

Personal and Family Savings Policy Brief

Introduction to the Issue

Personal and family savings enhance American economic prosperity by supplying the investment capital that is necessary to ensure long-term economic growth and job creation, while reducing dependence on more volatile sources of capital such as lending by foreign central banks. Equally important, savings are essential in achieving milestones across the entire lifecycle of individuals and families, from seeking higher education, to homeownership, retirement and the accumulation and transfer of wealth to the next generation. Savings enables entrepreneurship and other forms of investing for the future. A broad culture of personal and family savings and the public policies to support it are vital foundations of an Opportunity Economy and the health of the American Dream.

Despite its essential role in the economy, personal savings has been declining over the past two decades, reaching a negative rate at the end of 2005, the lowest since the Great Depression. Moreover, such negative savings have been most pronounced in the bottom half of the income spectrum, risking the emergence of a two-tiered system in which wealthy and upper middle class Americans benefit from savings and investment, while working class and poor Americans largely do not. The share of U.S. personal savings held by the top 20% of earners rose from 51% to 55% in the 1990s, where it remains today¹. Only 32% of American families hold savings representing even 3 months of their incomes². Only 30% of households in the bottom income quintile reported any savings at all³. Our public policies on savings are not succeeding in offsetting those trends and in some ways exacerbate them. Every American should have access to suitable savings mechanisms throughout his lifecycle regardless of his income level, but current approaches fall short in 4 ways:

- **Incentives reinforce two-tiered system** – more than 90% of federal subsidies in the form of retirement savings and homeownership (about \$300 billion in 2005) accrue to households earning over \$50,000 per year⁴, mainly benefiting those who already have assets. Savings incentives, in particular, tend to be based on tax deductions which benefit highest earners most, and which do not benefit the more than two-thirds of Americans who do not itemize their taxes⁵.
- **Programs are not universal and flexible for a changing workforce** – 401(k) plans benefit mainly full-time workers in larger companies. Nearly 80 % of small companies with fewer than 50 employees do not offer a pension plan. Contingent workers, freelancers and contractors cannot take advantage of these incentives due to long vesting periods and a lack of portability. Eighty-five percent of working Americans without access to pension savings

¹ McKinsey Global Institute Aging Consumers Model.

² Center for American Progress, “Middle Class in Turmoil: Economic Risks Up Sharply for Most Families since 2001.”

³ Federal Reserve Board, “Recent Changes in U.S. Family Finances: Evidence from the 2001 and 2004 Survey of Consumer Finances.”

⁴ Estimates from the Joint Committee on Taxation and the Office of Management and Budget

⁵ The U.S. Conference of Mayors on Federal Tax Reform, October 2005.

are either low-income earners, young and mobile workers, part-time employees, or employed by small firms.

- **Savings options and instruments are too complex** – benefiting from many available savings plans often requires expert consultation that is unaffordable to a majority of the population, and general levels of financial literacy are low. Research has shown that having savings automatically allocated into accounts (unless requested otherwise) can double savings rates, but most plans do not take advantage of that insight.
- **Low- to mid-income households face stronger incentives not to save** – since many Supplemental Security Income (SSI)⁶ programs set very low asset limits that are generally not inflation-indexed nor frequently raised, many low-income individuals are implicitly taxed on their savings. Moreover, despite some individual retirement arrangements (IRA) incentives for low income workers, the lump sum contributions necessary to establish an IRA outside of work is simply not feasible for many working Americans.

Identifying the Problem

Current savings options fall into three categories – self-administered, government-sponsored, and employer-based. Each of these approaches suffers from a mix of the four limitations listed above.

- **Self-administered:** Including a range of accounts from checking, savings and brokerage to Roth IRAs, self-administered plans tend to be as effective as the individual’s investment knowledge. It is arguably the ‘golden age’ of investing for savvy investors with a proliferation of products and risk management strategies – yet still less than one fifth of Americans hold more than \$5,000 in equities outside of retirement plans⁷. Making investment decisions on an individual basis in an environment that is difficult to navigate exposes ‘financially illiterate’ investors to greater transaction costs and vulnerability during market downturns. For example, the share of Americans investing in the stock market has still not recovered to levels seen before the bubble burst in 2000.
- **Government-sponsored incentives:** The federal government subsidizes plans that allow individuals to save on a tax-advantaged basis, including IRAs, tax-qualified retirement plans⁸, annuity contracts, life insurance, medical savings accounts and various education savings tools (e.g., 529s). Tax-advantaged plans have led to a mixed net savings impact when some households borrow funds (mortgage, home equity loan, etc.) to make deposits in tax-subsidized accounts. Moreover, the Saver’s Tax Credit that matches household contributions made to IRA or 401(k) plans benefits few low-income earners since they owe little or no tax, or do not itemize.
- **Employer-based:** Workers earning between \$30,000 and \$50,000 are almost 20 times more likely to save through workplace retirement plans than via individual incentives not involving

⁶ Federal income supplement program funded by general tax revenues (not Social Security taxes) designed to help aged, blind and disabled people, who have little or no income; and provide cash to meet basic needs for food, clothing and shelter.

⁷ Investment Company Institute and the Securities Industry Association, 2005. Federal Reserve data, 2004.

⁸ A plan of deferred compensation that meets the qualification standards of the Internal Revenue Code.

employers. As one of the biggest employer-based savings plans, the 401(k) allows an employee to save for retirement while deferring income taxes until withdrawal. Holders of 401(k) accounts can also benefit from matching contributions by their employers, and are currently operated on an opt-in scheme, meaning that employees can elect to have a portion of their wages deposited directly into the account. However, almost half the workforce does not even have access to a pension plan in the workplace since small companies cannot afford the high transaction costs that are associated with administering retirement benefits⁹.

Policy Recommendations

We can do better to support a goal so universally supported as improving savings, and a range of organizations and think tanks spanning the political and ideological spectrum have proposed ideas to boost savings for middle class and lower-income Americans. We believe that four principles can be combined in creative ways to improve our policies across all three categories. Savings should be:

1. **Universal.** It should be a goal of public policy to make responsible savings behavior – and actual savings – universal, with a goal in the next decade to double the share of Americans with 6 months of savings. This can be done by some variant of universal savings accounts (USAs), combined with incentives for low-income families to save – perhaps by a ‘staking’ first deposit in USAs for low-income households, or through ‘stakeholder’ accounts for kids.
2. **Portable.** Employer-based savings vehicles (the most widely adopted by workers) should be made portable, self-administered or government-sponsored plans – either by defining standards for portability or allowing employers to contribute to universal savings accounts.
3. **Simple and automatic.** This can be achieved by consolidating different savings vehicles into a single universal account and making deposits automatically. (e.g., automatic enrollment with voluntary opt-out for employer plans, automatic deposit of a portion of EITC credits, etc).
4. **Community-based.** One attractive aspect of educational savings plans (529s) is that anyone can contribute to them to invest in a child’s education. Much more could be made of this feature, and expanded to USAs, so that religious organizations, labor unions, businesses, philanthropists, or any other group could contribute to the savings of others.

Conclusion

Such savings policies and plans can be shaped in collaboration with the private sector and financial services industry, with appropriate safeguards and standards to prevent inappropriate penalties for emergency uses, particularly among low-income savers. Since personal responsibility is an essential foundation of personal savings, any of these initiatives must be accompanied by systematic improvements in financial education and literacy for both children and adults.

⁹ Hope Street Group, “Expanding Retirement Security for All Americans: Ensuring Portable and Universal Pension Benefits for American Workers,” June 2003.