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Precautionary tales

Tackling the problem of low saving among UK households

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The Resolution Foundation joined the abrdn Financial Fairness Trust to embark on a major investigation into the role of wealth in 21st century Britain. This Wealth in Focus is the first output in a new four-year project. The abrdn Financial Fairness Trust's mission is to contribute towards strategic change which improves financial wellbeing in the UK. Its focus is on tackling financial problems and improving living standards for those on low-to-middle incomes. It is an independent charitable foundation.

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Executive summary

Whether to cushion the shocks that life throws at us or to provide for ourselves in retirement, millions of UK families don't save enough. This widely recognised problem manifests in three distinct ways: a lack of accessible liquid savings to cushion small cashflow shocks, inadequate precautionary saving to see people through large and unexpected income shocks, and insufficient saving to provide an adequate income in retirement.

This report shows how the UK's savings policy architecture can be transformed to provide a joined-up solution to these three interconnected problems. In doing so, we draw on behavioural insights and lessons from how other countries navigate the same issues. As well as providing a concrete path towards financial security throughout the lifecycle, the integrated system outlined here can also generate the resources to finance some of the higher investment required to end the UK's economic stagnation.

British families don't save enough

Britain's dearth of savings leaves millions of families exposed to economic shocks and hardship. Despite overall improvements in household balance sheets since the onset of the pandemic, the UK still has a long-standing problem of remarkably low precautionary savings. As many as 1-in-3 (30 per cent) of working-age adults live in families with savings below £1,000, leaving them financially vulnerable and ill-equipped to respond to financial shocks. Unsurprisingly it is low-income families that are more likely to have inadequate precautionary savings: 45 per cent of those in the bottom third of the income distribution had savings below £1,000 compared to just 18 per cent of those in the top third of the income distribution.

The consequences of this vulnerability became clear during the cost of living crisis, during which those with low precautionary savings were more susceptible to volatile consumption, problem debt and poor mental health. For example, people with savings balances below £1,000 were more than twice as likely as those with more savings to have used credit cards, overdrafts, or borrowed money from formal lenders to cover daily living expenses between July and October last year (46 per cent compared with and 18 per cent respectively). Similarly, 15 per cent of those with savings below £1,000 reported that they had missed a payment on one or more priority bills between July 2023 and October 2023, three times the proportion of respondents with savings of £1,000 or more (5 per cent).

There is a strong association between financial vulnerability and health and wellbeing. Those with low savings were around three times more likely to report that their mental health was poor compared to those with larger savings: nearly a third (32 per cent) of adults with savings below £1,000 reported poor mental health in October 2023, compared to just over one-in-ten (11 per cent) among those with savings over £1,000. These differences remain even when controlling for other characteristics that are typically associated with mental health outcomes. Furthermore, qualitative evidence also highlights the anxiety that people report as a result of having low savings and debt.

Small savings pots offer some level of financial resilience, but they are unlikely to be sufficient to help people cope with bigger shocks, such as a prolonged spell of unemployment, relationship breakdown, illness, or bereavement. Around 300,000 people move from employment to unemployment every three months even during times of economic stability. In these situations, having limited precautionary savings carries severe consequences, especially considering the UK's low levels of out-of-work benefits: basic unemployment support is worth just 14 per cent of average earnings. As a result, around 40 per cent of those in employment experience an income loss of 20 per cent or more from one year to the next when becoming non-employed in the UK. Larger precautionary savings balances would help people cope with bigger shocks, but the country's savings shortfall is significant. If every working-age family in Britain had at least three months' income in precautionary savings, aggregate savings would be £74 billion higher.

But it is not only in accumulating precautionary savings that British families fall short: saving for retirement is also too low. 39 per cent of individuals aged 22 to the State Pension age (equivalent to 13 million people) were undersaving for retirement when measured against target replacement rates (TRRs), after housing costs (AHC), in 2023. More alarmingly, over half (51 per cent), or 17.7 million people, are projected to have a pension income below the Pension and Lifetime Saving Association (PLSA) moderate Retirement Living Standards (RLS).

All this highlights that there are three distinct savings challenges facing the UK. First, millions of families are not saving enough to manage minor levels of income volatility. Second, families tend to lack adequate precautionary savings to cushion against substantial financial shocks. And third, current pension saving rates indicate that a large number of people aren't saving enough to ensure a comfortable retirement.

The policy response to low savings has had mixed success

Recognising the widespread issue of low savings, successive governments have implemented various policies to address it. Policies to boost precautionary saving have largely involve fiscal incentives, such as tax breaks or bonuses based on account balances. These policies are expensive, exceeding £8 billion in 2023-24, and they disproportionately benefit wealthier households, with households in the highest tenth of the income distribution receiving around 10 times more from tax advantages and direct transfers per year than households in the poorest fifth. Furthermore, there is little evidence that that they boost savings among those most financially exposed.

Recent work shows that behavioural interventions could be far more effective at addressing the UK's precautionary savings problem. Nest Insight's New Worker Trial tested an 'opt-out' approach to workplace payroll saving. An auto-enrolment approach significantly boosted participation in saving, with an impressive 47 per cent of employees saving via the scheme, compared to just 1 per cent under similar 'opt-in' schemes. This suggests that getting serious about boosting precautionary saving means shifting the policy emphasis away from financial incentives and putting behavioural framing at the heart of the strategy.

Concrete evidence that behavioural interventions can raise saving levels can also be seen through pension auto-enrolment. Since its introduction, pension coverage has been transformed, the proportion of employees with a pension climbed from 47 per cent in 2012 to 79 per cent in 2021 – an extraordinary policy achievement.

But, although the pension reforms of the past 20 years have revolutionised coverage, saving rates remain inadequate if people are to be confident of achieving a decent standard of living in retirement. On reasonable assumptions, a median earner saving at the default contribution rate is unlikely to achieve the target income replacement in retirement of two thirds of final salary that was advocated by the Pensions Commission. How should policy evolve to address saving inadequacy?

A piecemeal approach could exacerbate the problem

With a successful framework for raising pension saving starting to mature, there is an obvious solution to improving the adequacy of retirement saving through increasing default contribution rates beyond the current 8 per cent.

However, there are two significant risks associated with increasing default pension contributions rates. First, there is the risk that opt-out rates could jump in the face of significantly higher contributions, potentially undermining the system. Evidence from the rollout of auto-enrolment, when employee contributions rose from 1 per cent to 5 per cent, and the experience of the cost of living crisis, gives grounds for optimism, however. Opt-out rates have remained low even as contributions increased and pressure on household finances mounted, suggesting a considerable degree of inertia in pension-saving behaviour. From April 2014 to March 2023, an average of just 2.7 per cent of employments stopped saving each month due to an active decision, non-eligibility, or the end of employment. In 2022-23, this remained broadly unchanged at 3 per cent. On the other hand, it would be unwise to assume that inertia would continue to dominate when asking people to lock away a significantly higher proportion of their incomes, particularly in the context of a stagnant outlook for wage growth.

The second, perhaps even more pressing risk, from raising the default pension contribution rate is that it would exacerbate the inadequacy of precautionary savings, leaving households even more financially exposed. In the absence of real income growth, an additional pound saved into a pension has to be funded either from reduced consumption or lower precautionary saving (or higher debt). Evidence from the rollout of auto-enrolment indicates that when default contribution rates were increased from 2 per cent to 8 per cent between April 2018 and April 2019, the primary impact was to reduce precautionary saving. For every £1 reduction in take-home pay due to higher pension contributions, employees reduced their consumption by 34p, with the rest of the contribution funded through either lower liquid saving or higher debt. However, people within the bottom third of the distribution of savings deposit balances tended to adjusted their spending much more, with up to three quarters of the reduction in take-home pay being matched by lower spending.

The UK has an unusually illiquid private pension system

This evidence highlights that precautionary and pension saving are intertwined, yet policy has treated them as separate objectives. This has resulted in the UK's highly illiquid pension system, which creates a tension for savers forcing them to choose between current consumption, saving for precautionary purposes and saving for retirement. However, there are ways to alleviate this tension so that more pension saving does not lead to less precautionary saving or more debt.

The UK is not the only country wrestling with the trade-offs between precautionary and pension (or lifecycle) saving. We can do better in helping people to navigate these trade-offs by learning from the experience of other similar countries. Among countries with comparable social safety nets, the UK is unusual in the inflexibility of its pension system, under which savings can only be accessed (without incurring a substantial charge) at age 55 (increasing to 57 by 2028) except in cases of terminal illness. By contrast, other countries alleviate the tension between precautionary and pension saving by allowing early access to pension savings under a variety of conditions so that they can also act as a precautionary savings vehicle.

A particularly common form of flexibility – found in the US, Australia, New Zealand, South Africa and Canada – is to allow early pension withdrawals in cases of financial hardship. For example, savers in the New Zealand system – KiwiSaver – can access their pension savings if they can provide evidence of an inability to afford 'minimum living expenses', mortgage repayments, medical bills or some other situations. Around NZD 140 million was taken in respect of hardship claims in 2022-23, equivalent to less than 2 per cent of contributions. Similarly, in the Australian Super, people can access up to AUD 10,000 in a 12-month period on grounds of financial hardship if they have been claiming benefits for at least 26 weeks and are struggling to meet reasonable household expenses. Canada's pension rules also allow withdrawals of up to CAD 34,250 from voluntary pension schemes when people face a substantial drop in income, with the withdrawal amount scaled to the size of the person's income shock.

Some countries also see long-term saving vehicles as part of a broader system for asset accumulation, in particular to help people buy a home. In New Zealand, around NZD 1 billion, approximately 10 per cent of total contributions, was withdrawn by first-time buyers in 2022-23 to put towards their deposit. In South Africa, people are allowed to secure a loan to fund their deposit on a house against their pension savings.

The US and South African systems provide even more liquidity, allowing savers to access their pensions for any reason. For example, in the US, people can access their 401(k) pension savings at any time by paying tax on the money drawn down, along with a 10 per cent penalty. Alongside outright withdrawals, most savers can take a loan from their 401(k) of up to 50 per cent of their savings up to USD 50,000 for any reason and without incurring a penalty so long as the money is repaid. This year, South Africa will implement a 'two pot' savings regime, where one third of contributions will go into a more liquid 'savings pot' allowing savers to make one withdrawal per year for any reason, while the rest goes into an illiquid pension scheme.

A key takeaway from looking at these countries is that all provide some form of flexibility around pension savings to help meet precautionary needs during working life. Of course, a drawback to allowing hardship withdrawals is that they inevitably deplete an individual's retirement fund, and legislation in some of these countries therefore sets a high bar to accessing funds for such purposes, limiting their utility for that purpose. The alternative is to allow pension fund loans under a broader set of circumstances, but with mandatory repayment, as in the US system. This provides a compelling alternative: by substantially reducing the risk of smaller pension pots and therefore the need for qualifying restrictions that hardship withdrawals typically demand, loan facilities can effectively balance the demands of precautionary and lifecycle saving.

Greater liquidity in the long-term saving regimes of these countries therefore helps people through difficult times, but it can also aid macroeconomic stabilisation at the economy-wide level. During the Covid pandemic in the US, the CARES Act allowed people to access up to USD 100,000 of their 401(k) savings without penalty if they were directly affected by Covid, and maximum loan size was also doubled; around 6 per cent of eligible participants took advantage of this flexibility. Similarly, in Australia, savers who were unemployed or lost work as a result of the pandemic were allowed to withdraw up to AUD 20,000 in two tranches between April and December 2020. Uptake of the scheme was substantial, with 3.5 million (typically younger) Australians withdrawing a total of AUD 36.4 billion under the early access scheme in 2020 – equivalent to around 2 per cent of GDP and around 1 per cent of assets under management, generating a significant macroeconomic stimulus.

The UK's illiquid pension systems contrasts sharply with these international examples, forcing people into a trade-off between precautionary and long-term saving. This rigidity seems unlikely to be optimal given the degree of limited precautionary savings held by British families. The flexibilities found in other countries, together with recent innovation both here and in the US, offer insights into how the UK's savings policy could evolve to help boost retirement saving while also making British families more financially resilient in the short term.

A new, cohesive savings strategy would provide protection against cashflow volatility and large infrequent income shocks

The intertwined nature of the UK's triple savings problem requires an integrated solution. Efforts to increase pension saving under the current policy regime risk exacerbating the inadequacy of household precautionary savings, leaving more people exposed to financial shocks. A more flexible savings policy architecture can instead raise households' financial resilience across the lifecycle. We propose a three-step reform plan to achieve this.

First, once currently planned reforms to auto-enrolement are implemented – that is, extending auto-enrolment to begin from the age of 18 and eliminating the lower earnings limit – the government should articulate a medium-term objective to raise the default pension contribution rate.

The sharp rise in rates of return on long-dated bonds (and, by implication, equities) since 2022 has substantially boosted anticipated replacement rates for people saving at the current default of 8 per cent. However, for a typical earner, the default contribution is still unlikely to achieve the target income replacement in retirement of two thirds of final salary, as advocated by the Pensions Commission, even on those higher returns. Moreover, the outlook for rates of return is hugely uncertain. In previous work we have advocated increasing the default contribution rate to 12 per cent over time to ensure adequate retirement saving, but that level should be sensitive to the returns environment at that point.

Second, these higher default contributions can pave the way for greater liquidity without undermining pension saving. To do this, we propose to draw on the example of reforms to US 401(k) schemes under the 2019 SECURE 2.0 Act, as well as the success of the Nest Insight opt-out payroll savings experiment, to integrate emergency saving into the existing auto-enrolment framework. Specifically, we propose that 2 percentage points of the higher default pension contribution should initially flow into a highly-liquid 'sidecar' savings account with no restrictions on its use. Any balance above £1,000 would roll over into the employee's pension, attracting tax relief at that point. This would create an accessible pool of savings to allow people to manage cashflow shocks without drawing on high-cost forms of borrowing.

A sidecar savings scheme can help households to manage limited cashflow volatility, but giving people access to the resources to cushion large, infrequent shocks requires a third reform. We propose that people be allowed to borrow the lesser of £15,000 or 20 per cent of their pension pot value, on condition of mandatory earnings-contingent repayment to their own retirement fund, with interest to reflect the forgone growth. In the US, pension fund loans are widely used: between 30 and 50 per cent of plan participants use a loan at some point over a seven-year period, largely to manage income shocks from unemployment or costs associated with family breakdown, with a median loan size being the equivalent of around £4,000. Repayment rates are high, with 90 per cent of borrowers repaying their loans without significantly reducing their ongoing pension contributions. Introducing a similar reform to the UK would allow people flexible access to significant resources in a way that would neither jeopardise their long-term pension savings nor leave them reliant on high-cost credit.

Taken together, these reforms would boost household financial resilience, help optimise their lifetime resources and, in the absence of dedicated unemployment insurance, help to improve the functioning of the labour market by allowing people to find jobs that better match their skills. What's more, they would contribute higher savings to boost investment and growth while also acting as a mechanism to aid macroeconomic stabilisation in times of economic volatility. It is time to take a broader view of the role of savings policy for the 2030s, and begin to chart a course towards an integrated savings regime that can help to boost not only resilience but also prosperity.

Section 1

Introduction

Britain doesn't save enough. For starters, many families simply don't have enough precautionary savings – the 'rainy-day' buffers that mean a drama doesn't turn into a crisis. Meanwhile, it's clear that pension saving is not sufficient to provide a good standard of living in retirement. The inevitability of retirement means that the need for such 'lifecycle' saving is obvious and has been prioritised by policy makers. This is not least because the costs of insufficient pension saving will be borne by the state. As a result, concerted cross-party policymaking, spanning more than two decades, has begun to address pension adequacy, with auto-enrolment revolutionising the way we provide for retirement. There is, nevertheless, further to go before the majority of people are on course for an adequate retirement income.

Conversely, the challenge of unpredictable shocks to household finances during working life has received much less attention, despite the risk of significant hardship when such shocks hit. Policymaking in this area has been spinning wheels, using the same expensive, and largely ineffectual, financial incentives to try boost precautionary saving with limited effect on those who are most in need of them.

This report argues that precautionary and pension saving goals are inextricably linked, given that people have to make choices between consuming today, saving for precautionary purposes, and saving for retirement. Failing to address these challenges together risks unbalancing saving behaviour – solving one issue while exacerbating another. With this in mind, this report articulates a strategic vision for the UK's savings policy architecture that considers these interactions in the round and sets out a radical agenda for change.

The report is structured as follows:

- We begin by exploring the UK's triple savings challenge of insufficient 'rainy day' savings, an inability to cope financially with bigger life events, and inadequate retirement incomes.

- In Section 3, we take stock of the variety of policies that have been implemented to address the UK's savings challenges.
- In Section 4, we outline the direction of travel for auto-enrolment contribution rates. In doing so we draw out the tension between precautionary and pension saving goals in the current policy framework.
- Section 5 explores how other comparable countries navigate the tension between precautionary and lifecycle saving by allowing for greater liquidity in their pension systems.
- Finally, in Section 6 we draw on these insights to propose an integrated model that resolves the tensions between precautionary and pension saving, and offers a comprehensive vision of savings policy in the 2030s.

Section 2

Millions of families in Britain don't have enough savings

The UK has a 'triple' savings challenge of insufficient 'rainy day' savings, an inability to cope financially with bigger life events, and inadequate retirement incomes.

Indeed, despite household balance sheets improving on aggregate in recent years, Britain still has alarmingly low precautionary savings. As many as 1-in-3 (30 per cent) of working-age people in Britain live in families with savings below £1,000. This leaves them financially vulnerable, without the buffers needed to cope with unexpected financial shocks.

This vulnerability has been made clear throughout the cost of living crisis, as individuals with even modest savings balances have been better able to avoid volatile consumption, problem debt and poor mental health. For example, 18 per cent of those with savings above £1,000 reported using credit cards, overdrafts, or borrowing money from formal lenders to cover daily living expenses between July 2023 and October 2023, this was less than half the proportion of those with savings balances below £1,000 (46 per cent).

While small savings pots offer some level of financial resilience, they are unlikely to be sufficient when people are faced with bigger shocks, such as prolonged unemployment, relationship breakdowns, illness, or bereavement. Taking unemployment as an example, having minimal precautionary savings during periods of job loss poses significant challenges, particularly given the UK's meagre out-of-work benefits. Consequently, around 40 per cent of employed people experience an income loss of 20 per cent or more from one year to the next when becoming non-employed in the UK.

It's not just precautionary saving that British families don't do enough of: saving for retirement is also too low. Analysis of future pension incomes reveals that 39 per cent of working-age individuals (equivalent to 13 million) are undersaving for retirement when measured against Target Replacement Rates (TRRs) After Housing

Costs in 2023. More alarmingly, over half of the population (51 per cent), amounting to 17.7 million people, are projected to have a pension income below the Pension and Lifetime Saving Association (PLSA) moderate Retirement Living Standards (RLS).

Low savings buffers leave many families vulnerable to economic shocks

Having money set aside in the form of a liquid financial buffer is at the heart of financial resilience. While the appropriate savings level varies based on individual circumstances, a range of benchmarks have been suggested. StepChange, the UK's largest debt charity, aims to enhance financial resilience and diminish problem debt by ensuring that all families have minimum savings of at least £1,000 to help them cope during a 'rainy day'.[1] This follows research which found that, for a household with an average net annual (regular) income of £25,000, the likelihood of problem debt is estimated to be 44 per cent lower if the household has cash savings of £1,000.[2] Others suggest maintaining an emergency fund of three to six months' worth of living expenses.[3] This provides families with the capacity to cope with more substantial financial shocks, such as unemployment, illness, or relationship breakdown.

On the whole, household balance sheets have improved in recent years. During the pandemic, there was an unprecedented surge in household saving, accompanied by substantial debt repayments. However, as previous research shows, the majority of these improvements were experienced by higher-income households – those that were already more likely to have higher precautionary savings. In contrast, lower-income households were more likely to see minimal, or negative, changes to their family finances. For example, 21 per cent of those in the lowest-income quintile reported a rise in savings during the pandemic, whereas 27 per cent said savings had fallen.[4] As a result, despite an aggregate rise in savings during the pandemic, Britain still faces a critical issue of alarmingly low precautionary savings balances.

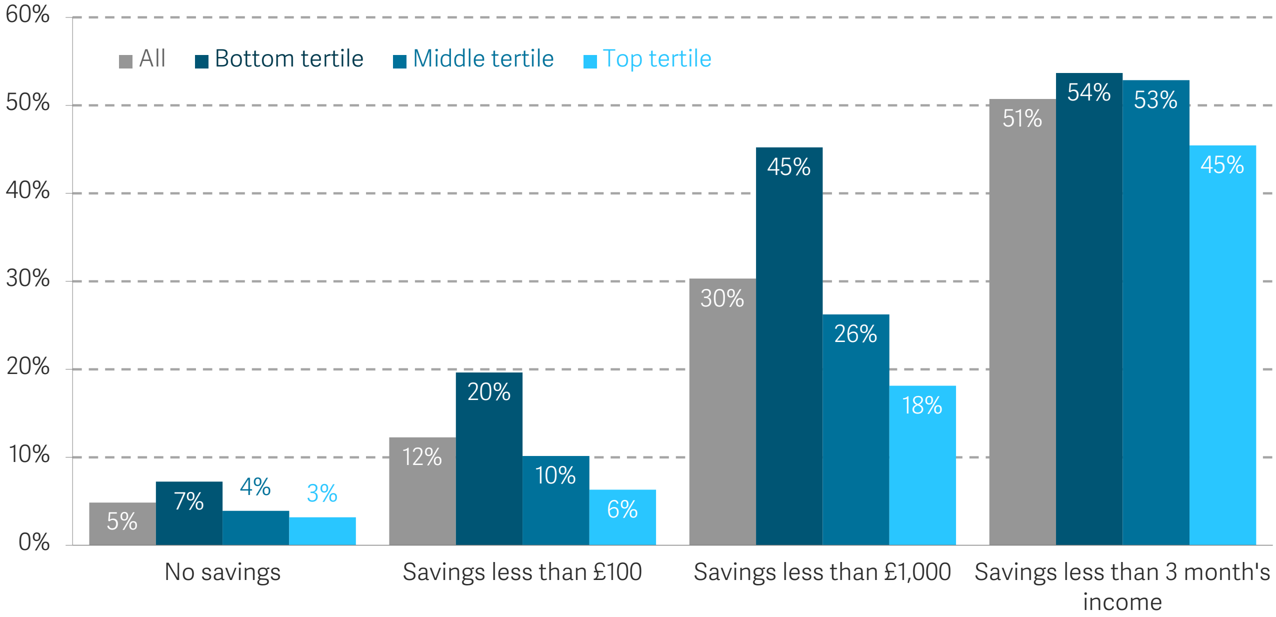
Figure 1 shows that 1-in-3 (30 per cent) of working-age adults lived in families with savings of less than the £1,000 recommended by StepChange, and over half (51 per cent) had less than three months income in savings in 2018-20. Astonishingly, around 5 per cent of working-age adults in Britain, approximately 1.8 million individuals, lived in families with no savings at all. As might be expected, Figure 1 also highlights that low-income families

1 StepChange, Becoming a nation of savers: Keeping families out of debt by helping them prepare for a rainy day, 2015.
2 StepChange consider those that find it difficult to make payments to their creditors as having debt problems. StepChange, An action plan on problem debt: How the next UK Government can reduce the £8.3 billion social cost of problem debt, 2015.
3 Money Helper, Emergency savings – how much is enough?, accessed 2 February 2024.
4 M Broome, I Mulheirn & S Pittaway, Peaked interest?: What higher interest rates mean for the size and distribution of Britain's household wealth, Resolution Foundation, July 2023.

are disproportionately prone to having inadequate financial resilience. For example, 45 per cent of those in the bottom third of the income distribution had savings below £1,000 compared to just 18 per cent of those in the top third of the income distribution.

FIGURE 1: **Many families in Britain are ill-prepared for a financial shock**

Proportion of working-age people living in families with savings below a given threshold, by income tertile: GB, 2018-20



NOTES: Savings and income measured at the benefit unit level. Savings defined as current accounts in credit, value of savings account, value of ISAs and value of national savings products. Savings thresholds are cumulative, so 'savings of less than £1,000' also includes those with savings of less than £100.
SOURCE: Analysis of ONS, Wealth and Assets Survey.

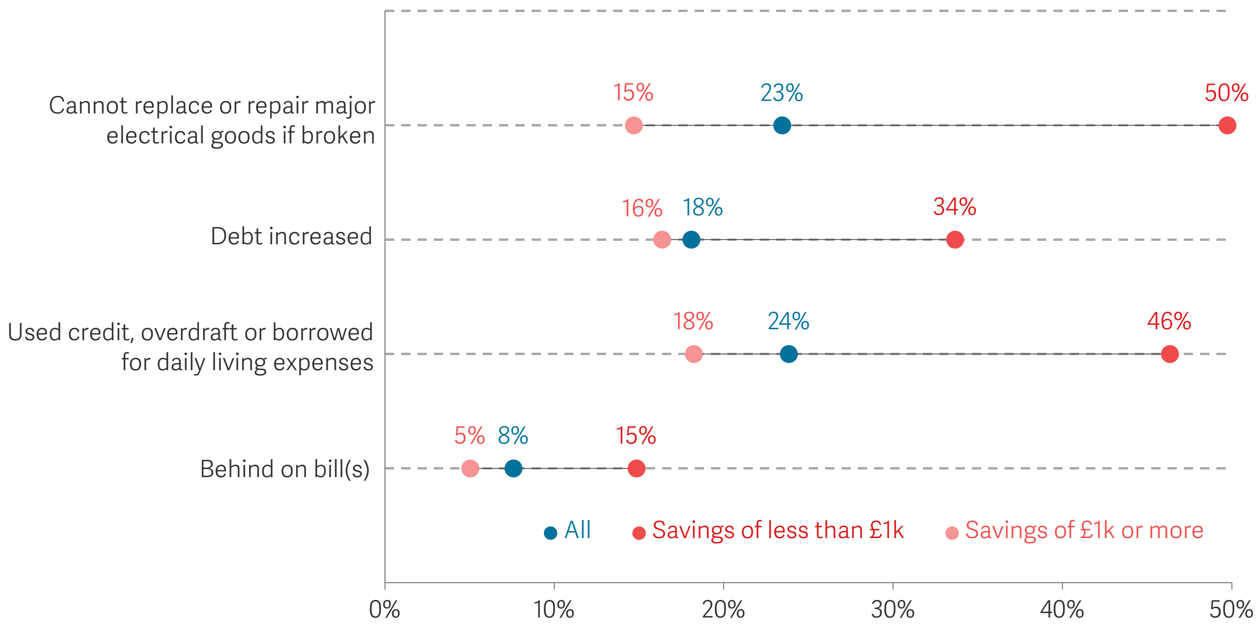
The cost of living crisis has demonstrated the importance of savings buffers

The consequences for families of this financial insecurity, volatile consumption, problem debt and poor mental health, have been made clear during the cost of living crisis. As shown in Figure 2, for example, those with more substantial savings buffers are better equipped to respond to unexpected expenses: 23 per cent of all respondents reported that they would not be able to replace or repair a major electrical good, such as the fridge or washing machine, if it broke. However, this proportion more than doubled to 50 per cent for those that had savings below £1,000.

Those with less precautionary savings were more likely to have accumulated debt during the cost of living crisis. Figure 2 shows that over a third (34 per cent) of adults with savings below £1,000 reported an increase in debt between October 2022 and October 2023, compared to 16 per cent among those with savings exceeding £1,000. Additionally, almost half (46 per cent) of those with savings below £1,000 resorted to using credit cards, overdrafts, or borrowing money from formal lenders to cover daily living expenses between July 2023 and October 2023 – this was more than twice the proportion of those with savings above £1,000 (18 per cent). Finally, respondents with smaller savings buffers were more likely have fallen behind on priority bills. Among those with savings below £1,000, 15 per cent reported that they had missed a payment on one or more priority bills between July 2023 and October 2023. This was three times the proportion of respondents with savings of £1,000 or more (5 per cent).[5]

FIGURE 2: **Having savings sheltered people from the worst of the cost of living crisis**

Percentage of respondents that reported the following outcomes, by savings thresholds: UK, 13-17 October 2023



NOTES: All respondents (n= 8378), savings of less than £1,000 (n= 2052), savings of £1,000 or more (n= 3911).
SOURCE: RF analysis of YouGov, Cost of Living Crisis October 2023 wave.

There is also clear evidence that having little or no savings is linked to worse health outcomes. For example, during the pandemic, people with mental health problems were more likely to have had no savings to help them cope with emergencies: 1-in-4 people with mental health problems said they had no savings that they could use in emergencies, compared to 18 per cent of the wider population.[6] Moreover, the Money and Pensions Service found that people unable to save regularly were less likely be satisfied with their life nowadays compared to their regularly saving counterparts (25 per

5 Our definition of priority bills includes: electricity, gas, water, Council Tax, TV Licence, child maintenance, Income Tax, National Insurance or VAT, any loan secured against your home, rent, and court fines.
6 N Bond & C D'Arcy, The state we're in: Money and mental health in a time of crisis, The Money and Mental Health Policy Institute, November 2021.

cent and 44 per cent respectively). Likewise, those unable to save regularly were more likely to feel anxious when it comes to thinking about finances – 46 per cent compared to 29 per cent among those saving regularly.[7]

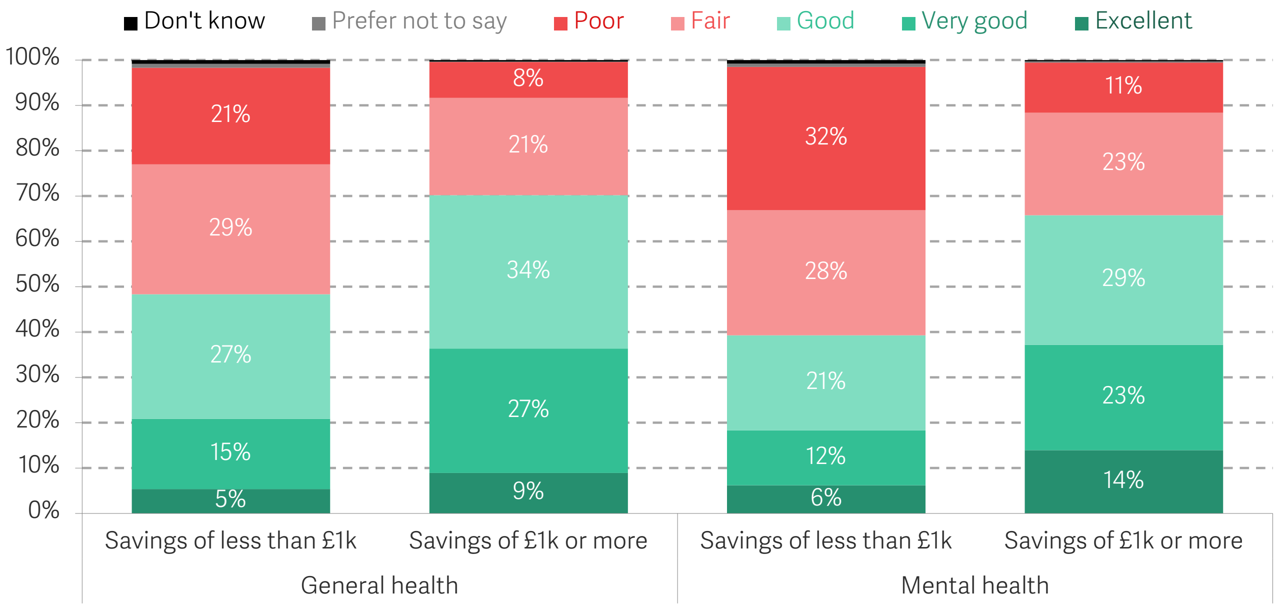
These associations between low savings and poor mental health could reflect a combination of three causal effects: low savings may create a sense of anxiety leading to worse mental health; worse mental health may make it harder to save, including indirectly via the impact of poor mental health on earnings; or some other factor may drive a deterioration in both savings and mental health. There is no quantitative evidence that allows us to examine the relative size of these effects. However, qualitative evidence from Nest Insight's sidecar saving trials show that people do report debt and low savings to be a cause of anxiety, and savings scheme participants report that higher levels of savings alleviate financial anxiety. This suggests that the causal effect of saving on mental health is significant.[8]

Figure 3 shows that over a fifth (21 per cent) of respondents with savings below £1,000 reported that their general health was poor, and almost a third (32 per cent) reported that their mental health was poor. This is in stark contrast to the 8 per cent of respondents with larger savings reporting poor general health and the 11 per cent reporting poor mental health. Even after accounting for various factors associated with people's health, such as age, income, tenure, employment status, and debt levels, these differences persist. Those with savings below £1,000 were over 4 percentage points more likely to report their general health as poor and 5 percentage points more likely to report their mental health as poor compared to someone with savings in excess of £1,000. These results are statistically significant, indicating that low savings are indeed linked to poorer health outcomes beyond the influence of income, age, debt, and other factors.[9]

7 Money & Pensions Service, Nation of Savers: a report from the UK Adult Financial Wellbeing Survey, September 2022
8 A Kuipers et al., Workplace sidecar saving in action, Nest Insight, April 2023.
9 We use a probit regression model to determine whether savings remains an indicator of poor health and wellbeing after controlling for other demographic and income-related contributing factors. We controlled for: housing tenure, age, ethnicity, family type, region, disability, employment status, income, and debt level.

FIGURE 3: **Having low savings is associated with poor general and mental health outcomes**

Respondents' assessment of their general and mental health, by savings thresholds: UK, 13-17 October 2023



NOTES: Savings of less than £1,000 (n= 2052), savings of £1,000 or more (n= 3911).
SOURCE: RF analysis of YouGov, Cost of Living Crisis October 2023 wave.

Modest precautionary help a lot with smaller shocks but do little to insulate against a lasting fall in income

As indicated in Figure 2, having relatively modest amounts of savings provides some financial resilience. However, savings of £1,000 are unlikely to serve as a sufficient safety net in the face of more significant shocks, such as prolonged unemployment, relationship breakdowns, illness or bereavement. Unemployment, for example, affects many people: around 1 per cent of those in employment employed move into unemployment each quarter, equivalent to around 300,000 people.[10] In these situations, having small, or no precautionary savings carries severe consequences, especially considering the UK's notably low levels of out-of-work benefits. The UK's basic unemployment benefit is unrelated to a recipient's previous earnings and now offers a replacement rate of just 14 per cent of average earnings, down from 24 per cent in 1980-81.[11] So, UK workers who experience job loss face, on average, more substantial income losses than their counterparts in most other high-income OECD countries, including nearly all Western European economies (shown in Figure 4). More recent research confirms this, finding

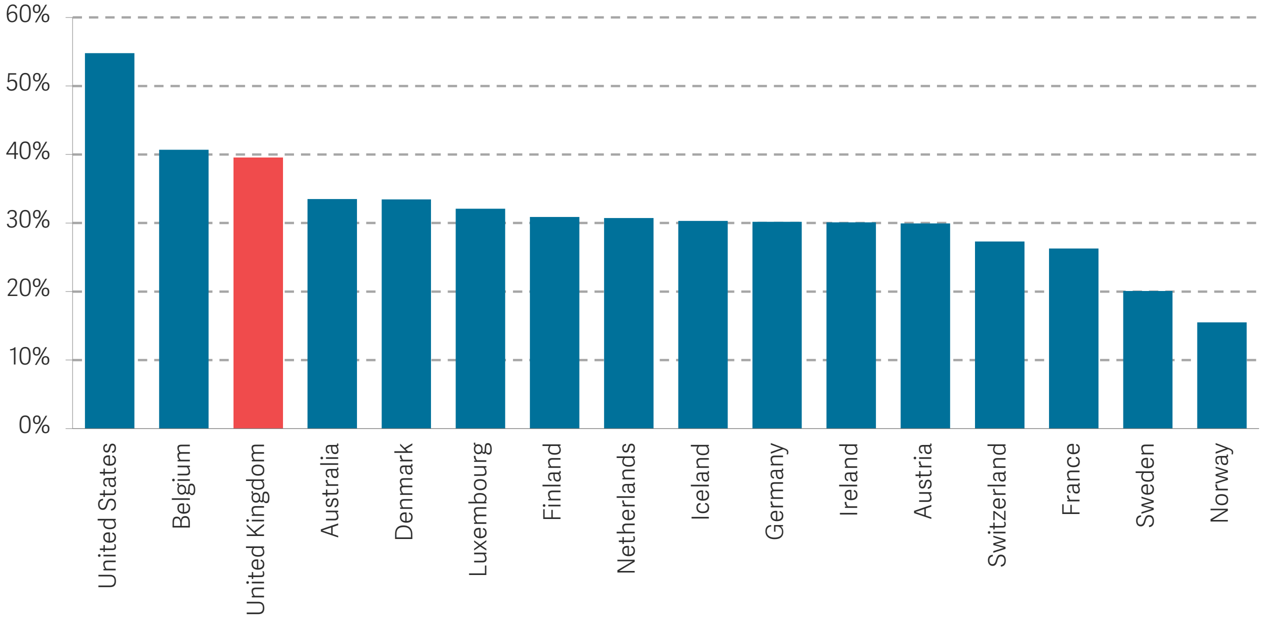
10 This figure includes those who have been made redundant if they have not moved into another job. ONS, Labour Force Survey flows estimates, August 2023. For more information on labour market flows see: N Cominetti et al., Changing jobs?: Change in the UK labour market and the role of worker mobility, The Economy 2030 Inquiry, May 2021.
11 M Brewer & L Murphy, From safety net to springboard: Designing an unemployment insurance scheme to protect living standards and boost economic dynamism, Resolution Foundation, September 2023.

that the cost to a household of job loss in the first year in terms of income lost is 22 per cent in the UK, more than double the rates in Denmark, Finland and Germany (at 10 per cent, 10 per cent, and 8.6 per cent respectively).[12]

Larger precautionary savings balances would help people cope with bigger shocks, but the country's savings shortfall is significant. If every working-age family in Britain had at least three months' income in precautionary savings, aggregate savings would be £74 billion higher.

FIGURE 4: **UK workers face larger income shocks compared to many OECD countries**

Proportion of employed people experiencing an income loss of 20 per cent or more from one year to the next when becoming non-employed: selected high-income OECD countries, early 2010s or latest



NOTES: Large income losses are defined as those of 20 per cent or more from one year to the next. Data for the United States refers to bi-annual transitions. Data is for the working-age population (18-65). Countries are those with levels of GDP per capita at least as high as the UK's, measured at purchasing power parity (PPP).
SOURCE: OECD, A Broken Social Elevator? How to Promote Social Mobility.

Previous work explored the connection between low levels of income replacement and lower dynamism in the UK's labour market.[13] There is extensive literature on the link between the duration and generosity of unemployment insurance and the quality of the subsequent job found. For example, one study found that, when unemployment insurance increases in generosity, workers tend to end up in more productive jobs. This

12 S Bedük et al., Insurance against risk? Economic cost and compensation of job loss in different welfare states, Working Paper, September 2023.
13 The rate at which workers move jobs slowing compared to two decades ago: in 2019, the job-to-job move rate was 2.5 per cent, up from a low of 1.7 per cent in 2009, but down from a rate of 2.9 per cent in 2002.

is because it allows workers to spend longer searching for a new job.[14] Therefore, a better-designed unemployment insurance scheme would enable people to find better-matched jobs, leading to higher wages and longer job durations, and a more productive economy overall.[15]

But, in the absence of such a scheme, ensuring individuals have sufficient precautionary savings to fall back on could deliver similar outcomes. Another paper found that less indebted households are able to spend longer searching more widely for a new job, leading to higher wages upon reemployment. It found that workers with lower debt-to-income ratios were able to extend their job search by 2.5 months and broaden the scope of their job search, leading to more occupational and industry switches, and matches with firms that pay higher wage premiums.[16] Higher precautionary savings balances would also allow people to extend and broaden their job search by removing some of the pressure to find a job quickly, which could also result in macroeconomic benefits from productivity gains. Furthermore, higher precautionary savings would also insure against more than just unemployment, such as, relationship breakdown, bereavement and ill health.

British families don't save enough for their retirement

It's not just precautionary saving that British families lack: pension saving is also too low. Pension coverage has dramatically improved in recent years, but concerns remain that the rate of saving is still inadequate, leaving people vulnerable to big living standards falls upon retirement.

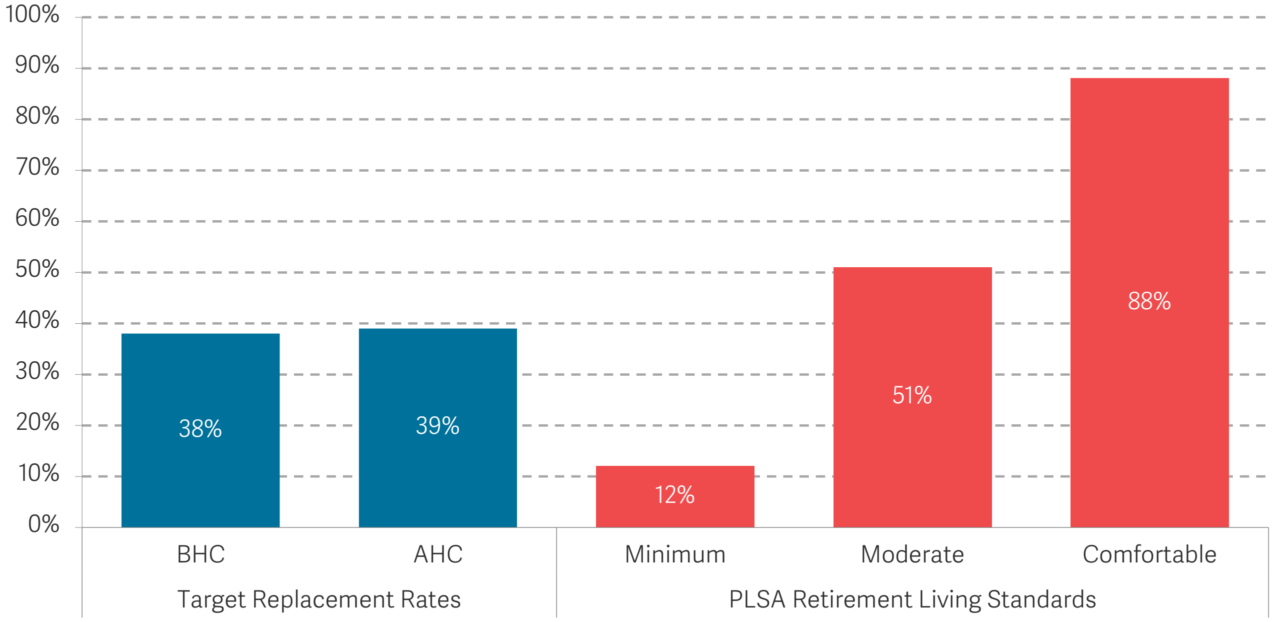
The Department for Work and Pensions' analysis of future pension incomes revealed that 39 per cent of individuals aged 22 to State Pension age (equivalent to 13 million people) are undersaving for retirement when measured against TRRs After Housing Costs (AHC) (see Figure 5) .[17] Similarly, when compared against the Pension and Lifetime Saving Association (PLSA) Retirement Living Standards (RLS), 12 per cent (4.1 million) are projected to have a pension income falling below the PLSA Minimum RLS.[18] More alarmingly, over half (51 per cent) of individuals aged 22 to State Pension age, amounting

14 J Eeckhout & A Sepahsalari, The Effect of Wealth on Worker Productivity, The Review of Economic Studies, July 2023.
15 M Brewer & L Murphy, From safety net to springboard: Designing an unemployment insurance scheme to protect living standards and boost economic dynamism, Resolution Foundation, September 2023.
16 G Kabas& K Roszbach, The price of leverage: Learning from the effect of loan-to-value constraints on job search and wages, VoxEU, May 2023.
17 Replacement rates for AHC 2021 pre-retirement earnings bands: less than £12,500 – 84 per cent; £12,500 to £23,999 – 75 per cent; £24,000 to £34,999 – 71 per cent; £35,000 to £56,499 – 63 per cent; over £56,500 – 53 per cent.
18 PLSA RLS 2021 (outside London) total income pre-tax: single person, £10,900 minimum, £22,860 moderate and £38,860 comfortable; couple, £16,700 minimum, £31,966 moderate, £55,840 comfortable.

to 17.7 million people, are projected to have a pension income below the PLSA Moderate RLS, with a significant majority projected to fall below the PLSA Comfortable RLS (88 per cent 30.4 million). [19]

FIGURE 5: **Millions of people are undersaving for retirement**

Proportion of working-age people (aged 22 to State Pension age) projected to not meet their TRR or PLSA RLS



NOTES: This chart was originally created by the Department for Work & Pensions.
SOURCE: Department for Work & Pensions, Analysis of future pension incomes, March 2023.

Recent evidence suggests that due to the default nature of auto-enrolment, there is little active decision-making in relation to workplace pension saving, particularly among low earners.[20] This means that many employees make pension contributions at the default level,[21] which may be exacerbating the undersaving. The Pension Commission has emphasised the need for employees to make contributions above the minimum requirements in order to secure an adequate income in retirement.[22]

All this highlights three distinct savings challenges facing the UK: inadequate savings among British families to navigate unforeseen expenses, insufficient buffers against significant financial shocks, and insufficient funds to secure a comfortable retirement. These challenges have been recognised by government, leading to the implementation of policies aimed at resolving them. Section 3 delves into the effectiveness of these policies in tackling the UK's low saving rates.

19 Department for Work & Pensions, Analysis of future pension incomes, March 2023.
20 Department for Work & Pensions, Research report: Low Earners and workplace pension saving – a qualitative study, February 2024.
21 Department for Work & Pensions, Automatic Enrolment evaluation report 2019, May 2020.
22 Department for Work & Pensions, Automatic enrolment review 2017: Maintaining the momentum, December 2017.

Section 3

Policies to fix the UK's savings challenge have had mixed success

The UK's low savings problem isn't for want of Government support. Successive governments have implemented various policies to address the issue. But these initiatives have met with varying degrees of success. Much of the effort in this area have taken the form of fiscal incentives, such as tax breaks or bonuses paid on account balances. These incentives have proved expensive, inefficient an ineffective. In 2023-24 such schemes cost the Government over £8 billion and overwhelmingly benefited richer households. There is little evidence to suggest they have been successful in increasing aggregate saving.

In contrast, new behavioural interventions show more promise in enhancing saving. In the precautionary savings landscape, Nest Insight has tested an 'opt-out' approach to workplace saving through its New Worker Trial. Results suggest that opt-out approaches significantly increase participation, rising from 1 per cent under an opt-in scheme to 47 per cent under an opt-out approach.

There's also evidence that behavioural interventions can raise saving from the experience of pension auto-enrolment. Its introduction has transformed pension coverage, with the participation rate climbing from 47 per cent in 2012 to 79 per cent in 2021 – an extraordinary policy achievement. This demonstrates that both the precautionary and pension savings problem is likely to most effectively be tackled through behavioural interventions rather than fiscal incentives alone.

Policies using fiscal incentive to tackle the low-savings problem have been expensive, inefficient and ineffective

Recognising the low level of saving overall, and the damaging consequences it has for household financial resilience and wellbeing, successive governments have put in place a range of policies to address the issue. These policies are discussed in more detail in Box 1 and fall into two broad categories: tax incentives (usually exemptions); and paying direct bonuses, or transfers, on a narrower definition of saving to further raise the incentive to save. These schemes come at a considerable cost to the Government: it is estimated that the total support for savings will cost over £8 billion in 2023-24. And evidence suggests that these policies have done little to incentivise greater saving, it's often the case that people who already have savings move their money around to maximise returns.[23] That contributes to the reality that overwhelmingly the financial benefits tend to go to the better off. Previous research found that the average household in the highest tenth of the income distribution receives around 10 times more from tax advantages and direct transfers per year than households in the poorest fifth (£800 and £80 respectively).[24]

BOX 1: **Government has used tax breaks and financial bonuses to encourage saving**

There two mechanisms built into the tax system to incentivise saving and reduce administrative burden of reporting and collecting taxes on low levels of returns on savings: the 'starting rate for savings' and the Personal Savings Allowance (PSA). The starting rate for savings applies to individuals with non-savings income below £17,570 and allows them to earn interest on their savings tax-free up to a maximum of £5,000. The 'starting rate for savings' is tapered away for every £1 of income above the Personal Allowance (£12,570). Under the PSA, basic-rate taxpayers can earn £1,000 in savings interest per year with no tax, and higher-rate taxpayers can earn £500 in savings interest per year with no tax. Additional-rate taxpayers are not entitled to a tax-free allowance.[25] In 2023-24, the PSA is estimated to cost £810 million in terms of foregone tax revenue, up from £600 million in 2022-23.[26] Scrapping the starting rate for savings would have a negligible impact on tax revenues, as there are few individuals with non-savings income of less than £17,570 who have significant income from savings.

Tax incentives for saving are also provided via Individual Saving Accounts (ISAs): individuals do not pay any tax on income or capital gains arising from their ISA savings and investments. ISAs are large in scale, with £67 billion being deposited into 12 million adult ISAs in

23 For further discussion of responsiveness saving behaviour to financial incentives, see: L O'Brien, The effect of tax incentives on private pension saving, Institute for Fiscal Studies, February 2023.
24 M Broome, A Corlett & J Leslie, ISA ISA Baby: Assessing the Government's policies to encourage household saving, Resolution Foundation, January 2023.
25 For more information see: GOV.UK, https://www.gov.uk/apply-tax-free-interest-on-savings, accessed 2 February 2024.
26 HMRC, Non-structural tax relief statistics, January 2023.

2021-22.[27] In 2023-24, ISAs are expected to cost the exchequer £6.7 billion in foregone tax revenue, up from £4.9 billion in 2023-23.[28]

The second type of savings incentive scheme involves more targeted matching schemes, specifically the Lifetime ISA (LISA) designed to help people save for a deposit on a house or for retirement, and the Help-to-Save matched saving scheme. LISAs allow people between the ages of 18 and 50 to put away up to £4,000 per year and have it matched by a 25 per cent bonus. The money can then be withdrawn to go towards the deposit for purchasing a house, be withdrawn in the event of terminal illness, or after the age of 60. Withdrawals for any other reason attract a penalty charge of 25 per cent of the post-match value – in other words the saver withdraws around 6.25 per cent less than they paid in to access the funds early. The total fiscal cost of the LISA bonuses was £500 million in 2023-24.[29]

Help to Save, on the other hand is specifically targeted at low- and middle-income households. Savers can put away up to £50 per month and after two years a bonus is paid equal to 50 per cent of the peak savings over the period. A second bonus is available at the end of the fourth year. Overall the cost of the scheme to the exchequer – and value of bonus payments to participants – is only around £43m per year. Compared to other savings policy incentives, Help to Save is the best targeted towards lower income households, hence the extension of the programme to 2025.[30] But take up of the scheme is limited: at the outset of the scheme, the Government estimated that as many as 3.5 million people could benefit, but only around 383,000 people have deposited into a Help to Save account since the start of the scheme indicating a take up rate of around 10 per cent.[31] Nevertheless, the scheme has clearly been successful at an individual level with qualitative research suggesting that Help to Save had a positive impact on saving behaviour. For example, the majority of users surveyed reported that Help to Save encouraged them to save more (71 per cent) and more often (65 per cent) than they did before. Furthermore, over half (56 per cent) said that they are more likely to save in the future, suggesting the scheme is successful in its aim of building a saving habit among users.[32]

27 HMRC, Commentary for Annual savings statistics, June 2023.
28 Note this figure includes the relief on Lifetime ISAs. For more information see: HMRC, Non-structural tax relief statistics, January 2023.
29 OBR, Economic and Fiscal Outlook – November 2023.
30 For more information see: HMRC & A Griffith, Help to save extended to April 2025, accessed 5 February 2024.
31 We recommended various reforms to Help to Save to boost participation including enrolling all new claimants of UC that are eligible for Help to Save automatically. For more information see: M Broome, A Corlett & J Leslie, ISA ISA Baby: Assessing the Government's policies to encourage household saving, Resolution Foundation, January 2023.
32 HMRC, Help to Save Customer Experience Research: Quantitative and qualitative findings from research with Help to Save customers, Research Report 623, August 2021.

In short, fiscal incentives have been expensive and ineffective in encouraging saving among low- and middle-income households. Too often, spending has been poorly targeted. And its impact on the target group's financial resilience appears limited. These problems have contributed to the development of a range of innovative interventions that instead draw on behavioural approaches to encouraging saving, especially in light of the success of pension auto-enrolment over the past decade.

Behavioural interventions appear to be more successful in addressing the precautionary savings gap

Nest Insight, a public benefit research and innovation centre that focuses on boosting the financial resilience of low- and middle-income households, has led the piloting and evaluation of a range of exciting new approaches that show promising results. Their experiments have focused on payroll-saving schemes of various types that aim to break down the behavioural barriers to saving.

Two such schemes are particularly relevant to the problem of low saving.

First, the Jars programme is a 'sidecar' savings scheme which has been piloted since 2018. Offered by five participating employers to over 80,000 employees, the scheme allows participants set their own saving rate, with the money automatically deducted from their pay and placed into an instant access savings account each month. Participants also choose a maximum balance for the liquid savings sidecar and once that level is reached any further savings become additional pension contributions.

Results have generally been encouraging, showing that participants tend to use Jars either as a cashflow management tool with regular withdrawals to manage small monthly fluctuations in income and outgoings; as a shock absorber, with ad hoc withdrawals made occasionally to cover significant expenses; or as the vehicle for achieving a savings target, with people withdrawing money to fund a major item – like a rental deposit or vehicle purchase – once the savings target is reached. A small but growing proportion of savers made additional pension contributions after hitting their savings target. However, the main shortcoming of the scheme has been low take-up of this 'opt-in' scheme with only around 1 per cent of those given the chance to participate ultimately doing so, despite 46 per cent saying they thought Jars would help them.[33]

Much more encouraging on the participation front has been the New Worker Trial, an 'opt-out' scheme that automatically enrols new employees into a £40 per month payroll saving plan. Launched in 2021, early evidence from the scheme shows that at over around 50 per cent after four months, participation in the scheme is far higher than

33 A Kuipers et al., Workplace sidecar saving in action: Learnings from a multi-year, multiemployer UK trial of a new approach to supporting employees with emergency and retirement saving, Nest Insight, 2023.

under an opt-in Jars scheme.[34] This resonates with a growing body of evidence that behavioural interventions can be very effective in increasing saving rates.

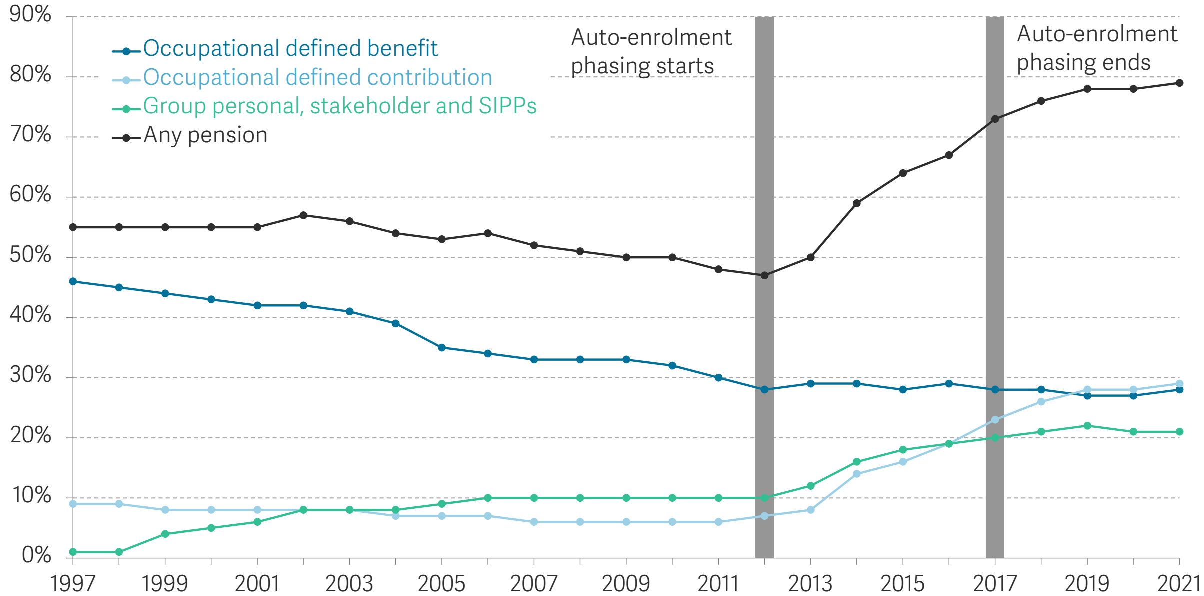
Nest Insight's work has demonstrated that the potential for boosting liquid savings by using behavioural framing is far greater than what can be achieved through fiscal incentives alone. At a time of significant pressure on the public finances, such approaches offer a way to boost improve households' financial resilience without imposing new costs on the taxpayer.

Behavioural interventions have also transformed pension saving

Pension auto-enrolment provides concrete evidence that behavioural interventions can be highly effective. Auto-enrolment was introduced in 2012 to help address the decline in private pension saving, and it has been extremely successful in increasing pension saving participation among workers. In April 2021, the pension participation rate in the UK was 79 per cent (22.6 million employees), up from 47 per cent in 2012 (as shown in Figure 6). The increase in pension uptake was largely driven by increased participation among private-sector workers in defined contribution (DC) schemes where contributions from employers and employees are invested to build a pension savings pot. Box 2 provides a more detailed description of the auto-enrolment policy.

FIGURE 6: **The proportion of employees saving for retirement has increased substantially since 2012**

Proportion of employees with workplace pension by type of pension, UK



NOTES: This chart was originally created by the ONS and has been adapted from their 'Employee workplace pensions in the UK: 2021 provisional and 2020 final results' release.
SOURCE: ONS, Annual Survey of Hours and Earnings.

34 J Phillips & E Stockdale, Opt-out autosave at work: A popular and proven way to powerfully boost people's saving, Nest Insight, 2022.

BOX 2: The introduction of auto-enrolment

The auto-enrolment scheme requires employers to automatically enrol employees aged 22 and over and earning over £10,000 per year to their workplace pension scheme. The Government sets the minimum contribution rates: these currently total 8 per cent, made up of a 5 per cent contribution from employees (including 1 per cent in tax relief from the Government), and 3 per cent from employers. These rates apply only to qualifying earnings: in the 2022-23 tax year, these were earnings between £6,240 and £50,270. Employees can opt out of the scheme or increase their contributions; those with earnings below £10,000 can opt in if they wish. Employers also have the option to contribute more than the minimum 3 per cent requirement.

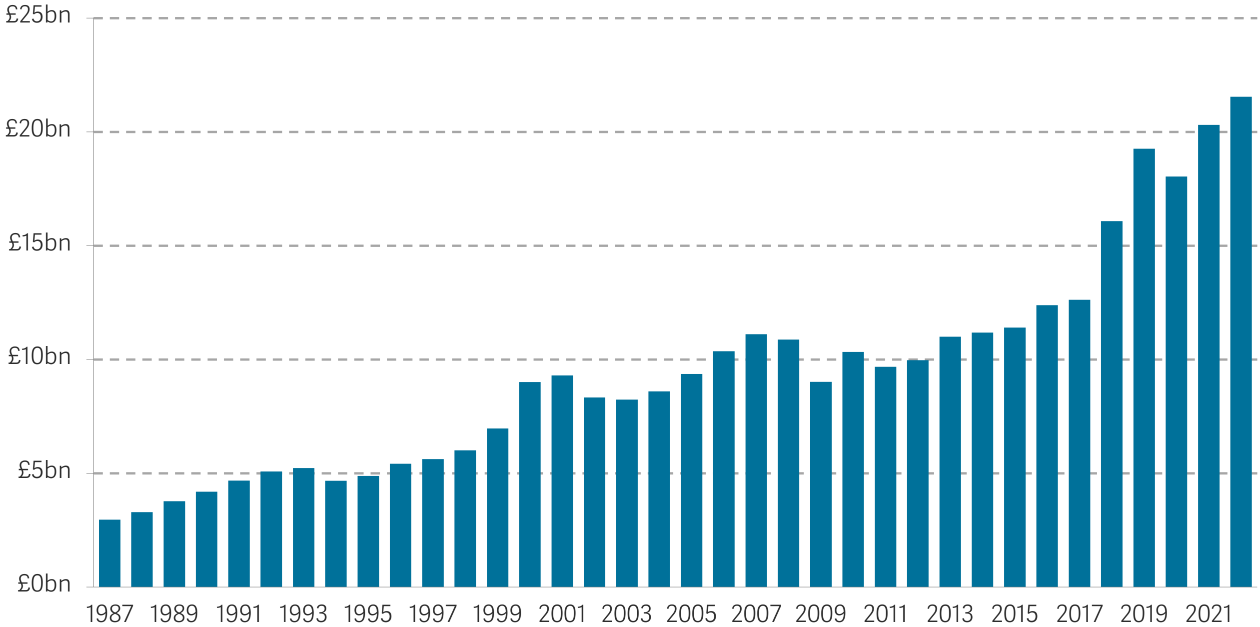
The statutory default contribution rates have risen over time, from 2 per cent during the initial introduction of auto-enrolment (with the minimum employer contribution at 1 per cent), to 5 per cent from April 2018 (with the minimum employer contribution at 2 per cent), and finally to the current 8 per cent from April 2019.

Thanks to greater pension saving participation, aggregate pension contributions have increased substantially in recent years. As Figure 7 shows, data from the National Accounts records employee pension contributions of £21.5 billion in 2022, up from £20.3 billion in 2021. The biggest year-on-year increase in employee pension contributions was between 2017 and 2018, where contributions increased from £12.6 billion to £16.1 billion – equivalent to a 27 per cent increase. This increase coincided with the period in which default employee contribution rates increased from 1 per cent to 3 per cent of earnings in April 2018. Aggregate employee-pension contributions also grew strongly between 2018 and 2019 when default employee contribution rates increased from 3 per cent to 5 per cent.[35]

35 Department for Work & Pensions, Workplace pension participation and savings trends of eligible employees: 2009 to 2022, November 2023.

FIGURE 7: **Aggregate employee pension contributions recently increased in line with minimum contribution rates**

Employee pension contributions: UK



SOURCE: ONS, UK Economic Accounts.

Pension reforms of the past 20 years have revolutionised coverage, but as discussed in Section 2, saving rates remain inadequate if most people are to be confident of achieving a decent standard of living in retirement. Section 4 discusses some of the pitfalls for savings in the round of simply raising default contribution rates.

Section 4

A piecemeal approach to saving could exacerbate the problem

Thanks to the success of auto-enrolment, the way forward in addressing the pension-saving problem is clear. There is a strong consensus that default contribution rates need to increase beyond the current 8 per cent. This would not only address adequacy concerns but also have macroeconomic benefits in the form of supplying extra domestic financing of investment.

But rather than taking a piecemeal approach to savings policy as we have in the past, it is crucial to think about savings in the round.

There are two significant risks from increasing default pension saving rates in the current policy context. First, higher contribution rates, particularly in the context of a stagnant outlook for household incomes, might lead to higher opt-out rates. To date, evidence from the rollout of auto-enrolment and the cost of living crisis suggests a strong degree of inertia in pension-saving behaviour, giving reason to think this risk might be contained. The other, arguably more serious risk from raising the default contribution rate, is that it will exacerbate the precautionary savings problem. Particularly in the context of very weak real-income growth, an additional pound saved into a pension has to be funded either from reduced consumption or lower precautionary saving (or higher debt). Evidence from our experience with auto-enrolment indicates that increases in the default contribution rate from 2 per cent to 8 per cent between April 2018 and April 2019 did reduce precautionary saving balances. For every £1 reduction in take-home pay due to higher pension contributions, employees reduced their consumption by 34p, with the rest of the contribution funded through either lower liquid saving or in some cases higher debt.

So precautionary and pension saving are inextricably linked, with people making choices between consuming today, saving for precautionary purposes, and saving for retirement. As a result, these challenges should be address together to avoid solving one issue while exacerbating another. This emphasises the need for a more for a more holistic savings framework in the UK.

Auto-enrolment provides a platform for raising pension saving

With auto-enrolment solving the pension-participation problem but not the pension-adequacy concerns, we at least have a well-established framework for enhancing pension saving in place.

This makes addressing the adequacy challenge easier, with some proposals already in train. A 2017 review of auto-enrolment outlined a number of recommendations that would broaden the scope of auto-enrolment. These recommendations included extending auto-enrolment to include workers over the age of 18 and eliminating the lower-earnings limit to ensure that contributions are calculated from the first pound of earnings.[36] But, despite being announced over six years ago, legislation creating the powers to make such changes was only passed last year, and the timing of implementation remains uncertain.[37]

Going beyond these recommendations, there is also a strong consensus on the need for raising default contributions. Organisations such as the PLSA have advocated for aligning employer contributions with those of employees, aiming for both parties to contribute 5 per cent by the end of the decade. Additionally, in the early 2030s, they propose a further increase of 1 per cent for both employers and employees, bringing the total automatic enrolment pension contributions to 12 per cent.[38] Similarly, the Work and Pensions Committee have also supported the goal of reaching a 12 per cent default contribution rate, beginning with an initial increase in employer contributions.[39]

Establishing an appropriate default auto-enrolment rate that delivers the target replacement rate for all eligible employees is challenging. The right contribution rate will depend on age, existing savings and the outlook for returns on those savings. This complexity was highlighted in the Living Pension study, which did not settle on a single benchmark. Rather, it demonstrated that the benchmark varies depending on the age of the workers involved. The 'whole career' benchmark for individuals starting saving in their 20s was 11.2 per cent, whereas the 'all age' benchmark, reflecting the under saving of various workforce cohorts in 2021, was 16.1 per cent. This resulted in the Living Wage Foundation recommending a 12 per cent contribution for full-time employees on a living wage salary.[40]

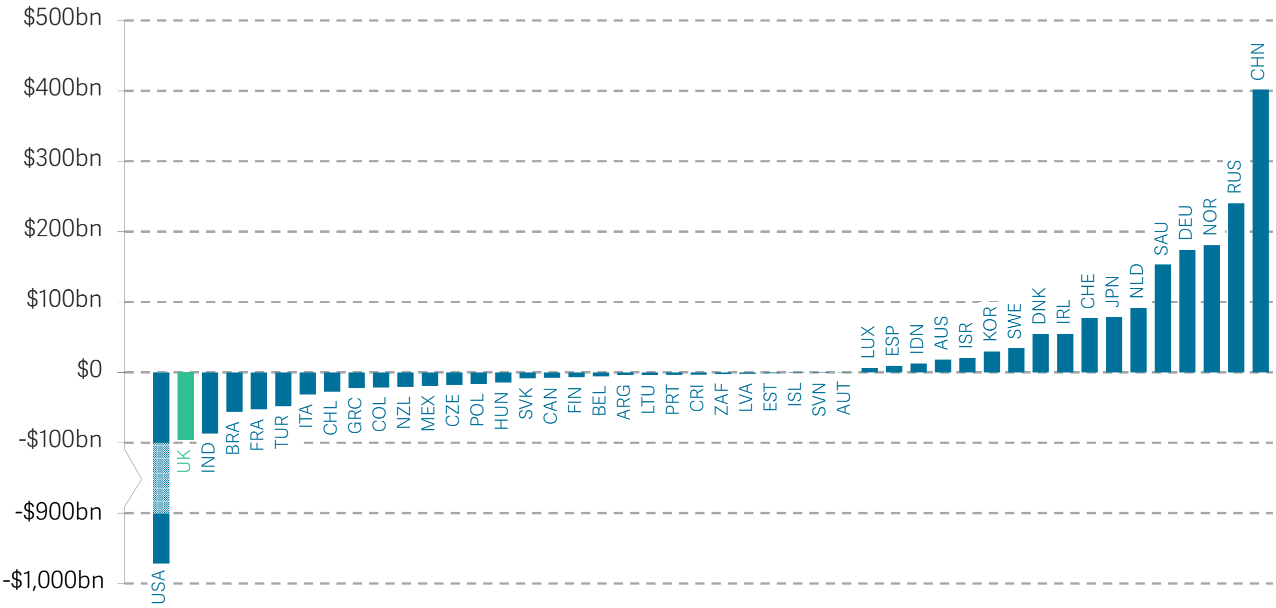
36 Department for Work & Pensions, Automatic enrolment review 2017: Maintaining the momentum, December 2017.
37 UK Parliament, Pensions (Extension of Automatic Enrolment) Act 2023, December 2023.
38 Pensions and Lifetime Savings Association, PLSA calls for levelling up of workplace pensions, February 2022.
39 House of Commons Work and Pensions Committee, Protecting pension savers – five years on from the pension freedoms: Saving for later life, September 2022.
40 N Cominetti & F Odamtten, Living pensions: An assessment of whether workers' pension saving meets a 'living pension' benchmark, Resolution Foundation, July 2022.

Increasing pension saving will also have macroeconomic benefits

There is also a strong macroeconomic rationale for raising default contribution rates. Previous research showed a substantial decline in business investment since the start of the 2000s.[41] Reversing this trend is a key part of improving the UK's stagnant growth outlook.[42] For example, if UK business investment had matched the average of France, Germany, and the US since 2008, our GDP would be nearly 4 per cent higher today, enough to raise average wages by around £1,250 per year.[43] However, higher business investment will need to be financed. A reliance on overseas borrowing would push up the UK's current account deficit. While that isn't necessarily a problem in principle, the UK already has an exceptionally high current account deficit – the second largest in the world in 2022 (Figure 8) – and a larger deficit increases the UK's reliance on the 'kindness of strangers', increasing external vulnerabilities.[44] Furthermore, given the UK's starting point of extremely low national savings, policy makers should aim to finance part of the increase in investment with higher domestic saving.[45]

FIGURE 8: **The UK has the world's second largest current account deficit**

Annual current account deficit in 2022: various countries



SOURCE: OECD, Current account balance.

41 P Brandily et al., Beyond Boosterism: Realigning the policy ecosystem to unleash private investment for sustainable growth, Resolution Foundation, June 2023.
42 Resolution Foundation & Centre for Economic Performance, LSE, Ending Stagnation: A New Economic Strategy for Britain, Resolution Foundation, December 2023.
43 P Brandily et al., Beyond Boosterism: Realigning the policy ecosystem to unleash private investment for sustainable growth, Resolution Foundation, June 2023.
44 M Carney, A Fine Balance, Mansion House Speech, June 2017.
45 P Brandily et al., Beyond Boosterism: Realigning the policy ecosystem to unleash private investment for sustainable growth, Resolution Foundation, June 2023.

Increasing contribution rates could exacerbate the precautionary savings shortfall

Increasing pension saving is clearly a key policy priority. But seeking to do so in isolation risks creating new problems. Pension saving does not take place in a vacuum – people choose between consuming today, saving for precautionary purposes, and saving for their retirement. Therefore savings policy should be considered in the context of the adequacy of precautionary saving.

Higher contribution rates could lead to higher opt-out rates...

One potential drawback associated with higher default contribution rates is the risk that, in the absence of wage growth, it could lead to increased opt-out rates. Here, the evidence on opt-outs so far suggests some cause for optimism.

During the gradual implementation of auto-enrolment, default contributions were increased twice. The first increase in April 2018 saw default employee contribution rates rise from 1 per cent to 3 per cent. Nest member data shows that the increase had no material impact on retirement saving behaviour. In the five months after phasing, member-led cessations were just 0.3 percent higher overall than in the preceding five months.[46] Similarly, in April 2019, default employee contributions increased from 3 per cent to 5 per cent. This increase did have a notable impact on opt-out rates among newly enrolled members, rising from 6 per cent for members enrolled at 3 per cent to 9 per cent for members enrolled at 5 per cent. However, cessation rates among existing members remained exceptionally low.[47]

More recently, given the ongoing cost of living pressures, one might have expected an increase in opt-out rates. However, evidence from HMRC's Real Time Information (RTI) data suggests a strong degree of inertia in pension-saving behaviour. For example, from April 2014 to March 2023, on average of 2.7 per cent of employees within RTI were identified as stopping saving each month due to either an active decision, non-eligibility, or the end of employment. In 2022-23, this cessation of saving remained almost unchanged compared to the previous year, at 3.0 per cent.[48]

Despite the relatively placid response of savers to higher default contribution rates, it would be unwise to assume that there wouldn't be a point at which people perceive pension saving as being no longer affordable. Therefore, a government committed to increasing default contribution rates might consider mitigating higher opt-out rates by allowing more liquidity, a topic further discussed in Section 6.

46 W Allport, C Pagliaro & W Sandbrook, How the UK Saves: The effects of phasing, Nest Insight & Vanguard, February 2019.
47 Nest Insight & Vanguard, How the UK saves: Effects of the second savings rate increase, June 2020.
48 Department for Work & Pensions, Workplace pension participation and savings trends of eligible employees: 2009 to 2022, November 2023.

...or exacerbate the inadequacy of precautionary savings

The other, perhaps even more pressing risk from raising the default contribution rate under the current pension regime is that could make the problem of low precautionary savings worse. In the absence of real-terms income growth, an additional pound saved into a pension has to be funded either from reduced consumption or lower precautionary saving (or higher debt). Since savings policy is about helping people to smooth consumption over their lifetime, the purpose of encouraging higher pension saving is to reduce consumption today. Yet recent research reveals that when the default contribution rates for auto-enrolment rose from 2 per cent to 8 per cent between March 2018 and April 2019, for every £1 reduction in take-home pay due to higher pension contributions, employees cut their consumption by 34p, with the rest of the contribution funded through either lower liquid saving or higher debt.[49]

Looking at the behaviour of sub-groups paints a more detailed picture. People with the lowest levels of liquid saving adjusted their spending much more than those who had more substantial savings balances. Indeed, for people in the lowest third of the distribution of deposits, up to three-quarters of the reduction in take-home pay was funded by reduced consumption.[50] However, this still implies that among the most financially pressed groups, a substantial proportion of higher pension saving is financed by reduced precautionary saving or higher debt.

Furthermore, recent research analysing the random phase-in of auto-enrolment among employers with fewer than 30 employees found that auto-enrolment led to a slight increase in individuals' unsecured debt. After being auto-enrolled, the average employee accrued an additional £32-£38 of observed pension saving per month, of which £16-£19 were from the employer contribution, £13-£15 from the employee contribution, and £3-£4 from tax relief. But this average employee simultaneously accrued an additional £7 of unsecured debt (such as personal loans and bank overdrafts) per month of enrolment, which was equivalent to 47 to 58 per cent of the increase in employee contributions.[51]

This evidence indicates a tension between precautionary saving and pension saving in the UK, where increases in pension saving may result in reduced precautionary saving and, in some instances, an increase in debt. Policy makers therefore face a dilemma – how to increase pension saving without exacerbating the precautionary savings problem further. In the UK, this problem is exacerbated by the inflexibility of the treatment of different types of savings pots. In Section 5, we outline how comparable countries have navigated this tension by establishing a more cohesive savings system which combines greater flexibility and liquidity.

49 T Choukhmane & C Palmer, How do consumers finance increased retirement savings?, September 2023.
50 T Choukhmane & C Palmer, How do consumers finance increased retirement savings?, September 2023.
51 J Beshears et al., Does Pension Automatic Enrollment Increase Debt? Evidence from a Large-Scale Natural Experiment, January 2024.

Section 5

The UK's approach to saving is much less flexible than in comparable countries

The previous section underscored the importance of thinking about savings policy holistically if it is to help families achieve financial security throughout life. But the UK's highly illiquid pension system instead creates an unhelpful tension for savers between their precautionary and retirement goals, whereby stronger pension saving means less precautionary saving and, in some cases, more debt. Around the world this isn't the norm. The UK is unusual in the strictness of the limits it places on accessing pension savings before retirement. In many comparable countries, the tension between precautionary and pension saving is alleviated by allowing early access under a broader set of conditions.

In this section we take a closer look at the private-pension regimes in the US, Australia, New Zealand, South Africa and Canada – countries which, like the UK, have significant defined contribution pension systems – to understand the degree of liquidity offered and the extent to which this combines precautionary and lifecycle savings in one vehicle.

A key takeaway from these countries is that all provide some flexibility around pension savings to help meet precautionary needs during working life. One drawback to hardship withdrawals allowed in most of these examples is that they inevitably deplete an individual's retirement fund, leaving legislation to set a high bar to accessing funds for such purposes, limiting their utility. Pension fund loans with mandatory repayment in the US system provide a compelling alternative. By substantially reducing both the risk of smaller pension pots and therefore the need for qualifying restrictions that hardship withdrawals typically demand, loan facilities can effectively balance the demands of precautionary and lifecycle saving.

The approaches adopted by these countries highlight how unusual the UK position is. It is very unlikely that such a rigid system is the right one, not least given the problem of low precautionary savings. The pension regimes offered in other countries provide insights into how the UK's pension system could evolve to help address the precautionary savings problem and make British families more financially resilient.

In the context of the UK's triple savings challenge, the rigid separation of pension savings from other forms of saving looks particularly counterproductive. At its core, the problem is the UK's long-standing illiquid pension system. This is in large part due to the tax relief offered on pension contributions, which necessitate a separation between pension and other forms of saving to avoid creating opportunities for tax arbitrage. Historically this has been exacerbated by the dominance of defined-benefit (DB) schemes which created additional administrative barriers to liquidity. But such schemes are now largely closed to new entrants and defined contribution (DC) is rapidly becoming the dominant pension provision.

The UK is at one extreme in terms of allowing almost no access to pension savings before retirement. Indeed, pension savings can only be accessed (without incurring a substantial charge) at age 55 (increasing to 57 by 2028) except in cases of terminal illness. By contrast, many other countries, even those with significant DB schemes, allow much greater flexibility during working age, even where contributions attract tax relief. Below we discuss the key feature of the systems in the US, New Zealand, Australia, South Africa and Canada – all similar to the UK in having established DC pension systems – to understand their different approaches to building precautionary flexibility into pension saving.

The US has a highly flexible savings regime

The US retirement saving regime is more liquid than that seen in most other countries.[52] The dominant long-term savings vehicle is a 401(k) plan. These are offered by employers and employees can decide what proportion of their salary to pay into their plan each month out of pre-tax income. Employers typically offer to match some proportion of employee contributions up to a limit.

Since 401(k) plans are pension funds, access to them is restricted until the age of 59 and a half. However, there are a wide range of exceptions to this, in particular people can access their savings at any time by paying tax on the money drawn down, along with a 10 per cent penalty to the Internal Revenue Service. Moreover, there are numerous grounds for early withdrawal without incurring the penalty, for example in cases of substantial medical bills, financial hardship, tuition fees, disability or the birth of a child. People can also withdraw their money on leaving their job once over the age of 55.

52 J Beshears et al., The availability and utilization of 401(k) loans, National Bureau of Economic Research Working Paper 17118, June 2011.

There are concerns about the rate of withdrawals from 401(k) plans and whether this 'leakage' is undermining people's provision for retirement. Roughly 22 per cent of net contributions made by people aged 50 or under in a given year are in some way withdrawn.[53] A key contributing factor to leakage is savers withdrawing all of their funds at the point they leave their employer, which happens disproportionately among lower-income people with low balances, as well as people whose employers offer more generous matches.[54] This suggests that leakage could be significantly curtailed by making pension provision move with the employee as they change jobs. Recent 'SECURE 2.0' legislation permits plan providers to offer automatic transfer of employees' funds to a new plan when they change jobs in order to address this.

However, research indicates that early withdrawal tends to be more common among people facing observable income shocks relating to job loss and family breakdown. [55] For example, early withdrawals from 401(k) plans tend to be strongly associated with income shocks and divorce, and the relationship is strongest for lower-income taxpayers.[56] This underscores the value of this liquidity in stabilising household finances in the face of short-term difficulties.

Alongside outright withdrawals, and depending on the scheme rules, most employees can take a loan from their 401(k) of up to 50 per cent of their savings up to USD 50,000. Loans have the advantage of not attracting a penalty charge and the money has to be repaid with interest typically over five years. Failure to repay results in the penalty charge being levied on the loan value. Past research suggests that around one-in-five to one-in-six plan participants have an outstanding loan at any given time, with advances averaging around USD 10,000 (the median is around half that level) or between 16 and 20 per cent of fund balances.[57] Looking at loan use over time reveals that it is very common for people to use their plans in this way with one study suggesting that as many as half of participants take a loan at some point over the seven-year period from 2002 to 2008.[58] A more recent study found that 29 per cent of eligible participants took out a loan at some point over the five years to the end of 2020.[59]

Typically interest rates charged on the loans are around 4 percentage points above the federal funds rate.[60] This interest is paid to the individual as a way of compensating

53 Congressional Joint Committee on Taxation, Estimating leakage from retirement savings accounts, April 2021.
54 Y Wang, M Zhai & J G. Lynch, Cashing out retirement savings at job separation, November 2022.
55 G Amromin & P Smith, what explains early withdrawals from retirement accounts? Evidence from a panel of taxpayers, National Tax Journal 56(3), September 2003.
56 R Argento, V L. Bryant & J Sabelhaus, Early withdrawals from retirement accounts during the great recession, March 2013.
57 S Holden, S Bass & C Copeland, How 401(k) plan participants use loans over time: An analysis of loan activity of consistent 401(k) plan participants, 2016–2020, September 2023.
58 J Beshears et al., The availability and utilization of 401(k) loans, National Bureau of Economic Research Working Paper 17118, June 2011.
59 S Holden, S Bass & C Copeland, How 401(k) plan participants use loans over time: An analysis of loan activity of consistent 401(k) plan participants, 2016–2020, September 2023.
60 S Holden, S Bass & C Copeland, How 401(k) plan participants use loans over time: An analysis of loan activity of consistent 401(k) plan participants, 2016–2020, September 2023.

for the foregone returns during the period in which the loan amount in not in the 401(k) scheme. While loans are commonplace, 90 per cent of them are repaid by plan participants and the proportion of people taking loans tends to drop as they approach retirement.[61] All of this suggests that loan access may be a helpful alternative to higher-cost commercial credit.

The US's flexible pension system also provided some macroeconomic stabilisation during the Covid pandemic through the CARES Act. This allowed people to access up to USD 100,000 of their 401(k) savings without penalty if they were directly affected by Covid – for example losing their job. Maximum loan size was also doubled. Observations from a range of plan providers suggest that around 6 per cent of eligible participants took out Coronavirus Related Distributions in 2020 in the form of a loan or withdrawal, with several thousand dollars typically withdrawn.[62]

While there are concerns about leakage rates in the US, there is also strong evidence of the value that the system's liquidity plays, particularly in the context of a relatively limited social safety net. That value is underscored by the growing issue of decumulation in retirement. Recent PPI research found that, across all wealth levels, US retirees still had 80 per cent of their pre-retirement savings almost 20 years after retirement on average.[63] This context does not immediately suggest that the liquidity of the US system during working age is suboptimal.

As well as offering a relatively high-degree of liquidity even in normal times, 401(k) plans are set to evolve further from 2025 with employers automatically enrolling new employees at a minimum contribution rate starting at 3 per cent and set to rise. There will also be provision for up to USD 1,000 of 401(k) savings to be withdrawn in emergencies without penalty, and separate 'sidecar' emergency savings accounts to be added, with balances of up to USD 2,500.[64] US policy has therefore evolved to reduce unnecessary leakage from pensions while also bringing behavioural tools to bear to boost liquid savings.

New Zealand allows access for hardship and home purchase

New Zealand's private pension system is based around Kiwisaver, a workplace saving scheme that complements the state pension – the New Zealand Super – which is a flat-rate non-contributory pension paid to all residents. Under the Kiwisaver, new employees

61 T Lu et al., Borrowing from the future: 401(k) plan loans and loan defaults, National Bureau of Economic Research Working Paper 21102, April 2015.
62 Congressional Research Service, The CARES Act: Selected Data on Coronavirus-Related Distribution and Loan Usage in 2020, July 2021.
63 N Hurman, What can the UK learn about other countries' approaches to accessing DC savings?, Pensions Policy Institute, November 2023.
64 R H Beck, How Secure Act 2.0 Changes Retirement, Forbes, March 2023.

are automatically enrolled into a pension plan, choosing to contribute between 3 per cent and 10 per cent of gross earnings. They can also choose to opt out of the scheme entirely. Employers must also contribute at a default rate of 3 per cent of gross salary. Contributions do not attract tax relief and are therefore made out of taxed income, and investment returns within KiwiSaver are also taxable. However, the New Zealand Government does provide a financial incentive to save in the form of a 50 per cent matching contribution, up to the value of just over NZD 500 per year. Unlike in the UK and US pension schemes, while Kiwisaver contributions are made out of taxable income, withdrawals are tax free.

Participants in KiwiSaver are only able to withdraw their funds freely at the 'age of eligibility', which is currently 65 – 10 years later than the current rules for DC pensions in the UK. But, as with US 401(k) plans, people are allowed to access their KiwiSaver before retirement under a range of circumstances. People can make withdrawals in cases of hardship if they apply to their scheme provider giving evidence of an inability to afford 'minimum living expenses', mortgage repayments, medical bills and some other situations. Withdrawals are also allowed for people to fund a deposit for buying their first home. Unlike in the US, people remain with their KiwiSaver provider when they change jobs, with their new employer making contributions into their existing scheme.

Compared to the US, leakage rates from KiwiSaver are fairly low, with just over NZD 1.1 billion withdrawn early in the year to June 2023 compared to NZD 9.8 billioin in contributions over the same period, an aggregate leakage rate of 12 per cent.[65] Almost NZD 1 billion was drawn down by first-time buyers in the most recent data. Only around NZD 140 million was taken in respect of hardship claims, equivalent to less than 2 per cent of contributions, with around 18,000 claims being made for an average of just under NZD 8,000 last financial year.[66] However, the most recent data suggests that both the number and total value of withdrawals for hardship are now running at twice the level seen in 2021, before the global inflation shock. This suggests that while macroeconomically small, hardship liquidity provides significant financial support for a meaningful number of households in the face of shocks.

Early access to the Australia's 'Super' is tightly restricted to cases of hardship

The Australian retirement saving system is based around the Australian Super, a compulsory employee saving scheme that currently requires contributions of 11 per cent of the employee's salary. The maximum annual contribution is AUD 27,500. Contributions are set to rise to 12 per cent by 2025. Rather than being tax relieved, as in the UK and US,

65 Inland Revenue Department; KiwiSaver statistics.
66 The Financial Markets Authority, KiwiSaver Annual Report 2023, September 2023.

Super contributions are taxed at a lower rate than income, while drawdowns after the age of 65 (or 60 if following a loss of employment) are tax free.

An important part of the reason for compulsion being at the core of the Australian private pension system is that the state pension, the 'Age Pension', is means tested. The Age Pension is currently worth just over AUD 500 per week, or AUD 26,000 per year, but a single pensioner with income above AUD 102 per week sees their entitlement reduced by 50 cents for each dollar. Consequently, even retirees with substantial amounts of private pension savings face an effective marginal tax rate of 50 per cent on the income they draw down.

While contributions to a Super are mandatory, there is a degree of liquidity in the system. People can access up to AUD 10,000 in a 12-month period on grounds of financial hardship if they have been claiming benefits for at least 26 weeks and are struggling to meet reasonable household expenses.[67] These withdrawals are then taxed at between 17 and 22 per cent.

While hardship withdrawals are usually limited in scale, during the early months of the pandemic savers who were unemployed or lost work as a result of Covid were allowed to withdraw up to AUD 20,000 in two tranches between April and December 2020. Uptake of the scheme was substantial with 3.5 million (typically younger) Australians taking advantage of the additional flexibility. In total AUD 36.4 million was withdrawn under the early access scheme in 2020 – equivalent to around 2 per cent of GDP and around 1 per cent of assets under management.[68] These early withdrawals are estimated to have had a significant macroeconomic stabilisation effect, contributing at least 0.8 per cent of GDP over a period of four months. Since the cost to the Government of this private spending was minimal, estimated at AUD 1.2 billion in forgone taxes, the direct fiscal multiplier of allowing early access is estimated at 13.4 – ten times larger than typically found for government cash transfers.[69] This provides further evidence of the potential for governments to use the management of liquidity restrictions on long-term savings vehicles as an additional macroeconomic stabilisation tool.

The appropriateness of early release for individuals is debated in Australia. Survey-based studies tend to find that people who made a withdrawal report having used the money to fund household expenses, make mortgage or rent payments and to pay down debt.[70] One study concludes that people withdrawing savings tended to end up with higher liquid

67 Withdrawals can also be made in cases of terminal illness, permanent incapacity and compassionate grounds. While there is also a scheme – the First Home Super Saver – for savers to build up a deposit for their first house at a tax-advantaged rate, the scheme requires these contributions to be additional to the employer pension contribution rate. Consequently the home purchase aspect of the Super regime is separate from the pension scheme.

68 D Warren, Families in Australia Survey: Towards COVID Normal Report no. 6: The COVID-19 early release of superannuation, Australian Institute of Family Studies, September 2021.

69 S Hamilton et al., Early Pension Withdrawal as Stimulus, September 2023.

70 Australian Bureau of Statistics, Household financial resources, September 2020.

savings and lower debts than otherwise similar people who did not make a withdrawal, as well as having higher levels of financial wellbeing.[71]

On the other hand, use bank transactions data to show that people who withdrew money tended to spend it rapidly, with some 43 per cent of the first tranche of withdrawals spent within eight weeks.[72] This could suggest limited consumption smoothing behaviour on the part of households. At the same time the composition of spending sheds some doubt on whether the withdrawals were always in the individuals' best long-term interests. There was, for example, a significant increase in spending on gambling, although this accounted for only 3 per cent of the withdrawals made in the first tranche and 7 per cent of the increased expenditure.[73]

The Australian early withdrawals experiment during Covid illustrates that there may be macroeconomic stabilisation benefits to allowing a greater degree of liquidity in pension saving. Concerns about whether more liquidity risks undermining pension saving and not being in people's long-term interest, are more likely to be an issue in a compulsory savings regime like the Australian Super than they are under voluntary pension schemes like the UK's.

South Africa is implementing a 'two pot' system

The South African pension system is undergoing significant reforms. Under the current DC pension regime, savers contributing to their pension pots out of pre-tax income have to convert two-thirds of their fund into an annuity at retirement and can take the remaining third in cash. However, savers have a substantial degree of early access at the point where they change jobs and can take the full value of their savings (less tax) at that point. This has led to concerns both that people are cashing out their long-term savings at the point of job separation and also deliberately leaving their jobs in order to access their pension savings. As a result, it is estimated that over 80 per cent of retirement fund members cash in their savings when changing job.[74] Nevertheless, there have also been concerns that the system provides insufficient liquidity for savers facing short-term financial difficulties, as highlighted during the Covid pandemic.[75]

To tackle both of these problems the South African government will radically overhaul its pension system. From 1 September 2024 two thirds of people's contributions will go into an illiquid 'retirement pot' which can only be used on retirement to purchase an annuity, meanwhile the other third of contributions will go into a more liquid 'savings pot'

71 N Wang-Ly & B R Newella, Allowing early access to retirement savings: Lessons from Australia, September 2022.
72 S Hamilton et al., Early Pension Withdrawal as Stimulus, September 2023.
73 S Hamilton et al., Early Pension Withdrawal as Stimulus, September 2023.
74 Actuarial Society of South Africa, Actuarial model shows that NTs two-bucket system is likely to triple future pensions, October 2021.
75 National Treasury, Retirement reform: draft legislation for the two-pot system, July 2022.

allowing savers to make one withdrawal per year for any reason.[76] While the US, Australian and New Zealand models all seek to navigate the trade-off between long-term savings adequacy and emergency access, South Africa's new model side-steps that question by establishing a twin-track savings regime where contributions are split between an illiquid and a semi-liquid scheme.

Alongside the reforms currently in train, South African pension funds allow for a further source of liquidity in the form of 'pension-backed home loans'. These allow an individual to use their pension fund as security for a loan to buy or improve a house.

Canada's private pension system allows early hardship withdrawals

The Canadian pension system has similarities to the US one, involving three pillars.[77] The foundation is the Old Age Security pension, a monthly payment that begins from the age of 65 and is worth around CAD 8,600 per year for people aged 65 to 74. Entitlements are reduced for pensioners with annual income above CAD 142,000 and there is a supplement available for low-income pensioners.

This core tax-funded provision is complemented by a second tier – the earnings-related Canadian Pension Plan (CPP). As of last year, employee contributions rates out of pre-tax income stood at 5.95 per cent of earnings applied to incomes up to CAD 66,000 per year (with additional contributions up to a higher income threshold soon to be phased in).[78] Employers are required to match these contributions. In return the CPP guarantees contributors a replacement rate of 33.3 per cent in retirement.

The third pillar of the Canadian system involves a variety of voluntary private and employer-sponsored pension schemes that attract tax relief on contributions. The employees who benefit from such schemes are overwhelmingly in the upper half of the income distribution.[79] As usual with tax-preferred pension schemes, early access to pension funds before retirement age is limited.

However, as with the other countries explored here, there are a range of scenarios in which people can draw money down early which introduces significant flexibility. Of particular relevance to the need for precautionary savings, Canada's pension rules allow withdrawals of up to CAD 34,250 when people face a substantial drop in income, with the withdrawal amount scaled to the size of the person's income shock.[80] Early access is also permitted to pay for medical or disability-related expenses and when pension pot values

76 A Changole & P Vecchiatto, South Africa lawmakers agree to delay pension-system revamp, Bloomberg, December 2023.
77 M Blackshaw & E Cahill, Canada's Retirement Income System, Parliament of Canada, July 2020.
78 Canada Revenue Agency, The Canada Pension Plan enhancement – Businesses, individuals, and self-employed: what it means for you, December 2023.
79 M Blackshaw & E Cahill, Canada's Retirement Income System, Parliament of Canada, July 2020.
80 Office of the Superintendant of Financial Institutions, Unlocking funds from a pension plan or from a locked-in retirement savings plan, Government of Canada 2024.

are small. Up to 50 per cent of the balance in Restricted Life Income Funds (RILFs) can be drawn down from the age of 55.

What can be learned from other countries' pension systems?

The examples discussed in this section demonstrate that the UK is fairly unusual in its illiquid pension-saving regime. Other countries with similarly limited social safety nets tend to recognise the value in allowing a degree of early access to pension savings for specific needs, particularly financial hardship, and some offer broader forms of access.

A drawback to hardship withdrawals is that they inevitably deplete an individual's retirement fund. That risk often means that the restrictions on making them – whether legal or administrative – can end up undermining accessibility for the very people who would benefit from flexibility. In light of that dilemma, the loan provisions in US pension plans make for a compelling solution. Mandatory loan repayment to one's own fund effectively mean that the leakage from such a drawdown is massively reduced, which in turn enables legislators to remove the qualifying restrictions that hardship withdrawals typically demand. The result is, therefore, a system that is better at cushioning shocks but does not materially reduce pension adequacy.

There are also lessons to be drawn at the economy-wide level from international experience. Additional flexibility and liquidity 401(k) accounts in the US and to Australian Super accounts during the pandemic highlights the potential macroeconomic stabilisation role savings policy can play when there is more liquidity in the pension-saving regime.

However, it's essential to strike the right balance of liquidity in the savings policy regime to avoid undermining pension saving. For example, government in both South Africa and the US are implementing changes in an attempt to draw a sharper distinction between 'legitimate' early access to savings for the purposes of consumption smoothing and less legitimate drawdown, for example withdrawals that occur for administrative reasons at the point of a person changing jobs.

Currently the UK pension regime offers none of these flexibilities. This seems suboptimal given the evidence presented earlier on the degree of limited precautionary savings held by British families. In the next section we conclude by drawing lessons from the examples explored here and propose a set of reforms that would work in the UK context to remove the tension between precautionary and lifecycle saving in order to boost households' financial resilience across the lifecycle.

Section 6

An integrated savings strategy for the UK would address our triple savings challenge

While needed, efforts to increase pension saving under the current savings policy regime risk exacerbating the inadequacy of household precautionary savings, leaving more people exposed to financial shocks. Addressing these interconnected challenges instead demands an integrated policy response. So in this concluding section we set out a savings strategy to address the UK's triple savings challenge.

We draw upon innovative examples of how this tension between short- and long-term savings objectives is managed in other countries to propose a three-step reform agenda to create a more flexible savings policy architecture that raises households' financial resilience across the lifecycle. First, once currently planned reforms to default contribution rates are implemented, the Government should articulate a medium-term objective to raise the default pension contribution rate to 12 per cent of salary, with both the employer and employee contributions rising to 6 per cent. Second, two percentage points of the employee's pension contribution should initially flow into a highly-liquid 'sidecar' savings account with no restrictions on its use. Any balance above £1,000 would roll over into the employee's pension, attracting tax relief at that point. This would create an accessible pool of savings to allow people to manage cashflow shocks without drawing on high-cost forms of borrowing. And third, to help manage larger shocks, we propose that people be allowed to borrow the lesser of £15,000 or 20 per cent of their pension pot value, on condition of mandatory earning-contingent repayment with interest.

Such an integrated policy framework can boost household financial resilience, help people optimise the use of their lifetime resources, and improve the functioning of the labour market. What's more, it will contribute higher savings to boost investment and growth while also acting as a mechanism to aid macroeconomic stabilisation in times of economic volatility.

It is time to take a broader view of the role of savings policy for the 2030s and begin to chart a course towards an integrated savings regime that can help to boost not only resilience but also prosperity.

The intertwined nature of the UK's triple savings problem requires a holistic solution with well-intentioned efforts to increase pension saving under the current policy regime running the risk exacerbating the precautionary savings' problem. This would leave millions of families exposed to financial shocks and, ultimately, facing the risk of significant hardship if the face of unexpected bad news.

As the previous section set out, this tension between precautionary and retirement savings is one that is managed much better in other countries with comparably meagre social safety nets. There are reforms afoot in some of the countries explored, and those in the US and South Africa are largely focused on creating a better balance between the precautionary and pension-saving objectives. Only in Australia is there a clear direction of policy to tilt savings more aggressively in the direction of mandatory illiquid retirement saving – a policy rooted the fact that the state pension is means tested.

The UK's pension settlement – with voluntary pension saving against the backdrop of a decent universal state pension – has far more in common with those countries that strike a balance between precautionary and retirement savings, so it is time to rethink policy's role in fostering precautionary saving.

There are three distinct – but related – problems to be fixed

How best to support precautionary saving depends on the policy problem we want to address. Schemes like the government's Help to Save matched saving scheme for people on low incomes and Nest Insight's Jars payroll saving pilot are designed to support the accumulation of small amounts of highly liquid savings that can help families cope with cashflow volatility or small unplanned expenditures. Having such a buffer can mean that people are protected from having to draw on high-cost credit, fall behind on rent or bill payments, or rely on financial support from friends and family. This could have a significant positive effect on improving financial security and reducing the anxiety that is strongly associated with precarious household finances.

However, alongside the benefits of small amounts of highly-liquid savings, there are potentially significant advantages to helping people build and access larger amounts of precautionary savings to weather large and infrequent shocks like unemployment and family breakdown. As we set out in Section 2, the Resolution Foundation and others have previously argued that relieving credit constraints on people seeking employment can lead to better job matches by allowing them the time to look for a role that better matches their skills and experience. Unlike many other countries in the OECD, some of which have contributory unemployment support schemes, the UK's meagre unemployment benefits do not adequately provide for that.

At the same time, allowing people access to significant financial support during unemployment has the potential to add to the state's own 'automatic stabilisers' in the form of the tax and benefits system. Bolstering private spending power during unemployment would therefore help to stabilise the economy in a downturn without putting a further burden on fiscal and monetary policy.[81] Small liquid savings buffers are unlikely to make a material difference to these broader goals.

A policy response to address inadequate precautionary savings therefore needs to account for the very different nature of small and high-frequency shocks compared to large and infrequent ones. We propose that both of these goals can be achieved by boosting overall saving rates while removing the tension between pension and precautionary saving. Three broad elements make up a comprehensive savings policy agenda for the next decade: higher pension contribution rates, a side-car savings vehicle and provision for people to take limited loans from their own pension funds. We explore each element in turn below.

Raising default pension contribution rates to bolster living standards in retirement

The first element of a better system is to move towards a higher default pension contribution rate. This should come after planned reforms – to remove the lower earnings limit and to lower the age of auto-enrolment from 22 to 18 – have been implemented. Increasing the default contribution beyond 8 per cent is an ambitious but critical change both to ensure that people save enough to provide them with a comfortable retirement and to increase the resources available to boost domestic investment required if Britain is to reignite productivity growth.[82]

The sharp rise in rates of return on long-dated bonds (and, by implication, equities) since 2022 has substantially boosted anticipated replacement rates for people saving at the current default rate of 8 per cent. However, as shown in Figure 9, for a typical, median earner the default contribution rate is still unlikely to achieve the target income replacement in retirement of two-thirds of final salary, advocated by the Pensions

81 M Brewer & L Murphy, From safety net to springboard: Designing an unemployment insurance scheme to protect living standards and boost economic dynamism, Resolution Foundation, September 2023.

82 Pensions Commission, A New Pension Settlement for the Twenty-First Century: The Second Report of the Pensions Commission November 2005; Resolution Foundation & Centre for Economic Performance, LSE, Ending Stagnation: A New Economic Strategy for Britain, Resolution Foundation, December 2023.

Commission. For example, assuming the lower earnings limit is removed and rates of return remain at the levels currently implied by long-dated bond yields, the typical full-time employee who contributes to their pension from 22 to 68 could expect a replacement rate of 64 per cent on retirement.

There remains huge uncertainty over future rates of return. If the rates of return currently implied by gilt markets prevail then the shortfall in pension saving will be mitigated. However, if rates of return were to slip back to pre-pandemic levels then an 8 per cent default contribution would be far from sufficient. For this reason, we have previously called for the default contribution rate to rise gradually to 12 per cent, with both the employer and employee contributions rising to 6 per cent. This will take time and the precise number for default contributions should respond to the returns environment we face at the time of the change (and be kept under review). The currently planned changes will need time to bed in, and employers and employees would need plenty of notice of a further increase. Moreover, pressing ahead with a higher contribution rate should be conditional on a more propitious outlook for household real incomes.

Nevertheless, it will be important to set out the strategic direction of the savings-policy regime and make progress towards raising default rates by the 2030s. In addition, such a hike in default contribution rates needs to be accompanied by a significant increase in the liquidity of the pension system, the first element of which is an integrated side-car savings vehicle.

An integrated 'sidecar' savings scheme to build a financial buffer for those on low and middle incomes

As we have shown, increasing contribution rates risks amplifying the tension described above and should therefore be complemented with two more radical reforms.

The first of these is the establishment of an automatic payroll savings scheme to help people accumulate liquid savings for the purpose of managing household cashflow volatility and small financial shocks. Taking on lessons from the experience of behavioural policies to increase saving, the scheme should be integrated into the wider auto-enrolment pension framework, with one system to make contributions into both the employee's pension and a liquid savings pot.

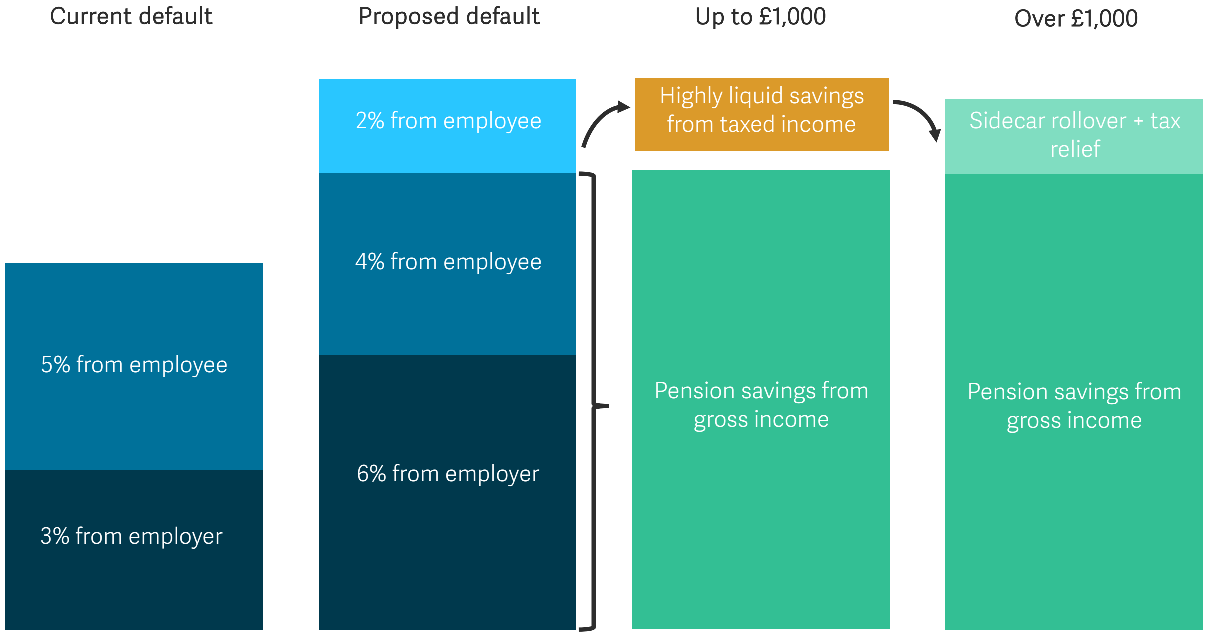
Similar to the Nest Insight Jars side-car savings programme, this could be designed as a limited liquid-savings buffer from which balances roll over into the employee's pension after reaching a given savings target of, perhaps, £1,000. This is the same principle behind new reforms to the US pension regime under the SECURE 2.0 Act of 2019. The new legislation creates scope for pension providers to offer savers the option to withdraw up to USD 1,000 per year without penalty or be auto-enrolled into a payroll emergency saving account for balances of up to USD 2,500.

However, to avoid this reducing the existing flow of pension saving, the sidecar savings should be accumulated only from a further increase in contribution rates above the current 8 per cent default. This increase would be subject to the same annual income trigger (currently £10,000 per year) as current pension contributions. We assume that the lower earnings limit of £6,240, on which no pension contributions are currently made, would have been abolished, in line with current Government plans, hence contributions to the sidecar account would also be made from the first pound of earnings.

We propose that out of the higher 12 per cent default pension contribution, two percentage points of the employee's contribution should initially move into this highly-liquid sidecar savings account. These contributions would initially occur without attracting tax relief, which would then be added to the pension pot as and when balances rolled over into the employee's pension. Figure 8 gives a graphical representation of how the pension and sidecar contributions would interact under the scheme.

FIGURE 9: **A pool of liquid savings could be built up over time under our proposals**

The operation of a sidecar savings scheme using the auto-enrolment infrastructure



SOURCE: Resolution Foundation.

This scheme could work in a number of ways. The detailed design is beyond the scope of this paper and would need to be developed in partnership with pension providers, banks and building societies. Nevertheless, in broad terms it is likely that sidecar accounts would need to be provided by banks or building societies, rather than pension providers, since deposit-taking institutions are best-suited to providing user-friendly accounts that enable people to access their savings instantly. It is possible that the sidecar provider could be chosen by the individual or by the employer as part of its pension offer. The former approach would maximise the flexibility that such a liquid savings buffer is there to provide but may not be compatible with the opt-out approach. An employer-provided sidecar, on the other hand, would be administratively simpler but could risk creating orphan savings pots, especially when people move jobs. Under either approach, it would be incumbent on the sidecar provider to manage additional contributions into the employee's pension when balances exceeded the £1,000 maximum.

How would people use such a savings accounts and what implications might that have for the level of pension saving? Evidence from the Nest Insight Jars programme suggests that behaviour tended to fall into one of three patterns. Some employees regularly dip into their sidecar savings account in order to manage cashflow volatility from week to week. This is an entirely valid use of the payroll savings idea, particularly if it helps households to manage cashflow shock without the need to draw upon high-cost credit or other forms of debt. This group therefore tends to have relatively low levels of savings in their accounts with no additional contributions rolling over into their pension. A second group of savers appear to build up a significant balance as a buffer against financial shocks, such as car repairs. This group would likely have minimal additional contributions rolling over into their pension. And a third group used their sidecar as a mechanism for achieving a specific savings goal, such as a holiday or home deposit, at which point funds were withdrawn and they began rebuilding their sidecar balance again.[83]

These behaviours illustrate the scope for people to tailor the use of the new account to their particular needs. If 12 per cent pension contributions puts too much pressure on current consumption, as is likely to be the case for the first group identified above, then the sidecar allows them to reduce their pension contributions – albeit to a level still higher than today's – without opting out entirely. Meanwhile, for the other groups, additional pension contributions will be made if the individual doesn't encounter a shock – precisely the purpose of the scheme.

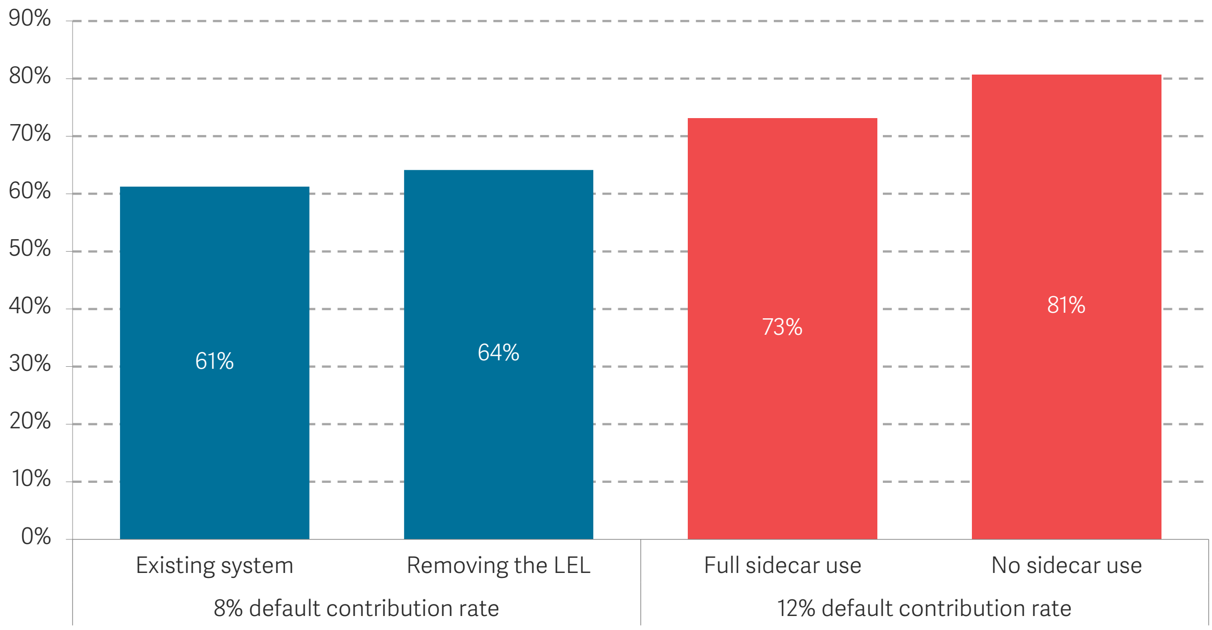
The sidecar offer can, therefore, succeed in raising pension saving for those on middle incomes who are at greatest risk of undersaving for their retirement, while allowing flexibility for those who cannot afford to do so. It also helps people on the lowest incomes to manage their finances without recourse to costly overdrafts, debt or delayed bill payments.

83 J Phillips et al., Payroll saving Behaviours: Learnings from the UK sidecar savings trial, Nest Insight, May 2022.

What is the likely combined effect of raising default contribution rates to 12 per cent and introducing a sidecar facility on retirement incomes? Figure 8 illustrates a range of possible outcomes and compares them to the current 8 per cent default regime, with and without the changes already in train. Under a 12 per cent default contribution, people who regularly spent sidecar funds would still achieve the target replacement rate of two-thirds income even if rates of return were to revert to their pre-pandemic levels.

FIGURE 10: **12 per cent default contribution and sidecar flexibility offers substantially improved retirement outcomes**

Income replacement rate for a median full-time employee under different conditions



NOTES: This assumes employees work full-time throughout the entirety of their working lives and contribute to their pension from age 22 to 68. Earnings growth is based on the OBR's long-term economic determinants projections. We assume a 3 per cent nominal return on bonds, a 6.5 per cent nominal return on equity and that pension providers charge a 0.5 per cent annual fee on returns. Pension pots have a 70:30 split between equities and bonds, which, 10 years before retirement age, rolls down linearly to 70 per cent bonds and cash.
SOURCE: RF analysis of: Bank of England, Yield curves; ONS, Annual Survey of Hours and Earnings; OBR, Economic and fiscal outlook March 2023.

A possible objection to the approach is that inevitably low interest rates paid on accessible sidecar savings would hold back returns for better-off savers. However, the option to withdraw from the scheme and contribute directly to one's pension at the full default contribution rate should address such concerns.

Nevertheless, a sidecar's benefits – small amounts of readily accessible money – make it inappropriate for protecting families against more significant and infrequent household income shocks such as unemployment or family breakdown. To help people manage these risks we need to complement the sidecar scheme with giving people limited and conditional access their pension pots during working life.

For larger shocks, we propose a flexible loans system with mandatory repayment

Since the purpose of a sidecar savings buffer is to help people manage small shocks, this puts a premium on flexibility and easy access. Such features are obviously undesirable for the bulk of pension saving, both because that risks jeopardising people's provision for their retirement and because the tax relief available on pension contributions means that early withdrawals would need to be taxed, creating administrative barriers and costs that undermine flexibility. This means that a different approach involving a lower degree of liquidity is required to help individuals weather large shocks to their income or costs.

One approach to achieving this is to allow people to withdraw some portion of their pensions savings in cases of hardship. There is provision for this in the US, Canadian, Australian and New Zealand systems. Typically, people need to provide evidence of their need or qualification for hardship withdrawals, for example in Australia people have to have been claiming out of work benefits for at least six months. However, there are significant drawback to allowing hardship withdrawals. First, they are likely to result in reduced pension saving – which may not be a bad thing in some cases, but will in many. And second, the system requires some form of bureaucratic assessment as the gateway to eligibility, which would add significant cost into the system and will probably lead to fewer people accessing the system when they have a genuine case for doing so.

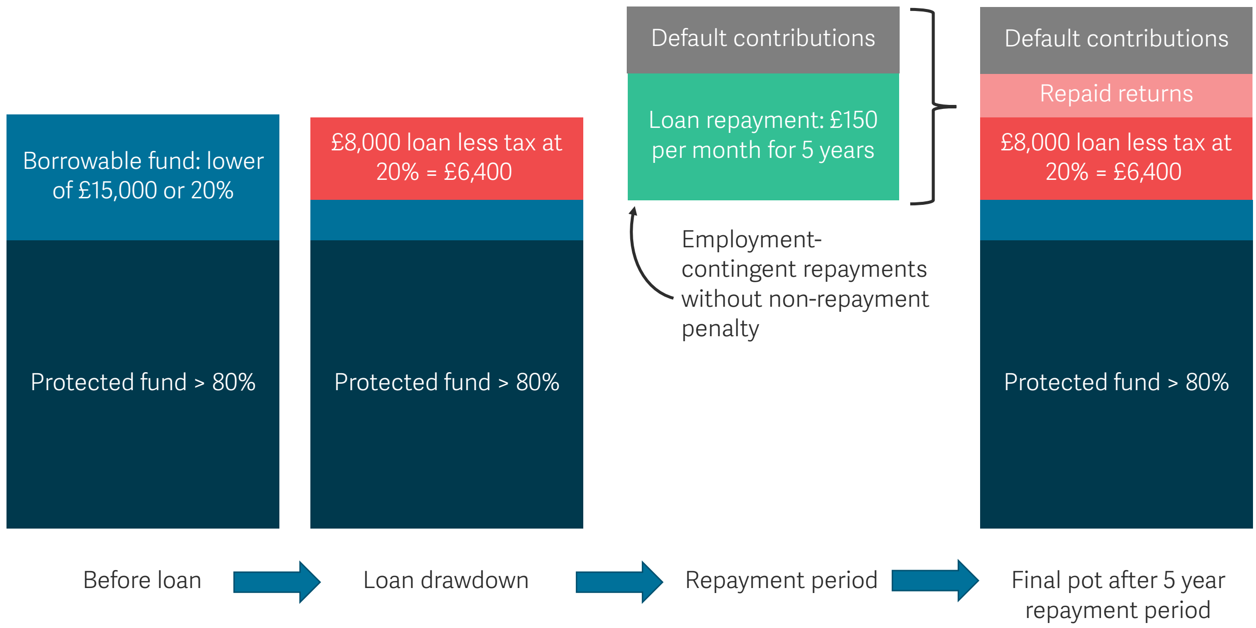
A better way to introduce such flexibility would be to follow the example of most US 401(k) plans and allow people to borrow from their own pension pots. We propose that loans would be restricted to the lesser of £15,000 (roughly six months' income for someone on median earnings) or 20 per cent of their pension pot value – significantly more restrictive than the USD 50,000 or 50 per cent limits on 401(k) loans. While an individual would be able to take multiple loans, the total outstanding principal would be limited to the 20 per cent or £15,000 maximum for any given pension pot. Fund managers would be required to liquidate some of their assets to make the loan disbursement and the money would be taxed on withdrawal at the individual's marginal rate. As in the US, pension providers would be entitled to charge an administrative fee for the service.

There would be no gateway test for eligibility for a loan, allowing people to draw down money for any purpose. However, anyone taking a loan from their pension would be required to agree to mandatory but earnings-contingent repayments of the loan, with interest, over a pre-agreed period of perhaps one, three- or five-years dependent on the size of the loan. Borrowers would take on an amortisation schedule of fixed monthly repayments when in work and earning above the income trigger for auto-enrolment. Unlike the US system, where non-repayment of a loan incurs a 10 per cent early withdrawal penalty, we propose that no penalty should be levied on non-repayment given that repayment would be linked to earnings and people failing to repay are, therefore, unlikely to be in a position to do so.

In the US system, this loan facility means that people can often avoid borrowing from higher-cost commercial lenders. But to avoid the depletion of their pension savings in the long term, an interest rate is charged on loans which go back into their savings alongside the principal. In the US, the interest rate is typically around one hundred basis points above the commercial prime borrowing rate (currently around 8 per cent in total at present). In the UK, the Financial Conduct Authority prescribes rates of return on different asset classes that govern the projections financial institutions can make when telling retail customers how they can expect their savings to grow.[84] Currently these suggest a central case of 5 per cent annual nominal return for a pension pot with a conventional asset allocation. To prevent the depletion of people's pension savings while taking out a loan it would therefore be reasonable to levy an interest rate equal to this expected rate of return.

FIGURE 11: **Allowing people to borrow from their pension savings allows smoothing through larger shocks**

The operation of pension-scheme loans under the auto-enrolment infrastructure



SOURCE: RF analysis.

How much leakage from pension pots might we expect to see under this kind of regime? In the US, as explored in Section 3, the loan facility in 401(k) plans is widely used with research suggesting that around one in five participants have a loan outstanding at any

84 Financial Conduct Authority, Rates of return for FCA prescribed projections, September 2017.

one time and between 30 and 50 per cent of participants take a loan from their pension plan at some point over a five-to-seven year period.[85] The median individual loan was USD 5,600 in 2015 prices, while the median total amount borrowed was USD 7,400, approximately £4,800 and £6,400 in today's money, respectively. Nevertheless, repayment rates are very high, with over 90 per cent repaying the borrowed funds into their pension pot and most of them doing so at the point of job separation.[86] This suggests that the 401(k) loan facility does not create significant leakage from US pension saving.

There are two potential sources of leakage under the system outlined here. One is that the borrower may not return to employment and so fail to repay the loan. This is particularly likely for older workers for whom a loan could end up looking similar to gaining early access to a proportion of their pension fund. However, this concern could be addressed by raising the normal minimum pension age (NMPA) from its planned level of 57 in 2028. For borrowers who are not close to retirement, non-repayment would only happen if they were unable to find employment. In that case, maintaining a substantial pension savings in the face of substantially reduced income in working life would result in undesirable income volatility in any case.

The second source of effective non-repayment is if people subsequently opt out of their regular default pension contributions. In other words, the individual repays the loan itself but makes lower contributions in the meantime, leaving their pension pot smaller than it would have been absent the loan. Naturally, since the UK private pension system is a voluntary one, people could opt out of making contributions at any time. And where people face straitened financial circumstances they are presumably more likely to opt out of making pension contributions in any case. So the nature of this risk can be overdone.

Evidence from the US also gives comfort that this effect is likely only to be marginal. One study concludes that loan repayments may reduce pre-loan pension contributions by around 0.5 to 1 per cent of earnings, from an average of 6 per cent to 5 to 5.5 per cent of annual earnings – a reduction of 8 to 17 per cent.[87] Another study finds that savers cut their pension contributions by around 6 per cent after taking a loan.[88]

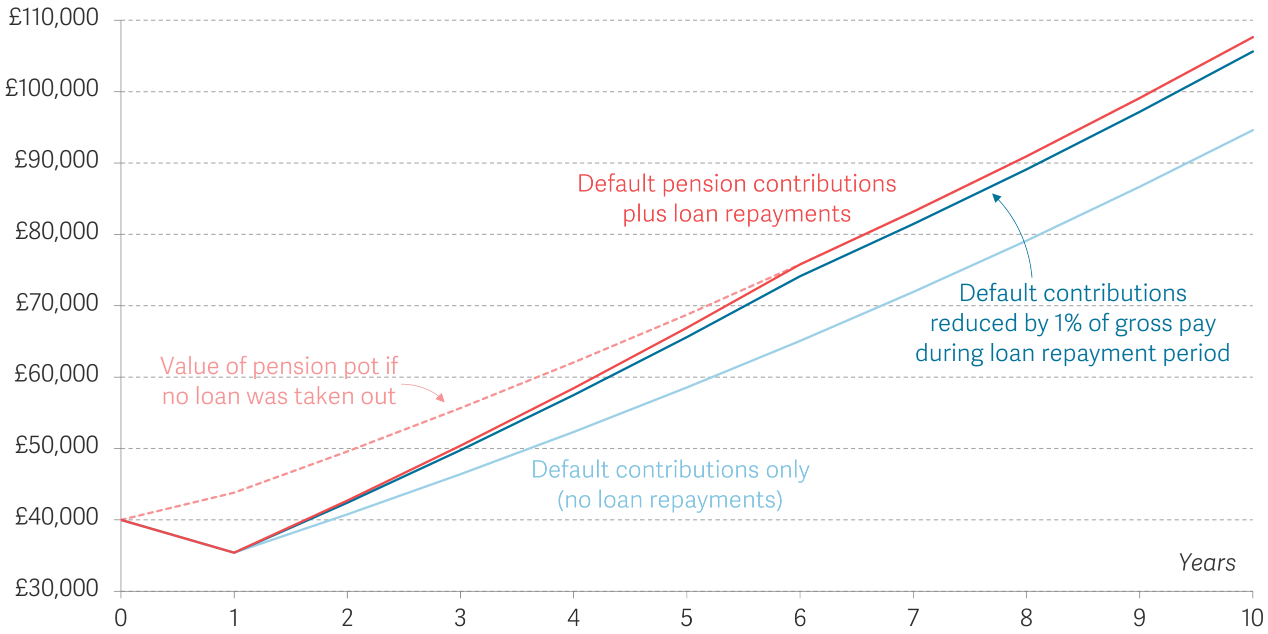
Either way, it is unlikely that that loans will significantly alter people's ongoing saving behaviour, and where they do so this may be for good reason. Modelling in Figure 12 shows how a representative individual's pension savings would evolve if they experienced

85 J Beshears et al., The availability and utilization of 401(k) loans, National Bureau of Economic Research Working Paper 17118, June 2011; T Lu et al., Borrowing from the future: 401(k) plan loans and loan defaults, National Bureau of Economic Research Working Paper 21102, April 2015.
86 T Lu, O S. Mitchell & S P Utkus, An Empirical analysis of 401(k) loan defaults, RAND Working Paper, October 2010.
87 J Beshears et al., The impact of 401(k) loans on saving, September 2010.
88 T Lu et al., Borrowing from the future: 401(k) plan loans and loan defaults, National Bureau of Economic Research Working Paper 21102, April 2015.

a six-month unemployment spell causing them to draw down £8,000 – broadly the mean US 401(k) loan size – and subsequently reduced their pension contributions by 1 per cent of their gross salary during the loan repayment phase (the upper end of the range suggested by the US studies). This modelling shows that the impact of temporarily reducing default pension contributions during the loan repayment period has a negligible impact on a person's pension pot after 10 years. For example, a person who re-enters employment earning £30,000 a year and reduces their default contributions by 1 per cent of their gross pay would see a 2 per cent reduction in their pension pot after 10 years compared to if they had continued to contribute at the default rate.

FIGURE 12: **A flexible system of loans could allow people to borrow to smooth through periods of unemployment**

Simulation of the impact of borrowing against a pension pot through a period of unemployment



NOTES: This is an indicative calculation of the impact for a typical earner of borrowing against a pension pot based on a number of assumptions. In year 1, the individual first experiences a six-month spell of unemployment and borrows £8,000 from their £40,000 pension pot. They subsequently return to employment at an income of £30,000 for the remainder or the year and remain in employment at the same level of earnings in all subsequent years. Default rates for employer and employee pension contributions are assumed to be 12 per cent in total. Reflecting an assumption that the lower earnings is removed, we assume that default rates apply to gross earnings. The £8,000 loan is assumed to be repaid over a five-year period starting in year 1. The individual's pension pot is assumed to grow at 5 per cent per year, in line with the FCA's latest prescribed rates of return. In order to repay lost returns, pre-tax loan repayments are set at £162 per month during the loan repayment period.
SOURCE: RF analysis.

A final consideration for both the loan facility and the sidecar scheme is that the capital rules within the benefit system mean that benefit units with more than £6,000 in non-pension, non-housing assets see their benefit entitlement reduced. Above £16,000 in savings their entitlement is reduced to zero. Given the typical scale of pension scheme loans drawn down in the US, it seems unlikely that these capital limits would be breached in most cases. Nevertheless, the capital limits have remained frozen at these levels since 2006 and uprating their value to today would see the thresholds reset at around £10,000 and £26,000 respectively, providing more headroom for people to use the new mechanisms to supplement any benefit claims.

There are wider benefits to increasing working-age savings' flexibility

With the full rollout of pension auto-enrolment, the UK pension settlement is beginning to mature. As we look ahead to the next decade there are many different policy issues on the agenda, including the already-planned changes to auto-enrolment age and income thresholds, pension scheme consolidation, the pensions dashboard, the 'productive finance' agenda outlined by the Chancellor in his 2023 Mansion House speech, and growing questions over decumulation. Raising default contribution rates and introducing the flexibilities we propose here would be a further significant set of changes.

But the experience of the early 2020s has served to underline the need to prioritise bolstering households' financial resilience. It is time to take a holistic view of savings policy rather than considering the pension system in isolation from its effects on household resilience and continuing to rely on largely ineffective financial incentives alone to boost precautionary saving. The integrated savings framework proposed above applies what we have learnt about the power of behavioural framing in a way that can improve dangerously low levels of household financial resilience in working age while also bolstering the adequacy of retirement provision.

In the process such a regime would generate additional micro and macroeconomic benefits. By giving people the resources to take time to find a better job match after a period of unemployment our proposal could both enhance productivity and bolster people's confidence to take the risky step of investing in their own skills. In boosting overall saving rates by households, this agenda would also contribute potentially significant quantities of finance for much needed domestic investment, reducing reliance on foreign lending. And by providing a potentially substantial financial safety net, the framework would create a private automatic stabiliser in the macroeconomy, helping to sustain household consumption at times of rising unemployment without increasing the burden on public spending.

For social, microeconomic and macroeconomic reasons, then, there is a growing case to reimagine savings policy for the 2030s. By thinking bigger about the tensions and opportunities it presents, and being creative about how we address them, we can begin to chart a course towards a settlement that boosts not only resilience but also prosperity.

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