Session 4: Saving and Investing by Low- and Middle-Income Households

The Two Worlds of Personal Finance: Implications for Promoting the Economic Well-Being of Low- and Moderate-Income Families

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Two worlds of policy interest, research, and advocacy exist today: (1) mainstream finance, which relates best to the upper-income population, and (2) low-income personal finance, which relates best to the low- and middle-income population—a population, by the way, that extends even into the 50th percentile of income. The purpose of this presentation is to place in a broader context the key differences between these two worlds and then discuss the salient policy issues affecting the low- and middle-income world: human capital, housing and retirement savings, social insurance, and precautionary savings.

Mainstream and Low-to-Middle-Income Personal Finance. Mainstream finance concentrates on people who have high levels of income and financial assets. Although the life-cycle model can be applied to all levels of income and wealth, even that model emphasizes portfolio analysis and financial assets—and thus tends to ignore the realities of low- and middle-income households.

Mainstream personal finance also emphasizes the importance of income tax incentives for clients, such as the mortgage interest deduction. But for low-to-middle-income households, many such incentives are unlikely to apply. Such households have low marginal tax rates, and even when they do have positive rates, they rarely itemize. They live in a very different world from the population that best benefits from mainstream personal finance.

Beginning in the early 1990s, particularly with the publication of *Assets and the Poor*,[1] foundations began to show interest in the issue of low-income asset building. Actually, the term "asset building" is a bit of a misnomer. The real goal is sound balance sheets for low-income households.

■ *Initiatives for the low- and middle-income population.* Out of this new interest in the second world of finance, a few initiatives have arisen, each associated with a considerable amount of research.

The first initiative is embodied in individual development accounts (IDAs), which combine a financial literacy program with matched savings. To qualify for the program, individuals must have income below a certain level. The program provides financial education as well as encouragement to open a savings account. Participant savings in these accounts will be matched for approved purposes. For example, if a participant has saved $1,000 and the match is 3:1, that participant will actually have $4,000 to put toward an approved purpose, such as placing a down payment on a house, paying tuition, or starting a business.

Other important initiatives include (1) educating lower-income households about the importance of Social Security, which I will cover later in more detail; (2) spreading the word about the detrimental effects of high-cost alternative financial service products; and (3) liberalizing the often-misguided asset tests used in benefit programs. For example, to qualify for food stamps—a program used by approximately 25 million Americans (a dramatic increase as a result of the Great Recession)—individuals and households must pass a liquid assets test. In most states, people can own a home, even an expensive home, and still qualify for food stamps. But if they have too much money in a bank account, they will not qualify. Some housing programs have similarly misapplied asset tests, as does Temporary Assistance for Needy Families, a cash assistance program for the low-income population.

■ *Characteristics of low-income populations.* Large numbers of lower-income people are born to parents who are unmarried or who later divorce. They may be cohabitating, but such relationships tend to be less stable than marriages. The instability of the household can come from uncertainty about who is contributing

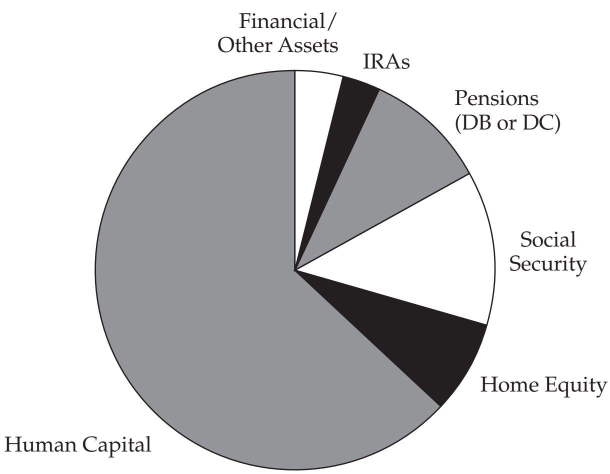
[1]Michael W. Sherraden, *Assets and the Poor: A New American Welfare Policy* (Armonk, NY: M.E. Sharpe, 1991).

to the household and who is spending the household's money. For low-income men, the buildup of arrearages in child support, often at high interest rates, is another issue that tends to be ignored in mainstream financial discussions.

Mainstream and low-income personal finance do, of course, have common elements, such as living within a budget, establishing good credit, and having retirement income. And the gradual recognition of the importance of behavioral economics plays a hand in both worlds. But each world has distinct perspectives on each of these elements, such as tax and transfer incentives, which I have already mentioned, and the importance of government social insurance, which Steuerle will cover, along with the policy debate centering on financial adequacy versus financial opportunity.

Human Capital. Human capital is the primary asset for most individuals, especially for low- and middle-income families, who have little in the way of financial assets, as **Figure 1** illustrates. In fact, Figure 1 significantly understates the potential of human capital because it is based on the earnings of 55-year-old workers, who it is assumed will retire in their early to mid-60s, which is not necessarily an accurate assumption for this population, as will be discussed later.

Figure 1. Estimated Human Capital and Total Assets for a 55-Year-Old Worker, Middle-Income Quintile



Notes: Human capital assumes an additional 19 years of work at the average Social Security wage. Working for an additional 19 years yields the same number of expected years spent in retirement as an average worker retiring in 1940.

Sources: Authors' estimates, with financial assets based upon Gordon Mermin, Sheila Zedlewski, and Desmond Toohey, "Diversity in Retirement Wealth Accumulation," Urban Institute Brief Series, no. 24 (December 2008). Estimates updated to 2010 dollars.

Educational needs of the low-income population. Consider also that mainstream financial advisers emphasize the importance of saving for college. Yet in low-income finance, this is hardly an issue. A top student from a low-income family is likely to get some scholarship support—perhaps a Federal Pell Grant—and most low-income students will go to state or community colleges that have low tuitions. Many Pell Grants will even pay living expenses, which will amply cover tuition and the other out-of-pocket costs of a community college.

Many individuals from low-income families will thrive and do well in college, which should continue to be encouraged. Yet when we talk about the development of human capital for this population, the bigger problem is the dropout rate for high school. The share of young people graduating from high school with a regular high school diploma has been relatively flat over the past few years, at approximately 75–78%. The graduation rate for more at-risk groups is around 60–62%. That statistic means 40% of these at-risk students are not earning a regular high school diploma, yet we focus the bulk of our effort on college. (Note that the high school dropout rate is somewhat disguised by the GED—an alternative high school credential—which has been shown to add little to human capital because the earning power of a person with a GED is little improved over the earning power of a high school dropout.)

Regular employment and apprenticeships. At low income levels, two factors are especially important. First is a steady work record. Work experience, even at low income levels, yields earnings gains over time, especially in a relatively stable occupational area. A stable work record is also essential to qualify for social insurance programs, such as unemployment insurance. Individuals with unstable work records often do not have enough quarters of prior employment to qualify for unemployment insurance. And a work record is essential for adequate coverage under the Social Security Old-Age, Survivors, and Disability Insurance (OASDI) program, which provides not just pension retirement but also survivor's insurance and disability insurance. Thus, the focus for human capital should be on improving the ability to earn.

Second, we need to develop better alternatives for career success aside from college. Many other countries have excellent apprenticeship programs in which people learn by doing. This idea is critical for the low- and middle-income population because with apprenticeship programs, participants are not forgoing earnings while they are building their human capital. While undergoing training, they typically earn a level of income similar to what they would at the beginning of a career, even as they gain the occupational skills that are so important for future earnings.

If I were to emphasize one policy message for the low- and middle-income population, it would be that we should help that population develop its human capital through steady earnings and expanded apprenticeship training.

Eugene Steuerle

As already mentioned, stocks and bonds rank fairly low in importance on the asset list for low- and middle-income families. Human capital is at the top of the list. After human capital come social security or social insurance (which we are presuming to count as an asset), homes, and then pension plans (both defined benefit and defined contribution). Only after all that do we come to the world of IRAs and portfolios of stocks and bonds.

Before addressing those asset groups, however, consider first the policy debate centering on financial adequacy versus financial opportunity for the low- and middle-income population.

Adequacy vs. Opportunity Policy Debate. The low-income advocacy community is divided between those who believe policy should focus on financial adequacy and those who think it is time to move in greater measure toward an opportunity agenda. My perspective is that as society expands its social welfare functions, the marginal returns from providing adequacy only become smaller and smaller. The natural progression, then, is to push more toward an opportunity agenda. But many advocates for low-income individuals either do not support an opportunity agenda or see it as an add-on because they cannot get something else.

For example, a number of groups, including the Ford Foundation, strongly advocate child accounts as a means of promoting saving and pushing into the opportunity agenda. But equally influential groups would rather stay with the adequacy agenda and simply use that money to increase SNAP (Supplemental Nutrition Assistance Program, formerly called food stamps). And this latter preference has a strong argument to support it. Promoting consumption at low income levels is easy to do. If I give low-income households an additional $100, they will more than likely spend the entire $100 on consumption. But if I help them invest in education or child accounts with matched funds, success is variable. The risk of failure is much higher. They may not study in the case of education or hang onto the saving in the case of subsidies for deposits to saving accounts.

One could also argue that the opportunity agenda is more regressive, that the ambitious person—the person more committed to long-term goals—will gain more from the opportunity agenda than those who are less committed. *Ex post*, then, the opportunity agenda will sometimes favor those who end up with higher incomes, such as those who take advantage of the educational subsidies.

But the "grand compromise" that now exists between liberals and conservatives tends to provide the most opportunity subsidies to those with higher incomes and then to the middle-income population. The opportunity subsidies provided to low-income households tend to be small and in some programs, nonexistent. There are exceptions, as in the case of subsidies for education.

Even there, however, the higher-income group still often gets more than the lower income group because more of the former take advantage of these subsidies, including state support for public colleges.

Thus, opportunity subsidies tend to go to higher-income people, and adequacy subsidies—the consumption subsidies—go to low-income people. Together, this mix of policies distorts incentives in ways that discourage low-income populations from trying to raise themselves to middle-class status.

Housing and Retirement Savings. From the early 1990s through the early 2000s, 25- to 35-year-olds from middle-wealth populations were saving $7,000 to $8,000 per year, as shown in **Figure 2**. People who were 35–45 years old were saving about $12,000, and people 45–55 years old were saving about $18,000 annually. With all the talk about the low savings rate in the United States, these amounts might seem implausible. How did middle-income families making only $50,000 a year save this much money? They did so through Social Security wealth, homeownership, and retirement savings. The growth of the last two depends on behaviors that become routine and lead to returns that also compound year after year.

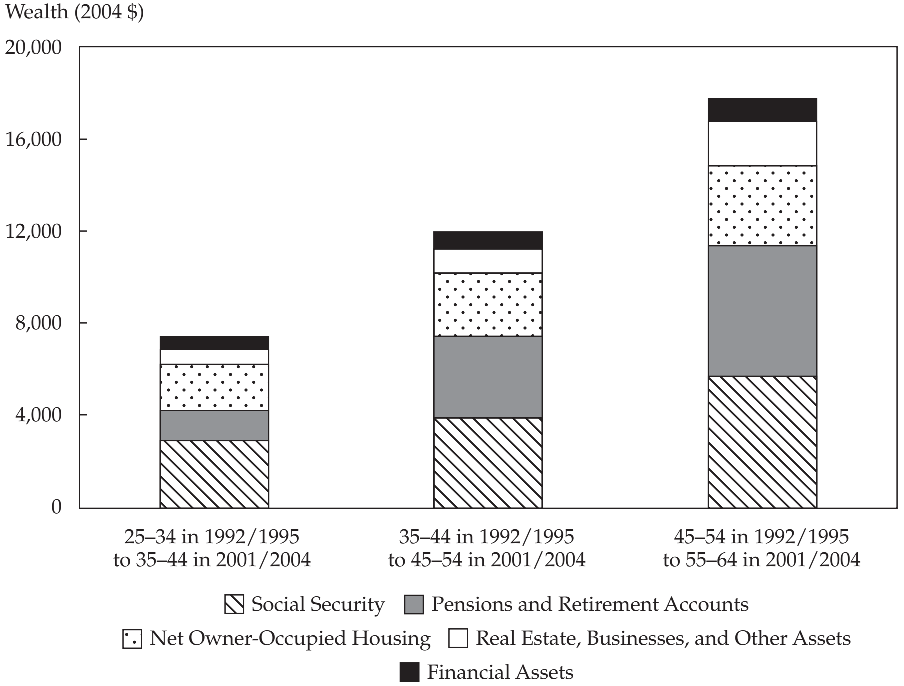
If we wish to increase saving by households, the behaviors that we should all be emphasizing include paying off the mortgage and putting money into a retirement account. We don't just need to stick to traditional methods. For instance, one initiative to encourage homeownership would be to make it easier for some to convert their rental subsidies into homeownership at low cost.

Note also that the importance of other financial assets, such as savings accounts, is relatively small. For many people, no matter their income level, most of their wealth is in their home and their retirement account. Certainly this is true at low income levels, even among those with only a high school diploma or less. Bottom line: Housing and retirement accounts are where most households save.

Importance of Social Insurance. When it comes to retirement, Social Security and Medicare, in the United States, provide the most important assets not only for low- and middle-income families but also for upper-middle-income families. I have estimated that the lifetime value of Social Security and Medicare (including a rough estimate for the value of backup Medicaid if a person ends up in a nursing home for a long time) is now close to $1 million per couple. That value is in excess of all the private wealth for about 75% or 80% of the population.

For the vast majority of people, their most important portfolio decisions relate to these social insurance policies. Whether or not these programs are sustainable at that level as the nation advances into the future is another question, but right now, that is where the money is. Decisions related to social insurance

Figure 2. Annual Wealth Accrual per Adult between Early 1990s and Early 2000s for Typical Households



Sources: Urban Institute calculations from the 1992, 1995, 2001, and 2004 Surveys of Consumer Finances and the Dynamic Simulation of Income Model (DYNASIM3).

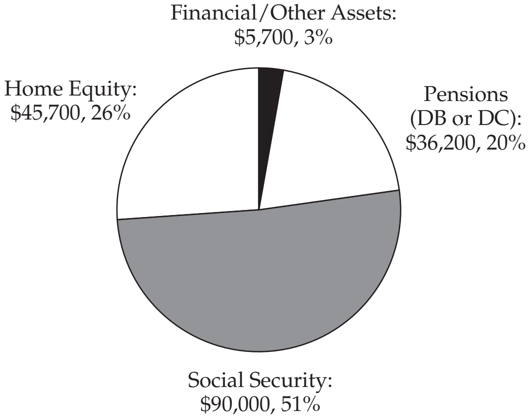
are even more important for low-income individuals because their replacement rates (the portion of pre-retirement or pre-disability income replaced by social insurance) are even higher than they are for higher-income people.

Figure 3 offers another view of this asset allocation (excluding the human capital component and Medicare) for both the low-income and the middle-income populations. Both charts again demonstrate the dominance of Social Security and homeownership, which account for 77% of low-income assets (51% + 26%) and 54% of middle-income assets (34% + 20%).

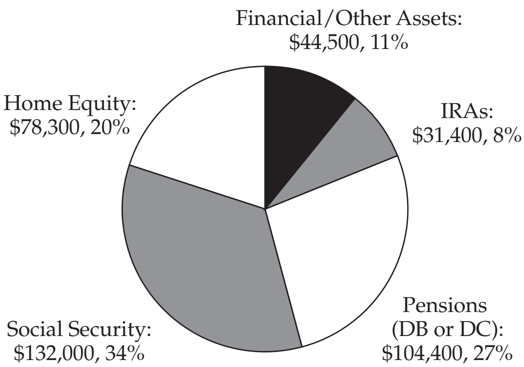
Combining these various figures, we conclude that the most important portfolio decision that the majority of low- and middle-income individuals make is when to retire (or from the other perspective, how long to keep working). It is a far more important decision than the choice of the best allocation of stocks and bonds in a portfolio. According to our research at the Urban Institute, for every additional year worked, annual income increases thereafter—in real, inflation-adjusted terms—by about 8%, largely because of the way

Figure 3. Composition of Assets for a Worker, Bottom- and Middle-Income Quintile, Aged 55–64 (2010 dollars)

A. Bottom Income Quintile, Total = $177,600



B. Middle Income Quintile, Total = $390,600



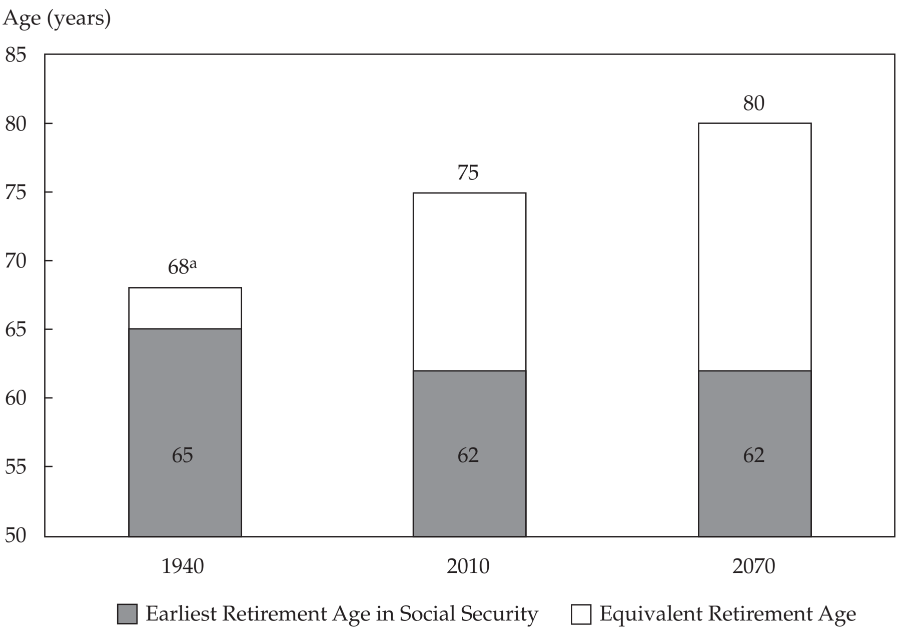
Notes: Financial and other assets include bank accounts, certificates of deposit (CDs), stocks, bonds, mutual funds, property, businesses, vehicles, and other financial assets net of nonhousing debt. Social Security and defined-benefit (DB) pension wealth are the expected present value of future benefits. Future Social Security benefits are based on lifetime earnings records that were statistically matched to adults in the Survey of Consumer Finance (SCF) from the Dynamic Simulation of Income Model (DYNASIM3). Future DB pension benefits are based on expected or current benefits. Analysis combines the 2001 and 2004 surveys. All amounts are in 2004 dollars.
Source: Gordon Mermin, Sheila Zedlewski, and Desmond Toohey, "Diversity in Retirement Wealth Accumulation," Urban Institute Brief Series, no. 24 (December 2008). Estimates updated to 2010 dollars.

that Social Security is designed. All Social Security old-age benefits are paid out as an annuity. One "buys" additional annuity income by forgoing receipt of Social Security at an earlier age (say, 62), thus increasing the size of the annuitized payout at the later age (say, 70).

The average person retiring at 62 has a life expectancy of 20–30 years. If people can increase their annual retirement income by 8% just by working one additional year, they accrue a lot of financial protection. If they work eight additional years, shifting their retirement age from 62 to 70, they can typically increase their retirement income by two-thirds or more, which is a lot more than they can obtain through any other portfolio decision.

Figure 4 shows just how far we have come in providing years of support since Social Security was started in the United States. In 1940, a few years after the system was first created, the average person retired at age 68, with 65 being the earliest retirement age allowed. If we assume retirement lasts the same number of years now as in 1940, the age at retirement today would be 75 because of increasing life expectancies. Go 60 years into the future to 2070, and the

Figure 4. Age of Retirement If Number of Years of Benefits Remains Constant



[a]Average retirement age in 1940 and 1950.
Source: Eugene C. Steuerle and Stephanie Rennane, "Social Security and the Budget," Urban Institute, Retirement Policy Program Policy Brief No. 28 (2010).

equivalent retirement age rises to 80. But we have not raised the normal Social Security retirement age significantly, and people are living in retirement for 10 or more years longer than they did when Social Security was first created.

Soon we will have a system in which the adult population is scheduled to be on Social Security for about one-third of its adult life. Given current birth rates, which are about at replacement, that means also that soon about one-third of the adult population in the United States will be on the system. Imagine people having to save enough over two-thirds of their adult lives to support themselves for the final one-third. To do this using private savings, one would have to save about a third of one's income every year. We're not even saving close to a fraction of this amount. Thus, the principal issues regarding retirement for most people are deciding how long to continue working and how to manage their Social Security.

Precautionary Savings. Although certain advocacy groups, such as the Ford Foundation, are encouraging child savings accounts and matched savings for individual development accounts (IDAs), these are not the areas where people will see high rates of return. One could argue, in fact, that many such savings accounts are earning negative real rates of return right now. Yet such accounts are still an extremely important vehicle for precautionary savings, not only for the money accrued and the safety net they provide but also for the positive effect they have on individuals' money management skills and credit profiles.

Many low-income individuals have low credit scores, and these low scores make it difficult for such individuals to obtain low-cost, short-term credit, which they often need because of their lack of liquid savings. They thus turn to high-cost vehicles, such as RALs and RACs (refund anticipation loans and refund anticipation checks, respectively), which can pay them their earned income credits or tax refunds as much as two weeks sooner than payment would be made by the IRS. But RALs and RACs typically cost \$50 or \$65.

A recent study by the Urban Institute using more than 1 million IRS returns found that, among other things, participants who received \$1 or more in interest from a savings vehicle, such as a bank account, were five times less likely to make use of RALs and RACs. This finding has, of course, a simultaneity problem because it does not prove that being "banked" led participants to be more precautionary or make better use of their funds and thus avoid high-cost vehicles, but it is a finding worth taking seriously. Low-income households who open savings accounts, who engage with the financial sector in the right way and thus experience compounding and real returns on assets, become better managers of their finances. That outcome is valuable, even when the returns on savings accounts are as low as they are today.

Annuitizing Social Security. As I mentioned earlier, the Social Security annuity is one of the best deals on the market. Almost no one knows it, and no one gets good advice on it. More often than not, people are advised to "take your money now." When people look at their Social Security account statements, they see that the Social Security Administration essentially is saying that it is almost immaterial whether they take their money now or later. The actual statement refers to a form of "actuarial neutrality" between taking one's money now or later. But those are not risk-adjusted statements. Once account risk is considered, the choice is not actuarially neutral. I challenge anyone to find a better deal than Social Security, which is, in essence, an inflation-indexed annuity that pays about 8 cents on the dollar year after year with the full protection of the U.S. government.

Most people assume that the decision to retire, the decision to take Social Security, and the decision to buy an annuity within Social Security are one and the same decision. In truth, they are three separable decisions. First, people can retire and not take their Social Security, which means that the amount of annuity they eventually take, especially after age 66, is technically up to them. After age 66, participants are eligible to receive a delayed retirement credit of $8 for every $100 of benefit not taken. Technically, retirees could take their benefits for six months, then not take them for six months, then take the benefits again for six months, and then again not take them for the next six months. Essentially, they can convert half of their Social Security checks for those two years into an annuity—effectively achieving half retirement for that period. If such a strategy is technically possible, why not let people choose it up front? Why not give them the option, perhaps up to the size of their Social Security check, to buy a Social Security annuity up front? A retirement planner might then advise them to put aside $100,000 into the Social Security annuity and withdraw from their 401(k), just as if they were buying a private annuity.

The Social Security benefit is not currently described as I have suggested, but there is no technical reason why people should not build up their annuity protection by taking Social Security benefits optimally. Furthermore, such a strategy does not have to cost Social Security any money. It is neither a liberal nor a conservative position.

Conclusion. Keep in mind four key policy issues. First, human capital is by far the most important asset for the majority of the population—even for people in their 50s and often into their early 60s. That people work and then suddenly hit a point when they must retire entirely because they have moved from being fully productive to unproductive is an outmoded and silly stereotype and assumption about their capacity.

Second, Social Security benefits are the most important nonhuman capital asset for low- and middle-income families, and a stable employment record is essential for realizing these benefits to their fullest.

Third, homeownership and pensions are other key mechanisms for achieving middle-class wealth. But the lessons learned from saving and experiencing the value not only of compounded savings but also of the positive effect that saving can have on credit scores are crucial to long-term improvement. This is an important area of emphasis for behavioral economics and finance education initiatives.

Finally, the tax and financial incentives currently available to low- and middle-income families should be reconsidered and reallocated in a way that helps low-income families progress onto a path that leads to middle-class status. Programs to promote opportunity should extend to all.