomes (Paxton, 2001). The government has stated the aim of not only getting more people to hold financial assets but also to ‘extend the savings habit to more people’ (Labour Party, 2001, p. 27). If it is this ‘savings habit’ that leads to the good subsequent outcomes observed by Bynner and Despotidou, then certain forms of asset-based welfare policies, such as those that provide individuals with a financial asset without making them save out of current income, are unlikely to deliver all the benefits that their proponents hope.

One possible way of seeing whether simply giving individuals assets, without also making them engage in the process of saving, had any beneficial effects on their subsequent outcomes would be to look at the impact of the receipt of inheritances. This might be better at demonstrating the effect of holding an asset rather than the effect of an individual being able to plan ahead and constrain their consumption.⁹ In fact, Bynner and Despotidou (2001) also looked at the effect of inheritances, but this ‘showed barely any effects so was dropped from the later stages of the analysis’.

Even if the correlations found in the NCDS are causal, this does not necessarily imply that providing an asset to individuals who did not save would improve their outcomes at age 33 in the same way, since individuals who chose not to hold savings at age 23 may be affected differently by holding an asset from those who did choose to save. Furthermore, the Bynner and Despotidou study only looks at the impact of asset holding on subsequent outcomes for one group of individuals at one point in time. Any relationships found could well change over time, due, for example, to the increase in numbers participating in further and higher education. In any case, if the objective of asset-based welfare is to improve, for example, subsequent employment or health outcomes, then it also needs to be shown that increasing public spending on asset-based welfare is better than alternative policies aimed at improving work incentives or improving the quality of health or education services.

⁹ Although there are potential problems with this type of analysis since individuals may anticipate receiving inheritances. In addition, those who received an inheritance would be considerably more likely to have experienced the loss of a close relative, which may also affect any subsequent outcome.

Some people are not saving enough?

An alternative, paternalistic, justification for asset-based welfare is a possible concern that some individuals are not currently saving enough. As shown at the beginning of this section, there are large numbers of people who do not have any financial assets. It is important to be clear about why people might not be saving 'enough', since there may be perfectly sensible reasons why individuals are currently consuming most of, all or more than their current income.

Even if there is evidence of people not saving enough, it is also important to determine what the most effective policy response is. For example, the government cites the fact that assets can act as a 'cushion for families if they are hit by unemployment or other unexpected adversity'.¹⁰ It has also been argued that there are new challenges for welfare policy from the fact that there have been changes in the risks that individuals face and also in life-cycle patterns (see Latham in Regan and Paxton (2001) and Paxton in Regan (2001)). Even so, it is still the case that a better-targeted policy might involve improving the standard of living provided by the social security safety net. One possible argument against this is that there are advantages to an individual from being self-reliant and not becoming financially dependent on state benefits. While this may be important, it is also true that it is welfare-improving for individuals to be able to insure against certain contingencies rather than bearing the risks themselves. Since certain events, such as job loss, may be uninsurable through private markets, large welfare gains from social insurance may be possible. These gains come from the fact that the risk of unemployment is then pooled across many families in a similar way to when individuals purchase private insurance of any other kind, such as against car theft.

While it is clear that there are large numbers of individuals who have no, or very small amounts of, savings, this alone is not sufficient to justify a role for asset-based welfare, since they may still be making sensible saving decisions. Those who are permanently on low incomes may find that they have little opportunity to build up any savings since this would require them to reduce their current consumption to a level below their current low income. The obvious example of someone in this situation would be a pensioner currently receiving the minimum income guarantee – there may be little for them to gain from holding any savings, especially since the government has already pledged that their income, over this parliament at least, will rise in line with earnings (Labour Party, 2001). Those who are only temporarily on a low income would be expected to be using part of any savings to finance their consumption needs. These individuals could also quite rationally decide to spend all of their savings and even build up debts if they felt that it was likely that their income would rise in the future. It is also not clear whether these individuals would be better off if the government decided to use an asset-based approach to welfare or simply decided to increase benefits that are payable to groups on low incomes.

There are quite plausible scenarios under which individuals are making non-rational savings decisions that could be corrected through some kind of government intervention. The appropriate design of any asset-based welfare package will depend on what the

¹⁰ HM Treasury, 2001a, para. 1.4.

reasons for individuals not saving enough are believed to be. Two possible related arguments are that:

1. individuals who do not have financial assets have insufficient knowledge of financial institutions and products; and
2. individuals have not got into the habit of either holding financial assets or consuming less than their current income.

Each of these possibilities provides a rationale for some form of government intervention. The first suggests that asset-based welfare could help, since individuals who are provided with an asset or a strong incentive to hold an asset may then obtain information that leads them to revise their saving patterns. If an individual is provided with one financial asset, they may then become more familiar with financial intermediaries and learn about the potential benefits involved in holding more financial assets. Similarly, if individuals are currently in a habit of not saving, then some form of time-limited incentive could be sufficient to get them into a habit of saving, which might improve their welfare for a longer period of time.¹¹

These types of arguments suggest that financial education could be extremely important in helping individuals who are not saving enough. There is evidence from the USA that the provision of financial education increases individuals' saving rates. The provision of financial education through schools has been found to have a positive effect on individuals' subsequent saving rates (Bernheim, Garrett and Maki, 2001). Financial education provided through the workplace, in the form of frequent seminars, has been found to increase individuals' contribution rates to private pension plans (Bayer, Bernheim and Scholz, 1996; Bernheim and Garrett, 1996). There have also been experiments with Individual Development Accounts (IDAs) in the USA which suggest that moderate amounts of financial education (six to 12 hours) increase the amount that participants in the programme save (Schreiner et al., 2001).

There are still some concerns that asset-based welfare may not be the right policy intervention. If individuals have not got into the habit of saving, then whether or not a particular form of asset-based welfare will work depends on precisely how these habits operate. Giving an individual a strong incentive to save for a short period of time may not be sufficient to get them into a long-term habit of reducing their consumption relative to their income. If individuals lack information about financial products, then it might be the case that a better-value-for-money policy intervention would be to provide more financial education instead of, rather than alongside, any asset-based welfare. However, it may be the case that asset-based welfare is needed to ensure that individuals get the most out of financial education. For example, it is possible that individuals will only be able to benefit fully from financial information if they are actually holding a financial asset. This would be true if individuals holding financial assets found that financial education was more relevant to them and if they were able to 'practise' that education at the time that they received it. Furthermore, in the USA, it has been

¹¹ Although evidence of such 'habits' does not necessarily imply that individuals are irrational in choosing not to begin saving. Becker and Murphy (1988) provide a framework for analysing consumption habits resulting from 'rational' decision-making.

suggested that ‘although match money may provide the necessary incentive to attract participants to the program, the financial literacy and asset-specific training classes may have the greatest impact on participant decision-making’ (Abt Associates Inc., 2000).

3.3 Which arguments come closest to justifying some form of asset-based welfare?

We have considered a number of possible justifications for asset-based welfare. Those based on a desire to influence the overall distribution of wealth do not look particularly strong since, in the short and medium terms, even a large asset-based welfare policy seems unlikely to have more than a very small effect. A policy targeted at young adults is likely to lead to a more equal distribution of wealth among that group and will certainly reduce the number in this group with no financial assets. This could help increase intergenerational mobility. However, a more cost-effective way of achieving this aim could be through increases in education spending focused on lower-income groups. Arguments based on individuals’ opportunities to invest in education also suggest that reforms to education policy, such as maintenance payments for individuals from low-income backgrounds, would be better targeted. Further research on any independent effects of holding savings and assets, in particular looking at precisely the mechanism that causes any improvements in ‘life chances’, is necessary to establish whether any particular form of asset-based welfare can be justified on these grounds.

More convincing rationales for an asset-based approach to welfare appear to be those based on individuals holding ‘insufficient’ savings, especially if the ‘insufficient’ saving occurs because of a lack of information about financial institutions and the benefits of saving or because individuals are finding it difficult to get out of a habit of consuming all of their current income. In particular, this points to the importance of providing high-quality, accessible financial information. Further research on whether it is the case that financial education is most effective when individuals currently hold a financial asset, and on which types of financial education work best, would be extremely useful. With these points in mind, we now turn to analyse the specific proposals that the government has put forward.

4. The government's proposals

The government's proposals for asset-based welfare involve the creation of two new savings instruments: a Saving Gateway¹² and a Child Trust Fund. These were discussed in an initial consultation document (HM Treasury, 2001a) and assumed the status of policy promises in Labour's general election manifesto (Labour Party, 2001). The precise form of these instruments remains to be decided at the end of the consultation process. In this chapter, we treat these two proposed types of account in turn and discuss what we know about the form that they will take and what remains to be decided. We also comment on the likely costs to the exchequer of introducing the accounts.

4.1 A Saving Gateway

This will be a new type of savings account and will almost certainly be available only to those with lower incomes. Those who are eligible will be given strong incentives to place some of their current income or assets into an account. As with Individual Development Accounts (IDAs) in the USA, the incentive to save in the account will be provided by the fact that – up to some maximum amount – an account holder's contributions 'will be matched by the government' (Labour Party, 2001, p. 10). There are many features of the Saving Gateway that remain unspecified:

- What will the eligibility criteria for the accounts be?
- Given that the Saving Gateway is to be targeted at those on lower incomes, will this involve family or individual income?
- Will changes in circumstances be taken into account when deciding on eligibility, and, if so, how?
- At what rate will matching occur?
- Should there be a minimum duration for which accounts must be kept open before the matching funds become available to the saver?
- What should the maximum duration (or 'gateway period') for the accounts be?
- Will savers be allowed to open second and subsequent accounts if they continue to satisfy the income criteria for eligibility after closing a first account?
- What financial assets should individuals be allowed to hold in their Saving Gateway?
- Will savers be allowed access to their funds during the gateway period, and will the access rules be different for own contributions and matching contributions?
- What will be the method for delivering financial education in conjunction with the Saving Gateway?

¹² There has been some confusion as to whether this would be a 'Saving Gateway' or a 'Savings Gateway'. We follow the initial consultation document (HM Treasury, 2001a) and omit the second s.

The ‘illustrative examples’ discussed in the final chapter of *Savings and Assets for All* (HM Treasury, 2001a) give us some further hints about the precise form that the Saving Gateway might take. They are calculated assuming that: eligibility will be determined according to some income test; the accounts will run for three years; contributions will be matched on a pound-for-pound basis up to a maximum of £50 per month. A scheme with these parameters would allow an individual to accumulate a maximum of £100 of assets (£50 from own contributions and £50 of matching funds) per month for 36 months, thus yielding potential contributions worth £3,600. The figures discussed in Section 3.1 indicate that this total is significantly greater than the total financial wealth holdings of the majority of people in the UK population.

Even assuming that the ‘illustrative examples’ accurately describe how the Saving Gateway will operate, it is still very difficult to cost the policy with any precision. This is partly because we have not been provided with any precise details about who the target group for the policy will be: we do not know what income groups will be eligible nor whether there will be criteria for eligibility other than an income test.

Even if we did know how the policy would be targeted, it would still be difficult to cost the policy because the amount that the exchequer will pay in matching contributions depends on how much individuals will choose to save in their accounts. Previous experience illustrates how difficult it is to predict how households will respond to saving incentives: when personal pensions were introduced in 1988, the reform package included significant financial incentives to individuals to encourage take-up, and the Department of Social Security underestimated the number of people who would opt into such schemes by a factor of eight (Disney and Whitehouse, 1992, p. 4). The difficulty of predicting behavioural responses is likely to be increased in this case by the fact that the Saving Gateway is aimed at lower-income families, many of whom have little experience of saving.

Our imprecise knowledge of how the Saving Gateway will be targeted also makes it difficult to assess the distributional effects of the policy, and again the difficulty is compounded by the fact that the impact of the policy depends on the behavioural responses of households. We would expect that, of those who are eligible for the scheme, it will be those with the highest current incomes and the lowest current consumption needs who will be the most likely to save. In a speech on the topic of asset-based welfare, Martin Barnes, the Director of the Child Poverty Action Group (CPAG), emphasised the fact that some of the policies proposed would not help the very poorest members of society if they cannot afford to save.¹³ In a recent article, Dobson (2001) makes a similar point and cites some evidence (drawn from Collard, Kempson and Whyley (2001)) from a Bristol-based survey that supports the view that those at the very bottom of the income distribution find it difficult to find money to save. This explains why the Saving Gateway cannot be regarded as a replacement for traditional income-based policies aimed at supporting those on the lowest incomes. The government does not view its asset-based welfare policies in this way but sees them as a new and ‘complementary, strand’ (HM Treasury, 2001a) in welfare policy. Since the Saving

¹³ Speech by Martin Barnes at the launch of the Institute for Public Policy Research (IPPR) Centre for Asset-Based Welfare, 8 May 2001.

Gateway will be means-tested, its impact will largely be felt by families near the bottom of the income distribution, although not by those at the very bottom of the distribution, for the reasons discussed in this paragraph.

We will discuss how individuals might respond to the incentives provided by matching in Section 5.1. Then, in Section 5.2, we discuss how the Saving Gateway might be targeted. Since the strength of the response to incentives and the precision of targeting will dramatically affect how much the exchequer will have to pay in matching contributions, we postpone a further consideration of the cost of the Saving Gateway until after these two sections. Even after considering possible behavioural responses and methods of targeting, we are not able to assess the impact of the policy precisely enough to give any more detailed distributional analysis than the discussion of this section.

4.2 A Child Trust Fund

This will be a savings account opened at birth for all children. The account will be opened when the government pays an initial contribution (this element of the policy explains why it has become popularly known as the ‘baby bond’). The size of this initial contribution will depend on a means test, but all children will receive something. This feature of giving some help to everyone but most help to the least-well-off is described by the government as ‘progressive universalism’. The assets held in the account will become available to the child when he or she reaches early adulthood, possibly at age 18. Family and friends will be given incentives to make supplementary contributions to the account before the asset is passed to the young adult. As with the Saving Gateway, many features of the scheme remain unspecified:

- How generous will the initial payment be?
- Will it be supplemented by further state contributions later in the child’s life?
- What form will incentives for individuals to make additional contributions into the account take?
- How active a role should families and/or children have in deciding how the funds are invested?
- What is the best way to build financial education into the scheme?
- At what age will children get access to the funds, and will there be any restrictions controlling how the funds can be spent?

The ‘illustrative examples’ in *Savings and Assets for All* (HM Treasury, 2001a) envisage a scheme that would pay an initial contribution of £500 to the poorest families, with further contributions of £100 when the child reaches ages 5, 11 and 16. Richer households would get half these amounts. Assuming that the funds accumulated at a 5

per cent real interest rate, the maximum state contributions would be worth approximately £1,640 when the child reached the age of 18.¹⁴

Since the decision to have a child is much less likely to be affected by policy than the decision of whether or not to save, it is much easier to provide an approximate costing for the Child Trust Fund than it is for the Saving Gateway. Assuming that the scheme is set up in such a way that half the recipients will receive £500 and half will receive £250, and that children who have already been born will not be eligible for the age-triggered payments, the policy would cost approximately £300 million in its first year. Paying the £100 and £50 supplements to all 5-, 11- and 16-year-olds (and again assuming that half of the population qualify for each amount) would add approximately £180 million to this cost.¹⁵

As with the Saving Gateway, it is difficult to assess the distributional impact of the Child Trust Fund, but for different reasons. With the Child Trust Fund, the amount that the government contributes to each account (ignoring the possibility of matching of supplementary private contributions) will be determined by the means test and will not depend on the behavioural response of the account holder. This means that it is possible to say where in the income distribution the families receiving the help will lie at the time that the contributions are paid. Who actually benefits from the introduction of the Child Trust Fund is unclear since the funds have to be locked away for several years, until the child reaches young adulthood. Those families who would have put some money away for their child at birth will, if they want, be able to benefit immediately, since they could adjust downwards the amount that they give to their child. Unless they can borrow against it, families who would not have put any money away for their child will not benefit until the fund matures. For these reasons, we do not attempt to assess the distributional impact of the policy here. We return to some of these issues in Section 5.4, which discusses whether or not a means test based on current income will facilitate accurate targeting of this policy.

¹⁴ It is assumed here that the interest is added annually and that the supplementary £100 contributions are uprated in such a way as to maintain their real value.

¹⁵ These estimates assume that there are approximately 800,000 children at each age at any point in time. The annual birth rate in the UK has averaged between 700,000 and 800,000 over the last 20 years. See Office for National Statistics, *Annual Abstract of Statistics 2001*, Table 5.2.

5. Design issues in the government's proposals

There are a number of details in the design of both the Child Trust Fund and the Saving Gateway that are raised by the initial consultation document (HM Treasury, 2001a). This chapter goes through some of these issues and raises several points that policy-makers need to consider. Subsequent consultation, as the precise form of the two proposals becomes clearer, will also be extremely useful to ensure that the benefits of the policies are maximised while the costs and any undesirable incentives are kept to a minimum.

5.1 Will individuals actually save more?

One of the main motivations for the Child Trust Fund and the Saving Gateway is 'to increase rates of savings and asset-ownership' (HM Treasury, 2001a). Providing individuals with assets, as with the Child Trust Fund, is clearly going to increase the proportion of people holding assets. In contrast, it is not possible to state with certainty whether the Child Trust Fund or the Saving Gateway will lead to an increase, a reduction or no change in the rates of saving among the target groups. This is because of three different effects that the introduction of the policies would have:

1. The Child Trust Fund will provide individuals with an increase in their wealth which, if anything, will reduce the amount that they decide to save. This is because the increase in wealth means that higher future consumption can be achieved with lower current levels of saving.
2. The Saving Gateway, and possibly the Child Trust Fund, will allow individuals to receive a government match from any savings placed in the fund. This could increase or reduce the amount of saving that they undertake. This is because, although the benefit from an additional pound of saving will be higher, those who were already saving will find that they can achieve the same eventual stock of assets by making a smaller contribution themselves.
3. Both policies may come alongside financial education. Again, theoretically, this could reduce or increase the amount of saving that individuals choose to do. If individuals are not saving sufficient amounts, then, as argued in Section 3.3, it is possible that an asset-based policy such as the Saving Gateway will make them re-evaluate their consumption decisions and decide to save more. As discussed in Section 3.2, there is empirical evidence from the USA suggesting that certain types of financial education increase saving rates.

The effect of any government match to individual savings will be extremely important in determining whether the two policies increase or reduce overall saving. We now look at this in more detail.

The effect of the matched savings

While the Treasury consultation document left open for consultation whether the government will match individual savings and, if so, what the appropriate level of matching is, the Prime Minister has stated that, with respect to the Saving Gateway, 'the

Government will match savings – pound for pound¹⁶. Any contribution from the government has the effect of increasing the annual return from each pound invested. The additional annual return received will depend on the rate at which the government decides to match and the minimum period that the recipient must wait before being able to spend the fund. Table 5.1 shows the rate of return provided by the government contribution, assuming that the funds are invested for various periods of time in an account paying a guaranteed zero real rate of return. A government match of 1:1 invested for a minimum period of three years is equivalent to an annual rate of return of 26.0 per cent. Even if the funds have to be held for 18 years, as in the case of the Child Trust Fund, then the annual rate of return is still a guaranteed 3.9 per cent. Higher matching rates offer much larger rates of return – with a return of 100 per cent a year being guaranteed if the match rate is set at 7:1 and the minimum holding period is three years. This very generous match rate of 7:1 is the highest available in Individual Development Accounts in the USA (Schreiner et al., 2001). It is clear from Table 5.1 that match rates of 0.5:1 still imply large real rates of return on any contributions made.

Table 5.1. What is the implicit rate of return on saving being offered?

Government contribution per £1 invested upon opening a Saving Gateway account	Annual return arising solely from government contribution if minimum holding period:			
	1 year	3 years	5 years	18 years
£0.00	0.0	0.0	0.0	0.0
£0.25	25.0	7.7	4.6	1.2
£0.50	50.0	14.5	8.4	2.3
£0.75	75.0	20.5	11.8	3.2
£1.00	100.0	26.0	14.9	3.9
£1.50	150.0	35.7	20.1	5.2
£3.00	300.0	58.7	32.0	8.0
£5.00	500.0	81.7	43.1	10.5
£7.00	700.0	100.0	51.6	12.2

Note: Assumes that a zero real rate of return is received on the investment.

Given the implicit rates of return shown in Table 5.1, it is also possible that individuals will decide to borrow money, perhaps from a relative, in order to benefit in full from the match. This could substantially increase the cost to the exchequer of providing matched contributions. This is a potentially significant problem with offering matched savings that should be addressed by the government. It might be possible to reduce it by defining the maximum amount of matching that an individual can qualify for over a relatively short time span. For example, having a maximum amount of £50 per month rather than £600 per year would reduce, but certainly not remove, the possibilities for individuals to borrow money in order to receive matched contributions on their ‘savings’. A monthly, rather than an annual, limit may also be more appropriate in trying to get individuals into a ‘saving habit’, as discussed in Section 3.2.

Those individuals who are eligible for matched contributions who have some existing savings might well decide to move these savings so they can receive the government’s

¹⁶ Speech made by the Prime Minister, 26 April 2001 (www.number-10.gov.uk/news.asp?NewsId=2023&SectionId=32).

contribution. This will mean that at least some of the money that attracts a government match will not be new savings.¹⁷ If the government opts for a lower match rate or sets the maximum match that an individual can receive at a relatively low amount, it will reduce these deadweight costs. However, if the scheme is not very generous, it might be insufficient to attract any new savings, and in particular it may be insufficient to persuade people to participate in potentially beneficial financial education. There is evidence from the USA that matched savings do work in getting people who had not previously saved to save. This research also suggests that more generous match rates *reduce* overall aggregate saving, since some individuals choose to reduce the amount that they save (Schreiner, 2001).¹⁸ When choosing the appropriate match rate, the government will have to decide between trying to maximise the number of people who save anything and trying to maximise aggregate saving among the target group. The number of participants will be increased by offering sufficient match to entice people into the programme, while the US evidence suggests that maximising aggregate saving might be achieved by a lower match rate.

5.2 How should the means test for the Saving Gateway be designed?

The Saving Gateway will be ‘targeted specifically at lower-income households’ (HM Treasury, 2001a, para. 5.18). To achieve this targeting, it will be necessary to employ a means test. The initial assessment of income will take place just before the account is opened and will establish eligibility for some period. It must be decided whether or not income should be reassessed in order to allow eligibility to be terminated if recipients’ circumstances change significantly.

It is interesting to consider whether or not an assessment of income when the account is opened will provide an accurate way of targeting the accounts towards individuals who have lower incomes throughout the period for which the account is held (the ‘gateway period’). We examine whether or not people who satisfy an income criterion at the beginning of a three-year period tend to be living still in lower-income households by the end of the period. If significant numbers are seen to experience large increases in income during a three-year period, then this would increase the motivation for reassessing income as a means of targeting the Saving Gateway accurately.

The aims of the Saving Gateway go beyond that of simple redistribution. The policy is intended to ensure that ‘the benefits of building up financial assets can be extended to lower-income families’ (HM Treasury, 2001a, para. 1.7) who do not currently realise these benefits because they save very little or nothing. The policy might be considered to be badly targeted if it covers a significant number of individuals who are already aware of the benefits of holding financial assets and who hold a stock of savings. The policy could become very costly if such individuals were included and could receive large amounts of

¹⁷ A similar example is that a large part of the funds held in TESSAs, PEPs and ISAs would have been held in other savings products had these relatively tax-favoured vehicles not been available (Banks, Dilnot and Tanner, 1997).

¹⁸ Both economic theory and the empirical evidence from the USA show that higher match rates will lead to an increase in the amount of money held in the accounts. This does not necessarily represent an increase in aggregate saving, since any contribution from the government simply implies higher government borrowing (assuming that other taxes and levels of public spending have been left unchanged), and any contribution from the individual may have come from reduced saving in other forms.

matching funds simply by transferring existing resources into the new accounts. This cost would come without achieving the goals of creating new saving and savers and teaching people about financial assets.

As well as catching individuals who already save, a simple income test for eligibility might also result in Saving Gateway accounts being given to individuals who actually have good reasons not to be saving. In Section 3.2, we argued that pensioners currently receiving the minimum income guarantee would probably be unwise to save from their low but stable incomes. Pensioners more generally are not an obvious target group for saving incentives. We would typically expect those who have retired to be funding current consumption from income generated by assets accumulated during their working lives, and possibly also by running down these assets. Other low-income groups would be ill advised to be saving because their income is only temporarily low. Students are a good example of a group that can expect higher incomes in the future, and they will often wish to borrow against this expected income in order to fund current consumption. It would be an odd blend of policies that encouraged students to save whilst providing some support to them via a system of loans. One reason why those on lower incomes might want to save is to cover rainy-day contingencies when needs are very high relative to current income. For many amongst the unemployed, today is their rainy day and so this is another group for whom saving might be ill advised.

In this section, we will examine data in an attempt to assess whether or not a simple income-based criterion for eligibility would result in many people who are already saving, or who we think might have good reasons for not saving, being eligible for the Saving Gateway. If it does, then this might suggest that there should be other criteria for eligibility alongside that of current income. Before moving on to this analysis, we will consider how successful a test based on current income would be in catching people who remain on low incomes throughout the duration of an account.

Would families remain on lower incomes for the duration of a Saving Gateway account?

We consider how many people who have low income in a particular year remain on low income for a three-year period. Three years is the duration suggested for a Saving Gateway in the 'illustrative examples' in *Savings and Assets for All* (HM Treasury, 2001a). Jarvis and Jenkins (1997) find that, in data from the British Household Panel Survey (BHPS) for the years 1991 to 1994, there is evidence of considerable movement upwards from the bottom of the income distribution. They find that, of the people in households that had less than half mean income in the first year of the sample, only 52 per cent also had income below this level in 1992. About a third (34 per cent) had income below half wave-one mean income for each of the first three years of the sample and about one-quarter had income below this level in all four years of the data. The data displayed in Table 5.2 are also taken from the BHPS, but for the years 1995, 1996 and 1997.¹⁹ The first column of the data displays a series of statistics for all individuals who have wealth data in 1995 and income data in all three years. The second column displays the same statistics for the poorest 22 per cent of individuals in this sample in 1995, which is to say those individuals who lived in households with incomes, adjusted for family size, of less

¹⁹ We chose 1995 as our first year because data on amounts of financial wealth holding were available for this year.

than £10,000 (in current prices) in 1995. The final column displays statistics for the next poorest 12 per cent, whose adjusted household incomes were between £10,000 and £12,000 in 1995. Columns two and three together account for approximately the poorest third of the 1995 sample.

Table 5.2. Characteristics of different groups

	All	Those with 1995 income:	
		Under £10,000	£10,000 to £11,999
% with income below £10,000 in 1995	21.8%	100%	0%
% with income between £10,000 and £12,000 in 1995	11.9%	0%	100%
% with income below £10,000 in 1995, 1996 and 1997	11.0%	50.8%	0.0%
% with income below £12,000 in 1995, 1996 and 1997	20.4%	70.3%	42.8%
% with income below £10,000 in 1995, 1996 or 1997	31.2%	100.0%	34.0%
% with income below £12,000 in 1995, 1996 or 1997	43.4%	100.0%	100.0%
<i>Number of observations</i>	<i>6,689</i>	<i>1,456</i>	<i>796</i>

Notes: Income in approximate January 2002 prices and adjusted for family size using the McClements equivalence scale. Sample only includes individuals who provided income information in 1995, 1996 and 1997 of the survey.

Sources: British Household Panel Survey, 1995–97; authors' calculations.

These data show that, amongst those living in households with income of less than £10,000 in 1995, slightly more than half had income of less than this amount in all three years of the sample and a further 20 per cent had income of less than £12,000 for all three years. Amongst those with income of between £10,000 and £12,000 in 1995, 43 per cent remained below the upper bound in all three years. These figures indicate that, if the Saving Gateway is targeted on the basis of a means test administered at the beginning of the gateway period, then a substantial proportion of recipients would have incomes above the eligibility threshold before their accounts are closed. This need not be too serious a problem if most of those whose incomes rise only move a little way up the income distribution and/or if they are likely to fall back into low income in the future: such individuals might still benefit in the way intended from the saving incentives that are provided. On the other hand, amongst those who choose to save in Saving Gateway accounts, the proportion who remain on low income throughout the time that their account is open may be lower than our data suggest, for at least two reasons. First, households that currently meet the income criteria but expect a boost to their income in the near future are perhaps the most likely of the potentially eligible group to feel that they will be able to afford to save and so the most likely to take out an account. Secondly, there would also be an incentive to reduce one's income temporarily in order to become eligible for the assistance provided by a Saving Gateway.²⁰ Individuals whose incomes become large during the gateway period could be disqualified from saving in Saving Gateway accounts if incomes are periodically reassessed. However, extra means-testing would increase the complexity and administrative costs of the policy and would

²⁰ In practice, households that only rarely have low income may be less likely to know about eligibility for benefits than those that often have contact with benefits agencies. This might reduce the scale of the problems to which we refer.

create a complex set of incentives to have low income during periods when income is being assessed. It might be decided that these costs are too large to be worth incurring.

Are lower-income families failing to hold financial assets without good reasons?

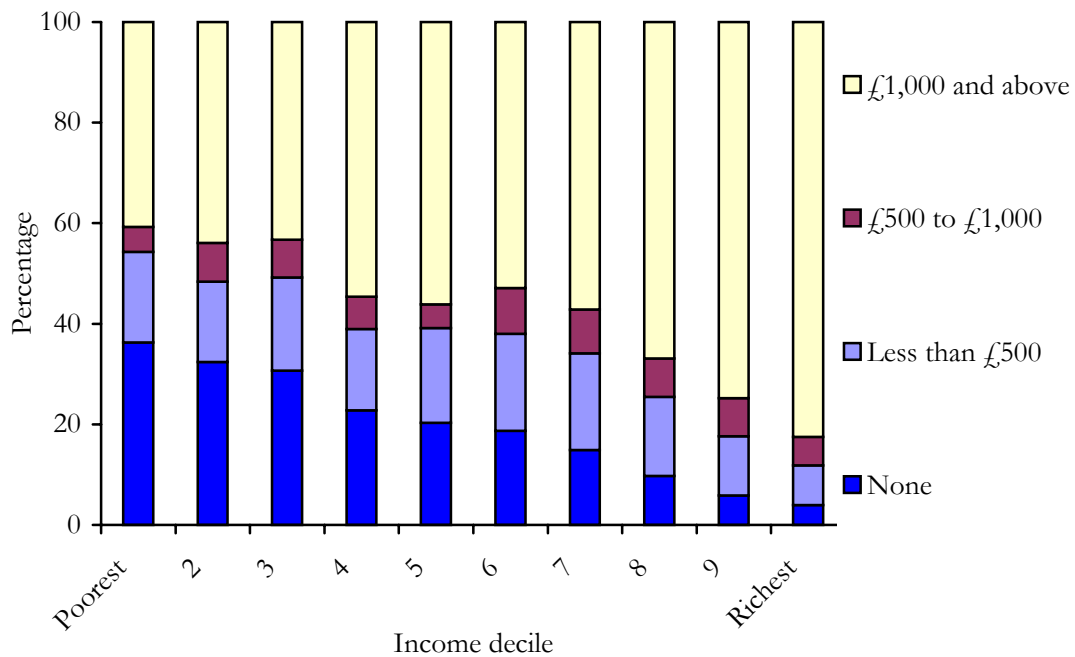
We argued above that a well-targeted Saving Gateway would not go to many individuals who already hold some assets. The data displayed in Figures 5.1a and 5.1b allow us to examine whether or not a means test based solely on income would be a good way of targeting the Saving Gateway towards people who have little or no asset holdings. The data used are the wealth data from the 1995 wave of the BHPS. We see that, amongst households with heads of all ages (Figure 5.1a), 45 per cent of the poorest 10 per cent of the sample have more than £500 in financial assets and 40 per cent have more than £1,000. Amongst the poorest 30 per cent of the population, almost half have assets exceeding £500 in value. This shows that low current income is far from being a perfect indicator of having low levels of savings.

Figure 5.1b excludes over-60s from the sample. Since the elderly tend to be over-represented near the bottom of the income distribution, but also tend to have some wealth, this reduces the proportion of people near the bottom of the income distribution who have some assets. We see that 80 per cent of people in the bottom 10 per cent of the income distribution for under-60s have less than £1,000 in assets. However, the proportions with assets do get somewhat higher as we move into deciles 2 and 3, where we would expect to find households that are more likely to be able to afford to save in a Saving Gateway. Across the bottom 30 per cent of the distribution, more than a quarter of individuals have financial wealth worth more than £1,000 and almost a third have financial wealth worth more than £500. These data suggest that the benefits of saving are already realised by a substantial proportion of low-income households. The fact that the data show that the proportions of people saving, and saving large amounts, increase with income is not surprising: this is precisely what we would expect in a population of individuals who were all making sensible saving decisions.

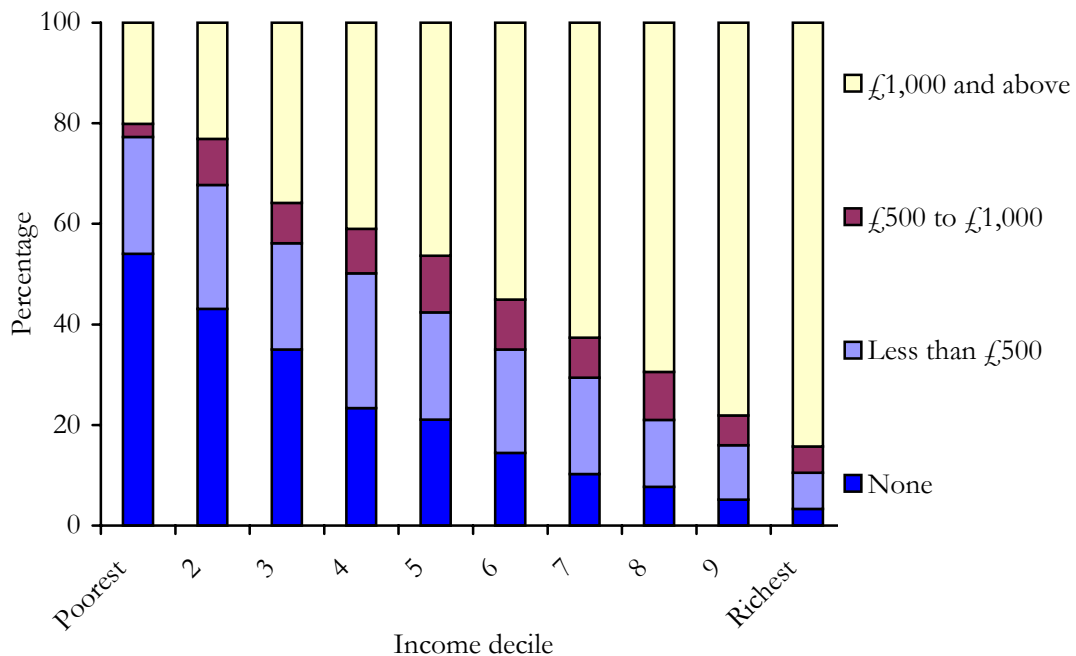
Nonetheless, there remain a large number of people from low-income households who also have little or no asset holdings. Table 5.3 displays some further data on the characteristics of individuals in the same sample of BHPS data that was used for Table 5.2. Again, the data are split into income bands so that the first column of the table displays data for all individuals in the sample, the second column contains statistics on the poorest 22 per cent of the sample and the final column contains statistics on the next poorest 12 per cent. We see that, amongst the poorest of these groups, only 31.5 per cent had savings exceeding £500 in 1995. Amongst those with incomes between £10,000 and £12,000, 36.1 per cent had more than £500 in savings. In other words, in the poorest third of the income distribution in this sample, around two-thirds of individuals did not live in families with savings exceeding £500 in value in 1995.

The table allows us to see whether or not these people with low incomes and asset stocks are pensioners, students or unemployed. In the above, we identified pensioners, students and the unemployed as groups of people that contain individuals who often have good reasons for not saving. Amongst those with income below £10,000 in 1995, 41.3 per cent

**Figure 5.1a. Estimates of household wealth, by income decile, 1995:
all individuals**



**Figure 5.1b. Estimates of household wealth, by income decile, 1995:
individuals in households with a head of household aged under 60 only**



Notes: Wealth is total household wealth in interest-bearing accounts, savings and investments in 1995 prices. Income deciles (weighted) are computed from annual net household income using all households in the sample for Figure 5.1a but only households with a head aged under 60 for Figure 5.1b. Calculations are weighted using cross-sectional household weights.

Sources: British Household Panel Survey, 1995; authors' calculations.

Table 5.3. Characteristics of different groups

	All	Those with equivalised income in 1995 of:	
		Under £10,000	£10,000–£11,999
% aged 16–29	23.1	25.3	20.4
% aged 30–39	22.1	17.9	21.0
% aged 40–49	17.7	12.4	16.2
% aged 50–59	13.3	7.5	10.6
% aged 60–69	11.1	12.8	13.9
% aged 70 or over	12.7	24.2	18.0
<i>All individuals</i>			
% with no savings ^a in 1995	25.3	41.9	36.7
% with more than £500 in savings ^a in 1995	48.4	31.5	36.1
% living in owner-occupied housing in 1995, 1996 or 1997	76.8	49.2	67.7
% with an occupational pension in 1995, 1996 or 1997	31.8	7.5	20.0
% with a personal pension in 1995, 1996 or 1997	21.8	9.1	15.3
As above but also making additional contributions in 1995, 1996 or 1997	13.5	4.7	8.8
% who are in full-time education	9.3	19.2	12.3
% who are unemployed	4.1	8.8	4.6
% who are retired	19.0	30.7	26.6
% not in full-time education, unemployed or retired	67.6	41.3	56.4
As above but also with less than £500 in savings ^a	35.6	30.8	40.6
As above but also not in owner-occupied housing and with no private pension	5.7	12.6	8.0
<i>Individuals aged under 60 only</i>			
% with no savings ^a in 1995	27.2	50.1	42.8
% with more than £500 in savings ^a in 1995	44.0	20.3	26.8
% living in owner-occupied housing in 1995, 1996 or 1997	78.9	45.6	70.5
% with an occupational pension in 1995, 1996 or 1997	40.9	11.8	28.6
% with a personal pension in 1995, 1996 or 1997	27.8	13.4	22.0
As above but also making additional contributions in 1995, 1996 or 1997	17.4	7.1	12.9
% who are in full-time education	9.7	24.7	15.1
% who are unemployed	5.0	13.2	5.7
% who are retired	1.6	1.1	1.5
% not in full-time education, unemployed or retired	83.7	61.0	77.7
As above but also with less than £500 in savings ^a	44.6	45.4	57.0
As above but also not in owner-occupied housing and with no private pension	6.8	18.0	11.1
<i>Number of observations</i>	<i>6,689</i>	<i>1,456</i>	<i>796</i>

^a 'Savings' refers to any funds held in interest-bearing accounts or investments. Unlike in Figures 5.1a and 5.1b, funds held in current accounts are not included.

Notes: Income in approximate January 2002 prices. Savings measured in 1995 prices. Only includes individuals who provided income information in 1995, 1996 and 1997 of the survey.

Sources: British Household Panel Survey, 1995–97; authors' calculations.

were neither students nor unemployed nor retired. If we also exclude those with savings exceeding £500, then we find that we are left with 30.8 per cent of our sample. We might also think that those who have chosen to hold a personal pension or who live in owner-occupied housing will have some knowledge of financial institutions and so would not gain all the benefits that the Saving Gateway is intended to deliver. If we exclude those who have a private pension and/or who live in owner-occupied housing, as well as those with some savings and students, pensioners and the unemployed, then we find that only 12.6 per cent of our low-income sample remain. This indicates that, if the Saving Gateway were targeted simply on the basis of income, then it might catch a lot of people who are already saving or who are sensible in choosing not to save. Whether or not we include those with private pensions and (in particular) those in owner-occupied housing has a large impact on the figures. An analysis of whether or not holding these assets provides the benefits that the government hopes will be provided by holding a Saving Gateway would be useful in informing a discussion of how many lower-income individuals would benefit from the new policy.

We have argued above that pensioners are likely both to have some assets and to have good reasons for not being current savers. If we exclude the over-60s from our sample, then we see that the proportion of people with low income and who we think might be appropriate targets for a Saving Gateway does increase. In the lowest income bracket we consider, we see that 61 per cent of all under-60s are not students, unemployed or pensioners. Amongst those in households with income between £10,000 and £12,000, 77.7 per cent do not fall into any of these three categories. Excluding anyone in one of these three groups and also those with over £500 in savings leaves us with 45.4 per cent of the lowest income band in our sample of under-60s and with 57 per cent of those with incomes between £10,000 and £12,000. If, on top of these exclusions, we also exclude those with private pensions or living in owner-occupied housing, then we again find a significant fall in the proportion of the sample that remains, to 18 per cent and 11.1 per cent respectively. These figures are again suggestive of the fact that targeting the Saving Gateway simply on low income amongst the under-60s could include many who do not need extra incentives to save or who have good reasons for not saving. Once again, the issue of whether home ownership and the knowledge of finances learnt when taking out a mortgage can bring the same benefits as the ownership and knowledge of financial assets will be important in determining how serious this problem is.

What are the implications for the targeting of the Saving Gateway?

What do these data suggest about how best to design a means test for the Saving Gateway? A first point to make is that our data use household income. This is not quite the same as the measure of combined income of adults in a family that will almost certainly be used as the unit of assessment for the means test: using this measure will be consistent with the method employed for all means tests introduced by Labour since 1997.²¹ If joint assessment is used, then there is an issue as to whether couples will be eligible for one or two accounts. In a couple with only one account, one member of the couple might learn less about financial institutions and the habit of saving than if they

²¹ These are the means tests for the working families' tax credit, the disabled person's tax credit, the minimum income guarantee / pension credit, the child tax credit / integrated child credit and the employment tax credit.

had their own account, which might incline us to think that an account per individual is the best system. The argument for individual accounts is strengthened by the fact that, if both individuals in a couple can have a Saving Gateway, then there is no complication about what happens if two people who both have accounts become a couple. Individual accounts would also mean that ownership of the asset should be easy to establish in the event of separation of a couple.

Once the measure of income that will be taken has been decided, a decision must be made about the period over which it will be assessed. In the working families' tax credit (WFTC), income is assessed over a six-week period in order to establish eligibility for six months. In income support, the assessment is based on weekly income. In the proposed integrated child credit (ICC) and employment tax credit (ETC), last year's taxable income will be the main measure used. For the Saving Gateway, it would seem that the annual period of assessment might be the best option. This is because having such a long period of assessment would increase the cost to individuals of temporarily reducing their income in order to qualify for the Saving Gateway.

If the measure of income taken were to be the same as that used in ETC and ICC, then eligibility for these benefits could be used as a means of 'passporting' people onto the Saving Gateway. This would be administratively simple because it would not require extra means tests to be created, and it would minimise the amount of extra form-filling that would be required of an individual wishing to apply for the Saving Gateway.

A system of passporting could operate by automatically opening a Saving Gateway account for individuals as soon as eligibility for a benefit such as ETC is established. This would increase the cost of delaying an application for the Saving Gateway, because, in order to delay an application, one would have to forgo some current benefit income. There could be an incentive to delay an application for the Saving Gateway if individuals are only allowed to open one account during their lifetime. It might be deemed desirable to restrict individuals to one account, as the Saving Gateway is intended as a means to get people into saving but not as a long-term savings instrument.²² If individuals can only have one account, then they will want to open it at a time when they will be best able to save enough to maximise the amount of matching funds that they receive. The decision of when to open an account becomes a complex strategic choice. Automatic passporting from another benefit would mean that delaying the application would only be worthwhile for those who have low current benefit entitlement, and so it would have the advantage of simplifying the choice about when to apply for a once-in-a-lifetime Saving Gateway. On the other hand, such automatic passporting would have the drawback of meaning that some people would exhaust the gateway period at a time when they find it difficult to save.

A system whereby eligibility was linked to ETC/ICC receipt would allow the Saving Gateway to be targeted relatively straightforwardly towards people from families in

²² If the Child Trust Fund proves an effective means of introducing people to financial institutions and the benefits of saving, then it might be decided that those who have received a Child Trust Fund at birth will not stand to benefit fully from having a Saving Gateway and so ought to be excluded.

which at least one adult is in work.²³ This gets around the problem of including in the Saving Gateway the unemployed and those with the very low incomes provided by income support.

Targeting on the basis of ETC/ICC eligibility would also exclude most pensioners. It would be possible to exclude all over-60s from the Saving Gateway and instead target help towards the low-income elderly by increasing the generosity of the minimum income guarantee / pension credit. It would also be easy to exclude the majority of those in full-time education from eligibility. Students are not eligible for many existing means-tested benefits, such as housing benefit and income support. It would be possible not only to make students non-eligible, but also to restrict the policy to (say) over-21s or over-25s. This could reduce the cost of the policy but it might not be desirable. It may be that young adults are the people who have the most to gain from learning about financial institutions and forward planning so that they are well placed to take decisions that will affect their long-term futures. As we noted in Section 3.2, young adults are particularly likely not to hold any financial assets.

One way of attempting to ensure that the aim of creating new savers and saving is fulfilled would be to disqualify those with more than a certain amount of assets from eligibility. We have seen that there are significant numbers of people who have low incomes but also have savings, who could transfer assets into a Saving Gateway account and receive matching funds without undertaking extra saving or learning anything new about financial institutions. However, there would be problems with administering an asset test. It would mean that eligibility for the scheme could not be simply linked to eligibility for benefits such as ETC or ICC: these new benefits will have no capital limits but will include interest income from savings in the means test. This means that introducing capital limits for the Saving Gateway could add to the administrative costs and complexity of the policy and would be inconsistent with the thrust of recent reforms. Additionally, the introduction of capital limits would create some odd behavioural incentives. People might find it worthwhile to spend a lump sum in order to run down their savings and qualify for matching funds, which could then be used to rebuild their savings. Such individuals would not be new savers. Even if capital limits did not induce people to spend away their assets, they could create incentives to pass assets to a trusted friend or family member or into a form that would make them more difficult to value for a capital test. Such behaviour might defy the letter of capital rules, but would be very difficult, and potentially costly, to police.

So far, we have not discussed whether eligibility for a Saving Gateway would simply cease at some threshold level of income or whether it would be tapered away. Tapering could be achieved either by gradually reducing the rate at which contributions are matched or by gradually reducing the maximum amount of matching funds that individuals are entitled to, as income increases. The disadvantage of not tapering eligibility is that it would create an effective tax rate of well over 100 per cent on the pound of income that would take a family that saved over the maximum eligible income

²³ Excluding all non-workers might be deemed unfair to certain groups, such as the disabled, who might find it particularly difficult to be in paid employment. This problem could be avoided by declaring eligible those who, for the purposes of other benefits, are assessed to have disabilities, but this would add to the costs of the scheme.

level. Such a family would have an incentive to manipulate their labour supply in order to keep income below the threshold. During the last parliament, the government reformed the National Insurance system in order to get rid of one such extremely high marginal tax rate. It could therefore be seen to be consistent to have a taper on the Saving Gateway. On the other hand, the costs of such high tax rates due to the Saving Gateway might be lower than the cost of having them due to the design of National Insurance. With the Saving Gateway, the problem would only affect those individuals who are precisely at the income threshold and who satisfy any other criteria for eligibility and would like to save. If the Saving Gateway is designed in such a way that individuals can only open one account per lifetime, and if eligibility is established by a one-off means test, then, at any point in time, there will only be a relatively small number of people affected by the tax rates implicit in the means test for the account. For these reasons, a simple eligibility threshold for the Saving Gateway would be unlikely to create spikes in the wage distribution, with large numbers of people earning just below the threshold, in the way that the National Insurance system did.

A simple cut-off would also have the advantage of making the Saving Gateway simpler and cheaper to administer via private financial service providers than if a tapered system were adopted. With a cut-off, knowledge that a Saving Gateway account was active would give the provider immediate knowledge of how much matching to provide for each pound of own contributions and of the total amount of matching per month that any individual was entitled to. This would make it easy for providers to credit matching contributions to accounts and then bill the government. With a tapered system, the provider would need detailed information of each individual's eligibility before the correct amounts of matching funds could be credited to accounts.

Some of the arguments presented in this section suggest that combining the means test for the Saving Gateway with the test for another benefit, such as ETC/ICC, would be a good idea. It would make for lower administrative costs and hassle to claimants than would the operation of separate means tests. The long period of assessment for ETC/ICC would also seem appropriate for the Saving Gateway, and attaching eligibility to eligibility for these benefits would mean that the Saving Gateway could be targeted towards working households. A concern would be that the ETC/ICC means test would not allow the exclusion of households that already hold assets, but there are potentially large problems with operating any asset test, especially in a policy that is designed to increase the asset holdings of individuals.

The evidence reviewed in this section indicates that simply having low income is not a good indicator that a family will have low asset holdings or other characteristics that might indicate that the family might benefit from incentives to save. Given that this is so, it might be a good idea to target the Saving Gateway initially much more tightly than simply to those families who satisfy the ETC/ICC income test. Newly eligible ETC recipients might be chosen, because this group will be predominantly made up of people who have just experienced a rise in their income on entering work. This change in circumstances might mean that these people would be wise to re-evaluate their consumption choices and, in many cases, to consider beginning to save. Such a small-scale Saving Gateway could be viewed as a pilot policy. It could be evaluated in terms of how well it achieved such goals as creating new savers and savings and also in terms of

whether or not the new asset holders experienced better outcomes than they might otherwise have expected. The small scale of the policy would mean that it could be scrapped without creating too many losers if it had not proved a success. If the evaluation were favourable, then the policy should be retained and possibly expanded to allow other groups to be eligible.

5.3 How much might the Saving Gateway cost?

Now that we have discussed what criteria might be used in order to establish eligibility for the Saving Gateway, it is possible to discuss how much the policy might cost under various different sets of rules. Table 5.4 lists a number of different estimated costings. The different restrictions considered make for large variation in numbers eligible, which means that the range of costings is large.

The table describes four different possible populations of people eligible for the Saving Gateway and details four different potential costings for the policy for each of these four groups. This gives a total of 16 potential costings. In all cases, we assume that the Saving Gateway matches funds at a one-to-one rate and pays a maximum of £50 per month to each account holder. The four different figures for each group depend on different assumptions about how much each saves in their Saving Gateway accounts, which in turn affects the value of matching funds that they receive. The four costings correspond to the eligible group receiving 80, 60, 40 or 20 per cent of the total amount of matched funds available to them. The cost of 100 per cent receipt is not considered on the grounds that full take-up would be unlikely for this means-tested policy.

For each of our four eligibility groups, the population of eligible working-age adults includes our best estimate of the number of adults in households that will be eligible to receive some employment tax credit in 2003. We chose ETC because eligibility for the Saving Gateway could be passported from eligibility for ETC. We assume that both adults in eligible couples would be able to have their own accounts, and express our eligible populations as projected numbers of adults in eligible families. In order to estimate the size of the eligible population, it is assumed that ETC is available to families with children that contain at least one adult working for more than 16 hours per week and that have income of not more than about £13,000 per year. Families without children must have at least one adult working for more than 30 hours per week and annual income of not more than about £9,000 for single people or about £13,000 for those in couples, and contain at least one adult aged over 25. For a detailed discussion of how ETC might be designed and what this will mean for the size and characteristics of the eligible population, see Brewer, Clark and Myck (2001). They estimate that approximately 1.7 million adults would be in families eligible for a benefit designed in this way. Our first set of costings assumes that only these individuals will be eligible for the Saving Gateway. Our second set of costings is based on a policy targeted in the same way except that the age limit for families without children is removed. We estimate that this would add approximately 600,000 adults to the eligible population. We consider adding these adults to the eligible population because it is not clear to us that excluding young adults from the Saving Gateway would be sensible. It should be noted that this set of rules would not allow for passporting directly from ETC eligibility if this benefit had an age restriction for families without children. The third set of costings that we report

again excludes those families that we project would not qualify for ETC on the basis of the age restriction, but adds in the 5.5 million adults that the government estimates would be in households that would be eligible for the pension credit in 2003 (Department of Social Security, 2000, conclusion, para. 3). It is slightly odd to include all those eligible for the pension credit when, amongst working households, we have excluded those adults from households with the very low income provided by income support.²⁴ However, there is no obvious benefit, other than the pension credit, from which eligibility for pensioner households could be passported. The final set of costings that we report is for the largest of the four eligible groups, which includes those on the pension credit and relaxes the age restriction that we assumed would apply in ETC.

Table 5.4 Costing the Saving Gateway when eligibility is linked to receipt of employment tax credit or pension credit

Who is eligible?	Minimum age for families without children	Number eligible (million)	% of maximum that is saved	Cost of policy in the first year (£ billion)
Adults in households projected to be eligible for some ETC	25	1.7	20%	0.2
			40%	0.4
			60%	0.6
			80%	0.8
Adults in households projected to be eligible for some ETC	None	2.3	20%	0.3
			40%	0.6
			60%	0.8
			80%	1.1
Adults in households projected to be eligible for some ETC or pension credit	25	7.2	20%	0.9
			40%	1.7
			60%	2.6
			80%	3.5
Adults in households projected to be eligible for some ETC or pension credit	None	7.8	20%	0.9
			40%	1.9
			60%	2.8
			80%	3.7

Notes: Costs are rounded to the nearest hundred million pounds. Age limits apply on the basis of the age of the oldest person in the couple. Costing for 80 per cent of maximum saving is consistent with individuals saving full amounts and 80 per cent take-up. This take-up rate is high compared with those for other means-tested benefits.

Sources: Estimated eligibility for ETC – Brewer, Clark and Myck (2001). Estimated eligibility for the pension credit – Department of Social Security (2000).

²⁴ In note 23, we mentioned that excluding all working-age adults who are in non-working families might be deemed unfair to certain groups. Allowing working-age income support recipients to open Saving Gateway accounts would extend eligibility to almost 2.5 million extra adults (see Department for Work and Pensions (2001)). Of these, around 1.2 million would be in families with a disabled adult and 900,000 would be single parents.

The range of costings in Table 5.4 is very large, varying from £200 million to £3.7 billion. It should be noted that the cost of the policy might rise in its second and third years as new households become eligible for the accounts while existing accounts are still active. Over time, the cost of the policy would decline if individuals are only eligible for one Saving Gateway account, as some individuals in lower-income households would have exhausted their eligibility.

There are two reasons why the range is so large. The first is that we do not have very precise information about who will be allowed to save in the Saving Gateway. The consultation document (HM Treasury, 2001a) does not suggest that the policy would be any more or less tightly targeted than any of the cases considered in Table 5.4. Our speculations above suggest that a pilot version of the policy could be somewhat more tightly targeted than any of the cases considered. Such a pilot scheme could be designed in a way that reduced the likely cost substantially. Once the government provides a more detailed description of how it will target the Saving Gateway, we will be able to provide a more accurate range of costings for the policy.

Even if we had precise information about the targeting of the policy, it would still be very difficult to predict how much eligible households would choose to save in Saving Gateway accounts. Since this will determine how much matching will be paid to each account holder, it follows that it is difficult to estimate how much the exchequer will have to pay in matching contributions. This is the second reason why it is difficult to cost the policy. In Section 4.1, we discussed the difficulties that have been experienced in the past in predicting how individuals will respond to saving incentives, and referred in particular to the case of personal pensions. Our discussion in Section 5.1 highlighted the fact that we know little about how individuals who are not currently saving will respond to the particular incentives provided by matching.

It will be possible to provide a more accurate range of costings for the Saving Gateway once the government has told us how the policy will be targeted, but the exact cost will not be known until after the policy has been enacted and the behavioural response to it has been observed.

5.4 How well targeted is the Child Trust Fund?

Standard means-tested welfare benefits are paid as income supplements to those who have the lowest current incomes. If low current income is a good indicator of need, then these policies may be considered to be a well-targeted way of redistributing towards current low-income families. They might also be successful as a means of providing the most help to those who have the lowest lifetime resources, since these will be precisely those families whose income is low in most periods of their lifetime.

With the proposed Child Trust Fund, the issue is more complex. The size of the fund that a young adult receives will, in part, depend on their parents' income when they were born. During this period, family circumstances may have changed considerably – the incomes of their parents may have changed, as may the number of adults living in the household. Some young people who receive a relatively large payment at age zero because their parents are on a low income will actually be in a high-income family when they reach adulthood. Possibly of more concern to the government is the fact that some

young people will be in higher-income families when they are born but in a relatively low-income family when they reach adulthood. The extent to which individuals born into low-income families remain in a low-income family throughout their childhood will be important in determining how well targeted the progressive element of the Child Trust Fund is.

Table 5.5. Relative incomes of mothers and mothers-to-be, by age of youngest child or number of years before birth

Years to birth (-) / Age of youngest child	Median income relative to sample	Sample size
-4	1.072	206
-3	1.084	275
-2	1.149	388
-1	1.129	528
0	0.954	1,530
1	0.922	1,424
2	0.941	1,188
3	0.952	1,000
4	1.001	892
5	0.992	768
6	1.030	725
7	1.020	685
8	1.050	673
9	1.039	617
10	1.036	561
<i>All</i>	<i>1.000</i>	<i>11,460</i>

Notes: Age of child refers to the age of the mother's youngest natural, adopted or step child aged under 11. If there is no child under 11 in the household, the number in the first column of the table refers to the number of years before the youngest child is born. Sample includes only those observations of women who either have a child under 11 in the year of interview or will give birth to a child in the next four years. Income is the net annual income of the household and is equivalised using a simple equivalence scale of 1 for the first adult, 0.7 for the second adult and 0.5 for any additional adults. Incomes are not equivalised for the number of children in the household. The table shows the median income for the relevant group relative to the median income for the sample in that year.

Sources: British Household Panel Survey, 1991–99; authors' calculations.

Data from all nine waves of the BHPS are used to look at how the incomes of mothers and mothers-to-be change over time. In order to look at the income dynamics of households before and after a child is born, we take as our sample only those women who either have a child aged under 11 at the time of interview or have a child at some point over the next four years.²⁵ Table 5.5 shows the average (median) household income by the age of the youngest child, or the number of years before birth, relative to our sample. This household income is adjusted for the number of adults in the household but not for the number of children. It shows that, for example, the median income of those women two years before the birth of a child who do not have any other children aged under 11 is 14.9 per cent higher than the average for the sample. Among those with a youngest child aged 1, it is 92.2 per cent of the average. This is without any adjustment for increased consumption needs due to the fact that women categorised as being two

²⁵ In order to look at household income before the child is born, we have to restrict our sample to mothers and mothers-to-be.

years before birth have no children aged under 11 in the household while those with a child aged 1 have at least one.

While there are several factors affecting the incomes presented in Table 5.5, such as changes in ages and family composition, it is also clear that, among this group of women, average incomes are relatively lower when the youngest child is aged under 4. This is likely to be caused, in part, by the difficulty of working full time with a pre-school-age child in the household. The figures could be used to support arguments that we should redistribute more towards groups with younger children, since this is a time when family incomes appear to be relatively lower, although families might plan for this in advance and might also choose the number of children that they have.

While it is clear from Table 5.5 that the incomes of families with children change over time, this does not show us the extent to which families that are on relatively lower incomes when the child is born are also on a relatively low income during the entire period of the child's upbringing. An indication of this is shown in Table 5.6. Again using the BHPS, children are placed into an income quartile depending on their family income and family size at age 1, and this is compared with the income quartile that they are in when they are aged 5. If the ranking of these children did not change between ages 1 and 5, then everyone would remain in the same quartile and the table would show 100 per cent in the cells on the leading diagonal, with zeros elsewhere. Alternatively, if the child's family income adjusted for family size at age 5 were completely unrelated to that at age 1, then 25 per cent of individuals from each income quartile at age 1 would be in each quartile at age 5.

Table 5.6. Income quartile of children aged 1 compared with income quartile when they reach 5

		Quartile when child is 5				Total
		1	2	3	4	
Quartile when child is 1	1	58.2%	24.8%	13.3%	3.6%	100.0%
	2	24.2%	44.2%	24.2%	7.3%	100.0%
	3	12.1%	24.8%	40.0%	23.0%	100.0%
	4	5.5%	6.1%	22.4%	66.1%	100.0%
Total		100.0%	100.0%	100.0%	100.0%	

Note: Number of observations = 660.

Sources: British Household Panel Survey, 1991–99; authors' calculations.

In fact, of those in the poorest income quartile at age 1, only 58.2 per cent were in the same income quartile at age 5, with 24.8 per cent moving up to quartile 2, 13.3 per cent moving up to quartile 3 and the remaining 3.6 per cent moving up to the richest quartile. Mobility was found to be slightly higher in the second and third quartiles, with less than

50 per cent being in the same quartile at age 5 as they were at age 1. While lower levels of mobility were found among those who were in the richest income quartile at age 1, it is still the case that 11.6 per cent were in the bottom two quartiles at age 5 and a further 22.4 per cent in quartile 3. These movements across the income distribution of young children could be due to either changes in family incomes or changes in family size or a combination of the two.

This mobility is over just four years rather than the entire duration that the Child Trust Fund will be held, which implies that income when the child is born may not be a particularly good proxy for the child's family income during their entire upbringing. This suggests that providing larger Child Trust Funds to young adults whose families were on low incomes at birth is not equivalent to providing larger Child Trust Funds to young adults whose families were on low incomes throughout their childhood. The government has suggested the possibility of making top-up payments, based on family income, into the child's fund during their life – for example, at ages 5, 11 and 16. If the government does decide to make progressive payments into the Child Trust Fund, it will need to decide whether to take into account the incomes of absent parent(s) or that of any parent's new partner living in the household. One problem with progressive top-up payments is that they might add to the administration costs of the government and the financial providers (Abbey National, 2001). However, these figures suggest that, if the government wants to provide a higher fund to those children from families that were relatively poor during their entire upbringing, then it should spread the payments over the child's life. It might be sensible to make each payment of a relatively similar size, unless there is strong evidence that, for example, family income at birth is far more important than family income at other ages in explaining a person's opportunities when they reach early adulthood.

While introducing a means-tested element to the Child Trust Fund might not be particularly costly in terms of administration, since individuals could be passported from other benefits, it is not necessarily costless in terms of stigma. While parents may not have the cost of additional stigma from receiving additional passported benefits, there may be a cost in terms of stigma felt by the child. This could be particularly problematic if the government wants the Child Trust Fund to help children to learn about the advantages of saving and compound interest at school.

In fact, given that, by the time they receive the fund, a young adult might be considered as being independent of their parent(s), it is not necessarily the case that making larger payments to people from low-income backgrounds achieves the best outcome. One viable alternative would be to base the means test on the circumstances of the young adult. If the government does want to redistribute more towards low-income families with children, then the integrated child credit looks like the obvious mechanism for delivering that aim. The strongest argument for redistributing towards young adults on the basis of family income during their childhood is that life opportunities are correlated with, but not caused by, this previous low family income. This would mean that young adults from low-income families did have fewer opportunities in life, but that increasing family income during their childhood would not have increased these opportunities. Even if this is the case, then it could still be true that a better alternative policy might be to focus greater educational resources on children from low-income families, since

evidence suggests that education is the main mechanism through which individuals from low-income families can achieve better outcomes (Johnson and Reed, 1996).

The evidence from the BHPS presented in this section shows that parents' income at birth is not a particularly good indicator of parents' income throughout childhood. Given that the government could carry out more redistribution to low-income families with children through the integrated child credit and that it could also focus more educational resources on children from low-income families, it is not at all obvious that the progressive element of the Child Trust Fund is the best way of targeting help to improve the 'life chances' of young adults from low-income families.

5.5 What assets should people be able to hold in the Child Trust Fund and the Saving Gateway?

The government is also consulting on which financial assets individuals should be able to hold in the Child Trust Fund and the Saving Gateway. The government could choose to limit the choice that individuals have to relatively safe investment options. This would reduce the amount of investment risk that these individuals hold but also reduce the expected returns from these assets. It is also possible that the gains people receive from financial education will depend on how much freedom they have to choose where to invest their funds.

In addition to many other individual circumstances, the optimal investment strategy will also depend on how long the individual expects to be able to hold the investment for. With the Child Trust Fund, it seems likely that the initial contribution to the funds will not be spent for at least 18 years, which is a relatively long time horizon. Hence, it might seem appropriate to allow individuals to consider equity-based investments. If equity-based investments are held, then individuals should consider moving away from riskier investments as the date at which they intend to spend the money approaches, as is the case with pension savings. It seems appropriate that the government ensures that individuals are informed about this. Otherwise, a downturn in equity prices occurring just before an individual with a Child Trust Fund is planning to spend the funds could leave them with lower amounts than they had hoped and an unwillingness to invest in equities in the future.

The Saving Gateway is likely to have a much shorter minimum holding period before individuals can spend the government's contribution. Furthermore, the target group for this policy is presumably those who have little or no savings. Hence, it is less clear that investing in equity-based products would be an appropriate investment strategy, and the government may decide that it is sensible to prevent individuals holding equity-based investments in the Saving Gateway. This is the view of the Association of Investment Trust Companies (2001), who argue that the Saving Gateway should be 'restricted exclusively to cash-type investments'. This view is not shared by the Association of Unit Trusts and Investment Funds (2001), who state that 'equity investment should be an option for the Saving Gateway'. Whether or not the government feels it should restrict the types of assets that individuals can hold will depend, in part, on the quality of financial information that it believes these people are likely to receive.

5.6 Should there be restrictions on how the matured assets can be spent?

In its consultation document, the government considers the possibility of ‘restricting the uses to which young adults can put the funds in their matured Child Trust Fund’ (HM Treasury, 2001a, para. 5.11). This is compared to the way that matching funds in Individual Development Accounts (IDAs) in the USA are made available only for expenditure on education or housing or to set up a small business. The government has not argued that funds held in a Saving Gateway should be restricted for certain uses, since it has stated that they should be ‘available on a rainy day’ (HM Treasury, 2001a, para. 5.28).

One justification for restricting how matured funds in the Child Trust Fund can be spent would be that a major point of the policy is to subsidise and encourage participation in the favoured activities amongst the groups targeted for assistance. There may be good reasons for wanting to subsidise these activities if market failures mean that some individuals have their opportunities to pursue them unfairly restricted. Even if we think that there are such failures, then, as we argued in Section 3.2, there would be more direct means of tackling them than the proposed asset-based policies: means-tested grants for those in education, subsidised housing and subsidised business loans are policy tools that are available to the government.

Furthermore, there is no mechanism to ensure that initial contributions to the Child Trust Fund, paid several years before the funds are spent, could be targeted towards those individuals likely to benefit the most from spending on the specified activities. Indeed, we may think that there are good reasons why those individuals most targeted by the policy are those who are least likely to gain from these types of spending. Although young adults from low-income backgrounds tend to be unlikely to stay on in education or to own their homes or to run their own businesses, there may be good reasons that do not reflect market failures for them choosing not to participate in these activities. They might well be individuals who choose not to invest in post-compulsory education because they would gain little from such education. Young adults who do not buy their homes may prefer to rent because this allows greater geographical mobility, which in turn allows them to pursue better-paid jobs away from their home town. The fact that young individuals find it difficult to borrow to fund new businesses may reflect the fact that they tend to make poor entrepreneurs, whilst the fact that poorer households are reluctant to undertake such debt may reflect the fact that they are risk-averse; in either case, low rates of business start-ups need not reflect a market failure that prevents households from getting access to funding.²⁶ If it is the case that the youngsters who receive the most financial support through the Child Trust Fund also tend to be those with little to gain from the activities that would be designated as possible uses for the funds, then placing restrictions on how the funds can be used would be counterproductive because it would reduce the effective value of the funds to precisely those individuals on whom the government is targeting the most help.

A further possibility is that the justification for restricting how the funds can be spent is a more paternalistic one depending on the fact that, without such restrictions, individuals

²⁶ Although see subsection on self-employment in Section 3.2 for other rationales.

would not choose to spend the funds in the way that most benefits them, perhaps because they do not realise the size of the future benefits accruing from spending on the designated purposes. This would seem to be a slightly odd argument to use if part of the aim of the Child Trust Fund, and the reason for opening accounts when a child is born rather than simply providing a lump sum to all young adults, is to teach youngsters and/or their families the virtues of forward planning. The government has not spelt out why it thinks that the best design for a policy intended to ensure that ‘all young people should be able to embark on their adult lives with a financial asset to invest in their future’ (HM Treasury, 2001a, abstract) involves setting up accounts at birth. It is possible that the reason for doing this is to facilitate means-testing that takes into account family circumstances at the time of birth (Section 5.4 discussed whether or not it is a good idea for the Child Trust Fund to have a means test that measures circumstances at birth). However, it seems likely that the beliefs that holding assets can help youngsters and/or their families to learn about finances and about how to plan ahead are also important motivating factors. If these are indeed factors motivating this design feature, and if the range of choices for how funds can be spent is to be restricted, then the government would need to make clear why it feels that Child Trust Fund holders would not learn enough about forward planning that they (or society) would benefit more from having an unrestricted rather than a restricted choice.

So far in this section, we have considered arguments for whether or not it might be a good idea to constrain how individuals can spend their mature Child Trust Funds. What we have not considered is whether or not it is practical to attempt to restrict how the funds are spent. If many of the individuals who receive the funds would have spent on the designated purposes in any case, then they would probably be able to adjust their finances to ensure that the money from the trust fund was spent in accordance with the regulations, without actually increasing their spending on the particular purpose chosen. Only if many of the individuals who benefit from the schemes would otherwise have spent little or nothing on the specified purposes will the policy be sure to create significant new spending on these things. Even then, it is possible that individuals could get immediate access to their funds unless there is strict policing of their behaviour. For example, they could purchase a property only to sell immediately, or they could set up their own small business and then liquidate it.

5.7 Should individuals have access to their own contributions?

The government is consulting about whether individuals should be able to have access, before accounts mature, to any contributions that they make to either a Child Trust Fund or a Saving Gateway. Along with the tax treatment and the presence of any government match, whether individuals have immediate access to any contributions that they make will also affect the incentives that they have to save in these accounts.

The target group for the Saving Gateway is those on lower incomes who have little or no savings. As highlighted in the Treasury consultation document, these groups might be better off saving in a relatively liquid form for a ‘rainy day’ rather than in an illiquid form, such as a stakeholder pension. Hence, it may seem sensible to allow individuals who have made contributions to a Saving Gateway to have access to those funds before the Gateway matures. If this is allowed, the government will have to decide whether

individuals who have withdrawn their contributions are still allowed to receive the matched funds when the gateway period comes to an end. If individuals are not allowed to retain the government match, then this will provide an incentive for those who suffer a ‘rainy day’ to borrow funds rather than to make withdrawals from their Saving Gateway. A more preferable outcome is likely to involve allowing these people to have immediate access to their own funds – particularly since it may help them to learn about the benefits of saving.

The policy of allowing individuals to retain their government match would also not be without complication, because it is important that individuals do not have an incentive to withdraw and re-contribute to their funds in order to receive additional matches without contributing any extra savings. In order to prevent individuals from getting multiple matches without actually building up a stock of their own contributions, further government matching should only be given when an individual has replaced all the funds withdrawn. This problem should not be insurmountable, but would place an additional administrative burden on the providers of the accounts.

With the Child Trust Fund, there is a manifesto commitment to ‘provide incentives for extended family and friends to contribute’ (Labour Party, 2001, p. 27). One potential difficulty that the government will need to consider concerns the ownership of the contributions into a Child Trust Fund – for example, if ‘extended family and friends’ do place savings in the account, would it be desirable to allow the child’s parents to withdraw these funds?

It is not clear, as yet, what the ‘incentives’ to individuals to contribute to a Child Trust Fund will be. The consultation document only mentions the possibility of using a ‘limited tax incentive based on the ISA model’ (HM Treasury, 2001a, para. 5.7). If this method for encouraging contributions is used, then a strategy of saving in an ISA offers the same tax relief and greater liquidity. Those who have already contributed up to the ISA limit in that year may be the only people for whom making contributions to a Child Trust Fund is a sensible strategy. These individuals are extremely likely to be drawn from the top end of the income distribution. Saving in a Child Trust Fund would be particularly attractive to those who have used their ISA limits if any tax relief were combined with immediate access to the funds. If the government decides to provide an incentive more generous than ISA-style tax treatment, then this would severely reduce the attractiveness of saving in an ISA for families with children. It would also undermine pensions policy by reducing the incentive for this group to save in any private pension, such as a stakeholder pension.

This is one of many interactions between the two proposals and other government policies affecting saving decisions. We now turn to consider some more.

5.8 How does this policy interact with other government policies?

Since 1997, the Labour government has introduced a number of measures that are likely to influence individuals’ saving decisions. In particular, it has implemented what it described as ‘radical reform of the whole pension system’, with the stated objective of increasing the proportion of pension income that comes from private sources (Department of Social Security, 1998). The government has also stated that, among other things, ‘the right environment for saving involves a stable macroeconomy’ (HM

Treasury, 2001a). While this may be true, it is also the case that a stable savings environment may improve saving decisions – in particular with respect to long-term savings such as those held for retirement (Tanner, 2000; Banks and Emmerson, 2000).

Continuing policy reforms have meant that there has not been a stable savings environment. For example, those individuals who were in the government's target group for stakeholder pensions – that is, those earning around £10,000 to £20,000 who had not yet made any private pension arrangement – could well be affected by two policies introduced after stakeholder pensions came into effect: the proposed pension credit and the Saving Gateway. Some of those who have decided to save in a stakeholder pension may now regret that decision, given that the introduction of the pension credit could mean that they face a 40 per cent withdrawal rate on income in retirement and given that they may become eligible for a Saving Gateway. The savings that they have tied up in their stakeholder scheme could instead have been used to place larger contributions into their Saving Gateway and hence entitle them to more matched savings from the government. They would also have greater liquidity, since funds in a Saving Gateway will not have to be tied up until retirement.

This does not suggest that we should never reform the savings environment, but it does demonstrate that many policies interact and that new reforms often come at the cost of increased complexity. Empirical evidence on people in the stakeholder pension target group had already suggested that they might be more appropriate targets for an ISA (Disney, Emmerson and Tanner, 1999). Until further details on the Saving Gateway are announced, individuals who might be eligible to receive a Saving Gateway account should certainly consider holding their savings in a liquid form so that they could benefit fully from any government match.

There are also a number of more specific issues relating to how the Child Trust Fund and the Saving Gateway might operate compared with the CAT marking²⁷ of ISAs and the structure of stakeholder pensions. Given that the consultation document contained very little detail on these issues, it would be sensible for these to be discussed more in subsequent consultation. It seems beneficial to allow individuals to switch funds between different providers with the minimum of cost, since this will maximise competition between providers for both new and existing accounts. It would also be consistent with the government's approach to both stakeholder pensions and CAT-marked ISAs. If it allows equity-based investments to be held in either the Saving Gateway or the Child Trust Fund, the government will also have to decide whether to restrict the way that funds can charge and, if so, whether it sets a maximum level of charge. Restricting the way that charges can be levied seems a sensible idea, since it may help promote competition. In particular, only allowing charges that are a percentage of the fund would again be consistent with the approach taken to both stakeholder pensions and CAT-marked ISAs and would enable individuals to make comparisons between the different products. Setting a maximum charge should not be necessary unless there are concerns about the extent to which competition can work in driving charges down.²⁸

²⁷ 'CAT-marked' is the government term for those financial products that meet a voluntary benchmark for Charges, Access and Terms. For more details, see Financial Services Authority (1999).

²⁸ For a discussion of these issues in the case of stakeholder pensions, see, for example, Emmerson and Tanner (1999).

6. Conclusions

This Commentary has looked at a number of issues arising from the government's consultation document, *Savings and Assets for All*. We have considered a number of alternative possible justifications for the introduction of asset-based welfare in the UK. Many of the market failures that asset-based welfare might be intended to help to alleviate might be better tackled by other interventions. For example, if low-income individuals find it difficult to borrow to invest in education, then means-tested assistance with maintenance costs would be a better-targeted policy.

The justification for asset-based policies need not rely on any particular market failure if it is the case that holding assets has an 'independent effect' on an individual's life chances. Our view is that the existing evidence of such effects is not strong enough to justify a large-scale programme of asset-based welfare policies. Perhaps more convincing are arguments that engaging in the process of saving, and thereby learning to plan ahead and learning about financial institutions, can help people to improve the outcomes that they achieve. If this is the strongest justification, then financial education has a significant role to play in any asset-based policies that are enacted.

The government has proposed two specific asset-based policies. One stated aim of the Child Trust Fund is to ensure that young adults are 'able to embark on their adult lives with a financial asset to invest in their future'. The proposed policy does not provide assets to young adults directly, but instead makes payments to children at birth. This suggests that there are other policy objectives. These could include that the holding of an asset helps to teach children about how to make saving decisions and plan ahead, and a desire to focus additional funds on individuals born to low-income families. If these benefits exist, it is not obvious that they would be felt more strongly by newborns, upon whom the current policy proposal is focused, than by other young children. The government is also consulting on whether young adults should be constrained in the way that they can use their funds. Such constraints would be extremely difficult to regulate and, in any case, sit oddly with a policy aimed, in part, at improving an individual's ability to plan ahead. Greater clarification of the aims of the Child Trust Fund and the reasons for the particular design features already suggested would make it easier for further consultation to be fully productive.

The Saving Gateway would seem to have a slightly clearer purpose, which is to encourage new saving and savers amongst lower-income households. Our analysis indicates that the way in which this policy is targeted is likely to be crucially important in determining whether or not the policy can achieve its aims without also incurring large exchequer costs by subsidising individuals who would have saved without encouragement.

A clearer statement of the precise aims of these two policies would be welcomed. This would assist the further consultation that will be necessary to determine the many outstanding details of the policies.

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