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An Assessment of Policies to Promote Financial Savings and Asset Building in the U.S.

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Abstract

This paper presents a review of the literature regarding public policies which intend to increase the amount and distribution of financial assets among households in the United States. Asset-based strategies are not new to public policy, and asset-building strategies are currently being piloted in many nations. Financial and non-financial assets are associated with positive outcomes for households, including elevated levels of education and improved quality of life for children. However, many policies in the U.S. have either prevented asset accumulation, or promoted the accumulation of higher-risk assets such as homes and small businesses, without supporting basic asset building strategies such as savings accounts. Also, consumer behavior and decision making remains challenging to model, suggesting the predicted outcomes of incentive programs may not come to fruition. Moving towards asset-based policies is a positive development, especially for low-income households, but policy makers need to craft programs which recognize the need for consumer education and promote a balanced portfolio approach to financial savings.

I. Introduction

Since the late 1980s, policy makers in the U.S. have increasingly voiced support for public policies which support households to create financial assets. Starting with the backing of major foundations and fueled by the work of prominent academics, by the late 1990s both U.S. political parties embraced asset-building strategies in their policy rhetoric. In the 2004 election, the Bush administration made the "ownership society" a pillar of its campaign platform. Asset policies range widely, from promoting savings accounts and matched savings programs, to supporting homeownership and small business creation. While some of these policies use the popularity of asset-building simply as political justification, there are valid economic, sociological and psychological arguments for supporting savings and the accumulation of financial assets by U.S. households.

This paper reviews the literature on financial savings and asset building in the U.S., as well as major asset-based policy initiatives in other nations. Section II defines differences between financial and non-financial assets, and reviews how psychology and behavioral economics consider savings strategies. This section also includes a brief historical overview of asset-based policies in the U.S. Section III reviews the evidence regarding how assets impact households, as well as market failures which may justify government intervention to subsidize asset building. A typology of policy rationales for asset-based policies is also introduced, based on current proposals. Section IV provides an evaluation of current and proposed policies, identifying gaps in the existing literature. Section V concludes with a series of working theories regarding asset-based policies, and recommendations for a more coherent approach to promoting a wider distribution of financial assets across households. While all aspects of asset holding are discussed, the focus of this paper is on financial savings and investments, rather than real estate, property and business assets. A key concern in this paper is low-income households historically prevented from accumulating assets.

This research is based on a review of economics, sociology, public policy and psychology literature, including academic journals and trade publications. Several phone interviews were also conducted with practitioner experts in the field. Also, this paper includes a brief overview of existing datasets related to U.S. household financial statistics in order to assess the existing distribution and level of assets among household types.

II. Development of Asset Building Policies

Historic Context

In the 1800s, the best examples of public policies that promoted the accumulation of non-financial assets were land grants to soldiers, educational institutions, and through the Homestead Act of 1864 as the Louisiana Territory was settled. After the Civil War, "economic levelers" hoped to give freed slaves assets in the form of "40 acres and a mule." Although that never became a reality, farmland represented the most significant asset for households in the 19th century. However, as people took on factory work and moved to urban areas, asset ownership declined (Sherraden, 1991).

Federal support for the ownership of non-financial assets in early 1900s stemmed primarily from provisions in the tax code. In 1913, the 16th Amendment to the Constitution launched the income tax. At the time all interest payments were deducted from income in calculating tax. This provided an incentive to borrow money to buy assets, as opposed to paying in cash. In the 1920s most homes were financed with a mortgage of 2 to 3 years and a requirement for at least a third of the home's value to be paid as a downpayment. For most families, this proved to be difficult to afford. In the first 100 days of the New Deal, the Home Ownership Loan Corporation was created, followed the next year by the Federal Housing Administration (FHA). FHA mortgage insurance was one of most important factors in expanding long-term credit for homeownership, providing a guarantee for lenders who made home loans, and solidifying the market for mortgages with terms of 30 years. The GI Bill, created to support veterans after World War II, provided families many opportunities to acquire non-financial assets through education, small businesses and housing (Boshara, et al, 2003). U.S. policy continues to strongly promote the accumulation of non-financial assets, such as homeownership and businesses, through tax deductions, federal loan guarantees, direct grants, and funding for local agencies.

In the late 1950s the first provisions were created to stimulate ownership of financial assets (Cramer 2004). These were originally intended to support individuals to save for their retirement, in some cases matched by employers. The 403b savings account was created in 1958, offering tax free contributions to a retirement fund. In 1974, the 401k account was created, and the Individual Retirement Account (IRA) in 1978. These programs will provide $90 billion in tax subsidies for retirement savings in fiscal year 2005 (Budget of the U.S. Government, Fiscal Year 2005). In the mid-1990s, policies were also created to promote saving financial assets to benefit the education of children through Coverdale and 529 college savings accounts. These are specialized versions of IRA accounts which allow funds to be used specifically for education costs. Other recent developments include Archer Medical Savings Accounts (MSAs) available to participants in high deductible health plans, specifically to save for medical insurance deductibles. The Medicare Prescription Drug, Improvement, and Modernization Act of 2003 also added provisions for health savings accounts ("HSAs") which provide tax-favored savings accounts for future medical expenses.

Entitlement programs begun in the 1930s and expanded in the 1960s, however, generally penalized recipients for accumulating assets. Anti-poverty strategies emphasized short-term consumption remedies. Holding or accumulating assets was perceived as a misuse of public resources. As a result, welfare programs created incentives for low-income families to dispose of any savings, and never accumulate any assets. In 1991, Professor Michael Sherraden of the Washington University of St. Louis suggested that income-based welfare programs might better serve lower-income families by focusing on building assets. As part of the welfare reform efforts of the 1990s, several initiatives were created to remove asset prohibitions from programs. Parallel reforms in public and subsidized housing launched the Family Self Sufficiency program, which provides families with financial education as well as savings accounts with matching contributions for each $1 saved. In 2002 the Treasury Department created a small $8 million pilot called "First Accounts" in 15 cities, with the goal of establishing savings accounts for very-low income families.

Based on many successful local programs, a national Individual Development Account (IDA) pilot provided grants to community-based organizations to establish matched savings accounts for low-income people. In some cases savers receive a match of up to $3 for each $1 saved. Individual Development Accounts were first authorized by the Personal Work and Responsibility Act of 1996. In 1998, the Assets for Independence Act established a five-year, $125 million Assets Development Demonstration program administered by the Department of Health and Human Services. Recently published findings from evaluations of this project, based on 14 sites and covering over 2,000 participants, are promising. Results suggest the average low-income household in the program saved $1,500 per year due to the IDA program's incentives compared to a control group (Mills, et al, 2004). Another evaluation tracked how IDA matched savings were used, finding 28 percent of savers spent funds to buy a home, 23 percent started a business and 21 percent used the funds for post-secondary education (Schreiner, et al 2001). While preliminary, supporters of IDA's cite these studies as proof even very low-income families can build assets given support.

In the UK, Child Trust Funds, also called "baby bonds," were passed in 2004 granting every newborn in the nation £250, or twice that amount if the child is born into a family with a poverty level income. The funds are invested tax free and any contributions by family members may be matched by the UK Treasury up to a maximum level. At age 18, the child takes over his or her account, free to use for any purpose. When the program is launched in 2006 it will represent the most extensive financial asset subsidy program in the world. Ireland, Canada, Singapore and Taiwan are piloting similar programs (Cornell, 2003).

Defining Financial Asset Building

Research on savings is quite varied, ranging from studies of saving for specific purposes such as emergency funds, education, homeownership, and retirement, to studies of how households accumulate and invest assets. In 1954, Nobel prize winning economist Franco Modigliani, with Richard Brumberg, suggested the so called life-cycle hypothesis to explain how and why households save. Households generally can anticipate that there is some probability of needing resources in a crisis. Therefore they will plan ahead by holding a few months of consumption in a reserve as "precautionary savings". This will allow for smoothing of the household's consumption over time even when income is reduced or extraordinary expenses occur. Households also know at some point they will no longer be in the workforce due to old age. Planning for retirement, they will save in order to fund future consumption. In theory, given

rational expectations and perfect information, people will maintain enough savings to smooth consumption over their life cycle (Browning and Lusardi, 1996). Failures of households to save, using this model, would be explained by an underestimation of life expectancy, low perceived probabilities of a crisis, or even the expectation that family, friends and government programs will provide income in a crisis (welfare) or in retirement (social security).

Each consumer has different preferences between consuming a dollar's worth of goods and services today, versus consuming that in the future. The mathematical relationship is referred to as a discount rate. Consumers will defer consumption if the rate of return they can receive from their savings is greater than their discount rates. By this definition, total income minus any consumption equals savings. Of course, some goods provide both consumption and savings features. For example, an object of art may provide utility to its owner, as well as increase in value.[1] But most goods and services consumed in the current period represent a reduction in savings (Beverly, et al 2003).

Beverly, Moore, and Schreiner (2001) provide a framework with respect to how low-income households accumulate assets. First, households have to decide to *reallocate* their consumption into savings. For many low-income households, fixed necessities such as food, clothing, housing, utilities and transportation absorb most of their paycheck. People must find ways to reduce the cost of their consumption, or reduce consumption altogether. Second, after moving income into an account, the assets need to be *converted* from liquid forms, such as a checking account, into an illiquid account which makes spending more difficult. The process of determining how to allocate savings into various types of assets is called "investment". Third, the funds need to be *maintained* over time, which means not only refraining from consuming savings in the current period, but investing in ways which provide a positive risk-adjusted return accounting for inflation. As a result the saver should have an asset in the future period which exceeds their value of that consumption in the current period.

Theory suggests low-income individuals will hold greater marginal utility for consumption than high-income individuals because so much of their income is absorbed by relatively fixed living expenses (Beverly, et al 2003). Studies show low-income households have the capacity to save by reducing the amount they spend through more careful shopping habits (Moore et al 2000). There is also evidence individuals who engage in behavior such as drinking, smoking, and low-levels of exercise accumulate lower-levels of financial savings (Lusardi, 2000). This may be consistent with the theory that people who have a low value for their future health also have high discount rates in regards to their preference for consumption in the future.

Other research has approached savings through the perspective of psychology and behavioral economics. Hersh Shefrin and Richard Thaler's (1988) work on the behavioral aspects of savings has highlighted many of the problems with the life cycle hypothesis. Most households do not exhibit savings behaviors predicted by the economic models. Using behavioral techniques, Shefrin and Thaler suggested individuals fail to save because they cannot exert self-control to restrain their current consumption, even if they highly value the future. There are many examples of people creating self-imposed constraints to prevent current consumption from impeding savings. For example, the use of direct deposits from paychecks into savings accounts is a "pre-commitment" to save which makes the individual better off than if they were subject to their own self-control (Maital, 1986). Shefrin and Thaler also noted that individuals use mental accounts to separate their current income, future income and assets. One

[1] Owner-occupied housing is another example, although it can also decrease in value, or require excessive operating costs.

example is a household unwilling to spend current income on certain luxury items, yet an increase in the value of their home is considered a windfall which they use to pay for a luxury vacation. Rationally, there is no difference between sources of the income used for current consumption. Even among high-net worth individuals, aspects of self-control and mental accounts appear to play a strong role in decision making (Kennickell, 1997).

Lowenstein and colleagues (2004) suggest that individuals are of "two minds," the rational actor and the affect-driven impulsive decision maker. The affect-driven side leads to people always preferring to consume today rather than deferring consumption to the future, even when they know they will be better off in the future by saving today. In animal and human studies these behaviors can be shown to lead to almost a complete disregard for the future. Even accounting for other indicators of high discount rates for the future, such as smoking, drinking, lack of exercise and low-levels of education, households still seem to have an irrational predisposition to consuming today (Lusardi, 2000).

Hyperbolic discounting is a way of modeling for the difference in the preferences a household has for over-consumption in the current period versus deferring consumption to the future (Harris et al 2001).[2] In a constant-discount-rate model, people would forecast the fact that their income will decrease as they approach retirement or other life anticipated life changes. Foreseeing this fall in income, households should save and their consumption would be smooth over time. With hyperbolic preferences decisions are not time-consistent. In the current period a consumer may promise himself he will save for the future, and even establish restrictions on his assets to prevent accessing that asset until the future. But inevitably consumers find ways to betray their future selves, by breaking their promises or running up liabilities offsetting their savings. Thus when the future arrives the consumer's preferences would not be fulfilled.

In addition to time preferences, classical economic models do not accurately predict risk preferences. For some people, a desire to achieve larger returns can lead to taking excessive risks (for example Enron employees who held their entire savings in Enron stock). Others are so afraid of a loss that they keep their funds as cash, which means the account loses value accounting for inflation (Loewenstein, 2004).

Measuring Holding

Most researchers divide wealth into net wealth (assets minus debt), financial wealth (cash and securities), real property wealth (land and buildings), and then personal business wealth. Generally assets such as vehicles (so called "wheel wealth") are excluded, since they depreciate over time. However, an automobile, or even business clothes, are assets that can earn a return in the form of employment or income, but are not generally measured. There are primarily three datasets used to track asset holding: the Federal Reserve's Survey of Consumer Finances (SCF), the University of Michigan's Panel Study of Income Dynamics (PSID) and the Census's Survey Income and Program Participation (SIPP). The SCF over-samples very wealthy households in order to reflect the skewed distribution of household assets. The SCF is therefore best at looking at aggregate national wealth, but lacks a large sample of minority or low-income households. It is the most widely used source of data, however. The SIPP surveys households eligible for income-based welfare programs. It is not designed to specifically collect data on assets, but does include a section on savings and consumption. Unlike the SCF, the SIPP has a large number of low-income responders in its sample. The PSID has more questions related to asset holding than

[2] If a and g are positive scalar parameters, hyperbolic discounting events t periods in the future are discounted by the factor (1+at)(-g/a).

the SIPP, and includes a significant number of lower-income households. The PSID is a panel, and therefore best to analyze changes in assets over time. The following cross-sectional tabulations are based on the SCF, using a high level of aggregation.

Figure 1 displays financial assets from the 2001 SCF tabulated for all households, and then households in the two lowest income quintiles. Overall, 93 percent of households have some form of financial assets, with the median value of $28,000. Asset ownership rates are lower for low-income households, and the median value is much lower at only $2,000. However, the most frequently owned financial asset is a checking account. These financial assets may simply represent the float between income and expenses to be paid for from the checking account. Only one in eight low-income households has a retirement account, compared to one-half of all households. Ownership of stocks, historically an investment providing high returns, is one-quarter the level of all households among low-income households. Overall, it is promising low-income households have some assets, but clearly their rate of ownership, and the value of these financial assets, is low relative to all households.

Figure 1

Financial Assets in 2001

Median Asset Amount for Households with Asset Share of Households with Asset						
	Any Financial Asset	Transaction Account	Retirement Account	Life Insurance	Savings Bonds	Stocks
All U.S. Households	$28,000	$4,000	$29,000	$10,000	$1,000	$20,000
	93%	91%	52%	28%	17%	21%
Low Income	$2,000	$900	$4,500	$3,600	$1,000	$7,500
(1st quintile)	75%	71%	13%	14%	4%	4%
Moderate	$8,000	$1,900	$8,000	$6,200	$600	$10,000
(2nd quintile)	93%	89%	33%	25%	11%	11%
Utilization Ratio						
Low to All	.81	.78	.25	.50	.24	.19

Source: Survey of Consumer Finances 2001, Federal Reserve Board

Structuring Supports for Asset Building

Beverly and Sherraden (2001) suggest six elements necessary for a successful savings program targeted to low-income families: accessibility, information, incentives, facilitation, expectations and limits. Services must be accessible. Relying on banks, for example, may not be successful in some communities with few bank branches near where low-income people live. Potential participants need to use the savings program as a means to learn financial literacy information and to internalize why savings is important. The IDA and other programs have shown incentives are important to recruit and retain participants. Facilitation refers to pre-commitment constraints such as direct deposit programs. Expectations are created by participants, peers and family members in order to enforce discipline on lapses in self-control which might lead to consuming rather than saving. Finally, limits refer to restrictions on how and when savings can be spent. Boshara (2003) emphasizes people do not decide to save. Instead,

they are presented with a formal structure and decide to participate in that structure. That structure leads them to start saving.

III. Current Context and Policy Problem

Benefits of Asset Holding

There are a number impacts of asset holding discussed in the literature. These can generally be grouped into six categories of potential benefits, although not all are supported by existing research.

First, assets serve as a reserve fund to get through unexpected life crises. Job losses, income reductions, illness, disability and divorce are all unpredictable events which can strike any household. Holding assets serves like an insurance in case these events happen. Households with assets are more likely to be able to manage these events without major hardships, such as bankruptcy or a significant reduction in standard of living (Bi, 2003). There is a paucity of research on the impact of precautionary savings among low-income families, however.

The second impact of assets is it provides a platform for borrowing money, such as a mortgage for a home or a small business loan. Even a small amount of savings can leverage a large loan which can provide considerable value to a household. This provides a foundation for risk-taking (Hogarth, 2003).

Third, assets can be used to fund investments in human capital, such as a college education or job training. Assets also provide opportunities for the education of children, as well as a general orientation to the future (Sherraden, 2000). There is some positive evidence from studies of non-financial assets (Aaronson, 2000) but few controlled studies on asset building and human capital.

Fourth, assets can support households in retirement. Having savings provides people the ability to reduce their work levels as they become elderly, but still live independently. It also provides an estate to pass on to heirs, an intergenerational transfer of assets to offspring (Boshara, 2003).

Fifth, asset holding provides households with a stake in society. People with assets may feel higher levels of self-efficacy, engage more eagerly in the political process, and exert greater influence in social networks in part because they want to protect their assets (Boshara, 2003, DiPasquale, 1999). There are no studies confirming this stakeholder effect due to ownership of financial assets.

Finally, likely as a combination of all of these factors, asset holding is associated with impacts on the health of households and children, as well as divorce and household stability (Sherraden, 2000). There are not many studies on this area, beyond non-financial assets such as homeownership. One study suggests divorce is less likely as there is a disincentive to separate if a couple has shared assets, although subsequent studies suggest alternative interpretations (Joshi, 1991; Schreiner, 2001). Even though more controlled research specific to low-income families and financial assets is clearly needed, its does seem even if only some of these impacts hold true, asset ownership is a valid objective for low-income families.

Rationale for Government Intervention

While many of the benefits described above are private in nature, some are associated with benefits for society as a whole. For example, there are externalities associated with educated children, entrepreneurship, homeownership, political participation, household stability and independence. Economic theory suggests these external benefits will not be realized by private households, and as such these households will save less than is socially optimal from society's

perspective. Therefore some subsidies are needed to boost savings. Examples of broad asset subsidies include 401k tax benefits and guarantees by the Federal Deposit Insurance Corporation (FDIC) for bank accounts.

Another rationale for intervention is related to market failure. The first form of this failure is due to information deficiencies. Economic theory assumes households have perfect information to form expectations, discount rates and make choices. In reality many households lack an understanding of basic financial literacy. One report by the Securities and Exchange Commission (1999) suggests "there is a financial literacy crisis in America." Financial planning is a complex and time consuming task. It is also a learned task, one most frequently handed down by parents with assets to their children. Few high schools teach even simple skills like managing a check book, let alone how to save and invest. Bi-annual surveys by the Jump$tart Coalition show high school seniors can correctly answer only half of questions on basic financial literacy (Mandell, 2004). Lusardi found 65 percent of people less than fifteen years from retirement age both saved too little and underestimated how much more they needed to save before they retire. More than half of households lack emergency savings equivalent to two months living expenses (Chang, 1997). The second market failure is even households with information behave irrationally. The life cycle model of consumption smoothing is shown to not be predictive of actual savings behavior (Lusardi 2003). Individuals need a structure to help them manage their savings choices and overcome issues of mental accounts, hyperbolic discounting and related behaviors.

The last rationale for intervention on behalf of supporting financial savings is on equity grounds. Minorities have long been discriminated against in access to banks, loans, homeownership, business ownership and other avenues of asset accumulation. Minorities and low-income households disproportionately lack bank accounts as well as social networks which facilitate access to assets. They also tend to work in fields which lack 401k plans or other retirement accounts (Hogarth, 2003). This historic bias has contributed to lower levels of financial literacy and reduced levels of savings. For example, the innovation of FHA mortgage insurance helped millions of white families accumulate assets through homeownership. But, seeking to limit its losses, the government shied away from offering FHA-backed loans in neighborhoods in decline, fearing that decreasing property values would result in abandoned homes and loan defaults. One factor used to determine if a neighborhood could be considered stable was its share of minority residents. Minority households and neighborhoods were therefore often denied loans. Low-income households are also among the least able to save, since all of their income is required to meet current consumption. But these households are also among the most likely to experience crisis events such as a disability or job loss. Given the extreme differentials in asset ownership, it could be argued a base level of assets is important for low-income households to be able to manage crisis events (Bi, 2003). Invoking the idea of equity proposed by Rawls, this rationale suggests all individuals in society should have a basic endowment at birth. While some will receive more than their base level due to inheritance, skill or luck, this approach will insure no individual is left with nothing (Ackerson, 2001).

Current Context

In 2004 the Bush Administration proposed partially "privatizing" Social Security accounts. Under this plan, workers would have the option to retain a portion of the payroll tax and invest it until their retirement in a special savings account. Each individual could select from a limited menu of investment options provided by private firms specified by the federal government.

While this proposal is quite controversial, it has begun to elevate the dialogue regarding savings rates and assets in the mainstream media.

There are primarily two types of strategies proposed for encouraging financial assets among low-income households. The first is an extension of IDA matched savings accounts to more households. This includes the broader use of IDAs beyond the demonstration program, and more federally-subsidized matching funds. The barrier to expanding IDAs are the relatively high costs of establishing matching programs and ongoing monitoring of accounts. A similar program in the UK in the late 1990s for education savings fell prey to fraud as people opened multiple accounts to exploit matching funds (Boshara, 2003). However, in terms of promoting financial literacy and savings for existing low-income families, IDAs are an emerging approach with strong potential.

The second approach is to create savings accounts from birth for all newborns, modeled on the UK Child Trust Fund. One proposal by the New America Foundation is to create American Savings Accounts (ASAs) for every child (with a social security number) in the year they are born. The child's parent would receive a voucher for $2,000 to seed a fund at the financial institution of their choice. Contributions to the fund would be tax free, and additional deposits from the federal government would occur at the entrance to kindergarten, completion of grade school and then high school graduation. The hope is each child will have $50,000 by the time they reach age 18, and the funds will be used to fund job training or secondary education, as well as homeownership or starting a small business. The seed funds provided by the federal government would be repaid through an added payroll tax starting at age 30 (Boshara, 2003).

In 2004 the Bush Administration proposed a number of new policies intended to create incentives for savings through the tax code. One component of this proposal is the Lifetime Savings Account (LSA). Individuals may contribute up to $5,000 annually to an LSA, regardless of age or income. Although contributions are not tax deductible, the source of the funds is not restricted, so families can contribute to accounts for minors, for example. Savings accumulate on a tax-free basis and are eligible for any use. This plan was proposed in a modified form for fiscal year 2005, as well.

Because most federal support for asset building is delivered through the tax code, low-income families do not benefit. Most low-income tax filings do not include itemized tax deductions (Joint Tax Committee, 2004). Because low-income families pay a lower marginal tax rate, the per dollar value of tax reduction due to deductions or exemptions is less than for higher-income taxpayers. It is estimated 90 percent of tax benefits for savings, retirement and homeownership flow to households with incomes of more than $50,000 (Boschera, 2003). Therefore grants or tax credits are required to directly target incentives to low-income families. The Bush Administration proposed nonrefundable tax credits for retirement savings contributions of up to $2,000 per year, depending on the adjusted gross income of the taxpayer (generally capped at $25,000 for single taxpayers). This is a limited program, but illustrates how the tax code could be used subsidize even low-income families. Because the credit is nonrefundable, however, taxpayers with a total tax bill less than their credit, or who receive the Earned Income Tax Credit, cannot use this credit. Converting the credit to a refundable credit, like the EITC, offers one solution for this problem.

Perspectives in the Current Environment

There appear to be four constituencies promoting government programs to support financial asset building. First there is a group of progressive advocates building on the issues of

welfare reform, including the ongoing work of Michael Sherraden. This perspective posits that poverty cannot be solved through consumption. They view income-based welfare with a Marxist's perspective, whereby income subsidies simply maintain the existing inequitable social structure. By encouraging savings among the poor from a very young age people will be more likely to build up human capital, take risks and effectively manage crises. This group seeks an expansion of IDAs and First Accounts for low-income families, as well as the creation of new Universal Savings Accounts, as proposed by the Clinton Administration in 2000.

The second constituency promoting financial asset subsidies are advocates for reforms in retirement savings programs. The oncoming financial problems of the Social Security fund as the Baby Boom generation retires continue to provoke new strategies to stimulate private savings. This is a different group than the constituency focused on low-income savers. Because the use of retirement plans is concentrated among middle and upper income households, the treatment of Social Security is important for low-income families for whom this is potentially their only income in retirement. The role of Social Security remains contentious. Some advocates believe Social Security is a common pool of assets all workers are entitled to at retirement, while others view it as actually crowding out private savings (Gale, 2003).

The third grouping of advocates for savings is focused on education, specifically post secondary and college education. This perspective enjoys broad political support, in part due to the widespread belief that parents should plan for the development of human capital of their children. By providing tax-free savings programs, such as the 529 accounts available in most states, parents can begin saving for college soon after their child is born. But voluntary contributions likely need more structure and incentives to reach lower-income participants.

The final constituency is made of community organizations and businesses associated with the credit and financial industry. This perspective supports the provision of financial literacy generally, with an emphasis on households learning to manage their budget, meet their debt obligations and establish savings to make payments even in the case of an income loss. Working through networks such as cooperative extensions and business associations, broad-based public awareness campaigns attempt to spread the message that more people need to learn about savings and money management. America Saves and Jump$tart are two leading examples. This constituency tends to support resources for providing financial education and counseling, as well as support for low-income families to establish bank accounts.

IV. Evaluation of Alternatives

Asset-building policies currently in effect in the U.S. have been effective. Efforts to promote homeownership, for example, have helped millions of families to buy their first home in the last decade. Policies to promote financial assets have been successful for the middle class, especially for retirement accounts. But even retirement policies continue to be hampered by problems of underutilization. IDAs represent one of the only programs targeted to low-income households, but they remain small in scale and expensive to administer. If promoting financial assets is a goal of public policy in the U.S., how can policies be improved upon in the future? The following are critical issues policymakers need to consider:

Consumer Knowledge

While there are stories of low-wage workers living on a bare bones budget and making millions in the stock market, these anecdotes are far from the norm. In fact, households at all levels of socio-economic status can be challenged by managing financial assets. In one study of

401k behavior, savers tended to make the wrong choice at the wrong time (Gale, 2003). Understanding risks is a complex task and most consumers do not have time to learn how to manage assets. Policies to promote savings must be highly structured with narrow options. Offerings may differ for various risk preferences, but this can be achieved with a few controlled choices within specific time frames. Relying on private sector financial institutions to provide clear information to consumers is start, but consumers need to know how to process that information. Recent surveys of high school students taking specific financial literacy classes, unfortunately, show low levels of knowledge and little success in teaching knowledge even in targeted programs (Mandell, 2004). More research is needed to understand how consumers gain financial knowledge, how and when they add to that knowledge, and how education is best delivered.

Paternalism

Because consumers lack knowledge in some cases, or may be prone to affect-driven irrational decisions with no regard for the future in other cases, there are often restrictions on how subsidized assets can be spent. For example, in the IDA program, uses are restricted to education, housing and small businesses. This is a paternalistic approach, limiting individuals from spending their assets for the uses they most value. In the UK's Child Trust Fund, individuals will be free to use their assets for any purpose at age 18, although it is hoped assets will be spent on education. Given what is being learned through behavioral economics, restrictions may in fact be welfare increasing, despite paternalist overtones. However, one of the values of precautionary savings is having a cash reserve for emergencies, job losses and unexpected expenses. Restricted assets are unlikely to have as many positive impacts for families as unrestricted assets if they cannot be used for these events. Policy design may need to include a blend of restricted and unrestricted accounts, in order to protect savers from their desire to consume, but also provide funds for extraordinary purposes. More research is needed to distill how households can overcome affect-driven spending, holding precautionary savings for the optimal uses.

Causality

It remains unclear if holding financial assets creates all of the benefits suggested by advocates, or if it is the process of accumulating assets that alters knowledge and behavior, and therefore creates positive effects on families. For example, while it is true having resources will help pay the bills and maintain household stability in a crisis, the skills learned in managing household finances in order to save that financial asset may be just as valuable. There is extensive research on non-financial assets such as homeownership, but less conclusive evidence of the impact of financial asset holding. Programs which provide matched savings or endowment grants, such as IDAs, may in fact remove the mechanism which allows individuals to acquire the skills and knowledge they need to manage their finances. Pairing these programs with financial literacy training, assuming effective delivery systems are developed, may be critical.

Managing Liabilities

Another important issue is that any household able to save financial assets can also borrow. The critical concept is the accumulation of <u>net</u> financial and non-financial assets. A low-income family with $5,000 in savings but $12,000 in credit card debt may quickly have

financial problems if there is a disruption in income. Increasingly households are able to convert illiquid assets, such as home equity, into credit which can be consumed in the present period (Bi 2003). While this may be a good choice for someone with no precautionary savings, households could rely on home equity to fund current consumption, liquidating their non-financial assets and running up large liabilities. In 2003, record numbers of foreclosures and bankruptcy filings suggest households may be overextended (The Administrative Office of the U.S. Courts, PACER data).

Given the development of risk-based pricing techniques in the lending industry, it is important for households to establish and maintain a good credit history. Borrowers with a record marked by missed payments will pay more for their loans, which may limit their ability to engage in non-financial asset building, such as homeownership or starting a small business. More research is needed to understand if efforts to boost savings results in even larger levels of borrowing. Savings and other asset building strategies may require complementary programs to help families manage access to credit as their assets levels rise.

V. Working Theory and Recommendations

A Comprehensive View of Financial Assets

Currently asset policies in the U.S. are narrowly focused on either low-return savings accounts or highly-leveraged investments such as a home or small business. Financial planners typically suggest clients pursue a balanced approach to their portfolio, with a mixture of savings and high-risk investments (Hensel, 1991). Included in this mix, as shown in Figure 2, are insurance products. None of the asset programs reviewed for this project includes insurance. Yet insurance can play much the same role as an emergency savings account, providing funds to cover expenses when an unexpected life event or crisis occurs. In fact, holding insurance can help preserve assets for households by keeping precautionary savings reserved for only those unexpected expenses not covered. Savings programs should promote the purchase of affordable insurance contracts as part of their design.

Figure 2

Categories of Assets

Cash / Savings Accounts
- Tax advantaged savings
  o Employer: IRA, 401k
  o College savings: 529
  o Medical savings
- Taxable savings
  o passbook accounts
  o CDs
  o payroll deductions
- Matched savings
  o IDAs
	Insurance
	- Whole Life Insurance
	- Annuities
	- Term Life Insurance
	- Disability Insurance
	- Health Insurance
	- Long Term Care Insurance

Fixed Income – Bonds & Annuities - Inflation protection (TIPS) - Treasuries - Annuity – insurance blends	**Equities** - Mutual funds – index, industry - Individual stocks **Leveraged Equities** - Owner occupied homes - Rental / investment property - Small business investment

Policies Need to Balance Risks by Focusing on Fundamentals

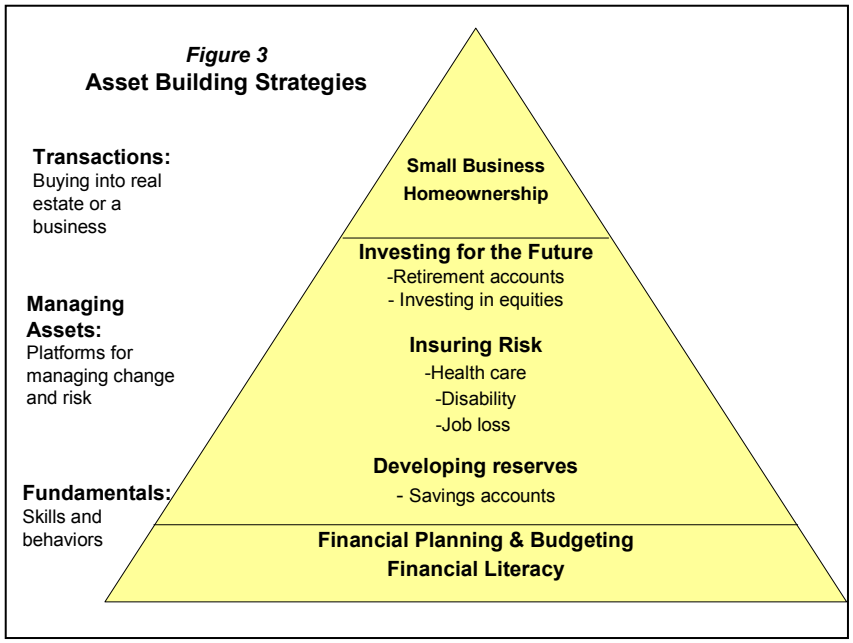

Figure 3 provides an illustrative framework for considering policies to promote assets. The base of the model contains knowledge and financial literacy. Building on that knowledge, consumers learn skills such as budgeting and how to manage their consumption. These are the fundamental components of a consumer's ability to accumulate and maintain assets which under gird all savings and investment. After acquiring knowledge and skills, households are ready to begin savings, initially as a reserve for emergencies. After establishing a precautionary "rainy day fund," households can begin to take out the appropriate level of insurance policies to protect them from random events which reduce income or incur high expenses. After these building blocks are in place, consumers can begin to save for retirement, allocating their portfolio as is appropriate for their risk tolerance and time horizon. At the peak of the pyramid are the most risky activities, borrowing to purchase a home or start a business. Often consumers in the U.S. seem to approach this model upside down. Hearing peers, the media and industry promote homeownership, or taking advantage of government support for small businesses, some consumers start by taking on highly leveraged assets with no investments, insurance, savings or financial literacy skills. Most quickly work to develop skills in these areas, but some will struggle. When income losses occur, these families are among the first to default on loans or declare bankruptcy.

Lack of Understanding of Behavior

How consumers engage in decisions of saving and financial planning continues to be unclear. Economic models are limited in their ability to predict consumer behavior, suggesting a combination of market failure, imperfect information and irrational decision making. A better understanding is needed to better craft policies promoting savings and asset building. It is clear that structures are necessary to facilitate savings, and some restrictions are needed to prevent individuals from behaving contrarily to their future self interest. Layering in how consumers manage their assets and incur liabilities complicates the dimensions required to regulate behavior. Incentives for one type of asset may be offset by borrowing against another. Even seemingly simple solutions such as providing financial literacy education are problematic. While programs providing financial education seek to increase knowledge and change behavior, the results of these programs are mixed. A broader understanding of how consumers learn and make decisions is needed, and precious "teachable moments" need to be identified.

VI. Conclusion

Public policies which increase the probability and magnitude of the ownership of financial assets are rooted in socially desirable outcomes, such as household stability, promoting the development of human capital, risk-taking and stake-holding. Policies in the U.S. traditionally have promoted the accumulation of higher-risk non-financial assets such as homes and small businesses. There is momentum building to support financial asset strategies such as savings accounts, but efforts are only beginning. Consumer decision-making remains challenging to model, suggesting the predicted outcomes of incentive programs may not come to fruition if more research is not conducted using behavioral analysis. Policy makers need to recognize the need for this research, as well as invest in ways to expand consumer education. Finally, a broader conception of financial assets is required, including insurance and managing debt and credit. Low-income families can in fact build financial assets, and will benefit given a balanced portfolio approach to savings.

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