

## Box C: Households savings amid the cost-of-living crisis

By Max Mosley (with contributions from Tibor Szendrei)

Throughout the cost-of-living crisis, we have seen evidence – including from NIESR – showing households having to spend more on essential goods than they have income. We know that households are therefore having to use whatever savings they have left to survive this cost-of-living crisis. Therefore, it is important to know how many households have subsequently run out of their last remaining source of liquidity and insurance against any subsequent negative shocks.

To this end, we analyse income and savings for a representative large sample of households drawn from the latest round of the UK Wealth and Assets Survey (data for the financial year 2019-20). Here, savings are defined as liquid wealth that can realistically be deployed as a source of financial assistance to smooth consumption. Therefore, we did not include illiquid financial wealth. For example, we include the value held in all Individual Savings Accounts (ISAs), apart from Lifetime ISAs as these would take too long for households to access and savers frequently incur a fee for doing so.

To project how these stocks of savings, for our sample households in 2019-20, evolve into the future, we combine these data with our microsimulation model LINDA (NIESR, 2016) and our global econometric model NiGEM (NIESR, 2018). LINDA provides us a pseudo-sample of household data moving forward in time tracking each household's income and expenditure in line with aggregate economy-wide projections drawn from NiGEM (NIESR, 2022). Generally, consumption shares are expected to vary over the income distribution but remain stable for individual households in the medium run (as evidenced for example in the Living Cost and Food Survey). So long as household income remains stable, we expect household consumption to do the same. The effect of rising prices therefore does not necessarily lead households to adapt their consumption immediately. Instead, we would expect them to run down their savings to maintain their preferred consumption behaviours and adjust their consumption to their permanent income only in the long-term. However, this usual pattern has been disturbed during recent periods of extreme stress following the Covid-19 pandemic and the cost-of-living crisis.

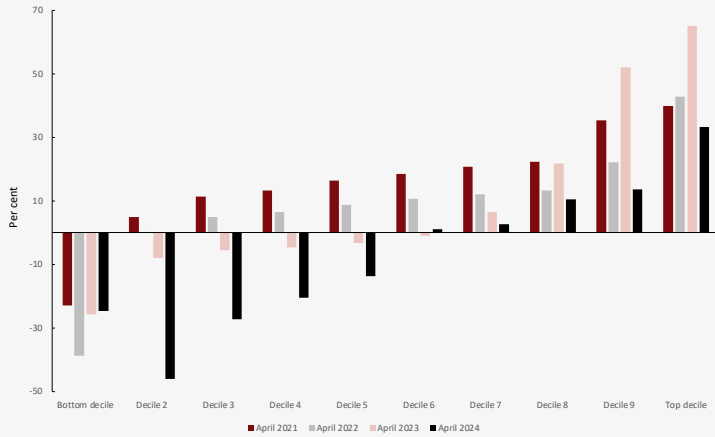
The Covid-19 lockdowns in 2020 and 2021 marked a unique shock to household expenditures. Based on inflation differentiated by goods and services relative to incomes, we model how spending would have adapted for this period – specifically, a large reduction in expenditure on transport, recreation and culture and a small increase on food and drink. Likewise, the ensuing cost-of-living crisis saw a massive rise in expenditures in 2022-23 as inflation, particularly in energy and food, shot through the roof. This meant some households had to make a choice between eating and heating, implying major shifts in consumption shares (Bhattacharjee et al., 2022).

Modelling the dynamics in income and expenditure allows us to infer the resulting effect on the level of savings – that is, income minus expenditure for a given year – for each household within our sample. If this balance is positive for a household in a specific year, it is deemed to be saving some of its income and subsequently increasing the stock of savings, and vice versa. The dynamic microsimulation approach implemented in LINDA evaluates expenditures (consumption) based on a lifetime utility model, and adjusts disposable income for borrowings, taxes and benefits. Further, it ensures that aggregate household income, wages, consumption, etc., are underpinned by economy-wide projections derived from NiGEM.

Once this model has delivered projected household income and savings into the future, we focus on two types of households. First, the number of households that have run out of savings and, second, those that we classify as having 'insufficient savings'. Drawing on Zeldes (1989), we define the latter as a household that has savings worth less than two months' disposable income. This is a helpful threshold for three reasons. First, it captures the number of households that may have some savings but not in sufficient quantity to act as a financial buffer. Second, it forecasts the households at risk of becoming virtually insolvent should the economic situation continue to deteriorate. Third, savings worth less than two months of income is the point at which we can consider a household 'liquidity constrained', i.e. a situation when the consumption for such households is very sensitive to temporary real income shocks given their lack of financial headroom.

Our analysis shows the distribution of savings trends across the income distribution, presented in Figure C1. Households in the lowest income decile tend to consume more than they have in income, which is consistent with data from the Living Cost and Food Survey (ONS, 2021) and the household analyses in NIESR’s Winter 2022 and Spring 2022 outlooks.

**Figure C1** Yearly Savings Flow and a Percentage of Income, by Income Decile

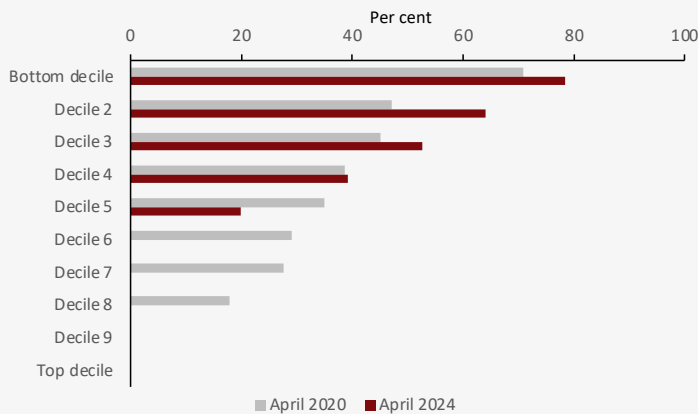


Source: NIESR Analysis of ONS Wealth and Assets Survey (2022), LINDA, NiGEM.

Once we have determined the flow of savings per household over a given time period, we can then estimate the subsequent stock of savings at the end of this time period for each household. We find that the number of households pre-Covid with no or insufficient savings was low, at only 6 per cent of the population. This proportion increases only slightly by April 2022, holding steady at around 7 per cent. From 2022-23, it begins to rise, but only moderately when compared to the doubling in the numbers by April 2024. We would expect a lag in the effect of rising prices on household savings, as households run down their savings to cope with the adverse shock, subject of course to their capacity to borrow, which in turn depends also on their accumulated savings.

When we consider the number of households with ‘insufficient savings’, two interesting observations emerge. First, there are a considerable number of such households. Figure C2 shows that 70 per cent of households in the bottom income decile have insufficient savings, which means that they are highly exposed to fluctuations in their income and the prices of necessities. We project that this proportion will rise to nearly 80 per cent by April 2024, with an even stronger growth in the number of hand-to-mouth households in other income deciles.

**Figure C2** Households with Less than 2 Months Income in Savings, by Income Decile



Source: NIESR Analysis of ONS Wealth and Assets Survey (2022), LINDA, NiGEM.

The second observation concerns relative trends. In 2020, a significant proportion of households around median incomes (sixth to eighth income deciles) also had insufficient savings. This well-known phenomenon of ‘wealthy hand-to-mouth’ households reflects their spending a substantial part of their income on mortgage interest payments together with non-essential goods and services partly driven by choice (e.g. eating out and expensive holidays).

The reason that the number of such households falls so sharply is likely because expenditure on non-essential goods such as eating out or travel in 2020-21 were constrained as a result of Covid-19 lockdowns. As a result, their high incomes added to their savings stock at a rapid rate. The ensuing effect is yet again two different stories between low- and high-income households, where the former have had to forfeit their financial resilience to withstand this cost-of-living crisis, whereas the latter have not.

Given these findings and the renewed rise in the energy price cap, the Chancellor will need to consider further support measures for households, especially the poorest households (those in the bottom income decile) but also the vulnerable households in the lower half of the income distribution. It is likely that this situation will force households to increase hours worked, take on second jobs, or (re-)enter the labour market. The latter will probably involve older workers who have previously dropped out (IES, 2022) but who face a number of obstacles in securing employment (Runge et al, 2021; Stockland, 2021).

This box concludes what economists and commentators have feared to be the case throughout this cost-of-living crisis: that low-income households could only withstand rising prices and stagnant incomes temporarily. The finding from the NIESR Outlook for Spring 2022 of 1.5 million households seeing food and energy bills greater than their disposable income (Bhattacharjee et al. 2022) implied many were having to resort to financial safety nets to absorb rising prices; however, the evidence presented in this Box and throughout Chapter 2 has identified that many households are now beyond the point of being able to maintain this level of expenditure.

Precisely how a household is able to respond to food and energy bills greater than their income but without any accumulated savings remains an open question. However, what is increasingly clear is that further targeted policy intervention is now undeniably urgent.

## References

- Bhattacharjee, A. Mosley, M., Pabst, A. and Szendrei, T. (2022), ‘UK Regional Outlook: Spring 2022 Chapter 2’, in National Institute UK Economic Outlook – National Institute of Economic and Social Research, May 2022, <https://www.niesr.ac.uk/wp-content/uploads/2022/05/UK-Economic-Outlook-Spring-2022.pdf>
- IES (2022), ‘Labour Market Statistics, March 2022’, Institute of Employment Studies, 15 March, <https://www.employment-studies.co.uk/resource/labour-market-statistics-march-2022>
- NIESR (2016), LINDA: A dynamic microsimulation model for analysing policy effects on the evolving population cross-section.
- NIESR (2018), NiGEM: National institute global econometric model - global macroeconomic model for economic forecasting, scenario and simulation, <https://nimodel.niesr.ac.uk/>
- NIESR (2022). ‘Box D: National Institute Regional Modelling System (NiReMS): Methodology and Updates’, in National Institute UK Economic Outlook – National Institute of Economic and Social Research, February 2022, <https://www.niesr.ac.uk/wp-content/uploads/2022/02/UK-Economic-Outlook-Winter-2022.pdf>
- Runge, J., Lasko-Skinner, R., Rolfe, H. and Carr, H. (2021), Understanding Individuals’ Recruitment Experiences, Centre for Ageing Better, NIESR and Demos, <https://ageing-better.org.uk/sites/default/files/2021-02/GROW-experiences-full-report.pdf>
- Stockland, K. (2021), ‘Age discrimination is a serious problem in the workplace—and employers need to act’, Prospect Magazine, 28 October, <https://www.prospectmagazine.co.uk/society-and-culture/age-discrimination-is-a-serious-problem-in-the-workplace-and-employers-need-to-act>
- Zeldes, S. P. (1989), ‘Consumption and Liquidity Constraints: An Empirical Investigation’, *Journal of Political Economy*, 97(2), pp. 305-346