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

- Two Worlds: Mainstream vs. Low Income Personal Finance
  - Savings/investment vs asset building
  - Worlds rarely interact

- Policy issues and their impact on the two worlds
  - Enhancing human capital
  - Retirement and housing decisions
  - Other factors
World of Mainstream Personal Finance

- Focused where money and data for risk/return analyses is (especially stocks)
- Economists add life cycle perspective
- Emphasizes portfolio analysis, of financial assets, recent links to human capital
- Risk management/insurance play significant roles
- Sometimes examines tax advantages
World of Low-Income Personal Finance

- Foundation money mainly emphasized:
  - Individual Development Accounts (IDAs)
  - Subsidized child savings accounts
  - Social Security (more recently)

- Other key goals:
  - Asset accumulation, shift to mainstream finance
  - Avoid high-cost alternative financial service products
  - Liberalize asset tests in benefit programs
Two Worlds: Common and distinct elements

- Common elements
  - Gradual recognition of behavioral economics and the potential to nudge
  - Retirement income
  - Living within a budget
  - Establishing, maintaining good credit

- Distinct elements
  - Tax vs transfer incentives
  - Government social insurance
Adequacy vs. Opportunity

- As economy & social welfare resources expand, increasing marginal benefits to devote:
  - A higher share to an investment/opportunity agenda
  - A smaller share to an agenda of consumption adequacy

- But opportunity agenda
  - Incurs greater risks (not all people will respond)
  - Is often less progressive (especially ex post)
Four Different Policy Approaches

- Human capital
- Retirement/disability
- Housing policies
- Precautionary savings
Human capital is the primary asset for most individuals, especially at the low end.

Public focus on college as main mechanism for enhancing human capital after K-12 system is ill-placed for helping low-income families.
Estimated Human Capital and Total Assets and for a 55 Year Old Worker, *Middle Income Quintile*

Human Capital Issues at Low-Income Levels

- Work record, experience, demonstrating non-academic skills is vital

- Few programs promote work experience through employability & occupational skills

- Work record is critical for dealing with contingencies

- Multi-year work record is essential for gaining access to disability, survivors, old age insurance
Replacement rates in OASI are higher for low-income

Disability insurance can also provide high replacement rates

Spousal/survivors insurance discriminate against singles, low-income single heads of household

Private pensions, insurance less critical
Composition of Assets for a Worker, Bottom & Middle Income Quintile, Aged 55-64 ($2010)

Notes: Financial and other assets include bank accounts, CDs, stocks, bonds, mutual funds, property, businesses, vehicles, and other financial assets net of non-housing 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 SCF from DYNASIM3. Future DB pension benefits are based on expected or current benefits. Analysis combines the 2001 and 2004 surveys and all amounts are in 2004 dollars. Mermin et al 2008, The Urban Institute.
The principal portfolio decision for most households is how long to keep working.

One additional year of work typically rises post-retirement income by about 8 percent.

Eight additional working years (say from 62 to 70) nearly doubles annual retirement income.

More work increases income proportionately more for lower-income households.
Age of Retirement if Number of Years of Benefits remain Constant

Earliest Retirement Age in Social Security

Average retirement age in 1940 and 1950: 68 years

Earliest Retirement Age in Social Security: 65 years

Equivalent retirement age in 2070: 80 years

Notes: Based on data from the Social Security Administration, Birth Cohort Tables. Stephanie Rennane and C. Eugene Steuerle, The Urban Institute, 2010.
The two primary ways that middle- and low-income families build up wealth are by:
- Accumulation of wealth in retirement plans
- Paying off mortgages

Current pension subsidies & housing subsidies are weighted toward high-income people, may even discourage saving

Opt out retirement policies only the tip of “behavioral” approaches to raising retirement saving

Stereotyping (poor should own/not own) dangerous: assistance in buying a home can be effective for some

Rental subsidies could be converted to ownership at low cost
Precautionary Savings, Credit Scores

- Low income families have limited liquid assets to use for unforeseen events.

- Low credit scores limit access to low-cost, short-term debt

- Financial education emphasizes good credit

- Savings accounts are important learning vehicles & forms of precautionary saving
  - But, in practice, not a primary source of accumulation
Conclusion: Links and Key Policy Issues

- Human capital is by far the most important asset for most of the population.
- Prospective benefits from Social Security are the 2nd most important asset for low- and middle-income households.
- A stable and formal employment record very important for low-income populations.
Homeownership and pensions are the other key mechanisms for achieving middle-class wealth:
- Both emphasize habitual behavior and compounding

Link savings initiatives to financial education, raising credit scores, & other precautionary saving goals, and increase the focus on social security in financial literacy programs.