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CONGRESSIONAL TESTIMONY

Building Assets for Low-Income Families

Testimony before Subcommittee on Social Security and Family Policy Committee on Finance United States Senate

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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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