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Policy Options to Encourage Savings and Asset Building by Low-Income Americans

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INTRODUCTION

This menu of policy options was written with federal policymakers in mind. It reflects the latest and best thinking, and draws heavily on the work of many experts focusing on various facets of savings and asset-building policy. As there are many policy routes to broadening savings and asset ownership, there is necessarily some overlap among the ideas presented below. The proposals are at varying stages of development—some (such as Individual Development Accounts) are fully developed, others (on asset protection, for example) need further refinement, while a few (including asset control issues, which are of particular importance to Native Americans) are still being discussed. This paper, along with the guidance of many experts, will inform the development of an omnibus savings and ownership bill that will be introduced in Congress later this year.[1]

1. Encourage Savings by Linking Existing Refundable Tax Credits to Savings Products

Background

The Earned Income Tax Credit (EITC) and Child Tax Credit refunds are huge infusions of cash for many households, and thus present an enormous opportunity for savings by low-income families. Individual Development Account (IDA) demonstration data show significantly higher deposits in March and April every year. EITC refunds, for example, have averaged about $1,700 to $2,100 per year, while the partially refundable Child Tax Credit adds about another $300 for certain low-income households. However, low-income people lack easy access to savings products (whether IRAs, 529s, Roth IRAs, etc.), so this money is often spent rather than saved. Moreover, data show that nearly $2 billion a year is siphoned-off from EITC refunds through "refund anticipation loans" and other short-term loans, so that funds belonging to EITC recipients went to high-interest loans (some up to 400% on an annual basis) instead of to high-yielding long-term savings. Further experiments in the private sector have shown that, when offered an easy way to save EITC refunds in a Section 529 account, IRA, or basic savings account, low-income people will in fact save. The key challenge, therefore, is to facilitate easy savings of tax refunds into existing—and possibly new—savings products.

Proposal

Three ideas to link refundable credits and savings products deserve consideration:

a. *Support IRS and Treasury efforts to split refunds.* Presently under consideration at Treasury is a proposal by Lily Batchelder and others to allow taxpayers to split their tax refunds and direct a portion of their refunds into no more than three accounts; currently a deposit into only one account is permitted. This "bifurcation" or, more accurately, "trifurcation" effort is critical because most low-income families, given a choice between spending or saving their entire refund would choose to spend it. If offered a chance to electronically save a portion of their refund (through the IRS allowing up to three routing numbers on tax returns), savings would dramatically increase—without requiring legislation, without requiring any new refundable tax credits, and at virtually no cost to the federal government.

b. *Provide a matching deposit, up to $500 per year, if a low-income taxpayer saves a portion of their tax refund in a targeted savings account (such as a 529, Roth IRA, or LSA, if those are created).* If low-income taxpayers were willing to set-aside up to $500 of their tax refund in an after-tax savings products they would be eligible for a 1-1 federal match, not to exceed $500 per year, that would be directly deposited by the government into that account. This proposal works best, of course, if low-income people already have one of these accounts; if not, perhaps the savings could be directed to a linked savings account, such as an Electronic Transfer Account (ETA). Ideally, at some point the IRS could consider listing these savings products directly on tax forms, so that with a check-of-the-box a portion of a tax refund (assuming the "split refunds" proposal goes forward) could be saved. While legislation would, of course, be necessary to provide the matching deposit, no new refundable tax credits, and no new financial products would be required.

c. *Allow parents to save in a newly created "Children's Retirement Savings Account."* Through exactly the same mechanism described in (b), parents who wish to begin saving for their children's future to do so in a Children's Retirement Savings Account (CRSA). With a slight modification to Roth IRA rules, namely that the account could be in the name of a child (while the parents would be the custodian), CRSAs could be created. Under no circumstances could the money be accessed prior to age 18, at which point it automatically converts into a standard Roth IRA with all of its applicable rules and restrictions. Thus, if a low-income parent or guardian diverts a portion of their tax refund into a CRSA, that contribution would be eligible for a government-provided match not to exceed $500 per account per year. Legislation would be required to authorize the CRSA and matching funds but, again, no new refundable tax credits are necessary.

2. Expand Individual Development Accounts (IDAs)

Background
IDAs are matched savings accounts typically restricted to buying a first home, pursuing post-secondary education and training, and starting a small business. The initial idea behind the IDA Tax Credit (presently, Title V of S. 476, The CARE Act, which cleared the Senate in April 2003) was to significantly increase the number of IDAs from the current 20,000 or so to the 40 million income-eligible persons. The IDA tax credit reimburses financial institutions for matching funds they provide to qualified persons saving in an IDA, up to $500 per person per year.

Proposal
To enable IDAs to reach scale in a profitable, sustainable way for financial institutions, three changes to the bill are necessary, and a fourth is strongly recommended:

a. *Remove the cap on the number of accounts eligible for the tax credit* (Sec. 511/Sec. 45G(i), page 119). Largely for budgetary reasons, the number of accounts eligible for the tax credit was capped at 300,000 accounts over the next seven years. This cap means that—even combined with private and other public efforts—only about 1% of the eligible population could get an IDA by the end of the decade. The cap also makes it nearly impossible for financial institutions to realize any economies of scale. (Note that a $1.7 billion version of the proposal, with a 900,000-account cap, has been included in every one of President Bush's budgets).

b. *Greatly ease the reporting and performance requirements* (Sec. 509, and Sec. 511/Sec. 45G). Financial institutions are saddled with onerous reporting performance requirements on IDAs that do not apply to any other financial products. Like the cap, this requirement will be a huge disincentive for financial institutions to offer IDAs. Specifically: First, strike Sec. 509(a)(2), and Sec. 509(b)(3), pages 110-114. Second, strike Sec. 511/Sec.45G(i)(2,3 and 4), pages 121-122.

c. *Remove the prohibition on fees on IDAs* (Sec. 504(b)(3), page 100). The bill, as drafted, does not permit financial institutions to charge IDA accountholders a fee for maintaining the account. If, however, the goal is to create a competitive, profitable market for IDAs, if we want accountholders to have the right to pay for services they want, and if we want costs to be transparent, the prohibition on fees must be removed. Financial institutions will find ways to cover their costs, so it's better to let these costs be as transparent as possible.

d. *Conform the Adjusted Gross Income (AGI) limits in the IDA tax credit to the proposed AGI limits in the Savers Credit* (Sec. 503(A)). IDAs are restricted to pre-retirement assets, while the savers credit (described below) is designed to boost retirement savings. These two proposals should work closely together. Presently, the IDA tax credit has steep AGI "cliffs" ($18,000 single, $30,000 head of household, and $38,000 joint). Ideally, IDAs (like the Savers Credit) should be available to joint filers with significantly higher incomes within the middle-income range, for example, up to $60,000, phasing out at about $70,000 to $75,000, and the phase-down should be smoothed, to resemble the phase-down of IRA eligibility by income.

3. Set up an American Stakeholder Account / SEED Account / Children's Savings Account for Every Child Born in America

Background
The best way to achieve a universal, progressive asset building system over time would be to provide each generation of children a restricted, start-in-life asset account at birth—an idea first proposed by Michael Sherraden and, separately, by former IRS Commissioner Fred Goldberg. While every child would have an account, it would especially benefit the 26 percent of white children, 52 percent of black children, and 54 percent of Hispanic children who start life in households without any resources whatsoever for investment. Different versions of children's savings accounts have been proposed by Members of Congress; most, however, are not progressive and are focused on building only retirement assets. A great model for the U.S. is the newly established Child Trust Fund in the U.K. Also, the recently launched, privately-funded SEED Initiative (sponsored by the Corporation for Enterprise Development (see http://seed.cfed.org)) is already providing highly valuable insights on policy design.

Proposal
There are many ways to design children's savings accounts. Goldberg writes that, from a design and implementation perspective, three questions must be answered: (1) How are the accounts funded? (2) How are they administered? and (3) What rules govern distributions? He states that another critical question is whether the system is voluntary or mandatory, or some combination thereof. Note that a version of American Stakeholder Accounts (ASAs) is presently being drafted by Representatives Pat Kennedy and Harold Ford, and they hope to introduce bi-partisan ASA legislation soon.

a. Create American Stakeholder Accounts. The legislation being developed by Kennedy and Ford—*The American Stakeholder Account Act of 2004*—includes the following provisions. Each of the four million kids born each year in the U.S. will receive a personal account, called an American

Stakeholder Account (ASA). The bill will establish a national fund within the U.S. Treasury, similar in structure to the Thrift Savings Plan, which would administer the accounts, hold all deposits, and manage investments. Personal ASA investment accounts would be created for children born after January 1, 2004 and endowed with an initial seed deposit (ranging from $1000 to $2,000—the policymakers haven't decided yet) once a child has been assigned a number by the Social Security Administration. A range of investment options will be created through index funds, including a government securities fund, a fixed income investment fund, and a common stock fund. The account holder custodians shall elect how money in the ASA investment account is invested, and will be able to change investment strategies at least four times a year. If no election is made, the money will be invested in the government securities fund. Provisions governing contributions and distributions are still being discussed but it is likely that voluntary contributions will be encouraged and distributions will be restricted to asset building investments, such as homeownership, post-secondary education, and retirement savings.

b. Link existing refundable tax credits to a newly created Children's Retirement Savings Account. While the ASA system described above would be universal and mandatory, we could start with a voluntary system that permits any parent or guardian to set up a Children's Retirement Savings Account (CRSA) for any dependent under the age of 18. Following the proposed CRSA outlined above, at a minimum we could use existing refundable tax credits as a source of initial deposits, to be followed by 1-1 federal matching contributions not to exceed $500 per account per year. The money could not be touched prior to age 18, at which point it becomes a regular Roth IRA with all of its restrictions.

4. Encourage Retirement Savings

<u>Background</u>

Recent data on defined-contribution retirement savings (e.g., 401(k)s and IRAs), show that participation rates, contribution rates, and levels of retirement savings for those near retirement are all significantly lower for lower-income workers. For example, data from the 2001 Survey of Consumer Finances, as summarized by Orszag and Greenstein, show that for the bottom 40% of workers, the median value of defined contribution and IRA assets for those with a retirement account is about $10,000, while the median value of those without an account is, perhaps not surprisingly, zero. Also, current tax incentives, which are based on marginal tax rates, offer virtually no incentives to those who need them most: 1999 data show that about only 10 percent of tax benefits for retirement savings reach households earning $50,000 or less per year.

<u>Proposal</u>

To encourage greater retirement savings for low-income persons, three ideas should be considered:

a. *Improve the "Savers Credit."* The 2001 tax bill (EGTTRA) authorized a voluntary individual tax credit—the Savers Credit—to encourage low-income workers to contribute to existing retirement products (IRAs, 401(k)s, SIMPLEs, etc). However, because the credit is not refundable, and because it offers a modest matching contribution, it benefits only a small proportion of those technically eligible. For example, Orszag and Hall show that only about 20% of filers get any benefit, while only one in one-thousand persons get the full benefit. Mark Iwry of the Brookings Institution, who helped design the Savers Credit, suggests four ideas to improve the credit: (a) make it refundable; (b) instead of a 50% credit that phases down to 20% for joint filers with AGI over $30,000, the 50% savers credit should be expanded to cover joint filers with significantly higher incomes within the middle-income range, for example, up to $60,000, phasing out at about $70,000 to $75,000; (c) the phase-down of the credit should be smoothed, to resemble the phase-down of IRA eligibility by income, instead of the "cliffs" now in effect; and (d) instead of sun-setting after five years (in 2006), the savers credit should be made permanent.

b. *Encourage firms to adopt "opt-out," instead of "opt-in," policies for defined contribution plans.* Currently, most workers must actively choose to participate in a company 401(k), or "opt-in." Many workers, especially low-income workers, choose not to do so. However, compelling research data have shown that many more workers participate and save in a company 401(k) when enrollment is automatic and employees have the option of *not* participating, or "opting out."

c. *Offer employers a tax credit for matching the deposits of low-income workers who save in a 401(k) or equivalent.* One possible alternative to making the savers credit refundable is to offer employers a tax credit for contributing matching funds to their low-income workers who save in the company's defined-contribution retirement plan. One disadvantage to this approach, compared to improving the savers credit, is that it would encourage contributions only to workplace-based retirement products—contributions by low-income workers to IRAs, for example, would not qualify for matching funds.

d. *Create a system of "Universal 401(k)s."* Mike Calabrese of the New America Foundation and Gene Sperling of the Center for American Progress have each called for a nationwide system of fully portable retirement savings or "career" accounts that are both tax-subsidized and automatically deducted from one's payroll. Such accounts would function like a government-facilitated 401(k)—just as employers match contributions by eligible employees, the government would match voluntary saving by individuals with a refundable tax credit that would be deposited directly in workers' accounts. This proposal is not unlike President Clinton's 1999 Universal Savings Account (USA) proposal, which did not receive (for political reasons) serious policy consideration. Finally, such a system could, if large enough and proposed at the right time, serve as a "compromise" between those wanting individual accounts in Social

Security and those who don't want any individual accounts (whether in or out).

e. Consider "Progressive Privatization" of Social Security. As proposed by Maya MacGuineas of the New America Foundation, Social Security reform—*if structured properly*—could be the route to widespread wealth creation in America. The current Social Security system is designed to be progressive: low-income retirees receive larger benefits relative to their earnings than do wealthier participants. Private accounts in their simplest form would undermine this progressivity since account earnings would be solely contribution-based with no progressive payout design. Instead, sliding-scale government matches should be included for the savings of lower-earners, to create a system of "Progressive Private Accounts" which would empower low-earners by bringing them into the asset-owning class, helping to build up their accounts more quickly, and maintaining the basic commitment to a progressive Social Security design.

5. Revise Asset Limits in Public Assistance Programs

<u>Background</u>
Any efforts to scale-up savings and assets for low-income Americans must address the issue of asset holdings, which are linked to program eligibility. The application of low asset limits is a are huge disincentive for saving. One of the great policy achievements of the 1990s was that nearly all states raised their assets limits as part of their TANF plans. In addition, in some instances states have been granted some flexibility to revise asset limits in the Medicaid and Food Stamp programs. While merited, however, it would be difficult and expensive to raise and standardize asset limits across all federal programs, given that the rules, decision-making authority, and flexibility vary greatly among programs and states: some are set at the federal level (SSI), some at the state level (TANF), and still others set by a combination of federal and state decision-making (Food Stamps and Medicaid). Furthermore, the rules fall under the jurisdiction of several congressional committees on different reauthorization timelines. However, there are two asset limit issues that are important, and achievable:

<u>Proposal</u>

a. Specify that restricted savings are disregarded. When scaling-up any restricted savings policy for the poor, specify in the authorizing legislation that any amounts saved (along with any matching deposits and earnings on the entire account) are disregarded in determining eligibility for any means-tested program. An example of this language can be found in the IDA tax credit legislation (S. 476, Title V, Section 512, page 124).

b. Specify that all retirement assets are disregarded. Clarify that defined-contribution savings plans are disregarded in determining eligibility for means-tested programs. Presently, the law excludes balances in defined-benefit plans, but not defined-contribution plans—even if the applicant has to pay a penalty for early withdrawal, he or she is expected to drain their IRA, 401(k), etc. balances before qualifying for public benefits. We understand that there may be a provision in Portman-Cardin III to address this issue.

6. Foster Access to Mainstream Financial Services and Assets ("Bank the Unbanked")

<u>Background</u>
Research over the last few years estimates that between nine and 20 percent of all households (or 22 to 56 million individuals) are "unbanked," meaning they lack a basic checking or savings account, and generally have no relationship with providers of mainstream financial services. Stated simply, low-income people—about a quarter of whom are unbanked—will never develop savings and assets if their financial services needs are met through check-cashers, pay-day lenders, and other "alternative" financial services providers. Presently there are a few "sticks" (CRA and other regulatory procedures) but not enough "carrots" to encourage mainstream financial institutions to provide basic financial services. In our view, federal policy must develop a carrot-led strategy—build some savings and wealth-creation subsidies into the tax code, and financial institutions will come and figure out a way to bank the unbanked. While the regulatory role is critical (and highly complex)—and CRA in particular could be strengthened to reward banking the unbanked—federal legislation can also play an important role. Three ideas should be considered:

<u>Proposal</u>

a. Create an incentive for banks to offer accounts to the unbanked. Establishing an un-capped IDA tax credit (per above) or, for that matter, any legislation that significantly scales-up savings incentives for the poor, will provide strong incentives for financial institutions to bank the unbanked.

b. Improve Electronic Transfer Accounts (ETA)s. Congress can reform ETAs and offer financial institutions a tax credit to offer or expand ETAs and other low-cost, electronically-based transaction accounts.

c. Expand initial demonstration efforts. Congress could significantly expand Treasury's "First Accounts" demonstration (which thus far has provided only about $10 million in grants) to encourage further innovation and experimentation in the private and non-profit sectors on how to move unbanked persons into the financial mainstream.

7. Expand Homeownership

There are several ways to expand homeownership, including (a) making the homeowner's mortgage deduction refundable for lower-income households; (b) enacting a refundable, First-Time Homebuyers' Tax Credit; (c) allowing public housing residents to become homeowners (some Public

Housing projects may be sold to residents or other non-profit entities with appropriate use agreements); (d) expanding the Voucher Homeownership (Section 8(y)) Program, which allows voucher recipients to use their subsidies to purchase a home; and (e) increasing use of the Family Self Sufficiency program by public housing authorities, which is a highly successfully but vastly underused employment and savings program for recipients of federal housing assistance. Finally, for many low-income families, affordable rental housing is often the first step towards homeownership, so programs aimed at expanding the supply of subsidized rental units also deserve consideration.

8. Expand Access to College

Note that with the Higher Education Act up for reauthorization in 2004, there may be some opportunities to move some of these proposals forward. With more "non-traditional" students aiming for college, and with a shift in federal aid away from grants and towards loans and (non-refundable) tax credits, college is becoming increasingly unaffordable for many low-income students and adults. Ideas include: (a) better funding of successful college readiness programs for low-income students of parents with low educational attainment, such as Gear Up and TRIO (currently, these programs only serve 10% of their respective eligible populations); (b) making Pell Grant funding levels more predictable (moving to a mandatory funding scheme, for instance) and, also, concentrating those grants in the first two years of college, when risk of drop-out is greatest; (c) adding refundability to existing tax credits for post-secondary education; (d) tying eligibility for federal student aid to eligibility for certain means-tested assistance programs (TANF, SSI, and Food Stamps, for example) to simplify the financial aid application process; (e) incentivizing states to match contributions by low-income families into state-administered 529 College Savings Plans; and (f) extending the exclusion of all assets from federal aid to *all* families with incomes less than $50,000 (presently, only those families eligible to file a 1040A or 1040EZ are entitled to this exclusion).

9. Fund and Encourage Microenterprise Development

AEO, the microenterprise trade association, suggests three proposals: (a) fully fund the Program for Investment in Microentrepreneurs (PRIME) at $15 million (recent funding was $5 million); (b) adequately fund the Community Development Financial Institutions (CDFI) Fund, which allows loans for microenterprise; and (c) explicitly allow and encourage microenterprise development by states in the Workforce Investment Act (WIA) and in TANF, both of which are presently under reauthorization consideration in Congress.

10. Strengthen Laws to Protect Assets

<u>Background</u>
While financial education efforts are critical to ensure that those low-income people who have assets don't lose them, and that low-income consumers make good financial choices, the market for providers of unscrupulous loans and financial services is vast, profitable, and poorly regulated. Some experts note that we have "dual" and unequal regulatory systems—one well-regulated for the mainstream, "high-road" providers, and the other weakly regulated for the alternative "low-road" providers. Policing this asset-stripping regime has been recently complicated by some of the high-roaders acquiring some of the low-roaders.

<u>Proposal</u>
Proposals to curb predatory lending through tighter regulations on financial products ranging from mortgages to payday loans could include the following provisions:

a. *Increase the oversight of the home-buying and refinancing processes, especially in the sub-prime market.*

b. *Provide federal oversight and coordination of now state-regulated alternative financial services providers (check cashers, pay-day lenders, and the like).* Provisions could include limiting the number of loans to an individual each year, creating a minimum loan term for each loan of at least 60 days, establishing a borrower's right to repay the loan in installments. In addition, states with stricter laws could be empowered to effectively enforce their laws within their boundaries.

c. *Revise, coordinate, and strengthen existing federal regulations (including the Community Reinvestment Act) now spread out among the OTS, OCC, OTS, and the Federal Reserve.*

d. *Reduce the cost of tax preparation by increasing free alternatives to preparation services.*

e. *Protect consumers from abusive credit card practices by: (1) restoring the 14-day payment grace period before late fees are imposed; (2) notifying customers at least 15 days prior to unilaterally raising rates, giving consumers an opportunity to change cards; (3) charging no late fees larger than the outstanding balance; (4) restricting bait and switch practices when customers are pre-approved at one rate but then offered a card with a higher rate; (5) requiring full disclosure and honest advertising.*

f. *Protect youth from receiving cards without cosigners.*

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[1] For a discussion of principles and policy design considerations for building assets, see "Federal Policy and Asset Building" (Issue Brief No. 1, by Ray Boshara, available at www.newamerica.net). For additional, comprehensive information on building assets—research, initiatives, existing and proposed policies, news stories, etc.—please see www.AssetBuilding.org.