

III – Is the UK saving enough?

There is a widespread view, reinforced by the conclusions of the first report of the Pensions Commission (October 2004), that the UK savings rate is too low, particularly in the context of an ageing population. At the macroeconomic level, the concern is that a low level of national savings means that either UK investment is constrained, reducing long-term economic growth, or the country has to run an unsustainably large current account deficit, which might eventually lead to a loss of confidence by international investors and a run on the pound¹. These potential problems mirror those discussed in Section IV below for the US, although there the current account deficit is relatively much larger and the decline in the dollar has already begun.

At an individual level, there are related concerns that current generations of workers are not saving enough for their retirement, which may result in relative poverty in old age, or a need to continue working much longer, or a higher burden on future taxpayers as future pensioners rely increasingly heavily on means-tested state benefits. This concern is amplified by the trend in recent years towards many employers scaling back their provision of occupational pensions.

In this special article we consider in more detail how significant these concerns are and discuss some of the potential implications for public policy, both as regards pensions and savings and as regards the Government's fiscal rules. The discussion is organised as follows:

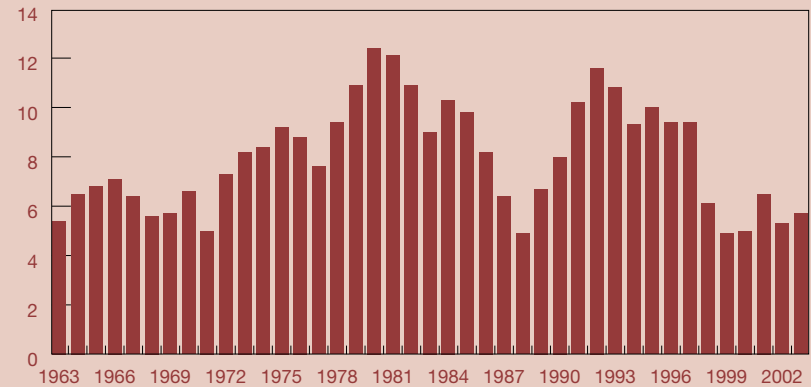
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- III.2: Adequacy of individual savings
- III.3: Public policy implications
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III.1 – Adequacy of UK national savings

Trends in UK savings rates

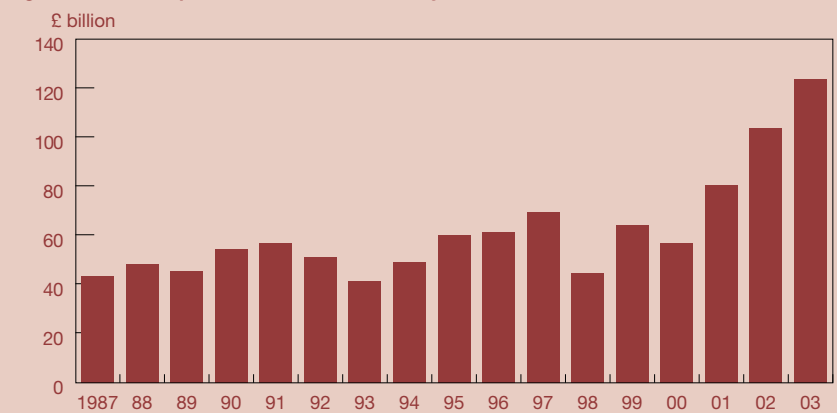
The most commonly quoted measure of UK savings is the **household savings ratio**,

Figure 3.1 – UK household savings ratio
% of total household resources



Source: ONS

Figure 3.2 – Net acquisition of financial assets by UK household sector



Source: ONS

where savings is measured as the difference between household disposable income² and household consumption. As can be seen from Figure 3.1, this ratio fell in the mid-to-late 1980s boom, rose again in the early 1990s recession, but then fell back sharply in the late 1990s as the economy started to boom again, and has stayed relatively low.

The decline in the household savings ratio shown in Figure 3.1 is often taken as evidence that the UK now has a problem of inadequate savings, although it should be noted that variations in the ratio largely reflect cyclical variations in household borrowing rather than changes in the amounts being invested by households in financial assets. In recent years, in fact, accumulation of financial assets by households seems to have been relatively strong (see Figure 3.2). Furthermore, changes in household borrowing tend to be closely linked to movements in house

prices (in particular through mortgage equity withdrawal), so both the asset and liability side of the household balance sheet have been increasing in recent years. In effect, rising house prices (and perhaps also rising share prices before 2000) have been doing much of the saving for households, allowing them to feel comfortable with a relatively low household savings ratio.

Another important point is that, with inflation now apparently anchored at a much lower level than was the case from the early 1970s to the early 1990s, there is less need for additional saving in order to maintain real wealth levels. Bank of England analysis³ suggests that this lower inflation environment can explain a significant element in the decline in the household savings ratio between the early 1990s and the late 1990s.

The decline in the household savings ratio since 1997 might therefore be regarded as

¹ Up to a point, some decline in the pound might be considered desirable but not if this is too large or too fast.

² An adjustment for changes in the net equity of households in pension funds is included in the income measure ('total household resources') used to calculate the household savings ratio.

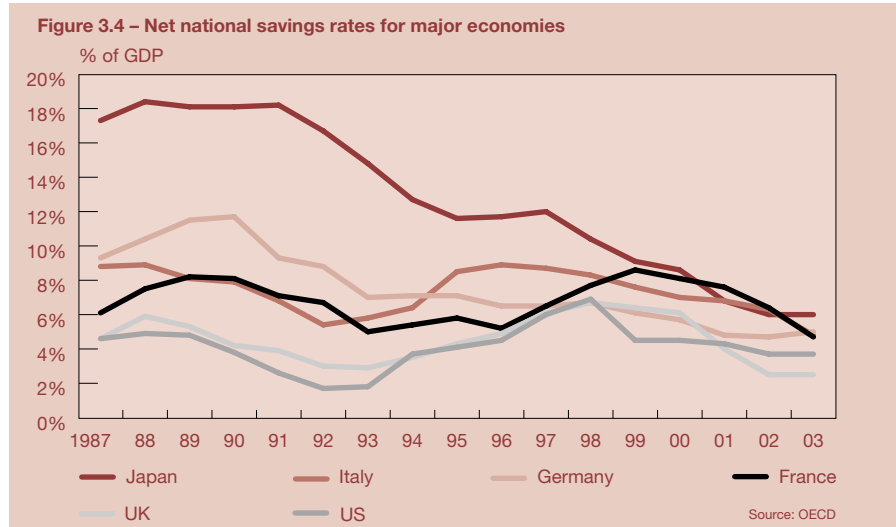
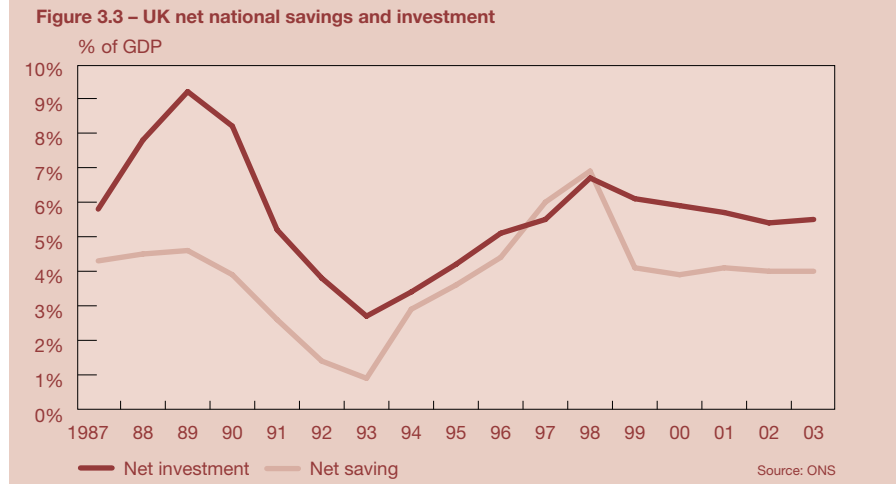
³ Melissa Davey, 'Saving, wealth and consumption', Bank of England Quarterly Bulletin, Spring 2001.

less of a concern once these additional factors are taken into account. Furthermore, it should also be noted that if a rapid increase in the savings ratio were to materialise over the next few years, associated with a sharp decline in household borrowing and consumption, this would not be particularly desirable as it might well push the UK economy into recession, given also that global economic growth is slowing at present.

Nonetheless, there remain some reasons to believe that a gradual upward adjustment in the UK's savings rate would be desirable. These can best be highlighted by focusing on a different measure, namely the **UK net national savings rate**. From a macroeconomic perspective, there are two reasons why this ratio is more important than the household savings rate. First, it also takes into account the savings of the corporate and public sectors, which can make an important contribution to determining the amount of domestically-generated resources available to fund UK investment without borrowing from abroad and thereby potentially running up unsustainable external debts in the long run.

Second, the household savings rate does not net off depreciation of fixed assets owned by the household sector (mostly dwellings). From an economic perspective, it is only once savings are more than adequate to cover depreciation of fixed assets that these savings can begin to contribute towards funding a genuine net increase in the capital stock of the kind necessary to support long-term economic growth. This is also the basis on which the Chancellor sets his 'golden rule', which requires the net public savings ratio (as a % of GDP) to be non-negative on average over the economic cycle, where net public savings are defined as the difference between total public sector receipts and total public sector current expenditure, including depreciation.

As illustrated in Figure 3.3, there has been a decline in net national saving since 1998, although the ratio remains well above its low point in the early 1990s. This has to some extent been mirrored by a decline in net national investment since 1998, though this has been mitigated by increased borrowing from abroad. This has, however,



resulted in an increase in the UK current account deficit, to around 2.5% of GDP in 2004, to fill the funding gap between domestic savings and investment⁴. At present, a deficit of this size does not pose significant concerns, but if it were to go much higher, then this situation could change, leading to a sharp fall in the pound. This, while good news for UK exporters, could push up inflation and interest rates. If UK investment is to increase in order to support longer-term growth, therefore, this really needs to be funded in the medium term through higher net national savings rather than by increased borrowing from abroad.

International comparisons

As illustrated in Figure 3.4, relatively low levels of net national saving are not a new phenomenon for the UK. Over the period 1987-2003, the average UK net savings rate of 4.1% of GDP was slightly lower than the US (4.5%) and significantly lower than other

major European economies (6.8-7.5%) and Japan (12.7%, although declining significantly over time). Low saving has been associated with a relatively low investment to GDP ratio in the UK and, indeed, the US, despite persistent current account deficits in both countries.

On the other hand, it would be hard to argue that there is any simple relationship between savings and investment ratios and economic growth. The UK has seen the second highest average GDP growth rate since 1987 after its low-saving cousin the US, while higher savings and investment rates in the other major EU economies and particularly Japan have been associated with relatively slow growth over this period. This may reflect the fact that the quality of investment in the US and, to a lesser degree, the UK has been relatively high, as indicated by the continued willingness of international investors to fund the current account deficits in these countries. It may also reflect the fact that high household savings rates in Euroland and Japan have

⁴ In practice, statistical discrepancies mean that the current account deficit is generally not identical to the savings-investment gap, but the two do move broadly together over time.

generally been associated with an endemic lack of consumer confidence in these countries that has made it difficult for them to sustain strong domestic demand growth.

These comparisons make clear that high national savings rates are not an end in themselves. They need to be combined with mechanisms to ensure that the funds are channelled into the most productive investments. In the period from the 1960s to the 1980s, the bank-based systems prevalent in other European countries and, in particular, Japan seemed to be relatively successful in achieving this, but the experience since the early 1990s has been more favourable to the market-based financial systems in the US and the UK. This is not to say, however, that US and UK growth could not have been greater had their savings and investment rates been higher: standard economic theory suggests that this would have been the case given a reasonably efficient system of financial intermediation. Is there any way, however, that we can try to quantify the extent to which UK national savings rates have been too low in recent years?

What would represent an adequate level of UK national savings?

One approach to this question has been suggested recently by Martin Weale (2004)⁵ in the context of setting EU fiscal targets. He suggests that a reasonable long-term objective might be to save enough to keep the ratio of national wealth to GDP constant. Assuming, in a steady state, that a constant proportion of national wealth is consumed each year, this would allow consumption to grow in line with income once the target wealth to GDP ratio had been reached. If trend GDP growth is g and the target wealth-GDP ratio is w , then the required net savings rate would be $w \cdot g$.

Weale suggests that it may be reasonable to focus on the net produced capital stock (i.e. excluding land) and suggests that a typical ratio to GDP based on historic international evidence might be around $w = 3$ on this definition. Given trend real

Table 3.1 – Alternative estimates of UK net national savings shortfall

£ billion (at 2004 values)		Trend real GDP growth rate		
		2.25%	2.5%	2.75%
Target capital stock to GDP ratio (w)	$w = 2.5$	17	25	32
	$w = 3$	30	40	48
	$w = 3.5$	43	53	63

Note: This table shows how much average net national savings (at 2004 values) would have to increase from 1987-2003 average of 4.1% of GDP to meet the long-term target implied by each set of assumptions
Source: PwC calculations based on approach set out in Weale (2004)

GDP growth of, say, 2.5%⁶, this implies a target net national savings rate of around 7.5% of GDP. Compared to the UK average of around 4.1% since 1987, this suggests a net savings shortfall of around 3.4% of GDP per annum on average over this period, or around £40 billion per annum at current values. A similar conclusion follows if we look just at the latest available annual data, which show a UK net national savings rate of 4% in 2003.

These estimates are clearly subject to some uncertainty concerning both the trend rate of GDP growth (g) and the target wealth-to-income ratio (w). A lower estimate might follow from assuming $g = 2.25\%$ and $w = 2.5$ (the latter is in line with current estimates for the UK). In this case, the target net national savings rate would be only around 5.6% of GDP and the shortfall would be only around 1.5% of GDP, or around £17 billion at current values. A higher estimate would follow from assuming $g = 2.75\%$ and $w = 3.5$ (the latter allows for some catch-up on the UK's past relative under-investment and/or a possible desired increase in the wealth to income ratio in anticipation of an ageing population). This would give a target net national savings rate of around 9.6% of GDP and a shortfall of around 5.5% of GDP, or around £63 billion at current values. Table 3.1 shows results for these and other possible combinations of assumptions.

It can be concluded from this analysis that UK net national savings do appear to be significantly below the levels necessary to achieve a stable wealth-to-income ratio in line with international norms, although the magnitude of this 'savings gap' is subject to great uncertainty, with a plausible range of around £20-60 billion⁷.

III.2 – Adequacy of individual savings

The above analysis relates to national savings. The estimated savings gap could in principle be filled through any combination of individuals, companies and government saving more. Much of the public debate on this issue, however, has focused on the narrower – but still very important – issue of whether individuals are saving enough for their retirement, given what they can reasonably expect in terms of state pension provision. The ABI⁸, for example, estimates that over 12 million people are not saving enough to ensure an adequate income in their old age. The Pensions Commission estimated in their first report that "around 9 million people may be under-saving, some by a small amount, some severely"⁹. The report also states, however, that this should be regarded as a minimum estimate of those under-saving in pensions: the true figure may already be higher and would be likely to grow over time as the shift from Defined Benefit (DB) to Defined Contribution (DC) schemes continues in the private sector, a shift which is generally associated with significant reductions in employer pension contributions.

As discussed in the Pensions Commission report (p.158-159) estimates of the number of people under-saving rely on a large number of simplifying assumptions and suffer from imperfect data on current pension saving together with an almost total lack of data on accumulated past stocks of pension saving. Given these severe data limitations, we have not attempted to produce estimates of our own of the number of people under-saving. Instead we have drawn on some of our previous research¹⁰, supplemented by new information contained in the Pensions

⁵ M. Weale, 'National Saving and the Stability and Growth Pact', NIESR discussion paper (2004). Further details of this approach were provided in O. Pomerantz and M. Weale, 'Are we saving enough? The macroeconomics of the savings gap', National Institute Economic Review, January 2005.

⁶ At present, the Treasury estimates trend GDP growth at 2.75%, but this is expected to fall to 2.5% after 2006/7 due to slower growth of the working age population. There could be further declines in trend growth after 2010 as the population continues to age.

⁷ Pomerantz and Weale (2005) estimate a somewhat similar range of £16-66 billion, although the derivation of this is rather different as it is based on a wider range for w of 2.5-4.3, a trend growth rate of 2.5% and an estimated current net national savings rate of 4.7% based on the average for 1997-2003, rather than the 1987-2003 average used in our analysis.

⁸ ABI, State of the Nation's Savings 2004, November 2004.

⁹ Pensions: Challenges and Choices, the First Report of the Pensions Commission, October 2004. The quote comes from page xi of the Executive Summary.

¹⁰ As summarised in an article on 'The Outlook for UK Pensions', in the February 2003 issue of this UK Economic Outlook publication.

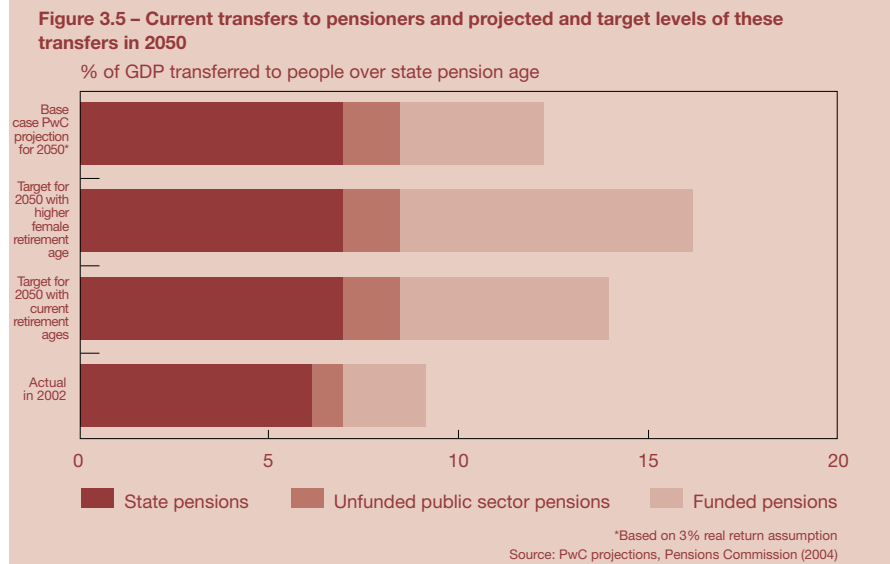
Commission report, to provide some estimates of total future payouts from UK private pensions based on alternative assumptions on, in particular, rates of return on pension fund investments and future contribution rates. This provides a cross-check on some similar analysis in Section 4 of the Pensions Commission report (p.144-149 and Appendix B). In common with that report, we focus on the adequacy of total projected incomes for pensioners in 2050.

The Pensions Commission report estimates (p.145) that, depending on the extent to which female average retirement ages rise to match those for men in response to the equalisation of male and female state pension ages between 2010 and 2020, the 'target' proportion of GDP that needs to be transferred to pensioners in 2050 to keep their relative living standards¹¹ the same as now would have to increase from around 9.1% of GDP in 2002 to around 13.9-16.1% of GDP in 2050 (see Figure 3.5). How likely is this target to be achieved?

Projected state pension payments

Starting with **state transfers to pensioners**, the Pensions Commission relies on government estimates that these will increase from around 6.1% of GDP in 2002 to around 6.9% of GDP in 2050. In practice, it is possible that these state transfers could be higher if private pension incomes do not grow in line with average earnings as the government assumes, so pushing more future pensioners on to means-tested benefits. The extent of this effect is highly uncertain, but could be significant (i.e. 1% of GDP or more). It therefore needs to be borne in mind as discussed further below.

Income from **unfunded public pension schemes** also needs to be taken into account. The Pensions Commission report notes that these kind of schemes currently pay out around 1.5% of GDP, but of this an amount equal to only around 0.8% of GDP goes to people above state pension age, presumably due to the normal retirement age currently being set at 60 in the public sector and the past prevalence of even earlier retirement in some of the public sector professions covered by these



schemes. The Pensions Commission assumes, in the absence of better data at the time they were preparing their report, that these figures remain constant over time, so that transfers to pensioners from this source remain at 0.8% of GDP in 2050.

Since then, however, the Treasury¹² has published for the first time long-term projections for unfunded public service pensions, indicating a rise from 1.5% of GDP in 2003/4 to around 2.2% of GDP by 2050. These projections take into account planned reforms to these public pension schemes, in particular a rise in normal retirement ages to 65, in order to keep costs under control. These reforms are also likely to increase the proportion of payments from these schemes going to people above state pension age. Taking this latter effect into account, we assume that total payments to pensioners from these unfunded pension schemes increase from around 0.8% of GDP at present (53% of the total) to around 1.5% of GDP (c.70% of the total of 2.2%) by 2050. This is somewhat arbitrary, but seems more plausible than the Pensions Commission assumption that these payments remain at only 0.8% of GDP.

Assuming for the moment that state pension transfers are in line with government projections, this therefore implies a total payout from government of around 8.4% of GDP, and a potential gap to be filled by private sector pensions of around 5.5-7.7% of GDP, depending on the assumptions made about future average

retirement ages. Can the private sector fill this gap?

Private pensions model description

To address this issue we have constructed a model that looks separately at each cohort of the UK population born between 1955 and 1985. These people will be aged 65-95 in 2050 and so would make up the great majority of the UK pensioner population at that date. We model private pension contributions, fund performance and payouts for representative individuals in each annual age cohort, which are then weighted according to the size of each cohort to produce our aggregate results. People are assumed to start saving at age 25 and to continue to do so until they retire at age 65. Pension fund assets during the accumulation phase are assumed to rise at a net real rate (after costs) that varies from 2-5% per annum in the various cases we have considered. Annuity rates are set based on an average life expectancy of 85 and a real net bond return of 1.3% on remaining funds during the decumulation phase. For simplicity, we do not vary this assumption over time. This was also the Pension Commission assumption.

Historic average private pension contributions are based on estimates in the Pensions Commission report for the period since 1991, and are assumed constant at 1991 levels in 1981-1990. In the future, our

¹¹Defined here as the ratio of pensioner incomes to average net incomes across the population as a whole.

¹²HM Treasury, Long-term public finance report, December 2004 (see Table 5.1 on p.50).

base case assumption, again in line with Pensions Commission projections, is that average private pension contributions (in total for employers and employees) decline gradually from 3.8% of GDP in 2003 to 2.9% of GDP in 2030, reflecting the assumed shift from DB to DC schemes. For simplicity, the same average pension contribution rate is assumed to apply to all cohorts aged between 25 and 65 in a given year. Alternative cases are also considered with pension contribution rates from 2030 set at between 2% and 5% of GDP and a gradual transition in each case between now and 2030.

Private pension model results

Table 3.2 summarises the results of our private pension modelling for real net rates of return on pension fund assets of between 2% and 5% per annum and long-term private pension contributions rates of between 2% and 5% of GDP (these are the key assumptions for sensitivity analysis in this model).

For the base case contribution rate of 2.9% of GDP and real rates of return of 3-4%, which broadly correspond to the assumptions for the main case presented by the Pensions Commission, the model suggests private pension payments of around 3.8-4.7% of GDP in 2050. Our estimates are somewhat higher than the corresponding Pensions Commission report estimate of 3.4-4.2% of GDP for similar assumptions (see Table 4.5 on p.147 of their report), but the difference is not great given the many uncertainties underlying any such long-term projections. This is illustrated by the alternative estimates in Table 3.2, which vary from only 2.6% of GDP in a case with only a 2% real rate of return and a 2% contribution rate, to 7.8% of GDP with both the real rate of return and the contribution rate set at 5%. These extreme cases are, however, relatively improbable.

If we compare our estimates of private pension payments in 2050 to the target of around 5.5-7.7% of GDP derived earlier, we can see that, based on a reasonably conservative real rate of return assumption of 3%, the gap would be around 1.7-3.9%

Table 3.2 – Alternative projections of total private pension income in 2050

% of GDP in 2050		Net real rate of return on pension fund			
		2%	3%	4%	5%
Private pension average contribution rate (% GDP)	2%	2.6	3.2	4.0	5.1
	2.9%	3.1	3.8	4.7	5.9
	4%	3.7	4.5	5.5	6.9
	5%	4.3	5.2	6.3	7.8

Source: PwC model estimates

of GDP (or around £20-45 billion at current values). To bridge this gap based on the lower bound of the target range (which assumes, plausibly enough perhaps, that female average retirement ages will eventually rise to match those of men) would require average long-term pension contributions to rise from around 2.9% of GDP in the base case to around 5.5% of GDP, an increase of around £30 billion. If female retirement ages remain lower on average than those of men, however, then the required pension contribution increase would be higher.

As pointed out in the Pensions Commission report, however, at present only around 60% of the income from private funded pensions goes to people of state pension age. The other 40% goes to early retirees. If this continues to be the case, then the contribution gap would be higher, although there are reasons to believe that this may change as a combination of increased expected longevity and the switch to DC schemes makes early retirement less attractive and common.

Whatever the precise assumptions made on average retirement ages, however, the general conclusion seems to be that current projections suggest that private pension contributions will not be sufficient to maintain relative pensioner living standards. To the extent that this is not politically acceptable, there would be pressure for increased state pensions spending, whether through a higher basic state pension (or a new citizen's pension) or just through significantly more pensioners coming to rely heavily on means-tested pension credit payments in the future. In either case, state pension costs seem likely to be higher than current government projections suggest unless a way can be found to boost private pension contributions over the next 10-20 years.

III.3 – Public policy implications

It is beyond the scope of this article to discuss all the possible public policy implications of the above analysis, but we comment briefly on three areas below: state pension reform, the case for increased compulsory pension savings, and the potential implications for the government's fiscal rules.

State pension reform

The government has put significant extra resources into state pensions since 1997 and has made some progress in reducing pensioner poverty. Despite these positive achievements, however, many commentators (including the ABI, the CBI, the TUC, the NAPF and Help the Aged) have expressed concern that the current regime implies a sharp increase in the long run in the proportion of pensioners who will be reliant on the pension credit and other means-tested benefits to top up a basic state pension that will, on current policy, decline to only around 7% of national average earnings (NAE) by 2050. Estimates by the IFS, for example, suggest that, based on current policies, around 80% of pensioners could be eligible for the pension credit by 2050.

This is a potential concern for two main reasons. First, take-up rates for means-tested benefits tend to be relatively low (only around 70% for the pension credit at present), which may mean that many relatively poor pensioners lose out, although it could be that take-up rates will rise in the future. Second, and probably more importantly in the light of the analysis above, the pension credit implies that, for those eligible for it, there is an effective 40% tax rate on the income from private pensions¹³. Given the possibility that this

¹³This is at least an improvement on the 100% effective tax rate that applied to some pensioners under the old MIG regime, but under the pension credit this lower effective tax rate applies to a much larger proportion of pensioners, particularly in the long run. Furthermore, once housing benefit and council tax benefit are taken into account, effective tax rates could be significantly above 40% for some pensioners under the current regime.

could apply to up to 80% of pensioners by 2050, this represents a significant potential disincentive to save. Although many potential savers may not be aware of this effect, financial advisers should be and this may deter them from offering private pensions and other long-term savings schemes to people on lower and middle incomes for fear of later mis-selling claims.

These concerns have led to a variety of proposals for reforming state pensions in order to reduce the reliance on means-testing in the long run. These generally involve boosting the basic state pension and possibly transforming it onto a citizen's pension basis. Such proposals have considerable attractions in terms of simplicity and clarity, but imply higher costs in the long run, requiring some combination of higher taxes and/or an increase in the state pension age. Proposals involving a rapid transition also tend to be funded in part in the short term by abolishing contracting-out rebates, which could have adverse effects on private pension schemes. There is therefore no easy, costless solution to the challenge of state pension reform. Nonetheless, there is a growing consensus that the current regime, with its prospect of ever-increasing reliance on means-testing, is not a satisfactory long-term solution, particularly if the government's aim is to boost private savings levels. The government will therefore need to look carefully at the options for state pension reform in the light of the recommendations of the Pensions Commission final report, which is due in Autumn 2005.

Compulsion

One possible conclusion of the Pensions Commission may be that voluntary savings alone cannot deliver the required increase in retirement income necessary to avoid an increase in relative pensioner poverty in future decades. This might suggest the need for an increase in compulsion beyond what is currently required through NIC payments to S2P or an appropriate contracted-out scheme.

Australia, which phased in a system of compulsory employer pension contributions (in return for some reduction

in wages) during the 1990s, is often regarded as a key test case here. The evidence on the effects of this policy change is, however, not clear cut. On the one hand, the Australian national savings rate has actually declined since the early 1990s, suggesting that the policy has had little effect at the macroeconomic level. On the other hand, an econometric study by the Reserve Bank of Australia¹⁴ suggests that, without the introduction of compulsion, the savings rate might have been around 2% lower than it actually has been in Australia.

As discussed in the Pensions Commission report (p.254), there are likely to be important differences in the impact of compulsion across the income distribution. Higher income households with significant voluntary savings already may just react to compulsion by shifting funds from voluntary to compulsory savings 'pots', with no net effect on total savings. Lower income households who currently save little or nothing voluntarily, however, may not be able to do this and so may be obliged to increase their total savings under compulsion. Whether this is actually desirable will vary from case to case. For a low income household with significant debts, for example, it may be better for them to use any surplus income to pay off these debts rather than to contribute to compulsory savings schemes. In other cases, compulsory savings may be at the expense of essential household expenditure. Making employers pay the compulsory contributions may not resolve this problem if the costs are just passed back to employees through lower wages (as has been the case to a significant degree in Australia, although this was agreed through national bargaining between employers and unions).

In summary, the impact of compulsion on total savings remains highly uncertain and, to the extent that there is such an effect, it may fall disproportionately on lower income households who would do better to use their limited resources in other ways. This would suggest that the government should think carefully before going down the compulsion route. There may, for example, be a viable alternative in the form of auto-enrolment in occupational or stakeholder pension schemes provided that some

minimum employer contribution is made and that the employee does not positively decide to opt out. This has been shown¹⁵ to be effective in the US by putting inertia on the side of pension savings, while still leaving room for people to opt out if they strongly feel it is in their interests to do so.

Fiscal rules

There is currently a reasonable political consensus in the UK that, preferably subject to a more independent monitoring and validation process, the government's two fiscal rules (the Golden Rule of borrowing only to invest on average over the economic cycle and the Sustainable Investment Rule of keeping net public debt below 40% of GDP) play a useful role in guiding fiscal policy in a way consistent with macroeconomic stability. It has been suggested by Martin Weale (2004), however, that the focus of the Golden Rule on ensuring non-negative public savings is not sufficiently tough in a situation where the UK has, based on the analysis described in Section III.1 above, been under-saving for many years. He suggests that the government should instead aim to run a significant current budget surplus, bearing in mind that increased public saving is likely to be offset to some degree (but not totally, since academic studies suggest that full Ricardian equivalence does not hold¹⁶) by lower private saving.

One alternative would be to aim for a balanced budget overall, which might imply a current budget surplus of around 2.25% of GDP in line with planned net public investment levels from 2006-7 onwards. But this seems unnecessarily restrictive since it would imply a continuous fall in the ratio of net public debt to GDP because nominal GDP would be rising at c.5% per annum, while the debt stock would be unchanged with a balanced budget.

A more reasonable target in our view would be an overall budget balance (on the PSNB measure) of around 1-1.5% of GDP, which would be consistent with a net public debt to GDP ratio of around 30% or less. Given net public investment of around 2.25% of GDP, this would imply a target current budget surplus (i.e. net public savings) of around 0.75-1.25% of GDP. This would

¹⁴E. Connolly and M. Kohler, 'The Impact of Superannuation on Household Saving', Research Discussion Paper 2004-01, Reserve Bank of Australia, March 2004.

¹⁵B. Madrian and D. Shea, 'The Power of Suggestion: Inertia in 401(k) Participation and Savings Behaviour', Quarterly Journal of Economics, Vol. CXVI, Issue 4 (2001).

¹⁶Analysis in the December 2004 OECD Economic Outlook report suggests that private savings might be reduced by around 50-70% of any increase in public sector savings, based on an analysis of past trends across OECD countries.

mean both that the public sector was making some positive contribution to net national savings and that there was a reasonable margin of error in meeting the Golden Rule.

III.4 – Summary and conclusions

Our analysis in this article lends support to the view that the UK suffers from an inadequate savings rate, both at the macroeconomic level in relation to maintaining a reasonable ratio of wealth to national income and at the individual level in relation to providing an adequate income in retirement.

At the macroeconomic level, there is no simple relationship between savings rates and economic performance, as indicated by the fact that relatively low saving countries such as the US and the UK have since the early 1990s generally grown faster than higher saving countries such as Germany and Japan (although the latter grew faster in earlier decades). This reflects the fact that it is the quality as well as the quantity of investment that matters for economic growth.

Nonetheless, the fact that net national savings have been relatively low at only around 4% of GDP on average in the UK

since the late 1980s means that, despite running a current account deficit for most of that period, the UK capital stock relative to GDP is relatively low. Alternative assumptions on trend growth and the target ratio of the produced capital stock to GDP would suggest a long-run target net national savings ratio of around 5.5-9.5% of GDP per annum. This would suggest the need to boost net national savings by around 1.5-5.5% of GDP, or around £20-60 billion per annum at current values. While the precise 'savings gap' implied by this analysis is subject to great uncertainty, the need for a significant rise in national savings seems clear.

These conclusions are backed up by our projections of future pension incomes, which suggest that, after allowing for projected state pensions in 2050, private pensions are likely to fall short of the levels required to maintain the current relative level of average pensioner incomes to average incomes in the population as a whole. As with any such projections, these are subject to significant uncertainty, but they suggest that private pension incomes in 2050 are most likely to be around 4% of GDP, as compared to target levels of around 5.5-7.5% of GDP. We estimate that bridging this shortfall would require an increase in private pension contributions of the order of at least £30 billion at current values and possibly higher. An immediate increase in

savings of this magnitude would not be desirable, of course, since it would imply a very sharp decline in consumer spending that could well push the UK economy into recession. But a gradual but persistent rise in savings over the next 10-20 years would seem desirable in terms of future pension provision.

Achieving this objective requires a mix of policies, including state pension reform to reduce reliance on means-testing in the long term. Increased compulsory private savings is another option, although it could have significant drawbacks if people on relatively low incomes were forced to save more than was optimal for them. An alternative policy of automatic enrolment in occupational or stakeholder schemes unless employees actively choose to opt out may be more attractive. There is also a need for the government to contribute to boosting net national savings, which we suggest could be achieved by aiming for a current budget surplus of around 1% of GDP as a medium term objective. This would also give a reasonable margin of error in meeting the Golden Rule in future economic cycles.