

# BUILDING ASSETS FOR LOW-INCOME FAMILIES

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HEARING  
BEFORE THE  
SUBCOMMITTEE ON SOCIAL SECURITY  
AND FAMILY POLICY  
OF THE  
COMMITTEE ON FINANCE  
UNITED STATES SENATE  
ONE HUNDRED NINTH CONGRESS

FIRST SESSION

APRIL 28, 2005



Printed for the use of the Committee on Finance

U.S. GOVERNMENT PRINTING OFFICE

WASHINGTON : 2005

26-852—PDF

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For sale by the Superintendent of Documents, U.S. Government Printing Office  
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# CONTENTS

## OPENING STATEMENTS

	Page
Santorum, Hon. Rick, a U.S. Senator from Pennsylvania, chairman, Subcommittee on Social Security and Family Policy .....	1
Lincoln, Hon. Blanche, a U.S. Senator from Arkansas .....	2
Bunning, Hon. Jim, a U.S. Senator from Kentucky .....	4

## WITNESSES

Simmons, Michelle, account holder, Women's Opportunity Resource Center (WORC), Norristown, PA .....	5
Beale, Dorothy, account holder, Women's Opportunity Resource Center (WORC), Philadelphia, PA .....	7
Palmer, Chuck, president, Institute for Social and Economic Development (ISED), Des Moines, IA .....	9
Gonzalez-Rubio, Dr. Victoria, principal, Delmar-Harvard Elementary School, University City, MO .....	10
Edelman, Ric, Edelman Financial Services, Incorporated, Fairfax, VA .....	12
Wilson, Bernard M., vice president, Outreach and Business Development, H&R Block, Kansas City, MO .....	14
Sherraden, Dr. Michael, author of "Assets and the Poor," professor, Washington University, St. Louis, MO .....	23
Shanks, Dr. Trina R. Williams, professor, University of Michigan, Ann Arbor, MI .....	25
Goldberg, Fred, Skadden, Arps, Slate, Meagher & Flom, LLP; former Commissioner of the IRS under President George H.W. Bush, Washington, DC .....	26
Boshara, Ray, director, Asset-Building Program, New America Foundation, Washington, DC .....	28
John, David, research fellow, The Heritage Foundation, Washington, DC .....	30
Iwry, J. Mark, nonresident senior fellow, The Brookings Institution, Washington, DC .....	31

## ALPHABETICAL LISTING AND APPENDIX MATERIAL

Beale, Dorothy:	
Testimony .....	7
Prepared statement .....	39
Responses to questions from Senator Lincoln .....	42
Boshara, Ray:	
Testimony .....	28
Prepared statement .....	43
Responses to questions from Senator Lincoln .....	60
Bunning, Hon. Jim:	
Opening statement .....	4
Edelman, Ric:	
Testimony .....	12
Prepared statement .....	61
Goldberg, Fred:	
Testimony .....	26
Prepared statement .....	65
Gonzalez-Rubio, Dr. Victoria:	
Testimony .....	10
Prepared statement .....	72
Responses to questions from Senator Lincoln .....	80

IV

	Page
Iwry, J. Mark:	
Testimony .....	31
Prepared statement .....	82
John, David:	
Testimony .....	30
Prepared statement .....	140
Responses to questions from Senator Lincoln .....	148
Lincoln, Hon. Blanche:	
Opening statement .....	2
Palmer, Chuck:	
Testimony .....	9
Prepared statement .....	149
Santorum, Hon. Rick:	
Opening statement .....	1
Prepared statement .....	154
Shanks, Dr. Trina R. Williams:	
Testimony .....	25
Prepared statement .....	158
Responses to questions from Senator Lincoln .....	168
Sherraden, Dr. Michael:	
Testimony .....	23
Prepared statement .....	171
Responses to questions from Senator Lincoln .....	192
Simmons, Michelle:	
Testimony .....	5
Prepared statement .....	194
Responses to questions from Senator Lincoln .....	197
Wilson, Bernard M.:	
Testimony .....	14
Prepared statement .....	198

## **BUILDING ASSETS FOR LOW - INCOME FAMILIES**

**THURSDAY, APRIL 28, 2005**

U.S. SENATE,  
COMMITTEE ON FINANCE,  
SUBCOMMITTEE ON SOCIAL SECURITY & FAMILY POLICY,  
*Washington, DC.*

The hearing was convened, pursuant to notice, at 10:37 a.m., in room SD-628, Dirksen Senate Office Building, Hon. Rick Santorum (chairman of the subcommittee) presiding.

Also present: Senators Bunning, Conrad, and Lincoln.

### **OPENING STATEMENT OF HON. RICK SANTORUM, A U.S. SENATOR FROM PENNSYLVANIA, CHAIRMAN, SUBCOMMITTEE ON SOCIAL SECURITY AND FAMILY POLICY**

Senator SANTORUM. Good morning. Let me thank all of those who are here this morning, particularly those who are going to be testifying before the committee this morning, for being here.

I have a rather lengthy statement which I will put in the record, without objection. Since I am the only one here—oh, I am sorry. You snuck up on me, there. Thank you, Senator Lincoln. You are not objecting though, are you?

Senator LINCOLN. No.

Senator SANTORUM. Good. [Laughter.] Well, thank you for being here.

[The prepared statement of Senator Santorum appears in the appendix.]

Senator SANTORUM. This is a hearing that I have actually been looking forward to doing for quite some time on an issue that I am excited about, because it is an issue that, in what seems to be an increasingly partisan atmosphere, has very strong and deep bipartisan support.

It is an issue of how we can work to bridge the wealth gap in America, how we can work together to create opportunities for ownership for lower-income individuals so they will have the ability to be able to climb the economic ladder, whether it is through financial literacy, by having savings accounts, or small business, or a home, or other financial assets in which they can become educated as to, again, moving up that economic ladder, or whether it is the opportunity of just having that security to know that you have a nest egg that you can fall back on, that you have other options available to you, that you are not just one paycheck away from a life-changing experience for the worse.

All of those things are important elements of a policy that I think the government has a role to play in, to create financial assets for lower-income individuals, to give them that security, to give them that literacy, to give them that opportunity to improve their lot in life and to move up the economic ladder of success.

So I am pleased. Senator Conrad and I are members of a bicameral, bipartisan caucus that is focused on asset accumulation and bridging the wealth gap. There are ideas that have been put out there.

Senator Lieberman and I, yesterday, introduced the Individual Development Accounts bill, which I said yesterday, I hope that it is the last time—it is probably the fourth time that we have introduced this legislation—we have to introduce this legislation, because that would mean it will have passed. We have come close many times, but we have not been able to get it done. But with the fact that the President has IDAs in his budget and that we have strong bipartisan support this year, maybe this is something that we can actually accomplish in this session of Congress.

Senator Corzine and I have introduced a piece of legislation called the KIDS Accounts as part of the ASPIRE Act. Again, it has bipartisan, bicameral support and is vitally important as a tool to help younger people. In fact, it is a proposal that provides a matched savings account for every child born in America.

So, every child will have the opportunity to have something of their own, something that they can build on, something that can realize the miracle of compound interest and investment over time, all of those things which are right now, simply, and unfortunately, not available to many children in our society. So, there are lots of ideas out there.

We want to hear today from those who are participating in programs either at a State level or through private philanthropy that are employing the ideas that I just spoke about, and other ideas, to try to help change the dynamic for lower-income individuals in our society.

So, I want to thank Chairman Grassley and Ranking Member Baucus for allowing this hearing to take place. This is something that is near and dear to my heart, and I know it is to Senator Conrad and to Senator Lincoln.

I thank you for being here, and I know this is also important for you, as someone who has worked hard on the CARE Act, on the charitable giving bill, which is another part of this program.

I certainly appreciate your attendance and your support of these efforts. I will now recognize you, if you would like to make an opening statement.

**OPENING STATEMENT OF HON. BLANCHE LINCOLN,  
A U.S. SENATOR FROM ARKANSAS**

Senator LINCOLN. Well, thank you, Mr. Chairman. Certainly, we appreciate you bringing us together to discuss building assets for low-income families.

We all know that increasing personal savings and assets is critically important to our country, but it is enormously important to putting people on a path away from poverty and towards financial independence. That is why encouraging personal savings has been

one of my key objectives throughout our discussion on Social Security, as well as many of our other debates.

Being able to give low-income working families the ability to take care of their children puts value in their families through the hard-earned dollars that they work for. I worked very hard on the refundability of the Child Tax Credit, and some other means with which to try to allow families to be able to do all of what they want to do on behalf of their families and to have the resources to do that.

I think that is really critically important. I know that from my own personal experience and upbringing, I am truly my grandfather's child, who was enormously alarmed about unusual amounts of debt. My grandfather pretty much put the fear of God in me about that.

I have certainly some great concerns about the historic debt that we are finding ourselves in, but also enormously alarmed with the fact that the United States has the lowest national savings rate of any industrialized nation. It clearly points to much of our societal changes that we currently have the lowest savings rate, one of the greatest nations, certainly in the history of the world.

But more and more, Americans find themselves facing financial commitments that impair their abilities to save, whether it is the fact that their wages have been stagnant for well over 7 years and they do not have that expendable income to set aside, whether it is that the cost of raising their families and providing for their families has increased without the increase in wages, has been a real issue.

But we desperately need to change. I appreciate the Chairman's comments about financial literacy, which is absolutely essential. If we do not begin to teach our children at a younger age the responsibility of balancing checkbooks and understanding what savings can mean to them, understanding what borrowing means and what kind of interest they can gain on an account that they start, regardless of what small amount they may put into it, but making sure that they understand financial literacy and the repercussions and consequences it has for them for the rest of their lives.

So we have an awful lot, I think, there that we can really move forward on. I hope, with the leadership of many in Congress, we will.

Just a couple of specifics. I am looking forward to exploring many of those options today, and I apologize, Mr. Chairman, that I will not be able to stay with you for the entire hearing. But the Individual Development Accounts are something that we have seen, particularly in a State where we are disproportionately low-income, which are assisted accounts that help low-income individuals save for a variety of things: business start-up, first-time home purchase or higher-education expenses.

One of the things I worked hard on before was the private mortgage insurance deduction, deductibility for home ownership and trying to ensure that we can provide all of the tools that individuals need for home ownership, which we know is a forced savings and an important way to provide individuals to save and to build equity.

Additionally, the saver's credit, which was created in the 2001 tax law, has encouraged savings among low- to moderate-income individuals. It is a good tool, and I hope that we will look for ways to build on the successes of both of these so that we can benefit even more people in the future.

The last thing that I was kind of interested in bringing up, and I hope we will hear from our panelists, is the Saving for Education, Entrepreneurship, and Downpayment, the SEED initiative.

An organization in my State of Arkansas is currently participating in this initiative. In fact, the SEED accounts program is being implemented in my hometown in eastern Arkansas, one of the 25 poorest counties in the Nation, and it is helping families successfully build long-term assets.

These are just a few of the programs that I think we already have seen we can expand on. One of the key things, particularly in terms of IDAs, is that those programs are not going to be successful unless we here in Washington support them, both in resources that are needed in the budget, and also in the tools that individuals need to implement those programs.

So as someone who represents a State where 80 percent of my taxpayers have an adjusted gross income of under \$50,000, and over 50 percent of them have an adjusted gross income of less than \$25,000, these are innovative programs, like the SEED initiative and others, that have an enormous opportunity to make an impact on people's lives in my own State, and certainly across the Nation, if we look seriously at them, how we can improve them, reinforce them, and make sure that people are aware that many of these programs exist.

So, thank you, Mr. Chairman. I have lots more, and I am excited about your interest here, and I look forward to working with you in the subcommittee and the full committee, and I look forward to our panelists.

Thank you.

Senator SANTORUM. Thank you, Senator Lincoln.  
Senator Bunning?

**OPENING STATEMENT OF HON. JIM BUNNING,  
A U.S. SENATOR FROM KENTUCKY**

Senator BUNNING. Thank you, Mr. Chairman.

I am pleased you have decided to spend time focusing this subcommittee on an important issue of helping low-income families to achieve the American dream.

President Bush has talked a lot recently about developing an ownership society. I believe so strongly in this principle. All individuals deserve the self-respect and independence that comes with being in control of their own lives and destinies. I want every individual to know that they have a stake in the future of this country.

On a micro level, we see time and time again, an individual becomes a home owner and starts to feel an even stronger sense of pride and dignity in their community than they ever did before.

They begin to feel strongly that they have a stake, not just in their home, but in their communities at large. This pride shows itself in ways that strengthen not just our society, but the individual and his or her family as well.

As one of our witnesses today stated in her written testimony, "It is the best feeling in the world to know I own something." Today, I hope we will be able to explore more ways to ensure that every individual in America knows that feeling. I know that we will be a better Nation for it.

Thank you, Mr. Chairman.

Senator SANTORUM. Thank you, Senator Bunning.

I would now ask the panelists to come forward so we can have our first panel of witnesses: Michelle Simmons, Dorothy Beale, Chuck Palmer, Victoria Gonzalez-Rubio, Ric Edelman, and Bernard Wilson, if they can all take their seats.

Let me thank the witnesses for coming. In particular, let me thank Michelle and Dorothy, two constituents from southeastern Pennsylvania. Michelle is from Norristown, who, as I mentioned yesterday, was at a press conference with Senator Lieberman and I, and Dorothy, from Philadelphia. Both are account holders of a similar thing, an FSA account in Pennsylvania, but it is what we call IDAs here on the Federal level.

We do not call them that yet because we do not have them done, but we will call them that when we get this legislation passed. I want to welcome them in particular for being here, and all of our other guests. We certainly appreciate the financial expertise that you bring to that. You bring different opinions, and we look forward to hearing those opinions.

But, please, Ms. Simmons, Michelle, would you begin your testimony? Thank you for being here.

**STATEMENT OF MICHELLE SIMMONS, ACCOUNT HOLDER,  
WOMEN'S OPPORTUNITY RESOURCE CENTER (WORC), NOR-  
RISTOWN, PA**

Ms. SIMMONS. Thank you, Mr. Chairman. My name is Michelle Ann Simmons, and I am a graduate of the Self-Employment Training Program and the Family Savings Account.

And if you hear me say "Family Savings Account," that is what it is known as in Pennsylvania, but here it is called the IDA. So, I just want to make that clear up front, just to repeat what the Senator just said.

I would like to tell you my story. For years, I was a hope-to-die dope fiend, living in a cardboard box on the streets of L.A. I was in and out of jail for 10 years.

I was released from prison, and I decided to try to break the cycle of addiction, imprisonment, and making all the promises to my children that I would be there. I knew I had to change or I would die.

When I was released from prison, I moved back to Montgomery County and had a difficult time finding employment and housing. I wanted a job, and I did not want a job at McDonald's. Not that I have anything against McDonald's, but it is real hard to work all week and make \$239, and your rent is \$524. It is just so frustrating. And me, already being an ex-offender, having that X in the box, it was real hard for me.

So, I wanted something viable, so I started to tell of my goals and my dreams, and someone directed me to the Women's Opportunity Resource Center. They said, maybe you should start your

own business. You have a big mouth, you like to talk, maybe you could do something.

I went there, and there is where I learned about the FSA account and the program. I was really encouraged when I heard about the program because I had never gotten a gift, or anybody wanting to help me or do anything.

From a very young age, I was abused and was told, "You are never going to be anything," "You are never going to have anything," and that is the mentality that I had. Then here it is, after 10 years of being in prison, in and out, somebody told me, if you help yourself, we are going to give you something else to help you.

They said, "What would you like to do?" I said, "I want my own house." They said, "Well, here is a program. If you begin to save, then we are going to help you with your savings." And it is not just the money piece that the FSA is so great about, it is the educational piece. I learned how to save. I did not ever have a savings account before I signed up for FSA.

I have never had a budgeting class. I did not know how important it is not to put my 50 cents in the soda machine every day. You see, we just drop 50 cents in there every day and we think it is just 50 cents, but my budgeting counselor taught me to add that up after 7 days, and then add that up at the end of the month, and that was a lot of money I was putting into that soda machine.

So, it was these little simple things that I learned by joining this program. I think it is real vital that legislation get passed, whoever needs to do it, because remember, I told you that I was on drugs, hoped to die.

I saw the light, and gave my life to God. But there are so many women in the same position, and men, that I was in, that just need that break, that just need that hand up, not a hand-out. We do not want to be giving anybody anything, but those that want a better life, that want some education, that want to start their own business.

I remember, when I signed up for FSA, I was not sure if I was going to get my house first or get my business, but I knew I was not going back to prison, and I knew I was not going to continue living that life.

There, I found different resources. With those resources, just knowing that they were available, gave me motivation, gave me incentive that I could do this. There were programs that were going to help.

One thing I would like to comment on, in closing, is what Senator Lincoln said about my children. My children used to be like, "Ma, why are you rushing down to the bank?" I said, "Because I have to get it in by the 31st." You have to save every month. They just learned discipline from that.

I probably could go on for another half hour talking about what this program has done for me and what it has meant for me, but clearly it has given me new self-esteem, new self-worth. I now own my own home. I now have my own business. I have a program for women ex-offenders, and I go back out into the community and let them know they can make it as well. With these programs, it just gives them the boost that they need. All right. So, thank you.

[Applause.]

Senator SANTORUM. Well done.

[The prepared statement of Ms. Simmons appears in the appendix.]

Senator SANTORUM. Dorothy, thank you for being here.

**STATEMENT OF DOROTHY BEALE, ACCOUNT HOLDER, WOMEN'S OPPORTUNITY RESOURCE CENTER (WORC), PHILADELPHIA, PA**

Ms. BEALE. Thank you for having me. I just want to start out by saying good morning to everyone on the panel, and all my fellow people that are up here with me. I am a little nervous this morning because I have never spoken in front of such important people, but we are all ordinary people when you think about it.

So, I just want to start out by saying, good morning. My name is Dorothy Beale, from Philadelphia, PA. I graduated, also, from the same program that Michelle was speaking of, the Women's Opportunity Resource Center, which has a family savings account program, which is also called the Individual Development Account, also known as IDA.

I joined the program in 2003 as a single mother who was working and just could not get ahead. I had always dreamed of having a house for myself and my three children. I was tired of throwing my money away on rent and wanted something I could call my own and one day pass on to my children. But I needed help.

At that time, my credit was, I like to say, tore up. I do not know if anyone in here can understand that, but everyone has credit issues. I will just explain it. You have good credit, then you have fair credit, and poor credit. Well, mine was below poor. It was tore up.

To fix my credit, I worked with a counselor at Acorn Housing. That is a nonprofit housing council and agency that is in Philadelphia.

I paid off the small debts first and I wrote letters to the credit bureaus to correct mistakes and negotiated payment plans with my creditors to pay off the larger debts. It was a long, long process and it took over a year, but I finally did it.

I also needed help saving towards a down payment. That was my biggest issue. I had never saved before, and I learned about the Family Savings Account program from Acorn Housing in April of 2003.

I went on to the IDA website, and that is how I did learn about WORC, which is the Women's Opportunity Resource Center. It is a nonprofit organization in Philadelphia that serves low-income women and their families through entrepreneurial training, and they have family savings accounts and small business loans.

Their FSA—short for Family Savings Account—program would help me to save towards a home and provide an incentive in the form of matched funds. I learned I could save up to \$2,000 over a 1- to 2-year period, and if I completed consistent savings and personal financial management classes, my savings would be matched dollar for dollar. I thought, wow! Who is going to give you, for every dollar you save, another dollar? I mean, I did not believe it.

So, the hard part for me was saving. I had never really saved before, like I said, and I needed something to discipline me. The per-

sonal financial management classes at Women's Opportunity Resource Center taught me to budget and track my funds. I thought about unnecessary things that I was spending money on and started making small sacrifices towards a larger goal.

After a few months, it got easier. I began to get excited, determined, and disciplined. I saw my money grow and my credit score rose. My confidence tipped the scales. It was the most beautiful thing in the world to me and my children.

According to the action plan that I had developed with my program counselor at WORC, I saved \$80 per month over a 15-month period, and even deposited a lump sum from my Earned Income Tax Credit to reach the \$2,000 goal.

With the work I did on my credit, I was able to obtain a mortgage for \$77,000, and with my \$4,000 in savings and matched funds, I was able to purchase my family's first home in September of 2004.

The most important thing is, this program has given me the opportunity to pass good budgeting and savings habits on to my children. While attending the program, I would take my children to the grocery store and show them how they could save money when shopping.

I would show them my bank statement so they could watch our savings grow over time. I was able to teach them the difference between wants and needs, something I had learned, but did not use.

I also opened savings accounts in their names and they now make regular deposits from their allowances and money they earn from chores. The program got me thinking about other long-term financial goals, such as retirement and my children's college education.

I decided to start saving more in my 401(k) plan, and I also opened college investment accounts for my children through Pennsylvania's Tuition Account program. Pennsylvania's State-wide Family Savings Account program is very essential.

The program provided me with the structures, incentives, and resources to achieve my dream of home ownership and to secure a sound financial future for my family. These are the keys to my front door. Every time I turn these keys, my heart just overflows. I am the one that Mr. Bunning quoted as saying, "It is the best feeling in the world to know I own something."

Thank you for your time.

[Applause.]

Senator SANTORUM. Thank you, Dorothy. Terrific. Thank you.

[The prepared statement of Ms. Beale appears in the appendix.]

Senator SANTORUM. I thank both of you, and congratulations.

Now it is my pleasure to have Charles Palmer. He is the president of ISED Ventures, which is a nonprofit organization specializing in asset development and micro-enterprise development services for low-income individuals and families.

Mr. Palmer?

**STATEMENT OF CHUCK PALMER, PRESIDENT, INSTITUTE FOR SOCIAL AND ECONOMIC DEVELOPMENT (ISED), DES MOINES, IA**

Mr. PALMER. Thank you very much, Mr. Chairman, Senators. I appreciate the opportunity to speak to this panel regarding building assets for low-income families.

I had the opportunity to serve as the director of the Department of Human Services for the State of Iowa for 11 years, prior to coming into this job, during the 1990s when we worked so hard on welfare reform. I think we achieved a lot of successes, with the help of Congress and the Senate.

With the help of Dr. Sherraden, who will speak later, I really learned to appreciate the importance of asset-development strategies built into welfare reform, and Iowa was the first to build the IDA into our waiver program back in the 1990s.

At that time, I talked a lot about, what we really needed to do was to work to change the culture, both for clients, and, frankly, for workers from a culture where there was a greater dependence on welfare to really trying to provide opportunities and incentives to move to economic self-sufficiency.

Well, across the country, welfare rolls dropped by half, and I am afraid that a number of people declared victory and went home. But victory has not really been achieved. There is the other half.

There is also the fact that I think there is an economic structural gap that exists for low-income citizens between beginning wages for people who are working very hard and what it is going to really take to be economically self-sufficient.

That, I think, speaks to the emphasis on workforce strategies, economic development strategies, job training, but it also speaks to the importance of the asset-development strategies that you are focused on.

I understand that potentially a third of American households have zero or negative assets. This can be as high as 60 percent for African Americans. As you noted, Mr. Chairman, this means that many, many American families are only one economic shock away from returning to welfare or debilitating debt. We need to help these families build their own safety net.

So, to stabilize and help low-income families improve their lives, we must focus on asset-development strategies with matched savings accounts at the core. As noted, I am the president of ISED Ventures, and now we have a sister organization, ISED Solutions. We have been active in the asset-development field for many years, and with IDAs since 1999.

We work with low-income citizens and have been very involved in working with refugees. In Iowa alone, we have 1,300 account holders. They have saved \$1.6 million, with a majority of those dollars going to the purchase of homes, and about \$10.3 million has gone into the State economy for the purchase of homes.

The refugee program at this point has not been refunded, due to budget problems. We believe that that is a very important program. With my experience in working in the field, I want to just give you some things to consider and think about as you begin to move into the next phase of asset-development strategies.

IDAs are critical, but I really think they have to be part of a comprehensive set of other reinforcing strategies. We have already noted the importance of financial literacy, the importance of moving people into relationships with mainstream financial institutions and getting people banked, helping people avoid predatory lending situations, helping people build credit with credit counseling, reinforced by financial literacy.

And in Iowa, the opportunity for people to get their full tax return based on their hard work through EITC has been a critical reinforcer, an opportunity to jump-start some people's IDA programs.

The programs need to be flexible and more individually tailored. I think we need to look at expanding some of the asset options. We have seen that in the refugee program, where people purchase vehicles to get jobs, to get more savings, to buy homes.

We need to expand the points of entry, not just human service agencies, but other points of entry as well. If we are going to step significantly into youth programs, then we need to look at extending the savings time period.

I think we need to focus on creating a culture of savings and a culture of generations who really are financially literate. Thus, greater focus on families and youth are really important, and we are doing that and expanding our program in Iowa.

More partners need to come into the program. We need to provide incentives for banks and corporations to contribute matching funds. I think we need to jump-start the opportunity for new Americans to get ahead with the reinstatement of the refugee IDA program, and I think it is important that we support continued technical assistance and program evaluation in a fast-growing field.

I thank you for the opportunity to make these comments, because I see this field as a critical next step in helping all hard-working Americans achieve economic self-sufficiency and build safety nets.

Thank you, Mr. Chairman.

Senator SANTORUM. Thank you, Mr. Palmer. I agree with you that it creates the next step. It is an important step, and I am, again, happy that we are here to talk about that.

[The prepared statement of Mr. Palmer appears in the appendix.]

Senator SANTORUM. Now it is my pleasure to introduce Dr. Victoria Gonzalez-Rubio. You are the principal of Delmar-Harvard Elementary School in St. Louis. Thank you for being here today.

**STATEMENT OF DR. VICTORIA GONZALEZ-RUBIO, PRINCIPAL,  
DELMAR-HARVARD ELEMENTARY SCHOOL, UNIVERSITY  
CITY, MO**

Dr. GONZALEZ-RUBIO. Thank you. Good morning. I am here this morning to tell you about a program called I Can Save. I Can Save is a 4-year demonstration program at Delmar-Harvard School in University City, MO, where I am the principal.

I Can Save is one of 13 sites in the SEED policy and practice initiative, a children's savings program. I Can Save, now in its second year at Delmar-Harvard, provides savings accounts, financial education, and incentives for all the kindergarten and first grade students that started last year at Delmar-Harvard.

The I Can Save program has a special place in my heart for two personal reasons. The first one, I have been an educator for over 31 years. I have taught at all levels, from pre-school through college.

The joys of young parents with hope and expectations for their children sometimes turn into heartbreak when their child becomes a high school senior and there is no possible way for them to go to college. Their dreams for a better life for their child are dashed when they do not have the means or the resources to make it happen. I saw it over and over again.

Second, I bring to you firsthand my own personal experience of how this program could make a difference. Both of my parents did not make it past the fifth grade. My father died before I was born. My family could not support, or even understand, my dreams for higher education.

If I had had the I Can Save program, it may have lessened the burden that I carried as I held down two to three jobs trying to make ends meet, and also perhaps there would have been resources available to figure out the financial options that may have been available to me.

Education is my passion. I wanted my own children to attend college and graduate, and I have the same dreams for every child at my school, and I communicate those dreams to them regularly.

The American dream is not about if you go to college, but when and where you go to college. The American dream is a ticket for many families to have a better lifestyle. When they do not have a college degree, many of them are locked into low-paying jobs, as one of my fellow panelists said, with no hope of advancing in their careers.

Many of my students are not only poor, but also of color. With programs like I Can Save, they can achieve academic success and break the cycle of poverty. As one of my second grade girls astutely said, "Well, if you don't go to college, you don't have a really good job."

Why do we think it will make a difference if children have savings for college? In my school, there are many, many parents that did not have the opportunity to go to college. Perhaps if they would have had a program like I Can Save or a nest egg, it would have been a possibility.

One of our students in I Can Save explained how money makes a difference. She said she thought it would be hard to get enough money for college because she would have to work so much. So we asked her if she wanted to go to college, and she replied, "To get smart, I do. But if it costs that much money, I don't think I want to go."

If this young student knew that she had a nest egg that would help her pay for college, she probably would have responded quite differently. In fact, another student in the program was more optimistic because she and her family have been saving regularly in the I Can Save program. She said, "I think if I save a lot, then it wouldn't be that hard for me to go to college."

Some parents hesitated before joining I Can Save. Why? So many thought, it sounds too good to be true. Some are skeptical of anything that sounds like it might be a scam, and others are just too

busy trying to make financial ends meet to investigate, or to explore, or even to read all of the things that we daily send home with their children.

But we made the personal one-to-one contact that enrolled 74 out of our 75 eligible students. It has been a great success. The students understand two things: that they are saving for college and they express regularly that they are college-bound. It is heart warming.

Parents tell me that I Can Save is a great program. They ask other family members to help them put away money for their children's accounts. Our children go weekly to Commerce Bank and deposit their pennies, their nickels, their dollars. These small deposits are adding up, but more than that, they are allowing these families to accomplish their dream and goal of college.

At this time, families have invested over \$27,000 into their I Can Save accounts at Delmar-Harvard. It touches my heart when I see parents, hardworking parents of very limited means, putting aside money so their dream of college can be realized for their children. I wish I had this program for every student at Delmar-Harvard, but more so, I wish we had this program for every child in our Nation. Thank you.

[Applause.]

Senator SANTORUM. Thank you.

[The prepared statement of Dr. Gonzalez-Rubio appears in the appendix.]

Senator SANTORUM. Our next witness is Ric Edelman. I just read here that Ric was inducted into the Financial Advisors Hall of Fame. Where is that located? Where is the Hall of Fame?

Mr. EDELMAN. As Red Buttons used to say, "I didn't even get a dinner." It is sponsored by Research Magazine and there are about 75, so far, inducted over the last 10 or 15 years.

Senator SANTORUM. Is there a hall that you go to and walk around?

Mr. EDELMAN. I keep looking for it.

Senator SANTORUM. Maybe we should see if we can get it in Pennsylvania. [Laughter.] So, we can work on that. Ric, thank you very much for being here.

Mr. EDELMAN. That is a bill killer. [Laughter.]

Senator SANTORUM. We look forward to your testimony.

**STATEMENT OF RIC EDELMAN, EDELMAN FINANCIAL SERVICES, INCORPORATED, FAIRFAX, VA**

Mr. EDELMAN. Thank you, Mr. Chairman. I am very excited to be here today to talk about this. In addition to being a financial advisor, I am very heavily involved in financial literacy programs and have written five books. I host radio and television shows, websites, and do a lot of speaking around the country, trying to help Americans learn the importance of personal finance and how to achieve financial security and retirement security for themselves and their families.

So I think that the idea that you have, Mr. Chairman, is absolutely brilliant. This is the best idea I have ever heard. I can say that, because I have the very same idea. [Laughter.]

Senator SANTORUM. Maybe it is the Rick thing going on.

Mr. EDELMAN. It is the Ric thing. I think I can say that I thought of it first. [Laughter.]

Senator SANTORUM. All right. When? [Laughter.]

Mr. EDELMAN. 1997. Does that beat you?

Senator SANTORUM. I will have to go back and look at the books. We will see.

Mr. EDELMAN. We will have to look. My idea is a little bit different. I invented something called the Retirement InCome—for Everyone Trust, RIC-E Trust. The RIC-E trust is a retirement planning tool for children. It was inspired by a phone call that I received on my radio show one day. I have the full history of it in my written testimony for you.

What it comes down to is, there is no vehicle that exists today that allows a child to save for retirement. We have the ability for working people to save and married people to save through IRAs, retirement accounts, spousal IRAs, et cetera, but there is no vehicle that enables you to set aside money for a newborn specifically for retirement purposes. We have the ability to save for college through the 529 programs today, but there is no specific vehicle for retirement.

So I invented the RIC-E Trust. It now has two patents. We launched it in 1998, and about 2,800 children are now enrolled in this program. Because it is in the private sector, the minimum account value is \$5,000. It requires a minimum investment of \$5,000, typically given by a parent or grandparent.

The money grows on a tax-deferred basis until the child reaches retirement age, minimum of 59½. There are no taxes all along the way, no trustee fees, no annual accounting fees.

On a tax-deferred long-term compounding basis, the child has the opportunity for \$5,000. Assuming a 10 percent return, that will grow to \$2.4 million by age 65. That is certainly a pretty good way to achieve retirement security.

The problem with the RIC-E Trust is pretty obvious, which is why your version of the idea is so much better than mine. Rather than \$5,000 which is privately funded—I mean, how many Americans can afford \$5,000 for a grandkid, and they typically have multiple grandkids, so you multiply the \$5,000 times 3, 5, 7 kids—it is simply not something that is realistically going to solve the problem for the millions of Americans so desperately needing this.

It is, frankly, an upper-middle-class to upper-class retirement tool. It helps wealthy people get wealthier. Well, that is my job, I am a financial advisor. But let us face it. If we take your version of the idea, knock it down to \$500 and automatically make it available for every child in America, wow. This is really pretty cool.

So your version of the program is far superior to mine, and because it will be tied into something based on the Federal Thrift Savings Plan, the expenses get driven down much, much lower than mine, because I have to have a profit motive, and I have to admit, people make money on offering things. We do not have to worry about that through the Federal program you have envisioned.

So your program is a dramatic improvement over the private sector model that I introduced a number of years ago, and I strongly support the initiative that you are developing.

The only thing that I would prefer that you do in your version, which is going to be contrary to what Dr. Gonzalez-Rubio would prefer, is that I would prefer that this be limited strictly to retirement planning, not for use for education or housing.

I say that simply because we already have programs for education, we already have programs for housing. There is yet no program to allow children to save for their retirement. So simply because of its unique positioning, I would prefer that this be limited to retirement.

The other reason that I argue for that—again, as a financial advisor, I have done counseling for thousands of Americans around the country—if you give them the choice of saying you can leave the money alone when you are 18 or you can use it for college, you can continue to leave it alone until you are in your 20s, 30s, or 40s and use it for housing, or you can leave it alone for retirement, guess what?

They are going to spend the money because we all have financial issues as we grow up. We are going to find the economic necessity: job layoff, medical problem, family issues, the need to go to college, the desire to buy a home.

By the time they reach 65, the money will be gone because of more imperatives. So if we give them the access, they will, indeed, spend the money. The real question will not be how much they have in retirement. The real question will be, what color is the sports car they buy at age 18? So my attitude is, it is strictly for retirement, and let us focus on college and housing in other programs.

Thank you very much, Mr. Chairman. Anything I can do to support this, I am happy to.

Senator SANTORUM. Thank you very much, Ric. I appreciate your comments.

[The prepared statement of Mr. Edelman appears in the appendix.]

Senator SANTORUM. Our final panelist for the first panel is Bernie Wilson. Bernie is the vice president for Business Development and Community Outreach at H&R Block. Thank you very much for being here, Mr. Wilson.

**STATEMENT OF BERNARD M. WILSON, VICE PRESIDENT, OUT-REACH AND BUSINESS DEVELOPMENT, H&R BLOCK, KANSAS CITY, MO**

Mr. WILSON. Thank you, Mr. Chairman, Senator Bunning. Thanks for the invitation for H&R Block to share our experience in helping low-income families save. We very much appreciate your leadership in this area.

H&R Block serves nearly 20 million taxpayers at 11,000 offices across the United States, including 490 in Pennsylvania and 199 in Kentucky, and through online and packaged tax preparation software.

In our 50th year, we are evolving from a firm devoted to helping families with their tax-filing responsibility to one that advises on a broader range of financial issues, including the need to save for retirement, home ownership, and education.

Our recent experience with the Retirement Savers Credit should be of some interest to the subcommittee. Enacted in 2001, the credit provides a government match of up to 50 percent for contributions to 401(k)s, IRAs, and other retirement plans. It covers taxpayers with incomes up to \$50,000 who have income tax liability.

Several features of the saver's credit play an important role in encouraging retirement savings. First, the credit relies on personal responsibility. People cannot claim it unless they make a substantial commitment on their own to save.

Second, it uses tax time to promote savings. The tax filing process, fueled by refunds averaging \$2,100, has become an annual financial check-up and an opportunity to turn good intentions and savings advice into immediate action.

Third, it supports the existing private retirement system, leveraging the well-known structure of IRAs, 401(k)s, and other vehicles, and encourages eligible taxpayers with low and moderate incomes to actually use them.

Fourth, the match rate of up to 50 percent provides a large-enough incentive to both strengthen savings and encourage first-time savers to actually take action.

Finally, the higher match rate for those with lower incomes targets benefits to those who most need help in saving. Many of our clients are eligible for the saver's credit, but the polls taken shortly after the enactment showed that 80 percent of Americans had no idea what it was.

In response, we provided extra training and beefed up our technology to help our tax professionals. We also used a low-cost, low-minimum-deposit express IRA account that we have developed to help our clients use the credit and save.

Our experience is that tax professionals can provide the pivotal education, advice, and facilitation necessary to enable taxpayers to benefit from the credit. As a result, over the last 3 years we have helped over 3.6 million clients obtain the Savers Credit, about 25 percent of all of the credits received nationally.

Our clients received over \$600 million in tax credits to help them save. This resulted in average savings of \$529 per client, with an average tax credit of \$167. By the way, this includes 57,000 Pennsylvanians who saved \$9 million in tax credits. It also includes 21,000 Kentuckians.

While most use the Savers Credit to match contributions to an existing 401(k), IRA, or other retirement plan that they had in place, over 243,000 clients used an express IRA with H&R Block, with an average tax savings of about \$180.

Let me give you a quick snapshot of the typical express IRA client. Their average income is \$27,000; about half are unbanked, two-thirds are Earned Income Tax Credit recipients. Eighty-five percent maintain their IRA account balances, and fully 80 percent of them were first-time retirement savers.

Our experience shows that the credit, combined with the tax refund, a low-cost savings vehicle, and the help of a tax professional can have a significant impact on retirement savings.

To build on this success, we encourage the Senate to consider extending the credit beyond 2006 and expanding it to include more middle- and low-income tax payers. Because recent tax cuts have

increased the number of Americans who have no tax liability, including families of four with incomes up to \$40,000, you may want to consider making the credit refundable so it is available to these families as well.

Mr. Chairman, we know from our experience that the Savers Credit works. As your subcommittee discusses ways to boost savings among low- and moderate-income families, we encourage you to consider making the credit permanent and expanding its reach.

Thank you.

Senator SANTORUM. Thank you very much, Mr. Wilson.

[The prepared statement of Mr. Wilson appears in the appendix.]

Senator SANTORUM. While you just finished speaking, let me just direct the first question to you. That is, you talked about the Savers Credit. Can I ask you, if we were to put forth and pass an IDA piece of legislation, is that something that you believe that your organization would be interested in getting involved in as another financial tool that you would make available to some of your clients?

Mr. WILSON. We would, most definitely.

Senator SANTORUM. I think the figure we have right now is a \$50 tax credit per account. Do you believe that is adequate to administer the accounts? Do you want to comment on the adequacy of that? Is that a big enough incentive for you folks to participate in it?

Mr. WILSON. Well, one of the reasons that this is important to H&R Block is because our reach is so significant in terms of scale. The number of clients that we can actually help is significant. So obviously as the scale grows, the need for account administration costs would reduce.

But \$50 is a pretty razor-thin administrative cost-coverage tax credit, I guess, but we would certainly support that, as well as any more that would help us get into this in a scaled way.

Senator SANTORUM. All right. That is a ringing endorsement for a higher than \$50 amount. I think that is what I was hearing.

Welcome, Senator Conrad. Thank you for being here.

Mr. Edelman, you expressed strong support for the KIDS Accounts, and I appreciate that, but limiting them to retirement only.

Now, Doctor, you have a similar program. Would you like to comment on the idea? Would your program be as successful, do you believe, for children if it was just a retirement-based program as opposed to something that is closer in time to them and to their needs?

Dr. GONZALEZ-RUBIO. I think that what he is saying is very, very valid, especially since I am going to be retiring next year. But I think that we have many families that need to save money for homes, they need to save money for college.

If our children are indeed our greatest asset, we need to make sure that they have the funds available that will allow them to have a better life than their parents'. I feel that ticket is college.

A good education is going to enable them to not only provide for themselves, but for their families. So, while I do agree there is a point here, I think that may be the long range. But an immediate one would be college savings. It may be, as he said, two different things, two different savings programs.

Senator SANTORUM. I will let you rebut.

Mr. EDELMAN. It is not so much a rebuttal, but a concession. I recognize that if you go to college and get the education you need which enables you to have the career which enables you to earn the money, it enables you to buy the house, which enables you to build equity in it, which enables you to tap into it for retirement. Therefore, college can lead to retirement security. They are not necessarily exclusive.

Both politically and pragmatically, it does make sense to keep the three of a theme. College, home ownership and retirement do fit together very nicely. Perhaps it could be left to the discretion of the parent.

When the child gets that \$500 at birth, let the parent check a series of boxes. They decide, do they want the \$500 to be used in the future for the child's education, housing, or retirement, and let them demarcate where it is. Instead of us trying to make that decision for every child in America, let that child's family make that decision on their behalf, or split the money into three buckets. They can use one piece for this, one piece for that, one piece for another, or what have you.

But because I am so focused on financial literacy and long-term retirement savings and the benefit of compound wealth, I just think if we do not emphasize retirement security, we are going to have lots of people entering retirement filled with regret over the decisions they made when they were younger.

Senator SANTORUM. We attempt to do that, as you probably know, in the legislation, which requires a certain amount of money—I think \$500—to stay in the account for longer term savings.

Mr. EDELMAN. Yes.

Senator SANTORUM. That is something we certainly are open to looking at and working with. One of the concerns I have, and I think the Doctor has is, if it is just long-term savings, if it is retirement, there may not be the incentive for people to contribute to the accounts and participate in the accounts because the benefit looks too far away for them.

Mr. EDELMAN. It is not exciting.

Senator SANTORUM. So I think we have to find some sort of balance here, but I appreciate your comments.

Just one additional question for you, Mr. Edelman. That is, with KIDS Accounts, and looking at it, again, from the standpoint of retirement, what do you think of the idea of the accounts post-18 years of age being governed by the Roth IRA rules?

Mr. EDELMAN. That makes sense. There is no reason to create yet a separate set of rules. We can clearly tap into them. The question then becomes, will they be roll-overable to the private sector Roths that will be handled by the financial markets as they would normally handle Roths, or would they remain in the TSP-type program that you are developing? I think that is a relatively trivial detail.

But I do agree with you, there is no reason not to sustain the use of the existing rules. We do not need to create a new set of rules for this unique program.

Senator SANTORUM. All right. I think I have used my time.

Senator Conrad, thank you for being here.

Senator CONRAD. I thank the Chairman. I apologize to my colleagues and to the witnesses for being late, but the governor of my State came to town, and we had a series of meetings critically important to my State that just concluded. So, I apologize. It was unexpected. We only found out yesterday that he would be here.

So, one of the things that I had asked my staff to do was to tell me how much we are spending a year on incentives for private-sector savings. They came back with an answer that we are spending \$125 billion a year in incentives for private-sector savings.

I then asked them to find out for me, how much in private-sector savings are we getting a year? They came back and said \$85 billion. So, we have a problem here. We have a set of incentives, well-meaning, that are clearly not very efficient in terms of delivering what they are intended to deliver, which is an increase in private-sector savings and investment.

Can any of the panelists tell me, tell the panel here, why you think that might be occurring? What is wrong with our system of incentives, that we are spending more than we are getting?

Mr. Wilson? Mr. Edelman? Any of the witnesses. I would be interested in what could be done to improve the structure that we have of incentives. Why is it not working as well as we might hope?

Mr. EDELMAN. Senator, some of the programs that I am familiar with result in, rather than increasing the level of savings, it simply moves money around. For example, look at IRAs. It encourages people to put away a few thousand dollars into an account, but does it encourage people to save who otherwise would not?

In fact, you are taking people who have money that is in a taxable account and enables them to move it to a tax-advantaged account, but it does not necessarily increase the amount of savings.

In other words, they are targeted people who already have wealth to help them become wealthier, as opposed to programs that are targeted to folks who would simply like to become wealthy in the first place.

I think that that is one of the advantages of this proposal, that it is really targeted to people who frankly have no opportunity to set money aside for something as long-term as college, home ownership, and retirement.

So I think that is part of the problem, in that many of the programs we create simply manipulate money rather than getting people to increase the amount of money that they are saving.

Senator CONRAD. One of the things we found in this review that we have just started is, where you have a program that requires a person to opt in versus opt out, you get a much different level of involvement.

That is, if you require somebody to opt in, you would have a much lower rate of participation than if you just put them in automatically, but give them the chance to opt out. It is a very dramatic difference in participation that one gets just by making that simple change.

Well, Mr. Chairman, I appreciate the time. I appreciate this hearing. I think it is absolutely critically important as we try to do a better job of providing incentives that are meaningful and that work. Dr. Rubio?

Dr. GONZALEZ-RUBIO. I have one comment. I think sometimes we give parents a lot of information, and the people who really need the information are not aware of the information because of the readability level of that information and the forms, the multitude of forms for someone who may have a low educational background or a low reading level. So, I think we need to look at that.

Like I said, at Delmar-Harvard, where we were able to enroll by one-on-one contact, 74 of the 75 eligible students, that one-on-one contact means enough. So, I think we need to reach out to those community partners that have those contacts to be your sales people and explain to them why savings for college and savings for a home are important, because people are somewhat skeptical. What do you want to do with my money? But if you have someone that they trust, then of course that trust filters down and you are going to get it sold.

Mr. WILSON. Senator Conrad, I might add also to your question, obviously the majority of that \$125 billion is going to high wealth, tax-free gains inside IRAs or 401(k)s.

We have focused a number of initiatives and pilots, some on our own, some with a variety of nonprofit and outside groups, researchers, to understand the savings substitution if someone is getting an incentive, a match, and it is our experience, people at low income levels who have never saved before, are now starting to save. We have less information about whether or not they were holding cash at home somewhere, but at the very least we can now see that they are using mainstream financial institutions and retaining those assets.

Somewhat anecdotally, but we are learning quantitatively that, at low income levels, people will start to save and maintain that savings, whereas, there is some evidence, at higher income levels, it becomes a substitution. So, if someone gets an incentive, a tax credit, a tax break, at higher income levels, they are just shifting their savings, as Ric talked about.

Senator CONRAD. Thank you.

Senator SANTORUM. Jim?

Senator BUNNING. Thank you, Mr. Chairman.

Ms. Simmons and Ms. Beale, both of your statements today were well-expressed and moving. Do you share with your children what you learned in the Family Savings Account program? Do you think that their knowledge and understanding of money management has been impacted by your experiences?

Ms. SIMMONS. Yes, I have expressed the importance of saving and budgeting with my children. As a matter of fact, when we first moved into our home, for the first year we did not have cable. My daughter could not understand why we could not have Nickelodeon. I told her, "Because we have a mortgage now, and we have to save. We have regular TV, and we will just have to catch the cartoons on Channel 12." This is one of the things I learned.

We did not go get name-brand soda, we got soda that was 50 cents at the Wal-Mart. They did not understand why we could not get what they wanted. I said, "Well, if you want some money at the end of the week to do something, then we have to budget like this." These are the things I learned from my class which I transferred to them in expression, so they did learn it too.

Senator BUNNING. So they are learning as you learned what it means to budget.

Ms. SIMMONS. Exactly. My daughter gets an allowance and she is not to spend her \$15 on junk food or fast food. She had better bring home some deodorant or a pair of socks, because you need to start at 10 years of age.

My mother feels like that is a shame, I am making this 10-year-old child buy deodorant or socks, but that is what we had better do. You are going to have to hold your own and you are going to have to spend the money wisely, because that is what I was taught.

So they are getting taught really early to at least spend \$5 at the dollar store on some hair gel or something. I got that from the FSA program, how to put down a \$3 gel and get the \$1 gel that does the same thing. So, this is very plain and very simple stuff, but it saves us a lot of money, which allows us to have a home and pay my taxes at the end of the year.

Senator BUNNING. Ms. Beale?

Ms. BEALE. And also, I stated in my speech that I had opened accounts for my children, savings accounts. They get an allowance from different chores that they do, and they earn money. Every week, we go to the bank. Someone mentioned Commerce Bank. I think that is a wonderful bank.

But they have a change booth where you can put your change in accounts, and it prints out a little thing. They have even gotten to the point where they have taken their change, put it in the booth, counting it out, and they will put it in the bank.

I have learned that children learn from their parents. We are examples. They are like little adults, really. They take on the same habits that they see their mother or their father doing.

From us going to the program and me learning to differentiate the wants from the needs, just like Michelle said, they learned that when we go to Wal-Mart or Path-Mart, any store, we write out a list and we stick to the list. Some things, you do not need. Some things you want, but it is not a need. So, they learn to differentiate their wants from their needs.

I have learned that from budgeting with the program and just going to the different workshops. I even took my son to a workshop one time when I went, and they have learned a lot from my examples.

Senator BUNNING. Good.

Dr. Gonzalez-Rubio, first, I want to commend your school and its partners for all your success with the I Can Save program. I hope that you will keep the committee up to date on the progress of that program.

Could you tell us a bit more about the financial education aspects of your program? Could you address this part of the program, both in terms of the topics that the students and parents cover in the program, and the challenges you face to attract participation in the financial education classes?

Dr. GONZALEZ-RUBIO. We have two strands. We have a weekly I Can Save club for children and classes in the regular school day where teachers incorporate words like "credit" and "financial use."

Senator BUNNING. What age is it?

Dr. GONZALEZ-RUBIO. This year, they are first and second graders.

Senator BUNNING. First and second grade.

Dr. GONZALEZ-RUBIO. And so they make piggy-banks and they earn money, and then when they go to Commerce Bank, that is changed into real money. But they are learning about opportunities and how you channel your resources.

Also, too, right now they are studying how to be entrepreneurs, so they are imagining, if they were later in life, what type of businesses they might do. So we have had hair dressing businesses, and ice cream. That is real—

Senator BUNNING. Popular.

Dr. GONZALEZ-RUBIO. They called it Ice Statics. So the children are doing this. They are working on the projects as we speak. At the end of the month, they are going to have a program for their parents, where their parents can see it. It is a first step.

I mean, when you hear children talk about opportunities, what they can do with their money, that they are saving it, it is just heart-warming. It is heart-warming that our parents are buying into it.

As one mother said, because her child lost his \$3 that he brought to school—but it was found—“Dr. G.R., I know it is not a lot, but it is a lot to me.” I told her, that is exactly what we want our families to do, to put a few dollars away each week, and it will build up. And your child, Chase, will be going to college. You know what I mean? Because he is hearing that from all his family members. He is hearing it from me.

We make visits to the neighborhood college campuses. We have a close partnership with Washington University. When I take the kids on campus, I tell them, today you are visiting Washington University. Tomorrow, you will be attending Washington University, or some university like it. But every chance that I can get, I tell them.

They may be tired of hearing it, but they know that this is my thing. I also tell my students that they are special to me all the time. The other day, a little girl was making an announcement from the rain forest, and she was a child of special needs. She ended it with, “And like Dr. G.R. says, you are special to me.” So, I just had to smile.

What do I want to be remembered for? I hope that I am remembered for, at the end of my retirement, that I really, really was not just paying lip service, but that I did everything that I could to get more of our children into college and planted that seed in them.

We even, for those classes that were not involved in it, recently had a parent breakfast as part of our Dr. Seuss thing, where I brought in our MOST representatives—that is our college saving incentive program—to come and talk about it. Because even if the parents are not a part of that two-grade cohort, the I Can Save cohort, I want them still to know that there are opportunities for them to save money, and they need to start saving it now.

In my own case, my daughter started college this past year. She shared with me recently when she bopped into the car, mom, so and so’s parents had to take out another \$11,000 loan. Thank you so much. My kids, like you, think that deals in the dollar stores

are my favorite places to shop, and I buy nothing that is not on sale. But there are a lot of things that we have realized.

Senator BUNNING. I have another question for Mr. Palmer, but go right ahead.

Senator SANTORUM. Well, actually we need to move to the next panel, if that is all right. If you have one question, go ahead.

Senator BUNNING. One question.

Mr. Palmer, you discussed briefly in your written testimony the differences in allowable uses for money saved in the refugee IDA program and the citizen's IDA program. Can you comment more on these differences and how participants in your programs have used IDA funds?

Mr. PALMER. The differences are, in the refugee IDA program, people are also allowed to invest money in a vehicle, a computer to start a business or to further their education, and in housing rehabilitation. We saw a majority of people initially invest money in purchasing a vehicle so they could get to work.

A second family member also invested in an IDA, and usually with that they were focused on starting a business or in buying a home. But for this group, the vehicle, as a way to get to work, to establish themselves in this society, was a very high priority. The majority did that, but then they continued in the program, moving towards, in many cases, home ownership.

Senator BUNNING. Thank you.

Senator SANTORUM. I want to thank members of the panel. Would you like to say something?

Ms. SIMMONS. I have one more thing I have a burning desire to say. He asked me about my children and the saving. I am the founder and director of Why Not Prosper, and there are 67 counties in Pennsylvania. I go to the two State penitentiaries and all 59 of the counties that have facilities for women, so not only are my children getting the budgeting that I have learned, it is going into the prisons with me as I go and speak to the ladies. As they are coming to my facility, they are getting the budgeting and they are getting directly from where I got it from. Amen.

And then lastly for him, Senator Conrad, you said that you see a difference in the money. Well, the money may be a little different, but the change in the lifestyle, that is the piece, the gap you all are missing. Because you do not see the cash back, but for a life like mine that was on a slippery slope to hell, these programs kind of got me back on the right track.

So you are missing the money, but you have some new lives that are being rebuilt, so that is taking up the gap of the money that is missing.

Senator SANTORUM. Thank you very much, all of you. I appreciate it.

[Applause.]

Senator SANTORUM. Our second panel, if they will come forward, is Dr. Michael Sherraden, Dr. Trina Williams Shanks, Mr. Fred Goldberg, Ray Boshara; David John, and Mark Iwry.

Doctor, if you are ready to proceed. Dr. Sherraden is the author of "Assets and the Poor," and he is a professor at Washington University in St. Louis, MO.

Doctor, thank you for being here.

**STATEMENT OF DR. MICHAEL SHERRADEN, AUTHOR OF “ASSETS AND THE POOR,” PROFESSOR, WASHINGTON UNIVERSITY, ST. LOUIS, MO**

Dr. SHERRADEN. Thank you, Chairman Santorum and members of the subcommittee, Senators Bunning and Conrad. I am honored to present testimony today on inclusion in asset-building.

As we know, many Americans are asset-poor. Twenty-five percent of U.S. households do not have enough net worth to live for even 3 months at the poverty line.

This suggests two things. One, that many U.S. households have very little financial cushion to sustain them in the event of a job loss, illness, or other shortfall of income. Two, development of these households is limited by lack of assets for investing in education, homes, businesses, and other strategies to get ahead.

Asset-based policy would shift social policy—and this committee is very much about Social Security and family policy—from an almost exclusive focus on maintenance to a focus on development: development of individuals, families and communities.

This is not to say that there is no role for social insurance. Indeed, the right idea is to balance asset-building with social insurance. If there are to be individual accounts in Social Security, I believe they should be above and beyond the current Social Security system.

The goal of asset-based policy should be inclusion. By inclusion, I mean that policy should, one, bring everyone into asset-building; two, make the policy lifelong and flexible; three, provide at least equal public subsidies to everyone in dollar terms. Right now, we provide most of the public subsidies through the tax system to people who are already well-off. Four, achieve adequate levels of asset accumulation, given the purposes of the policy.

My insights into asset-building came in discussions with welfare mothers nearly 2 decades ago, talking with them about why welfare—then it was called AFDC—was a trap. These women said to me that it was very difficult to get anywhere in the current welfare system. Those discussions led eventually to a proposal for Individual Development Accounts.

As originally proposed, Individual Development Accounts would have been a kind of universal asset-building system where everyone has an account that was started as early as birth, with matched savings for the poor, recognizing that in current policy we provide tax benefits for asset accumulation in homes and retirement accounts, and not much of this reaches the poor.

IDAs would do matched savings for the poor, and indeed, that is what they do. There could be multiple sources of matching deposits, accompanied by financial education, which you have heard a lot about. These savings could be used for homes, business capitalization, education, and other purposes.

Since IDAs were introduced, we have made some policy progress, as we have heard about today. There is the Assets for Independence Act, which is some Federal resources for IDAs. The Savings for Working Families Act that Senator Santorum has talked about is nearly ready to pass in the Congress, and we hope that it does.

And there have been other developments. More than 40 States have some kind of IDA program at the State level. But honestly,

these are all fairly small programs at the present time, and we are really a long way from a large policy that includes everyone in this idea of asset-building for Americans.

The most important contribution, I think, today, is that this is an active discussion. When we started this work 15 or 20 years ago, there was really no discussion of asset-building for poor people, certainly not in the context of social policy.

Today, this is a very active discussion, and both Republicans and Democrats use the language “asset-building,” “asset-based policy,” “stakeholding” and “ownership society.” I think we have come a long way.

We are learning a great deal from research. We find in IDA research that if we increase the matched cap—that is, how much people can save and be matched—\$1, we get 40 or 50 cents more savings. This is a very strong effect.

We have other findings. We know that if we provide financial education, we can increase savings for about the first 10 hours of financial education, and after that, not much effect. This is important to know because financial education is expensive, and if we are going to invest in it, we need to know how much is the right amount.

We find, from talking with IDA participants, that they see IDAs as an opportunity. These are people who mostly do not have access to a retirement account at work. One IDA participant said, “Oh, I get it. This is like a 401(k), only for me.” This is a person who would not have access to a 401(k) otherwise.

We find that IDA participants like restrictions. They like the fact that the money is put aside and they like the fact that it can be used only for homes, or education, or business capitalization, because, as some of the discussion earlier has indicated, they feel the money would just be spent if it were readily available. So this idea of restrictions, we think, will play a role in future policy, or should.

Turning to the effects of IDAs, we find that asset-building has positive effects; especially we know that home ownership has positive effects. I see my red light is blinking, so I will move to my conclusion.

There are a lot of positive effects for asset-building. The one point that I would like to leave you with is that we believe that asset-building in public policy ought to be in the form of a plan, a plan that can be inclusive and reach out to include everyone.

Most people accumulate assets in a 401(k) plan, a thrift savings plan, and that is why the plan features of the ASPIRE Act, for example, modeled after the Thrift Savings Plan, are so desirable.

The plan can offer a few simple investment choices. It can be low-cost. We think, for long-term policy development that is really going to include the whole population, this is the right way to go. Thank you very much.

Senator SANTORUM. Thank you, Doctor.

[Applause.]

[The prepared statement of Dr. Sherraden appears in the appendix.]

Senator SANTORUM. Next, is Trina Williams Shanks, who is a professor at the University of Michigan, Ann Arbor. Thank you.

Dr. Shanks?

**STATEMENT OF DR. TRINA R. WILLIAMS SHANKS, PROFESSOR,  
UNIVERSITY OF MICHIGAN, ANN ARBOR, MI**

Dr. SHANKS. Thank you very much, Senator Santorum, for inviting me today, and Senators Conrad and Bunning. It is an honor to be able to speak before you and share my thoughts.

I have spent much of my academic career thus far examining the impact of household wealth on child development outcomes, and I have approached this topic in two ways.

The first is using nationally representative data sets, like the Panel Study of Income Dynamics, to test in a statistical way if household wealth makes a difference for children.

Some of the things I found included that household wealth helped us to better understand child outcomes, things like academic test scores and reported behavior problems. If you have information on household wealth, in addition to things like income or parental educational levels, we can better understand what possible outcomes are going to be for children.

I have also seen that in many instances, growing up in households with even a small amount of net worth, seems to make a positive difference for children. So, it does not have to be large amounts. Even small amounts, particularly for low-income households, can make a difference.

But what I find most interesting is, having assets seems to really benefit low-income households and children, particularly those of African Americans and those that maybe face multiple disadvantages, perhaps having a head of household with less than a high school education.

A second way that I will examine the impact of wealth and asset accumulation on child outcomes is through this initiative you heard a little bit about, the SEED initiative, Saving for Education, Entrepreneurship, and Downpayment.

I am a co-investigator for the impact-assessment portion of that initiative, so we are going to have an experimental design where there are 500 low-income families whose children are enrolled in Head Start programs. They will be offered college savings plans that are seeded with \$1,000.

We also will be following, through interviews, a control group, so that at the end of a 4-year period we will be able to say with some confidence that those who were offered these accounts perhaps turned out differently than these same type of families that were not offered accounts. The results are not in yet, but we will be able to give that answer as we gather data over time.

So, you have my written testimony. I would be more than happy to talk to you about my research. But I would like to end with just a few observations. Before I started doing academic research, I ran a church-sponsored family mentoring program.

So, we offered tutoring and activities for children, we offered life skills classes and access to mentors from one of the two congregations of families. I like to think we made a difference, but attendance was inconsistent. They really did not meet very many of their economic goals.

Two years into this program, we started offering Individual Development Accounts, IDAs. These public housing residents that we were working with started coming to the classes, bringing their

children, saving money, meeting their goals, and they also invited their friends to be part of the program as well.

So, I see asset-building policies as an opportunity to provide a vehicle that supports individuals in a very concrete way to help them work toward their own personal dreams and goals.

The image that comes to my mind is, we have a person standing on a riverbank and they need to get to the other side. Someone comes by and they have a boat and they can cross over easily. Maybe some are strong enough to swim and beat the current and make it to the other side.

But that other person is standing back, saying, I do not have a vehicle to cross. So, maybe the community can decide to build a bridge, so any time they want to cross over to the other side, they can.

In my mind, that is kind of what asset-building policies are, because I think that most people would want to save and not go from paycheck to paycheck, and have a little bit of financial security. I think that most people would want to guide their children to a safe and productive future.

But they come across obstacles, particularly those who are low-income and face multiple disadvantages. So, these asset-building programs are really the appropriate vehicle to help them to reach their own goals. I would just say, if you would ask me what might be the impact of having child savings accounts that begin as early as birth and throughout elementary school, and allow parents and their children to work together to focus on helping their children meet goals of education and personal betterment using money in these specially designated accounts, I can say, from my analyses from longitudinal data, that household wealth can lead to better outcomes for children.

But I would say the potential, at least, is that more young people would have glimpses of hope rather than expectations of repeating inter-generational experiences of failure, both academically and economically. So if you ask my opinion, that would be the impact of such accounts.

Thank you very much.

[Applause.]

Senator SANTORUM. Thank you, Dr. Shanks.

[The prepared statement of Dr. Shanks appears in the appendix.]

Senator SANTORUM. It is my pleasure to introduce Mr. Fred Goldberg, who is a lawyer at Skadden, Arps and is a former Commissioner, if I recall, of the Internal Revenue Service.

Mr. GOLDBERG. Yes, sir. And I am here to help you.

Senator SANTORUM. Thank you. [Laughter.]

Fred?

**STATEMENT OF FRED GOLDBERG, SKADDEN, ARPS, SLATE,  
MEAGHER & FLOM, LLP; FORMER COMMISSIONER OF THE  
IRS UNDER PRESIDENT GEORGE H.W. BUSH, WASHINGTON,  
DC**

Mr. GOLDBERG. Thank you. It is a pleasure to be here today. I would like to offer two brief observations and submit my written statement for the record.

I will also note, having appeared before each of you many times in my prior lives, I have never before attended a Senate hearing where the witnesses have been applauded. I think it is a wonderful tradition.

Senator SANTORUM. Do not expect that for you, Fred.

Mr. GOLDBERG. No, I do not. [Laughter.] Generally, it is boos, Senator.

First, while more than 90 percent of all taxpayers have positive tax liability over their lifetimes, more than 90 percent of us, when you look at us over our lives, pay positive tax to the government. Forty percent of us, 40 percent of all taxpayers, have no tax liability in any particular tax year. We are kidding ourselves to talk about policies to promote asset-building among low- and middle-income families in the absence of refundable credits.

More broadly, in my judgment, the failure to provide a refundable Savers Credit, the phase-out of eligibility for traditional IRAs and Roth IRAs, the grotesque array of savings incentives, make an absolute mockery of our policies to promote asset-building.

This has nothing to do with the heated rhetoric that refundable credits are welfare. It has nothing to do with the heated rhetoric that says universal eligibility for IRAs is a give-away to the rich.

What tax policy justifies denying savings-based credits to families living in a small town in the Dakotas where their cost-of-living adjusted-income is exactly the same as a family living in Philadelphia?

What tax policy justifies denying the benefits of IRAs to families living in Philadelphia, when those families are living on the same cost-of-living adjusted-income as families living in the Dakotas?

What tax policy justifies punishing millions and millions of families who try to save because their incomes fluctuate as the result of a layoff, a family illness, taking time off to have a child, pursuing continuing education?

What tax policy justifies the grotesque array of so-called savings incentives that do nothing for low- and middle-income families, are beyond the comprehension of tax professionals, not to mention normal citizens?

And what tax policy justifies complex rules and phase-outs, in the interest of soaking the rich, that undermines any incentive for financial institutions and intermediaries to effectively market savings programs to low- and middle-income families?

There is no justification, on policy grounds, for the current system. Fundamental reform is long overdue. The IDA provisions of the CARE Act and the recently introduced ASPIRE legislation represent a dramatic step in the right direction, because low-income families and their children benefit without regard to their current-year tax liability.

But more should be done. In addition to IDAs, in addition to ASPIRE, Congress should scrap what is out there on a revenue-neutral basis, enact the administration's LSA, RSA, and ERSA proposals, and a robust refundable Savers Credit.

My second observation has to do with administrative and policy infrastructure. Each of these areas has received far too little attention. By administrative infrastructure, I mean systems necessary to implement measures under consideration by Congress.

Our country is blessed with a remarkable private and public financial infrastructure that can support universal asset policies that were unthinkable 20 or 30 years ago: the administration's split refund proposal, IDAs, the CARE Act, the ASPIRE legislation, restructured Savers Credit, personal retirement accounts that are either part of, or are an add-on to Social Security.

The fact is, we can make these policies work, and work well. In my view, the keys to successful and durable policy infrastructure are universality, simplicity, and appeal to shared values. The most important feature of your ASPIRE legislation is that it creates a truly universal savings infrastructure for all Americans.

With all due respect to the witnesses who have commented, the most important aspect of the ASPIRE provision is not the money. The importance is, it creates a universal platform where individuals can build and individuals can assume personal responsibility for their own well-being.

It is clear that the existing administrative structure makes it possible to implement these policies that satisfy the criteria. It is clear that these objectives can be accomplished in ways that are fiscally responsible in light of massive deficits. It is clear that we have many policies to choose from. What is unclear, is whether the political process will make those choices.

Thank you.

Senator SANTORUM. Thank you, Fred.

[The prepared statement of Mr. Goldberg appears in the appendix.]

Senator SANTORUM. It is now my pleasure to introduce Ray Boshara. Ray is the director of the Asset-Building Program at the New American Foundation.

Ray, thank you for being here.

**STATEMENT OF RAY BOSHARA, DIRECTOR, ASSET-BUILDING PROGRAM, NEW AMERICA FOUNDATION, WASHINGTON, DC**

Mr. BOSHARA. Thank you, Senator Santorum, Senator Conrad, Senator Bunning. I have dedicated my professional life thus far to this idea, and it is great to be here. This is a great moment, and I commend all of you for your leadership, for your efforts to expand savings and ownership for all Americans.

I would also like to thank the foundations that have made my work possible for the last 10 years: the Ford Foundation, the Charles Stuart Mott Foundation, Casey Schwab, and Citigroup Foundation. None of us would be here if it was not for their support.

So what would I do? I would propose three things to Congress. First, things that really do not cost any money, very low-cost ideas: splitting refunds on tax returns, automatic 401(k)s, and an idea that Peter Tufano of the Harvard Business School gave us—putting savings bonds back on tax returns. It is a great idea, something that we should look more into.

Second, I would support matched savings accounts for the working poor, including the Savers Credit and IDAs. I was going to cite the research about IDAs, but I think Michelle and Dorothy did it better than I could.

I commend you, Senator Santorum, for reintroducing the Savings for Work and Families Act yesterday with Senator Lieberman. I spent 5 years on that bill, and I would love to see it become law.

The third thing I would propose, no surprise to anybody, is KIDS Accounts, the ASPIRE Act, which, of course, New America and the field I work with have been promoting for some time now.

Let me give you three reasons why I think KIDS Accounts deserve favorable consideration by Congress. First of all, I think we need to create a culture of savings and investing compared to the culture of spending and consuming, and it especially needs to be directed at kids. Also, as Ric Edelman and others will tell you, the earlier we save, the better. Why miss the first 20 or 25 years of accumulation? It makes no sense whatsoever.

Second, I think we have to increase national and household savings. There are all kinds of great macroeconomic arguments in favor of targeting savings incentives to kids, and we should really pay attention to that.

At some point, Asia is no longer going to finance our consumption and our deficits, and we need to find ways to increase savings in the U.S. There is actually a fabulous report just put out by the McKinsey Global Institute on this very point.

Finally, I would just note that we do absolutely nothing to help poor kids build savings and assets. Right now, we have WIC, food stamps, tax credits, and health insurance programs for kids—but we do nothing to help them save. It is not surprising then that one-quarter of all white kids, and half of all other kids, grow up in households with zero or negative assets for investment.

A couple of questions I would like to address. First, why are KIDS Accounts relevant to retirement security? There is a lot of talk about retirement security. Why do we need to think about KIDS Accounts in this context?

As Fred said, we need to create a permanent lifetime platform for saving, wealth accumulation and retirement security. Over the long term, we can solve our pervasive problem of the unbanked. And, when you die, you can pass this money on to your heirs. I think we have to think about asset-building as from birth to death.

Also, these accounts can be used for two purposes which are very relevant to retirement security, buying your home and going to college. Certainly those are the major components of my economic security at retirement.

We do have programs for going to college and buying homes, but they are inadequate. Too many kids do not buy homes and do not end up going to college. So, I think we have to think about these elements together.

The way the ASPIRE Act is written, the account becomes a Roth IRA at age 18, meaning that you can use it tax-free and penalty-free for buying your first home, going to college, and, of course, for retirement.

One final question I will close with. Would KIDS Accounts be worth the cost? The answer is yes. In an era of growing deficits and mounting pressures on entitlements, I think we have to enact ideas that will reduce the need for government over the long term. We have to spend money in each generation to save even more money in future generations.

When Michelle said that she is now a homeowner and a taxpayer, there you are. That is how a program like KIDS Accounts and IDAs will save money for this government over the long term.

Also, I think we have some examples to learn from. Britain, as you know, has enacted its Child Trust Fund. Two million accounts were set up already this year. Two million kids in Britain now have their own Child Trust Fund, and they are saving for their future. Canada has Learning Bonds for education established at birth, and New Zealand just proposed something called the Kiwi Account.

So, I think this is happening, and I hope the U.S. plays a real strong leadership role in establishing KIDS Accounts at birth for every child in America.

Thank you.

[Applause.]

Senator SANTORUM. Thank you, Ray.

[The prepared statement of Mr. Boshara appears in the appendix.]

Senator SANTORUM. It is my pleasure to introduce David John, who is a research fellow at the Heritage Foundation.

David?

**STATEMENT OF DAVID JOHN, RESEARCH FELLOW, THE  
HERITAGE FOUNDATION, WASHINGTON, DC**

Mr. JOHN. Thank you for having me. Thank you also for holding a hearing on this important issue.

Lincoln said that a house divided against itself cannot stand. And while the situation is vastly different, we do have a wealth gap in this country and a wealth gap that is only growing. We found over the years that income-transfer programs simply do not work. They do not provide what might end up being a permanent solution to this.

However, proposals such as the ones mentioned here, IDAs, ASPIRE, KidSave, SEED accounts, et cetera, can expand the opportunities for people to grow out of low-income situations. They expand the opportunities for savings, home ownership, and full participation in the economy.

Now, as Ray just mentioned, this is not just a U.S. concern. We have had significant conversations with an Australian Labor Party Senator by the name of Nick Sherry who is one of the architects of their mandatory Retirement Savings Plan.

What he said was, as a Labor Union official, the reason he got involved with this type of an effort—savings, asset-building—was that he sat and watched upper-income people become wealthier because they had assets and they could watch those assets grow. What he wanted was to see his members and low-income Australians have the same opportunities.

IDAs, ASPIRE, KidSave, SEED, et cetera, are investment programs, and they pay much more than just financial benefits. For instance, various studies, one of them by the gentleman at the far end of the table there, showed that people with assets are much more future-oriented, prudent, confident in their prospects, and connected with their communities.

Other studies show that, in the event of auto workers affected by plant closings, that people who owned houses were much less likely than renters to suffer from depression or alcoholism, even after taking into account differences in income.

These also apply to the next generation. Various studies have shown, and this applies to the first panel here, that the savings habits of families are more important than family income in predicting teen-aged savings behavior.

So, a history of a family that saves will likely continue into future generations. Likewise, the children of homeowners are more likely to stay in school than those of renters.

Last, but not least, increased levels of home ownership among low-income families lead to higher rates of high school graduation and college attendance in the children of those families.

Now, in addition to the other fine programs that have been mentioned here, let me also mention KidSave, which was developed originally by Senator Bob Kerrey and was co-sponsored by, I believe, the Senator from Pennsylvania back in 2000.

Now, this is a program that was specifically structured to provide savings for retirement, and it is one that would work very effectively. It has been most recently introduced into the House by Representative Jerry Weller, a Republican from Illinois, and Representative Sherrod Brown, a Democrat from Ohio. I would recommend it also to your consideration.

Now, a key factor in all of these programs that have been mentioned is that they are not new entitlements. We seem to have more than enough problem with the entitlements that we have at the moment. These are a hand up. This is the way that families and communities have always helped each other, and it is a very appropriate way to help low-income families to build assets and to help close the wealth gap in this country.

Thank you.

Senator SANTORUM. Thank you. Appreciate it.

[Applause.]

[The prepared statement of Mr. John appears in the appendix.]

Senator SANTORUM. Our final panelist is Mr. Mark Iwry, who is a nonresident senior fellow at The Brookings Institution.

Mr. Iwry?

**STATEMENT OF J. MARK IWRY, NONRESIDENT SENIOR FELLOW, THE BROOKINGS INSTITUTION, WASHINGTON, DC**

Mr. IWRY. Thank you, Mr. Chairman. I am Mark Iwry. I am here today on behalf of the Retirement Security Project, which is supported by the Pugh Charitable Trusts and is a partnership between Georgetown University and The Brookings Institution.

The Retirement Security Project is dedicated to working on a nonpartisan basis to make it easier for lower- and middle-income working families to save, particularly for longer-term needs for a secure retirement.

Our private pension system has accumulated what is perhaps the largest pool of investment capital in the history of the world, some \$11 trillion.

Senator Conrad, you have noted that we spend about \$125 billion a year—that is the Joint Committee on Taxation estimate—on our

private pension system: defined benefit, defined contribution, 401(k), Keough, IRA plans.

The benefits, however, are more skewed toward the top than they should be, and one reason has to do with the question you asked. Why is our taxpayer investment of \$125 billion a year apparently not generating adequate money's worth for the taxpayers in terms of increased national saving?

The answer is fairly clear. The way our tax preferences are structured is essentially upside-down. The amount that someone gets by way of tax preference for saving is proportional to their tax bracket, and this is consistent with what Fred Goldberg was talking about, and others in the previous panel.

We have a deduction-based system. If you are in the 35-percent bracket and you contribute a dollar to a 401(k), it costs you 65 cents, the dollar minus the 35-cent deduction. If you are in a 10-percent tax bracket, that dollar of saving costs you 90 cents instead of 65 cents.

As Fred Goldberg said, again, this is irrational. What we need to do is target our efforts to the three-quarters of Americans who are in the 15-, 10-, or 0-percent bracket who pay payroll taxes but do not necessarily pay income taxes in a given year because they do not have income tax liability that year.

The way to do that is quite simple: tax credits instead of tax deductions. What is the difference? As you know, a tax credit would provide an incentive that is based on how much you contribute, how much you save, rather than how much you earn, rather than what your income is.

The Savers Credit is a tax credit that we developed at Treasury several years ago when I headed up the pension policy and regulation there in order to address the very problem that all of you have raised, how best to improve asset accumulation and savings for moderate- and lower-income people.

It levels the playing field between those who have a high tax bracket and those who, in any given year, have a low- or 0-percent tax bracket. It is the first, and so far the only, major Federal legislation actually enacted that is directly targeted to promoting retirement savings for the majority of the working population, that is, those whose bracket is 15 percent or less.

It simply provides a tax credit of 50 percent for every dollar that one puts into a 401(k), other employer plan, or IRA if one's income is \$50,000 or less as a family. It was used by 5.3 million taxpayers in 2002, and again in 2003, and it costs only about 1 percent of that \$125 billion that we spend, Senator Conrad, that you cited, on the whole tax-favored pension and IRA system.

Unfortunately, during the legislative process, the Savers Credit was truncated drastically. As a result, it is set to expire at the end of 2006. It does not help most of the people it was intended to help. Five million is a lot, but the number of people it was intended to help runs to the many tens of millions.

We know from the evidence, such as what Bernie Wilson of H&R Block discussed very effectively in the first panel, that the Savers Credit works. It gets lower-income people to save.

It can have a huge positive effect on savings if we extend it, make it refundable, and extend the 50-percent credit rate to every-

one who earns \$50,000 or less. Right now, it is nominally 50 percent, but really it is 10 percent for most of the relevant people.

Employer plans are a proven and powerful vehicle for accumulating assets for lower-income people, for a variety of reasons that I go into in my written testimony.

By way of comparison, IRAs have a take-up rate of less than 1 out of 10 people who are eligible; 401(k)s, 2 out of 3, and that has dropped from 3 out of 4 a few years ago. We can do better. One out of three are leaving money on the table, and the balances of people in 401(k)s are grossly inadequate compared to what they really need.

A lot of people do not participate simply because they do not get around to signing up. They look at the investment choices and they are daunted, dazzled. They do not know which to invest in. They might not even be able to decide exactly how much they ought to be investing of their pay.

Fortunately, there is a disarmingly simple approach that can address this participation gap in the employer plan system, basically automatically enrolling people. It has been mentioned before.

We can change the default so that if you do not sign up, you are in the plan. If you want out of the plan, you sign something and you opt out. You are in the plan at some default contribution rate at some reasonable investment that makes sense for regular American working people, and if you want to change that, you can change at any time.

When I was at Treasury, we decided to approve this automatic enrollment and automatic 401(k)s, and to promote it because it was voluntary, on condition that people get an advance written notice of what the default is and get to opt out at any time, opt out to whatever they want, including nonparticipation in the plan.

How well does this work for lower-income people? A recent study of a 401(k) plan where people earning less than \$20,000 were participating at a 13-percent rate in that plan, using regular enrollment where you have to sign up in order to get in, showed that when the plan converted to automatic enrollment, so people were automatically in unless they opted out, the participation rate went up from 13 percent to 80 percent.

We can do this in our 401(k)s across the board. Together with many of the other good ideas that have been suggested today, we can make a dramatic impact in savings and asset accumulation for lower-income people.

Thank you.

Senator SANTORUM. Thank you, Mr. Iwry. I appreciate that. I am actually working on a piece of legislation to do just that, so I agree with your idea of the opt-out versus the opt-in.

[The prepared statement of Mr. Iwry appears in the appendix.]

Senator SANTORUM. Just a couple of questions. I know we are running late here. There have been different thoughts in the previous panel and this panel with respect to some of these ideas out there and putting limits on how this money can be spent, either from the standpoint of just retirement, the standpoint of retirement or education.

I think some of the savings proposals that were mentioned, I know by Mr. Goldberg, have no limitation as to what that money

can be spent on. Do you have a feeling as to how we should be structuring these savings accounts? It is a free-for-all.

Mr. IWRY. I will start off. I think it is important to bear in mind that our existing vehicles for retirement saving, the IRAs, the 401(k)s, in particular, actually are not limited to retirement.

Let us recall that there is not much difference between them and many of the proposals that are being discussed today. There is a special exception for getting your money out penalty-free from 401(k)s for college tuition, for financial hardships, for purchase of a home.

IRAs let the money out under all circumstances, but with a 10-percent penalty that does not apply for higher education, for purchase of a home, and for various other pressing needs. So when people talk about retirement, in many cases they are really talking about many of the same long-term investments in one's future that everyone here is talking about.

Dr. SHERRADEN. If I could just add another word. I fully agreed with Dr. Gonzalez-Rubio's comments, and Ray Boshara's comments, that education and owning a home really are about retirement security.

So, while I do not feel these plans should be opened up to any possible use, I think that the important uses for long-term investment, such as education and home ownership, ought to be included.

Mr. GOLDBERG. Senator, I think the elegance of the administration's LSA and RSA proposals is, it is some of each, and let the people choose. I think that the most important point is a universal platform.

One concern I would have about, for example, the ASPIRE proposal is that, if you give every child in the country a \$500 account that all of them can use for education, I would be concerned that, as an economic matter, that will disappear into the pockets of the universities very quickly through adjustments in scholarship programs.

A caution I would have on savings policies generally is, to the extent universities alter their scholarship policies in response to children's assets, I think we have accomplished absolutely nothing.

Mr. BOSARA. Just a brief comment. I think we should structure savings for long-term asset accumulation—buying homes, going to college, and retirement, in particular.

But I also think there is something right about LSAs, which is that poor people, in particular, also need to save money to fix the car and the washing machine, and there is some benefit in the government supporting savings for emergencies and fixing the car in addition to long-term asset accumulation. So I think we should have a suite of savings policies for people, not just one.

Senator SANTORUM. Anybody else?

[No response.]

Senator SANTORUM. All right. I am told we have a vote, so I am going to pass on to Senator Conrad, if you have any questions you would like to ask. Jim, would you?

Senator BUNNING. I just have one for Dr. Shanks.

Your analysis of the impact of wealth and asset accumulation on child development is extremely interesting.

Can you talk a little bit more about what your findings show regarding the impact of specialty-designed savings on parents' expectations of their child's future, and the impact that those expectations can have on a child's attitude, or children's attitudes?

Dr. SHANKS. Well, from long-term developmental psychology studies, we know that expectations by parents and in the minds of children as early as first and second grade can be very predictive of things like going to college as they go through high school and make decisions about college; thus, we have included questions about expectations in our survey, the experimental design I was telling you about as part of the SEED demonstration, so we could try to capture that effect.

So I cannot say for sure what such accounts will do, but we know from developmental psychology that expectations as early as first and second grade can be quite predictive of what happens when the children actually get old enough to go to college.

So, that is why we are asking those questions about parental expectations and the child's expectations in this experimental design with SEED.

Senator BUNNING. Thank you.

Senator CONRAD. Can I just ask the panel, one of the things that strikes me is, there are so many different things out here, it is very hard for people to follow. We have HOPE scholarships, we have IRAs, we have Keough plans, we have 401(k)s, we have KidSave, we have so many proposals, RSAs, LSAs.

I think one of the problems, frankly, that we have, is that there are so many different things, that it just confuses people. Confusion prevents people from acting. I do not know if it was Mr. Iwry or Mr. John who was referencing, people are faced with this weltering number of choices and they get frozen.

How much of our effort here should be to simplify and streamline?

Dr. SHERRADEN. If I could just add a word. Most of these asset-building programs, in particular, are relatively new in terms of public policy, all of them since 1970, essentially. So, I think it is a relatively young area that has not really consolidated.

But I think what makes sense in the long term is that these programs are folded in, if not into one large system with different choices and maybe a partition for home ownership and a partitioned amount for retirement, then certainly into a simpler system than exists today. I think what you are thinking about makes a lot of sense.

Mr. GOLDBERG. Senator, as you know as a former tax administrator, it is impossible. I think none of us can get our heads around how screwed up the system is right now.

To me, the concept of ASPIRE is you have a universal platform, some form of save-it-for-whatever-purpose-you-need, and some form of put-it-away-until-you-retire-or-you-pass-on-and-leave-it-to-your-heirs. That is all you need. I think that moving in that direction is essential because it just is not working the way it is.

Senator CONRAD. I would just like to make this comment. I agree with you. I think, now, we have such a welter of plans out there, we are just confusing people. We have to find a way to simplify and

streamline, because to have a message that resonates and kind of pierces the veil, simplicity has to be a key part of it.

Mr. BOSHARA?

Mr. BOSHARA. I would just add that, in the drafting of the ASPIRE Act, we felt very strongly, Senator Corzine, Senator Santorum, and others, that we should work with what is on the books already and not create new products. So, these accounts become Roth IRAs at 18, and you have the option of rolling them into a 529, period.

Mr. IWRY. Senator, it is, in part, more confusing for those of us who are looking at legislative alternatives than it necessarily is for a given individual. Lower-income people are lucky if they have one or two realistic options that are in fact available to them. I think that is what everyone on both of these panels is talking about.

There is a lot of convergence here. There are different names, different bills, different genealogies of these proposals, but we are converging quite a bit on universal proposals that are targeted in particular to the people who need the help the most. I think that, while there sort of seems to be a welter of alternatives, we can prune the irrationality from the system without getting rid of the things that work.

One of the things that works is the employer system. Sixty-five million people are covered. We have lots of moderate- and lower-income people who have gotten meaningful benefits, and we can reform that to make it more rational, to go more to tax credits, away from deductions, and add a universal base for those who are not in employer plans. I would not replace employer plans, I would expand on them.

Senator SANTORUM. Go ahead, Mr. John.

Mr. JOHN. I would also agree that simplicity is a key factor and is going to be very important as time goes on. The one concern I have with the whole idea of one platform or one account, and this is true whether it is ASPIRE or whether it is some of the existing savings accounts, is that there is a tremendous temptation throughout a person's working life to meet their immediate needs, whether it is repairing the house or something along that line, at the expense of their future needs, which is saving for retirement.

This is one of the values to the President's plan with the LSAs and the RSAs, in that they are separated out into two different programs. Keeping retirement in a separate program, to the extent that you can, at least ensures that there is going to be a certain level of assets available when an individual retires rather than having to turn around and sell the house.

Mr. GOLDBERG. The elegance of a single platform for everybody, for everybody in this room, from Bill Gates' kid on down, is you can use that as your plumbing. That is your infrastructure, and the plumbing matters.

We cannot tell people how to live their lives, but as long as they have that infrastructure, that platform, the individual can choose between saving for current needs and saving for retirement. I agree with Dr. John, you want to offer both of those.

Also, having spent a lot of time on this, you can get there in a revenue-neutral basis. This is not about spending more money. If you look at the whole array of programs that are on the books right

now, you can take that and say, within that framework, we are going to have a system that benefits everybody dramatically more than we are benefitting folks today.

So it is not a question of, cut more taxes, spend more money. It is a question of, the Federal Government impacts savings too, and is doing a terrible job. So you can get where you are talking about, Senator Conrad, and not do damage to the deficit.

Senator SANTORUM. Well, I think Senator Conrad and I would both say that we look forward to working with the members of this panel, and others, to do exactly what you have just suggested, which is to try to be more efficient in how we promote savings, and also be more universal in those who will benefit from the government expenditures. I think we heard a lot of good ideas here today and look forward to working with you to see if we can make that happen. Thank you.

We are adjourned.

[Whereupon, at 12:37 p.m., the hearing was concluded.]



## APPENDIX

### ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

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Dorothy Beale  
Testimony before the Subcommittee on Social Security and Family Policy of the Finance  
Committee of the Senate Committee on Finance  
“Building Assets for Low-Income Families”  
Thursday, April 28, 2005

My name is Dorothy Beale from Philadelphia, Pennsylvania, and I graduated in September of 2004 from the Women’s Opportunities Resource Center’s (WORC) Family Savings Account program, which is also called the Individual Development Account program.

I joined the program in 2003 as a single mother who, like many others, had been working hard but could not get ahead. I had always dreamt of having a home for myself and my three children. I was tired of throwing my money away on rent and wanted something that I could call my own and one day pass on to my children. But I needed help.

At that time, my credit was “tore up,” and for those of you who don’t know that expression, let me explain: you can have good credit, fair credit, and poor credit. Mine was *below poor*, or “tore up.”

To fix my credit, I worked with a counselor at Acorn Housing, a nonprofit housing counseling agency, and paid off the small debts first, wrote letters to the credit bureaus to correct mistakes, and negotiated payment plans with my creditors to pay off the larger debts. It was a long process that took over a year, but I finally did it.

I also needed help saving towards a down payment. I learned about the Family Savings Account Program from Acorn Housing in April of 2003. I went on to the Women’s Opportunities Resource Center’s website and learned about their programs. WORC is a non-profit organization in Philadelphia that serves low income women and their families through entrepreneurial training, Family Savings Accounts, and small business loans. Their FSA program would help me to save towards a home and provide an incentive in the form of match money. I learned I could save up to \$2000 over a one to two year period and if I completed consistent savings and personal financial management classes, my savings would be matched dollar for dollar.

The hard part was saving. I had never saved before, and I needed something to discipline me. The personal financial management classes at Women’s Opportunities Resource Center taught me to budget and track my expenses. I thought about unnecessary things that I was spending money on and started making small sacrifices toward larger goals. After a few months it got easier. I began to get excited, determined and disciplined. I saw my money grow, my credit score rise, and my confidence tip the scales.

According to the action plan I developed with my program counselor at WORC, I saved \$80 per month over a fifteen month period and even deposited a lump sum from my Earned Income Tax Credit to reach the \$2000 goal. With the work I did on my credit, I was able to obtain a

mortgage for \$77,000, and with my \$4000 in savings and match funds, I was able to purchase my family's first home in September 2004.

Most importantly, this program has given me the opportunity to pass good budgeting and savings habits on to my children. While attending the program, I would take my children to the grocery store and show them how they could save money when shopping. I would show them my bank statements so they could watch our savings grow over time, and I was able to teach them to differentiate between wants and needs. I also opened savings accounts in their names and they now make regular deposits from their allowances and money they earn from chores.

The program got me thinking about other long term financial goals such as retirement and my children's college education. I decided to start saving more in my 401K, and I also opened college investment accounts for my children through Pennsylvania's Tuition Account Program.

Pennsylvania's Family Savings Account Program is essential. Pennsylvania developed this statewide program in 1997 and is grandfathered into the Assets for Independence Act, which allows Pennsylvania to receive up to \$1 million annually. This program is up for reauthorization and it is important that the grandfathering clause is maintained in order to continue a successful statewide program. Pennsylvania provides half the matching funds for the program and the other half comes from the Assets for Independence Act. (See attached fact sheet regarding the AFIA reauthorization.)

The program provided me with the structures, incentives and resources to achieve my dream of homeownership and to secure a sound financial future for my family. Every time I turn these keys in my door, my heart just overflows. It is the best feeling in the world to know I own something.

## **Assets for Independence Act Reauthorization**

### **Current Status**

The Assets for Independence Act (AFIA) is up for reauthorization. Two bills (HR 7 and S 1786) were introduced last legislative session, however the session recessed and legislation was not passed. Pennsylvania and Indiana were grandfathered in the initial AFIA legislation. However, these bills did not include the grandfathering clause. It is essential that the grandfathering clause be retained when legislation is reintroduced this session.

Under the grandfathering clause, each state can receive up to \$1 million in annual funding, which in Pennsylvania is matched dollar to dollar with state funds. Pennsylvania and Indiana are taking advantage of the program and have successful and effective programs.

Pennsylvania's legislation was enacted in 1997. Since 1997 over \$7 million has been appropriated.

Elimination of the grandfathering will have the following impact:

1. AFIA dollars are an incentive for Pennsylvania to maintain significant level of funding. Pennsylvania's state funds are matched dollar for dollar with AFIA funds. Given the current economic crisis in the state, changes in legislation could potentially reduce the amount of state funding.
2. Elimination of the grandfathering will require significant changes to the structure and administration of Pennsylvania's program.
  - Pennsylvania's program is administered statewide utilizing a Request for Proposal process. There are currently 34 grantees in Pennsylvania. This would require community-based organizations to apply to both AFIA and the state, which would be inefficient and costly to implement.
  - Pennsylvania's match rate was changed in 1999 from a 50% \$600 match rate to a 100% \$2000 match rate (One thousand state dollars and one thousand federal dollars). This change was made with the expectation that Pennsylvania would continue to receive AFIA funding.
  - Pennsylvania's program allows for additional usages such as home improvement, education for child, credit repair as long as it allows for the purchase of an asset and automobile purchase for attending work or school. Elimination of the grandfathering would require restructuring of the program, which has been effective.
  - Account structure in Pennsylvania's program does not require a reserved account and does not place restrictions on non-federal money. Matching funds must be placed in an FDIC insured account. All matches are made payable to the vendor and the account holder.

**Question for the Record From Senator Lincoln for  
Ms. Dorothy Beale  
April 28, 2005**

**Question:** Your stories are certainly inspiring to all of us. They highlight the importance of increasing financial literacy and what a difference this can make in peoples' lives. It is also heartening to hear how you're passing on your financial discipline to your children. Do you have any recommendations for increasing the financial literacy of the general public?

**Answer:** I think one way we can increase financial literacy to the general public is to find a way to spread the importance of budgeting. Maybe one way of doing that is to include it somehow in our public schools curriculum. As you know, the children are our future.

Testimony of

Ray Boshara

Director, Asset Building Program  
New America Foundation  
[Boshara@newamerica.net](mailto:Boshara@newamerica.net)

and

Reid Cramer, Ph.D.

Research Director, Asset Building Program  
New America Foundation  
[Cramer@newamerica.net](mailto:Cramer@newamerica.net)

1630 Connecticut Avenue, NW, 7th Floor  
Washington, D.C. 20009  
202-986-2700

Subcommittee on Social Security and Family Policy  
Senate Committee on Finance

Hearing on  
“Building Assets for Low-Income Families”

April 28, 2005

Good morning. We wish to thank the Subcommittee on Social Security and Family Policy—especially Chairman Santorum and Ranking Member Conrad—for this opportunity to testify on building assets for low-income families, an idea we’ve worked on for over ten years now. Senators, we commend you on your outstanding leadership and commitment to enabling all Americans—and low-income Americans in particular—to build the savings and long-term assets that lead to economic security and opportunity.

Also, we would like to recognize the generous support and leadership of the foundations that have made our work on asset building at the New America Foundation possible thus far: The Ford Foundation, the Charles Stewart Mott Foundation, the Annic E. Casey Foundation, The Charles and Helen Schwab Foundation, and the Citigroup Foundation. The program was launched in July of 2002.

Mr. Chairman, with the nation deeply concerned about both low levels of personal savings and lack of financial security at retirement, we believe there is now a unique opportunity for Congress to expand savings and asset-building opportunities for millions of Americans, and low-income Americans in particular. In a word, we encourage the Committee to favorably consider in the near future:

- (a) Low-cost proposals such as “automatic 401(k)s” and encouraging the IRS to allow the splitting of refunds on tax returns;
- (b) Modest proposals, capably developed and led by asset-building pioneer CFED, to expand Individual Development Accounts through tax credits to sponsoring financial institutions, as outlined in the Savings for Working Families Act legislation sponsored by Senators Santorum and Lieberman; and
- (c) Bolder, transformative proposals for lifelong savings, financial education, and retirement security—especially establishing a “Kids Account” for every child born in America in 2007 and beyond, as proposed in the Aspire Act last week by Senators Santorum, Corzine, Schumer and DeMint and a bi-partisan team of Members in the House of Representatives.

Further information on each of the proposals is included in our statement below. But before we proceed to describe these proposals, we’d like to establish the policy rationale for building assets for low-income Americans—and hope that the Finance Committee, the full Senate, the House of Representatives, and the President will see asset-building for low-income American and our policy proposals as key to achieving and fulfilling the promise of an “ownership society.” With the bottom 60% of the nation collectively owning less than 5% of the nation’s wealth, we believe that asset-building proposals focused on low-income, low-wealth Americans should be the starting point of our nation’s efforts to ensure that *all* Americans can save, invest and in fact become owners of and stakeholders in America.

#### **The Case for Asset-Building and an Inclusive Ownership Society**

In a relatively short period of time, Michael Sherraden’s (1991) groundbreaking idea of building assets for low-income persons has made remarkable progress in influencing policy efforts for three reasons. First, policymakers have easily grasped both the distinction between income and assets,

and the importance of assets. Second, the idea debuted and progressed as the nation and policymakers were highly receptive to new ideas for ending welfare and poverty. And third, data generated (Schreiner et al., 2001) showed that poor people could save, thus overcoming the principal doubt among politicians and others whether asset building and Individual Development Accounts (IDAs) could work. Today, while the “income paradigm” still dominates anti-poverty policy and analysis, the “assets paradigm” has made its mark and is now seriously considered in policymaking circles at all levels. In fact, its basic tenets are in line with the calls to foster an ownership society, where all Americans are given the opportunity to save and build wealth.

Success in America today requires not just a job and growing income, but increasingly on the ability to accumulate a wide range of assets. It is the combination of both income and assets that provides the means to take advantage of the broad opportunities offered by a prosperous society. Yet many Americans have no assets to their name; they are disadvantaged from the start of their lives relative to those children born into affluence. Regrettably, the asset-building system already in place that facilitates wealth creation disproportionately benefits those households with higher incomes, better job benefits, and larger income tax liabilities. Lower-income families are offered fewer ways, and less attractive ways, to build wealth. Developing more inclusive asset building policies is a prerequisite in offering each American the opportunity to have a direct stake in the economy, become more financially independent, and bequeath wealth and opportunities to future generations.

In his second Inaugural Address, and elsewhere, President Bush has offered his vision for creating an “Ownership Society” in America. By this he means encouraging more Americans to save in tax-benefited accounts for retirement, college, health care expenses, homeownership, and small business development. Americans who do this, the President believes, will be able to exercise more personal responsibility and better control their and their kids’ economic futures.

Although the goals of promoting ownership should not displace social insurance and other programs aimed at struggling but aspiring Americans, the claim that families benefit from being able to build up assets is compelling. The underlying assumption is that ownership creates stakeholders and expanding opportunities for people to accumulate productive assets has broad social and economic benefits. In fact, the data show that many Americans have experienced the benefits of building assets and associate success and security with the accumulation and holding of financial resources.

We believe that an ownership society is a goal worth achieving, one this nation has embraced in the past through the Homestead Act and GI Bill. But to identify policies that can help us achieve a more inclusive ownership society, we need to ask, “Who owns America?” After all, if ownership policies further concentrate the ownership of assets for those who already own a lot, while doing little for those who own nothing, what’s the point?

### **Who Owns America?**

To understand the inherent challenge in creating an inclusive ownership society, it is useful to consider what ownership in America looks like today. Aided by policy incentives, Americans build wealth in both financial and non-financial assets. This past year the homeownership rate exceeded 69%, a historic high. The minority homeownership rate has risen in recent years as well, but continues to lag the overall population. In 2003, almost 50% of minority households owned their

own home. In the aggregate, home equity makes up 27% of total assets for all households and the median home value is \$121,000.<sup>1</sup> Home equity plays a particularly important role for many low-income families and minority families. While their homeownership rates are lower, home equity makes up 77% of total assets for lower-income families and 55% of total assets for minority families.<sup>2</sup>

While home equity represents the single largest component of household wealth, families store resources in a variety of other assets, such as bank accounts, stock investments, and retirement accounts. The percentage of families holding assets varies considerably. It is estimated that over 90% of families have money stored in checking or savings accounts, while only 21% own stock directly in a company. Furthermore, 17.1% own shares of a mutual fund, 16.7% own savings bonds, and 28.0% have assets held in a life insurance policy. Meanwhile, over half of all families (52.2%) have a personal retirement account, such as an IRA or a 401(k).<sup>3</sup> However, the numbers for a defined contribution pension plan are lower and declining: 33.8% of American families own a defined contribution plan.<sup>4</sup>

	Stocks	Mutual Fund	Savings Bonds	Retirement Accounts	Bank Accounts	Life Insurance
<u>Percent of income</u>						
Less than 20%	3.8%	3.6%	3.8%	13.2%	70.9%	13.8%
20%-39.9%	11.2%	9.5%	11.0%	33.3%	89.4%	24.7%
40%-59.9%	16.4%	15.7%	14.1%	52.8%	96.1%	25.6%
60%-79.9%	26.2%	20.6%	24.4%	75.7%	98.8%	35.7%
80%-89.9%	37.0%	29.0%	30.3%	83.7%	99.7%	38.6%
90%-100%	60.6%	48.8%	29.7%	88.3%	99.2%	41.8%
<b>All Families</b>	<b>21.3%</b>	<b>17.1%</b>	<b>16.7%</b>	<b>52.2%</b>	<b>90.9%</b>	<b>28.0%</b>

The percentage of families holding assets is strongly correlated with their incomes. Compared to those households in the top 10% of income, households in the bottom forty percent of income were less likely to own stock (11% to 61%), retirement accounts (33% to 88%), and transaction accounts (89% to 99%). The differences in retirement asset holdings are especially revealing. The number of families owning a retirement plan drops to less than 15 percent for families making \$15,000 or less, while 75 percent of those making more than \$50,000 have a retirement savings account. For defined contribution plans, over 54% of families with incomes over \$50,000 have such plans, while only 18.9% of families with incomes under \$30,000 have them.

1 U.S. Market Conditions (2004); Aizocorbe, Kennickell, and Moore (2003).

2 Di (2003).

3 Aizocorbe, Kennickell, and Moore (2003). Includes only all employment-based defined contribution plans plus IRAs and Keogh plans, but not defined benefit plans.

4 Includes all types of defined contribution plans owned through a current employer or former employer.

5 Aizocorbe, Kennickell, and Moore (2003). Figure for 2001.

Beyond differences in what households own, there are also differences in how much they own. The mean net worth is over \$380,000, but 17.6% of households have zero or negative net worth, and slightly over 30% of households have a net worth of less than \$10,000.

<b>Family Net Worth<sup>6</sup></b>	
Median	<b>\$73,500</b>
Mean	\$380,100
Percent with net worth	
a. Zero or Negative	17.6%
b. Less than \$5,000	26.6%
c. Less than \$10,000	<b>30.1%</b>

Further, the distribution of wealth by wealth class is highly unequal. According to data from the Federal Reserve, the bottom 40 percent of the nation owns less than 1 percent of the nation's wealth, while the bottom 60 percent owns less than 5 percent. The top 20 percent of our population commands 84 percent of the wealth. Another dimension with which to examine wealth holdings is race. In general, minority households own less than ten cents for every dollar of wealth owned by a typical non-Hispanic White family.<sup>7</sup> Even though their income is roughly two-thirds of that of White families, their wealth is only 10% as much.

<b>Mean Net Worth by Wealth Class<sup>8</sup></b>				
<i>In thousands</i>				
	Top 20%	60-80%	40-60%	Bottom 40%
	\$1,604.7	\$215.3	\$75.0	\$2.9
Percent of Wealth Owned	<b>84.5%</b>	<b>8.8%</b>	<b>3.9%</b>	<b>0.2%</b>

### **Public Policy and Asset Building**

By almost any standard, the United States has been particularly successful at generating wealth. The interaction between the country's political and economic system has created a foundation for wealth creation on a massive scale, producing some of the world's largest corporations and richest families.<sup>9</sup> Beyond the fortunes of the rich, the rise of a broad middle class is one of the major social achievements of the United States as the sharing of wealth has ensured that a majority of citizens have a stake in the functioning of the economy and society as a whole. Through an array of policies and programs, the public sector has played a significant role in both the expansion of wealth and its distribution. American history is marked by a series of major policy initiatives that have successfully expanded ownership of capital and promoted stakeholderism.

<sup>6</sup> Wolff (2004).

<sup>7</sup> Wolff (2004); Kochar (2004).

<sup>8</sup> Wolff (2004).

<sup>9</sup> Kevin Phillips (2002).

Even before many of the stakeholder policies that encouraged homeownership, investment, and savings, took shape in the 20th century, one of the most influential founding fathers expounded a universal stakeholder proposal. In one of his last great pamphlets, *Agrarian Justice*, Thomas Paine argued for the creation of a national fund from which each citizen would be given an asset pool upon entering adulthood to formalize equal citizenship.<sup>10</sup> Paine believed individuals should be offered opportunities to participate in the creation of economic wealth as he was concerned with the effects of pervasive poverty on social cohesion. The 15 pounds sterling he proposed every adult receive upon reaching the age of 21 would be enough to get them started in an occupation or economic endeavor. He thought that rather than allowing people to suffer deprivation and then asking society to intervene, it would be more logical to intervene beforehand. Paine wrote, “Would it not, even as a matter of economy, be far better to adopt means to prevent their becoming poor?”<sup>11</sup>

Historic initiatives, such as the Homestead Act of 1862, The GI Bill of 1944, and the creation of the Federal Housing Administration (FHA) in 1934, have expanded access to important elements of wealth creation and produced tangible results. By providing land to those that would go west, stake a claim, and work it for five years, the Homestead Act provided an opportunity to build wealth by developing property. Of the million and a half people that successfully took the government up on its offer, passing this wealth and property on to the next generation proved to be one of the most enduring legacies of the Act.<sup>12</sup> The GI Bill offered veterans grants to pay for training and higher education, loans for setting up new businesses, and mortgages to purchase homes. Through this law, some \$14.5 billion was spent by the federal government between 1944 and 1956 benefiting almost 8 million veterans.<sup>13</sup> A congressional report has estimated that the GI Bill generated returns of up to seven dollars for every dollar invested, an impressive performance by any standard.<sup>14</sup> In addition to the economic multiplier effects, the influx of veterans permanently transformed the American university system, creating “an avenue for mass mobility rather than gentlemanly certification.”<sup>15</sup> The FHA was created to help many Americans purchase a home. Through its mortgage insurance and other financing products, FHA has played a role in the country’s rising homeownership rate.

Each of these efforts was grounded in the twin objectives of ownership and opportunity. The underlying assumption being that ownership creates stakeholders and expanding opportunities for people to accumulate productive assets has broad social and economic benefits. The role of public policy in encouraging asset building continues to this day; it is a hallmark of the prevailing policy framework that identifies wealth creation as a central policy objective.

Many of the policy levers currently used to achieve these ends are promoted through the tax code. Tax expenditure programs in the form of tax deductions, tax credits, preferential tax rates, tax deferrals, or income exclusions are a primary vehicle for achieving many federal policy objectives.

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10 Thomas Paine’s essay on *Agrarian Justice* was written in 1795-96 and introduces the broad themes of rights and reciprocity, security and humanity, and poverty and social justice. He proposes “to create a national fund, out of which there shall be paid to every person, when arrived at the age of twenty-one years, the sum of fifteen pounds sterling, as a compensation, in part for the loss of his or her natural inheritance, by the introduction of the system of landed property.”

11 Paine (1795).

12 Williams (2003) estimates that up to one-quarter of the adults in the U.S. potentially has ancestors that can trace their legacy of asset ownership to the Homestead Act.

13 Skocpol (1996).

14 Subcommittee on Education and Health of the Joint Economic Committee (1988).

15 Skocpol (1996) cites the statistics that only 9 out of 100 young people attended college in 1939, but the rate doubled by 1947.

Collectively, they subsidize a broad range of activities, including many asset-building investments such as mortgage payments, business investments, retirement savings, and educational expenditures. As calculated by the government, the value of these asset building tax expenditure programs exceeds \$365 billion on an annual basis, and thus deserves scrutiny.

The theory behind using tax expenditures as a policy vehicle is that it works best when the benefits or incentives are related to income and are intended to be widely available. While tax expenditure programs may subsidize worthy activities and generate sizeable social and economic returns, they are not accessible to a large number of citizens that would benefit from them the most. Many lower-income households do not have large enough tax liabilities to take advantage of these tax expenditure programs. Not surprisingly, 90 percent of the benefits in the two largest tax expenditure categories (homeownership and retirement) reach households with incomes above \$50,000 a year.<sup>16</sup> All told, the federal government offers over \$156 billion a year in support of homeownership and over \$117 billion to subsidize retirement savings.

The table below identifies the tax expenditures included in the Federal Budget related to asset building. Some are familiar and easy to understand, while others are obscure and more complicated. For the purpose of this presentation, tax advantages that can be claimed by businesses are not included, even if they help subsidize employee training.

**Value of Select Asset Building Tax Expenditures:  
Fiscal Year 2006**  
(in millions of dollars)

<b>Housing</b>	
Deductibility of Mortgage Interest on Owner Occupied Housing	76,030
Deductibility of Property Tax	14,830
Capital Gains Exclusion on Home Sales	36,270
Exclusion of Net Imputed Rental Income on Owner-Occupied Housing	29,720
<i>Subtotal Housing</i>	<i>156,850</i>
<b>Investment: Commerce</b>	
Capital Gains	28,370
Capital Gains Exclusion of Small Corporation Stock	250
Step-up Basis of Capital Gains at Death	28,760
Carryover Basis of Capital Gains on Gifts	290
Exclusion of Interest on Life Insurance Savings	24,070
<i>Subtotal Commerce</i>	<i>81,740</i>
<b>Education</b>	
HOPE Tax Credit	3,220
Lifetime Learning Credit	2,080
Education Individual Retirement Account	190
Deductibility of Student Loan Interest	800
Deductibility of Higher Education Expenses	1,840
State Prepaid Tuition Plans	650
<i>Subtotal Education</i>	<i>8,780</i>
<b>Retirement: Income Security</b>	
Net Exclusion of Pension Contributions: Employer Plans	51,050

<sup>16</sup> U.S. Congress Joint Committee on Taxation (2003). Estimate of Federal Tax Expenditures for Fiscal Years 2004-2008.

Net Exclusion of Pension Contributions: 401 (k) Plans	48,140
Net Exclusion of Pension Contributions: IRAs	7,310
Net Exclusion of Pension Contributions: Savers Credit	1,170
Net Exclusion of Pension Contributions: Keough Plans	9,980
<i>Subtotal Income Security</i>	<i>117,650</i>
<b>TOTAL</b>	<b>365,020</b>

Source: Office of Management and Budget, Executive Office of the President. Budget of the U.S. Government, Fiscal Year 2006. Analytical Perspectives, Table 19-1.

### Exclusionary Policies

Federal policy has historically discouraged asset building among households with fewer resources. Not only has the structure of tax expenditure programs denied benefits to poorer households but also anti-poverty policy efforts have been, and remain, focused on facilitating income maintenance and short-term consumption. In this spirit, many federal programs impose asset limits as an element of means-testing program eligibility. The unintended consequence of this approach is that it creates a disincentive to engage in the types of activities that can help a family move up and out of poverty, namely savings and asset building.

Consequently, the benefits of stakeholding, which have made a difference for many American families, have not been experienced by all. Millions of Americans live in households with few or no assets. One-quarter of white children and half of non-white children grow up in households without any significant levels of savings or resources available for investment.<sup>17</sup> This represents an important dimension to the problem of inequality, which is usually discussed in terms of income. Wealth inequality is more severe than income inequality. According to the most recent Survey of Consumer Finances, conducted by the Federal Reserve in 2001, the top 10 percent of households in the U.S. ranked by income earn 44 percent of the nation's income but own 57 percent of total family net worth.<sup>18</sup> In contrast, the bottom 60 percent earn 22 percent of the nation's income and own less than 17 percent of the nation's wealth.<sup>19</sup>

The pattern of wealth distribution is instructive because it reflects inequalities that have formed over an extended period of time. Yet the more pressing issue from a policy perspective is the plight of those households that are asset poor, possessing insufficient resources to sustain a household through any extended period of economic disruption.<sup>20</sup> Research on asset poverty has focused on developing measures of economic vulnerability that can provide an accounting of households without a stock of resources to survive a loss of income.<sup>21</sup> Haveman and Wolff have estimated that the number of asset poor households with precarious resource shortages substantially exceeds the official poverty rate, and that the disparity has grown over the last twenty years. In 1998, one out of eight Americans were officially classified as poor, 34.3 million people or 12.7% of households, but

17 Shapiro (2002).

18 Aizcorbe, Kennickell, and Moore. (2003).

19 Aizcorbe, Kennickell, and Moore. (2003).

20 Oliver and Shapiro (1997) first proposed a definition for asset poverty in their 1997 book, *Black Wealth/White Wealth*. They defined "resource deficient" households as those without enough net financial worth reserves to survive three months at the poverty line.

21 Haveman and Edward (2000) have built upon this approach and used existing data sources to estimate a series of asset poverty measures.

the ranks of the asset poor included one of every four, 69.1 million people or 25.5% of households.<sup>22</sup> And that disparity has grown. Between 1983 and 1998, income poverty declined about 16 percent, while asset poverty rose 14 percent.<sup>23</sup>

### **The Value of Assets**

The value of assets is based not only on the economic security they provide but also in how they enable people to make investments in their future and exert a stake in the broader society that income alone cannot provide. Michael Sherraden, author of *Assets and the Poor*, observes that, "Few people have ever spent their way out of poverty. Those who escape do so through saving and investing for long-term goals."<sup>24</sup> Oliver and Shapiro write that "Wealth is a particularly important indicator of individual and family access to life chances...It is used to create opportunities, secure a desired stature and standard of living, or pass class status along to one's children."<sup>25</sup>

In a review of the literature on the effect of asset holding, Scanlon and Page-Adams found that much of the research focused on the impacts of homeownership, but a number of other studies focused on assets in the form of savings, net worth, or small business ownership.<sup>26</sup> Despite the variety of asset measures used in this literature, they concluded that together financial and property assets appear to have positive effects on economic security, household stability, physical health, educational attainment, and civic involvement.<sup>27</sup> This conclusion has also been supported by work in the United Kingdom which examined that effect of assets on life chances and found a "persistent effect of assets on a number of outcomes, which were impervious to a wide range of controls," and "the assets effect was sustained, with employment, psychological health, belief in the political system and values, all appearing to be enhanced by assets."<sup>28</sup>

Thus, the body of evidence that links asset holding with positive outcomes is significant, growing, and has been shown to work for both the poor and non-poor alike. Recent findings from a national demonstration project of matched savings accounts for low-income individuals found that program participants responded positively to savings incentives, overcoming doubts among policymakers as to whether the poor could save.<sup>29</sup> The research results do not in and of themselves justify a rejection of income maintenance programs, but they provide support for building on approaches that combine an income and assets perspective.

### **Policy Principles for Achieving an Ownership Society**

The challenge of building an ownership society to us appears clear: maximize the number of families capable of building assets and securing their future. Current public policy provides us many

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22 Haveman and Wolff (2000).

23 Haveman and Wolff (2000).

24 Sherraden (1991).

25 Oliver and Shapiro (1997), page 2.

26 Scanlon and Page-Adams (2001).

27 Scanlon and Page-Adams (2001).

28 Bynner and Despotidou (2001).

29 Key findings from *Saving Performance in the American Dream Demonstration: A National Demonstration of Individual Development Accounts* (Shreiner, Clancy and Sherraden, 2001) include the observation that the majority of people who participated in the demonstration were savers; and program characteristics, such as match rate, financial education, and use of direct deposit, are linked to savings performance.

tools, but it is imperative that these tools be employed with three overriding principles in mind. First, policies should create opportunity by broadening access to benefits; second, all Americans should be able to participate; and third, benefits should be commensurate and not skewed towards those who already own a lot. Given the distribution of current resources today, the starting point of our nation's savings and ownership policies has to be the majority of Americans who are asset-poor.

This would be wise for several reasons. First, targeting savings incentives to those who don't save or own much would boost our abysmal national savings rate and reduce our risky and unsustainable reliance on foreign investment. Second, our economy is generating greater returns on assets than on labor—that is, we are earning more from owning assets than from working—a fact that is evident to many homeowners. And, finally, there's recent compelling evidence that owning assets fosters better citizens: Owners take better care of their homes, neighborhoods and schools; they're more likely to plan for their and their kids' futures; more likely to vote and be engaged in community affairs; and more likely to stay married.

While we shouldn't penalize those who've done well—in fact, we should continue to reward hard work, creativity and initiative—there's little for our nation to gain by further concentrating wealth. And there is an enormous amount to be gained by broadening it. Wealth begets wealth; the real challenge is to create it in the first place. To do so, we must identify a set of policy proposals that can assist the millions of Americans without significant asset holdings begin the process of savings and asset building.

#### **Expanding Savings and Ownership: Low-Cost Solutions to the National Savings Problem**

There are a number of policy options that would promote asset building among lower-income families that have relatively low costs. These include proposals that could strengthen retirement security and encourage savings.

For example, *firms should be encouraged to adopt inclusive policies for defined contribution plans, such as “opt-out” instead of “opt-in” enrollment, automatic allocation, and automatic escalation.* Only about one-half of employers offer their employees 401(k) retirement plans. Roughly three-quarters of employees choose to participate, but participation tends to be linked with income. The problem is that currently workers are required to 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 has shown that participation in retirement savings plans increases if workers are automatically enrolled rather than compelled to sign up. In one study by Madrian and Shea, this “opt-out” approach was found to increase participation from 36 percent to 86 percent when employed at a Fortune 500 company, and the increase was higher for lower-income workers. Automatic allocation would ensure that all employee contributions would be automatically placed in a balanced, diversified set of low-cost funds. Many plans offer too many investment choices. Too large a variety of options can lead to paralysis, especially for novice investors. One outcome that should be avoided is the tendency for these investors to choose low-yielding funds rather than a more diversified portfolio in line with their life cycle needs.

Another low-cost proposal is to *use tax returns to connect tax refunds to savings products.* The tax system can be a gateway to the financial system and to building savings and assets. Last tax season

the IRS sent refund checks averaging \$2,300 to 130 million tax filers. These cash infusions are often the best chance people have to save some money in any given year. This is particularly true for lower-income families. Over 20 million lower-income families—one in six taxpayers—received an average \$1,700 boost to their refund from the Earned Income Tax Credit (EITC), a refundable tax credit designed to reward work. People may spend rather than save their refunds because they do not have an easy way to convert a portion of their refunds into savings vehicles. Recent research finds that many Americans—including lower income ones—can and will save their refunds if offered appropriate incentives and a clear way to do so.

The challenge for policymakers is to facilitate and incentivize the savings of tax refunds into existing—and possibly new—savings products. The tax filing process should be changed to allow tax refunds to be split among multiple accounts. Under this proposal, people could deposit their refund into IRAs, 529 college savings plans or a variety of other savings accounts. Right now, taxpayers have only one choice; refunds are issued in a lump sum. If it is easier for people to save right on their tax forms, to split their refunds into “money to save” and “money to spend,” people will save more, perhaps much more. Research has indicated that even low-income tax filers would use this “splitting” option to save. The Administration has signaled their intention to implement this change to the tax filing process by the 2007 tax year; they should be encouraged to keep to this implementation schedule.

A third, low-cost proposal worth exploring is to *allow tax filers to purchase savings bonds with part of their tax refunds*. People do not need accounts to buy savings bonds. The process to buy savings bonds is relatively simple, but could be made even easier for savers if the process was linked to the tax filing process. Peter Tufano, a professor at the Harvard Business School and a founder of the Doorways to Dreams Fund, recommends that the rules governing savings bonds be changed to make them more useful for asset building by low-income families.<sup>30</sup> For example, the bond holding periods could be shortened for smaller denominations, people could be allowed to exit the bonds in case of emergency, and the interest rate could increase the longer they are held. Furthermore, this proposal could allow low-income individuals to accumulate the savings to meet the minimum balance requirements in IRAs.

#### **Asset Building Accounts**

Naturally, any policies that build significant wealth for millions of Americans could cost billions of dollars—and it would be money well spent. The Homestead Act and the GI Bill both rightly cited by the President at his inauguration as great ownership society programs, generated huge financial returns and remain the foundation of our middle class. The profusion of individual accounts over the last three decades, including the advent of 401(k)s, IRAs and Section 529 College Savings Accounts, represents a shift toward asset-based policy and has carried a big price tag. But the distribution of benefits from these accounts, as delivered through the tax code, has been considerably more regressive than the preceding social insurance and means-tested transfer programs developed after the New Deal. To date, the incentives simply don’t work for those who would benefit from them the most. A better idea is to construct an inclusive system, one that is capable of targeting support and helping Americans chart a path that expands opportunity and ownership by encouraging savings and investment.

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<sup>30</sup> Tufano and Schneider (2004).

It is very possible that at the center of such an inclusive asset building agenda is an account-based system that is simple, widely available, and portable. Sherraden (1997) has observed that domestic policy goals are increasingly achieved through individual asset accounts instead of large, nation-bound, categorical programs. He predicts that, someday, all the existing individual asset account structures—IRAs, Medical Savings Accounts, 401(k)s, Individual Training Accounts, and Individual Development Accounts—are likely to merge into one system. Anticipating that, and recognizing that most of these accounts are currently delivered through the tax system, which excludes the majority of low-income persons, it is important to think now about how this evolving system can include families with fewer resources and provide them with equivalent incentives (through matches and refundable tax credits) to participate.

#### **Individual Development Accounts**

Along these lines, we commend the Administration as well as the Finance Committee for its support expanding of Individual Development Accounts (IDAs). IDAs are matched savings accounts typically restricted to buying a first home, pursuing post-secondary education and training, and starting a small business. Recent experimental research has demonstrated that low-income persons can successfully save in IDAs, and that IDAs are effective in building assets (Boshara, 2005). Accordingly, Congress should expand the number of IDAs available for low-income, working persons and join the President in his call to create an IDA tax credit that would provide dollar-for-dollar matching contributions of up to \$500 a year targeted to lower-income individuals through a 100 percent credit to sponsoring financial institutions. The Senate has previously endorsed creating such a tax credit that could be used to fund up to 300,000 accounts, but the President has proposed authorizing up to 900,000. We are pleased to support these efforts, capably led by one of the leading pioneers in the asset-building field, CFED.

#### **Children's Savings Accounts**

One of the most promising ways 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.<sup>31</sup> This “accounts-at-birth” approach represents a social investment in every child at the same time as it gives the child a stake in broader society. Each child will grow up knowing they will have a modest pool of resources at their disposal to help them succeed. These accounts would establish a universal platform and infrastructure to facilitate future savings and lifelong asset accumulation. Beyond the individual benefits, investing in children could have large multiplier effects, especially when it is linked to increasing social engagement and expanding opportunity. In the long run, building wealth through children's savings accounts and other means has the potential to help break the vicious cycle of intergenerational poverty.

Children's accounts can also be a means of ensuring retirement security because they will offer a means of building assets that can be strategically employed in times of need or productively invested to generate future returns. The nature of assets is that they work as building blocks over a lifetime, serving as bridges connecting different stages of the life cycle—just as investing in one's

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<sup>31</sup> See Cramer (2004) for details.

human capital by going to college generates opportunities to increase income or buying a home serves as a forced savings plan that can be tapped at retirement. The path of security does not start at retirement but must be treaded throughout life.

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 (most notably former Senator Bob Kerrey's "KidSave" proposal, which recently has received renewed attention). 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, funded by the Ford Foundation and Charles Stewart Mott Foundation, among others, is already providing valuable insights on policy design.

The recent introduction of the America Saving for Personal Investment, Retirement, and Education Act (ASPIRE Act) by a strong bi-partisan coalition of legislators in both the House and the Senate offers a blueprint of what a universal accounts-at-birth system might look like. Sponsored in the Senate by Senators Rick Santorum (R-PA) Jon Corzine (D-NJ), Charles Schumer (D-NY), and Jim DeMint (R-SC) and in the House by Representatives Harold Ford, Jr. (D-TN), Patrick Kennedy (D-RI), and Phil English (R-PA), the ASPIRE Act would provide every child with an account at birth—called a KIDS Account—that would be endowed with \$500. The account would be supported with progressive, targeted savings incentives until age 18, at which point it could be used for going to college, buying a home, or building up a nest-egg for retirement. (For more information, see [www.AspireAct.org](http://www.AspireAct.org).)

One of its novel features is that accountholders in eligible families will be given the opportunity to earn additional matching funds for amounts saved in the account. The Senate bill provides a dollar-for-dollar match of the first \$500 contributed and the House bill provides a dollar-for-dollar match for the first \$1,000 contributed. Access to account funds will be restricted until the accountholder reaches the age of 18, and parents or legal guardians would control investment decisions until that time. The bill will establish a national fund within the U.S. Treasury, similar in structure to the Thrift Savings Plan, which would provide a life-long savings platform and would be responsible for administering the accounts, holding all deposits, and managing investments.

The policy rationale supporting the children's savings accounts proposal is to provide a foundation for a broad account-based asset building system. Governed by a uniform set of rules and administrative structures that would serve as the "plumbing" to support a national system of accounts, and universally accessible to each and every child, these accounts will help integrate the currently disparate account-based vehicles at the same time as they guarantee everybody is included in the system.

In many ways asset building policies can be conceptualized as an investment strategy, with large multiplier effects for the entire economy. These effects could be magnified if focused on kids. Modest investments in children can grow, and with responsible stewardship can provide a means of ensuring that every citizen is afforded opportunities to succeed. As such, these accounts are intended to play a role in supporting the achievement of diverse national policy objectives, including the promotion of child welfare, the increase in the national savings rate, the enhancement of financial literacy, the incorporation of the unbanked into the financial mainstream, and the

support of educational achievement. These are broad and worthy objectives; fulfilling any of these goals would represent a major societal achievement. Yet the success of this effort could be found at the household and community level. Each child will grow up knowing there is an account with their name on it that can be used as they mature to help them make productive investments. These accounts provide a vehicle to enhance civic engagement and social participation. As a universal program, the accounts-at-birth approach offers each child an economic opportunity to participate in asset building, and also provides an opportunity to construct an integrated system for managing account-based asset building on a large scale. The importance of this achievement may be profound as it provides a unifying structure to integrate the asset building policies currently spread throughout the tax code.

For several reasons it makes most sense to focus on an asset building policy on children. The very nature of asset building is long-term, investing when children are born provides the most time for assets to grow, and the dynamics of accumulation will provide their own lessons. Also, the experience of asset holding may be transformative, changing attitudes for the better. Beyond the potential economic effects, stakeholder accounts could serve as a means of providing financial education, a skill set which will be in need of augmentation if the ownership of equities and investments is to become further democratized.

Creating a universal system of accounts for children is a powerful approach to social policy because it has the potential to contribute to both economic growth and social development. It does so by investing on an individual basis in a manner that creates widespread opportunities. While investment returns are not guaranteed, they are likely to offer each participant access to a modest stock of financial assets when they begin their adult lives. For some, this asset pool can be used to seed profitable and productive investments, for others, it may provide a sense of security many now lack. The public investment signals that society has an interest in the success of every child, and they, in turn, will be responsible to make appropriate choices throughout their lives.

Implementing children's savings accounts is consistent with contemporary approaches to social policy that have moved away from guaranteed entitlements and toward more account-based support mechanisms. In contrast to traditional income supports, the level of investments in the account is no substitute for social protection. Rather they are intended to promote social and economic development at the household level, at the same time as they advance fiscal stability, savings, and investment at the macroeconomic level.

The challenges in building a universal account-based system are significant, but they certainly can be addressed through the process of program design and implementation. Constructing a system of accounts that is workable and effective is achievable. The greater challenge is gaining political support for the proposal, sufficient to shepherd it through the legislative process. This may ultimately depend on policymakers accepting the premise that inclusive asset building policies are a means to promote social and economic development. These policy goals should be distinguished from other anti-poverty objectives because, at the core, asset-based policy is intended to enable individuals to exert greater control over their lives and expand their capacity to take advantage of the diverse opportunities offered by American society. Any large-scale asset-based policy effort should complement, rather than replace, existing policies that provide social insurance.

The central problem with the current array of asset policies is that they are regressive and, for the most part, exclude the poor. A universal system is able to reach those currently excluded while

providing every participant the opportunity to benefit. Asset building and savings are sound objectives for every citizen, and universal access to an account merely offers each citizen the opportunity to participate, regardless of the income status of their family.

#### **Meaningful Asset Building Requires Inclusion**

The Bush Administration has picked up on the account-based approach with a set of far-reaching savings proposals. In its fiscal year 2004 budget, the Bush Administration first proposed creating three new tax-preferred accounts, to be called Lifetime Savings Accounts (LSAs), Retirement Savings Accounts (RSAs), and Employer Savings Accounts (ERSAs).<sup>32</sup> These accounts are designed to substantially expand opportunities for tax-sheltered savings and consolidate rules for tax-advantaged saving. Every individual could set up a LSA and a RSA; contributions to each account would not be tax-deductible and would be capped at \$5,000. Because these accounts would have no limits on household income and substantially higher contribution limits than current Individual Retirement Accounts (IRAs), the Administration's proposal would provide a disproportionate share of benefits for higher income households, particularly those with incomes above existing limits on IRAs.

Noting the substantial tax sheltering opportunities created by the new accounts, some analysts have questioned whether the proposals would even raise the private saving rate because the transfer of existing taxable assets into LSAs would reduce taxes but not increase private saving.<sup>33</sup> The opportunity to shelter income is a less valuable incentive to lower income households even though they still would benefit from savings incentives. These proposals would be strengthened if they were revised to offer substantial matching deposits to the asset-poor. Still, one of the most notable features of the Bush proposal is the attempt to unify many of the diverse tax-preferred accounts into a more simplified account-based system. This represents an important trend that any proposal for asset building savings accounts should consider.

The Administration's focus on the ownership society will create the ongoing opportunity to focus on policy proposals that help families, and particularly lower-income families, build savings and assets beginning at birth. The ASPIRE Act may receive consideration in these debates as it offers a means of facilitating large-scale financial education and savings activity through a system of private, portable, and flexible accounts that is well-suited for the 21<sup>st</sup> century. Regardless of one's views on Social Security reform, it appears that these ideas could be supported by a broad range of policymakers.

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Mr. Chairman, thank you very much for this opportunity to testify before the Subcommittee. We would be pleased to answer any questions you and the other members of the Subcommittee may have.

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<sup>32</sup> See Burman, Gale, and Orszag (2003) for an in-depth analysis of the Bush Administrations proposal to create LSAs, RSAs, and ERSAs.

<sup>33</sup> Burman, Gale, and Orszag (2003).

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**Question for the Record From Senator Lincoln for  
Mr. Ray Boshara  
April 28, 2005**

**Question:** Individual Development Accounts (IDAs) clearly help low-income people to save. The Good Faith Fund has over 500 participants who have built cumulative savings of over \$1.1 million dollars. What do you see as the role of the private sector to partner in encouraging personal savings? Do you see other opportunities for the private sector to partner with States, local business, and local communities to improve our national savings?

**Answer:** The private sector presently plays a critical role as a partner in encouraging personal savings, and must continue to do so going forward. The best savings policies reflect the best possible balance between the (1) Federal and State governments (to get the financial incentives, product, and regulatory framework authorized properly in law); (2) the private sector (to offer those products, ideally at a profit or at least not as money losers, in ways that are accessible and affordable to savers at all income levels); and (3) the individual saver, who should assume the responsibility for working, saving, and using their money wisely.

Yes, I see other opportunities for the private sector to partner with States, businesses and local communities. A great example of State partnerships are the so-called "529" college savings plans. Each State has entered into a partnership with a financial institution (and sometimes employers) to offer the 529 product. While 529s could be improved in many respects, they nonetheless represent the kinds of partnerships between States and the private sector that work very well and should be replicated. Local communities, too, have played a crucial role of encouraging savings and financial education among low-income persons, and these communities—often through a local non-profit like the Good Faith Fund—have entered into productive partnerships with the private sector, both employers and financial institutions.

Testimony: Ric Edelman  
Hearing: "Building Assets for Low-Income Families"  
Hearing Date: April 28, 2005

I am honored to present testimony today before the Subcommittee on Social Security and Family Policy of the Senate Committee on Finance.

In short, the ASPIRE Act is a brilliant idea, and I highly commend Senators Rick Santorum and Jon Corzine for sponsoring this legislation. I can say that this idea is brilliant because I had the same idea – and brilliant minds think alike. I also get to brag that I thought of it first, although yours is an improvement in several important ways. Let me explain.

I am a financial advisor and founder of Edelman Financial Services, the largest independent financial planning firm in the nation, based on number of clients, according to *Bloomberg Wealth Manager*. My firm manages more than \$2.6 billion in client assets for more than 7,000 individuals and families. Unlike the vast majority of advisors, my firm does not work primarily with the high-net worth market. Instead, we cater to middle class families who want to achieve financial and retirement security.

I also host radio and television programs on personal finance, and I have written 5 books, including 3 national best-sellers which collectively have sold more than 1 million copies. I also host a financial education web site, [www.ricedelman.com](http://www.ricedelman.com), publish a monthly newsletter and am very active in financial literacy activities.

Several years ago, I invented the RIC-E Trust® - the Retirement InCome – for Everyone Trust®. This is a retirement planning tool for children that is so unique it has two U.S. patents (6,064,986 and 6,085,174). So far, approximately 2,800 RIC-E (pronounced RICKY) Trusts® have been created.

The idea was inspired several years ago by a caller to my radio show. He said his wife had just delivered a baby and he wanted to save for this new son's future. When I began explaining how best to save for college, he interrupted me. "I'm not talking about college," he said. "I want to know how to save for his *retirement*."

I was stunned – and told him so. "Nobody saves for a baby's retirement!" I exclaimed. The entire notion is preposterous – we all know how hard it is to save for *college* – can you imagine the cost of saving for a baby's *retirement*!?!?

To prove my point to him – while still on the air – I pulled my financial calculator from my briefcase and quickly punched in a formula. If you set aside \$5,000 at birth and leave the money untouched until the baby is 18 and ready for college, assuming a 10% annual return (the average annual return of the S&P 500 Stock Index since 1926 is 10.4%, according to Ibbotson Associates), you'll accumulate about \$27,000. That's not enough to pay for college today, let alone 18 years from now.

But that same \$5,000, at the same 10% return, if left invested for 65 years, would grow to \$2.4 million!

Contrast that with the experience of a hardworking American who dutifully saves in a 401(k) plan for an entire career. Even if a worker saves 10% of pay every year from age 20 to age 65, and even if that worker chooses the right investments the entire time, that account will be worth – if the worker is lucky – only about \$750,000. By comparison, a one-time contribution of just \$5,000 produces more than three times as much!

The reason, of course, is the magic of compound interest. Never before has anyone tried to grow money for such a long period of time. Yet, that's the key to retirement security.

Unfortunately, there are two problems with my simple math, and I explained them to my caller. First, my calculation did not adjust for taxes. If you have to pay taxes annually on the account's profits, you won't end up with \$2.4 million. Instead, assuming a 33% tax rate, you'll accumulate only less than \$350,000 – rendering the value of the effort hardly worthwhile. Second, if you set aside money for a child, the child at age 18 gets legal access to that money – so the real question is not wondering what the account balance will be at age 65 but, rather, what color the sports car will be when the child graduates high school. Indeed, based on my nearly 20 years of experience counseling thousands of families, I can assure you that if the child can spend the money, he or she will.

Even if the child refrains from a frivolous splurge, it is still unlikely that the account will survive intact all the way to retirement. Why? Because we all encounter financial issues during our adult lives – the need for a down payment to buy a house, large unexpected medical bills, sudden job loss, marital or family problems and more. Being able to tap into an account often is too tempting to resist. Only later, in retirement, do people express regret.

So, the harsh realities of taxes and access burst the bubble of the idea. But I was convinced there was a solution, and that finding a solution could translate into a huge benefit, not only for America's babies, but for the next generation and, by extension, all of American society.

It took me two years to overcome the tax and legal hurdles these problems presented, but I succeeded and as a result the RIC-E Trust® was introduced in 1998. Although designed for newborns, a RIC-E Trust® can be created for anyone of any age (although, obviously, the younger the beneficiary and the later the benefits are received, the more the account can grow). The trust is irrevocable, meaning that money contributed cannot be accessed until the beneficiary (the child) reaches retirement age (which is set by the grantor upon creation of the trust; it cannot later be changed and cannot be less than age 59½). There are exceptions for the child's disability (he or his parent/guardian gets the money) or death (his estate gets the money for distribution to heirs). This solves the access problem.

To solve the tax problem, the trust invests the money in a variable annuity, which allows the money to grow tax-deferred until withdrawal. This allows for tax-free compounding over

decades, just like an IRA. The money can be invested in a wide range of asset classes – stocks, bonds, government securities, real estate funds and more.

There is a one-time set-up fee of \$300 to establish a RIC-E Trust®, and there are the typical fees charged by annuities. There are no other expenses – no annual fees, no custodian or trustee fees, and no annual income tax, nor any tax reporting or preparation. The minimum investment is \$5,000 and additional contributions can be made at any time in amounts of \$500 or more. But other than voluntarily adding money to the account, the RIC-E Trust®, once established, is completely hands-off. Time will do the rest, with quarterly statements issued to the child and grantor.

The program envisioned by the ASPIRE Act is much better than my RIC-E Trust® for two reasons: first, it is automatic for every child in America; mine requires decisive action by parents and grandparents, and of course requires them to have financial ability to contribute \$5,000 for each of their family's children and grandchildren. This puts the RIC-E Trust® beyond the reach of the vast majority of Americans. Second, if the ASPIRE Act operates similarly to the federal Thrift Savings Plan, the operating expenses would be extremely low – much lower than those of private-sector variable annuities like the one my RIC-E Trust® uses. These lower costs can translate to higher account values for the children.

I have only two concerns with the ASPIRE proposal. First, I would prefer that the account be restricted to retirement. Currently, it also can be used for education and buying a home. This is not necessary: with the advent of student loans and mortgages, both college and home ownership have become pay-as-you-go expenses. Nobody pays cash for a home anymore. Instead, they pay for it while they live in it – if they move, they sell the home and use the proceeds to pay off the mortgage. Similarly, nobody needs to pay for college up-front anymore. Instead, students can get through school via loans, and then repay those loans over the course of their 40-year careers. This is not only an acceptable approach, it is increasingly the only approach that is viable for today's college students.

But you cannot pay for retirement on a pay-as-you-go basis; it is the one major expense that *must* be paid for in advance. After all, you can't save for retirement while you're in retirement, and for that reason, I recommend that the ASPIRE Act restrict distributions to retirement age, with exceptions for death and disability. Otherwise, we face the risk that many will spend the proceeds long before they reach retirement age.

Second, since the proposal already permits Americans to make additional voluntary contributions, I would recommend that these limits be increased. While the program should not become a tax shelter for the rich, raising the ceiling to the RIC-E Trust®'s level of \$5,000 would be of value to middle class and upper middle class families, and would result in larger numbers of Americans being able to reach retirement age with a higher degree of retirement security. This, in turn, would reduce their dependency on government in their elder years, freeing the government to focus its resources on other important needs.

I fully realize that the establishment of accounts under the ASPIRE Act would put my RIC-E Trust® out of business, rendering it both redundant and more expensive than the ASPIRE Act's federally sponsored version. This would cause me economic harm.

Go ahead and do it. It's the right thing to do for Americans, and for America. And I will do everything I can to support this initiative and help it become law.

*Related website:* <http://www.ricetrust.com>

Statement of Fred T. Goldberg, Jr.  
Before the Senate Finance Committee  
Subcommittee on Social Security and Family Policy

April 27, 2005

Mr. Chairman and Members of the Subcommittee, it is an honor to appear before you today on the timely and important topic of "Building Assets for Low-Income Families. I am appearing today on my own behalf and not on behalf of any client or other organization.<sup>1</sup>

Enacting policies that promote asset-building and savings for all Americans is one of the greatest domestic policy challenges – and opportunities – we face today. Mr. Chairman, you have provided much needed and unwavering leadership in this area. Your support of Social Security personal accounts challenges the conventional wisdom of Democrats, while your support of refundable credits to promote asset accumulation through Individual Development Accounts (IDAs) and universal children's savings accounts challenges the conventional wisdom of Republicans. For many of us, you are right and the conventional wisdom is wrong on both counts. While there are important differences on program specifics, we applaud both your policy judgments and your political courage.

I first became interested in – or, as my wife and five children claim, obsessed by – the need for universal policies to promote savings and asset-building by low- and middle-income (LMI) families while serving as Executive Director of the Kerry-Danforth Commission on Entitlement and Tax Reform (1993-1995). Former Senator Kerry had the foresight to recommend Social Security personal accounts long before most elected officials were willing to embrace the idea. Beginning in 1995, I then had the pleasure of working with Senator Kerry and his colleagues on legislation approved overwhelmingly by the Senate (but dropped in Conference) establishing a limited form of children's savings accounts.

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<sup>1</sup> While appearing on my own behalf today, I am currently a partner at the law firm Skadden, Arps, Slate, Meagher & Flom. We represent a large number of financial institutions with interests in policies to promote savings. I also serve on the Board of Trustees of the Corporation for Enterprise Development (CFED) and Doorways to Dreams (D2D), and on the Board of Advisors of Wall Street Without Walls (WSWW). Each of these non-profit organizations is actively involved in promoting asset-based policies on behalf of low income workers and families. Among its many activities, CFED sponsored the pilot program demonstrating the feasibility of Individual Development Accounts (IDAs) and is currently sponsoring a large-scale pilot program testing children's savings accounts. Among various technology-based initiatives focused on savings by low- and middle- income (LMI) families, D2D sponsored a pilot program demonstrating the great promise of the Administration's split refund program. Working with the Federal Reserve Banks, among others, WSWW is actively involved in using current capital market techniques to provide capital for low income communities. In addition to the foregoing, I am currently working with a broad-based coalition whose goal is to help ensure the effective implementation of the split refund initiative.

My route to the Entitlements Commission and asset-based policies came by way of my work as IRS Commissioner (1989-91) and Assistant Secretary for Tax Policy (1992) during the first Bush Administration. While the connection may not be apparent, it brings me to the critical point I wish to emphasize today: based on my experience as IRS Commissioner and Assistant Secretary for Tax Policy, as well as my private sector experience, it is quite clear that the government and the private sector have the administrative systems and infrastructure in place to implement efficient and effective universal policies that will promote asset-building by all Americans, with particular emphasis on LMI workers and families. Making these policies “work in the real world is not the issue; what’s missing is Congressional action.

I would like to comment briefly today on the following topics: why assets matter; the compelling case for refundable tax credits in the context of asset-based policies; and the importance of infrastructure in designing and implementing asset-based policies.

A. Assets Matter. While the focus of your hearing is on asset-building by low income families, I think it is essential to view this issue in the broader context of why assets matter for all Americans. At risk of stating the obvious, assets matter for at least three reasons:

- *National Savings Create Jobs and Opportunity*: At a macroeconomic level, savings promote the economic growth necessary for jobs, improved standards of living and opportunities for all Americans. The paltry rate of private savings is well-recognized and a legitimate cause for concern. Likewise, while tax cuts over the past several years have promoted growth in the face of a weak economy, chronic deficit spending by the Federal government to support current consumption and other recurring costs represents negative savings. This approach may be acceptable in the short term, but it does involve consuming today at the expense of young families and workers, our children and grandchildren.
- *Family Savings Promote Security and Opportunity*: At the family level, assets matter for a host of obvious reasons. What is important in the context of today’s hearing is that far too many families lack the assets necessary to provide for their financial security and opportunities for advancement for themselves and their children. This applies not just to families now living in poverty but also to the millions of families who are one lay-off or one illness away from falling from the lower rungs of self-sufficiency and into a morass of unsustainable debt and the ranks of the new-poor. The data is overwhelming (all data as of 2001):<sup>2</sup>
  - *Tax-Favored Retirement Accounts*: More than 75% of families with incomes in the bottom 40% have *no* tax-favored retirement accounts of any kind, and the average account balance among those who do have accounts is less than \$10,000.

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<sup>2</sup> Data below is from National Academy of Social Insurance, Uncharted Waters: Paying Benefits From Individual Accounts in Federal Retirement Policy, 31-40 (2005).

- *Homeownership*: More than 25% of all families and more than 55% of all non-white and Hispanic families do *not* own their own homes.
- *Asset Poverty*: Taking only liquid assets into account, about 40% of all families lack sufficient assets to meet basic needs at the poverty level for three months in the absence of other income. The percentage would be far higher when measured against liquid assets equal to three months of current earnings.
- *Insurance Against Illness or Disability*: More than 30% of all private sector workers lack any type of paid sick leave or short-term disability benefits.
- *Liquid Investment Assets*: Almost 60% of all families and almost 80% of all non-white and Hispanic families own no mutual funds, stocks or bonds.
- *Credit Card Debt*: By conservative estimates, about 35% of families with incomes between \$10,000 and \$25,000 carry credit card debt, with an average balance of \$2,250; about 50% of families with incomes between \$25,000 and \$50,000 carry credit card debt, with an average balance of \$3,565.
- *The Unbanked*: The size of the “unbanked” population – those who do not have a checking or savings account with a bank or credit union – is estimated to be between 10 and 20 percent of all U.S. families.

Whether it’s accumulating assets for a first home, a car to get to work, a computer for the kids, or a “rainy day fund” in case of a lay-off or illness, it is clear that far too many families have insufficient savings.

- *Savings to Pre-Fund Retirement and Health Care Needs*: It is essential that we pre-fund future retirement and health care needs. We cannot wish away the \$35.2 trillion dollar permanent shortfall in Social Security and Medicare Part A. We cannot afford to ignore the GAO’s recent conclusion that, by 2045, federal spending as a percent of the economy on Medicare, Medicaid, and Social Security *alone* will exceed the post-war average for *total* federal tax revenue as a percentage of gross domestic product (GDP).

In many ways, a key aspect of the current and looming debate over Social Security, Medicare and Medicaid boils down to the following question: should we continue to fund these programs on a pay-as-we-go basis through some combination of benefit cuts and tax increases, or should we move – in one way or another – to a partially pre-funded system that does not rely solely on Trust Fund monies that are borrowed to finance government expenditures on current consumption and other recurring costs. While there are widely divergent views

on the proper mix of reforms, it is clear that honest pre-funding, however it is accomplished, must be part of the solution.

B. The Compelling Case for Refundable Credits in the Context of Asset-Based Policies. Any consideration of tax policies focused on asset-building should come to terms with the need for refundable credits.

1. *Refundable Credits.* As this Committee knows, there has been a long-running debate over the wisdom of refundable tax credits. For the most part, the hallmark of this debate has been caricature and heated rhetoric (on all sides) having little to do with the underlying tax policy considerations. It's not a question of "welfare through the tax system versus "distributive justice. Rather, the issues are far more prosaic and best considered on traditional tax policy and tax administration grounds. Are refundable credits necessary or appropriate to achieve the desired tax policy objectives? Can they be administered efficiently from the standpoint of affected taxpayers and the IRS, taking compliance issues into account? On these grounds, the case for refundable tax credits intended to promote asset-building is compelling.

While more than 90% of all taxpayers have positive tax liability over their lifetimes, 40% of all families and workers do not have positive income tax liability in any given year. This means that non-refundable credits intended to promote savings by LMI taxpayers (e.g., the Saver's Credit under current law) will fail to achieve their stated objective. Moreover, non-refundable credits intended to promote savings violate basic norms of horizontal equity and fail to take account of families living in different parts of the country. Imagine the following families dealing with a non-refundable \$500 credit under circumstances where families with incomes under \$30,000 don't pay any taxes and therefore do not get the credit, while families with \$40,000 pay sufficient taxes to take full advantage of the credit:<sup>3</sup>

Family A, living in Big City, has income of \$50,000 in Year 1, but its income declines to \$30,000 in Year 2 because one spouse takes a year off after the birth of a child, or to go to school, or because of an illness.

Family B, also living in Big City, has income of \$30,000 in Year 1, but its income increases to \$50,000 in year 2 because the primary earner gets a raise after completing a training program during Year 1, or because the second spouse goes back to work after a layoff or illness.

Family C, also living in Big City, has income of \$40,000 in Year 1 and Year 2.

Family D, living in Small Town, has income of \$30,000 in Year 1 and 2 – the equivalent of \$40,000 in Big City.

All four families have the equivalent of \$80,000 in income over two years – yet family C gets \$1,000 in credits, while families A and B get \$500 in credits and family D gets

<sup>3</sup> While not the subject matter of this hearing, these same observations apply to the phase-out of credits.

nothing in credits. This result makes no sense from a tax policy perspective. As Yogi said, “It just ain’t fair.

From the standpoint of tax administration, the implementation of refundable credits to promote savings is relatively straight-forward, thanks to current IRS/FMS and private sector technology and existing tax information reporting systems. Moreover, refundable tax credits intended to promote savings do *not* pose many of the compliance issues posed by many other provisions of the tax law for two reasons: (i) current information reporting systems generally permit verification of eligibility and (ii) the pool of saved assets in the hands of third parties provides a ready source of funds for IRS collection in cases of inadvertent or intentional non-compliance.

Further, while not refundable credits *per se*, the IDA provisions in the CARE Act benefit low-income families and the ASPIRE legislation benefits children of LMI families without regard to whether the participants have current tax year liability. As such, they represent a major break-through in asset-building policies for low income families. The sooner they are enacted, the better.

2. *Income Exclusions.* While less heated, there is some debate over the relative merits of tax incentives that provide up-front deductions and tax back-end distributions (*e.g.*, traditional IRAs and employer-sponsored retirement plans) versus those that do not provide up-front deductions but do not tax back-end distributions (*e.g.*, Roth IRAs and Section 529 Plans). All else equal, these are equivalent from the standpoint of net tax benefits. From the standpoint of the 40% of all taxpayers with no tax liability each year, however, up-front tax deductions provide no tax benefits while back-end exclusions may be of significant benefit. If the goal is to promote asset-building among LMI families, the no-deduction/future-exclusion is far preferable to a system of current deduction/future tax.

3. *A Trade That’s Waiting to Happen.* The Tax Reform Act of 1986 – with PEP, Phase and phase-outs – planted the seeds for a bargain that has bedeviled tax policy for the past twenty years. Republican orthodoxy abhors refundable credits while Democratic orthodoxy demands phase-outs to prevent give-aways to the so-called rich.<sup>4</sup> The net result is that LMI families with no tax liability are left out in the cold; middle income families (especially those in communities with a high cost of living) are phased out; and the truly rich don’t receive tax benefits that are meaningless in the scheme of things. In the context of savings policy, using phase-outs and other eligibility criteria creates mind-numbing complexity and discourages private sector financial institutions from marketing saving to potential savers.

The far better approach would be to enact asset-based policies that are truly universal by eliminating phase outs and providing refundable credits. To take one example, as you know, the Saver’s Credit is set to expire next year. Recent experience

<sup>4</sup> For what it’s worth, I’ve never understood why a family in Philadelphia is “rich” where one spouse is a teacher and the other is a first responder. Be that as it may, they are likely “phased out” from eligibility for the Saver’s Credit, IRAs, the Hope Credit, HSAs, etc.

demonstrates that it is an effective program for those families who are eligible to claim the credit. The kicker, of course, is that very few families are eligible. The credit excludes most LMI families because it is not refundable and imposes punitive marginal rates because it phases out too quickly.

At the same time, the Administration has once again proposed and members of Congress have re-introduced Lifetime Savings Accounts (LSAs) and Retirement Savings Accounts (RSAs), which use the no-upfront-deduction/no-back-end-tax model that is most beneficial to LMI taxpayers. Because there are no phase-outs, LSAs and RSAs do not penalize families with fluctuating incomes and families that live in high cost of living communities.

Tax policy and tax administration would be best served by extending and modifying the Saver's Credit to make it refundable and to make the phase-out more gradual, and by enacting the Administration's LSA and RSA proposals. All of this could (and should) be accomplished on a revenue-neutral basis by repealing the bewildering array of targeted savings incentives and setting the credit and contribution amounts at appropriate levels. Coupled with enactment of the CARE Act's IDA provisions and ASPIRE, the net result would be radical simplification of the tax law and asset-based policies that are truly universal and of greatest benefit to LMI taxpayers.

C. Infrastructure Matters. My final observation has to do with administrative and policy infrastructure, each of which has received far too little attention in the debate over legislation to promote savings, especially among LMI families.

Administrative infrastructure refers to the systems necessary to implement measures under consideration by Congress. If it won't work as a practical matter, why bother. Fortunately, the country now has a remarkable private and public financial infrastructure that can support universal asset policies that were unthinkable even twenty or thirty years ago. Thanks to technology and innovation by the private sector and by government:

- Mutual funds have have seccessfully democratized participation in the capital markets.
- The Federal government's Thrift Savings Plan demonstrates the feasibility of an efficient, low-cost and secure alternative for savings by those not yet ready to participate directly in the private markets.
- The Savings Bond program could be revitalized as yet another alternative.
- A majority of individual tax returns will be filed electronically this year or in the near future.
- In 2003 the IRS and FMS issued more than \$206 billion in tax refunds to more than 100 million taxpayers, representing an average refund of more

than \$2,000, and more than 47 million tax refunds were issued by way of electronic funds transfers to financial institutions.

- At the same time, the EITC has greatly increased the amount of tax refunds going to LMI families. In 2003, about 22 million LMI taxpayers received more than \$38 billion in refunds through the EITC, representing an average EITC refund of about \$1,700.

These and other aspects of the current financial landscape provide the infrastructure that can be used to implement policies such as the Administration's split refund proposal, the IDA provisions of the CARE Act, the ASPIRE legislation recently introduced by you and your colleagues, a restructured (and refundable) Saver's Credit, and personal retirement accounts that are enacted as a part of – or as a complement to – Social Security reform. The fact is that we can make these policies work, and work well.

In my view, the keys to a successful and durable policy infrastructure are universality, simplicity and appeal to shared values. It is absolutely clear that the existing administrative structure makes it possible to implement asset-based policies that satisfy these three criteria. It is also clear that these objectives can be accomplished in ways that are fiscally responsible in light of massive deficits and the need to pre-fund future retirement and health care needs. Finally, it is clear that we can choose from numerous specific proposals that – taken together – would achieve truly universal asset-based policies that would be “user friendly” and reflect our shared values.

What is unclear is whether the political process will allow these choices to be made.

**Testimony for Hearing on  
“Building Assets for Low-Income Families”  
Subcommittee on Social Security and Family Policy  
Senate Finance Committee  
April 28, 2005**

**“I Can Save”: A Savings Program for Children in Primary School**

**Dr. Victoria Gonzalez-Rubio, Principal  
Delmar-Harvard Elementary School  
University City, Missouri**

Good morning, Senator Santorum and Members of the Subcommittee. I am here this morning to tell you about a program called *I Can Save*. *I Can Save* is a four-year demonstration program for young children based at Delmar-Harvard Elementary School in University City, where I am the Principal. *I Can Save* is one of 13 sites in the Saving for Education, Entrepreneurship, and Downpayment (SEED) Policy and Practice Initiative, a children’s savings demonstration. *I Can Save*, now in its second year, provides savings accounts, financial education, and incentives to all children who entered kindergarten and first grade at Delmar-Harvard Elementary School. The purpose of *I Can Save* is to increase savings among children and their parents for post-secondary education and training. We believe that young students who are saving and learning financial concepts, and who know there is a nest egg for their college or training expenses, will engage more fully in their studies, and this in turn will contribute to higher academic achievement. Although we only started this program last year, we are hearing many positive comments from these young students and their families about saving and college.

I have been an educator for 31 years. Education is my passion. I wanted my own children to attend college, and I have these same dreams for every student at my school. The American Dream is not about *if* students go to college, but *when* and *where* they go to college. A college degree used to be a ticket to a better life. Now a college degree may only get you a place at the bus stop of opportunity, but often without it young poor adults are locked into low-paying jobs that don’t lead to career advancement. Many of my students are not only poor, but also of color. These are double strikes that demand we support our greatest asset, our children, with programs like *I Can Save* so they can break the cycle of poverty and achieve academic success. As a second grade girl astutely said: “*Well, if you don’t go to college, you don’t have a really good job.*”

Why do we think that it will make a difference if children have savings for college? In my school many parents did not have the opportunity to go to college. Savings for college could have made a big difference. They might have believed college was a real possibility. One of our students in *I Can Save* explained how money makes a difference. She said she thought it would be hard to get enough money for college because she would have to work so much. So we asked her if she wanted to go to college? She replied: “*To get smart, I do. But if it costs that much money, I think I don’t want to go.*”

If this young student had a nest egg with enough in it to help pay for college, she probably would have responded quite differently. In fact, another student in the program was more optimistic because she is saving for college: *"I think if I save a lot then it wouldn't be that hard [to go to college]."*

Some parents hesitated before joining *I Can Save*. Why? So many said *"it sounds too good to be true."* Some are skeptical of anything that sounds like it might be a 'scam' and others are too busy trying to survive financially to pay attention to all the information that comes home with their children.

But Tiffany (not her real name) and her mother helped us understand better. Tiffany had not enrolled in *I Can Save* by the second year of the program. Tiffany's teachers doubted that she would ever enroll because her mother, Darlene, is not good about returning papers to the school. When the program coordinator reached Darlene, she said she said she would ask her son to look at the papers, but she was not really interested. The next week she said her son told her to enroll Tiffany, but that someone would have help her fill out the paperwork because she cannot read. She said she was excited to have a chance to save for Tiffany's future so that she would not have to go through what she has endured in her lifetime, not knowing how to read. She said she was happy that Tiffany would have a better chance to succeed.

#### **What are SEED and *I Can Save*?**

*"You get to learn how to count money and go to the bank... 'cause we're saving up money for college."* (Jessie, 2<sup>nd</sup> grade)

*"I love learning about money. It's pretty fun and you get real money sometimes. I like how we get the money. They pass out the money...we put in our little piggy banks. And there's some kind of tube that goes from the library to the bank. So you put it in...it sucks it up...it goes right down to the bank."*  
(Corey, 2<sup>nd</sup> grade)

SEED is a multi-year national initiative to develop, test, and promote the idea of matched savings accounts and financial education for children and youth. The initiative seeks to set the stage for inclusive American policy for asset building through children's savings.

*I Can Save* is the only SEED site that focuses on very young children in the public schools. All children in two grade cohorts in my school have a savings account at Commerce Bank, located across the street from the school. When the children open their *I Can Save* accounts, an initial deposit of \$500 is made. Thereafter, all savings deposits are matched dollar-for-dollar. Deposits are made by students, their parents, and others who want to invest in the children's future education. Students earn money by participating once a week in the after-school *I Can Save* Club, where they learn financial concepts and entrepreneurship principles. Students take monthly trips to the bank where they deposit their "earnings" from the club and other deposits. This money is matched when they deposit it into their savings account. During the school day, teachers offer financial education to students. Parents also participate in financial education

workshops where they sharpen their financial management skills and learn more about household asset building.

Over four years, *I Can Save* will provide up to \$1500 per account in dollar-for-dollar matches and other incentives (in addition to the initial \$500 deposit). If children and families participate fully in *I Can Save*, each child could have up to \$3,500 saved for college.

At the end of the four years, the students' savings will be deposited into a MOST account, Missouri's college savings (529) plan. Children and parents will be encouraged to continue depositing into the college savings plan throughout middle school and high school. If children and their parents participate fully in the program, and continue to deposit \$50 per year into the account until they graduate from high school, they should have enough money in their account to pay for approximately two years of community college.

Several important principles guide our work at *I Can Save*, and at the other SEED demonstration sites:

- Children's saving should include all children. This is why we chose to include all of the children in the two cohorts.
- Children should receive an initial deposit to help get the savings started. Our students started with an initial deposit of \$500. This attracted families to the program, and encouraged them to believe that it would be of real assistance.
- The accounts should be matched. All deposits into the accounts by family, friends, relatives and others, are matched dollar-for-dollar, up to a maximum. Many of the children at Delmar-Harvard Elementary School come from working poor families and are eligible for the free and reduced lunch program. This match provides an important incentive for additional deposits, and motivates families to put aside small amounts of money each week.
- The program should be simple so every child can have an account. Although the cost of a demonstration like this one is high, we are conducting research to understand what parts of the program are the most important, so that we can make it efficient and expand this program throughout the school district.
- The accounts should be viewed as long-term investment capital, but with opportunities to use the funds for related educational expenses during primary and secondary school years. Our students' accounts will be rolled over into Missouri MOST accounts, our state's college savings plan. This will protect their savings and encourage further saving for education.
- Accounts should be held in secure private financial institutions that provide limited investment options. *I Can Save* is partnering with Commerce Bank to safeguard the students' savings and provide access to the formal banking system.

- Savings policy and programs should build financial aspirations, knowledge, and skills. Students are learning how to manage their money using *Financial Fitness for Life*®, *Wise Pockets World*®, Citigroup's financial education curricula, and other materials. Although school districts are not required to include financial education in their curricula, we believe this is an important part of lifelong saving and healthy financial management.

#### **What are we learning?**

In the first couple of years, we have learned a great deal about how this kind of program works. Thus far, we know that:

- Families will sign up for the program. By December 2004, 74 children out of a possible 75 total children in the two grades were enrolled in *I Can Save*. Children receive financial education in their classrooms once a week, and 49 children participate once a week in the after-school *I Can Save Club*. Parents have participated in seven financial education workshops on topics such as: budgeting and spending, debt and credit, and financial goals. Parents also have access to online financial education.
- Children and their families can save. Children have a total of \$55,165 in their savings accounts, an average of \$744 per child. The average reflects \$122 of families' savings, \$122 in match deposits, and an initial \$500 program contribution. Some families have only been in the program a short time; they began signing up in November 2003 and the last ones joined in December 2004.
- Children, parents and teachers are enthusiastic about *I Can Save*. They like having a savings account, the matching deposits, visiting the bank, the financial education. One child in the *I Can Save After School Club* said: "I love going to the bank. I get to put money in my account myself." The children encourage their parents to give them additional money to put in their accounts on bank day, and one clever child asked if he could come more days to the After School Club so that he could get more money in his account. Another student said the best thing about *I Can Save* is "if we get our little piggybank full, we get to make another one." And one little boy talks about the goal at the end of the program: "Like at the end of the whole thing...the whole *I Can Save*...you get to go to the bank in the Loop...and then they give you real, big dollars and stuff."
- Financial education is important. Our experience shows that children can learn economic concepts. They are learning how to be entrepreneurial. Shaun, a shy boy in second grade, came into his own when the students created their own businesses. Shaun called his ice cream store "*Icstatic*." Everyone thought it was a great name, and after that Shaun began to get more involved. He listened better to instructions and began using the concepts he was learning, such as "*income*," "*saving*," "*earning*," "*deposit*," "*withdrawal*," "*goods*," and "*services*."
- It would make more sense if all of the children in the school and the school district were in the program. Kids encourage each other to join and to save. Financial education can be

incorporated into teachers' class plans. Children could transfer to another school without leaving the savings program.

- The program should be simple. Simple and straightforward rules will encourage people to sign up and help them understand what they need to do.
- The program should be operated by a trusted organization. Families are increasingly wary of unscrupulous financial schemes and it takes time to assure them that their money will be safe. It is very important that the financial institution is known and trusted.
- The biggest challenge is to get all parents involved in financial education. Our parents are very busy; many work more than one job. But once they participate, parents are enthusiastic. As one mother said: "*I wish someone had taught us about money growing up.*" Learning about the Earned Income Tax Credit was a popular topic and I was surprised that people still do not know about it. Interestingly, an indirect effect has been that at least one teacher now participates in Missouri MOST as a result of information learned in the program.

#### **Why is it important for young children to save?**

For many young people, especially minority and low-income children, attending college is a genuinely desired but elusive goal. Among high school graduates, only 39 percent of African-Americans, 32 percent of Latinos, and 45 percent of whites enroll in college (U.S. Bureau of Census, 2001). Typical costs to attend a 2-year public college are below \$2,000 per year; 4-year public college expenses are estimated to be just under \$4,000 annually. Yet, two in five American children will never complete a single year of college. Thirty-nine percent of all children—54 percent of Hispanic and 52 percent of Black children—live in households with too few resources to survive for even three months in the event that income is interrupted. More than a third of the 4 million American children born each year—and more than half of minority children—are born into families with negligible savings to weather emergencies or invest in their futures. People with a bachelor's degree earn over 80 percent more, on average, than those with only a high school diploma.

Children understand that college costs a lot and that they might not have enough money to attend. One of our students explained: "*Some kids are poor and they don't have enough money to go [to college].*"

When we asked a second grader how easy or hard it would be to have enough money to go to college, he said: "*I think it'll be hard to save enough money, because your mom might be poor and your father might be too. I don't even have a father, and my mom's pretty poor, so I should know.*"

Too often, an inability to afford college contributes to low expectations for higher education (Perna 2000, Cabrera & La Nara 2001). Too often, lack of opportunity to attend college leads young people to slowly give up their efforts to excel in school and to abandon plans to enter and complete college. It is important to get them invested in the idea while they are still young and

enthusiastic about learning. When asked about staying in school, one young girl said: “*I want to learn extra. I want to learn very, extra, because...I want to be in school as long as I can.*”

When we asked the children how we can help kids go to college, the children often talked about money. One student, Sara, said: “*You should help them save money...if they can't earn enough, and like you're earning more, then you should help them get more money.*” Following up, she said: “*The people that have more money should teach the person that's not getting enough money...like how to get a lot of money.*” Her classmate Ivan said: “*One day when you grow up, you should be like...the 'I Can Save' worker. . . and you should help kids save money.*”

*I Can Save* is designed to intervene early with children and their parents to provide college savings, financial knowledge, and financial skills to make higher education a realistic and achievable option. What difference would it make if children grew up knowing they had a nest egg to go to college? Research suggests that financial education and asset building may begin to provide both the resources and the encouragement necessary for children and their parent to make a reasonable choice that leads toward academic achievement (Sherraden 1991). Research on academic achievement suggests that parental assets contribute to children's lower drop out rates (Green & White 1997), higher standardized test scores (Essen et al. 1977), greater educational attainment (Mayer 1997), and more planning for children's education (Moore et al. 2001; Sherraden, et al. 2004). Despite this evidence, more research is needed to analyze models of school-based financial education and college savings programs and to determine if financial education and asset building have positive effects on financial literacy, academic engagement and achievement, and expectations for college.

Many years ago, Eugene Lang proposed the idea through his program “*I Have a Dream*,” that securing college funds will motivate children to work harder in school. Nonetheless, most schools lack integrated financial education and college savings programs. Many children and their families who try to save for college often lack the financial knowledge and tools to maximize their efforts. They often do not know their financial options for higher education (Ikenberry et al. 1998). According to the National Council for Economic Education (NCEE), 31 states had economic education standards in 2002, but only 17 required implementation of the standards, and only four required students to complete a personal finance course before graduating from high school (NCEE 2003). The State of Missouri has personal finance standards for middle and high school grades, but districts are not required to implement them. Nonetheless, interest in financial education and college savings is high. According to the Jump\$tart Coalition (Thomas 2004), 27 bills or resolutions concerning financial education were submitted in state legislatures in 2003. In 2004, the federal FACT Act was passed, establishing a Financial Literacy and Education Commission. It appears that more college savings programs are emerging.

We believe that our experience with *I Can Save* will provide evidence about the positive effects of financial education and savings on children's academic aspirations and achievement.

#### **Who manages and supports *I Can Save*?**

*I Can Save* is a project of a unique university-community partnership called University-Community Achievement Partnership (U-CAP), which is dedicated to enhancing savings and

academic success among children in University City through improving schools, increasing financial assets in households, and supporting families. Beyond Housing/NHS in St. Louis manages *I Can Save*. Beyond Housing/NHS provides comprehensive family and community services through (a) creating and managing service-enriched, single-family rental housing, (b) organizing intensive community building in the St. Louis Metropolitan Community, and (c) asset building, including operating a region-wide Homeownership Center. Other partners include Commerce Bank, the University of Missouri in St. Louis, Washington University, and the Missouri State Treasurer's Office.

SEED is organized by CFED and funded by a consortium of foundations. It is an initiative aimed at testing the efficacy and impact of children's savings accounts as a tool to promote economic independence. SEED began full operation in 2003 and will span an additional five years. The first year was devoted to selecting community partners, ramping up individual programs, completing development of initiative systems and tools, and opening the first accounts. The following four years are dedicated to operation, communication, research, evaluation, innovation, and advocacy. The final year will focus on compiling, assessing, and communicating the lessons of the initiative.

CFED coordinates the initiative by raising funds; issuing a request for proposals for community partners; managing the selection of community partners; providing technical assistance; fostering on-going communication; sponsoring semiannual learning conferences; managing finances; developing and advocating policies; promoting public education; and disseminating emerging lessons from the initiative on-line, in newsletters, and other publications. Research on the initiative is designed and conducted by the Center for Social Development of Washington University and the School of Social Welfare at the University of Kansas. The Research Triangle Institute (RTI) is conducting an impact evaluation at a SEED site in Michigan.

Funders of SEED include the Ford Foundation, Jim Casey Youth Opportunity Initiative, Charles and Helen Schwab Foundation, Citigroup Foundation, Ewing Marion Kauffman Foundation, Charles Stewart Mott Foundation, MetLife Foundation, Richard and Rhoda Goldman Fund, Evelyn and Walter Haas, Jr. Fund, and Edwin Gould Foundation for Children. Local funders for *I Can Save* include the United Way of Greater St. Louis, and Parkview Gardens Neighborhood Association.

The Center for Social Development at Washington University, and the Schools of Social Welfare and Education and the Center for Entrepreneurship and Economic Education at the University of Missouri in St. Louis are supporting and conducting *I Can Save* research.

#### **In conclusion**

Parents tell me regularly that *I Can Save* is a great program. They ask other family members to help them put money away for their children's accounts. Students bring a few dollars to school each week to deposit at Commerce Bank, our *I Can Save* partner. A few dollars each week may not seem like much, but in time these small deposits add up.

It touches my heart when I see parents—hardworking parents of very limited means—putting aside money so their dream of a college education for their child can be realized. I wish that I had this program available for all my students and all the children in our district.

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**Question for the Record From Senator Lincoln for  
Dr. Victoria Gonzalez-Rubio  
April 28, 2005**

**Question:** As you know, Helena AR is one of the sites in the Saving for Education, Entrepreneurship, and Downpayment (SEED) Policy and Practice Initiative. Their target audience is 3–4 year old children, and they have successfully enrolled 60 low-income families. It is clear that, given the proper incentives and financial information, low-income children and families can and do save. I wanted to ask if you have noticed additional benefits as well. For instance, are children starting to take a more long-term view of their future? In particular, are they becoming more interested in college and planning for that, as well as becoming more aware of the need for savings and setting financial goals?

**Answer:** I think it is important to create a culture of college expectations, and then to provide the tools (quality teaching and savings for college) to achieve them. My students hear me say regularly that I expect each and every one of them to graduate from college. My school has several unique partnerships with nearby Washington University (WU) where we visit the campus regularly and interact with WU students and staff. During our campus visits I ask WU students to share their stories of how they got to college. I ask specific questions that allow my students to understand that college plans start in elementary school. We also invite community leaders to visit our classrooms. WU Vice-Chancellor Mark McLeod visited Delmar-Harvard, and read to my students the book, *Martin's Big Words*. He discussed with them how Dr. King impacted his life, and shared with them his own story of higher education. It was a powerful experience for everyone.

My students are hearing from a variety of sources that college is a real possibility for them. When we visited the WU campus last year, one of my younger students shared with a WU official that he was going to attend WU when he went to college. Then in a whisper he shared that it was very expensive to attend WU. When asked "How much?" he replied that he had heard it cost \$100 to go there. Don't we wish that was all it cost to attend a leading university? The sad fact is that many times there are financial options available, but many students and their families are unaware of scholarships, or can't navigate through the required forms. I regularly state that we are visiting WU today, and attending WU or another college/university tomorrow.

I believe that my students are more "tuned in" to the idea of going to college. When they are asked in the weekly after-school meetings of the I Can Save Club "What are you saving for?" they shout out "college!" From preliminary data, we find also that savings in the children's accounts has increased significantly during those months when the children took trips to the bank during the after-school club.

From a research perspective, we do not yet really know the answer to the question that you asked, Senator Lincoln, but I have included some quotes from a recent teacher focus

group that might be helpful. The teachers themselves say that it is probably too early to tell, but do give a few supporting comments.

**Quote 1:**

Teacher: I mean, where, we're in first grade and I think between the two of us, we are . . . I think our kids are pretty actively involved. I mean, I would say, first grade is probably the most actively involved, as far as, not that we're teaching them a lot of the lessons, because it does get lost in the shuffle . . . but that after-school club is a huge deal in first grade. They talk about how much they've saved, you know, things like that.

**Quote 2:**

Interviewer: And how about in terms of changes in students' attitudes and/or behaviors? Are you seeing anything there?

Teacher: I heard a lot when they had it in my room, where they would all of a sudden blurt out, that that's not something that you need. . . . They got into a lot of the talk like that. And they talked about saving money. They were saving for something specific. So that was much more on the frontline with them. They talked a lot about it.

When I talk individually with parents, I sense that they are more hopeful that their children will attend college, and the I Can Save Program offers them a viable way to save to achieve this goal. These hard-working parents want to envision their children in better lives, and college offers them the key to this brighter future.

Other benefits may be reflected in our rising achievement scores for all students, and our high attendance rate. While it may be too early to say anything definitive, we are currently engaged in research and will have a better idea in a couple of years. As a school principal, I see the I Can Save Program as an important investment in the future of our children.

The community is excited about this program, and surrounding schools that are not involved in it want to be a part of I Can Save. Teachers and principals in other school districts in St. Louis have asked for more information about this program. While the results are not yet known, the potential for and interest in this program is positive.

Testimony of J. Mark Iwry  
Senior Adviser, Retirement Security Project  
Nonresident Senior Fellow, The Brookings Institution<sup>1</sup>

Before the Subcommittee on Social Security and Family Policy  
of the  
Committee on Finance  
United States Senate

Using the Private Pension System and IRAs  
to Promote Asset Accumulation for Lower-Income Families

April 28, 2005

Chairman Santorum, Ranking Member Conrad, and Members of the Subcommittee, I appreciate the opportunity to appear before you to discuss the issues involved in building assets for low-income families.<sup>2</sup>

I am appearing today on behalf of The Retirement Security Project. The Retirement Security Project is supported by The Pew Charitable Trusts in

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<sup>1</sup> The witness is Senior Adviser to the Retirement Security Project, Nonresident Senior Fellow of the Brookings Institution, Research Professor in Public Policy at Georgetown University, and a practicing lawyer. He served as the Benefits Tax Counsel of the U.S. Department of the Treasury from 1995 through 2001. Further biographical information, as requested by the Subcommittee, is attached.

The views expressed in this testimony should not be attributed to the staff, officers, or trustees of the Brookings Institution, to Georgetown University, to The Pew Charitable Trusts, or to any other institution or organization.

<sup>2</sup> This testimony draws on joint work with William Gale, Peter Orszag and Robert Greenstein. In addition, because I have been asked to address some of the same issues in previous congressional testimony before other committees of the Senate and the House of Representatives, this written statement draws heavily on previous written statements that I have submitted as testimony before other committees as well as on articles or policy briefs that I have authored or co-authored on these topics (including substantial passages drawn verbatim from the previous testimony and articles or policy briefs). The previous testimony and writings include Testimony of J. Mark Iwry Before the Special Committee on Aging, United States Senate (April 12, 2005); Testimony of J. Mark Iwry Before the Committee on Education and the Workforce, Subcommittee on Employer-Employee Relations, U.S. House of Representatives (April 29, 2004); Testimony of J. Mark Iwry Before the Committee on Education and the Workforce, Subcommittee on Employer-Employee Relations, U.S. House of Representatives (June 4, 2003); William G. Gale, J. Mark Iwry and Peter R. Orszag, "The Saver's Credit" (Retirement Security Project, February 2005); William G. Gale, J. Mark Iwry and Peter R. Orszag, "The Automatic 401(k): A Simple Way to Strengthen Retirement Savings" (Retirement Security Project, March 2005); William G. Gale, J. Mark Iwry, "Automatic Investment: Improving 401(k) Portfolio Investment Choices" (Retirement Security Project, April 2005).

The three listed policy briefs were written under the auspices of the Retirement Security Project and are available at [www.retirementsecurityproject.org](http://www.retirementsecurityproject.org).

partnership with Georgetown University's Public Policy Institute and the Brookings Institution.

The goal of The Retirement Security Project is to work on a nonpartisan basis to make it easier and increase incentives for lower- and middle-income Americans to save for a financially secure retirement. The Project is dedicated to promoting common sense solutions to improve the retirement income prospects of millions of American workers.

Our nation's private pension system and IRAs, in their current form, have serious shortcomings as a platform for asset accumulation for lower-income households. However, as described in this testimony, there are a number of practical and highly promising reforms that could rapidly turn this situation around and dramatically increase opportunities for lower- and moderate-income households to build assets, savings, and retirement security.

This written statement, which focuses on asset building in the context of the current retirement savings system, is organized as follows: Section I (pages 3-11, below) briefly assesses the effectiveness of the nation's private pension system in raising national savings and accumulating assets for lower-income families, and identifies several general aspects of the system that need improvement to more effectively achieve these goals. Sections II through VI outline four strategies for reform that would make the private pension system and IRAs more effective in building assets for lower-income families:

- **Expand the Saver's Credit for 401(k) and IRA Contributions by Lower- and Moderate- Income Savers** (Section II, pages 13-21, below)
- **Facilitate and Increase 401(k) Asset Accumulation Through Automatic Enrollment, Automatic Escalation and Automatic Investment** (Sections III and IV, pages 21-35, below)
- **Encourage Contributions to IRAs By Allowing Taxpayers to Elect Direct Deposit of a Portion of Their Tax Refunds** (Section V, pages 35-41, below)
- **Exempt Retirement Savings When Applying Asset Tests in Public Means-Tested Benefit Programs** (Section VI, pages 41-42, below)

Other witnesses will be testifying before the Subcommittee regarding individual development accounts, proposed "KIDS accounts"<sup>3</sup>, and the United Kingdom's children's trust account initiative, among other proposals. This testimony does not attempt to be comprehensive, and therefore does not address these or various other asset accumulation strategies or proposals (some of which may be beyond the scope of this hearing), such as "universal savings accounts," the Administration's "lifetime savings account" and "retirement savings account" proposals, the role of employer-sponsored defined benefit plans, or proposals relating to Social Security.

### **I. Where Does Our Current Private Pension System Fall Short?**

#### **A. Taxpayers' Current Investment in Private Pensions**

For decades, the US tax code has provided preferential tax treatment to employer-provided pensions, 401(k) plans, and individual retirement accounts (IRAs) relative to other forms of saving. These tax preferences represent a significant investment by the taxpayers, who effectively are partially subsidizing the private pension system. The Treasury Department has estimated the cost of the tax-favored treatment for pensions and retirement savings – the amount by which the pension tax advantages reduce federal tax revenues – as having a present value in the neighborhood of \$174 billion (for calendar year 2004). This present-value estimate is designed to take into account not only the deferral of tax on current contributions and on earnings on those contributions but also the tax collected when those contributions and earnings are distributed in the future, whether within or beyond the "budget window" period.<sup>4</sup>

Of this total, nearly half is attributable to section 401(k) plans (as opposed to other employer and self-employed plans and IRAs).<sup>5</sup> Because large portions of the employer-sponsored defined benefit plan universe are in each of the private sector and the public (mainly state and local government) sector, a significant

<sup>3</sup> Chairman Santorum on April 21, 2005 introduced S. 868, the "America Saving for Personal Investment, Retirement, and Education Act of 2005" (also known as the "ASPIRE Act of 2005"), a proposal to establish "KIDS accounts", co-sponsored by Senators Corzine, Schumer, and DeMint. A companion bill, H. 1767, was introduced in the House on the same date by Representative Harold E. Ford, Jr., co-sponsored by Representatives Phil English and Patrick Kennedy. Substantially similar legislation was introduced in the 108<sup>th</sup> Congress, 2d Session.

<sup>4</sup> Budget of the U.S. Government, Fiscal Year 2006, Analytical Perspectives ("FY 2006 Analytical Perspectives"), table 19-4 (## 19-22). The Treasury's estimate of the annual value of the retirement savings tax expenditures on a cash basis for FY 2005 is \$116 billion (table 19-1)(## 121-125, 130), and the roughly corresponding cash basis estimate prepared by the Joint Committee on Taxation for FY 2005 is \$125 billion. See Joint Committee on Taxation, "Estimates of Federal Tax Expenditures for Fiscal Years 2005-2009" (JCS-1-05, January 12, 2005), Table 1, pages 36, 38-39. The cash basis estimates take into account incoming revenues for the current year associated with prior-year contributions and accrued earnings (as opposed to future revenues associated with current-year contributions).

<sup>5</sup> FY 2006 Analytical Perspectives. The budget documents also contain other tax expenditure estimates that are based on alternative methods.

percentage of the tax expenditure for non401(k) pensions is attributable to the plans in each of those sectors.

#### B. Effectiveness of Pension Tax Subsidies in Promoting Security and Savings

The effectiveness of this system of subsidies remains a subject of controversy. One can readily conclude, in assessing our nation's private pension system, that the glass is half full or that the glass is half empty.

The system has been quite successful in important respects. It has provided meaningful retirement benefits to millions of workers and their families, and has amassed a pool of investment capital exceeding \$11 trillion (including IRAs and retirement plans maintained by Federal, State, and local governments) that has been instrumental in promoting the growth of our economy<sup>6</sup>. Some two thirds of families will retire with at least some private pension benefits, and at any given time, employer-sponsored retirement plans cover about half of the U.S. work force.<sup>7</sup>

However, the benefits earned by many are quite small relative to retirement security needs. Despite the accumulation of vast amounts of wealth in pension accounts, concerns persist about the ability of the pension system to raise private and national saving, and in particular to improve saving among those households most in danger of inadequately preparing for retirement. Those moderate- and lower-income households are disproportionately represented among the roughly 75 million workers and spouses who are excluded from the system. They are far less likely to be covered by a retirement plan.<sup>8</sup> When they are covered, they are likely to have disproportionately small benefits and, when eligible to contribute to a 401(k) plan, are less likely to do so. (Fewer still contribute to IRAs.)

Accordingly, the distribution of benefits – retirement benefits and associated tax benefits – among households by income is tilted upwards.

<sup>6</sup> Board of Governors, United States Federal Reserve System, Statistical Release Z.1, Flow of Funds Accounts of the United States (March 10, 2005), tables L.119, 120, 121, 225. This rough figure is as of the end of 2004. It is unclear how much of these accumulated assets in retirement plans represent net national saving (private saving plus public saving), because this dollar amount has not been adjusted to reflect the public dissaving attributable to government tax expenditures for pensions or to reflect any household debt or reduction in other private saving attributable to these balances. See Eric Engen and William Gale, "The Effects of 401(k) Plans on Household Wealth: Differences Across Earnings Groups." NBER Working Paper No. 8032 (Cambridge, Mass.: National Bureau of Economic Research, December 2000).

<sup>7</sup> Testimony of J. Mark Iwry, Benefits Tax Counsel, Office of Tax Policy, Department of the Treasury, before the Committee on Health, Education, Labor and Pensions, United States Senate (Sept. 21, 1999) ("Sept. 21, 1999 Testimony").

<sup>8</sup> It has been estimated that over 80% of individuals with earnings over \$50,000 a year are covered by an employer retirement plan, while fewer than 40% of individuals with incomes under \$25,000 a year are covered by an employer retirement plan. See Testimony of Donald C. Lubick, Assistant Secretary (Tax Policy), U.S. Department of the Treasury, before the House Committee on Ways and Means, Subcommittee on Oversight, page 6 (March 23, 1999) ("Treasury 1999 Testimony").

Yet providing retirement security for moderate- and lower-income workers – in other words, for those who need it most -- should be the first policy priority of our tax-qualified pension system. This is the case not only because public tax dollars should be devoted to enhancing retirement security as opposed to retirement affluence – minimizing the risk of poverty or near-poverty in old age, reducing retirees' need for public assistance and potentially reducing pressure on the nation's Social Security system.<sup>9</sup> It is also because targeting saving incentives to ordinary workers tends to be a more effective means of promoting the other major policy goal of our pension system: increasing national saving.

Pensions can be viewed as increasing national saving to the extent that the saving attributable to pensions (net of any associated borrowing or other reductions in other private-sector saving) exceeds the public dissaving attributable to the tax preferences for pensions. Accordingly, the issue can be framed in terms of the efficiency of tax expenditures in promoting saving: how much "bang for the buck" do particular incentives provide in terms of added saving? To what extent do particular types of tax preferences give taxpayers good money's worth on the tax dollars they have invested in those preferences?

Tax expenditures that are of use mainly to the affluent tend to be inefficient to the extent that they induce higher-income people simply to shift their other savings to tax-favored accounts, direct to tax-favored accounts current income that would otherwise be saved in nontax-favored vehicles, or offset additional contributions with increased borrowing. To the extent such shifting occurs, the net result is that the pensions serve to shelter income from tax, rather than as a vehicle to increase saving, and the loss of government revenue does not correspond to an increase in private saving.

In contrast, contributions and saving incentives targeted to moderate- and lower-income workers – households likely to have little if any other savings or assets that could be shifted into tax-preferred accounts -- tend to increase net long-term saving rather than merely shifting assets.<sup>10</sup> This enhances retirement security for those most in need and advances the goals of our tax-favored pension system in a responsible, cost-effective manner.

These goals have been articulated by the Department of the Treasury in congressional testimony as follows:

"First, tax preferences should create incentives for expanded coverage and new saving, rather than merely encouraging individuals to reduce taxable savings or increase borrowing to finance saving in tax-preferred

<sup>9</sup> Treasury 1999 Testimony, page 3.

<sup>10</sup> See Engen and Gale (2000) and Daniel Benjamin, "Does 401(k) Eligibility Increase Saving? Evidence from Propensity Score Subclassification," *Journal of Public Economics* 87, no. 5-6 (2003): 1259-90.

form. Targeting incentives at getting benefits to moderate- and lower-income people is likely to be more effective at generating new saving....

“Second, any new incentive should be progressive, i.e., it should be targeted toward helping the millions of hardworking moderate- and lower-income Americans for whom saving is most difficult and for whom pension coverage is currently most lacking. Incentives that are targeted toward helping moderate- and lower-income people are consistent with the intent of the pension tax preference and serve the goal of fundamental fairness in the allocation of public funds. The aim of national policy in this area should not be the simple pursuit of more plans, without regard to the resulting distribution of pension and tax benefits and their contribution to retirement security....

“Third, pension tax policy must take into account the quality of coverage: Which employees benefit and to what extent? Will retirement benefits actually be delivered to all eligible workers, whether or not they individually choose to save by reducing their take-home pay?”<sup>11</sup>

#### C. Why the System Does Not Do More to Benefit Lower-Income Households

There are a number of reasons why the system is not doing more to address the needs of lower- and moderate-income workers.

First, tax incentives – the “juice” in our private pension system – have traditionally been structured in such a way that they prove to be of little if any value to lower-income households. This is because these tax incentives, though intended to encourage participation in employer-based retirement plans and IRAs, consist primarily of exclusions and deductions from federal income tax. Pension contributions and earnings on those contributions are treated more favorably for tax purposes than other compensation: they are excludible (or deductible) from income until distributed from the plan, which typically occurs years if not decades after the contribution is made. However, the value of this favorable tax treatment depends on the taxpayer’s marginal tax rate: the subsidies are worth more to households with higher marginal tax rates, and less to households with lower marginal rates.

Workers who pay payroll taxes but no income taxes or income taxes at a low marginal rate derive little or no value from an exclusion from income (or tax deduction) for contributions to a plan, earnings on those contributions, or distributions of the contributions and earnings. Roughly three out of four American households are in the 15 percent, 10 percent or zero income tax brackets. Thus, for example, a taxpaying couple with \$6,000 in deductible IRA

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<sup>11</sup> Treasury 1999 Testimony, pages 3-4.

contributions saves \$2,100 in tax if they are in the 35 percent marginal tax bracket, but only \$600 if they are in the 10 percent bracket.<sup>12</sup>

The income tax incentive approach, as currently structured, thus reflects a mismatch between subsidy and need. The tax preferences tend to encourage saving least for those who most need to save more to provide for basic needs in retirement, and most for those who need to increase their saving least (who are least likely to need additional saving to achieve an adequate living standard in retirement).<sup>13</sup> As discussed in the next section of this testimony, below, tax credits – even nonrefundable tax credits such as the saver's credit for 401(k) and IRA contributions under section 25B of the Internal Revenue Code -- would help address this problem.

Second, and more obviously, after spending a higher proportion of their income on immediate necessities such as food and shelter, lower-income families often have little if anything left over to save.

Third, lower-income families have less access to financial markets and credit and tend to have little if any experience with tax-advantaged financial products, investing and private financial institutions.

Fourth, the qualified plan rules permit many moderate- and lower-income workers to be excluded from coverage. The rules provide considerable leeway with respect to proportional coverage of moderate- and lower-income employees, and do not require any coverage of millions of workers whose work arrangements are part-time, based on independent contractor status, contingent, or otherwise irregular.

Reflecting these structural deficiencies, the nation's pension system betrays several serious shortcomings. First, only half of workers are covered by an employer-based pension plan in any given year, and participation rates in IRAs are substantially lower. Second, even workers who participate in tax-preferred retirement saving plans rarely make the maximum allowable contributions. Only 5 percent of 401(k) participants make the maximum contribution allowed by law, and only 5 percent of those eligible for IRAs make the maximum allowable contribution.<sup>14</sup> Third, despite the shift from defined benefit to defined contribution

<sup>12</sup> Some of this difference may be recouped when the contributions are withdrawn and taxed, if families who are in lower tax brackets during their working years are also in lower tax brackets in retirement.

<sup>13</sup> See, for example, Eric M. Engen, William G. Gale, and Cori E. Uccello, "The Adequacy of Household Saving," *Brookings Papers on Economic Activity*, no. 2 (1999): pp. 65-165.

<sup>14</sup> For example, an unpublished study by a Treasury economist found that only 4 percent of taxpayers eligible for conventional IRAs in 1995 made the maximum allowable \$2,000 contribution. Robert Carroll, "IRAs and the Tax Reform Act of 1997," Office of Tax Analysis, Department of the Treasury, January 2000. For IRA contributors at the limit, see also Craig Copeland, "IRA Assets and Characteristics of IRA Owners," *EBRI Notes*, December 2002. Other studies have found only a small percentage of 401(k) contributors to be constrained by the statutory dollar maximum. For example, the General Accounting Office (now the Government Accountability Office) found that an increase in the statutory contribution limit for 401(k)s would directly benefit fewer than 3 percent of participants (General Accounting Office, "Private Pensions:

plans, many households approach retirement with meager defined contribution balances.<sup>15</sup> The median 401(k) and other defined contribution (including IRA) balance among all households ages 55 to 59 was only \$10,000 in 2001. Excluding the 36 percent of households who had no IRA or defined contribution plan account, the median balance for this age group was still only \$50,000.

#### D. Targeting Incentives More Effectively to Promote Savings and Security

Given this reality, focusing incentives for retirement saving on lower- and moderate-income households makes sense for two reasons. First, such incentives are more likely to bolster long-term economic security and reduce elderly poverty, since higher-income households already tend to have substantial assets and to be better prepared to provide for their needs in retirement than other households. For some low-income families, income may be so modest that it is impossible to save after paying for necessities. Yet 60 percent of households at or below the poverty line indicate that they save at least something.<sup>16</sup> Experience with programs (including individual development account (IDA) programs) that provide tax incentives and matching funds to encourage saving among low-income families suggests that they will participate in savings programs if presented with incentives to do so.<sup>17</sup> The evidence on the efficacy of automatic enrollment also suggests that low-income workers will save if presented with incentives and a sound structure within which to do so.

The second reason for focusing incentives on lower- and middle-income households is the potential impact on national saving. National saving is the sum of public saving and private saving. All else equal, every dollar of forgone revenue reduces public saving by one dollar. Consequently, for national saving to increase, private saving must increase by more than one dollar in response to each dollar in lost revenue. To raise private saving, the incentives must not simply cause individuals to shift assets into the tax-preferred pensions but instead must generate *additional* contributions.

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Issues of Coverage and Increasing Contribution Limits for Defined Contribution Plans," GAO-01-846, September 2001). Data from the Congressional Budget Office suggest that only 6 percent of all 401(k) participants made the maximum contribution allowed by law in 1997. (Calculations based on Congressional Budget Office, "Utilization of Tax Incentives for Retirement Saving," August 2003, table 27.) See also David Jouffain and David Richardson, "Who Takes Advantage of Tax-Deferred Saving Programs? Evidence from Federal Income Tax Data," Office of Tax Analysis, U.S. Department of the Treasury, 2001.

<sup>15</sup>For a discussion of this shift from defined benefit to defined contribution plans, see Ivry, Testimony before the House Committee on Education and the Workforce, Subcommittee on Employer-Employee Relations, June 4, 2003.

<sup>16</sup>Jeanne M. Hogarth and Chris E. Anguelov, "Can the Poor Save?" *Proceedings of Association for Financial Counseling and Planning Education* (2001).

<sup>17</sup>Michael Sherraden, "Asset Building Policy and Programs for the Poor," in *Assets for the Poor: The Benefits of Spreading Asset Ownership*, edited by Thomas Shapiro and Edward Wolff (New York: Russell Sage Foundation, 2001). Also, homeownership rates rose in a demonstration program that gave strong incentives for low-income families to purchase housing. See Gregory Mills and others, "Evaluation of the American Dream Demonstration: Final Evaluation Report" (Cambridge, Mass.: Abt Associates, August 2004).

Since those with modest or low incomes are less likely to have other assets to shift into tax-preferred pensions, focusing pension tax preferences on moderate- and lower-income workers increases the likelihood that lost tax revenue will reflect additional contributions rather than shifts in assets.<sup>18</sup> The empirical evidence suggests that tax-preferred retirement saving undertaken by lower- and middle-income workers is much more likely to represent new saving than tax-preferred retirement saving undertaken by higher-income workers.<sup>19</sup>

Moderate- and lower-income households save very little, but not because they lack the option to save: most workers have accounts available to them in which they could save money on a tax-preferred basis for retirement, and any household lacking such an option could always contribute to an IRA. For those who have at least some income available after paying for necessities, the reasons they do not save lie elsewhere and are essentially twofold.

The first problem, as discussed above, is the upward-tilted structure of the current deduction-based pension tax incentives. The second problem has to do with the shift from pensions (such as defined benefit or money purchase pension plans or employer-funded profit-sharing plans) to retirement savings arrangements.

#### E. Dealing With the Shift from Pensions to 401(k)s

Over the past quarter century, private pension plans in the United States have trended toward a do-it-yourself approach, in which covered workers bear more investment risk and make more of their own decisions about their retirement savings. In the early 1980s, most Americans who had private retirement plan coverage obtained it chiefly from employer-sponsored, defined benefit pension plans, and to a lesser extent from defined contribution plans such as employer-funded profit-sharing and money purchase plans. Since then, pension coverage has shifted away from these programs and toward new types of defined contribution plans, especially 401(k)s. In 1981 nearly 60 percent of workers with pension coverage had only a defined benefit plan, while just under 20 percent had only a 401(k) or other defined contribution plan. By 2001, however, the share having a defined benefit plan as their only plan had dropped to slightly over 10

<sup>18</sup>Economists continue to debate the impact on private saving from existing pension incentives. Most agree, however, that, whatever the overall effect, focusing incentives on those with fewer opportunities to shift assets from taxable to nontaxable forms is likely to produce a larger increase in private saving for any given reduction in government revenue.

<sup>19</sup>See, for example, Eric M. Engen and William G. Gale, "The Effects of 401(k) Plans on Household Wealth: Differences Across Earnings Groups," Working Paper 8032 (Cambridge, Mass.: National Bureau of Economic Research, December 2000), and Daniel Benjamin, "Does 401(k) Eligibility Increase Saving? Evidence from Propensity Score Subclassification," *Journal of Public Economics* 87, no. 5-6 (2003): 1259-90.

percent, while the share having only a 401(k) or other defined contribution plan had risen to nearly 60 percent.

Conventional analyses tend to describe this solely as a trend away from defined benefit plans and toward defined contribution plans. Such a characterization tends to focus attention on the increased portability of pensions from one job to another and the shifting of investment risk from employer to employee. But perhaps an even more fundamental development is the extent to which the accumulation of retirement benefits under the plan has come to depend on active and informed worker self-management and initiative. Traditional defined benefit and profit-sharing plans require the covered workers to make almost no important financial choices for themselves before retirement.<sup>20</sup> The firm enrolls all eligible workers within a defined classification, makes contributions on their behalf, and decides how to invest those contributions (or retains professional investment managers to do so). A worker's only real choices are when and in what form to collect benefits. In 401(k)-type plans, in contrast, the burden of all these decisions rests with the employee.

When 401(k) plans began their rapid spread in the early 1980s, they were viewed mainly as supplements to these traditional employer-funded plans. Since 401(k) participants were presumed to have their basic retirement income security needs covered by a traditional employer-funded plan and Social Security, they were given substantial discretion over their 401(k) choices, including whether to participate, how much to contribute, how to invest, and when and in what form to withdraw the funds.

Over the past 25 years, however, the pension landscape has changed dramatically. The 401(k) plan has come to play a far more central and critical role in the private pension system than was envisioned 25 years ago. Many workers covered by an employer plan now have a 401(k) as their primary or only plan. Yet 401(k)s have made few changes in their basic structure, and still operate in much the same way as in the early 1980s. Workers still must, for the most part, decide for themselves whether and how much to contribute, how to invest, and how and when to withdraw the funds. Imposing on workers the responsibility to make these choices may have been relatively harmless when 401(k)s were smaller, supplemental plans with limited coverage. The risk of workers making poor enrollment, investment and distribution choices looms much larger as 401(k)s have become the primary pension vehicle.

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<sup>20</sup> In this sense, traditional private pensions may be characterized less by their defined benefit structure --in fact, many were defined contribution profit-sharing and money purchase plans--than by the fact that employers took the initiative to fund and manage the plans, bearing most of the risk and making most of the decisions for their employees. For a discussion of these developments, including the shift from defined benefit to defined contribution plans, see J. Mark Iwry, "Defined Benefit Pension Plans," Testimony before the House Committee on Education and the Workforce, Subcommittee on Employer-Employee Relations, June 4, 2003.

The trend away from the traditional, employer-managed plans and toward savings arrangements directed and managed largely by the employees themselves, such as the 401(k), is in many ways a good thing. Workers enjoy more freedom of choice and more control over their own retirement planning. Disciplined, sophisticated savers can benefit enormously from participating in a 401(k). By persistently contributing a sizable share of their earnings to a 401(k), and investing in a well-diversified portfolio of assets, employees can generate a substantial retirement income without bearing unnecessary risk. Considerable numbers of workers have thrived under this more individualized approach, amassing sizable balances in 401(k)s and similar plans, which will assure them a comfortable and relatively secure retirement income.

For many if not most workers, however, the 401(k) revolution has fallen short of its potential.<sup>21</sup> Most workers are not covered by a 401(k) plan at all. Among those covered, many do not participate. Among those who participate, many contribute little to their accounts, and others take the money out before reaching retirement age. As a result, most households have few 401(k) assets. As noted earlier, 36 percent of households aged 55 to 59 had neither a 401(k) (or other defined contribution plan) nor an IRA in 2001, and, among those who did, the median balance in such plans was only about \$50,000.

Work, family, and other more immediate demands often distract workers from the need to save and invest for the future. Those who do take the time to consider their choices find the decisions quite complex: individual financial planning is seldom a simple task. For many workers, the result is poor decision making at each stage of the retirement savings process, putting both the level and the security of their retirement income at risk. Even worse, in the face of such difficult choices, many people simply procrastinate and thereby avoid dealing with the issues altogether, which dramatically raises the likelihood that they will not save enough for retirement. Thus, this increasingly 401(k)-dominated system—both the process it has evolved into and the results it is producing—leaves much room for improvement. The complications involved in investing in a 401(k) place substantial burdens on workers to understand their financial choices and assume a certain degree of confidence in making such choices. As a result, many workers shy away from these burdensome decisions and simply do not choose, while those who do choose often make poor choices. Section III of this testimony outlines an approach for making saving easier.

The next three sections of this testimony outline approaches designed to address each of these major shortcomings: the upward-tilted structure of our tax incentives (Section II, relating to expansion of the Saver's Credit) and the

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<sup>21</sup> For an excellent discussion of these shortcomings, see Alicia H. Munnell and Annika Sundén, *Coming Up Short: The Challenge of 401(k) Plans* (Brookings, 2004).

practical impediments to saving in a 401(k)-dominated system (Sections III and IV, relating to automatic enrollment and automatic investment).

#### F. Employer-Sponsored Retirement Plans and IRAs

The saving and asset accumulation strategies outlined in this testimony below build on our existing system of employer-sponsored plans and IRAs. The automatic enrollment, escalation and investment in 401(k)s relates to employer plans; the ability to split refunds for direct deposit relates to IRAs; and the Saver's Credit expansion as well as the relief from asset tests that count retirement savings balances relate to both employer plans and IRAs.

Employer plans and individual accounts such as IRAs each play an important role in building assets for lower-income families. IRAs provide a tax-favored saving opportunity for those who are not covered by an employer plan and for lower-income households that may wish to supplement their employer plan coverage with their own stand-alone accounts. Employer plans, for their part, play a particularly important role for moderate- and lower-income families.

Employer plans have attributes that tend to facilitate saving for lower-income households and that account for the fact that, on average, two out of three eligible employees participate in 401(k) plans while the rate of participation in IRAs is less than one out of ten. These advantages of employer plans include

- The possibility of automatic employer contributions or other automatic coverage (as under profit sharing plans or under 401(k) plans that use automatic enrollment);
- Cross-subsidies enforced through the nondiscrimination standards that use high-income individuals' eagerness to save on a tax-preferred basis to encourage more saving by reluctant savers who are typically in lower tax brackets;
- The possibility that such encouragement will take the form of employer matching contributions geared to employee contributions;
- The availability of professional investment management;
- Economies of scale and risk pooling that can reduce the cost of investment management, life annuities, and general administration;
- Employer-provided education regarding saving and investment; and
- Potential peer group reinforcement for saving.

It is important to bear in mind that policy changes intended to make individual

accounts more attractive can have indirect effects on employer plans, and some of those effects can be devastating. For example, individual accounts with tax-favored treatment can be designed to be more attractive to high-income individuals than employer plans (potentially because of high contribution limits, high income eligibility limits, highly advantageous tax treatment, liquidity, and cost-savings resulting from the absence of nondiscrimination standards and other worker protections). The availability of individual accounts that present a more favorable package of costs and benefits to business owners and decisionmakers than employer plans would tend to reduce the decisionmakers' interest in sponsoring plans for their employees. The resulting substitution of individual accounts for employer plans would deprive lower- and moderate-income families of the advantages of employer plan coverage as described above.

Similarly, if individual accounts are made more attractive to moderate- and lower-income employees than employer-sponsored 401(k) plans, 401(k) plan sponsors will likely be unable to achieve favorable or acceptable nondiscrimination results. This in turn will reduce the advantages of the plan to the higher earners who generally make the decision whether to sponsor the plan. In order to promote saving and asset building for lower-income families, policymakers must be sensitive to these potential interactions.

## **II. Expanding the Saver's Credit: A Solution to the "Upside Down" Structure of Tax Incentives**

### **A. In General**

In 2001, Congress took a first step toward addressing the first structural problem described above -- the upward-tilted structure of the current deduction-based pension tax incentives -- by enacting the Saver's Credit. The Saver's Credit in effect provides a government matching contribution, in the form of a nonrefundable tax credit, for voluntary individual contributions to 401(k) plans, IRAs, and similar retirement savings arrangements. Like traditional pension subsidies, the Saver's Credit currently provides no benefit for households that owe no federal income tax. However, for households that owe income tax, the effective match rate in the Saver's Credit is higher for those with lower income, the opposite of the incentive structure created by traditional pension tax preferences.

The Saver's Credit is the first and so far only major federal legislation directly targeted toward promoting tax-qualified retirement saving for moderate- and lower-income workers.<sup>22</sup> Although this is a historic accomplishment, the credit as

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<sup>22</sup>Retirement saving for these workers is promoted -- or designed to be promoted -- indirectly by nondiscrimination and certain other provisions of the Internal Revenue Code of 1986 (IRC) and the Employee Retirement Income Security Act of 1974 (ERISA). Those provisions, which are subject to extensive exceptions, are intended to impose some constraint on the degree to which tax-favored benefits

enacted suffers from key design problems, not the least of which is the credit's scheduled expiration at the end of 2006.

#### B. Basic Design and Evolution

The Saver's Credit was enacted as part of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA).<sup>23</sup> In principle, the credit can be claimed by moderate- or lower-income households who make voluntary retirement saving contributions to 401(k) plans, other employer-sponsored plans (including SIMPLE plans), or IRAs. In practice, however, the nonrefundability of the credit means it offers no incentive to save to the millions of low- and moderate-income households with no income tax liability.

The design of the Saver's Credit reflects two key objectives. First, the credit represents an initial step toward addressing the "upside-down" structure of other tax incentives for saving—leveling the playing field for moderate- and lower-income workers by, in effect, matching contributions at higher rates for savers with lower incomes. Second, the credit was designed to coordinate with and support the employer-based pension system.

#### C. Higher Matching Rates for Lower-Income Savers

The matching rates under the Saver's Credit reflect a progressive structure — that is, the rate of government contributions per dollar of private contributions falls as household income rises. This pattern stands in stark contrast to the way tax deductions and the rest of the pension system subsidize saving. The Saver's Credit is currently a small exception to this general pattern: as noted, the Treasury Department estimates that the tax expenditures associated with retirement saving preferences in 2005 will total roughly \$150 billion, of which only \$1 billion is attributable to the Saver's Credit.<sup>24</sup>

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accrue to a limited number of owners and executives rather than the large majority of workers. The IRC and ERISA also protect and regulate the accumulation and preservation of retirement benefits. For additional discussion of these issues by the Treasury Department, see Donald C. Lubick, Assistant Secretary (Tax Policy), U.S. Department of the Treasury, Testimony before the House Committee on Ways and Means, Subcommittee on Oversight, March 23, 1999.

<sup>23</sup>Section 25B of the IRC of 1986 was added by section 618 of EGTRRA, Public Law 107-16, 115 Stat. 38. See also IRS Announcement 2001-106, 2001-44 I.R.B. (October 29, 2001), and IRS News Release IR 2001-107, 2001-44 I.R.B. (November 7, 2001). The credit was officially titled "Elective Deferrals and IRA Contributions By Certain Individuals." Although now generally referred to as the "Saver's Credit," that term actually appears nowhere in the law. "Saver's credit" was first used in IRS/Treasury administrative guidance at the suggestion of the witness in mid-2001 with a view to facilitating the "public marketing" of the provision, as discussed below. See IRS Announcement 2001-106, 2001-44 I.R.B. (October 29, 2001); IRS News Release IR 2001-107, 2001-44 I.R.B. (November 7, 2001).

<sup>24</sup>Office of Management and Budget, *Fiscal Year 2005 Analytical Perspectives*, table 18-2.

The Saver's Credit applies to contributions of up to \$2,000 per year per individual.<sup>25</sup> As table 1 shows, the credit rate is 50 percent for married taxpayers filing jointly with adjusted gross income (AGI) up to \$30,000, 20 percent for joint filers with AGI between \$30,001 and \$32,500, and 10 percent for joint filers with AGI between \$32,501 and \$50,000. The same credit rates apply for other filing statuses, but at lower income levels: the AGI thresholds are 50 percent lower for single filers and 25 percent lower for heads of households.<sup>26</sup> Of course, the figures in table 1 assume that the couple has sufficient income tax liability to benefit from the nonrefundable income tax credit shown.

The credit's effect is to correct the inherent bias of tax deductions or exclusions in favor of high-marginal-rate taxpayers. A \$100 contribution to a 401(k) by a taxpayer in the 35 percent marginal federal income tax bracket generates a \$35 exclusion from income, resulting in a \$65 after-tax cost to the taxpayer. In contrast, without the Saver's Credit, a taxpayer in the 15 percent marginal bracket making the same \$100 contribution to a 401(k) gets only a \$15 exclusion from income, resulting in an \$85 after-tax cost. The tax deduction is thus worth more to the higher-income household.<sup>27</sup> However, if the lower-income taxpayer qualifies for a 20 percent Saver's Credit, the net after-tax cost is \$65 (\$100 minus the \$15 effect of exclusion minus the \$20 Saver's Credit). Thus, the Saver's Credit works to level the playing field by increasing the tax advantage of saving for moderate- and lower-income households.

The credit represents an implicit government matching contribution for eligible retirement savings contributions. The implicit matching rate generated by the credit, though, is significantly higher than the credit rate itself. The 50 percent *credit rate* for gross contributions, for example, is equivalent to having the government *match* after-tax contributions on a 100 percent basis. Consider a couple earning \$30,000 who contribute \$2,000 to a 401(k) plan or IRA. The

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<sup>25</sup>Both spouses in a married couple may receive the credit. For example, if each spouse contributes \$2,000 to his or her IRA, and they file jointly with adjusted gross income not exceeding \$30,000, the couple will receive a nonrefundable tax credit of \$2,000 (\$1,000 each) if they have sufficient federal income tax liability to use the credit. As discussed later, however, because of the nonrefundable nature of the credit, very few taxpayers actually qualify for the 50 percent match.

<sup>26</sup>To prevent "churning" of contributions to generate credits, the level of contributions eligible for the credit is reduced by the amount of distributions from any retirement saving plan or IRA by the participant or the participant's spouse during the year for which the credit is claimed, the two preceding years, or the portion of the following year that precedes the tax return due date.

<sup>27</sup>As discussed in note 2, the entire subsidy associated with saving incentives depends not only on the tax rate at which the contribution is deducted, but also on the tax rate that applies to withdrawals, the length of time the funds are held in the account, the tax rate that would have applied to taxable funds while the funds are held in the tax-preferred account, and the rate of interest. Controlling for the latter factors, taxpayers who can deduct the contribution at a higher rate will generate larger tax savings.

Saver's Credit reduces that couple's federal income tax liability by \$1,000 (50 percent of \$2,000). The net result is a \$2,000 account balance that cost the couple only \$1,000 after taxes (the \$2,000 contribution minus the \$1,000 tax credit). This is the same result that would occur if the net after-tax contribution of \$1,000 were matched at a 100 percent rate: the couple and the government each effectively contribute \$1,000 to the account. Similarly, the 20 percent and 10 percent credit rates are equivalent to a 25 percent and an 11 percent match, respectively (table 1).

#### D. Enhancement of Employer-Sponsored Plans

The Saver's Credit was very deliberately designed to support, rather than undermine, employer pension plans. Employer-sponsored plans encourage participation through employer contributions, nondiscrimination rules designed to require cross-subsidies from eager to reluctant savers, the automatic character of payroll deduction, peer group encouragement, and, often, professional assistance with investments (for example, through employer selection of investment options or provision of investment management). To support these benefits of employer-sponsored plans, the Saver's Credit matches contributions to 401(k) and other plans by moderate- and lower-income employees.<sup>28</sup>

Moreover, the Saver's Credit applies in addition to any employer matching contributions. It can thus raise the return on 401(k) contributions: eligible taxpayers can obtain higher effective matching rates when the Saver's Credit is combined with employer matching contributions to a 401(k). For households who receive a 20 percent Saver's Credit, for example, a 50 percent employer match of the employee's 401(k) contributions implies that the total (employer plus government) effective match rate on after-tax contributions is 87.5 percent. That is, for every \$100 in net contributions the taxpayer puts in, up to the appropriate match limits, the account will generate \$187.50 in value.

In evaluating these high effective matching rates, it is important to emphasize that they apply only to the first \$2,000 of an individual's contributions. Moreover, they apply only to moderate- and lower-income households, who tend to be more reluctant savers than higher-income households because, among other reasons, they tend to have less disposable income after providing for basic necessities. A higher effective matching rate focused on the first dollars of saving may help to "jump start" voluntary contributions by moderate- and lower-income households, many of whom currently do not save at all.

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<sup>28</sup>See J. Mark Iwry, "Expanding the Saver's Credit," Testimony before the House Committee on Education and the Workforce, Subcommittee on Employer-Employee Relations, July 1, 2003, pp. 2-3. In particular, the Saver's Credit applies to both before-tax and after-tax contributions by eligible individuals. In addition, although this is not widely recognized, the credit can be claimed for voluntary employee contributions to an employer-sponsored defined benefit plan, although typically it applies to employee contributions to a defined contribution plan such as a 401(k).

Employee 401(k) contributions that qualify for the Saver's Credit also count toward meeting the employer's 401(k) nondiscrimination tests. Accordingly, to the extent the Saver's Credit encourages increased participation among lower earners, higher earners may also benefit, since their ability to contribute on a tax-favored basis depends on the level of contributions by less highly paid employees.<sup>29</sup>

Recognizing the potential benefits of the Saver's Credit for plan sponsors, the Internal Revenue Service (IRS) has provided employers a model notice to inform employees of the credit.<sup>30</sup> Moreover, some employers that have refrained from adopting a 401(k) plan because of expected difficulty in meeting the nondiscrimination test may be encouraged by the Saver's Credit to set up a plan. The credit not only makes it easier for the employer to pass the nondiscrimination test but also gives eligible employees a greater incentive to demand a 401(k) plan.

The Saver's Credit is also designed to complement employer plans through its interaction with automatic enrollment. As discussed elsewhere in this testimony, automatic enrollment makes it easier for employees to save in a 401(k) (or 403(b) or 457) plan by enrolling employees to participate automatically without being required to complete and sign an election form. Automatic enrollment makes the Saver's Credit available to more employees who otherwise would not receive it because they did not contribute to a 401(k). By the same token, the Saver's Credit may encourage wider use of automatic enrollment because the credit makes automatic enrollment more valuable, and hence more acceptable, to employees who are entitled to the credit (without requiring the employer to make any additional matching contributions).

#### E. Effects of the Saver's Credit

Although it is too soon to obtain a definitive reading of the impact of the Saver's Credit, preliminary estimates and evidence can be useful in identifying some basic themes.

##### 1. Eligibility.

The nonrefundability of the credit substantially reduces the number of people eligible for it. Further, the low match rates for moderate-income households substantially reduce the number of people eligible to receive a significant incentive. Nonrefundability results in a credit that provides no incentives to tens

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<sup>29</sup>See IRS Announcement 2001-106, A-10.

<sup>30</sup>IRS Announcement 2001-106.

of millions of low-income filers who qualify on paper for the 50 percent credit rate, but who have no income tax liability against which to apply the credit.

Table 4 shows that 59 million tax filers in 2005 will have incomes low enough to qualify for the 50 percent credit.<sup>31</sup> Since the credit is nonrefundable, however, only about one-seventh of them actually would benefit from the credit *at all* by contributing to an IRA or 401(k). Furthermore, only 43,000 — or fewer than one out of every 1,000 — of filers who qualify based on income could receive the maximum credit (\$1,000 per person) if they made the maximum contribution. These are the households who have sufficient tax liability to benefit in full from the Saver's Credit but sufficiently low income to qualify for the highest match rate.

For families with somewhat higher incomes, the nonrefundability of the credit poses much less of a problem, since more of these families have positive income tax liabilities. For these families, however, the credit provides only a modest incentive for saving. For example, a married couple earning \$45,000 a year receives only a \$200 tax credit for depositing \$2,000 into a retirement account.

## 2. Usage

IRS data indicate that about 5.3 million tax filers claimed the Saver's Credit in each of 2002 and 2003, the first two years it was in effect. This figure likely understates the true number of qualifying individual savers, however, because a significant portion of these returns are from married couples filing jointly, where each of the spouses may have made a separate qualifying contribution.

## 3. Effects on Private Saving

A full assessment of the effects of the credit on private saving would require more information than is currently available, but some possibilities suggest themselves. A necessary, but not sufficient, condition for the credit to raise private saving is that there be an increase in 401(k) and IRA contributions among the eligible population. In one survey of 401(k) plan sponsors in 2002, representatives of 71 percent of the plans indicated that they believed the Saver's Credit had already increased participation in their 401(k) plan, and 18 percent believed the Saver's Credit had caused a "major increase" in participation.<sup>32</sup> The tax preparer H&R Block has said that it claimed the credit in 2002 on behalf of more than a million clients, who saved an average \$175 on their tax bills. An H&R Block representative has been quoted as saying that many

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<sup>31</sup>The estimates presented in the tables attached to this testimony are generated by my colleagues using the Urban-Brookings Tax Policy Center microsimulation model. For more detail about the model, see [www.taxpolicycenter.org](http://www.taxpolicycenter.org).

<sup>32</sup>See the website of *Plan Sponsor* magazine ([www.plansponsor.com](http://www.plansponsor.com)), July 23, 2002.

of these clients were first-time contributors to a retirement savings plan.<sup>33</sup>

#### F. Options for Expansion

Several significant changes could be made to improve the Saver's Credit: making the credit permanent, making it refundable, expanding it to provide stronger incentives for middle-income households, changing the rate at which it phases out, and indexing it to inflation.

##### 1. Eliminating the 2006 Sunset

In order to reduce the apparent revenue cost, Congress stipulated that the Saver's Credit would sunset at the end of 2006. It would cost between \$1 billion and \$2 billion a year to make the Saver's Credit permanent.

##### 2. Making the Credit Refundable

As noted above, tens of millions of low-income workers are unable to benefit from the credit because it is nonrefundable. To extend the intended saving incentive to most lower-income working families would require making the Saver's Credit refundable.<sup>34</sup>

Some Members of Congress and others have long had reservations about making tax credits refundable. Their concern is often based on a sense that refundability converts a tax credit into a form of "welfare," which is viewed as undesirable, and that refundable credits tend to pose an unacceptable risk of fraud or other noncompliance. It is not clear, however, that the concerns typically raised about refundable credits are applicable to making the Saver's Credit refundable. First, the Saver's Credit is not based on status, but requires positive action: in order to qualify for the Saver's Credit, an individual must make a contribution to a tax-preferred account. Second, the contribution is verified by third-party reporting (by the IRA trustee or plan administrator). In addition, to limit potential abuses, policymakers could require tax filers to have at least \$5,000 in earnings per person in order to claim the refundable credit.

Making the credit refundable would help equalize the tax benefits of saving for higher- and lower-income households, leveling the playing field between income tax payers and workers who pay payroll tax but have no income tax liability. Short of direct income tax refundability, other variations and alternatives are

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<sup>33</sup>B. Tumulty and C. Burnett, "Bush Shuns Retirement Tax Credit," Gannett News Service, March 1, 2004; B. Tumulty, "White House Drops Saver Credit," *Green Bay Press-Gazette*, February 21, 2004.

<sup>34</sup>This change was proposed in a bill introduced by then-House minority leader Richard Gephardt in 2002 (H.R. 4482, 107<sup>th</sup> Cong., 2d Sess.). It was also proposed in a bill introduced by then-Senator John Edwards (D-NC) in 2004 (S. 2303, 108<sup>th</sup> Cong., 2d Sess.).

possible. For example, a bill introduced by Senator Jeff Bingaman (D-NM) in 2002 would in effect make the Saver's Credit refundable, but only by matching qualifying contributions of individuals with no income tax liability who purchase an inflation-indexed U.S. savings bond that they cannot redeem until retirement age.<sup>35</sup> Another possibility would involve providing a tax credit to financial institutions for contributions that they make to their clients' savings accounts, as was proposed in the Treasury Department's February 2000 Retirement Savings Accounts approach.<sup>36</sup> The effect would be similar to that of a refundable tax credit at the individual level. A final possibility would be to deposit the refund directly into the saving account or 401(k), which would raise significant technical issues.<sup>37</sup>

### 3. Expanding Eligibility to More Middle-Income Households

Another set of possible expansions to the Saver's Credit would extend eligibility to additional middle-income households. The credit could be expanded in this way along three dimensions: changes to the credit rate, the income limit, and the manner in which the credit is phased out.

First, the 20 percent and 10 percent credit rates available to eligible joint filers with AGI between \$32,500 and \$50,000 could be raised to 50 percent.<sup>38</sup> This would make the 50 percent credit available to tens of millions of additional households who, for the most part, confront zero, 10 percent, or 15 percent marginal income tax rates and therefore have relatively little to gain from the traditional income tax incentive structure.

Second, the 50 percent credit rate could be expanded to working households

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<sup>35</sup>See S. 2733 (107<sup>th</sup> Cong., 2d Sess.).

<sup>36</sup>See U.S. Department of the Treasury, "General Explanations of the Administration's Fiscal Year 2001 Revenue Proposals" (February 2000), pp. 49-52.

<sup>37</sup>One apparent problem is the lack of easily accessible bank routing numbers for many IRAs and 401(k)s. Other complications include the need for plan sponsors to administer the account balances resulting from such deposits, including the possible need for additional "buckets" in plan data systems to keep separate track of different kinds of funds. This would be a particularly challenging problem if the balance attributable to the Saver's Credit were taxable when withdrawn from a Roth IRA, even after retirement. On the other hand, if the Saver's Credit balance were not taxable when withdrawn from a Roth IRA, it would escape tax permanently. In addition, consideration reportedly has been given to the possibility of treating the government's deposit as satisfying some of the employer's contribution obligations under the nondiscrimination standards, as if the government deposit were an employer contribution. This would in effect shift part of the employers' responsibility for funding retirement benefits for lower-income employees from employers to the government. As noted, the Saver's Credit already helps plans pass the nondiscrimination tests insofar as it induces additional contributions by moderate-income workers.

<sup>38</sup>See Iwry, "Expanding the Saver's Credit," Testimony before the Subcommittee on Employer-Employee Relations of the House Committee on Education and the Workforce, July 1, 2003, p. 4.

with AGI up to \$60,000 or \$70,000 (for joint filers).<sup>39</sup> Some of these households — about 5 percent under the option that increases eligibility for the 50 percent credit to \$70,000 for joint filers — are in the 25 percent marginal tax bracket and therefore already receive a somewhat larger incentive to save under the traditional system of tax subsidies. The vast majority, however, are in the 15 percent bracket, and many of these households have somewhat more disposable or discretionary income remaining after meeting essential short-term needs than do lower-income families in the same tax bracket. These households may thus be more likely than lower-income households to respond to the incentive, and more likely than higher-income households to respond by increasing their net saving rather than merely shifting assets.

Finally, whatever the level of AGI at which eligibility for the 50 percent credit rate stops, the credit rate could be made to phase down ratably from 50 percent to zero over a specified range of AGI, such as \$10,000. Such a smooth phase-down would remove the “cliffs” in the current credit structure, which involves steep declines in the credit rate as income rises, resulting in very high effective marginal tax rates for many savers who use the credit.

Expanding the Saver’s Credit would provide more powerful incentives for moderate- and lower-income households to save for retirement, and would likely reduce economic insecurity and poverty rates among the elderly and raise national saving. Estimates of the revenue cost of these expansions are provided in the attached tables and paper.

### **III. Automatic Enrollment and Escalation of Contributions**

#### **A. Factors That Discourage 401(k) Participation**

As discussed, the shift from employer-funded pensions to 401(k)-type retirement savings plans has meant that, increasingly, it is left up to the employee to choose whether to participate, how much to contribute, which of the investment vehicles offered by the employer to invest in, and when to pull the funds out of the plan and in what form (in a lump sum or a series of payments). Workers are thus confronted with a series of financial decisions, each of which involves risk and a certain degree of financial expertise.

To enroll in a 401(k), an eligible employee usually must complete and sign an enrollment form, designate a level of contribution (typically a percentage of pay to be deducted from the employee’s paycheck), and specify how those contributions will be allocated among an array of investment options. Often the

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<sup>39</sup>Income eligibility levels would be increased to various degrees by the Bingaman and Gephardt bills (S. 2733 and H.R. 4482) and slightly by the Portman-Cardin bill (H.R. 1776, section 401).

employee must choose from among 15, 20 or more different investment funds. An employee who is uncomfortable making all of these decisions may well end up without any plan, because the default arrangement—that which applies when the employee fails to complete, sign, and turn in the form—is nonparticipation.

For those employees who do choose to participate, payroll deductions and associated contributions are made automatically each pay period, typically continuing year after year, unless the employee elects to make a change. Although the contributions continue over time, the traditional 401(k) arrangement does nothing to encourage participants to increase their contribution rates over time, or to diversify or rebalance their portfolios as their account balances grow. In other words, employees in a 401(k) not only must take the initiative to participate, they must further take the initiative to invest wisely and to increase their contribution rates over time.

As a result, about 1 in 4 employees who is eligible to participate in a 401(k) or similar plan fails to participate, and 401(k) balances for most employees are small relative to their needs.

#### B. Automatic Enrollment and Related Approaches to 401(k) Decisions

Fortunately, a disarmingly simple concept – automatic enrollment (and a similar approach to other 401(k) decisions) – has the potential to change this pattern. A growing body of evidence suggests that the judicious use of default arrangements—arrangements that apply when employees do not make an explicit choice on their own—holds substantial promise for expanding retirement savings. The effects appear to be particularly promising for middle- and lower-income households, who have the greatest need to increase their savings. Retooling America's voluntary, tax-subsidized 401(k) plans to make sound saving and investment decisions more automatic, while protecting freedom of choice for those participating, would require only a relatively modest set of policy changes—and the steps taken thus far are already producing good results.

In a nutshell, this approach consists of changing the default option at each phase of the 401(k) savings cycle to make sound saving and investment decisions the norm, even when the worker never gets around to making a choice in the first place. Given the current structure of most 401(k) plans, workers do not participate unless they actively choose to. In contrast, under automatic enrollment, they would participate unless they actively choose not to—and similarly for each major decision thereafter. Contributions would be made, increased gradually over time, invested prudently, and preserved for retirement, all without putting the onus on workers to take the initiative for any of these steps. At the same time, however, workers would remain free to override the default options—to choose whether or not to save, and to control how their savings are invested—but those who fail to exercise the initiative would not be left behind.

A growing body of empirical evidence suggests that this may be the most promising approach to bolstering retirement security for millions of American families. A number of economists have undertaken important research and contributed practical suggestions concerning the actual and potential uses of automatic enrollment and related default arrangements in 401(k) plans.

The core concept behind this approach is quite simple: design a 401(k) to recognize the power of inertia in human behavior and enlist it to promote rather than hinder saving. Under this approach, each of the key events in the process would be programmed to make contributing and investing easier and more effective.

- Automatic enrollment: Employees who fail to sign up for the plan—whether because of simple inertia or procrastination, or perhaps because they are not sufficiently well organized or are daunted by the choices confronting them—would become participants automatically.
- Automatic escalation: Employee contributions would automatically increase in a prescribed manner over time, raising the contribution rate as a share of earnings.
- Automatic investment: Funds would be automatically invested in balanced, prudently diversified, and low-cost vehicles, whether broad index funds or professionally managed funds, unless the employee makes other choices. This aspect is discussed in Section IV of this testimony, below.
- Automatic rollover: When an employee switches jobs, the funds in his or her account would be automatically rolled over into an IRA, 401(k) or other plan offered by the new employer. Traditionally, many employees receive their accumulated balances as a cash payment upon leaving an employer, and many of them have spent part or all of it. Automatic rollovers would reduce such leakage from the tax-preferred retirement savings system. At this stage, too, the employee would retain the right to override the default option and place the funds elsewhere or take the cash payment. Automatic rollover is actually being implemented this year with respect to the smallest qualified plan distributions (not exceeding \$5,000).

In each case – automatic enrollment, escalation, investment, and rollover – workers can always choose to override the defaults and opt out of the automatic design. The integrated strategy of using default arrangements to promote saving without sacrificing individual choice was first formulated – and began to be implemented – between 1998 and 2000 by the U.S. Treasury. The Treasury and the Internal Revenue Service (IRS) approved automatic enrollment for 401(k) plans in 1998 and first permitted automatic rollover in 2000. In 2001 Congress enacted legislation making automatic rollover mandatory for small lump-sum distributions, to take effect this year. Both automatic enrollment and automatic

rollover were designed also to lay the groundwork for automatic investment: both generally, by establishing the principle that pro-saving defaults should apply to major retirement decisions, and specifically, by requiring plans to prescribe default investments to be used in conjunction with automatic enrollment and automatic rollover.

It is worth stressing that none of these automatic or default arrangements are coercive. Workers would remain free to opt out at any point, but automatic enrollment points workers in a pro-saving direction when they decline to make explicit choices of their own. The Treasury rulings authorizing automatic enrollment include provisions to ensure that employees retain control of enrollment and investment decisions. The plan must provide employees advance notice and an adequate opportunity to make their own, alternative choices before proceeding with the default arrangement. Similarly, under automatic rollover, employees have a variety of choices and must be given advance notice of those choices before the automatic arrangement takes effect.

### C. Automatic Enrollment

Under a plan that uses automatic enrollment, unless an employee affirmatively expresses a different preference, the default mode is that the employee participates at a stated percentage of compensation.<sup>40</sup> This, as a practical matter, is particularly geared toward encouraging participation by moderate- and lower-income employees, who are least likely to participate without it. Studies suggest that autoenrollment can boost the rate of 401(k) plan participation from a national average of about 75 percent of eligible employees to between 85 and 95 percent. Particularly dramatic increases are seen among those subgroups of workers with the lowest participation rates. For example, one study found that, among employees with between 3 and 15 months, automatic enrollment increased participation from 13 percent to 80 percent for workers with annual earnings of less than \$20,000, and from 19 percent to 75 percent for Hispanics.<sup>41</sup> (Automatic enrollment, like the Saver's Credit, also enables higher-paid employees to contribute more by making it easier to obtain favorable results under the 401(k) nondiscrimination test.)

Interesting administrative variants exist that can accomplish much of what automatic enrollment does. One alternative would require that all employees make an explicit election to participate or not, rather than enroll them automatically if they make no election. In at least some cases this approach has

<sup>40</sup>Automatic enrollment was approved in IRS Revenue Ruling 2000-8 and in Treas. Regs. Section 1.401(k)-1(a)(3)(ii). The IRS has recently affirmed that plans are permitted to increase the automatic contribution rate over time in accordance with a specified schedule or in connection with salary increases or bonuses. See letter dated March 17, 2004, from the Internal Revenue Service to J. Mark Iwry.

<sup>41</sup>Brigitte Madrian and Dennis Shea, "The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior," *Quarterly Journal of Economics* 116, no. 4 (November 2001): 1149-87.

produced participation rates in the same high range as automatic enrollment. In addition, firms could require that employees who opt out sign a statement acknowledging that they have read the plan's disclosures regarding the advantages of contributing.

Despite its demonstrated effectiveness in boosting participation, autoenrollment is used today by only a small minority of 401(k) plans. According to a recent survey, 8 percent of 401(k) plans (and 24 percent of plans with at least 5,000 participants) have switched from the traditional "opt-in" to an "opt-out" arrangement. As already noted, automatic enrollment is a recent development, and therefore it may yet become more widely adopted over time, even with no further policy changes. But policymakers could accelerate its adoption through several measures. Some of these policy measures would be appropriate only if automatic enrollment were adopted in conjunction with other features of the automatic 401(k), especially automatic escalation.

First, the law governing automatic enrollment could be better clarified. In some states, some employers see their state labor laws as potentially restricting their ability to adopt automatic enrollment. Although many experts believe that federal pension law preempts such state laws as they relate to 401(k) plans, additional federal legislation to explicitly confirm this would be helpful. Any such explicit preemption should be undertaken only to the extent necessary to protect employers' ability to adopt automatic enrollment.

Second, some plan administrators have expressed the concern that some new, automatically enrolled participants might demand a refund of their contributions, claiming that they never read or did not understand the automatic enrollment notice. This could prove costly, because restrictions on 401(k) withdrawals typically require demonstration of financial hardship, and even then the withdrawals are normally subject to a 10 percent early withdrawal tax. One solution would be to pass legislation permitting plans to "unwind" an employee's automatic enrollment without paying the early withdrawal tax if the account balance is very small and has been accumulating for only a short period of time.

Third, Congress could give automatic enrollment plan sponsors a measure of protection from fiduciary liability (as discussed in Section IV, below).

Fourth, broader adoption of automatic enrollment and the other key pieces of the automatic 401(k) could be encouraged by reforming an exception to the rules governing nondiscrimination in 401(k) plans (as described below). Many firms are attracted to automatic enrollment because they care for their employees and want them to have a secure retirement, but others may be motivated more by the associated financial incentives, which stem in large part from the 401(k) nondiscrimination standards. These standards were designed to condition the amount of tax-favored contributions permitted to executives and other higher-paid employees on the level of contributions made by other employees. They

thus gave plan sponsors an incentive to increase participation among their less highly paid employees. Automatic enrollment is one way for them to do this.

In recent years, however, employers have had the option to satisfy the nondiscrimination standards merely by adopting a 401(k) "matching safe harbor" design. The matching safe harbor provision exempts an employer from the nondiscrimination standards that would otherwise apply as long as the firm merely offers a specified employer matching contribution. It does not matter whether employees actually take up the match offer—all that matters is that the offer was made. Indeed, the more employees contribute, the greater the employer's cost to match those contributions, without any compensating improvement in nondiscrimination results. By thus attenuating employers' interest in widespread employee participation in 401(k)s, the matching safe harbor provision presents an important obstacle to wider adoption of automatic enrollment.

To restore the attractiveness of automatic enrollment to employers, policymakers could change the rules to allow the matching safe harbor only for plans that feature automatic enrollment and the other key parts of the automatic 401(k) (especially the automatic escalation feature described below). Plan sponsors currently using the matching safe harbor could be given a transition period in order to have sufficient time to plan to meet the new safe harbor conditions, comply with the nondiscrimination standards based on regular testing, or consider the 3% nonelective safe harbor.

#### D. Automatic Escalation

One potential drawback of automatic enrollment, highlighted by recent research, is that it can induce some employees to passively maintain the default contribution rate over time, when they might otherwise have elected to contribute at a higher rate. This adverse effect can be mitigated through automatic escalation, whereby contributions rise gradually and automatically over time (for example, from 4 percent of the worker's pay in the first year to 5 percent in the second, 6 percent in the third, and so on). For example, in the "Save More Tomorrow" program proposed by Richard Thaler and Shlomo Benartzi, workers would agree (or not) at the outset that future pay increases will generate additional contributions. In one trial, "Save More Tomorrow" was shown to lead to a substantial increase in contribution rates over time for those who participated, relative to other 401(k) participants at the same company. Alternatively, workers could agree to future contribution increases even in the absence of pay raises. Automatic escalation plans have been explicitly approved by the IRS in a general information letter obtained by the witness.<sup>42</sup>

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<sup>42</sup> General information letter from Internal Revenue Service to J. Mark Iwry, March 17, 2004 (copy attached).

### E. Automatic Investment

A third and related approach is automatic 401(k) investment, which is discussed in Section IV of this testimony, below.<sup>43</sup>

### F. Automatic Rollover

A similar automatic or default-based approach has already been applied to plan payouts before retirement, to limit leakage of assets from the retirement system. Currently, most people who receive distributions from 401(k) and similar plans take one-time cash payments. In general, the smaller this lump-sum distribution, the less likely it is to be saved by being transferred ("rolled over") to another employer plan or to an IRA. In fact, data suggest that, as of 1996, the median lump-sum distribution was \$5,000, and a sizable majority of defined contribution plan participants who receive a lump-sum distribution of \$5,000 or less do not roll it over to a qualified plan or IRA.<sup>16</sup>

For years, account balances of up to \$5,000 could be involuntarily "cashed out," that is, paid to departing employees without their consent, and these payments were the least likely to be preserved for retirement. In 2000, however, a Treasury-IRS ruling permitted retirement plan sponsors to transfer such amounts to an IRA established for a departing employee who did not affirmatively elect any other disposition of the funds. A year later Congress mandated such automatic rollover for distributions between \$1,000 and \$5,000. Under this legislation, scheduled to take effect in March 2005, plan sponsors may no longer force cash-out distributions of more than \$1,000 on departing employees. Instead they are required to follow the employee's instructions either to transfer the funds to another plan or an IRA, pay the funds directly to the employee, or keep the funds in the plan if the plan permits that option. The individual thus has the choice to preserve or consume the retirement savings, but, if the individual makes no other choice, the default is preservation—either in the employer's plan, if the employer so chooses, or in an IRA that the employer opens for the employee. The employee must also be notified that, if the payout is automatically rolled over to an IRA, he or she may then roll it over to another IRA of his or her choice.

Automatic rollover was designed to have a potentially valuable byproduct, namely, broader utilization of IRAs. Currently, fewer than 10 percent of those eligible to open and contribute to an IRA on a tax-preferred basis actually do so. Like enrolling in a 401(k), opening an IRA requires individuals to overcome inertia and to navigate their way through a number of decisions (in this case, choosing

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<sup>43</sup> Many of the approaches outlined in this and the following section of this testimony are contained in H.R. 1508, the "401(k) Automatic Enrollment Act of 2005," introduced earlier this month by Representative Rahm Emanuel (D-IL). Another recently-introduced bill intended to promote automatic enrollment is S. 875, the "Save More for Retirement Act of 2005" introduced by Senator Bingaman (D-NM)(co-sponsored by Senators Snowe, Lieberman and Obama) on April 21, 2005.

among a vast number of financial institutions and investments). Automatic rollover instead calls upon the employer to take the initiative to set up an IRA and choose investments on the employee's behalf, again unless the employee chooses to do so. The intended result is not only to preserve the assets within the tax-favored retirement plan universe, but also to create an expanding infrastructure of portable, low-cost individual accounts for the millions of workers who have no IRAs but who are covered at some point by an employer-sponsored retirement plan. Automatic rollover thus has the potential to help achieve a far broader expansion of retirement plan coverage for middle- and lower-income households. Indeed, this broader agenda is explicitly reflected in the automatic rollover legislation, which directs the Treasury and Labor Departments to consider providing special relief for the use of low-cost IRAs.

Eventually, leakage might be further limited by expanding automatic rollover to a wider array of distributions. However, for various reasons, any such expansion would need to be examined carefully. For one thing, in most cases, benefits in excess of \$5,000 currently remain in the employer plan as the default arrangement that applies if the employee makes no explicit election regarding disposition of the funds.

### G. Other Potential Automatic Arrangements

Alternative default options could also be considered for other aspects of retirement savings, including the form in which distributions are made at retirement. Current law reflects some preference for encouraging payouts to take the form of a lifetime annuity, which guarantees periodic payments for life (as opposed to a single cash payment, for example). Lifetime annuities are a sensible way to reduce the risk of retirees (other than those with very short life expectancies) outliving their assets, yet few people purchase them.

In defined benefit and money purchase pension plans, a lifetime annuity is generally the default mode of distribution. In contrast, 401(k) and most other defined contribution plan sponsors have been able for the most part to exempt themselves from such default requirements. (Proposals have been advanced to extend to 401(k) plans default arrangements (including spousal protection) based on those that apply to defined benefit and money purchase plans.) Products are needed, and are being developed, that would provide lifetime guaranteed income at reasonable cost in ways that are more flexible and more responsive to the needs of moderate- and lower-income families than most traditional annuity products.

### IV. Automatic Investment

Even those workers who successfully navigate the problems of coverage, participation, level of contribution, and retention of the funds must still deal with the challenge of sound investment. In the accumulation phase of 401(k) retirement savings, too many employees find themselves confronted by a confusing array of investment options, and lack the expertise, time, or interest to become expert investors. As a result, it appears that millions of 401(k)-type accounts fail basic standards of diversification and sound asset allocation. Rather than maintain a balanced portfolio, many hold either no equities (and are overinvested in safe but low-yielding money market funds) or almost nothing but equities. Many also apparently fail to systematically rebalance their portfolio or adjust its asset allocation over time, and some underperform because of unsuccessful attempts at market timing.

In addition, millions of workers are overconcentrated in their employer's stock.<sup>44</sup> This can prove especially costly: if the employer falls upon hard times, workers stand to lose not only their jobs but their retirement savings. But even when the plan sponsor does not collapse, poor investment choices impose unnecessary risk on workers, threaten the level and security of their retirement income, and reduce the public policy benefits from 401(k) tax preferences.

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<sup>44</sup> Jack VanDerhei has found that, in plans that allow employer stock as an investment option, 46 percent of participants (some 11 million employees) hold more than 20 percent of their account balance in employer stock, and one-sixth hold more than 80 percent.

The risks of inadequate diversification are widely recognized. In fact, pension law generally requires plan trustees, who make investment choices in plans without employee self-direction, to diversify plan portfolios to reduce the risk of large losses. Virtually all investment professionals scrupulously avoid investing more than a minuscule fraction of assets under their management in any single company. Economic theory suggests that undiversified portfolios create significant risk without providing additional expected returns. Moreover, when the undiversified stock is that of the investor's employer, the risk is compounded, as noted above.

#### A. Sources of the Problem

Congress has enacted two important provisions that actually encourage both self-directed investment and overinvestment in company stock while doing little to help workers manage the responsibilities arising from the dramatic shift toward 401(k)s. First, ERISA relieved employers of most fiduciary responsibility for investment losses if they allowed employees to direct their own investments—which likely was one factor encouraging the shift to 401(k)s. Yet self-direction of investments is not working as well as it should. Second, the main exception to the pervasive use of employee-directed investment in 401(k)s has been plan sponsors' frequent decision to make their contributions to these accounts in the form of employer stock. Although this tendency undermines diversification and might normally be considered a conflict of interest, Congress actually granted special exceptions from the normal fiduciary standards to allow employer (and employee) contributions to be heavily invested in employer stock.

With the expansion of 401(k)s, employer stock has moved from a supplemental to a far more central place in the pension landscape. Meanwhile, one of the main policy rationales originally articulated for providing special exceptions for employer stock—encouraging worker ownership of equities—has already been addressed by, among other things, the ready availability of diversified equity investments through 401(k)s. There are two other potential rationales for investing in employer stock: seeking to encourage higher productivity through increased worker ownership, and encouraging employers to contribute to retirement plans. But both these rationales fall short of justifying the extent to which employer stock has come to dominate so many workers' 401(k) portfolios.

In addition, Professor Richard Thaler and his coauthors have explored the causes of overconcentration in employer stock. They find that most 401(k) participants are unaware that investing in a single stock is riskier than holding a diversified portfolio. For various reasons (several possibilities are suggested below), workers do not appear to make the connection between what happened at Enron (or at other failed or distressed companies) and the risks of investing in their own company's stock.

### B. Current Policy Responses

The leading 401(k) legislative proposals under consideration, which were developed in the wake of recent corporate scandals, fail to respond to either the specific problem of overinvestment in employer stock or the more general problem of less than optimal allocation of 401(k) assets. The proposals would limit plan sponsors' ability to explicitly require participating employees to invest in employer stock (with broad exceptions for the special plans known as employee stock ownership plans, or ESOPs). However, the proposals would allow employees—possibly with the effective encouragement of corporate management—to continue to overinvest their retirement funds in employer stock. As a result, such legislation would not prevent future 401(k) debacles because most 401(k) overinvestment in employer stock does not result from employers explicitly requiring such investment. It seems to result instead from a combination of factors: workers may view their own company as a more comfortable investment because it is familiar to them; they may also be influenced by management's strongly positive view of the company's prospects or by a concern about not appearing sufficiently loyal to the company. These factors may be buttressed by peer group reinforcement and by simple inertia.

One current legislative proposal would require 401(k) sponsors to give participants notice regarding the virtues of diversification. This, however, could prove ineffectual in many cases. For example, a company that still seeks to maximize plan investment in company stock may be able to make the notice inconspicuous or otherwise counteract its effects.

Another proposal would relax current fiduciary standards to allow 401(k) investment fund providers to advise workers on investing in the providers' own funds and those of their competitors. This has raised concerns and controversy about new conflicts of interest arising on the part of the providers (concerns that are avoided when the adviser is independent and is not providing advice on its own funds). In addition, evidence suggests that only a small share of 401(k) participants respond to offers of investment advice. For example, at a June 2004 Brookings Institution conference on this topic, Michael Henkel, president of Ibbotson Associates, noted that, in his firm's experience, only about 5 percent of 401(k) participants follow investment advice provided on the Internet.

Finally, despite assertions that the proposed investment advice legislation would prevent future 401(k) fiascos, the legislation as currently drafted actually stops short of requiring that investment advice extend to employer stock. It thus ignores precisely the area where employees have the most serious need for independent professional advice.

### C. A General Strategy

A more promising approach would offer employers relief from selected fiduciary liabilities if they offer participants alternatives to mandatory self-direction, through either standardized investments or professionally managed accounts. Such alternatives could be the default investment option. This strategy would improve 401(k) asset allocation and investment choices while protecting employers and preserving employees' right to direct their accounts themselves if they so choose.

#### 1. Standard Investments

Congress could designate certain standardized, broadly described types of investments as qualifying for a measure of fiduciary safe harbor treatment. In other words, plan sponsors would enjoy a degree of protection from certain challenges for imprudence or lack of diversification under ERISA if they made such standard investments the plan's default investment and participants did not opt out of the default (or if participants affirmatively selected such investments from among an array of options). In addition to stable-value investments such as bond and money market funds, standard investments would include balanced, prudently diversified, low-cost funds (such as low-cost index funds) with a range of permissible allocations between equities and bonds. Plan sponsors would not be required to offer such investments but would be permitted to impose them on all participants, include them among participants' investment options, or make them the plan's default option. Standards could be drawn broadly enough so that market competition would continue on price, service, and, to some extent, product.

Plan sponsors would have an incentive to use standard investments to the extent that doing so would help protect them against charges of imprudent asset allocation or lack of diversification. Employers would not be given a blanket exemption from all fiduciary responsibility: plan fiduciaries would retain appropriate responsibility for avoiding conflicts of interest, excessive fees, lack of diversification, and imprudent investment choices. However, employers would receive meaningful protection under ERISA, thus encouraging more employers to consider automatic enrollment. Indeed, the market might come to view the types of investment that receive such favorable treatment as in effect enjoying a presumption of prudence. Use of "presumptively prudent" balanced or life-cycle funds as the default investment in lieu of stable-value funds or employer stock seems likely, in turn, to improve investment returns for participants.

The law could provide explicit approval for short-term default investment in stable-value funds, which then switch to balanced or life-cycle funds thereafter. This option could be especially useful for firms that include automatic enrollment as part of their 401(k) plan. The purpose would be to ensure that workers who quickly changed their minds and wanted to opt out of the 401(k), perhaps

because they had not realized that they would be included as a result of automatic enrollment, would not experience capital losses.<sup>45</sup>

## 2. Managed Accounts

Congress could also make it clear that plan sponsors seeking protection from fiduciary liability could designate an independent professional investment manager to invest participants' accounts. This would free participants from having to manage their own accounts, although they could retain the option to do so. The plan sponsor and trustee would be protected from fiduciary responsibility for investments appropriately delegated to an independent investment manager (except for the continuing responsibility to prudently select and monitor the manager).

The law may be sufficiently clear in this area that no statutory change is required. However, Congress could clarify how a managed account approach can fit into an otherwise self-directed 401(k) plan, which might accelerate the expansion of professional account management services, already an emerging trend. Like standard investments, managed accounts generally would ensure reasonable asset allocation and adequate diversification. (In practice, the two approaches would likely converge.) Accordingly, an important by-product would likely be the divestiture of excessive amounts of employer stock in the interest of diversification. And Congress could give managers a fiduciary safe harbor or exemption for investing some fraction (say, up to 5 or 10 percent) of each account balance in employer stock, if desired.

## D. Policy Strategies Targeted More Specifically to Employer Stock

Specific policy changes relating to company stock are also warranted. The goal is not to eliminate company stock investments, but rather to reduce the overconcentration that exposes so many participants to unnecessary risk. David Wray, President of the Profit-Sharing 401(k) Council of America, has noted that sometimes the choice is effectively between employer contribution of company stock and no contribution at all—especially during economically difficult times and for privately held companies.

### 1. "Crowdout" of Employer Stock

A minimalist strategy for diversifying away from employer stock, in the context of the above proposals, would be to do nothing specifically about it, on the ground

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<sup>45</sup> As discussed earlier, Congress could encourage automatic enrollment by providing a short "unwind" period during which workers who decided to opt out of the 401(k) could withdraw their contributions and could avoid early withdrawal penalties. Accordingly, the default investment could be a stable-value fund for the duration of this unwind period.

that exposing employees' 401(k) accounts to professional investment management (or standardized default investments) is itself likely to reduce the concentration in employer stock over time. The gospel of sound asset allocation and diversification will become more pervasive, and professional expertise will permeate the system far more readily, once employees are no longer the only or primary managers of their plan portfolios. Accordingly, as professional management and standard investments increasingly replace employee self-direction, the practice of overconcentration in employer stock and poorly balanced portfolios would eventually give way to diversification and sound asset allocation.

### 2. Diversification Safe Harbor for Plan Sponsors

Congress could also give a fiduciary safe harbor to plan fiduciaries that follow a systematic employer stock divestiture program. This would facilitate divestiture by plan sponsors that recognize they might have gotten in too deep but are still hesitant to divest themselves of the company stock. Employers fear litigation for fiduciary breach if their plans sell company stock or sell it too quickly (in the event the stock value subsequently rises) or too slowly (in the event the stock value falls). A safe harbor "glide path" for systematic, gradual diversification would also help address employers' other legitimate concerns that large sales of company stock from the plan might depress the market for the stock or, more commonly, might be perceived by the market or by employees as a signal that management lacks confidence in the company's future.

### 3. "Sell More Tomorrow"

Richard Thaler and Shlomo Benartzi suggest that plan sponsors offer employees the option of participating in a systematic program of gradual employer stock divestiture over a period of years.<sup>46</sup> Consistent with the employer-level safe harbor "glide path" approach suggested above, Thaler and Benartzi advocate this creative, employee-level approach (which they call "Sell More Tomorrow") as a way to encourage employees to take a possibly difficult step by arranging to do most of it in the future. By spreading out the sale of the shares over time, this approach also avoids potentially depressing the market for the stock and mitigates any risk of remorse on the part of employees for having sold at the wrong time.

### 4. Threshold Approach

Another possible approach to reducing overconcentration in employer stock would permit employees to invest employee contributions in employer stock only

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<sup>46</sup> Shlomo Benartzi and Richard H. Thaler, "Sell More Tomorrow: Using Behavioral Economics to Improve Diversification in 401(k) Plans: Solving the Company Stock Problem," University of California, Los Angeles, 2002.

to the extent that the contributions in a given year exceed some threshold. Such a threshold could be set, for example, at 7 percent of pay—a level slightly above the actual average 401(k) contribution rate.

#### E. Autoinvestment in General

The automatic investment approaches described here—particularly the use of managed accounts or sound standard investments not only as an investment option but also as the default investment mode—would improve 401(k) asset allocation and investment performance generally while working in concert with other methods described here to reduce overconcentration in company stock. Approaches such as these would save employees from having to be financial experts while continuing to allow self-direction for those employees who want it. And by improving investment performance, such a strategy should increase retirement savings.

### V. Direct Deposit of Tax Refunds to IRAs<sup>47</sup>

#### A. The Potential

For many middle- and lower-income families, the best opportunity to save and accumulate assets outside an employer-based plan may arise when they file their federal income tax returns. Each year, over 100 million American households put themselves in a position to receive federal income tax refunds averaging more than \$2,000 each (resulting mainly from overpayment of withholding taxes). For many families, the refund is the largest single payment they can expect to receive all year. Accordingly, individual income tax refunds present a unique opportunity – a “savable” or “savings” moment” -- to increase personal saving, whether for retirement or for shorter-term needs, and one that seems particularly well suited for moderate- and lower-income households.<sup>48</sup> This is particularly true since there is evidence suggesting that many people tend to view large, extraordinary payments (such as their tax refunds) as separate and different from their normal wages or other income.<sup>49</sup> Indeed, in the case of a tax refund, such separate “mental accounting” corresponds to the reality that the payment is initially segregated from other income or assets.

<sup>47</sup> Most of this Section of the testimony is extracted verbatim from a forthcoming Retirement Security Project issue brief by the witness: J. Mark Iwry, “Tax Refunds as a Retirement Savings Opportunity” (Retirement Security Project, forthcoming, May 2005).

<sup>48</sup> In fiscal year 2004, individual income tax refunds amounted to \$228 billion and went to 106 million out of a total of 131 million individual income tax returns (*IRS Databook FY 2004*, publication 55b, tables 1, 2, 8, 9. See also P. Orszag, “Tax Fact, Individual Income Tax Refunds,” *Tax Notes* (January 31, 2005).

<sup>49</sup> Hersh M. Shefrin and Richard H. Thaler, “Mental Accounting, Saving, and Self-Control,” in *Choice Over Time*, edited by G. Loewenstein and J. Elster (New York City: Sage Foundation, 1992).

For families who routinely make ends meet with their regular paychecks, the annual refund may be viewed, at least in part, as discretionary funds that could be saved rather than immediately consumed. A moderate- or lower-income household that wishes to save can do so by forgoing immediate use of part of the refund, rather than having to come up with out-of-pocket funds. Moreover, the size of the refund generally is known before it is received. This enables households, if they wish, to commit themselves to saving the funds ahead of time, such as by deposit to an IRA or other savings vehicle, when the amount of the refund has been determined but before the refund is actually in hand. This may be a particularly opportune moment for households to make a decision to save.

Currently, households that are willing to save the entire refund have a ready means of implementing such an advance commitment: a household can elect on its income tax return to have the refund directly deposited to an IRA or other account at a financial institution instead of being mailed to the household in the form of a paper check. The opportunity for precommitment thus arises in two stages. First, regular tax deductions are made automatically from each paycheck without the need for any action by the individual (at least once the initial decision has been made to initiate the pattern of paycheck deduction and accumulation). This series of deductions gives rise to the refund. Second, at the time the return is filed, households can precommit themselves to saving by instructing the government to make a direct deposit of the refund. This may make saving easier for many who, in principle, would like to save the refund but are struggling against the temptation to spend it.

#### B. The All-or-Nothing Versus Dividing the Refund

Unfortunately, this refund-saving strategy currently suffers from a major practical obstacle: the direct deposit of a federal income tax refund is now an all-or-nothing proposition. The household can direct that the entire refund be deposited to a single account at a bank or other financial institution, or can receive a check in the mail for the entire refund amount, which takes longer to arrive.<sup>50</sup> But the federal income tax system does not currently provide the option of bifurcating a refund. Households, for example, cannot direct a portion of the refund to one or more accounts (such as IRAs) for saving while receiving the balance (as a check or as a direct deposit to a checking account) to meet more immediate spending needs. In addition, a married couple filing jointly cannot split their refund into, for example, separate IRA contributions for each spouse.

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<sup>50</sup> Another option available to taxpayers is to direct on the return that the refund be applied to pay estimated taxes. Private tax-preparation firms also offer options for tax filers to gain more rapid access to their refunds, but some of these ("refund anticipation loans") have proven to be controversial because of the fees charged.

Accordingly, while more than 49 million tax filers in 2004 received their federal tax refunds by direct deposit, they did not have the choice to allocate the direct deposit to more than one account.<sup>51</sup> This might help explain why less than 4 percent of those who filed their return by April 1, 2005 indicated on their return that the account to receive the direct deposit of the refund is a “savings” account as opposed to a “checking” account (indicated by about 53 percent of early filers). Yet both intuition and evidence suggest that households would be more likely to contribute part of their refunds to saving accounts such as IRAs if they could choose, on their tax return, to divide their refunds. Many households that require much or most of the refund for immediate needs might be willing to save a portion of it if they had an easy and convenient way to do so—by simply checking a box on the tax return form.<sup>52</sup>

Some preliminary empirical evidence suggests that the ability to split a tax refund by direct deposit could increase deposits to savings accounts even by lower-income households. A forthcoming issue brief from the Retirement Security Project will explore the evidence from a pilot project that allowed lower-income households to put part of their refund into a savings account, while also receiving part in a more liquid form. This evidence -- along with the significant size of aggregate refunds, the fact that over 49 million refund recipients chose direct deposit, and that millions of moderate- and lower-income households can claim a tax credit (the Saver’s Credit) for direct deposits of refunds to an IRA -- suggests that allowing households to deposit part of their tax refunds directly into a savings account is likely to be beneficial.<sup>53</sup>

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<sup>51</sup> Some have access to private-sector services that allocate refunds among multiple accounts, although low-income taxpayers may be less likely to be customers who are offered such services.

<sup>52</sup> By way of analogy, the evidence shows, as discussed above, that participation in 401(k) plans has been significantly increased by automatic enrollment. Similarly, there is preliminary evidence suggesting that 401(k) participation increases even when newly hired employees are simply forced to complete a form explicitly electing or declining to participate; this reduces the risk that employees will fail to enroll because they postpone the decision, lose the form, etc. Direct deposit of a refund on a tax return is somewhat similar, in that most taxpayers are effectively forced to complete a form (the tax return) on which they can commit themselves in advance to save funds that are not yet in hand. Excess income tax withholding is a more universally available method of accumulating savings than 401(k) payroll withholding. It also has the advantage of avoiding the inefficiencies that may be caused by persistently very small contributions under payroll deductions, but this efficiency comes at the cost of forgone interest or earnings for the taxpayer.

<sup>53</sup> Lower- and moderate-income households that make direct deposits of only a portion of their tax refunds to IRAs would also be able to claim the saver’s credit (the retirement savings tax credit) with respect to those direct deposit contributions, provided that Congress extends the credit beyond 2006, as suggested above. However, as discussed earlier, the saver’s credit currently is also not refundable and, therefore, depending on which other credits the taxpayer is claiming, may fail to give such households additional incentive to contribute to IRAs, 401(k)s, and similar plans.

### C. Other Implementation Issues

#### 1. Issues for Individuals

To realize these benefits of refund splitting, households must have a savings account or establish one. Some already have IRAs to which they could direct the deposit of a portion of their refunds. In addition, those who use commercial tax preparers might be able to open an IRA with the preparer (sponsored by an IRA trustee or custodian working with the preparer) when their return is prepared. An example of this approach is H&R Block's "Express-IRA" product, which allows clients to establish an IRA on-site and deposit some of their refund in it while receiving the balance in a check or separate direct deposit. H&R Block has reportedly opened more than 440,000 such IRAs.<sup>54</sup>

Unfortunately, many lower-income tax filers who would benefit from saving do not have a savings account.<sup>55</sup> The availability of refund splitting directly through the IRS and the increased use of direct deposit, however, might prompt the financial services industry to develop easier and more efficient ways for such households to open accounts. New approaches might focus on creating accounts before, during, or after the filing of the tax return. For example, one might imagine financial providers effectively disseminating routing transit and account numbers to encourage households to open accounts when splitting their refunds. However, current signature requirements to open an account may present an obstacle to such practices; indeed, at least some appropriate safeguards would seem to be necessary to help prevent efforts to misuse routing transit and account numbers to misappropriate households' refunds.

#### 2. Issues for the Internal Revenue Service

The Internal Revenue Service could provide a split refund option by administrative action without the need for legislation. However, changes of this nature would ordinarily involve significant administrative tasks affecting IRS systems, including programming, processing, transcription, and testing (as well as an additional schedule to the Form 1040) and would entail associated administrative costs. (A number of these issues are explored in a forthcoming Retirement Security Project issue brief.) However, on balance, none of these administrative issues appears to present an insuperable obstacle; they ultimately

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<sup>54</sup> Peter Tufano and Daniel Schneider, H&R Block and Everyday Financial Services, HBS Case No. 205-013 (Boston: Harvard Business School Publishing, 2004).

<sup>55</sup> See, for example, Michael S. Barr, "Banking the Poor," 21 *Yale Journal on Regulation* 121 (2004).

should be resolvable, and the associated costs would seem to be outweighed by the significant potential of split refunds to encourage saving.<sup>56</sup>

However, administrative concerns and potential costs may help explain why efforts within the Department of the Treasury and IRS since the late 1990s to implement refund splitting have not yet come to fruition. The current administration's budget states that saving will be "simplified and encouraged" by administrative changes to the tax filing process that will "allow taxpayers to have their tax refunds directly deposited into more than one account."<sup>57</sup> Similar language was included in each of the last two Treasury explanations of the administration's tax-related budget proposals, and the current budget specifies that the availability of split refunds is "planned for the 2007 tax-filing season."

During the past year, bipartisan efforts in Congress and the private sector have sought to encourage the IRS to move forward. Chairman Santorum on April 29, 2004, and a bipartisan group of 12 Members of the House of Representatives on January 31, 2005, wrote to the IRS urging it to implement a program that would allow taxpayers to split the direct deposit of refunds. A similar letter was sent to IRS Commissioner Everson by a wide array of organizations in October 2004.<sup>58</sup> In March 2005, Congressman Rahm Emanuel (D-Illinois) introduced HR 1048, the Direct Deposit Savings Act of 2005, which would require the IRS to offer refund splitting. On March 25, 2005, Commissioner Everson responded to one of these letters, stating that an IRS implementation committee was being formed to work toward making refund splitting available by 2007.<sup>59</sup>

#### D. Possible Variations on the Tax-Refund IRA

As noted earlier, a key obstacle that might limit participation in refund splitting is the need to have an IRA (or other saving account) to receive the refund. If the tax filer does not already have an IRA, an IRA has to be set up—including choosing a vendor, choosing investments, and taking any other steps necessary to open

<sup>56</sup> See Michael Sherraden and Michael S. Barr, "Institutions and Inclusion in Saving Policy," Paper presented at "Building Assets, Building Credit" Symposium at the Joint Center for Housing Studies, Harvard University, November 17-19, 2003 (March 2004); Michael S. Barr, "Banking the Poor," 21 *Yale Journal on Regulation* 121 (2004).

<sup>57</sup> "Analytical Perspectives," *Budget of the United States Government, Fiscal Year 2006*, p. 282. See also Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2006 Revenue Proposals* (February 2005), p. 8; Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2005 Revenue Proposals* (February 2004), p. 10.

<sup>58</sup> The letter and associated effort was organized by Fred T. Goldberg Jr. (former IRS Commissioner, Assistant Treasury Secretary for Tax Policy, and for many years a leading advocate of promoting saving by refund splitting and other means), Reid Cramer (Research Director of the New America Foundation's Asset Building Program) on behalf of the New America Foundation, and the witness.

<sup>59</sup> The IRS letter is dated March 25, 2005 and is addressed to Representative Jim Cooper (D-TN).

the account. These steps may be a significant impediment in some cases. A possible response would be to allow households to direct on their returns that a portion of their refund be applied to the purchase of U.S. savings bonds. Such an option was made available to households from 1962 to 1968, but it was available only on an all-or-nothing basis: If any of the refund was invested in savings bonds, all of it had to be so invested. The option was terminated after 1968 because few households took advantage of it. However, the option to invest a *portion* of the refund in U.S. savings bonds might well prove to be more popular.<sup>60</sup>

Another alternative would allow households who do not have an IRA to direct on their tax returns that the government open an IRA in their names at a designated "default" financial institution that has contracted with the government to provide low-cost IRAs, with well-designed default investments, for this and related purposes. Any such approach would raise a variety of issues, including the challenge of designing an appropriate IRA to minimize costs, the allocation of costs between the private sector and the government, the need to avoid creation of a substantial government bureaucracy to administer the arrangement, the choice of default investment, and the issues relating to possible transfer of larger balances to regular IRAs.

These and other issues would arise in exploring possibilities such as permitting households to make direct deposits of refunds to accounts in 401(k) plans or to accounts held by some expanded form of the Thrift Savings Plan which is sponsored by the Federal Government as a 401(k)-type plan for its employees. Among the additional issues that would be raised are whether the IRS and Financial Management Services (a bureau of the U.S. Department of the Treasury that pays refunds and other amounts) could send direct deposits to the typical 401(k), which is organized as a trust fund with legal title to all of the assets held by the plan trustee, not by individual employees (who have beneficial interests in their accounts). In addition, if such refund deposits to a 401(k) could be arranged, they would be after-tax contributions; making refund splitting available to 401(k) plans might encourage households to make contributions via direct deposit that would fail to qualify for the exclusion from income associated with a salary reduction 401(k) contribution. Other potential complications would include the administrative tasks imposed on 401(k) plan sponsors and recordkeepers required to keep track of such deposits separately from other kinds of funds.

Before embarking on more ambitious approaches such as these, however, a good case can be made that the first step should be to allow refund recipients to split refunds among multiple direct deposits and to assess whether the IRA market is making it sufficiently easy to open new accounts.

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<sup>60</sup> See Peter Tufano and Daniel Schneider, *Reinventing Savings Bonds: A Modest Proposal*, HBS Working Paper, 2004.

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The ability to split tax refunds among multiple direct deposits appears to have great potential for increasing personal saving and building assets, especially in the case of moderate- and lower-income households. These tax filers might be deterred from saving by the need to come up with the funds needed to make the investment and by the sense that they cannot afford to save their entire refund, rather than using at least a portion of it to meet immediate needs. Allowing households to split their refund could facilitate saving, and since federal individual income tax refunds total some \$228 billion a year, even a modest increase in the proportion of refunds saved could represent a significant increase in saving.

**VI. Exempting Retirement Savings When Applying the Asset Tests in Means-Tested Public Programs**<sup>61</sup>

Under major means-tested public assistance programs, such as Medicaid, the State Child Health Insurance Program (SCHIP), programs funded under the Temporary Assistance for Needy Families (TANF) block grant, and the Food Stamp Program, states are allowed or required to condition eligibility on satisfaction of certain asset tests. The federal Supplemental Security Income (SSI) program has similar tests. Some of the asset tests do not take into account defined benefit pension benefits as assets, but do take into account defined contribution plan or IRA balances. This application of the tests can force families that rely – or expect that they might need to rely in the future -- on these means-tested benefits to choose between spending down their retirement savings or forgoing benefits under the program. Low-income households that use or contemplate using these programs therefore face a disincentive to accumulate assets in retirement savings accounts – in effect, an implicit tax on such saving.

The treatment of retirement savings under the asset tests is not uniform across the various programs and often is not uniform within a single program across various states. The resulting uncertainty and potential confusion are likely to discourage saving by low-income families. As a general proposition, exempting defined contribution and IRA balances from the asset tests or otherwise modifying or even eliminating asset tests under these programs would remove an obstacle to asset accumulation by low-income households.

A forthcoming Retirement Security Project paper will describe in detail the asset tests and the manner in which they treat retirement savings, and will set out

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<sup>61</sup> This Section of the testimony borrows heavily from a forthcoming Retirement Security Project policy brief by Robert Greenstein et al. regarding the issues discussed in this Section.

specific recommendations regarding appropriate changes to the tests to encourage asset building by low-income families.

**Conclusion**

A number of practical and highly promising reforms could significantly encourage saving and the accumulation of assets by lower-income households. These include expansion of the saver's tax credit for contributions by moderate- and lower-income households to employer-sponsored retirement plans and IRAs; expanded use of automatic enrollment, automatic escalation, and automatic investment approaches in 401(k) and similar retirement savings plans; arrangements allowing taxpayers to have a specified portion of their federal income tax refunds deposited directly into IRAs or other saving accounts (without requiring that the entire refund be so deposited); and modifications to asset tests in means-tested public programs for low-income families that would exempt retirement savings account balances.

Mr. Chairman and Ranking Member Conrad, I would be pleased to respond to any questions you and the Members of the Subcommittee might have.

**Table 1**  
**Saver's Credit Rates and Effective Matching Rates by Income<sup>1</sup>**

Dollars except where stated otherwise

Adjusted gross income	Tax credit for \$2,000 contribution		Effective after-tax match rate (percent)
	Married filing jointly	After-tax cost of \$2,000 contribution	
0-15,000	50	1,000	100
15,001-16,250	20	400	25
16,251-25,000	10	200	11

Source: Authors' calculations.

(1) Calculations assume that the taxpayer has sufficient income tax liability to benefit from the nonrefundable credit shown, and exclude the effects of any tax deductions or exclusions associated with the contributions or with any employer matching contributions.

**Table 2**  
**Total Effective Match Rates with Saver's Credit and a 50 Percent Employer Matching Contribution<sup>1</sup>**

Credit rate (percent)	Dollars except where stated otherwise					
	Tax credit for \$2,000 before-tax employee contribution	Net after-tax contribution	Total contribution after 50 percent employer match	Ratio of total contribution to employee's after-tax contribution	Effective after-tax match rate (percent)	
50	1,000	1,000	3,000	3	200	
20	400	1,600	3,000	1.875	87.5	
10	200	1,800	3,000	1.667	66.7	

Source: Authors' calculations.

a. Calculations assume that the taxpayer has sufficient income tax liability to benefit from the nonrefundable credit shown, and exclude the effects of any tax deductions or exclusions associated with the contributions.

**Table 3**  
**Ownership of Assets in Retirement Accounts among Households Aged 55-59, by Income, 2001<sup>1</sup>**

Income percentile	Percentage of households in indicated income range with assets	Median assets		Share of aggregate assets of all households (percent)
		All households in income range	Households with assets only	
Below 20	2.5	0	8,000	1.1
20-39.9	49.6	0	12,000	4.2
40-59.9	61.6	7,200	28,000	8.6
60-79.9	91	50,000	54,000	16.7
80-89.9	95.4	148,000	190,000	18.8
90-100	92.1	215,000	299,000	50.6
All households	63.6	10,400	50,000	100

Source: Authors' calculations using the 2001 Survey of Consumer Finances.

(1) Throughout table, "assets" refer only to assets held in defined contribution plans or Individual Retirement Accounts.

Table 4  
Eligibility for 50 Percent Credit Rate

	Returns by Filing Status (thousands) <sup>1</sup>				Total
	Single	Married Filing Jointly	Head of Household	Other	
(A) Total Returns	59,235	61,658	21,915	2,513	145,321
(B) Returns Eligible for 50 Percent Credit Based on Income <sup>2</sup>	25,679	20,105	12,916	511	59,211
(C) Returns That Would Receive Any Benefit from 50 Percent Credit <sup>3</sup>	5,195	2,327	743	183	8,448
As a share of those eligible based on income (=C/B)	20.2%	11.6%	5.8%	35.8%	14.3%
(D) Returns That Would Benefit in Full for Maximum Allowed Contribution <sup>4</sup>	1	3	39	0	43
As a share of those eligible based on income (=D/B)	0.0%	0.0%	0.3%	0.0%	0.1%

Source: Urban-Brookings Tax Policy Center Microsimulation Model.

- (1) Both filing and nonfiling units are included. Filers who can be claimed as dependents by other filers are excluded.
- (2) Eligible returns exclude filing units above the relevant AGI threshold and those claimed as dependents on other tax returns.
- (3) Returns that would receive any benefit from the saver's credit are eligible and would see some reduction in taxes as a result of the credit if a contribution were made to an approved retirement account.
- (4) Returns that would benefit in full from the 50 percent saver's credit for the maximum allowable contribution are both eligible and would see a reduction in taxes equal to the size of the credit if the maximum contribution were made to an approved retirement account.

**Table 5**  
**Effect of the Saver's Credit<sup>1</sup>**  
**Distribution of Income Tax Change by Cash Income Class, 2005**

Cash Income Class (thousands of 2003 dollars) <sup>2</sup>	Tax Units <sup>3</sup>			Percent Change in After-Tax Income <sup>4</sup>	Percent of Total Income Tax Change	Average Tax Change (\$)	Average Federal Tax Rate <sup>5</sup>	
	Number (thousands)	Percent of Total	Percent with Tax Cut				No Credit	Current Law
Less than 10	20,301	14.0	0.3	0.0	0.1	0	3.3	3.3
10-20	26,357	18.1	5.0	0.1	19.9	-15	5.5	5.4
20-30	20,537	14.1	9.9	0.1	26.3	-25	10.9	10.8
30-40	15,633	10.8	7.8	0.1	19.2	-24	15.0	14.9
40-50	11,543	7.9	10.9	0.1	16.1	-27	17.0	17.0
50-75	20,112	13.8	5.5	0.0	16.9	-17	19.0	18.9
75-100	11,773	8.1	0.3	0.0	0.6	-1	20.4	20.4
100-200	14,039	9.7	0.2	0.0	0.7	-1	22.6	22.6
200-500	3,588	2.5	0.1	0.0	0.0	0	25.6	25.6
500-1,000	593	0.4	0.0	0.0	0.0	0	27.6	27.6
More than 1,000	284	0.2	0.0	0.0	0.0	0	31.1	31.1
All	145,321	100.0	4.9	0.0	100.0	-14	20.7	20.7

Source: Urban-Brookings Tax Policy Center Microsimulation Model.

(1) Baseline is current law without the saver's credit.

(2) Returns with negative cash income are excluded from the lowest income class but are included in the totals.

(3) Includes both filing and non-filing units. Tax units that are dependents of other taxpayers are excluded from the analysis.

(4) After-tax income is income less: individual income tax net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax.

(5) Average federal tax (individual income tax, net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax) as a percentage of average cash income.

**Table 6**  
**Alternative Estimates of Revenue Effects of Saver's Credit**

Fiscal Year	Joint Tax Committee, revenue effect given sunset	Administration fiscal 2005 budget, tax expenditure estimate <sup>1</sup>	Revenue effect from eliminating sunset	
			Congressional Budget Office	Urban-Brookings Tax Policy Center
2002	1			
2003	2.1	0.9		
2004	2	1		
2005	1.9	1.1		
2006	1.8	1.2		
2007	0.9	0.7	0.6	0.6
2008	0.1		1.9	1.7
2009	0.1		1.7	1.6
2010	0.1		1.6	1.5
2011	0.1		1.4	1.6
2012			1.4	1.8
2013			1.3	1.7
2014			1.1	1.6
2015				1.5

Sources: Joint Tax Committee, Office of Management and Budget; Congressional Budget Office; authors' calculations using Urban-Brookings Tax Policy Center Microsimulation Model.

(1) Note that tax expenditure estimates do differ in certain respects from estimated revenue effects.

**Table 7**  
**Revenue Cost of Extending Saver's Credit and Making It Refundable**

Billions of dollars	Fiscal Year	Extend existing credit beyond 2006	Extend and make refundable
	2006	0	1.1
	2007	0.6	3.8
	2008	1.7	4.8
	2009	1.6	4.7
	2010	1.5	4.5
	2011	1.6	4.3
	2012	1.8	4.1
	2013	1.7	4
	2014	1.6	3.8
	2015	1.5	3.7
	Total, 2006-15	13.5	38.8

Source: Authors' calculations using Urban-Brookings Tax Policy Center Microsimulation Model.

Table 8  
Effect of Making the Saver's Credit Refundable<sup>1</sup>  
Distribution of Income Tax Change by Cash Income Class, 2005

Cash Income Class (thousands of 2003 dollars) <sup>2</sup>	Tax Units <sup>3</sup>			Percent Change in After- Tax Income <sup>4</sup>	Percent of Total Income Tax Change	Average Tax Change (\$)	Average Federal Tax Rate <sup>5</sup>	
	Number (thousands)	Percent of Total	Percent with Tax Cut				Current Law	Proposal
Less than 10	20,301	14.0	3.8	0.2	8.4	-14	3.3	3.1
10-20	26,357	18.1	8.2	0.2	29.2	-36	5.4	5.1
20-30	20,537	14.1	8.1	0.2	30.6	-49	10.8	10.6
30-40	15,633	10.8	6.6	0.1	16.3	-34	14.9	14.8
40-50	11,543	7.9	4.6	0.1	7.1	-20	17.0	16.9
50-75	20,112	13.8	1.5	0.0	4.2	-7	18.9	18.9
75-100	11,773	8.1	0.3	0.0	1.0	-3	20.4	20.4
100-200	14,039	9.7	0.3	0.0	1.5	-3	22.6	22.6
200-500	3,588	2.5	0.1	0.0	0.2	-2	25.6	25.6
500-1,000	593	0.4	0.1	0.0	0.0	-1	27.6	27.6
More than 1,000	284	0.2	0.1	0.0	0.0	-2	31.1	31.1
All	145,321	100.0	4.5	0.0	100.0	-22	20.7	20.7

Source: Urban-Brookings Tax Policy Center Microsimulation Model.

(1) Baseline is current law.

(2) Returns with negative cash income are excluded from the lowest income class but are included in the totals.

(3) Includes both filing and non-filing units. Tax units that are dependents of other taxpayers are excluded from the analysis.

(4) After-tax income is cash income less: individual income tax net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax.

(5) Average federal tax (individual income tax, net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax) as a percentage of average cash income.

**Table 9**  
**Revenue Cost of Extending Saver's Credit and Expanding Eligibility for Top Credit Rate**

Year	Extend existing credit beyond 2006	Extend and expand eligibility for 50 percent credit rate to joint filers with AGI up to		
		\$50,000	\$60,000	\$70,000
2006	0.0	1.9	3.5	5.3
2007	0.6	6.0	10.4	15.4
2008	1.7	6.7	11.0	15.8
2009	1.6	6.3	10.4	15.1
2010	1.5	6.0	9.9	14.4
2011	1.6	6.2	9.9	14.3
2012	1.8	6.9	10.4	14.7
2013	1.7	6.6	9.9	13.9
2014	1.6	6.2	9.4	13.1
2015	1.5	5.9	8.9	12.4
Total, 2006-15	13.5	58.7	93.9	134.5

Source: Authors' calculations using Urban-Brookings Tax Policy Center Microsimulation Model.

The income cut-offs for single filers and heads of households would remain in the same proportion to the joint filer thresholds as under the current Saver's Credit

**Appendix Table 1**  
**Saver's Credit Options**  
**Effect on Income Tax Revenues in \$ Billions, 2006-2015**

	Fiscal Year											Total 2006-2015
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2006-2015	
<b>Current Law Baseline</b>												
Extend Saver's Credit	0.0	-0.6	-1.7	-1.6	-1.5	-1.6	-1.8	-1.7	-1.6	-1.5	-1.5	-13.5
Extend and Index	0.0	-0.7	-1.9	-2.0	-2.0	-2.3	-2.8	-2.8	-2.8	-2.9	-2.9	-20.3
Extend and Make Refundable	-1.1	-3.8	-4.8	-4.7	-4.5	-4.3	-4.1	-4.0	-3.8	-3.7	-3.7	-38.8
Extend, Index, and Make Refundable	-1.2	-4.0	-5.2	-5.3	-5.4	-5.3	-5.3	-5.4	-5.4	-5.5	-5.5	-48.0
Extend and Increase Phaseout to \$50,000	-1.9	-6.0	-6.7	-6.3	-6.0	-6.2	-6.9	-6.6	-6.2	-5.9	-5.9	-58.7
Extend and Increase Phaseout to \$60,000	-3.5	-10.4	-11.0	-10.4	-9.9	-9.9	-10.4	-9.9	-9.4	-8.9	-8.9	-93.9
Extend and Increase Phaseout to \$70,000	-5.3	-15.4	-15.8	-15.1	-14.4	-14.3	-14.7	-13.9	-13.1	-12.4	-12.4	-134.5
Extend, Index, Increase Phaseout to \$50,000, and Make Refundable	-3.9	-11.8	-13.0	-13.0	-13.0	-12.8	-12.7	-12.7	-12.7	-12.8	-12.8	-118.5
Extend, Index, Increase Phaseout to \$60,000, and Make Refundable	-5.7	-16.8	-18.0	-18.0	-18.0	-17.8	-17.6	-17.4	-17.3	-17.2	-17.2	-163.9
Extend, Index, Increase Phaseout to \$70,000, and Make Refundable	-7.5	-22.1	-23.2	-23.2	-23.1	-22.9	-22.7	-22.5	-22.3	-22.2	-22.2	-211.8

Source: Urban-Brookings Tax Policy Center Microsimulation Model.

**Appendix Table 2**  
**Saver's Credit Options**  
**Effect on Income Tax Revenues in \$ Billions, 2006-2015**

	Calendar Year										Total	
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2006-2015	2015
<b>Current Law Baseline</b>												
Extend Saver's Credit	0.0	-1.7	-1.6	-1.6	-1.4	-1.9	-1.8	-1.8	-1.6	-1.5	-1.4	-14.4
Extend and Index	-0.1	-1.9	-1.9	-2.0	-2.0	-2.8	-2.8	-2.8	-2.8	-2.9	-2.9	-22.1
Extend and Make Refundable	-3.2	-4.8	-4.7	-4.6	-4.4	-4.1	-4.0	-3.9	-3.9	-3.7	-3.6	-41.1
Extend, Index, and Make Refundable	-3.4	-5.2	-5.3	-5.4	-5.4	-5.3	-5.3	-5.4	-5.4	-5.4	-5.5	-51.6
Extend and Increase Phaseout to \$50,000	-5.5	-6.9	-6.4	-6.1	-5.8	-7.0	-6.7	-6.3	-6.3	-6.1	-5.7	-62.5
Extend and Increase Phaseout to \$60,000	-10.0	-11.3	-10.6	-10.1	-9.5	-10.6	-10.1	-9.5	-9.5	-9.1	-8.7	-99.5
Extend and Increase Phaseout to \$70,000	-15.0	-16.1	-15.3	-14.7	-13.9	-15.0	-14.2	-13.4	-12.7	-11.9	-11.9	-142.2
Extend, Index, Increase Phaseout to \$50,000, and Make Refundable	-11.1	-13.0	-13.0	-13.0	-12.9	-12.7	-12.7	-12.7	-12.7	-12.8	-12.8	-126.8
Extend, Index, Increase Phaseout to \$60,000, and Make Refundable	-16.2	-18.0	-18.0	-18.0	-17.9	-17.6	-17.5	-17.3	-17.3	-17.3	-17.2	-175.1
Extend, Index, Increase Phaseout to \$70,000, and Make Refundable	-21.5	-23.3	-23.2	-23.2	-23.0	-22.8	-22.6	-22.4	-22.2	-22.2	-22.0	-226.1

Source: Urban-Brookings Tax Policy Center Microsimulation Model.

**Appendix Table 3**  
**Effect of Reforming the Saver's Credit<sup>1</sup>**  
**Distribution of Income Tax Change by Cash Income Class, 2005**

Cash Income Class (thousands of 2003 dollars) <sup>2</sup>	Tax Units <sup>3</sup>			Percent Change in After-Tax Income <sup>4</sup>	Percent of Total Income Tax Change	Average Tax Change (\$)	Average Federal Tax Rate <sup>5</sup>	
	Number (thousands)	Percent of Total	Percent with Tax Cut				Current Law	Proposal
Less than 10	20,301	14.0	3.8	0.2	2.5	-14	3.3	3.1
10-20	26,357	18.1	9.8	0.3	10.6	-45	5.4	5.1
20-30	20,537	14.1	16.6	0.5	21.6	-117	10.8	10.4
30-40	15,633	10.8	16.8	0.4	16.8	-119	14.9	14.6
40-50	11,543	7.9	17.7	0.4	16.9	-163	17.0	16.6
50-75	20,112	13.8	17.8	0.3	29.1	-161	18.9	18.7
75-100	11,773	8.1	1.2	0.0	1.2	-11	20.4	20.4
100-200	14,039	9.7	0.6	0.0	0.8	-7	22.6	22.6
200-500	3,588	2.5	0.4	0.0	0.1	-3	25.6	25.6
500-1,000	593	0.4	0.2	0.0	0.0	-2	27.6	27.6
More than 1,000	284	0.2	0.1	0.0	0.0	-2	31.1	31.1
All	145,321	100.0	10.5	0.2	100.0	-76	20.7	20.6

Source: Urban-Brookings Tax Policy Center Microsimulation Model.

(1) Baseline is current law. Reform includes making the credit refundable, increasing the AGI limit for married couples filing jointly to \$50,000, and phasing out the limit over \$10,000.

(2) Returns with negative cash income are excluded from the lowest income class but are included in the totals.

(3) Includes both filing and non-filing units. Tax units that are dependents of other taxpayers are excluded from the analysis.

(4) After-tax income is cash income less: individual income tax net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax.

(5) Average federal tax (individual income tax, net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax) as a percentage of average cash income.

**Appendix Table 4**  
**Effect of Reforming the Saver's Credit<sup>1</sup>**  
**Distribution of Income Tax Change by Cash Income Class, 2005**

Cash Income Class (thousands of 2003 dollars) <sup>2</sup>	Tax Units <sup>3</sup>			Percent Change in After-Tax Income <sup>4</sup>	Percent of Total Income Tax Change	Average Tax Change (\$)	Average Federal Tax Rate <sup>5</sup>	
	Number (thousands)	Percent of Total	Percent with Tax Cut				Current Law	Proposal
Less than 10	20,301	14.0	3.8	0.2	1.7	-14	3.3	3.1
10-20	26,357	18.1	9.8	0.3	7.3	-45	5.4	5.1
20-30	20,537	14.1	16.6	0.5	15.2	-120	10.8	10.3
30-40	15,633	10.8	22.9	0.6	17.5	-181	14.9	14.4
40-50	11,543	7.9	18.5	0.5	12.9	-182	17.0	16.6
50-75	20,112	13.8	27.9	0.6	40.9	-329	18.9	18.4
75-100	11,773	8.1	7.1	0.1	3.4	-46	20.4	20.4
100-200	14,039	9.7	0.9	0.0	0.8	-9	22.6	22.6
200-500	3,588	2.5	0.6	0.0	0.1	-6	25.6	25.6
500-1,000	593	0.4	0.2	0.0	0.0	-2	27.6	27.6
More than 1,000	284	0.2	0.2	0.0	0.0	-2	31.1	31.1
All	145,321	100.0	13.2	0.2	100.0	-111	20.7	20.5

Source: Urban-Brookings Tax Policy Center Microsimulation Model.

(1) Baseline is current law. Reform includes making the credit refundable, increasing the AGI limit for married couples filing jointly to \$60,000, and phasing out the limit over \$10,000.

(2) Returns with negative cash income are excluded from the lowest income class but are included in the totals.

(3) Includes both filing and non-filing units. Tax units that are dependents of other taxpayers are excluded from the analysis.

(4) After-tax income is cash income less: individual income tax net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax.

(5) Average federal tax (individual income tax, net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax) as a percentage of average cash income.

**Appendix Table 5**  
**Effect of Reforming the Saver's Credit<sup>1</sup>**  
**Distribution of Income Tax Change by Cash Income Class, 2005**

Cash Income Class (thousands of 2003 dollars) <sup>2</sup>	Tax Units <sup>3</sup>			Percent Change in After-Tax Income <sup>4</sup>	Percent of Total Income Tax Change	Average Tax Change (\$)	Average Federal Tax Rate <sup>5</sup>	
	Number (thousands)	Percent of Total	Percent with Tax Cut				Current Law	Proposal
Less than 10	20,301	14.0	3.8	0.2	1.3	-14	3.3	3.1
10-20	26,357	18.1	9.8	0.3	5.5	-45	5.4	5.1
20-30	20,537	14.1	16.6	0.5	11.5	-120	10.8	10.3
30-40	15,633	10.8	24.0	0.7	15.7	-216	14.9	14.3
40-50	11,543	7.9	24.7	0.6	11.4	-212	17.0	16.5
50-75	20,112	13.8	29.2	0.8	37.0	-395	18.9	18.3
75-100	11,773	8.1	26.5	0.4	16.1	-293	20.4	20.1
100-200	14,039	9.7	1.6	0.0	1.1	-17	22.6	22.6
200-500	3,588	2.5	0.7	0.0	0.1	-8	25.6	25.6
500-1,000	593	0.4	0.3	0.0	0.0	-4	27.6	27.6
More than 1,000	284	0.2	0.2	0.0	0.0	-3	31.1	31.1
All	145,321	100.0	15.6	0.3	100.0	-148	20.7	20.5

Source: Urban-Brookings Tax Policy Center Microsimulation Model.

(1) Baseline is current law. Reform includes making the credit refundable, increasing the AGI limit for married couples filing jointly to \$70,000, and phasing out the limit over \$10,000.

(2) Returns with negative cash income are excluded from the lowest income class but are included in the totals.

(3) Includes both filing and non-filing units. Tax units that are dependents of other taxpayers are excluded from the analysis.

(4) After-tax income is cash income less: individual income tax net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax.

(5) Average federal tax (individual income tax, net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax) as a percentage of average cash income.



DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

MAR 17 2004

J. Mark Iwry  
1775 Massachusetts Avenue, N.W.  
Washington, D.C. 20036-2188

Dear Mr. Iwry:

This general information letter responds to your request, dated December 15, 2003, for information regarding the use of automatic compensation reduction elections (also known as "automatic enrollment"), as described in Revenue Rulings 2000-8, 2000-1 C.B. 617, and 2000-35, 2000-2 C.B. 138 (the "Rulings"); Announcement 2000-60, 2000-2 C.B. 149; and section 1.401(k)-1(a)(3)(ii) of the Proposed Income Tax Regulations.

Section 3.06 of Revenue Procedure 2004-4, 2004-1 I.R.B. 125, describes a general information letter as a statement issued by the Internal Revenue Service that calls attention to a well-established interpretation or principle of tax law without applying it to a specific set of facts.

As used in this general information letter, the terms "automatic compensation reduction election" (in contrast to an "affirmative election"), "compensation reduction contribution," and "compensation reduction percentage" are intended to have the same meanings those terms have when used in Revenue Ruling 2000-8.

The compensation reduction percentage pursuant to an automatic compensation reduction election under an Internal Revenue Code ("Code") section 401(k) plan or a Code section 403(b) tax-sheltered annuity or custodial account is permitted to be any percentage of compensation that would be permitted in the case of an elective contribution or elective deferral made pursuant to an affirmative, explicit election (i.e., in which the default is no elective contribution or elective deferral). Accordingly, there is no special maximum limit on the automatic compensation reduction percentage and no safe harbor automatic compensation reduction percentage. The holdings in the Rulings therefore would be equally applicable to each of the plans described in the Rulings if the automatic compensation reduction percentage under the plan were any percentage greater or less than the percentages specified in the Facts sections of the Rulings. Thus, for example, the automatic compensation reduction percentage need not be limited to the percentage of compensation that limits, under the plan, the amount of elective contributions or elective deferrals that are matched by employer matching contributions. Of course the amount of an elective contribution or elective deferral is

subject to the limitations imposed under or as a result of sections 401(a), 401(k)(3), 402(g), 403(b), 415, and any other applicable provision of the Code.

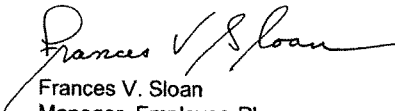
The analysis and the holdings in the Rulings would be equally applicable to the plans described in the Rulings if the automatic compensation reduction percentage under each plan increased or otherwise changed over time, pursuant to a specified schedule. However, this would be the case only if the notices provided to employees (explaining the automatic compensation reduction election and the employee's right to elect to have no such compensation reduction contributions made to the plan or to alter the amount of those contributions, including the procedure for exercising that right and the timing for implementation of any such election) described the amounts and timing of any planned changes to the automatic compensation reduction percentage.

The analysis and the holdings in the Rulings would be equally applicable to the plans described in the Rulings if the automatic compensation reduction election under each plan, or an increase in the automatic compensation reduction percentage, applied in part or in whole to one or more future increases in or supplements to compensation (including pay raises and bonuses) or if the automatic compensation reduction election or increase in percentage was conditioned on or scheduled to take effect at the time of such compensation increases or supplements. However, this would be the case only if each of the notices provided to employees (explaining the automatic compensation reduction election and the employee's right to elect to have no such compensation reduction contributions made to the plan or to alter the amount of those contributions, including the procedure for exercising that right and the timing for implementation of any such election) described how the automatic compensation reduction election would apply to any such future compensation increases or supplements.

We hope this general information will be helpful to you. However, the information provided in this letter is not a ruling and may not be relied on as such.

If you have any questions concerning this letter, please contact Susan Taylor, ID # 50-07189 at (202) 283-9640.

Sincerely,



Frances V. Sloan  
Manager, Employee Plans  
Technical Group 3



214 Massachusetts Ave. N.E. Washington D.C. 20002 (202) 546-4400 [www.heritage.org](http://www.heritage.org)

*CONGRESSIONAL TESTIMONY*

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## **Building Assets for Low-Income Families**

**Testimony before  
Subcommittee on Social Security  
and Family Policy  
Committee on Finance  
United States Senate**

**April 28, 2005**

**David C. John  
Research Fellow  
Thomas A. Roe Institute for Economic Policy Studies  
The Heritage Foundation**

I appreciate the opportunity to appear before you today to discuss building assets for lower-income families. This is an extremely important subject, and I would like to thank both Chairman Santorum and Senator Conrad for scheduling this hearing. Let me begin by noting that while I am a Research Fellow at the Heritage Foundation, the views that I express in this testimony are my own, and should not be construed as representing any official position of the Heritage Foundation. In addition, the Heritage Foundation does not endorse or oppose any legislation.

### **The Importance of Building Assets**

A growing body of research has shown a connection between asset accumulation and several positive intergenerational effects, especially among lower-income families. These reports usually emphasize the effects that wealth has during the formative and adult working years of parents and their children, while the retirement benefits of such asset creation are often only assumed.

The possession of even modest assets over the course of a person's lifetime contributes greatly to that person's development and economic security, as well as the development and economic security of his or her children. Research by Gautam N. Yadama and Michael Sherraden of the Center for Social Development (CSD) indicates that people with assets may be more future-oriented, prudent, confident about their prospects, and connected with their community. Deborah Page-Adams and Nancy Vosler, also from the CSD, found that, among autoworkers affected by a plant closing, those owning homes were less likely than renters to suffer from depression or alcoholism, even after taking into account differences in income and education.

However, the positive effects of assets do not stop with the current generation of workers. Other research has shown that wealth accumulation may also produce important behavioral and socioeconomic improvements for families *across* generations. One set of researchers found that the saving habits of families are more important than family income in predicting teenage saving behavior. Richard K. Green and Michelle J. White demonstrated that children of homeowners are more likely to stay in school and that daughters of homeowners are less likely to have children as teenagers, compared to children of renters. They further concluded that these positive improvements were most dramatic among those with low incomes. Finally, Thomas P. Boehm and Alan M. Schlottmann found that increased levels of home ownership among low-income families lead to increased rates of high school graduation and college attendance for children in those families.

While assets are important during a person's developing and working years, they also increase one's range of retirement options. Expanding retirees' options over the use of their retirement contributions is vital because wealth at retirement can be used for more than just income security. As one set of researchers observed, "Wealth is something

like traveler's checks: you take them along on vacation 'just in case,' but odds are they will remain uncashed and available for sundry goods after the journey is complete."

### **KidSave: An Innovative Step Towards Better Retirement Security**

Studies of retirement savings plans show that the most important step toward retirement security is the decision to save. This simple decision is even more important to an individual's retirement income than how the money is invested. The United Kingdom recognized this fact by creating a small trust fund for every child born in Britain after September 2003. Although not limited to retirement, the British plan would enable people of all income levels to build savings for the future.

In this country, a bipartisan proposal in 2000--sponsored by former Senator Robert Kerrey (D-NE) and cosponsored by Senators Rick Santorum (R-PA), Charles Grassley (R-IA), and John Breaux (D-LA) and former Senator Daniel Patrick Moynihan (D-NY)--would have made that decision much easier by creating "KidSave" accounts as a first step toward providing retirement security for future generations. More recently, on March 2, 2005, Rep. Jerry Weller (R-IL) and Rep. Sherrod Brown (D-OH) introduced KidSave into the House of Representatives as HR 1041. Congress should revive the Kerrey proposal as a way to encourage all Americans to begin building nest eggs for their futures.

#### **How KidSave Would Work**

Under the proposal, at birth, every American child would receive a loan of \$2,000 from Social Security to open a KidSave account. After 2005, the amount would be indexed annually for inflation. The funds could be withdrawn only at retirement or after the account owner's death. Even if no other money is ever added to the account, the \$2,000 initial loan could grow to more than \$50,000 by the time the child retired. The nest egg could then be used for such things as increasing retirement income, sending a grandchild to college, starting a small business, or making a donation to a church or community organization.

This money would be invested through the Thrift Savings Plan (TSP), which helps federal employees invest for retirement. The TSP currently offers three safe and low-cost investment options: a stock index fund, a corporate bond fund, and a government bond fund. Under the proposal, the parents or legal guardians of under-age citizens would choose one of the investment options. In addition to the base loan of \$2,000, parents would be allowed to deposit up to \$500 annually in each child's account until the child is 19. Part of the \$500 could also come from grandparents, who would be allowed to roll over money, tax-free, from 401(k) or similar retirement plans.

When the account owner reached the age of 30, the initial loan would be repaid without interest in five equal annual installments. However, the account owner would repay an inflation-adjusted amount. In other words, if the \$2,000 initial loan had

increased to \$3,500 in inflation-adjusted dollars over the 30 years, the owner would repay \$3,500 in five equal annual installments.

#### **Positive Features of KidSave**

In addition to enabling all individuals to build a retirement nest egg, the KidSave plan would have other benefits. Specifically:

- **KidSave would be available for everyone.** Every child, regardless of family income level, would receive a KidSave account. Instead of attempting to redistribute income or targeting only a few specific groups, the program would help all Americans save for retirement. Lower-income workers would have the same opportunity to build assets as those in higher income brackets.
- **KidSave would be a loan, not a gift.** KidSave would teach children that while people may be willing to assist them, loans must be repaid. Unlike proposals to "seed" retirement accounts with government matching grants, KidSave would not divert other people's tax dollars into the accounts.
- **KidSave would help to reduce the gap between rich and poor.** Many lower-income individuals find it impossible to save because Social Security and other taxes leave them with nothing after rent, food, and other expenses. KidSave would enable low-income families to accumulate a nest egg for the family's future without cutting into their paychecks. Furthermore, since a KidSave account would be owned by the individual and would become part of his or her estate, it would help the family even if the worker died before retirement.
- **KidSave money would stay in the community.** Since every KidSave account would be owned by the individual worker and become part of the worker's estate after death, the KidSave accounts of lower-income workers would tend to remain in their communities, giving these communities a greater opportunity to build wealth.
- **It would be harder to divert KidSave money to other purposes.** A continuing problem with other types of retirement savings plans is that Congress allows workers to use that money for other expenses, such as education and purchasing a home. While these may be worthy goals, they do not directly help a worker prepare for retirement. Because KidSave accounts would be funded by a loan from Social Security, it would be politically difficult for future Congresses to permit account holders to divert KidSave money to non-retirement uses.

Congress should revive Senator Kerrey's KidSave plan. Such a move would be an innovative step toward enabling every American to build a retirement nest egg, permitting all income groups to build assets. This would be especially important in lower-income communities, where today workers often retire with only Social Security for income. KidSave would allow all young Americans to look forward to a retirement that did not depend entirely on traditional Social Security benefits.

## **ASPIRE Accounts**

A similar approach to building assets is contained in the recently introduced ASPIRE Act. This bill has many of the positive features contained in KidSave accounts, but the accounts are not limited to retirement. I will not duplicate other witnesses' testimony by describing the ASPIRE Act. Instead, I will limit my written comments to a general endorsement of this approach, while noting my personal preference for a retirement-oriented account.

## **Individual Development Accounts**

IDAs are subsidized savings accounts that may be used to build funds for such purposes as opening a small business, purchasing a first home, or paying for post-secondary education. There currently are 14 existing IDA programs in operation. Under H.R. 7, IDAs would be available to individuals between the ages of 18 and 60 whose federal adjusted gross income on their federal income tax forms does not exceed \$20,000 annually, to single heads of households with incomes below \$25,000, and to married couples with incomes below \$40,000.

Individuals and families who qualify for IDAs would receive a dollar-for-dollar match for the first \$500 saved in the account per person (in families) per year. Thus, a married couple could receive a match of up to \$1,000 per year. They could save more than \$500 per person per year, but only savings up to \$500 would receive any match. The contributions come from after-tax income, and interest on them would be taxable. However, any matching funds and interest earned by the matching funds would be tax-free.

In order to receive the matching funds, the savers must open an IDA with a qualified financial institution. The term "qualified financial institution" includes any financial institution that is allowed under federal law to hold Independent Retirement Accounts (IRAs). In addition, nonprofits such as credit unions, community development financial institutions, 501(c)3 organizations, and Native American Tribes may sponsor an IDA program. Nonprofits can affiliate with a profit-making financial institution or subsidiary.

The IDA savings matches would be placed in a parallel interest earning account that the account holder could not access until it is time to purchase the approved asset. During the savings period, account holders must attend general financial education classes that are offered through the financial institution or an affiliated non-profit. This system is somewhat overly paternal, but does ensure that savings matches are only used for their intended purpose.

The cost of the savings matches and certain other costs borne by the financial institution would be reimbursed through a tax credit payable to the institution or program sponsor. These tax credits would repay the cost of the actual savings matches plus an annual \$30 per account to cover administrative costs. In addition, program sponsors would receive a one-time \$100 per account credit to cover the cost of financial education provided to account holders, marketing, administration, and similar expenses.

**Do IDAs Work?**

Savings are important to low income households for two reasons. First, through savings goals and budgets, they encourage workers to focus on the future instead of on instant gratification and consumption. This changes behavior and improves the odds of getting out of poverty. They become more focused on improving their children's lives and are more likely to identify with their community and to feel that they have a stake in its future.

Just as important, saving allows low-income workers to build assets. Studies show that it is very difficult for these workers to improve their economic status simply through spending their income. It takes accumulated assets to purchase a house, start a small business, or to increase one's level of education.

Empirical data from demonstration projects indicate that IDAs are an effective way for lower income individuals to save for life-improving purposes. A recent study of the 14 existing IDA programs shows that participants made a deposit in 7 out of 12 months and accumulated an average of \$552 of their own money. Most of this money appears to be new savings that would not have occurred except through the IDA program.

Through June 30, 2000, the study found that only about 16 percent of participants had left the programs without receiving a savings match. The rest either had continued to build savings or had withdrawn their money and used it for a purpose that qualified for a match. About a quarter of those who received a match used their money to purchase a home, and about an equal proportion invested in a small business. About 21 percent used their money for education, with the rest using their money for home repair, job training or retirement.

More important, the data show that when given financial education, IDAs provide the lowest income groups with an incentive to build assets. The study showed that lowest income group saved an average of 5.6 percent of their income in IDAs. This is well above the national personal savings rate. Experts believe that the combination of financial education and a savings match provides lower income workers with the belief that they can reach their savings goal and improve their lives.

**Why Use a Tax Credit Instead of a Tax Refund?**

If a taxpayer-subsidized savings match is desirable, in most circumstances it would be preferable to finance it through a refund of taxes that the individual pays. However, those who qualify for IDAs have incomes that are so low that in most cases they would not actually pay any federal taxes. As a result, the matches must be funded through other methods.

It is true that the mechanism used to fund IDAs is complex, but it does ensure both that the savings matches are used for the planned purpose and that the participants

receive financial education that would not necessarily be available otherwise. In addition, the program is structured to meet its goals with a minimum level of day-to-day federal involvement that would otherwise consume money that could be better used to match actual savings.

Operating the program through community-based organizations and financial institutions allows the program to meet the special needs of the populations being served. This helps to avoid the usual one-size-fits-all mentality found in far too many federal programs.

IDAs are not perfect. As mentioned above, the program is complex and somewhat paternalistic. However, demonstration projects have shown that IDAs are a successful way for lower income workers to begin to save and to increase their financial education. Because beginning to save has been shown to greatly change behavior, it is worth the cost of funding IDAs.

### **Conclusion**

This concludes my written statement. Thank you for focusing on the urgent need to build assets in lower-income families. Regardless of what is done to resolve America's problems with entitlement programs, modest programs such as KidSave, ASPIRE and IDAs can make the American Dream accessible to millions who are currently excluded because they lack the means to save.

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**Question for the Record From Senator Lincoln for  
Mr. David John  
April 28, 2005**

**Question:** Individual Development Accounts (IDAs) clearly help low-income people to save. The Good Faith Fund has over 500 participants who have built cumulative savings of over \$1.1 million dollars. What do you see as the role of the private sector in encouraging personal savings? Do you see opportunities for the private sector to partner with States, local business, and local communities to improve our national savings?

**Answer:** IDAs have been quite successful at allowing low-income workers to build savings balances. The private sector should have a continuing role in encouraging personal savings. It is likely to be much more effective than purely government programs, and to have the flexibility to adapt savings plans to meet local conditions. Savings plans are likely to be much more successful if they meet the specific needs of the different communities they serve. Local businesses are likely to have a much better idea of their community's specific needs than a government agency located miles away. A public-private partnership of government and business should be strongly encouraged to play an increasing role in building savings.

**Building Assets for Low-Income Families**

Subcommittee on Social Security and Family Policy, Senate Committee on Finance

Thursday, April 28, 2005

By Charles M. Palmer, President, ISED Ventures

Since national welfare reform in the mid-90s, much progress has been made to bring low-income people towards economic self-sufficiency, but the job is not done. In order to be successful in today's economy and sustain personal security, people need to develop assets. Assets are considered any appreciating investment such as savings, retirement savings, or ownership of a house or business, and can also include personal investments such as education that can increase income.

The asset poor are very vulnerable to economic shock because they do not have savings to carry them through difficult financial times. They often lack financial education, an understanding of the value of savings, and incentives to look beyond short-term economic hardships to their long-term economic self sufficiency. It has been reported that 25.5% of all American households are asset poor, and that more than 1/3 of all American households (and 60% of African American households) have zero or negative net financial assets. It also is estimated that 40-70 million low income Americans are not currently saving toward asset accumulation.

A comprehensive set of strategies are necessary to reinforce asset development among all Americans, especially the asset poor. Strategies that support asset development include financial literacy education and the Earned Income Tax Credit. The core strategy for wealth building and asset development is Individual Development Accounts.

**ISED Ventures and Asset Development in Iowa**

In the mid-1990s, the State of Iowa began to shape its welfare policy from maintaining families on welfare to a program that emphasized exiting welfare and supporting the movement to self-sufficiency. The goal was to create more flexibility and incentives in the system. Policymakers then and now know leaving welfare does not equate to self-sufficiency, so the challenge is to close the gap.

Individual Development Accounts have become a crucial tool in closing the gap. From the beginning Iowa chose to include IDAs in its welfare reform legislation. In 1999, the Institute for Social and Economic Development began an IDA program still in existence today.

The Institute for Social and Economic Development (ISED) has been dedicated to creating opportunities for low-income families and communities through a variety of programs, technical assistance, and training services since its incorporation in 1987. In 2003, the Board of Directors of ISED decided to restructure the organization with two

subsidiaries – ISED Ventures in Iowa and ISED Solutions in Washington, D.C. ISED Solutions specializes in consulting and research nationally and internationally.

ISED Ventures was organized in 2004 by the Institute for Social and Economic Development (ISED) as the successor organization to the Economic Development Division of ISED. ISED Ventures continues ISED's 18-year mission as a statewide Community Development Corporation dedicated to strengthening the social and economic well-being of individuals and communities in Iowa. More specifically, the purpose of the CDC is "to assist individuals, families, and communities to reach long-term positive social and economic outcomes; and to plan, develop, and implement/manage community development initiatives, including business development, asset development, housing development, and other economic and community development in low-income communities."

ISED Ventures began in 1987 as a microenterprise or small business development agency, focusing on persons below 200 percent of poverty who could pursue self-employment as a welfare-to-work strategy to escape poverty. Today, it has expanded its services and is now providing asset development at a level of scale greater than many other service providers in the nonprofit field. ISED Ventures' target audience remains those who are at or below 200 percent of poverty, including women, minorities, refugees, and persons formerly incarcerated. ISED was the winner of the 1998 Presidential Award for Microenterprise Development in the area of poverty alleviation. In 2003, ISED was named one of eight recipients of the Families Count: National Honors Program of the Annie E. Casey Foundation. This award recognizes organizations that are making a difference in the lives of families struggling to survive in low-income neighborhoods and disadvantaged communities.

ISED Ventures has managed two IDA programs, one for low-income citizens and the other for refugees. Project partners include the United Way of Central Iowa, the State of Iowa and the federal Assets for Independence Act. In the citizen program, nearly 300 Iowans saved a total of \$676,000 as of December 2004. Of those 300 account holders, 114 saved to buy their first home. Another 50 saved to open a small business, and 72 saved toward post-secondary education. Over \$3.4 million was added back to the state's economy in home purchases.

The refugee program grew to become the fifth largest refugee IDA program in the country in which 962 account holders saved more than \$926,000 as of December 2004. The vast majority of refugees chose to save for a vehicle, which was permitted in the refugee program. Ventures found refugees were very concerned about having reliable transportation for employment. Approximately 67 percent of refugees chose to save for a vehicle, which added nearly \$3 million to the economy. Another 22 percent saved for their first home, adding nearly \$7 million to the local economy. Funding for the program ended in September 2004.

Ventures knows the national impact of IDA programs as well. Its sister organization, ISED Solutions, is a leading provider of training and technical assistance to IDA

programs. It also creates resource materials, operates peer listservs, and collects and compiles data on program outcomes. ISED Solutions' experience is that poor people across the nation **are** saving, and those savings are being leveraged to purchase assets that are increasing their sense of belonging and ownership within their communities.

In fact, ISED Solutions has been working with 49 refugee service agencies whose refugee IDA programs were funded by the Office of Refugee Resettlement. Outcomes as of December 31, 2004 are truly amazing:

- 18,000 enrolled savers
- Total savings goals of \$30 million
- \$25 million already saved
- The nearly 14,000 (77 percent) who have made matched withdrawals to purchase assets have saved over \$20 million.
- Participants purchased assets valued at \$238 million, of which more than \$150 million (63 percent) was for home ownership.
- This represents a leverage of 1,172% on participant savings and 418% on their savings plus match funds.

Another essential asset development strategy is the Earned Income Tax Credit (EITC). ISED Ventures has promoted EITC throughout the Des Moines area, focusing on the eligible working low-income population. In the recently-completed 2005 campaign, approximately 1,378 returns were filed with the Internal Revenue Service, with a median EITC of \$1,574, and approximately \$1.7 million in refunds returned to working, low-income families. The EITC represents a significant start for a low-income family to open an IDA, pay off debt, or move the refund into retirement savings. Working with local financial institutions that are present at the tax sites, ISED Ventures gives unbanked filers the opportunity to become banked.

The EITC campaign represents Ventures' largest outreach activity in an urban community. However, the organization wants to continue to strengthen asset development across Iowa, with a focus on rural areas. Joining forces with the Evangelical Lutheran Church in America, Lutheran Services in Iowa, and rural hospitals and clinics in Iowa Health Systems, ISED Ventures provides asset development services in an initiative called Barnabas Uplift. The name is meant to signify "uplifting" and encouraging low-income individuals and families to achieve economic self-sufficiency. The effort is a faith- and community-based inclusive strategy with economic development, health care and asset development components. Along with 518 churches and hospitals, the involvement of key community leaders gives Barnabas strong community ties.

#### **Developing a Culture of Saving**

ISED Ventures has continually proved that low-income populations are very capable of attaining economic self-sufficiency when given the proper incentives and support. Through longstanding experience within the asset development field ISED Ventures has learned very important lessons about how to effectively develop assets among the poor.

These lessons help to better formulate strategies to begin to move people from asset poverty to saving. It is crucial to continue to move from a culture of dependence on welfare to a culture of saving and economic self-sufficiency.

ISED Ventures' experience with the previous ORR program demonstrated the value of additional asset choices. Whereas the AFIA funded citizen IDA program limits the asset choices to the purchase of a home, small-business start-up or expansion, or post-secondary education, the refugee IDA program expanded the asset choices to include the purchase of a vehicle, computer, and home renovation. Additional asset choices increase the scope of asset development and allows for more individuality.

Adopting a hybrid system where nonprofits and financial institutions better complement each other is an important policy consideration. In this system the accounts could be run through the financial institution while the support services would remain the responsibility of the non-profit. This could lower program costs and allow the potential for accounts to be run more like traditional financial investments without time restrictions. A culture of saving will take a long time to create and requiring people to save enough to buy a significant asset within two or three years does not maximize desired outcomes. The hybrid model could also help the transition away from the one-size-fits-all model of IDA delivery to a more individually tailored IDA where match rates, and amount of financial education and support services are determined by the accountholders income and financial awareness.

One of the most important lessons learned by ISED Ventures over the years is that a culture of savers cannot be created quickly or without significant programmatic support. This has led ISED Ventures to start to focus part of the IDA program on youth. An excellent strategy to develop long-term asset development habits is to reach people when they are young to begin to build strong saving habits.

ISED Ventures has positioned itself to provide a comprehensive set of asset development strategies to help low-income lowans build assets and achieve economic self-sufficiency. The support of the government and financial sectors will strengthen this strategy and more flexibility will increase the scale of IDA programs.

In order to sustain IDA programs and achieve the scale that is necessary to serve more income people, many changes and modifications to the program will be needed. The program in many ways is still in its beginning stages and there is much yet to be learned from practice and experimentation in a fast-changing field.

Some recommendations to consider from ISED Ventures' and Solutions' experience are as follows:

- Increase the range of asset choices in an IDA, including vehicles.
- Allow more flexibility in the IDA program to increase points of access, and the length of time available to save.
- Provide an option to waive some current AFIA program requirements, specifically not everyone in a matched savings program needs financial education.

- Create incentives for banks and other corporations to contribute match funds to help the IDA program grow in scope and impact.
- Provide an appropriation to sustain the previous Office of Refugee Resettlement IDA program.
- Continue to provide quality technical assistance to help local agencies increase the effectiveness and impact of their programs.
- Increase investment in youth IDAs, supporting the culture of saving in young Americans.

Thank you for the opportunity to provide testimony to the subcommittee.

**Statement**  
**Sen. Rick Santorum**  
**Chairman**  
**Hearing of the Subcommittee on Social Security and Family Policy of the**  
**Senate Finance Committee**  
**“Building Assets for Low-Income Families”**  
**April 28, 2005**

I would like to thank my colleague Senator Conrad, the Ranking Member of the Subcommittee on Social Security and Family Policy, for joining me and these distinguished panels of witnesses to take a closer look at the critical question of what policies best encourage the building of assets for low-income families.

In an environment where there is much debate about whether defending the status quo provides an adequate solution to the savings and asset challenges facing many Pennsylvanians and families throughout America, this is an appropriate time to examine existing proposals, bipartisan contributions, and additional ideas to improve and facilitate low-income savings. Michelle Simmons’ story from Norristown, PA provides just one dramatic example of how faith, hard work, the charitable community, and strategic use of government incentives through Individual Development Accounts (IDAs) or Family Savings Accounts (FSAs), as they are called in Pennsylvania, can make a significant difference in people’s lives.

Real life experience with the miracle of compounding interest and the resulting benefits of better access to capital and opportunity needs to become a reality for more Americans– shorter term savings for asset building purposes such as education and homeownership are essential components- as well as longer-term savings for retirement security– and the choice to pass on resources to the next generation or to charity.

Clearly, an ownership society includes at least several key elements such as an emphasis on financial education and skills, incentives for savings with special emphasis on low-income families, and empowerment through expanded choice. Along with Senator Conrad, I recently started a Congressional Savings and Ownership Caucus which is bipartisan and bicameral. Many Americans face an ongoing savings and assets crisis. One third of all Americans have no assets available for investment, and another fifth have only negligible assets. The United States household savings rate lags far behind that of other industrial nations, constraining national economic growth and keeping many Americans from entering the economic mainstream by buying a house, obtaining an adequate education, or starting a business.

I am pleased that some of the witnesses will touch on IDAs and KIDS Accounts in particular. IDAs, as previously mentioned, are a bipartisan proposal with years of demonstration experience of approximately 20,000 accounts nationwide demonstrating that low-income families can save. Just yesterday, I introduced along with Senator Lieberman the Savings and Working Families Act of 2005, S. 922.

Low-income Americans face a significant hurdle when trying to save. Individual Development Accounts (IDAs) provide them with a way to work toward building assets while instilling the practice of savings into their everyday lives. IDAs are one of the most promising tools that enable low-income and low-wealth American families to save, build assets, and enter the financial mainstream. An IDA provision providing for 300,000 accounts was included in the CARE Act which passed the Senate last Congress 95-5.

Based on the idea that all Americans should have access, through the tax code or through direct expenditures, to the structures that subsidize homeownership and retirement savings of wealthier families, IDAs encourage savings efforts among the poor by offering them a one-to-one match for their own deposits up to \$500 a year. IDAs reward the monthly savings of working-poor families who are trying to buy their first home, pay for post-secondary education, or start a small business. These matched savings accounts are similar to 401(k) plans and other matched savings accounts, but can serve a broad range of purposes.

The Savings and Working Families Act of 2005 builds on existing IDA programs by creating tax credit incentives for an additional 900,000 accounts. Individuals between 18 and 60 who are not dependents or students and meet the income requirements would be eligible to establish and contribute to an IDA. For single filers, the income limit would be \$20,000 in modified Adjusted Gross Income (AGI). The corresponding thresholds for head-of-household and joint filers would be \$30,000 and \$40,000, respectively. Participants could generally withdraw their contributions and matching funds for qualified purposes, which include certain higher education expenses, first-time home purchase expenditures, and small business capitalization. President George W. Bush has supported IDAs and included this proposal for a national demonstration in his budget, which is estimated to cost \$1.7 billion dollars over 10 years.

It has been demonstrated that IDAs work to spur savings by low-income individuals. The American Dream Demonstration, a 14-site IDA program, has proven that low-income families, with proper incentives and support, can and do save for longer-term goals. Average monthly net deposits per participant were \$19.07, with the average participant saving 50% of the monthly savings target and making deposits in 6 of 12 months. Participants accumulated an average of \$700 per year including matching contributions. Importantly, deposits increased as the monthly target increased, indicating that low-income families' saving behavior, like that of wealthier individuals, is influenced by the incentives they receive.

Additionally, key to the success of IDAs is the economic education that participants receive. Information about repairing credit, reducing expenditures, applying for the Earned Income Tax Credit, avoiding predatory lenders, and accessing financial services helps IDA participants to reach savings goals and to integrate themselves into the mainstream economic system. The encouragement and connection to supportive services helps low-income individuals to keep early withdrawals to a minimum and overcome obstacles to saving. Banks and credit unions benefit from these new customer relations, and states benefit from decreased presence of check-cashing, pawnshop, and other predatory outlets. But more than income enhancement, asset accumulation

affects individuals' confidence about the future, willingness to defer gratification, avoidance of risky behavior, and investment in community.

Another recent bipartisan proposal are KIDS Accounts. I recently introduced "The America Saving for Personal Investment, Retirement, and Education (ASPIRE) Act of 2005", S. 868, along with Senator Corzine, Senator Schumer and Senator DeMint. The bill creates a Kids Investment and Development Savings (KIDS) Account for every child at birth and creates a new opportunity for the children of low-income Americans to build assets and wealth.

This country has seen a growing number of Americans investing in the stock market and has witnessed an historic boom in homeownership, which has reached record high levels. However, this growth in assets has not reached every American. While many middle- and upper-income families have increased their assets in the past decade, many low-income families have not had the same financial success. A recent study conducted by the Federal Reserve found that the median net worth of families in the bottom 20 percent of the nation's income level was a mere \$7,900 -- an amount that is far too low to ensure a comfortable economic future for their family. This challenge needs to be addressed to ensure that lower income families have a significant opportunity to accrue wealth and expand opportunities for their families.

Under this legislation, KIDS Accounts would be created after a child is born and a Social Security number issued. A one-time \$500 deposit would automatically be placed into a KIDS account. Children from households below the national median income would receive an additional deposit of \$500 at birth and would be eligible to receive dollar-for-dollar matching funds up to \$500 per year for voluntary contributions to the account, which cannot exceed \$1,000 per year. All funds grow tax-free. Access to the account prior to age 18 would not be permitted, but kids--in conjunction with their parents--would participate in investment decisions and watch their money grow. When the young person turns 18, he or she can use the accrued money for asset building purposes such as education, homeownership, and retirement planning. Accrued funds could also be rolled over into a Roth IRA or 529 post-secondary education account to expand investment options.

I would like to highlight what I view as the two major benefits of this legislation. The first, and most apparent, is that this bill will help give younger individuals, especially low-income Americans, a sound financial start to begin their adult life. For example, a typical low-income family making modest but steady contributions can create a KIDS Account worth over \$20,000 in 18 years. Second, and perhaps more important, is that KIDS Accounts create opportunities for all Americans to become more financially literate. The account holders and their guardians will choose from a list of possible investment funds and will be able to watch their investment grow over time. All Americans will have the opportunity to see firsthand that a smart investment now can grow over time into considerable wealth.

I believe that this bill could be a significant and strategic step forward in the effort to expand asset opportunities to all Americans, and lower-income Americans in particular.

Some proposals are modest yet would have a significant impact on the low-income savings rate. One such example is the effort of myself and others in both chambers to spur the Internal Revenue Service (IRS) to allow for split refunds. In other words, to allow taxpayers to send a portion of their refund to two or more accounts to encourage upfront savings while resources are available. It is estimated that this simple administrative change could result in a large increase in low-income savings-- as some will divert money to medium term savings objectives and some to a Roth IRA for long-term retirement savings. For example, last year the IRS sent refund checks averaging \$2,300 to 130 million tax filers. For many, this represents the best chance to save money during the year.

There is common ground to be had on building assets-- but we need to follow where the evidence leads. In families where assets are owned, children do better in school, voting participation increases, and family stability improves. Reliance on public assistance decreases as families use their assets to access higher education and better jobs, reduce their housing costs through ownership, and create their own job opportunities through entrepreneurship. As many in the media and elsewhere like to point out about asset building proposals-- it's also hard to avoid the lessons and implications for Social Security reform of individuals and families improving their lives through the expanded opportunity that assets bring. Our goal today is not to avoid- but to examine what works for low-income families in particular. I look forward to the testimony of the witnesses. Thank you for your willingness to appear before the Subcommittee.

The Impact of Wealth on Child Development Outcomes

Invited Testimony to the Senate Finance Committee,  
Subcommittee on Social Security and Family Policy

Trina R. Williams Shanks, Ph.D.  
Assistant Professor  
University of Michigan School of Social Work

April 28, 2005

University of Michigan  
School of Social Work  
1080 S. University  
Ann Arbor, MI 48109-1106  
Tel: 734-764-7411  
Fax: 734-763-3372  
E-mail: [trwilli@umich.edu](mailto:trwilli@umich.edu)

Thank you, Senators Santorum and Conrad and Members of the Senate Finance Committee Subcommittee on Social Security and Family Policy, for inviting me here today. I am honored to give this testimony.

It is well documented that income poverty has negative consequences for children (Duncan & Brooks-Gunn, 1997). But if a poor family accumulates wealth, does this ameliorate negative consequences (wealth building as a promotive or protective factor)? In the last decade, with more attention being given to wealth as an indicator of inequality, several authors have included it as an aspect of household socio-economic status (SES) when considering child outcomes. Conley (1999) tests the hypothesis that most of the differences attributed to race are actually class differences defined primarily by wealth. Measuring the adult outcomes of children born since 1962, Conley analyzes differences in net worth, high school graduation, college graduation, repeating a grade, labor force participation, wages, welfare receipt, and pre-marital childbearing (for daughters) and finds that racial differences are either no longer significant or dramatically lessen once parental wealth is added to the equation. Shapiro (2004) makes a similar case using qualitative interviews to demonstrate how parents use either personal wealth or money inherited from their own parents' wealth to create transformative opportunities for children, particularly via enrollment in better schools.

It is difficult, however, to disentangle the effects of wealth, income, parental education, home environment, and neighborhood effects on child outcomes. Thus some doubt whether encouraging asset building would be most beneficial to children as a policy option. I have tried to respond to this conversation in two ways. Firstly, by examining the impact of wealth on child development outcomes using a longitudinal nationally representative dataset, the Panel Study of Income Dynamics (PSID) and its 1997 Child Development Supplement. Most of the research presented here comes from this secondary analysis. But secondly, I am also currently working with colleagues to gather primary data that directly tests the efficacy of children's savings accounts (more information on SEED demonstration and research is provided later).

My initial research question is simply: what is the impact of household wealth on the academic and behavioral outcomes of young children?

A second research question is: Do racial disparities in child outcomes decline as wealth is added to regression models? This inquiry reflects the idea that large and longstanding differences in wealth by race may be an important contributing factor to racial disparities in a variety of child outcomes.

Using PSID data, I examine the impact of household wealth on multiple child development outcomes for Black, White, and Hispanic children between the ages of three and twelve. Overall, household wealth is a significant predictor for academic achievement test outcomes and reported behavior problems even at these young ages. In a few instances, not only does having information about household wealth over and above traditional SES measures such as income and parental education add explanatory value, but it also reduces the statistical significance of income. Turning to the issue of

racial differences, disparities in the academic achievement domain by race go away or are significantly reduced as wealth and the other SES variables are added to the model. Initially there are no racial differences in reported behavior problems. After all the SES measures are added, however, Blacks and Hispanics become less likely to have such problems. (See Tables 1-2 in the Appendix to observe selected specific statistical findings).

A third question is whether household wealth is of benefit to children in families that are poor or face other disadvantages. Thus far, it has been established that even when controlling for other important variables, wealth seems to influence child outcomes. But is this a robust finding or does it really just confirm that households with few assets also have less of other resources so wealth just serves as a proxy for these other things? The issue is complex because so many of these factors are interconnected. In an attempt to address this question, I divide the sample into four groups based on whether the household is income poor and or asset poor. Income poverty is based on the standard definition of whether household income falls below the federal minimum for a given family size. Asset poverty is based on a measure of net worth including home equity. Households that are in the bottom quartile of the wealth distribution (net worth <\$750) are defined as asset poor.

The distribution of these various subcategories can be found in Chart 1. Although a slight majority of the income poor is also asset poor, 40 percent of these households do have a net worth higher than \$750. And although the majority of those above the poverty line have some wealth, 18 percent are poor in assets, with a net worth of lower than \$750. Given that there is some differentiation of asset holdings within income groups, it becomes possible to examine income poor households that have some assets to see if their children fare better than poor households with few or no assets. It is also possible to consider households that are above the poverty line but have few assets and examine if their children fare worse than households with more wealth.

Summaries of dependent variables, independent variables, and mediating variables for the four combinations of income and asset poverty can be found in Table 3. Analysis of Variance (ANOVA) was conducted to test for significant differences between groups. When a group's mean for a variable is significantly higher than the groups below it, the value is in bold type. When a group's mean is significantly lower than the groups above it, the value is marked with a "+". As can be seen in the table, outcomes often increase in an orderly fashion from the most disadvantaged group (Asset poor and Income Poor) to the most advantaged group (Asset rich and Income Rich).

There are several interesting patterns that emerge. For many measures, the most advantaged group (Income rich and Asset Rich) is far ahead of all other groups. This is true for the academic test scores, the behavior problem index, parental expectations and economic strain. For other measures, the two Income poor groups are similar and the two Income rich groups are similar, regardless of asset level. This is true for several of the physical health outcomes and parental depression. For some measures, the two mixed groups are similar with the advantaged group faring significantly better and the more

disadvantaged group (Income Poor and Asset Poor) faring significantly worse. This is true for homeownership, neighborhood rating, and the food security scale. Overall, assets don't seem to help much in terms of the physical health variables although even within households with incomes above the poverty line, children in those with assets have statistically higher birth weights. For school attendance (days absent), those that are income poor but asset rich are not statistically different from either of the non-poor groups.

Income poor asset rich households tend to have the most favorable outcomes within the intermediary variables. In a sense, they look more like the non-poor households. Excluding parental depression, HOME scores, and economic strain, the income poor households with a net worth above \$750 are most similar to the income rich asset poor group. They rate their neighborhoods as a better place to raise kids, they read to their young children, they are less likely to experience food insecurity, they have higher expectations for their child's schooling, and their children watch less television on average. Thus, it is possible to make the case that community and family processes differ for households with assets. This criteria alone might lead to the expectation that children in income poor, but asset rich households are better off than children income poor households without assets.

Of course, assets are not a panacea for all potential problems that are associated with income poverty. However, in most instances children living in households with higher levels of net worth seem to have consistently better results than those in households with little or no net worth. This seems to hold true even for those households that fall below the income poverty line. These analyses were done with a low threshold for asset poverty (net worth including home equity < \$750). This is reflective of the UK finding that even low levels of savings and assets seem to make important differences (Bynner, 2001). Patterns are similar, however, when higher levels of wealth are considered. Chart 1 demonstrates how the distribution of households in each category changes with a higher cut-off point. When summarizing the same variables in Table 3 defining asset poverty using the higher \$5000 threshold, results are almost identical.

Although there are benefits to using large-scale nationally representative longitudinal datasets to address important policy concerns, there are also limitations. In the PSID, there are possibly unobserved variables that influence parental economic situation as well as child outcomes. Thus, any significant findings may not be solely due to the effects of assets.

Arnold Sameroff in his studies of child development in the context of environmental risk finds that any one risk factor (such as low-income or single parent households) does not guarantee poor child outcomes. Typically it is a constellation of multiple high-risk variables that is most predictive of the most negative child results. In fact, he consistently finds that a competent child with a high level of human capital living in conditions of high environmental risk does worse than children of low competence in low-risk environments.

A second way to examine the impact of wealth and asset accumulation on child development is through primary data collection where families in a variety of contexts are offered the opportunity to participate. With support from philanthropic foundations, a group of national partners is undertaking an intensive multi-year initiative known as SEED—Saving for Education, Entrepreneurship, and Downpayment. This demonstration will develop and test the efficacy of matched savings accounts and financial education for children and youth. For more information on the specifics of SEED, visit the website [www.cfed.org](http://www.cfed.org).

I am co-investigator for the impact assessment portion of SEED where in the context of a quasi-experimental design, 500 low-income families with pre-school children will be offered college savings accounts in Michigan. These families will be followed over a four year period and compared with a control group on a variety of parental and child outcomes. Wave One surveys have already been completed and the families are now being recruited to sign up for accounts.

As we look forward to the findings of the SEED initiative to address questions about the possible impact of child accounts more concretely in the near future, there is one result my colleagues and I found from in-depth interviews with ADD (American Dream Demonstration) participants I would like to highlight. In addition to saving money and over time possibly acquiring an asset such as a home or secondary education, being in the program seemed to create focus and generate hope, even in economically fragile households. This focus and hope was not found at the same level in the control participants.

In the SEED impact assessment survey, we ask questions about parental expectations for their child's future and how much money is being put aside for their child's education. We know from theoretical work by Jackie Eccles that the beliefs and expectations of a child's socializer can impact their own self-schemas, which in turn affects a child's achievement related choices and performance over time. If findings similar to those from ADD can be found in SEED, we might note that parents have more hope and focus on helping their children reach goals of education and personal betterment using money set aside in these specially designated accounts. Based on my analyses of data from longitudinal nationally representative datasets, it is feasible that assets and household wealth can lead to better outcomes for children. The potential, at least, is that with child accounts or some focused asset-building plan more young people could have glimpses of hope rather than expectations of repeating intergenerational experiences of failure both academically and economically.

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## Appendix

Table 1: OLS Regression Model Predicting Applied Problem  
(N=1466)

Independent Variables	<u>Model I</u> B(s.e)	<u>Model II</u> B(s.e)	<u>Model III</u> B(s.e)	<u>Model IV</u> B(s.e)	<i>Beta</i>
<i>Child Controls</i>					
1. Female	-3.36 (1.1)**	-3.04 (1.1)**	-3.11 (1.0)**	-2.97 (1.0)**	-.09**
2. African-American	-13.05 (1.2)***	-7.68 (1.3)***	-7.27 (1.3)***	-6.25 (1.4)***	-.13***
3. Hispanic	-15.47 (2.3)***	-10.92 (2.0)***	-10.90 (2.1)***	-10.29 (2.3)***	-.21***
4. Number of children	-1.01 ( .6)	-1.20 ( .5)*	-1.08 (.5)*	-.95 ( .6)	-.06
5. Age of child	.87 ( .2)***	.89 ( .2)***	.84 (.2)***	.78 ( .2)***	.17***
<i>Parental Controls</i>					
6. Female-headed household		.51 (1.3)	2.09 (1.4)	2.72 (1.4)	.07
7. Education of head		1.52 ( .3)***	1.08 ( .3)***	.91 ( .3)**	.15**
8. Parental Skills Test		.60 ( .1)***	.54 ( .1)***	.52 ( .1)***	.15***
<i>Income</i>					
9. Permanent Income			.60 ( .2)***	.34 ( .2)	.08
<i>Wealth</i>					
10. Net Worth				.45 (2)**	.11**
11. Cash Accounts (Dummy)				2.67 (1.4)	.07
12. Debt/Cr.Cards (Dummy)				-2.99 (1.0)**	-.09**
13. Stocks/IRA (Dummy)				1.01 (1.3)	.03
R <sup>2</sup>	.13	.21	.22	.24	
R <sup>2</sup> Change	--	.08	.01	.02	
F-value	32.77***	37.63***	34.99***	27.60***	

Note: Models I-IV contain unstandardized coefficients; analysis weighted by 1997 child level weight.  
\* p < .05, \*\* p < .01, \*\*\* p < .001

Table 2: OLS Regression Model Predicting Behavior Problem Index  
(N=1885)

Independent Variables	Model I B(s.e)	Model II B(s.e)	Model III B(s.e)	Model IV B(s.e)	Beta
<i>Child Controls</i>					
1. Female	-1.06 (.5)*	-1.12 (.5)*	-1.09 (.5)*	-1.07 (.5)*	-.07*
2. African-American	.87 (.5)	-1.58 (.7)*	-1.85 (.7)*	-1.70 (.8)*	-.08*
3. Hispanic	-1.70 (1.4)	-2.84 (1.3)*	-3.08 (1.2)*	-2.68 (1.3)*	-.12*
4. Number of children	-.11 (.2)	-.25 (.2)	-.24 (.2)	-.28 (.2)	-.04
5. Age of child	.09 (.1)	.10 (.1)	.12 (.1)	.14 (.1)	.07
<i>Parental Controls</i>					
6. Female-headed household		2.32 (.7)***	1.73 (.8)*	1.76 (.8)*	.09*
7. Education of head		-.29 (.1)*	-.08 (.1)	-.08 (.1)	-.03
8. Employment Status of Head		-3.55 (1.2)**	-3.33 (1.2)**	-3.29 (1.1)**	-.14**
<i>Income</i>					
9. Permanent Income			-.26 (.1)***	-.19 (.1)*	-.09*
<i>Wealth</i>					
10. Net Worth				-.18 (.1)*	-.10*
11. Cash Accounts (Dummy)				-.03 (.8)	.00
12. Debt/Cr.Cards (Dummy)				1.48 (.5)**	.09**
13. Stocks/IRA (Dummy)				.43 (.7)	.03
R <sup>2</sup>	.01	.06	.07	.08	
R <sup>2</sup> Change	--	.05	.01	.01	
F-value	2.37*	6.01***	7.10***	6.17***	

Note: Models I-IV contain unstandardized coefficients; analysis weighted by 1997 child level weight.

\* p < .05, \*\* p < .01, \*\*\* p < .001

Table 3 Variable Summaries, by Income Poverty and Asset Poverty (Net Worth, &lt;\$750)

Variable	N	Group 1 : Asset Poor and Income Poor		Group 2 : Asset Rich and Income Poor		Group 3 : Asset Poor and Income Rich		Group 4 : Asset Rich and Income Rich	
		Mean	s.d.	Mean	s.d.	Mean	s.d.	Mean	s.d.
<i>Dependent Variables</i>									
Letter-Word Identification	1663	94.5	14.1	97.1	19.2	99.4	16.3	<b>106.1</b>	17.8
Applied Problems	1656	97.1	17.6	98.7	15.5	101.9	15.8	<b>108.7</b>	17.3
Sum of Digit Span	1820	10.1	4.7	9.5	5.0	10.2	4.9	<b>11.3</b>	5.1
Passage Comprehension (Children 6-12)	1153	95.3	14.8	98.6	14.1	100.4	15.3	<b>106.8</b>	15.6
Calculation Standard Score (Children 6-12)	1148	94.7	15.4	95.7	17.5	97.6	16.1	<b>104.0</b>	17.9
Birth Weight	2910	6.73	1.6	7.04	1.54	7.24	1.4	<b>7.49</b>	1.3
Health at Birth	2923	1.88	.57	1.88	.57	1.82	.56	1.79	.57
Disability	2933	.06	.24	.09	.29	.03	.18	.03	.17
Child's Current Health	2919	2.05	.99	2.06	.87	<b>1.79</b>	.88	<b>1.61</b>	.76
Specific Medical Conditions	2936	1.18	1.7	1.16	1.3	.92	1.4	.90	1.2
Behavior Problem Index	2230	43.8	10.8	42.1	9.4	41.0	9.1	<b>39.2</b>	7.5
Repeat a Grade	1467	.15	.35	.15	.36	.10	.30	.06	.24
School Attendance	863	2.17	3.9	1.28	1.4	1.53	3.1	.77	1.8
<i>Independent Variables</i>									
Permanent Income (average of 1994-1997)	2933	\$9,511	6,667	\$17,918	12,773	<b>\$30,139</b>	20,205	<b>\$56,635</b>	36,216
Homeownership	2936	.08+	.26	<b>.38</b>	.49	.36	.48	<b>.76</b>	.43
Change in net worth, 1994-99 (truncated)	1967	\$6,258	18,583	\$-3,828	26,983	<b>\$17,778</b>	30,465	\$24,065	52,514
Net Worth 1994 (top-coded at 100,000, bottom 0)	2076	\$56	157	<b>\$25,201</b>	32,567	\$58	153	<b>\$49,839</b>	38,299
<i>Intermediary Variables</i>									
Neighborhood Rating	1852	3.29+	1.04	<b>2.79</b>	1.08	2.60	1.09	<b>2.11</b>	1.09
Parent Reads to Child	2928	3.82	1.7	4.24	1.81	4.23	1.66	4.13	1.78
HOME Scale	2936	17.78	3.01	18.60	3.00	<b>19.52</b>	2.89	<b>21.03</b>	2.77
Parental Depression	1829	4.12	.74	4.06	.77	<b>4.30</b>	.67	<b>4.44</b>	.48
Food Security Scale	2936	1.25+	2.79	.61	2.79	.44	2.51	<b>-4.3</b>	1.63
Parental Expectations	2877	4.00	2.08	4.48	1.89	4.68	1.93	<b>5.47</b>	1.65
Economic Strain	1796	2.50	1.90	2.40	2.15	2.05	1.73	<b>1.55</b>	1.78
Television Use (hours a day)	1731	8.34	4.35	7.44	5.54	6.24	4.32	<b>5.30</b>	3.64

Note: **Bold** denotes that the group mean differs significantly from all groups below, + denotes a sig. difference from all groups above.

Chart 1 Alternative Cross-tabulations of Income Poverty and Asset Poverty

*With asset poverty threshold set at \$750*

	Income Poor	Income Rich
Asset Poor	200	317
Asset Rich	131	1426

*With asset poverty threshold set at \$5000*

	Income Poor	Income Rich
Asset Poor	250	480
Asset Rich	81	1263

**Question for the Record From Senator Lincoln for  
Dr. Trina R. Williams Shanks  
April 28, 2005**

**Question:** Individual Development Accounts (IDAs) clearly help low-income people save. The Good Faith Fund has over 500 participants who have built cumulative savings of over \$1.1 million dollars. What do you see as the role of the private sector in encouraging personal savings? Do you see opportunities for the private sector to partner with States, local businesses, and local communities to improve our national savings?

**Answer:** Yes, there is a role that the private sector can play. Ideally, for any plan to work over the long term, there would be shared responsibility among individuals, the public sector, and the private sector. When there are policies, savings vehicles, and tax incentives in place to encourage low-income people to save, the private sector can provide an environment and the specific institutional mechanisms to assist in and ease the burdens of savings. Specifically, if employers are interested and able to help low-income families build assets, there are many ways they can contribute, both directly and indirectly.

**Direct:**

- All payroll checks and earnings can be made by direct deposit. As demonstrated in the American Dream Demonstration (ADD), direct deposit facilitates savings in that participants are 22 percentage points more likely to be savers in an IDA. In addition, it saves time and money while reducing transaction costs.
- For those employees who don't have checking or savings accounts, direct deposit might lead to a demand for an alternative mechanism similar to the EBT. Stored value cards, employer payroll cards, and reloadable debit cards use new forms of technology that could help bring all workers into the larger financial services system. If these options help employees save and manage money, they are a step in the right direction. But such technologies will only become widely available if employers demand them. There might also be a need for government (regulatory) oversight to require accessibility and encourage features that help low-income families save.
- Create work-sponsored opportunities for financial education. Although there are many sources of good financial information, establishing availability through the workforce might make an important impact by reaching more people and increasing its perceived importance. Evidence from ADD demonstrates that up to 9 hours of financial education facilitates savings. This might include traditional topics such as budgeting and credit repair, but also address specific topics of interest—*i.e.*, buying a car, buying a home, planning for college, choosing investments, purchasing stocks, planning for retirement.

- The employer can offer financial services. This might include tax preparation assistance, legal assistance, access to credit repair services, preferred membership at a credit union, or discount bulk purchases.
- The employer could offer matched savings accounts for retirement or asset-building purposes. Once established, the preferred way would be an opt-out plan rather than requiring people to sign up, which has been shown to lead to greater participation. If the government provides progressive match, a similar expectation could be placed on employers to balance saving and investment by the public and private sector.

In addition to the above ways to directly encourage savings by assisting employees in saving more or managing their savings better, employers can also encourage savings in indirect ways. Thus, the employer can have an impact by reducing the hardships that draw down existing savings or prevent people from saving in the first place.

**Indirect:**

- Arrange for on-site or prorated childcare for employees with young children. In addition to reducing the stress and expense of searching for quality childcare, there might also be a reduction in absenteeism.
- Offer or subsidize health insurance. The most frequent reason for going into bankruptcy is a major illness and its subsequent medical expenses. With expanded health coverage, the likelihood of bankruptcy would drop and hopefully savings would increase.
- Create internal mechanisms to respond during times of emergency. Perhaps a very small amount from each payroll check could go to create this emergency fund. Ideally a group of one's peers would review each request and respond accordingly. Possible triggers might include a car accident, death of a spouse, or property damage due to natural disaster.
- Establish associations and partnerships to pool risk and establish administrative and delivery systems for any or all of the above ideas, so entrepreneurs and small business owners would not have to support all of these arrangements alone. Through such mutually beneficial arrangements, even smaller businesses could utilize mechanisms to encourage savings.

At a time when many large corporations are seeking to cut costs and reduce benefits, a strategic vision to assist low-income workers that includes asset-building opportunities would be welcome. These ideas are just a template, but I am including two examples to illustrate how they could work in practice. It would be fruitful to seek other models of corporate programs that encourage employee savings as well as examples of policy incentives that encourage such private-sector activity.

**Examples:**

- In Grand Rapids, MI, three private-sector organizations started working with a local non-profit to launch an Employer-Assisted Housing program that helps workers find or maintain permanent housing. Each employer tailors benefits to its own needs. Offerings can include: housing counseling and education; grants for closing costs or down-payments; group mortgage discounts on fees, closing costs, and interest rates; or a company match of employee savings dedicated to home purchase or improvements. For more information, see article “Program helps workers own homes” in *The Grand Rapids Press* on July 1, 2005.
- The Economic Opportunity Institute has proposed Washington Voluntary Accounts to give all workers the chance to participate in a defined-contribution retirement savings plan at their workplace. The program would be portable and voluntary and administered by the State of Washington. For more information go to [www.EOOnline.org](http://www.EOOnline.org).

## **Inclusion in Asset Building**

Michael Sherraden, PhD  
Benjamin E. Youngdahl Professor of Social Development  
Director, Center for Social Development  
Washington University in St. Louis

Testimony for Hearing on  
“Building Assets for Low-Income Families”  
Subcommittee on Social Security and Family Policy  
Senate Finance Committee

April 28, 2005

### **Inclusion in Asset Building**

Thank you, Chairman Santorum and Members of the Subcommittee. I am honored to present testimony today on inclusion in asset building. My statement is an overview of reasoning, theory, research, policy innovations, challenges, and potential for an inclusive policy for asset building in the United States, and beyond.

#### **Context and Meaning of Asset-Based Policy**

The term “assets” has many potential meanings. These include financial wealth, tangible property, human capital, social capital, political participation and influence, cultural capital, and natural resources. While all of these meanings have value, I focus on meanings of assets that have direct relevance for social policy.

Public policy cannot do all things well. Policy is most successful in simple, large-scale tasks. More complex and particular tasks are often better left to communities and families. This thinking is captured by a saying from Confucius: “Governing a large country is like frying a small fish. You can ruin it with too much poking.”

Considering asset building in the context of public policy, it may be wise to focus on building financial wealth for the purpose of household social and economic development. Building financial wealth is something that public policy can do simply and effectively, and outcomes can be measured.

Income (as a proxy for consumption) has been the standard measure of poverty in the social policy. To be sure, income and consumption are essential, but they do not improve long-term conditions. Development of families and communities (that is, reaching potential) occurs through asset accumulation and investment (Sherraden, 1991).

From this perspective, income inequality is different from asset inequality in both extent and meaning. As an example, we can look at US income and net worth inequality by race. The ratio of white to non-white income is about 1.5 to 1, which is a large inequality. This means that the typical white person in America has about 50 percent more income than the typical person of color (African Americans and Latinos are the largest non-white groups). However, the ratio of white to non-white net worth (total assets minus total liabilities) exceeds 10 to 1 (Oliver & Shapiro, 1995; Kochhar, 2004). In other words the typical white person has net wealth more than ten times greater than the typical person of color. If assets represent potential for social and economic development, asset inequality may be the most fundamental racial issue in the United States.

As another view of why assets matter, we can compare household income poverty and asset poverty. Haveman & Wolff (forthcoming, 2005) have undertaken a detailed study of “asset poverty” in the United States. They find, for the year 1998, that official income poverty rate was 10.0 percent. As one definition of asset poverty, they look at net worth below three months of income at the poverty line. By this measure, they find a 25.5 percent asset poverty rate. As another definition of asset poverty, they look at liquid assets

(cash, savings accounts, checking accounts) below three months of income at the poverty line. By this measure they find a 39.7 percent asset poverty rate.

In 1999, the net worth of the poorest 10 percent of US households was negative \$1,800 (Caner & Wolff, 2004). Between 1983 and 2001, the average net worth of the poorest 40 percent of US households declined by 44 percent, falling to \$2,900 in 2001 (Wolff, 2004).

In other words, a large percentage of US households are “asset poor”. The above figures suggest two things: One, many US households have little financial cushion to sustain them in the event of a job loss, illness, or other income shortfall. And two, development of these households is limited by lack of assets for investing in education, homes, businesses, or other strategies to get ahead.

Today there is increasing questioning of income as sole definition of poverty and well-being. Amartya Sen (1993, 1999) and others are looking toward capabilities. Asset-based policy can be seen as part of this larger discussion. Asset holding is one measure of long-term capabilities. As public policy, asset building is a form of “social investment” (Midgley, 1999).

Asset-based policy would shift social policy from an almost exclusive focus on maintenance, toward a focus on development of individuals, families, and communities. In this sense, asset-based policy is an explicit complement to income-based policy (Sherraden, 1991).

This is not to say that there is no role for social insurance. Indeed the right idea is to *balance* asset-based policy with social insurance, supplemented by means-tested assistance where necessary. As I have testified before the President’s Commission on Social Security, if there are to be individual accounts, these should be above and beyond the existing Social Security system (Sherraden, 2001).

The goal of asset-based policy should be *inclusion*. By inclusion, I mean that policy should: (1) bring everyone into asset-based policy, (2) make asset-based policy life-long and flexible, (3) provide at least equal public subsidies for the poor in dollar terms; and (4) achieve adequate levels of asset accumulation, given the purposes of the policy.

#### **Can Public Policy Aim for Asset Accumulation?**

Asset-based policy is not new. The United States and many other countries already have large asset-based policies. In many cases, these operate mostly through the tax system, i.e., the public transfers occur via tax benefits (either tax deferrals or tax exemptions). In these circumstances, the poor, who have little or no tax liability, often do not receive any benefits.

Examples of US asset-based policy include: home ownership tax benefits; investment tax benefits; defined contribution retirement accounts with tax benefits at the

workplace, such as 401(k)s, 403(b)s (named after sections of the internal revenue code); and defined contribution accounts away from the workplace, such as Individual Retirement Accounts (IRAs), and Roth IRAs. Other asset accounts with tax benefits include Individual Training Accounts, Educational Savings Accounts, State College Savings (529) Plans, and Medical Savings Accounts.

These asset-based policies in the United States are growing rapidly. Individual account policies have all appeared since 1970, and there are more variations of these all the time. Total tax expenditures for asset building in homes, retirement accounts, and investments are growing rapidly.

Altogether, asset-based policies in the United States are large and regressive. Over \$300 billion annually in tax expenditures for assets (homes, investments, retirement accounts), and over 90 percent of this goes to households with incomes over \$50,000 per year (Sherraden, 1991; Howard, 1997; Seidman, 2001; Corporation for Enterprise Development, 2004).

The shift to individual asset accounts in social policy is occurring in many countries around the world, and policy discussion is emerging (e.g., OECD, 2003; World Economic Forum, 2003; USAID, 2004). Indeed, as a global phenomenon, this is a near revolution in public policy. This is especially true in retirement policy. It is rare to see a new retirement policy based on principles of social insurance, and common to see a new retirement policy based on principles of defined contribution in the form of individual accounts. It is possible that asset accounts will become a primary social policy instrument during the 21st century.

At the same time, the poor do not have the same opportunities and subsidies for asset accumulation. The reasons are threefold. First, the poor are less likely to own homes, have investments, or have retirement accounts, where most asset-based policies are targeted. Second, the poor have little or no tax incentives, or other incentives, for asset accumulation. Third, asset limits in means-tested transfer policies discourage saving by the “welfare poor,” and probably also the “working poor” (Powers, 1998; Ziliak, 1999). In effect, the United States and many other countries have a dual policy, consisting of asset building subsidies for the non-poor, and asset building disincentives for the poor. This dual policy is both unfair and counterproductive. If asset building is how individuals, families, and communities develop, then a sensible public policy would promote asset building for all, because this would have the greatest payoff in social and economic development.

Given these conditions, we may ask: Why not asset accumulation by the poor?

#### **Policy Innovation**

My first insight for this thinking came during my discussions with “welfare” mothers during the 1980s. The women said that part of the problem was that they could

not “get anywhere” because they could not accumulate resources for long-term goals such as better housing, education, or starting a small business.

These discussions led to a proposal for Individual Development Accounts or IDAs. IDAs were proposed as (1) universal savings accounts, (2) started as early as birth, (3) with savings matched for the poor, up to a cap, (4) multiple sources of matching deposits, (5) accompanied by financial education, and (6) savings to be used for investments in homes, education, business capitalization, or other development purposes (Sherraden, 1991).

Since asset-building and IDAs were proposed, there has been modest policy progress in the United States. There have been increases in welfare asset limits in nearly all states during the 1990s. IDAs were included as a state option in 1996 “Welfare Reform Act”. The federal Assets for Independence Act, first public IDA demonstration, became law in 1998. Other legislation to extend IDAs is before the US Congress (Boshara, 2003; Cramer et al., 2005). Over 40 US states have adopted some type of IDA policy (Edwards and Mason, 2003). All of this signals a change in thinking, but not yet a major change in policy. Most IDA programs in the United States are very small.

The most important contribution to date is that saving and asset accumulation by the poor, which was seldom discussed 15 years ago, is today a mainstream idea in the United States, and political support is bipartisan. Both Republicans and Democrats use the language of “asset building”, “asset-based policy”, “stakeholding”, and “ownership society”.

Research on IDAs at the Center for Social Development at Washington University in St. Louis (CSD) has had some impact policy development elsewhere, including the Saving Gateway and Child Trust Fund in the United Kingdom (HM Treasury, 2001, 2003; Sherraden, 2002; Paxton, 2003; Kempson et al., 2003, 2005), Family Development Accounts in Taipei (Chen, 2003), IDAs and “Learn\$ave” demonstration in Canada (Kingwell et al., 2003), and matched savings programs for the poor in Australia, Uganda, and elsewhere.<sup>1</sup>

### Theory and Evidence

Two general theoretical statements underlie this work. The first is that saving and asset accumulation are shaped by institutions, not merely individual preferences. In CSD’s research on IDAs, we have identified the following institutional factors that may affect saving and asset accumulation: (1) access, (2) expectations, (3) information, (4) incentives, (5) facilitation, (6) restrictions, and (7) security (Beverly & Sherraden, 1999; Sherraden, et al., 2003; Sherraden & Barr, forthcoming, 2005). These constructs appear to be useful in explaining saving outcomes, and they have direct relevance for policy.

For example, we find in research on IDAs that, controlling for many other factors, the monthly saving target (expectation) is associated with a 40-to-50-cent increase in

<sup>1</sup> CSD has consulted in the policy and program innovations listed here.

average saving for every dollar the target is increased—a huge effect. We find that financial education (information) up to about 10 hours is associated with increased saving performance, but after 10 hours there appears to be no effect. Because financial education is expensive, this is important to know. We find that increasing the saving match (incentive) keeps people saving in the IDA program, but among the “savers” does not increase amounts saved. This result is very similar to findings in research on 401(k)s. We find that direct deposit (facilitation) also keeps people saving but among “savers” does not increase amounts saved (Schreiner et al., 2002; for the most recent analyses see Schreiner & Sherraden, forthcoming, 2005).<sup>2</sup>

We find that IDA participants see the program as an opportunity (access) that they would not otherwise have, because few are offered retirement plans at work. In a focus group, one potential IDA participant said, “I get it. This is like a 401(k), only for us.” We find that IDA participants like the fact that their matched saving account is “off limits” and can be used only for specific purposes (restrictions), even though this is contrary to mainstream economic theory which assumes that people prefer as much choice as possible (Margaret Sherraden et al., forthcoming).

These and other results from IDA research have direct relevance for saving policy, program, and product design.

The second theoretical statement is that assets have multiple positive effects, not merely deferred consumption. To take one example, it may be that homeownership creates not just financial equity in housing, but also more stable and more committed citizens. Theory regarding effects of asset holding, when specified and supported by evidence, has the potential to provide a solid rationale for inclusive asset-based policy. The possible effects of asset holding are to: (1) improve household stability, (2) create orientation toward the future, (3) stimulate enhancement of assets, (4) enable focus and specialization, (5) provide a foundation for risk taking, (6) increase personal efficacy, (7) increase social connectedness and influence, (8) increase political participation, and (9) enhance the well-being of offspring (Sherraden, 1991). A broad range of research in economics, sociology, political science, anthropology, and social work provides evidence generally in support of these propositions (for reviews, see Page-Adams & Sherraden, 1997; Scanlon & Page-Adams, 2001).

### **Research on Effects of Assets**

In this section, I briefly review some of the research on effects of asset holding. First we turn to examples of basic research, using existing large data sets.

In a study of the “asset effect” Bynner & Paxton (2001) use the longitudinal National Child Development Study in the United Kingdom. They find that holding assets

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<sup>2</sup> These findings on IDAs are based on account monitoring research in the “American Dream Demonstration” (ADD). ADD was implemented by the Corporation for Enterprise Development (now CFED). ADD research at CSD was funded by the Ford, Charles Stewart Mott, F.B. Heron, and MetLife Foundations.

at age 23 is associated with later positive outcomes such as better labor market experience, marriages, health, health behaviors, and political interest. This generally supports the “multiple positive effects” perspective on asset holding. These researchers also find that the presence of an asset appears to matter more than the monetary value of the asset. This latter finding raises theoretical, measurement, and policy issues that are important. For example, if the presence of a housing asset matters most, then policy should encourage home ownership as early in adult life as possible.

In a study using the Panel Study of Income Dynamics (PSID), accompanied by field interviews, Shapiro (2004) finds that intergenerational wealth transfer is very different by race. He also finds that the presence of small wealth at critical times, especially for home ownership and being in a better neighborhood for schooling, can have “transformative” effects on the life course. This idea of a “transformative” asset at critical times may have important policy implications.

Looking at the impact of wealth on child developmental outcomes, Williams (2003), using the PSID, finds that, controlling for many other factors, parental wealth is positively associated with cognitive development, physical health, and socio-emotional behavior of children. This supports the proposition of assets leading to better well-being of offspring--in this case, above and beyond economic well-being. Williams finds that the effects occur even among very income-poor families. She also finds that wealth seems to be a better predictor of well-being as children grow older (while income is a better predictor when they are younger). This last finding may suggest that “asset effects” are a long-term phenomenon, perhaps not easily measured in the short term.

In a study of assets, expectations, and educational performance, Zhan & Sherraden (2003), using longitudinal data from the National Survey of Families and Households, find that low-income, single mothers’ assets are positively associated with children’s educational attainment. These results occur in part through expectations of the mother: Assets are associated with higher educational expectations, which are in turn associated with higher educational attainment. This study supports a cognitive theory of “asset effects”, wherein assets may change thinking, which in turn may change behavioral outcomes. Also of note in this study, income is associated with educational achievement when assets are not in the model. However, income becomes non-significant when assets are included. This finding suggests that much prior research on effects of economic resources on well-being may be under specified when assets are not included in the regression models.

In a test of assets on multiple outcomes, Yadama & Sherraden (1996) use the PSID and simultaneous equation modeling to test alternative theories within the same study. The focal explanation is that assets lead to positive attitudes and behaviors. The two alternative explanations are that (a) positive attitudes and behaviors lead to assets, and (b) income leads to positive attitudes and behaviors. All three explanations are supported to some extent in the analysis, but the focal explanation has the strongest support. The finding that assets lead to positive attitudes and behaviors, and positive attitudes and behaviors lead to assets may be a glimpse of a “virtuous cycle”, wherein household development is a

reinforcing feedback loop. Arguably, the most efficient use of public policy is to find such virtuous cycles and support them.

Turning to examples from applied research on IDAs, we turn to some of the results of the American Dream Demonstration (ADD). ADD was the first major demonstration of IDAs. It took place at 14 IDA programs around the United States. ADD from 1997 through 2001, with research continuing through 2005. ADD was organized by Corporation for Enterprise Development (CFED) in Washington, DC, and research designed by Center for Social Development.

One of the most important findings in ADD is that, controlling for many other individual and program variables, income was only weakly associated with saving outcomes, i.e., the poorest participants saved about as much as those who were not as poor, and saved a higher proportion of their income (Schreiner et al., 2002). This finding suggests that saving by the very poor should not be dismissed in public policy.

Turning to uses of IDA savings, at the last data collection point, 754 participants (32 percent) had taken a matched withdrawal (“purchased an asset”). Of these 28 percent were for home purchase, 23 percent for microenterprise, 21 percent for post-secondary education, and 18 percent for home repair. The intended use among the remaining IDA “savers” was 55 percent for home purchase (Schreiner et al., 2002). These results indicate a high demand for home ownership among this group, and raise the question of demand for home ownership among low-income people in general.

Turning to possible effects of IDAs, a cross-sectional survey of ADD participants reports the following: On perceptions of economic effects, 59 percent agree or strongly agree that, because of the IDA, they are more likely to work or stay employed, and 41 percent are more likely to work more hours. On human capital effects, 59 percent agree or strongly agree that, because of the IDA, they are more likely to make educational plans for themselves, and 60 percent to make educational plans for their children. On security and control effects, 84 percent agree or strongly agree that, because of the IDA, they feel more economically secure; 93 percent feel more confident about the future; and 85 percent feel more in control of their life (McBride et al., 2003). Because these are only opinions, and the data are cross-sectional, these results are only suggestive, but they do indicate that asset holding in the form of IDAs may have very positive psychological and behavioral outcomes.

On IDAs and future orientation, in-depth interviews with IDA participants and controls reports that IDA participants say they can “see more clearly” and “better visualize a future” than they could before IDAs. IDA program are said to “create goals and purpose”, and provide “way to reach goals” (Margaret Sherraden et al., forthcoming). These findings may support a cognitive approach to understanding “asset effects”, that is, it appears that asset holding changes the way people think.

Experimental results from ADD report that, compared to a randomly assigned control group, IDA participants increased their rate of homeownership and total assets.

Positive effects appear to be stronger for African Americans (perhaps because past practices have discriminated against African Americans in home ownership, leading to greater demand). The IDA program did not affect net worth over the time of the study (Mills et al., 2004). These results may suggest that IDAs can move people into asset holding, though effects on net worth, at least in the short term, are not evident. In additional analysis of these data, we find evidence of positive social outcomes in marriage and household relationships (CSD research in progress).

Overall, results from both basic and applied research suggest that asset holding has multiple positive effects.

### **Directions for an Inclusive Asset-Based Policy**

Reflecting on progress to date, this body of work is contributing to a change in thinking about poverty and policy. The idea of inclusive asset building is now common in US policy discussions. This is apparent in proposals for expanded IDAs, such as legislation for the Savings for Working Families Act currently before the US Congress, and many other ideas and proposals for asset building. But today we are far short of a large, inclusive policy.

So that discussion of large-scale policy does not seem entirely speculative, we turn next to proposals for a large, inclusive saving plans in the United States, and a universal, progressive child saving policy in the United Kingdom.

President Clinton proposed Universal Savings Accounts (USAs) in his State of the Union address in 1999. In his State of the Union address in 2000, Clinton offered a similar proposal, saying:

*Tens of millions of Americans live from paycheck to paycheck. As hard as they work, they still don't have the opportunity to save. Too few can make use of IRAs and 401(k) plans. We should do more to help all working families save and accumulate wealth. That's the idea behind the Individual Development Accounts, the IDAs. We ask you to take that idea to a new level, with new retirement savings accounts that enable every low- and moderate-income family in America to save for retirement, a first home, a medical emergency, or a college education. We propose to match their contributions, however small, dollar for dollar, every year they save.*

The USA proposal in 1999 was like a 401(k) for all workers, with deposits and matching funds for those with lowest incomes.

During the presidential campaign of 2000, George W. Bush proposed \$1 billion in tax credits to financial institutions to match savings in IDAs. During the campaign, Bush (2000) said:

*If a low-income person is able to save up to three hundred dollars, we will encourage banks, with a federal tax credit, to match that amount. The money can then be withdrawn tax free to pay for education, to help start a business or buy a home.*

*The great promise of our time is to fight poverty by building the wealth of the poor. A home to anchor their family. A bank account to create confidence. And, I believe, a personal Social Security account, which would give millions of low-income Americans not just a check, but an asset to own, a stake in our prosperity.*

### **Potential of Children's Savings Accounts**

With Senator Santorum as a leader and original co-sponsor, a visionary and bipartisan ASPIRE Act, which would create a savings account for every newborn in the United States, has been introduced in the Congress in 2004 and 2005.<sup>3</sup>

A serious discussion of asset-based policy began in the United Kingdom in 2000 (Kelly & Lissaur, 2000; Nissan & LeGrand, 2000; Institute for Public Policy Research, 2001). In a major policy development in April 2001, Prime Minister Tony Blair proposed a Child Trust Fund for all children in the United Kingdom, with progressive funding. He also proposed a demonstration of a Saving Gateway, matched saving for the poor. Blair (2001) said:

*I believe we have already made important strides in extending opportunity for all – through improving skills and work, through improving living standards, and through improving the quality of public services.*

*But now we want to add a fourth element: more people getting the benefit of assets and savings, so that we help spread prosperity and opportunity to every family and community.*

*We want to see all children grow up knowing that they have a financial stake in society. We want to see all children have the opportunity of a real financial springboard to a better education, a better job, a better home, a better life.*

In April 2003, Prime Minister Blair announced that he would go forward with the Child Trust Fund. Beginning in April 2005, each newborn child is being given an account, retrospective to children born from September 2002. The children receive an initial deposit of at least 250 pounds, and children in the bottom third of family income will receive 500 pounds. Additional government deposits are not yet specified. (HM Treasury, 2003). The Child Trust Fund provides universal and progressive contributions to the child's account. As David Blunkett (2000) observed when he was Secretary of State for

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<sup>3</sup> An important background paper for what became the ASPIRE Act was written by Reid Cramer (2004). Ray Boshara and his team at the Asset Building Program at the New America Foundation have been very instrumental in organizing the introduction of the ASPIRE Act.

Education and Employment: “We are on the cusp of a different way of looking at the welfare state – one which focuses on capital and assets.”

Universal and progressive accounts for all children at birth have been proposed in the United States by Sherraden (1991), Lindsey (1994), Boshara & Sherraden (2003), Cramer (2004), and Goldberg (forthcoming, 2005).<sup>4</sup> Children’s savings accounts (CSAs) may be a promising pathway to inclusive asset building in United States. As one perspective on this, the United States is one of the few economically advanced nations without a children’s allowance (monthly cash payment to all families with children). The average children’s allowance in Western Europe is 1.8 percent of GDP. The United States is unlikely, for ideological and political reasons, to adopt a children’s allowance, but a CSA is ideologically and politically much more likely. Even 0.1 percent of US GDP would be enough for a \$2,500 start in life account for every newborn (see Curley and Sherraden, 2000).

The Ford Foundation and several other foundations are now in the process of demonstrating and testing an inclusive CSA in the form of the Saving for Education, Entrepreneurship, and Downpayment (SEED) initiative. SEED is a demonstration and research partnership among CFED, CSD, the New America Foundation, the Institute for Financial Security of the Aspen Institute, and others. The goal of SEED is to model, test, and inform a universal CSA policy for the United States. I am particularly grateful to the Ford, Charles Stewart Mott, and MetLife Foundations for funding SEED research, so that we can learn as much as possible from this demonstration.

The potential of CSAs as a long-term pathway to inclusive asset building may be great, because: (1) lifetime accumulation and compounded earnings will lead to greater asset accumulation; (2) it is likely that having an account from birth will create positive psychological and behavioral effects for both parents and children; (3) there are very important reasons to save for education and home ownership, in addition to retirement (education and home owning are ultimately retirement strategies as well); and (4) newborns are in some ways more politically appealing than adults. Regarding the last point, investing in children can be a bipartisan effort, even in these partisan times (see for example the bipartisan effort for the ASPIRE Act).

Of course, a CSA is not ultimately about children. After several generations of children born with a CSA, everyone would have an account throughout life.

Thinking about this in terms of institutions and behavioral economics, there is a great deal of current research and discussion about “defaults”, that is, putting people in a saving plan (or some aspect of it) unless they make a choice *not* to participate (sometimes called “opt out” or “automatic”). We might think of a universal CSA as the ultimate

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<sup>4</sup> Discussions of CSAs in the United States go back at least to the George H.W. Bush administration. Goldberg was a proponent of CSAs in the Bush senior administration, and at the request of the Bush White House, Sherraden outlined a plan for a CSA with an initial deposit of \$1,000 for all children in the United States.

“default”—every child would automatically be born with a birth certificate and an asset-building account.

Looking to the future, CSAs may also have appeal in developing countries, and for international aid. Although it may seem farfetched today, it is conceivable that, when information technology is well developed, there could be an account for every newborn on the planet. No other single strategy that would have a greater impact on economic development. For example, one of my former graduate students, Fred Ssewamala, now on the faculty at Columbia University, is testing CSAs with HIV/AIDS orphans in Uganda. His strategy is to enable the children to save enough to pay for secondary school (four years of secondary school costs about US\$600). These young people will be vastly better off economically and socially if they complete secondary school. If every child had an account, these could be targets for international aid that goes directly to children—avoiding dictators, mismanagement, and corruption.

Such accounts would promote international ties and might even contribute to mutual interests, tolerance, and peace. For example, imagine what would happen if every child in the Middle East had a Middle East Development Account (MEDA), and some portion of the billions of dollars that pour into violence in that region instead poured into MEDAs.<sup>5</sup>

#### **Transnational Policies in the Future**

Looking to the future, the world is becoming more global. During the 20<sup>th</sup> century, social policies were created within nation-states. With more mobile populations, and increasing regional and global ties, it is very likely that social policies will begin to transcend national boundaries during the 21<sup>st</sup> century (this is already apparent in the European Community and in some aspects of regional agreements elsewhere). Eventually, workers should be able to participate in retirement plans and health care policies, regardless of where they work. Asset accounts may be the chief instrument for regional and global social policies, due to ease of portability (Sherraden, 1997).

As one small example, IDA projects with remittances to Mexico are under discussion. (Remittances are capital flows from expatriate workers to their home country. US-to-Mexico remittances are substantial, larger than foreign direct investment in Mexico.) Mexican workers could build assets in IDAs wherever they were working. Eventually there might be regional, portable accounts, perhaps called North American Development Accounts (alas, the acronym NADA means “nothing” in Spanish; probably a different name will have to be found). These accounts could be used for housing, education, retirement savings, and other social and economic purposes.

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<sup>5</sup> Preliminary discussions are underway for a Middle East Development Account. This is tough going; dialogue is often impossible; but we hope for a small pilot project to begin.

### Public Sector Role

In America, we have very well developed financial services and as efficient, transparent, and secure financial markets as any in the world. These markets are a huge national and global resource. In any savings policy, it would be almost foolish not to use private markets for investments.

This said, however, there is a necessary role for the public sector in an inclusive savings policy.

Although sometimes called “private” or “privatized”, asset building in the form of defined contribution individual accounts (the most likely vehicle for this policy) are in fact defined and regulated by government, often with large public subsidies through the tax system. In these fundamental senses, these are *public* policies.

There is a critical role of the public sector. Large-scale, inclusive asset building cannot occur through private corporations or non-profit organizations. Government will be required for: (1) establishing the institutional framework that brings everyone into the asset building and keeps costs low, (2) legal protections and regulation, and (3) resources for inclusive asset building.

Major long-term challenges include: (1) financial infrastructure (the ability to take deposits and hold accounts), (2) investment risk (both individual and for the pool of accumulated capital), (3) government risk (stability of policy, effectiveness of governance), and (4) currency risk (primarily the threat of inflation).

The considerable advantages of asset building as a family and community development strategy are that: (1) it is simple and clear, (2) it is easy to communicate, (3) it has widespread appeal and acceptance, (4) it is flexible and adaptable, (5) it can be both a large policy and a local strategy, (6) outcomes are relatively easy to measure, (7) multiple positive outcomes are likely, and (8) theoretical propositions are testable.

The basic principles for an inclusive asset-based policy are (in order of priority): (1) universal: bring everyone into asset-based policy; (2) fair: at least subsidies for the poor;<sup>6</sup> (3) life-long: birth to death, and flexible across the life course; and (4) adequate: sufficient assets to achieve policy purposes.

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<sup>6</sup> I prefer that asset-building policy is progressive, i.e., greater subsidies for the poor, but I would settle for a policy that is at least fair, i.e., equal subsidies for everyone in dollar terms. Today, asset-based policy in the United States is a long way from fair. To take one example, some wealthy households get \$20,000 or more in annual subsidy for home ownership (via the mortgage interest tax deduction), while most poor households get nothing. A fair home ownership policy would provide the same dollar amount to every household.

### **The Challenge of Inclusion**

The greatest challenge in asset-based policy is *inclusion*. This challenge is in part technical, in part academic, and in part political, but mostly it is a matter of policy design.

The technical capability to create universal asset accounts is rapidly developing. Information technology will one day make it possible to give everyone an account, with instantaneous and secure investment options in any of the financial markets in the world. This technical capacity, one aspect of “globalization” in the information age, has the potential to sweep the entire planet into social and economic development more completely than has heretofore occurred.

Academically, the knowledge base for how to shape asset-based policy, and its likely effects, is also developing, as illustrated by research examples in this testimony. There is more work to do in specifying and testing theory, and drawing policy implications. To keep this in perspective, however, we can already say with confidence that asset holding is likely to have multiple positive effects. Some of the most important effects may be with development of children. Moreover, we have reason to think that institutional factors such as access, information, incentives, and facilitation affect saving and asset accumulation, and these have direct policy relevance (as discussed above).

Still other considerations are political. Creating an inclusive asset-based policy will require visionary leadership, raising asset building to the level of a long-term national project. This project would be, in the most basic sense, creation of a universal system of accounts, an infrastructure to promote asset accumulation. This is perhaps analogous to creation of a national system of highways to promote transportation. One the infrastructure is in place, development will occur.<sup>7</sup> Political leaders and planners would have to understand asset building in these expansive terms. Once established, such a policy would likely generate strong political support, for example note the exceptional popularity of the Central Provident Fund of Singapore (Sherraden et al., 1995; Vasoo & Lee, 2001), and the same is likely to happen with the Child Trust Fund in the United Kingdom.

Looking to the future, asset accounts are ideally suited to the 21st century economy because of their greater individual control, choice, and portability, even across national boundaries. The continuing development of information age financial services will be a key to asset-based policy by increasing feasibility and reducing risks.

#### **Pathway to Inclusion: Not Just Saving Products—a Saving Plan**

If saving and asset building are to be inclusive, the policy must be in the form of a *savings plan*, such as a 401(k) or 403(b) plan, the Federal Thrift Savings Plan, or a College Savings (529) plan. Such plans are in fact how most Americans are able to save.

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<sup>7</sup> For this insight on universal asset accounts as a public infrastructure and public good, I am indebted to Fred Goldberg.

To bring this point home, each of us in this room should pause and ask ourselves how much retirement savings we would have if we were not in a 401(k), Thrift Savings Plan, or similar saving plan structure. Every American should have this opportunity.

Savings plans (contractual savings) have important features that lend themselves to *inclusion*. These features are: centralized and efficient accounting, outreach and education, a limited number of low-cost investment options, low initial and on-going deposit requirements, automatic deposits, and opportunities to establish other practices and “defaults” that increase saving performance. These include automatic enrollment, savings match, match cap (amount of savings that can be matched), a default low-cost fund, automatic increases in savings deposits with pay raises. During the payout period, it may be desirable for a required minimum annuitization for income protection.<sup>8</sup>

For these very good reasons the ASPIRE Act calls for a plan structure something like the Federal Thrift Savings Plan.

At the Center for Social Development, we think there is also potential in using College Savings (529) plans as a platform for inclusion in asset building. To be sure, some state 529 plans have high fees and high investment costs, and such plans are undesirable. But some state 529 plans keep costs low, have very low deposit requirement, provide outreach to state residents, and match savings for the poorest savers. These state plans, or something like them, have the potential to be a platform for an inclusive children’s savings account (for research and discussion, see Clancy & Sherrden, 2003; Clancy, Orszag, & Sherraden, 2004; Clancy, Cramer, & Parrish, 2005).

Recognizing the importance of a plan structure, President Bush, when discussing individual accounts and Social Security in his 2005 State of the Union Address, said:

*The goal here is retirement, so we will set careful guidelines for personal accounts. We’ll make sure the money can only go into a conservative mix of bonds and stock funds. We’ll make sure that your earnings are not eaten up by hidden Wall Street fees. We’ll make sure there are good options to protect your investments from sudden market swings on the eve of retirement. . .*

*Personal retirement accounts should be familiar to federal employees, because you already have something similar, call the Thrift Savings Plan, which lets workers deposit a portion of their paychecks into any of five different broadly-based investment funds.*

While I do not think that personal accounts should be “carved out” of the existing social insurance system, I heartily agree that there is an important role for inclusive personal accounts in public policy. In this regard, President Bush is exceptionally wise in calling for a savings *plan* with a few simple investment options, very low costs, incentives

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<sup>8</sup> These plan features are expressions of institutional constructs for saving, discussed above.

for those with low-incomes, and basic protections that are possible only within a plan structure.

### **Conclusion**

If properly designed as an inclusive and low-cost savings plan, an inclusive asset-based policy would be a large-scale public good. All citizens could benefit. The policy could drive asset accumulation in households, spur economic development, and create more engaged citizens for many decades into the future. This is not farfetched. A transition to asset-based policy is already occurring and will likely continue. The major challenge is to have the vision and commitment to include everyone, and the policy wisdom to use a savings plan structure to do so.

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**Resources on Asset-Based Policy and Research**

New America Foundation  
Washington, DC  
[www.newamerica.net](http://www.newamerica.net)

CFED  
Washington, DC  
[www.cfed.org](http://www.cfed.org)

Institute for Public Policy Research  
London  
[www.ippr.org.uk](http://www.ippr.org.uk)

Center for Social Development  
Washington University in St. Louis  
<http://gwbweb.wustl.edu/csd/>

**Questions for the Record From Senator Lincoln for  
Dr. Michael Sherraden  
April 28, 2005**

**Question:** Individual Development Accounts (IDAs) clearly help low-income people to save. The Good Faith Fund has over 500 participants who have built cumulative savings of over \$1.1 million dollars. What do you see as the role of the private sector in encouraging personal savings? Do you see opportunities for the private sector to partner with States, local business, and local communities to improve our national savings?

**Answer:** In America, we have very well-developed financial services and as efficient, transparent, and secure financial markets as any in the world. These markets are a huge national and global resource. In any savings policy, it would be almost foolish not to use private markets for investments.

There will always be this fundamental private-sector role in any saving policy in America. The government should not try to manage savings and investments. For example, the Federal Thrift Savings Plan, a government program, uses private sector asset managers.

If saving and asset-building are to be inclusive, the policy must be in the form of a savings plan, such as a 401(k) or 403(b) plan, the Federal Thrift Savings Plan, or a College Savings (529) plan. Such plans are in fact how most Americans are able to save.

To bring this point home, each of us in this room should pause and ask ourselves how much retirement savings we would have if we were not in a 401(k), Thrift Savings Plan, or similar saving plan structure. Every American should have this opportunity.

Savings plans (contractual savings) have important features that lend themselves to inclusion. These features are: centralized and efficient accounting, outreach and education, a limited number of low-cost investment options, low initial and on-going deposit requirements, automatic deposits, and opportunities to establish other practices and “defaults” that increase saving performance. These include automatic enrollment, savings match, match cap (amount of savings that can be matched), a default low-cost fund, and automatic increases in savings deposits with pay raises. During the payout period, it may be desirable for a required minimum annuitization for income protection.<sup>[1]</sup>

For these very good reasons the ASPIRE Act calls for a plan structure something like the Federal Thrift Savings Plan.

At the Center for Social Development, we think there is also potential in using College Savings (529) plans as a platform for inclusion in asset-building. To be sure, some State 529 plans have high fees and high investment costs, and such plans are undesirable. But some State 529 plans keep costs low, have very low deposit requirements, provide

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<sup>[1]</sup> These plan features are expressions of institutional constructs for saving, discussed above.

outreach to State residents, and match savings for the poorest savers. These State plans, or something like them, have the potential to be a platform for an inclusive children's savings account (for research and discussion, *see* Clancy and Sherraden, 2003; Clancy, Orszag, and Sherraden, 2004; Clancy, Cramer, and Parrish, 2005).

Recognizing the importance of a plan structure, President Bush, when discussing individual accounts and Social Security in his 2005 State of the Union Address, said:

The goal here is retirement, so we will set careful guidelines for personal accounts. We'll make sure the money can only go into a conservative mix of bonds and stock funds. We'll make sure that your earnings are not eaten up by hidden Wall Street fees. We'll make sure there are good options to protect your investments from sudden market swings on the eve of retirement. . . .

Personal retirement accounts should be familiar to Federal employees, because you already have something similar, called the Thrift Savings Plan, which lets workers deposit a portion of their paychecks into any of five different broadly based investment funds.

While I do not think that personal accounts should be "carved out" of the existing social insurance system, I heartily agree that there is an important role for inclusive personal accounts in public policy. In this regard, President Bush is exceptionally wise in calling for a savings plan with a few simple investment options, very low costs, incentives for those with low-incomes, and basic protections that are possible only within a plan structure.

Thus, the right policy, in my view, is definitely to use private-sector financial markets, but do so within a plan structure. On this I think there can be broad bipartisan agreement.

Michelle Simmons  
Testimony before the Subcommittee on Social Security and Family Policy of the Finance  
Committee of the Senate Committee on Finance  
"Building Assets for Low-Income Families"  
Thursday, April 28, 2005

Hello, my name is Michelle Anne Simmons. I am a graduate of the self employment training program and the Family Savings Account program, also called the Individual Development Account program in Pennsylvania, and I would like to tell you my story.

For years I was a "hope-to-die" dope fiend, living in a cardboard box on the streets of Los Angeles. I was in and out of jail for over 10 years. In 1999, I was released from prison and decided I was tired of the cycle of addiction, imprisonment and making promises to my children that I knew I couldn't keep. I was going to change my life or die.

When I was released from prison, I moved back to Montgomery County, Pennsylvania and was having a difficult time finding viable employment and housing. I wanted to find a job that that would provide for me and my two children. I knew working at McDonald's at \$6.50 per hour was not going provide a good life for my family.

A friend encouraged me to start my own business. My idea was to start a nonprofit organization for women ex-offenders to transition back into society and to become productive, self-sufficient individuals. I came to Women's Opportunities Resource Center after hearing about their entrepreneurship program. WORC is a Philadelphia non-profit organization that provides self-employment training, Family Savings Accounts, and micro loans to low income women and their families. There I received six weeks of intensive training on how to start my own business including how to write a business plan and do effective marketing. I don't know where I would be without the training and resources I received at the Women's Opportunities Resource Center. They helped my dream come alive.

While participating in the self employment training program, I heard about the Family Savings Account Program. Pennsylvania developed this statewide program in 1997 and is grandfathered into the Assets for Independence Act, which allows Pennsylvania to receive up to \$1 million annually. This program is up for reauthorization and it is important that the grandfathering clause is maintained in order to continue a successful statewide program. Pennsylvania provides half the matching funds for the program. See attached fact sheet regarding the AFIA reauthorization.

After living in a cardboard box for so many years, my dream was to have a stable home for my children. Through the FSA program, I saved \$1007 and was matched \$1007. This \$2014 covered my down payment and with the help of a housing counseling agency and Habitat for Humanity, I was able to secure a \$50,000 no-interest, low-down payment mortgage.

The FSA program taught me money management and budgeting. It taught me simple things like writing down everything I spent and cutting out unnecessary expenses. I had never saved before. Saving was not easy but I stayed focused and kept thinking about my long term goals of

starting my business and purchasing a house for my family. Getting the grant was a great incentive. It was the first time in my life that someone rewarded me for a doing a good job.

The program gave me a sense of accomplishment. It built my self-esteem and self-worth and now I look forward and welcome new challenges because now I know that I can do it. At one time I didn't even think beyond the next day, and now I'm planning for my future and my children.

My life has changed so much since I enrolled in the Family Savings Account program. In 2002, I graduated from the self-employment training and was ordained as a minister. In 2003, my nonprofit "Why Not Prosper, Inc" opened its doors to its first resident, and with the help of the FSA program, I moved into my first home. In 2004, I received the Women's Way Local Honoree Award which recognizes outstanding work done by women in the community.

When I look back over my life, I can't believe the strides that I have made. Programs like these are essential to help those in my former circumstances succeed and prosper. It is a blessing to be clean and to be there for other women who have fallen on hard times. I am thankful now to be a mentor for them and for my children.

## **Assets for Independence Act Reauthorization**

### **Current Status**

The Assets for Independence Act (AFIA) is up for reauthorization. Two bills (HR 7 and S 1786) were introduced last legislative session, however the session recessed and legislation was not passed. Pennsylvania and Indiana were grandfathered in the initial AFIA legislation. However, these bills did not include the grandfathering clause. It is essential that the grandfathering clause be retained when legislation is reintroduced this session.

Under the grandfathering clause, each state can receive up to \$1million in annual funding, which in Pennsylvania is matched dollar to dollar with state funds. Pennsylvania and Indiana are taking advantage of the program and have successful and effective programs.

Pennsylvania's legislation was enacted in 1997. Since 1997 over \$7 million has been appropriated.

Elimination of the grandfathering will have the following impact:

1. AFIA dollars are an incentive for Pennsylvania to maintain significant level of funding. Pennsylvania's state funds are matched dollar for dollar with AFIA funds. Given the current economic crisis in the state, changes in legislation could potentially reduce the amount of state funding.
2. Elimination of the grandfathering will require significant changes to the structure and administration of Pennsylvania's program.
  - Pennsylvania's program is administered statewide utilizing a Request for Proposal process. There are currently 34 grantees in Pennsylvania. This would require community-based organizations to apply to both AFIA and the state, which would be inefficient and costly to implement.
  - Pennsylvania's match rate was changed in 1999 from a 50% \$600match rate to a 100% \$2000 match rate (One thousand state dollars and one thousand federal dollars). This change was made with the expectation that Pennsylvania would continue to receive AFIA funding.
  - Pennsylvania's program allows for additional usages such as home improvement, education for child, credit repair as long as it allows for the purchase of an asset and automobile purchase for attending work or school. Elimination of the grandfathering would require restructuring of the program, which has been effective.
  - Account structure in Pennsylvania's program does not require a reserved account and does not place restrictions on non-federal money. Matching funds must be placed in an FDIC insured account. All matches are made payable to the vendor and the account holder.

**Question for the Record From Senator Lincoln for  
Ms. Michelle Simmons  
April 28, 2005**

**Question:** Your stories are certainly inspiring to all of us. They highlight the importance of increasing financial literacy and what a difference this can make in peoples' lives. It is also heartening to hear how you're passing on your financial discipline to your children. Do you have any recommendations for increasing the financial literacy of the general public?

**Answer:** I think programs like IDAs are instrumental in teaching people how to budget, save, and plan for the future. In Pennsylvania's FSA program, I learned so many financial management skills that have stuck with me. I still use those skills every day to make wise economic choices. With a regimented savings plan, people learn discipline and how to be responsible, and this is really important. Mandatory lessons on financial topics may seem like a burden at first, but really people will come to realize that they are a blessing.

Broadening the FSA program would allow more people to increase their financial literacy. With counseling and help from organizations like the Women's Opportunities Resource Center and the reward of owning a home or a business once you complete the program, people will begin to make good decisions, save money, watch it grow and pass the habit on to future generations.


**H&R BLOCK**

**STATEMENT OF  
BERNARD WILSON, VICE PRESIDENT, H&R BLOCK  
ON BUILDING ASSETS FOR LOW-INCOME FAMILIES  
SUBCOMMITTEE ON SOCIAL SECURITY AND FAMILY POLICY  
SENATE FINANCE COMMITTEE  
APRIL 28, 2005**

Mr. Chairman, thank you for the invitation to share H&R Block's experience in helping low-income families save.

H&R Block serves nearly 20 million taxpayers at 11,000 offices across America, including 490 offices in Pennsylvania, and through online and packaged tax preparation software.

In our 50<sup>th</sup> year, we are evolving from a firm devoted to helping families deal with their tax filing responsibility to one that advises on a broader range of financial issues, including the need to save for education, home ownership, and retirement.

Our recent experience with the Retirement Saver's Credit may be helpful to the subcommittee.

Enacted in 2001, the credit provides a government match of up to 50% for contributions to 401(k), IRAs, and similar retirement plans. It covers taxpayers with incomes up to \$50,000 who have income tax liability.

The features of the Saver's Credit play an important role in encouraging retirement savings.

- First, the credit relies on personal responsibility. People can't claim it unless they are willing to make a substantial commitment to the futures of their families through their own contributions. This is not a hand-out, but a hand-up on the road to retirement security.
- Second, it uses tax time to promote savings. One hundred million tax filers have refunds averaging \$2,100. With nearly 60% using professional tax preparers, the run up to April 15 is also a chance for an annual family financial check up and an opportunity to turn good intentions and savings advice into immediate action.
- Third, it supports the existing private retirement system, leveraging the well-known structure of IRAs, 401(k)s, and other vehicles and encouraging eligible taxpayers with low- and moderate-incomes to use them.
- Fourth, the match rate of up to 50% provides a large enough incentive both to strengthen savings and to encourage first-time savers.
- Finally, the higher match rate for those with lower incomes targets benefits at those who most need help in saving in contrast to traditional incentives favoring those in the highest tax brackets.

Many of our clients are eligible for the Saver's Credit. But polls taken shortly after enactment showed more than 80% of Americans had no idea what it was. In response, we provided extra training for our tax professionals. We also created a low-cost, low-minimum-deposit "Express IRA" to help more clients use the credit to save. Professional tax return preparers can provide pivotal education, advice, and facilitation to enable taxpayers to benefit from the credit. As a result—

- Over the last three years, we have helped over 3.6 million clients obtain Saver's Credits, about 25% of the total number of Saver's Credits claimed nationally. Our clients received over \$600

million in tax credits to help them save. This resulted in average savings of \$529 per client with an average credit of \$167 each per year.

- While most used the Saver's Credit to match contributions to an existing 401(k), IRA, or other retirement plan, over 243,000 used an Express IRA, with an average tax benefit of \$179. Among these clients—
  - the average income is \$27,000
  - half are considered "unbanked"
  - two-thirds are Earned Income Tax Credit recipients
  - 80% are first-time retirement savers
  - 85% maintain their IRA account balances

Our experience thus shows that the credit – combined with a tax refund, a low-cost savings vehicle, and the help of a tax professional – can have a significant impact on retirement savings.

To build on this success, we encourage the Senate to consider extending the credit beyond 2006 and expanding it to include more middle- and low-income taxpayers. Because recent tax cuts have increased to 40% the number of Americans who have no income tax liability (families of four with incomes up to about \$40,000), you may want to consider making the credit refundable so it is available to these families as well.

We know from our experience that the Saver's Credit works. As the Committee deliberates ways to boost savings among low- and moderate-income families, we encourage you to consider making the credit permanent and expanding its reach.

Celebrating its 50th anniversary in 2005, H&R Block is the world's largest tax services provider, having served more than 400 million clients since 1955. The sixth largest retailer in the world, H&R Block has more than 12,500 locations serving taxpayers in the United States, Canada, Australia and other countries. Headquartered in Kansas City, H&R Block served more than 19 million U.S. clients during fiscal year 2004 at approximately 12,000 H&R Block retail offices worldwide and through software and online services. Over 167,000 company and franchise employees deliver tax services including preparation of one out of seven individual tax returns filed with the IRS. H&R Block tax schools trained 250,000 students including 84,000 enrolled in our 66-hour basic tax course. H&R Block served 3.2 million tax clients through its *TaxCut*® software and through online tax preparation services.

H&R Block's subsidiaries also deliver financial advice, investment and mortgage services, and business accounting and consulting services. H&R Block Financial Advisors Inc., headquartered in Michigan, offers investment services and securities products. With approximately 1,000 financial advisors serving clients at approximately 270 branch offices, H&R Block Financial Advisors is a member NYSE, SIPC, a registered broker-dealer and investment advisor. H&R Block Inc. is not a registered broker-dealer and is not a registered investment advisor. H&R Block Mortgage Corp. offers a full range of retail mortgage services. Option One Mortgage Corp., headquartered in California, provides mortgage services and offers wholesale mortgages through large financial institutions and a network of 24,000 independent mortgage brokers. RSM McGladrey Business Services Inc., headquartered in Minnesota, and its subsidiaries serve mid-sized businesses and their owners with tax, accounting and business consulting services, as well as personal wealth management services. H&R Block Small Business Resources, operating in 14 U.S. cities, serves the tax, financial and business needs of small business owners. H&R Block Small Business Resources is not a licensed CPA firm.