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7. Developments in asset-based welfare policy

At the time of the Pre-Budget Report, the Treasury published a second consultation document discussing two proposed asset-based welfare policies, the Saving Gateway and the Child Trust Fund. These are intended to 'extend the benefits of saving and asset-ownership more widely'.[1] In this chapter, we consider each of these two policies in turn. We discuss what the new document tells us about the policies and then consider what issues remain to be resolved before the policies are implemented.

7.1 The Saving Gateway

The Saving Gateway will be a new form of savings account available to families (or adults in families) with lower incomes. The policy is intended to 'increase rates of saving and asset-ownership'[2] among eligible families. The precise nature of the policy is yet to be finalised. The consultation document envisages accounts with the following features:

- Eligibility will be established using a means test. This will probably involve 'passporting' from or a linkage to an existing working-age benefit or tax credit or to the measure of income used in such a benefit or credit.
- An individual's contributions to his or her account will be matched at some fixed rate by the government. The level of matching 'could be set at £1'[3] for each pound placed in the account.
- There will be limits on the amount of matching payable per month and possibly also over the lifetime of the account. These might be set at £25 and £1,000 respectively.
- The maximum lifetime of accounts might be five years.
- Whilst accounts are still live, savers will be able to access their own savings but not the matching funds.
- The assets will be held in cash deposits.
- When the account matures, it will be possible to transfer the funds held into a stakeholder pension or an Individual Savings Account (ISA) without this counting against the annual contributions limit for that savings vehicle.

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[1] Paragraph 1.1 of HM Treasury, *Delivering Saving and Assets*, The Modernisation of Britain's Tax and Benefit System no. 9, London, 2001.

[2] Abstract in HM Treasury, *Saving and Assets for All*, The Modernisation of Britain's Tax and Benefit System no. 8, London, 2001.

[3] Paragraph 4.10 of HM Treasury, *Delivering Saving and Assets*, The Modernisation of Britain's Tax and Benefit System no. 9, London, 2001.

- Financial education will be provided in conjunction with the accounts.
- There will be a single provider of Saving Gateway accounts.

Some features of these accounts are not precisely determined. Pilot versions of the policy have been promised, and these might clarify some of the uncertainties that remain. The piloting of the policy is welcomed. We will now consider some of the issues that will influence how the Saving Gateway should be designed. In the light of this discussion, we end this section by considering how best the pilots might be set up and evaluated in order to inform the design process.

Targeting the Saving Gateway

We know that the Saving Gateway will be targeted towards adults in lower-income households. If income is the only criterion for eligibility, then many of the adults who are eligible either might not need the incentive to save because they already have savings, or might stand to gain little from being given the incentive because they have good reasons for not saving. The latest proposal suggests that eligibility will be linked to that for a working-age benefit or tax credit; the obvious benefit or credit to use would seem to be the working tax credit (WTC) or income support (IS). Linking the Saving Gateway to the WTC alone would mean that eligibility was contingent on an individual or their partner being in work as well as on having low income. We now discuss what other criteria there might be for eligibility, and whether these would result in a policy that is well targeted towards individuals who stand to benefit from being encouraged to save more.

If eligibility for the Saving Gateway is linked to that for a working-age benefit or tax credit, then students and lower-income pensioners will not be eligible. This seems sensible, as both of these groups would be likely to benefit more from supplements to their current income than from being encouraged to save.[4]

Should young adults be eligible?

It might be decided that, as well as making students ineligible, all young adults should be prevented from having Saving Gateway accounts. This would make for simpler administration if eligibility were to be linked to that for the WTC. This credit will not be paid to adults under the age of 25 who do not have children. However, young adults might be a group who stand to gain a lot from the forward-looking activity of saving, because they expect to have a long period of life ahead of them. It might therefore be unwise to exclude them from the Saving Gateway. As we will see below, whether or not young adults are included could have quite a significant effect on the cost of the policy.

[4] The issues of why it might be sensible to exclude pensioners and students from the Saving Gateway, and the more general issues surrounding how the policy should be targeted, are discussed in greater detail in C. Emmerson and M. Wakefield, *The Saving Gateway and the Child Trust Fund: Is Asset-Based Welfare 'Well Fair'?*, Commentary no. 85, Institute for Fiscal Studies, London, 2001 (www.ifs.org.uk/pensions/abw.pdf).

Should workless families be eligible?

If the Saving Gateway is linked to the WTC, then adults from families in which nobody is working will not be eligible. This might be sensible. The benefits that are paid to the unemployed (jobseeker's allowance or income support) provide only a basic standard of living and so it may not be desirable to encourage those receiving these payments to forgo current consumption in order to save in a Saving Gateway. Indeed, those who have become unemployed might find that their income is temporarily insufficient to meet their consumption needs and so prefer to be running down any savings that they have, rather than to be currently saving.

Linking eligibility to the WTC alone would also be administratively simpler than attempting to include the unemployed by using some combination of the means tests for the WTC and IS. The two means-tests differ administratively and the WTC means test would seem a more appropriate method of assessment for the Saving Gateway because it measures income over a long (annual) time period rather than taking a weekly snapshot view. This is important because it would make it harder for people to reduce their income temporarily in order to gain access to government matching.

An alternative way of discouraging such behaviour would be to have reassessment of means so that individuals would have to show regularly that their income was low in order to continue to be eligible for matching contributions. Such reassessment would reduce the amount of matching that the government had to pay out and would prevent payments from going to those whose incomes had risen significantly before they had exhausted their entitlement to matching. On the other hand, reassessment would add considerably to the administrative costs of the policy and to the hassle involved in claiming matching. It would also provide a disincentive to work for families who, by working longer hours or achieving promotions, could increase their income a little above the threshold for Saving Gateway eligibility.

Even without such reassessment, a Saving Gateway linked to the WTC would have an impact on incentives to work. Those who only need to sacrifice a small amount of income in order to become eligible for a potential £1,000 of government matching might choose to do so. For example, some families might choose not to have a second adult work part-time for a low income, if this second income would make the family ineligible. Individuals who were taking a career break, perhaps because they have a young child, might find that it is worthwhile to extend the period for which they remain out of work if doing so means that their family income falls within the Saving Gateway eligible range.

Although it has advantages, excluding IS recipients from the Saving Gateway might be deemed unfair. It might be especially unfair to certain groups, such as those who are prevented from working for health reasons. Those who are assessed to be disabled for the purposes of other benefits could be declared eligible for the Saving Gateway without this requiring that all IS claimants are offered accounts. This should only be done if these people are thought likely to benefit more from being given a financial incentive to save from their

benefit income than from receiving the money as a boost to their current income.

Targeting the Saving Gateway towards the working poor would mean that a larger proportion of the eligible population could already have assets than would be the case if the scheme were aimed at the poorest members of society. Figures from the British Household Panel Survey (BHPS) for 1995 show that amongst the poorest tenth of the population of adults of working age (under 60), approximately one in five lived in a household with more than £1,000 in financial wealth.[5] Amongst the third poorest tenth, slightly more than one-third of adults lived in households with this level of financial wealth. Such adults would be able to transfer their existing resources into a Saving Gateway account to benefit from the government match. This would not be new saving but it would add to the cost of the policy. Although this problem is made worse if the working rather than the workless poor are targeted, it is also possible that workless families would benefit more from supplements to their income than from financial incentives to save. The working poor might benefit more than those in workless households from the incentive to save and could potentially be a better target population for the Saving Gateway.

A gateway open to newly employed only?

As well as indicating that the Saving Gateway might be linked to a tax credit or working-age benefit, the most recent consultation document states that 'the Government will also consider options for targeting the Saving Gateway at people moving into paid employment'.[6] These people might form an appropriate target group because they are likely to receive a boost to their incomes when they move into work.[7] As such, they might have good reason to reconsider their spending and saving decisions. More research would be needed to establish whether they need prompting to undertake this reconsideration. Restricting the policy to new WTC recipients would make it considerably less costly than if all WTC recipients were eligible for matched savings accounts, but it might also create incentives to change employment status in such a way as to become a new WTC claimant. It might also be seen as unfair to give this form of assistance to only some of the WTC eligible population.

[5] These figures, and other more detailed data, were first published and discussed in C. Emmerson and M. Wakefield, *The Saving Gateway and the Child Trust Fund: Is Asset-Based Welfare 'Well Fair'?*, Commentary no. 85, Institute for Fiscal Studies, London, 2001 (www.ifs.org.uk/pensions/abw.pdf).

[6] Paragraph 4.8 of HM Treasury, *Delivering Saving and Assets*, The Modernisation of Britain's Tax and Benefit System no. 9, London, 2001.

[7] The argument that newly employed people might be an appropriate target group for the Saving Gateway is made on pages 31–2 of C. Emmerson and M. Wakefield, *The Saving Gateway and the Child Trust Fund: Is Asset-Based Welfare 'Well Fair'?*, Commentary no. 85, Institute for Fiscal Studies, London, 2001 (www.ifs.org.uk/pensions/abw.pdf).

Will the Saving Gateway create new savers and saving?

The Saving Gateway is intended to ensure that adults in the target population 'are encouraged to save for themselves'.[8] The strength of the incentive provided by matching should certainly encourage some people who are not currently saving to invest in the accounts. If a lack of knowledge is hindering the saving of some adults from lower-income families, then the financial education provided alongside the Saving Gateway might serve to increase saving. On the other hand, matching might induce some people to reduce the amount that they put aside from their current income because the matching contributions will allow a given stock of wealth to be built up with lower own contributions. Whether overall saving by the target group would go up or down will depend on the relative sizes of these different effects. This will in turn be influenced by who is in the eventual Saving Gateway target group. An evaluation of the proposed pilots of the Saving Gateway might allow an assessment of the scale of these different effects.

A concern is that, since matching provides a strong financial incentive, some of the eligible population might find that it is worthwhile to borrow in order to take advantage of the government match even though they feel that they cannot afford to save from their income. This might not generate much saving because such account holders would have to use much of their final fund to pay off their debt. Such account holders also would not have to learn to constrain their consumption below the level of their income in order to save. For those who cannot borrow from a friend or family member, it would only be worthwhile to borrow to 'save' if the effective rate of return from matching is greater than the rate of interest on commercial loans.

Table 7.1 lists some effective rates of return from pound-for-pound matching over certain different durations of Gateway accounts. The calculations assume that the money paid into the account is paid in equally sized amounts each month for the duration of the account, and that zero real interest is achieved on funds held in the account. The latter assumption means that the figures in the table represent a lower-bound estimate of the interest rate at which it would be worthwhile to borrow to 'save'. The first row of the table gives the maximum annual rate of interest that would still make it worthwhile to borrow a lump sum when the Saving Gateway account is opened. The full value of such a loan would incur interest throughout the period of the account. The second row lists the rate of interest that it would be worthwhile to borrow at if a loan could be set up such that the funds were only received, and only started incurring interest, at the time when they were paid into the Saving Gateway account.

To clarify the difference between the figures in the two rows, it is helpful to consider a numerical example. Suppose that someone puts £10 into a Saving Gateway account each month for 18 months. At the end of the eighteenth month, the account would contain a total of £360. Half of this would be matching contributions and the remaining £180 would be own contributions. If the individual needed to borrow this money, then one method of doing so

[8] Paragraph 5.17 of HM Treasury, *Saving and Assets for All*, The Modernisation of Britain's Tax and Benefit System no. 8, London, 2001.

would be to borrow the entire £180 at the beginning of the 18-month period. This loan would then accumulate interest for 18 months. The value of the repayment required at the end of the eighteenth month would be £360 if the annual percentage rate at which interest was incurred were 59%. That is, it would be worthwhile to borrow in this way to save in the account if one could borrow at an annual interest rate of less than 59%. This is the meaning of the second figure in the first row of Table 7.1.

A shrewder way of borrowing the £180 would be to borrow £10 each month as it was required. This could be done by setting up a contract with a single provider agreeing to pay a series of £10 loans. The first loan would last and incur interest for 18 months. The second loan would be for the 17 months from month 2 until the end of the account. Each subsequent loan would be for one month's less duration, until the eighteenth and last loan, which would be taken out to make the final month's contribution into the Saving Gateway. Borrowing in this way at an annual percentage rate of 123% (the second figure in the bottom row of Table 7.1) would necessitate a repayment of £360 at the end of the eighteenth month. So, it would be worthwhile to borrow in this way to 'save' in the account if an annual percentage rate of less than 123% were available. It is because most of the funds borrowed incur interest for less than 18 months that borrowing by this method is worthwhile at higher interest rates than if the full amount is borrowed when the account is opened.

Table 7.1. Interest rates at which borrowing to save is worthwhile

	Number of months of contributions			
	12	**18**	**40**	**60**
Maximum annual interest rate at which it is worthwhile to borrow upfront	100%	59%	23%	15%
Maximum annual interest rate at which it is worthwhile to borrow month by month	224%	123%	45%	28%

Note: Assumes that: a zero real rate of return is received on the investment; matching is pound for pound; contributions are distributed evenly over the lifetime of the account. Rates of return are rounded to the nearest percent.

The above numerical example is based around an 18-month Saving Gateway account. This is the proposed duration for the pilot versions of the policy. In the table, we also consider a 40-month duration and a 60-month duration. Forty months is the time period required to accumulate the lifetime account limit of £1,000 of matching if £25 were saved each month. Sixty months (or five years) is the proposed maximum duration for accounts. The figure for one year is included to provide a benchmark for comparison. Since the latest proposal is that individuals would be able to access the government's matching contributions when 'the account matures i.e. after five years, once the total matching limit of £1000 has been reached, or *if the account is closed for good*, whichever is earlier',[9] it would seem that individuals might be able to choose to have accounts lasting for a short time period such as a year.

[9] Paragraph 4.19 of HM Treasury, *Delivering Saving and Assets*, The Modernisation of Britain's Tax and Benefit System no. 9, London, 2001 (italics added).

Borrowing to save over such a time period would be profitable even at extremely high interest rates.

The rates of interest at which people would be prepared to borrow to 'save' for the longer time periods are probably lower than would be offered by door-to-door loan sellers or loan sharks. On the other hand, if providers knew that Saving Gateway eligible individuals could profitably invest funds borrowed at an APR exceeding 40%, then this might be sufficient to encourage these lenders to offer loans at such interest rates to individuals who could prove their eligibility. The rates of return achieved over shorter time periods are more attractive and so the policy could provide some of what some commentators have referred to as 'loan shark lolly'.[10] Borrowing to 'save' might be more of a problem if individuals can choose to close their accounts before the 'Gateway period' ends. The fact that the pilot accounts will last for a shorter time than is envisaged for a national policy might make it difficult to assess how severe a problem there could be with borrowing to 'save', at least if the same match rate applies in the pilot scheme as would apply in the full policy. The ability to make this assessment could also be restricted if loan providers were prepared to introduce products to facilitate borrowing to 'save' in response to a large-scale national policy but not in response to the initial pilots.

How much is matching likely to cost?

The previous two subsections have discussed who might be eligible for the Saving Gateway and how they might respond to the incentives provided within the policy. These two factors will determine a major element of the cost of the policy: how much the government will have to pay in matching contributions. In this subsection, we consider this issue in more detail. We assume that the Saving Gateway takes the form described at the beginning of this section, with limits on matching of £25 each month and £1,000 over the lifetime of the account. Since we do not know exactly who will be eligible for the Saving Gateway, nor how they will respond to the policy, we provide a range of different costings reflecting different assumptions about which tax credits or benefits the Saving Gateway will be linked to and how much the eligible population will put into their accounts.

Three different eligible populations are considered. Each includes an estimate of the population of working-age adults that will be eligible for some WTC in 2003.[11] The estimate is that 1.7 million adults will be living in households eligible for this benefit. Our first set of costings assume that only these adults are eligible for Saving Gateway accounts. The second set of costings in Table 7.2 assume that the minimum age of 25 that will apply for the WTC will not apply for the Saving Gateway. It is interesting to consider this population

[10] 'Learning from the ILA disaster', *Financial Times*, editorial, 26 October 2001.

[11] The assumptions underlying this estimate are described in M. Brewer, T. Clark and M. Myck, *Credit Where It's Due? An Assessment of the New Tax Credits*, Commentary no. 86, Institute for Fiscal Studies, London, 2001 (www.ifs.org.uk/taxben/taxcred.shtml). At the time that that document was written, the credit now known as WTC was called the employment tax credit.

since there are reasons (discussed above) why it might be decided that young adults who are not in full-time education should be allowed to save in Saving Gateway accounts. Admitting the under-25s includes an extra 600,000 adults. The third and final eligible population again includes the under-25s and also includes the 2.5 million working-age adults who are in families receiving IS, alongside WTC claimants. Among those on IS, around 1.2 million live in households containing a disabled adult. This third eligible population is by far the largest that we consider and so gives rise to the highest costs for the policy. None of these hypothetical eligible populations includes pensioners. This is because it seems unlikely that pensioners will be able to save in Saving Gateway accounts, since the government has stressed that eligibility for the scheme might be linked to that for an existing 'tax-credit or working age benefit'.[12] As discussed above, pensioners might well be better supported via other policy tools.

Table 7.2. First-year costing for the Saving Gateway when eligibility is linked to receipt of the working tax credit or income support

Who is eligible?	Minimum age for families without children	Number eligible, million	% of maximum that is saved	Cost of policy in the first year, £bn
Adults in families projected to be eligible for some WTC	25	1.7	20%	0.1
			40%	0.2
			60%	0.3
			80%	0.4
Adults in families projected to be eligible for some WTC	None	2.3	20%	0.1
			40%	0.3
			60%	0.4
			80%	0.6
Adults in households projected to be eligible for some WTC plus working-age IS recipients	None	4.8	20%	0.3
			40%	0.6
			60%	0.9
			80%	1.2

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% of maximum saving is consistent with individuals saving full amounts and 80% take-up. This take-up rate is high compared with those for other means-tested benefits.
Sources: Estimated eligibility for WTC – M. Brewer, T. Clark and M. Myck, *Credit Where It's Due? An Assessment of the New Tax Credits*, Commentary no. 86, Institute for Fiscal Studies, London, 2001 (www.ifs.org.uk/taxben/taxcred.shtml). Estimated eligibility for IS – Department for Work and Pensions, *Income Support Quarterly Statistical Enquiries May 2001*, London, 2001.

For each eligible group, we offer four costs for matching paid within the policy. These costs correspond to those eligible saving enough to receive 20%, 40%, 60% or 80% of the total available matching contributions. If the policy is enacted, then how much matching is paid out will depend on how strongly eligible adults respond to the incentive to save. It is possible that matching will

[12] Box 4.1 of HM Treasury, *Delivering Saving and Assets*, The Modernisation of Britain's Tax and Benefit System no. 9, London, 2001.

be a strong enough incentive to encourage many among the eligible population to save in Saving Gateway accounts. If the eligible population contains many people who already hold assets that can be transferred into the accounts, or if borrowing to 'save' becomes widespread, then a high proportion of the total potential available matching payments are likely to be claimed. We provide the four different costings rather than making a judgement on how people will respond to the incentive because it is notoriously difficult to predict behavioural responses to financial incentives to save. When personal pensions were introduced in 1988, there were significant financial incentives to encourage take-up and the Department of Social Security underpredicted the number of people who would opt into the schemes by a factor of eight.[13] The difficulty of making predictions is likely to be increased in the case of the Saving Gateway because the eligible population might include many people with limited experience of financial institutions.

The range of costings listed in Table 7.2 is large, spanning from £100 million to £1.2 billion. It should be noted that these are costings for the first year of the policy, during which nobody among the eligible population has exhausted their matching limit. The cost of the policy might rise in its second and subsequent years as new households become eligible for the accounts while existing accounts are still active. This effect will be especially large if the government chooses not to disqualify people from eligibility on the basis of reassessments of means during the lifetime of an account. From the fourth year of the scheme onwards, this effect could be offset if savers begin to exhaust the proposed £1,000 ceiling on matching contributions paid into any single account. Over the longer term, the cost of the policy would decline if individuals were only eligible for one Saving Gateway account, as some individuals in lower-income families would have exhausted their eligibility.

The pilot versions of the policy might allow more accurate costings to be provided if they are evaluated sufficiently thoroughly to allow some assessment of how people respond to the incentive provided by matching. Knowledge of the exact target population would also allow for more precision. If the Saving Gateway were made available only to those who have just moved into employment and who are newly eligible for the WTC, then it would be less costly than any of the options considered in Table 7.2.

Should there be a single provider of Saving Gateway accounts?

The government believes that 'the Saving Gateway would probably be better suited to provision through a single provider than through a competitive market'.[14] This view is based on a perception, gleaned from the initial round of consultation, that the Saving Gateway market would not sustain a group of competing providers. The market will be relatively small and the accounts will have only a limited duration and are likely to contain low balances even though account holders might make large numbers of transactions. Provision

[13] Page 4 of R. Disney and E. Whitehouse, *The Personal Pensions Stampede*, Institute for Fiscal Studies, London, 1992.

[14] Paragraph 4.4 of HM Treasury, *Delivering Saving and Assets*, The Modernisation of Britain's Tax and Benefit System no. 9, London, 2001.

is especially unlikely to be profitable if providers have to bear some of the 'outreach' costs of informing potential account holders about the products, and if they have to meet some or all of the cost of providing information and education in conjunction with the accounts. Having a single provider would simplify State involvement in providing or regulating outreach and information and education services.

If the government wants to involve the private sector in providing the accounts, then there is a problem of how the single provider should be chosen. The government will have to consider the minimum level of financial education that it expects to be provided and the minimum rate of return on the accounts. If a competitive tender were to be run, then all bidders would have to satisfy the criteria chosen. The government could then choose the provider that promised to meet these criteria at the lowest cost, in order to minimise the size of any State subsidy, or it could choose on the basis of a judgement about which provider offered the best package to potential Saving Gateway account holders. It is not clear that the lowest-cost scheme would be the best, but it is also not clear what criteria could be used before the scheme is enacted to determine what the best package would be. Piloting of the policy might help to show what criteria could be applied.

Piloting the Saving Gateway

The government intends to set up three or four pilot versions of the Saving Gateway. These will be run in different locations and will each involve around 500 participants. The pilot accounts will run for 18 months. The aim of the pilot projects is to examine 'the practicalities of designing and delivering'[15] the Saving Gateway. Part of the focus of the pilots will be on how financial education should be delivered in conjunction with the accounts. This might be done by combining the Saving Gateway pilots with pilots of Community Finance and Learning Initiative schemes that are intended to get local organisations involved in tackling financial exclusion.

Piloting the policy is a good idea. The 18-month pilots should be used to assess how people respond to the incentives created by matching: will significant new saving and savers be created or will the transfer of existing assets and borrowing to 'save' be more prevalent? The pilot schemes will not last for long enough to allow an assessment of whether Saving-Gateway-style accounts can have a lasting effect on people's behaviour, which might improve the outcomes they achieve even after their accounts have been closed. It is important that the pilot schemes be fully evaluated, quantitatively and qualitatively, in order to ensure that they provide the best possible information on those issues that they can legitimately be expected to address.

Having four different schemes offers scope for examining how different variations on the design of the policy will affect the outcomes it achieves. However, having too many dimensions of variation would limit the ability to make inferences about design features from observation of these relatively small-scale pilots.

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[15] Paragraph 4.29of HM Treasury, *Delivering Saving and Assets*, The Modernisation of Britain's Tax and Benefit System no. 9, London, 2001.

Thoroughly evaluated pilot versions of the Saving Gateway should throw some light on whether or not the policy can achieve the effects that its proponents hope for. If it does not, then, instead of having a nationwide version of the policy, the money that this would involve could be spent on other policies.

7.2 The Child Trust Fund

A Child Trust Fund will be a savings account that will be set up for every child. The accounts will be set up when the government pays an initial contribution to each newborn child. The latest round of consultation proposes that the trust funds have the following features:

- All children will receive an account, but the endowment contributed at birth will be larger for children from lower-income families.
- The government will make further contributions to the accounts, possibly when the child reaches ages five, 11 and 16.
- It will be possible for the child or family and friends of the child to make supplementary contributions to the account. Up to some annual contribution limit, possibly of around £1,000, the growth of these contributions will be exempt from tax in a similar way to the method that applies to the growth of funds held in ISAs.
- Money held in the accounts can be invested in a wide range of vehicles, including equities.
- Neither the child nor the parent(s)/guardian(s) of the child will be able to access assets, including their own contributions, before the fund matures.
- The child will be given access to the funds at age 18.
- No restrictions will be placed on how the matured fund can be used.
- Financial education, including through the National Curriculum, will be integrated with the accounts.

The government wants the current round of consultation to focus particularly on whether the Child Trust Fund should be delivered via open competition or through a limited number of licensed providers. Later, we discuss some of the pros and cons of each of these modes of delivery, but first we consider some other issues that arise, given the proposed design of the Child Trust Fund.

Who will benefit from ISA-style tax relief?

It is proposed that family and friends of children should be able to make supplementary contributions to a Child Trust Fund. Up to some limit, returns on these contributions may be exempted from tax, as will withdrawals from the account. This tax treatment would be similar to that that currently applies to funds held in ISAs. Such tax relief is of no value to an individual whose income is so low that they pay no tax. It is most valuable to higher-rate taxpayers, who would be exempted from 40 pence of tax on each pound of returns accruing to their Child Trust Fund investments. Families who are

choosing to exhaust their ISA limits might particularly welcome being given extra tax relief via a Child Trust Fund account.

As well as giving ISA-style tax relief, the current proposal for the Child Trust Fund suggests that all funds placed in accounts will be locked away until the account matures. This means that funds placed in a Child Trust Fund will be less liquid than funds in an ISA. Families looking for tax-efficient savings vehicles would be well advised to exhaust their ISA contribution limits before using Child Trust Fund contributions. Even if they intend to earmark the saving for their children, saving in an ISA might be preferred to contributing to a Child Trust Fund because the ISA funds can be accessed at a time of unforeseen need. The Child Trust Fund would be preferred by parents who have not exhausted their ISA limits only if they value the forced commitment of this account. Friends and relatives other than the parent(s) of the child who want to give financial gifts for when the child grows up would welcome tax relief which will ensure that the value of any payment made is not eroded by tax. They might also like the fact that the assets in a Child Trust Fund are locked away so that neither the child nor his/her parents can spend the money before the date at which it is intended that it be received.

It is predominantly adults in richer families who will have exhausted their ISA limits. Even if parents who have not exhausted these limits save in Child Trust Fund accounts, it will generally be richer parents, many of whom save already, who will make the largest contributions. Therefore, both because they are saving the most and because the tax exemption is worth the most to them, it will be richer families who will gain the most from ISA-style tax relief on contributions to Child Trust Fund accounts. This might lead some to argue that giving ISA-style tax relief to contributions would continue the trend of having policies to encourage saving and asset holding that give 'help to the wrong people'.[16]

On the other hand, ISA-style tax relief can be seen as removing a distortion that is a disincentive to save, rather than as a tax perk to the already rich. At present, savings in interest-bearing accounts are typically taxed in two ways. The initial deposits are made from income that has usually already been taxed, and any interest accruing to the saved asset is also taxed. This second tax reduces the return received on savings compared with a regime in which taxation only occurs at the first point. Income that is spent immediately is only taxed at this first point. This means that the tax system creates a distortion that encourages spending, rather than saving, from current income. ISA-style exemptions from tax for interest income remove this distortion. Extending the principle of ISA-style exemptions via Child Trust Fund accounts might therefore be seen as a welcome step that further erodes a disincentive to save that is created by the tax system.

It might still be argued that poorer families would need stronger incentives to save in Child Trust Fund accounts. Tax relief will not tackle the disincentive problems faced by these families due to asset income disqualifying them from benefit receipt. Even if it is a good idea to provide stronger incentives to save

[16] G. Kelly and J. Le Grand, 'Special report: assets for the people', *Prospect Magazine*, December 2001, p. 52.

to some poorer households, the Child Trust Fund does not seem the appropriate tool for doing this. Providing positive incentives via the Child Trust Fund would distort choices between saving in this form or in an ISA or a private pension such as a stakeholder pension.

Is the progressive element worth it?

The arguments of the previous subsection imply that it would be the children of richer parents who would tend to have the largest mature Child Trust Fund accounts. The fact that richer families might be the most financially literate and the most willing to bear risk could mean that they invest their Child Trust Funds in assets that realise high returns, which would accentuate this tendency. The proposal that government contributions to the accounts will depend inversely on family income would have an offsetting effect. This might help the policy to achieve the aim of 'widening opportunity'[17] for young adults from poorer households.

The problem with attempting to equalise opportunity by having a means-tested element of the Child Trust Fund is that the targeting achieved might not be very accurate. It seems likely that the largest part of the means-tested element of the government's contribution will be paid at the time when the child is born.[18] Evidence published in a recent IFS Commentary[19] suggests that a means test conducted at this time might not accurately capture how well off a child's family will be throughout the child's upbringing. It is difficult to argue that family income at a child's birth significantly limits opportunities in early adulthood in a way that is better corrected by giving an asset to the child rather than by supplementing family income or by giving the child financial assistance at age 18 that depends on circumstances at that time.

Having the means test at birth determine the size of the largest chunk of the fund would also create certain anomalies. For example, two siblings born a year or two apart could have very differently sized funds simply because the family's circumstances had changed a little. This could seem unfair to the children.

Means testing of contributions to the Child Trust Fund would more accurately capture family income throughout the child's upbringing if means-tested contributions were paid regularly during the early part of the child's life. On the other hand, the extra payments and means testing would add to the administrative costs of the policy. The scheme as currently envisaged does not necessarily offer the best solution to this trade-off between administrative cost and accurate targeting. If it is enacted, then it is possible that the means testing

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[17] Paragraph 5.2 of HM Treasury, *Saving and Assets for All*, The Modernisation of Britain's Tax and Benefit System no. 8, London, 2001.

[18] Chapter 5 of HM Treasury, *Saving and Assets for All*, The Modernisation of Britain's Tax and Benefit System no. 8, London, 2001.

[19] C. Emmerson and M. Wakefield, *The Saving Gateway and the Child Trust Fund: Is Asset-Based Welfare 'Well Fair?'*, Commentary no. 85, Institute for Fiscal Studies, London, 2001 (www.ifs.org.uk/pensions/abw.pdf), pages 34–8 of which discuss these issues in much more detail.

will add to administrative costs without successfully targeting the policy towards those that the government wants to help the most.

Competition or licensed providers?

The government has requested that the current round of consultation focuses on the issue of how the Child Trust Fund market is organised. The two options under consideration are open market competition or a limited number of licensed providers (probably five to ten) chosen by competitive tender.

If the route of licensed providers is chosen, then issues such as how funds charge and how information and education are integrated with accounts could be specified in the terms of licences.

If competition is preferred, then regulation of charging and the provision of information might be necessary. If it were thought that competitive pressures would be sufficiently strong to keep charges low, then regulation might still be used to ensure that charging operates on a comparable basis in different funds, to aid the transparency of competition. Such regulation could operate in a similar way to that in the stakeholder pension market, where only funds that satisfy certain criteria concerning (amongst other factors) how and how much they charge can be declared as 'stakeholders'. This might be seen to be overly restrictive in the case of Child Trust Funds because an alternative form of provision analogous to non-stakeholder personal pension provision does not exist. Therefore a system of benchmarking, which gave the parent(s) a choice between marked or unmarked products, might be preferred. This could operate in a similar way to the 'CAT marking' of some ISAs. CAT-marked ISAs must meet a voluntary benchmark on *C*harges *A*ccess and *T*erms.[20] Ensuring that Child Trust Funds operate in a way that is similar to the way in which ISAs and stakeholder pensions operate would mean that the information that youngsters learn about financial products by being fundholders would be likely to be useful to them in later life.

Comparing the two possible methods of organisation, the biggest advantage of licensing would be that it might make the eventual Child Trust Fund market simpler to understand if it means that there are fewer providers than would be the case in a competitive market.[21] This would make it easier for new parents to choose which provider to invest their child's account with. Indeed, the choice could almost become a 'tick box' feature of the child benefit application procedure. Such simplicity might be particularly welcomed by those new parents who are not familiar with financial products, and these might be concentrated in low-income families. A simple market might also make it easier to organise default provision for accounts where parents do not make a choice for their child: it might be possible to divide such funds amongst the licensed providers rather than requiring that the State provide an extra default option.

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[20] For more details, see Financial Services Authority, *FSA Guide to ISAs*, London, 1999.

[21] Although the Child Trust Fund market will be much smaller than, for example, the market for personal pensions and so might not support (many) more providers than the envisaged number of licensees.

A licensed market would still have some competition for customers between providers. If licensing acted as a restriction on the number of providers, then it is possible that this competition would be less effective in delivering the best accounts to fundholders than would open competition. The effectiveness of competition among licensed providers might also depend on how the competitive tender to enter the market had operated. If the funds promising the lowest charges won the tenders, then it might be that half a dozen or so basic and very similar accounts were provided. These might not be suitable for some individuals in the market. On the other hand, it is not clear that the government or a market regulator could pick the best accounts from a more complex 'beauty contest' organised before the market begins to operate. For this reason, free entry might be preferred.

In sum, it seems that the main advantage of a system of licensing is that it might result in a simple market. Free competition might promote a better range of products to meet the needs of customers in the market.

7.3 Conclusion

The latest round of consultation on asset-based welfare policies focuses on detailed design issues: how pilot versions of the Saving Gateway can be used to test practical elements of the design of a nationwide policy, and on how to organise the market for a nationwide Child Trust Fund.[22] It seems very likely that the policies will be rolled out nationally, and it has been argued that they will form a good complement to existing welfare policies.[23] Increased spending on traditional forms of welfare provision or State-provided services would also complement existing provision. It is not clear that spending on matched savings accounts represents a better way of supporting lower-income families than would using the same funds to increase benefit expenditures or to pay for more financial education. Equally, it is not clear that children from low-income families will be better supported by being provided with an asset that grows through their childhood, rather than by targeted increases in financial support to their families or by targeted education spending. Prior to considering design issues, it would have been useful to have had a stage of the consultation process that invited comments on whether the new policy direction that is asset-based welfare is a good one to take.

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[22] Paragraphs 4.26 and 3.22 of HM Treasury, *Delivering Saving and Assets*, The Modernisation of Britain's Tax and Benefit System no. 9, London, 2001.

[23] Paragraph 1.2 of HM Treasury, *Saving and Assets for All*, The Modernisation of Britain's Tax and Benefit System no. 8, London, 2001; W. Paxton, 'Assets: a third pillar of welfare', in S. Regan, (ed.), *Assets and Progressive Welfare*, IPPR, London, 2001.