

Universal Savings for American Workers





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Center for Economic Progress

The Center for Economic Progress is a nonprofit organization dedicated to helping hard-working, low-income families move from financial uncertainty to financial security.

We are local in service. Founded in 1990, the Center provides free tax and financial services to improve the bottom line of Illinois' families. Thanks to more than 1,000 volunteers, we operate one of the largest and most established free tax preparation programs in Chicago and Illinois. We have served more than 200,000 families, returning \$300 million plus in refunds. We also provide year-round financial counseling and tools that support and empower the residents of our communities.

We are national in voice. Leading a coalition of like-minded organizations from across the country, we find the solutions that work for working families. What we learn on the ground, we translate into best practices in the field and into workable policies at the federal and state levels.

The Center for Economic Progress is the parent organization of the National Community Tax Coalition.

Visit us at: www.economicprogress.org

National Community Tax Coalition

The National Community Tax Coalition (NCTC) represents the 4,500 free tax preparation sites known as Volunteer Income Tax Assistance or VITA programs (VITA). Our vast and vibrant network of organizations from all sectors of society provides critical, on-the-ground financial services for working families. NCTC affiliates work to create a more accessible and equitable tax system for American workers.

We actively seek to broaden the reach and impact of community tax preparers and are a leading voice in Washington, DC for low-wage workers and against unfair financial practices. We believe that together, we can strengthen economies, build communities and improve life for all American families.

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Executive Summary


Savings is as important as consumption when it comes to the future economic health and vitality of the U.S. economy. Supporting savings should become a more explicit focus of federal policy for all workers and their families, not just those with sufficient income to set aside for retirement. Savings plays a critical role in ensuring financial stability for working families and keeping the U.S. economy moving forward. Savings acts as a reserve, a resource for parents and their children, when emergencies arise or opportunities present themselves. For example, when a car breaks down and getting to work is not an option, when a child is ill and the deductible must be paid prior to medical treatment or when advancing in the workplace means enrolling at a local community college.

In these cases, most Americans dip into savings to pay the \$500 or \$1,000 it takes to keep or get a good job, or to ensure their family's security, and to avoid taking out high-cost debt to make ends meet. But what if you have little or no savings, which is true for most low-income working families? What do you do when you need \$500 or \$1,000 to deal with an emergency or take advantage of an opportunity and your take-home pay only covers basic expenses? Your options are limited: you can rely on family or friends for help or a loan, or you can take out a loan that requires the payment of high interest rates and fees. In some situations, the federal government offers assistance through a patchwork of social services and tax credits, i.e., social insurance. If it is the right time of year, getting a tax refund may also be an option.

However, in most situations, going (deeper) into debt is the only option, as workers are forced to take out a high-cost loan or cover an emergency with their high-interest credit card(s). What is clearly needed is a new approach, a well-designed system of "personal insurance" that helps working families meet both obligations and opportunities that occur unexpectedly.

Unfortunately, federal savings policy is currently "upside down" (a term coined by Office of Management and Budget Director Peter Orszag) in that most incentives are targeted at higher-income households who actually require the least incentive to save, given their high earnings and extensive assets. Moreover, most low-income working families need the tools and supports to save for today, not tomorrow, but federal policy conversations are presently centered more around savings for retirement than savings for present-day financial security and near-term economic opportunity.

That being said, President Obama has laid the foundation for a more comprehensive federal savings policy by proposing this past February 24, 2009 before a Joint Session of Congress to "create tax-free universal savings accounts for all Americans." And, the President also announced recently that the option to purchase U.S. Savings Bonds will be added to the federal tax return beginning in 2010. These actions represent a significant first step for the country and underscore the importance of connecting the tax code and tax incentives to savings opportunities for Americans of all economic means, not just the wealthy.



The Center for Economic Progress (CEP), which leads the National Community Tax Coalition (NCTC), proposes that the Administration and Congress take the President's initial savings policy proposals one step further, and invest in programs that increase short-term and long-term savings, while promoting savings for low- and moderate-income families in particular. NCTC's Universal Savings for Economic Security (USES) plan builds on the President's plan by

1. opening avenues to save through Universal Direct Deposit and Prepaid Debit Cards;
2. providing incentives to save through more non-retirement savings options and targeted savings matches, and
3. creating opportunities to save during Tax Time and all year-round.

As the U.S. slowly emerges from a deep recession, we might ask is now really a time to talk about savings? The answer is "yes," despite the 'paradox of thrift' counterargument, which posits that if and when consumers save during economic slowdowns, it burdens businesses and hinders growth. While consumption certainly spurs economic expansion, over time, savings can sustain it. While the national personal savings has increased into the low single digits in recent months, this spike may only be a temporary blip in the nation's steady decline in personal savings rates without a more explicit policy to support Americans' savings habits.

As President Obama proclaimed in his September 5, 2009 weekly address to the nation, "We have to revive this economy and rebuild it stronger than before. And making sure that folks have the opportunity and incentive to save—for a home or college, for retirement or a rainy day—is essential to that effort." As the economy rebounds, we believe that the time to build a new financial architecture that undergirds the stresses and strains facing America's working families is now. The USES plan we propose is designed to help American workers both access future economic opportunities and weather day-to-day income shocks, which will ultimately lead to greater financial stability for all families and greater economic prosperity for the country as a whole.

Introduction

Saving money is difficult, particularly for Americans who earn low or modest wages and who do not have much left over after they buy groceries, fill up the tank with gas, pay the rent or mortgage, and purchase other necessities. As a result, it is no surprise that most low- and moderate-income (LMI) families lack adequate savings, not just for investments, like a down payment on a home or a class at the local community college, but even for emergencies. The lack of a savings cushion to draw on causes many households to rely on costly sources of debt, leaves them more vulnerable when crises hit, and limits their job security and upward mobility.

Defining Low- and Moderate-Income

Government agencies and nonprofits often use the term **low- and moderate-income (LMI)** to describe individuals and families with limited financial resources. We will loosely define low-income households as those with incomes of less than \$21,204 and moderate-income households as those with incomes between \$21,204 and \$40,253.

The income ranges correspond to the bottom two income quintiles of the U.S. Census Bureau's *2007 American Community Survey*. This means that 80% of U.S. households have higher income than low-income households and 60% of households have higher income than moderate-income households. Survey data cited throughout the report may not match our definition exactly, in which case, any discrepancies will be noted.

In recent years, the affiliates of the National Community Tax Coalition (NCTC) have participated in a number of community-based savings initiatives that have taken advantage of tax time to encourage low-income individuals and families to begin saving. For example, the D2D Fund partnered with free tax preparation programs to lead a three-year pilot program that enabled taxpayers to purchase U.S. Savings Bonds at tax sites. Designed and implemented by community-based practitioners who work directly with low-wage workers, these initiatives often adopt strategies that are consistent with the findings of behavioral economics. Savings initiatives are embedded within the free tax preparation services offered by the organizations, made possible through the assistance of thousands of volunteers, and funded by foundations as well as private donations. Free tax preparation programs have been remarkably effective in finding new and innovative ways to leverage tax time to promote savings, but limited financial resources and ineffective public policies prevent programs from expanding beyond their target communities and delivering large-scale results.

A primary objective of these community-based savings initiatives is to overcome the misconception—held by many policymakers and financial institutions—that LMI workers cannot save. This misconception is fueled in part by an incentive structure for saving and investing that is heavily skewed toward middle- and upper-income workers.

Peter Orszag, the Director of the Office of Management and Budget (OMB), has characterized the current structure of retirement savings incentives as, “upside down”—one that “gives the strongest incentives to participate to higher-income households who least need to save more to achieve an adequate retirement living standard and who are the most likely to use pensions as a tax shelter, rather than as a vehicle to raise savings.”¹ Under this system, “the subsidies are worth the least to households who most need to save more for retirement and who, if they do contribute, are most likely to use the accounts to raise net saving.”

This paper makes the case for a comprehensive and inclusive approach to promoting savings, what we call a Universal Savings for Economic Security (USES) plan. Building on President Obama’s retirement savings proposals, USES would apply findings from behavioral economics to increase savings rates among LMI workers, with an emphasis on “security savings.” Like President Obama’s Automatic IRA proposal, USES would aim to increase savings at work through the use of a default mechanism—automatic direct deposit of paychecks, with a specified percentage going into a default savings “bucket”—and offer a savings incentive by providing a match that is available to all LMI workers.

Defining “Security Savings”

Security Savings are easily accessible funds set aside for emergencies such as a car repair, medical bill, or a broken appliance. Funds should be easy to access, but not so easy that they are spent for non-emergency needs. While financial advisors recommend that families have at least six months of living expenses in savings, accumulating this amount of savings is a challenge for middle-income families and may be an unrealistic goal for low-wage workers.

The Consumer Federation of America (CFA) found that low- and moderate-income families (the bottom 40% of families by income) report annual emergency expenditures of \$2,000.² CFA also found that less than three-tenths of low-income families and less than one-half of moderate-income families have emergency savings of \$500. A number of factors determine one’s capacity to save, but based on CFA’s findings, a realistic security savings goal may range from \$500 to \$2,000 for low- and moderate-income families.

1. Peter R. Orszag, *Progressivity and Saving: Fixing the Nation’s Upside-Down Incentives for Savings*, Testimony before the House Committee on Education and the Workforce, February 25, 2004, http://www.retirementsecurityproject.org/pubs/File/Testimony_Progressivity_and_Savings.pdf.

2. Stephen Brobeck, *The Essential Role Of Banks And Credit Unions In Facilitating Lower-Income Household Saving For Emergencies*, Consumer Federation of America, June 2008.

USES would expand on the Obama approach in complementary ways. In particular, it would seek to boost a broader range of savings, particularly modest levels of savings for unforeseen expenses as well as unanticipated opportunities. And, because low-wage workers' immediate needs often leave little room for cutting back on the income they receive from work, USES would provide support for tax time savings, when over 76 million LMI workers receive lump-sum tax refund payments, a portion of which can easily be directed toward savings.³

New refundable tax credits adopted by Congress in the American Recovery and Reinvestment Act (ARRA) of 2009 and expansions of existing refundable credits will make this avenue for savings even more important in coming years.

Our plan—what we call Universal Savings for Economic Security (USES)—is relatively simple and has five main components:

1. Universal Direct Deposit: All employees would have access to direct deposit and the ability to split paychecks between checking and savings accounts. Direct deposit is less costly to employers than issuing paper checks, but to offset transaction costs for small employers (fewer than 10 employees) who do not currently offer direct deposit, a one-time tax credit would be provided.

2. Prepaid Debit Cards: An estimated 18.5 million households are unbanked (i.e., currently do not have a bank account) and an additional 21.6 million households are underbanked (i.e., rely on check cashers and other alternative financial services providers).⁴ USES would enable unbanked and underbanked workers to direct deposit paychecks and federal tax refunds onto prepaid debit cards.

3. A More Robust Automatic IRA: USES would build on President Obama's proposed Automatic Individual Retirement Account (IRA) to facilitate security savings, making non-retirement savings options available to LMI workers, and applying IRA features—for example, automatic enrollment and default investment options—to existing employer-sponsored retirement plans such as 401(k)s.

4. An Accessible Saver's Credit: President Obama's proposed Saver's Credit expansion would provide a refundable 50% matching tax credit (up to \$500 a year) for the first \$1,000 of savings in a retirement account. USES would offer a *dollar-for-dollar match* (up to \$500) on contributions to retirement as well as some non-retirement *savings accounts*.

5. Tax Time Innovations Fund: Free tax preparation programs throughout the country continue to design small-scale savings pilots to increase savings at tax time. A federal innovations fund would enable programs to deliver scalable results, while leveraging tax time to maximize the full potential of savings incentives.

3. Adjusted gross incomes less than \$50,000. For information on tax refunds see columns 80 and 81 of, Internal Revenue Service, Statistics of Income, *Tax Stats – Individual Income: Tax Returns Table 3.3 All Returns: Tax Liability, Tax Credits, and Tax Payments, by Size of Adjusted Gross Income, Tax Year 2007*, <http://www.irs.gov/pub/irs-soi/07in33ar.xls>.

4. Sarah Gordon, *Beyond Microfinance: Consumer Products*, Presented at Microfinance California 2009, Center for Financial Services Innovation, May 2009, http://www.microfinancecalifornia.org/presentations/pdfs/beyond-microfinance/Beyond_MF_Overview.pdf.

Policy Recommendations

BOOSTING SECURITY SAVINGS FOR LOW-INCOME WORKERS

Policies to encourage and subsidize savings and investment should be both *comprehensive* and *inclusive*. A comprehensive savings policy would provide a set of incentives and subsidies that support and reward a *full range of socially desirable savings activity*, including savings for short- and mid-term financial security as well as opportunities to get ahead in the labor market. An inclusive savings policy would also provide a progressive set of incentives and subsidies that supports and rewards socially desirable savings activity by working families *across the full range of the income distribution*. Unfortunately, the current set of federal incentives and subsidies for savings and investment is neither comprehensive nor inclusive and particularly favors the affluent.

Effective federal savings policies for LMI individuals and families will also need to draw on the lessons of behavioral economics and the innovative community-based savings initiatives discussed in this paper. In particular, saving needs to be easy to do, and, to the extent possible, made into a default or near-default option by making enrollment in savings plans automatic.

To date, most of the literature and policy proposals related to the savings behavior of LMI families have focused on longer-term types of “asset-building.” Moreover, “asset-based” policy is often sharply distinguished from “income-based” policy, most commonly on the basis that the former is long-term and the latter short-term. For example, the central policy concept developed by the asset-building movement in the United States has been Individual Development Accounts (IDAs), in which savings are accumulated for future investments in education, homeownership, and small business development. The one area in which income- and asset-based policies are seen as intertwined is retirement policy, although the focus there is still on long-term savings. In addition to IDAs, there are a variety of other federal asset-building policies that create restricted accounts for specific purposes, such as higher education or health care expenses.

One limitation of these asset-building policy proposals is that they generally do not meet the stated preference of LMI persons, to save for emergency reasons. In addition, the focus on ambitious but difficult-to-reach long-term savings goals may actually be de-motivating relative to programs that focus on attainable shorter-term goals. Finally, further attention needs to be paid to the potentially complicated “choice architecture” that these proposed policies could create if adopted. In essence, if public policy offers too many different options for long-term savings, people may have more choices but may actually save less as they become overwhelmed with the details of making a decision.

Our Proposal: Universal Savings for Economic Security

An alternative focus for federal savings policy would prioritize precautionary savings and view savings and consumption as connected rather than separate spheres. For some workers, particularly LMI ones as well as people in their 20s and early 30s, making savings for retirement the default over other valuable forms of savings may “put the cart before the horse.”

Many Americans have more pressing savings needs than retirement, needs that are related to economic security and opportunity during their working years and arise far before they retire.

For them, an optimal financial strategy—one that maximizes their income and well-being over their *entire lives*—would prioritize savings for emergencies, which could otherwise disrupt job security and career advancement, and for various assets, including computers and dependable personal transportation, that could increase their economic mobility in both the long and short term. Similarly, parents may want to prioritize savings for these same purposes as well as for investments that enhance their children’s development and life chances. Of course, it is never too early to start saving for retirement, but retirement savings is currently the one form of savings that is already mandatory for all workers (in the form of Social Security).

1. UNIVERSAL DIRECT DEPOSIT

Savings Goal: All workers have access to direct deposit and the ability to split paychecks between multiple checking and savings accounts.

Policy Proposal:

1. Require businesses to offer all employees direct deposit.
2. Create a federal law allowing employers to require all of their employees to use direct deposit.
3. Ensure that direct deposit allows employees to split paychecks between multiple accounts.
4. Create a one-time tax credit to offset the cost of establishing direct deposit for small businesses that are not required to offer an Automatic IRA (businesses that have fewer than 10 employees or are less than two years old).

Direct deposit reduces the cost of making payments for employers and the cost of receiving them for employees. Workers have immediate access to their paychecks without having to go to a bank (or use a check-cashing service), or wait for the bank to make the funds available. Another, less obvious, benefit of direct deposit is that it can facilitate savings by enabling employees to make regular, automatic contributions to savings accounts. There is some evidence that employees with employers who allow them to direct deposit to more than two accounts are more likely to save than those without such access. Direct deposit is an implicit component of President Obama’s Automatic IRA proposal: “For most employees, the payroll deductions would be made by direct deposit similar to the direct deposit of employees’ paychecks to their accounts at financial institutions.”⁵

5. Department of Treasury, *General Explanations of the Administration’s Fiscal Year 2010 Revenue Proposal*, 7-9, <http://www.treas.gov/offices/tax-policy/library/grnbk09.pdf>.

There is little question that low-wage workers have less access to direct deposit than other workers. For one, most employers who do not offer direct deposit are small businesses, which are more likely to employ low-wage workers than larger ones. A 2008 survey of 2,000 adult Americans by the Consumer Federation of America found the following:

- one-half of *low-income* workers direct deposit paychecks—compared to two-thirds of *all* workers.
- 85% of all workers have access to direct deposit.
- 77% of workers with incomes below \$25,000 have access to direct deposit.
- Nearly two-thirds of low-income employees with access to direct deposit use the benefit.⁶

President Obama’s Automatic IRA would require businesses to adopt direct deposit to facilitate employee contributions to retirement savings accounts. With direct deposit capabilities established, it should be relatively easy for employers to offer the same benefit for checking and savings accounts.

FACT:

Switching from paper checks to direct deposit is estimated to save businesses between \$0.80 and \$1.80 per check.⁷

Payroll cost savings for employers may be limited if a number of employees choose not to use direct deposit. The federal government could help businesses eliminate the need to issue paper checks and cut costs by giving them the freedom to make direct deposit mandatory for all employees. Employees without access to a bank account would automatically receive a payroll (or prepaid) card.

In some respects, many private employers are already ahead of the federal government. Wal-Mart, the nation’s largest private employer, recently announced that it is eliminating paper checks in favor of direct deposit and prepaid debit cards (for workers without bank accounts). As employers continue to switch to direct deposit on their own, it will become more important for the federal government to monitor the fees and costs associated with prepaid debit cards issued by employers. Mandating that employers offer direct deposit will enable the federal government to stay ahead of the curve by establishing standards for businesses to follow.

Small businesses, those with fewer than 10 employees, and businesses less than two years old would not be required to offer an Automatic IRA under the President’s proposal. Presumably, many of these employers do not currently use direct deposit. Federal policy can bring small and new businesses one step closer to offering the Automatic IRA by providing a small one-time tax credit to offset the cost of establishing direct deposit. With direct deposit in place, many businesses may voluntarily establish Automatic IRAs.

6. Stephen Brobeck, *Access to and Use of Direct Paycheck Deposit: Findings of a 2008 Survey*, Consumer Federation of America, July 2008.

7. Office of the Comptroller of the Currency, Community Affairs Department, *Payroll Cards: An Innovative Product for Reaching the Unbanked and Underbanked*, Washington DC: June 2005, <http://www.occ.treas.gov/Cdd/payrollcards.pdf>.

2. PREPAID DEBIT CARDS

Savings Goal: Transition the 18.5 million unbanked and 21.6 million underbanked households to reasonably priced financial services.

Policy Proposal:

1. Require businesses mandating direct deposit to offer employees prepaid debit cards as an alternative to direct deposit into regular bank accounts.
2. Automatically issue federal tax refunds through prepaid debit cards for taxpayers who do not provide direct deposit account information on their tax returns.

Employers can pay workers through general-purpose reloadable debit cards (also called prepaid cards, stored value cards, or prepaid VISA or MasterCard debit cards) or payroll cards. Prepaid debit cards provide a relatively accessible and affordable alternative to conventional bank accounts as well as to high-cost alternatives like check-cashing services.⁸ Introduced in the early 1990s, the cards function like electronic bank accounts without checks. Users load funds on the card—typically through direct deposit or at a card distributor’s site—and can use them to make purchases in the same way as a conventional VISA or MasterCard debit card. Unlike a conventional checking account, prepaid card users cannot overdraw their account. And, even consumers with a poor credit or banking history are eligible for prepaid debit cards.

Unbanked Social Security recipients already have the option to receive their benefits on prepaid debit cards through the Treasury Department’s *Direct Express* program. *Direct Express* offers unbanked Social Security recipients a safe, convenient, and cost-effective way to receive their federal benefits. The New America Foundation’s SAFE-T account is one example of how Treasury could adopt a similar system to issue tax refunds on prepaid debit cards. Taxpayers who do not provide direct deposit account information or elect to receive a paper check would automatically receive their tax refund through a prepaid debit card. Ideally, the prepaid debit card would be reloadable and offer a semi-restricted savings component.

3. A MORE ROBUST AUTOMATIC IRA

Savings Goal: Design an Automatic IRA for employees, who lack access to an employer-sponsored retirement plan, that enables them to accumulate emergency savings and begin saving for medium- and long-term goals such as higher education, homeownership, and retirement.

Policy Proposal:

1. Create an Automatic IRA that is divided into two components: a low-risk security savings account and a long-term retirement account.
2. Facilitate security savings by automatically directing the first \$2,000 of employee contributions toward the security savings account.

8. Fee structures vary, and may include a fee to open an account, a monthly maintenance fee, ATM fees to deposit or withdraw funds, and per-transaction fees. For example, one of the more commonly used cards, the NetSpend card, gives customers an option between a “pay-as-you-go” and monthly fee plan. The pay-as-you-go plan costs \$10 to open and an additional \$1 per purchase. The monthly fee plan costs \$10 per month, but has no per-purchase charge. One promising feature of the NetSpend card is a free interest-bearing savings account into which users can transfer funds.

3. Develop a diversified, low-cost savings vehicle such as a life-cycle fund to serve as the default retirement savings account.⁹
4. Allow workers to make unrestricted, penalty-free withdrawals of up to \$1,000 a year from the security savings component and further penalty-free withdrawals from the retirement component for specified purposes such as first-time home purchases and higher education expenses.
5. Allow workers to direct deposit a portion of their tax refund into their Automatic IRA.
6. Extend key features of the Automatic IRA—automatic enrollment and default investment options—to employer-sponsored retirement plans (for example, 401(k)s, 403(b)s, Section 457 plans, and SIMPLE IRAs).

Defining Automatic Enrollment

Automatic enrollment or “opt-out” makes it easy for workers to take advantage of employer-sponsored retirement plans such as 401(k)s. Studies have shown that the participation rate for 401(k)s employing automatic enrollment exceeds nine out of 10 eligible employees. In comparison, when employees must initiate enrollment in employer-sponsored plans (opt-in), only three out of four eligible employees participate.

Automatic enrollment achieves high participation rates by making saving the default option. Employees, without having to take action, are enrolled in the employer-sponsored retirement plan at a specified contribution rate. Employees who do not wish to participate have the freedom to “opt-out” of the plan. Automatic enrollment is a feature of President Obama’s Automatic Individual Retirement Account (Automatic IRA) proposal and has already been adopted by many companies.

Many workers without access to an employer-sponsored retirement plan are employed by small businesses or nonprofits that cannot afford to offer 401(k) or 403(b) plans. President Obama’s proposal would require businesses with 10 or more employees to offer employees an Automatic IRA—a low-cost retirement product featuring automatic enrollment and a default savings vehicle. Employers offering the Automatic IRA would automatically enroll employees at a contribution rate of 3% of pay, while allowing employees to opt-out of the plan.

Specific details of the President’s Automatic IRA proposal are not yet available, but there are several important features that should be included in the final plan. For one, the current focus on retirement savings does not address the short- and medium-term security savings needs of LMI individuals and families. USES would allow employees to have unrestricted access to at least \$1,000 held in a savings account or similar low-risk financial product offered through the Automatic IRA.

FACT:

An estimated 75 million people, or half of all workers, do not have access to an employer-sponsored retirement plan.¹⁰

9. Life-cycle funds offer investors a portfolio of stock, bond, and money market funds that is adjusted automatically to become more conservative as investors approach retirement.

10. J. Mark Iwry and David C. John, *Pursuing Universal Retirement Security Through Automatic IRAs*, Washington DC: The Retirement Security Project, 2009, http://www.retirementsecurityproject.org/pubs/File/RSP_AutoIRA2009Final.pdf.

To help workers accumulate security savings, worker contributions to the Automatic IRA would begin accumulating in a savings account (or similar product). Once the savings account balance reached \$2,000, additional contributions would be directed automatically toward a default investment such as a low-cost life-cycle fund. Financial institutions could offer alternative investments, but the default investment should meet a minimum federal standard for cost as well as transparency.

Like traditional IRAs, the Automatic IRA should continue to allow penalty-free withdrawals for higher education, first-time home purchases, and unreimbursed medical expenses. USES would also allow workers who have not exceeded the annual contribution limit to direct deposit a portion of their tax refund directly into their Automatic IRA. Community-based savings initiatives have shown that workers often find it easier to save a lump-sum tax refund than to make regular payroll contributions.

Policymakers see the Automatic IRA as a stepping stone for small businesses to begin offering a standard employer-sponsored retirement plan such as a 401(k). Employer-sponsored plans have several advantages over the Automatic IRA, including higher contribution limits and the option to provide an employer match. However, employer-sponsored plans could increase participation rates by adopting several simplifying features of the Automatic IRA, such as automatic enrollment and the availability of a default investment. These simplifications may increase participation among LMI workers who already have access to an employer-sponsored plan and are therefore ineligible for the Automatic IRA.

4. AN ACCESSIBLE SAVER'S CREDIT

Savings Goal: Offer potential LMI savers a meaningful and straightforward savings incentive that rewards short- and medium-term security savings in addition to retirement savings.

Policy Proposal:

1. Replace the existing Saver's Credit with a dollar-for-dollar credit of up to \$500 for contributions made to Automatic IRAs as well as employer-sponsored and individual retirement plans.
2. Offer the Saver's Credit for investments in certificates of deposit (CDs), U.S. Savings Bonds, and higher education savings plans.
3. Automatically deposit the Saver's Credit in the qualified savings account or product to which the person contributed.

USES would build on President Obama's Saver's Credit proposal to provide a greater reward for small-dollar savings and to encourage a variety of non-retirement savings goals. Our proposal is similar in many ways to the Saver's Bonus—a matched savings incentive developed by the New America Foundation and introduced as the Saver's Bonus Act (S. 3372) during the 110th Congress by Senator Robert Menendez of New Jersey.

A dollar-for-dollar match of up to \$500 provides the same maximum benefit as President Obama's proposal (a 50% credit on up to \$1,000 of savings). However, as Table 1 shows, a dollar-for-dollar match is slightly more generous for small-dollar savings. A worker hoping to reach \$500 of savings must contribute \$333 with a 50% match, but only \$250 with a dollar-for-dollar match.

Table 1. A Dollar-for-Dollar Match Compared to a 50% Match

	50% Match			
Worker Contribution	\$167	\$333	\$667	\$1,000
Saver's Credit	\$83	\$167	\$333	\$500
Total Saved	\$250	\$500	\$1,000	\$1,500
	Dollar-for-Dollar Match			
Worker Contribution	\$125	\$250	\$500	\$1,000
Saver's Credit	\$125	\$250	\$500	\$500
Total Saved	\$250	\$500	\$1,000	\$1,500

Like the Saver's Bonus, USES would encourage workers to accumulate security savings and to save for non-retirement goals by applying the Saver's Credit to a variety of financial products, including higher education savings plans, U.S. Savings Bonds, and CDs. In addition, contributions made to savings accounts and similar low-risk products held within Automatic IRAs would also be eligible for a match.

As President Obama and the New America Foundation propose, USES would automatically deposit the Saver's Credit in the savings product to which the person contributed, making the credit more like the familiar employer matching contribution rather than a complicated and poorly understood tax benefit. Not only is a direct match a clear and tangible benefit, it is also more likely to be saved if it is applied directly to a financial product rather than distributed as part of a lump-sum tax refund.

The major difference between the Saver's Bonus and our proposal is that we recommend following the President's more generous income guidelines, which would begin phasing out the credit at \$65,000 for married couples filing jointly; \$48,750 for heads of households; and \$32,500 for singles and married individuals filing separately. In comparison, the Saver's Bonus would begin phasing out at 120% of the Earned Income Tax Credit (EITC) threshold for each filing status. The phase-out threshold makes a substantial difference for single and married workers without children who would begin losing the Saver's Bonus at income levels as low as \$16,128 for singles and \$22,128 for married couples filing jointly.

5. TAX TIME INNOVATIONS FUND

Savings Goal: Encourage low- and moderate-income taxpayers to take advantage of tax time to increase savings.

Policy Proposal:

1. Create a federal Tax Time Innovations Fund for free tax preparation programs to pilot innovative savings and financial services programs.
2. Designate funding for thorough, evidence-based evaluations of pilot programs.

Starting with the 2010 filing season, taxpayers will be able to use tax refunds to purchase U.S. Savings Bonds directly through the tax return. President Obama has also proposed to make the Saver's Credit refundable and to enable taxpayers to open savings accounts on their federal tax returns, making it easier and more straightforward for LMI families to save. But there is no guarantee that families will take advantage of these and other benefits. Policy experts believed that the ability to split tax refunds between multiple accounts on the federal tax return would increase savings rates. During filing season 2008—the second year refund splitting was allowed—fewer than three out of every 1,000 taxpayers (with a refund) took advantage of the option.

The lesson learned from split refunds is something free tax preparation programs have understood for years. Lowering barriers to saving is not enough; potential savers often need an additional nudge. Community-based programs continue to leverage tax time to provide that extra push. In large part, this work continues in a vacuum—unsupported by federal funding and without a coherent federal savings policy for LMI families. In recent years, several NCTC affiliates piloted innovative programs, featuring:

- U.S. Savings Bonds;
- Prepaid Debit Cards;
- Matched Savings Incentives; and
- Alternative Refund Anticipation Loans.

A comprehensive savings platform consisting of default savings options and savings incentives will work, but for the program to reach its full potential, many savers will require face-to-face assistance. Tax time is the time to offer this help, when more than 100 million taxpayers receive refunds. Over 70% of EITC recipients (16 million taxpayers) rely on paid tax preparers and an additional 3 million LMI taxpayers take advantage of free tax preparation services each tax season. A Tax Time Innovations Fund could be used to train volunteers to discuss savings options with clients, to develop software that enables clients to take advantage of savings opportunities more easily, and to design marketing campaigns that promote savings opportunities. Such a fund would spur innovation among nonprofit programs that would in turn inform both government and private sector policies and practices.

Pilot programs will yield valuable information for policymakers if the programs are properly evaluated. A thorough evaluation lets researchers know if a pilot program achieved its desired outcome. However, evaluations continue to be prohibitively expensive for community-based organizations, many of which lack sufficient expertise to evaluate pilots and cannot afford to hire an independent evaluator. While President Obama has made evaluation a priority, the reality is that the federal government must set aside funding, specifically for community-based organizations to conduct proper evaluations. A Tax Time Innovations Fund should provide adequate funding to design and carry out rigorous evaluations.

FACT:
In 2008, households with incomes less than \$50,000 received tax refunds in excess of \$140 billion for an average tax refund of \$1,850 per household.¹¹

11. Internal Revenue Service, Statistics of Income, *Tax Stats – Individual Income: Tax Returns Table 3.3 All Returns: Tax Liability, Tax Credits, and Tax Payments, by Size of Adjusted Gross Income, Tax Year 2007*, <http://www.irs.gov/pub/irs-soi/07in33ar.xls>.

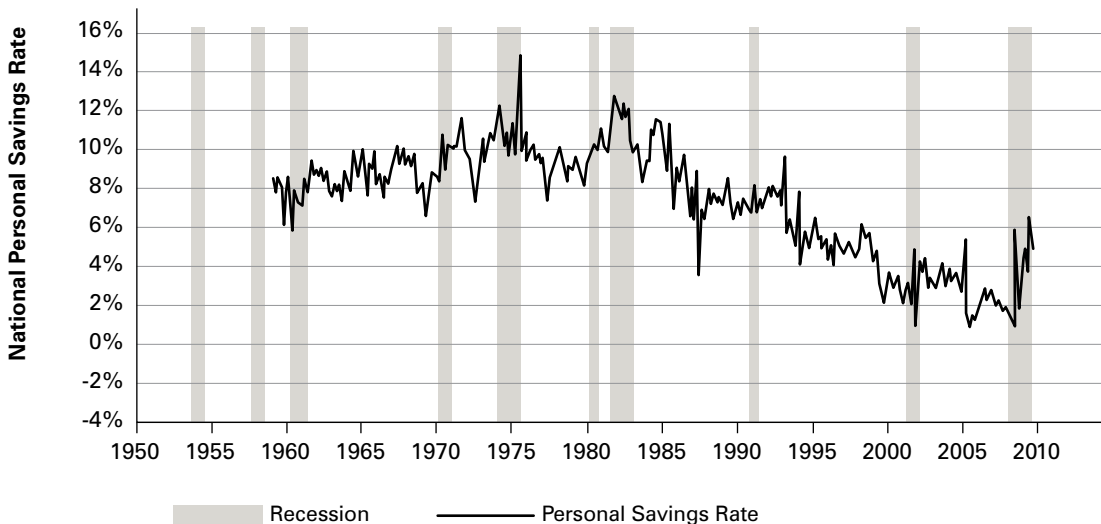
Savings Rates in the United States

U.S. PERSONAL SAVINGS RATES

During the early 1980s, U.S. personal savings rates regularly exceeded 10% of disposable income. Since that time, Americans have saved an ever-smaller portion of their income. Over the last decade, personal savings rates dipped below 1% for brief periods of time, meaning that many Americans relied on credit to spend more than they earned. After bottoming out in 2005, the savings rate remained below 3% for several years, where it seemed destined to stay.

Then late in 2008—frightened by the collapse of the housing market and the sudden Wall Street implosion—Americans began, once again, to save. Driven in part by a temporary increase in incomes resulting from federal stimulus payments to retirees and other transfers, the May 2009 savings rate reached 6.0%—a peak not seen in over 11 years. As expected, the July 2009 figure fell back to 4.2%—lower than the previous month, but still higher than the rate maintained over much of the past decade.

The jury is still out on whether America’s new-found frugality is a lasting behavioral change or simply a temporary response to the current economic crisis. Historically, the personal savings rate has spiked during or shortly after a recession, making it difficult to know whether the current trend will continue.



Source: Federal Reserve Bank of St. Louis.

Figure 1. National Personal Savings Rate

SAVINGS AMONG LOW- AND MODERATE-INCOME HOUSEHOLDS

The personal savings rate represents savings as a percentage of national income. While this information tells us how much Americans are saving, it does not help us to identify *who* is saving. A small number of wealthy Americans could drive the national savings rate upward, even if LMI workers continue to spend more than they earn.

- In 2007, before the economic crisis took root, only one-third of low-income families (those making less than \$20,600) saved throughout the prior year—compared to four out of five high-income families.¹²

It is not surprising that the majority of high-income families save: after all, they have more disposable income available after purchasing basic necessities like food, housing, and utilities. A greater capacity to save means that high-income families are able to accumulate assets at a much faster rate than LMI families.

Table 2 illustrates this point. In 2007, the highest-income families earned nearly 17 times as much as their low-income counterparts—a substantial difference—but the value of financial assets held by the same wealthy families was 238 times greater than the value held by families at the opposite end of the spectrum. As supporters of IDAs have argued, assets enable the upward mobility of LMI families across generations, while providing a cushion for families to fall back on in emergencies. A shortage of assets, and liquid assets in particular, not only limits upward mobility, but threatens financial stability as well.

Table 2. Family Savings Behavior and Financial Assets, 2007

Family Income Level ¹	Median Income	Percentage of Families that Saved	Median value of holdings for families holding asset (2007 dollars)	
			Medium Value of Checking and Savings Account	Medium Value of Financial Assets ²
Low	\$12,300	33.7%	\$800	\$1,700
Moderate	\$28,800	45.1%	\$1,600	\$7,000
Middle	\$47,300	57.8%	\$2,700	\$18,600
High	\$75,100	66.8%	\$6,000	\$58,300
Very High	\$114,000	72.9%	\$12,900	\$129,900
Top 10 Percent	\$206,900	84.4%	\$36,700	\$404,500
All Families	\$47,300	56.5%	\$4,000	\$120,300

(1) The 2007 Survey of Consumer Finances divides consumers into income quintiles. In this table, low-income refers to the bottom income quintile (income under \$20,600) and moderate-income refers to the second income quintile (income between \$20,600 and \$36,500).
 (2) Financial Assets include transaction accounts, certificates of deposit, stocks, bonds, retirement accounts, pooled investment funds, and the cash value of life insurance policies.
 Source: Federal Reserve Board, *Changes in U.S. Family Finances from 2004 to 2007: Evidence from the Survey of Consumer Finances*, February 2009.

12. Federal Reserve Board, *Changes in U.S. Family Finances from 2004 to 2007: Evidence from the Survey of Consumer Finances*, Federal Reserve Bulletin, February 2009, Page A5, <http://www.federalreserve.gov/pubs/bulletin/2009/pdf/scf09.pdf>.

THE NEED FOR “SECURITY SAVINGS”

American families that save too little for retirement can rely on Social Security to provide a secure financial base during their retirement years and need-based financial aid is available to help families with college-aged children and young adults pay for higher education.

The real danger of families spending more than they earn is that too little money is available for emergency situations: an unforeseen car repair, a sick child, or a layoff. As the current economic crisis has shown, emergency savings are necessary for families to weather these unexpected events. Next to cash, checking and savings accounts are generally the most liquid assets. But, as Table 2 shows, low- and moderate-income families have few resources to meet emergency needs. Among those with checking or savings accounts, the median value of those accounts is quite low—not nearly enough to meet a monthly mortgage payment or to cover a major car repair.

- The Federal Reserve Board’s *2007 Survey of Consumer Finances* found that 25% of low-income families and 13% of moderate-income families lack a checking or savings account.¹³
- According to the survey, among families with a checking or savings account, the combined median value of both types of accounts was only \$800 for low-income families and \$1,600 for moderate-income families.
- The amount LMI households have set aside or otherwise readily available for emergencies is even lower. According to a survey conducted by the Consumer Federation of America (CFA), more than 70% of low-income households and more than 50% of moderate-income households report not having emergency savings of at least \$500.¹⁴

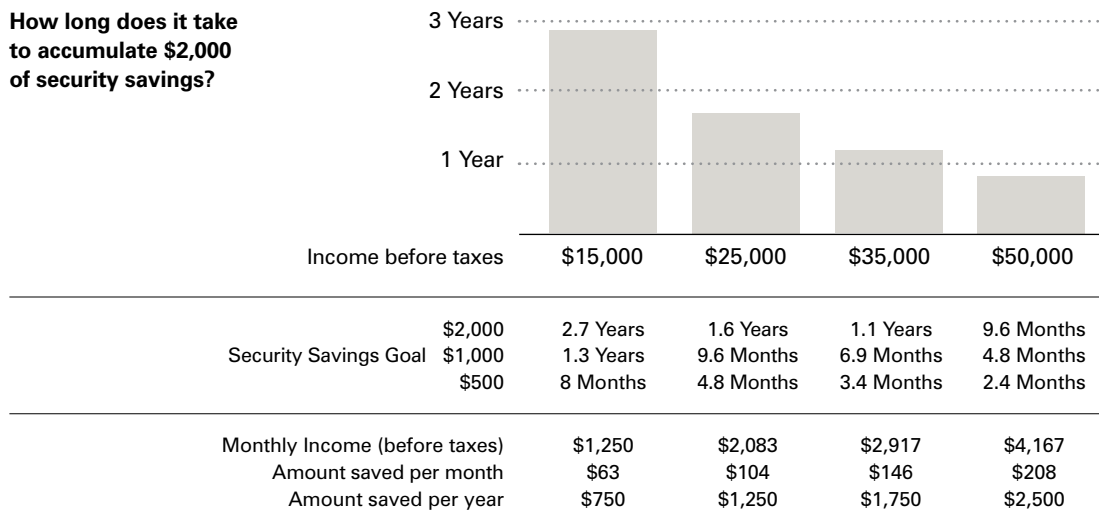
Research conducted at the local level is consistent with this national data. The Center for Economic Progress, which operates a high-volume free tax preparation program in Chicago, found that that most people taking advantage of free tax assistance had little or no confidence in their ability to pay for a financial emergency costing about \$1,000. Some 24% of respondents reported having “no confidence” and 29% reported having “a little confidence” in their ability to meet such an emergency expense; only 12% expressed a high level of confidence. Similarly, the *Detroit Area Study on Financial Services* found that 37% of households in LMI neighborhoods faced a “major expense for which they were unable to save.”¹⁵

13. The *2007 Survey of Consumer Finances* divides consumers into income quintiles. We refer to low-income as the bottom income quintile (income under \$20,600) and moderate-income as the second income quintile (income between \$20,600 and \$36,500).

14. Stephen Brobeck, *Unmet Emergency Savings Needs and the Role of Financial Institutions in Meeting Them*, Consumer Federation of America, 2007. This same survey also finds that only one-third of low-income households have savings accounts.

15. Michael S. Barr, *Financial Services, Saving and Borrowing Among Low- and Moderate-Income Households: Evidence from the Detroit Area Household Financial Services Survey*, March 2008, Electronic copy available through Social Science Research Network, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1121195.

How long does it take to accumulate \$2,000 of security savings?



Note: Author's calculations based on saving 5 percent of before-tax income each month.

Figure 2. Saving 5 Percent of Pay, How Long Will Take Low- and Moderate-Income Families to Accumulate Security Savings?

A DESIRE TO SAVE FOR EMERGENCIES

It is not that LMI families do not want (or need) to save. According to CFA's survey data, LMI families generally report wanting to have at least \$2,000 to \$3,000 on hand as security savings. This amount of desired precautionary savings is consistent with spending on emergency needs. According to the CFA survey, the bottom two-fifths of families by income report typical annual emergency expenditures of about \$2,000 a year.

The *Detroit Area Study* found a similarly strong desire to save among respondents. The vast majority of families in the survey—about 83%—disagreed with the statement that “saving is not worth it.” But large majorities also said it was hard to save “because money goes to necessities” (85%) and it is “hard to resist spending” (65%).

Research on the relationship between emergency savings and economic hardship is limited. However, CFA finds that **a lack of adequate emergency savings is associated with a number of negative financial events for LMI households, including overdrawing one's checking account, using a high-cost payday loan, and paying interest and late fees on a credit card balance (survey results are summarized in Table 3).**¹⁶

16. Stephen Brobeck, *Understanding the Emergency Savings Needs of LMI Households: A Survey-Based Analysis of Impacts, Causes, and Remedies*, Consumer Federation of America, November 2008.

Table 3. Impact of Emergency Savings on Financial Outcomes for Low-Income Workers (Income less than \$25,000)

Financial Outcome	Emergency Savings	
	Less than \$500	Greater than \$500
Bill payment		
Concern paying monthly bills*	70%	36%
Difficulty paying mortgage or rent*	42%	16%
Checking account management		
Not met monthly minimums past year	18%	13%
Overdrawn account past year*	52%	22%
Checking card management		
Carry a balance	74%	62%
Pay monthly minimum or somewhat more*	51%	35%
Paid fee in past year	35%	26%
Usage of high-cost loans		
Payday*	8%	3%
Car title*	7%	3%
Pawnshop*	8%	0%
Stress factors		
Worried about personal finances in past year*	91%	75%
Lose sleep*	68%	40%

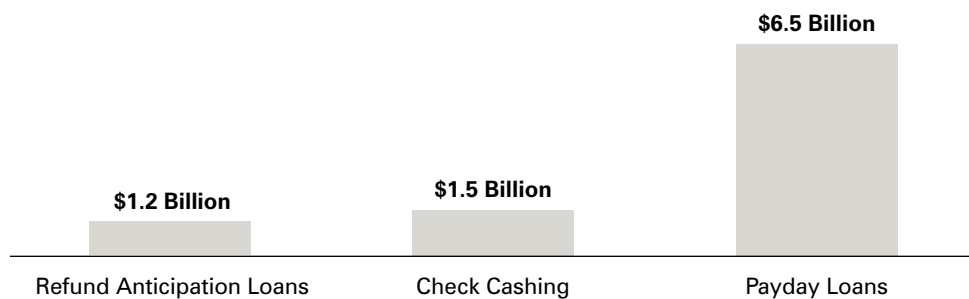
*Indicates statistical difference at the 5% level.

Source: Stephen Brobeck, *Unmet Emergency Savings Needs and the Role of Financial Institutions in Meeting Them*, Consumer Federation of America, 2007.

CREDIT USAGE AND DEBT AMONG LMI FAMILIES

Credit is often a double-edged sword for LMI families. On one hand, access to credit is necessary for financial stability and long-term asset building (assuming debt to purchase a home, start a business, or pay for college). Yet, if families cannot pay for emergencies, like a car repair, or opportunities, like a college class, they are forced to turn to credit and debt, which are commonly causes of financial instability. *While median debt levels are relatively low among LMI households (\$500 in the Detroit Area Study)*, mean debt levels are more than \$5,000, suggesting that high debt is a serious problem for a substantial minority of LMI households. This cross-sectional data does not capture the likelihood that the vast majority of LMI households experience problematic debt levels over time. There is clear evidence that various expensive forms of credit siphon off billions of dollars each year from LMI consumers, income that could be better used for savings and consumption purposes.

- **Borrower Practices:** The *Detroit Area Study* found that just over half of LMI households borrow during the year. Of those who borrow or rely on debt, a substantial share report relying on or considering using alternative and typically high-cost financial services such as tax refund anticipation loans (21.8%), checking account overdrafts (20.3%), credit card cash advances (7.9%), payday loans (4.4%), and borrowing from pension or retirement accounts (6.9%).
- **Credit Card Balances:** According to the *Survey of Consumer Finances*, just over one-quarter of low-income families (incomes under \$20,600) and almost 40% of moderate-income families (incomes between \$20,600 and \$36,500) reported a credit card balance in 2007. The median balances were \$1,000 and \$1,800 respectively.



Source: Matt Fellowes and Mia Mabanta, *Banking on Wealth: America's New Retail Banking Infrastructure and Its Wealth-Building Potential*, Washington DC: Brookings Institution, January 2008.

Figure 3. Estimated Annual Spending on Predatory Financial Products

A **refund anticipation loan or RAL** is typically a high-interest, short-term loan that is secured by a taxpayer’s expected tax refund. Such loans are most commonly provided by paid tax preparers in partnership with financial institutions. Since taxpayers using direct deposit can receive their refunds within 10 to 14 days, the benefit of such loans is limited to meeting immediate cash needs. It is evident from the number of people paying for RALs each tax season (8.4 million in 2009) that many taxpayers have emergency needs that could be met if they had security savings on hand.¹⁷

- In tax year 2006, just over one-quarter of EITC filers received a RAL, paying on average about \$100.¹⁸
- RAL users tend to be young (nearly half are between the ages of 25-34) and have limited access to credit.¹⁹

Figure 3 shows that consumers spend over \$9 billion a year on high-cost, short-term loan products and check cashing fees. LMI workers who possess a modest amount of security savings and who have access to low-cost bank products may be able to meet emergency cash needs without having to rely on costly financial products.

17. Government Accountability Office, *Interim Results of IRS's 2009 Filing Season*, GAO-09-640, Washington DC: June 2009, <http://www.gao.gov/new.items/d09640.pdf>.

18. Children’s Defense Fund, *Avoiding the Pitfalls of Refund Anticipation Loans*, March 2009, <http://www.childrensdefense.org/child-research-data-publications/data/ral-report-2009.pdf>.

19. Gregory Elliehausen, *Consumer Use of Tax Refund Anticipation Loans*, Washington DC: Georgetown University, April 2005, <http://www.business.gwu.edu/research/centers/fsrp/pdf/M37.pdf>.

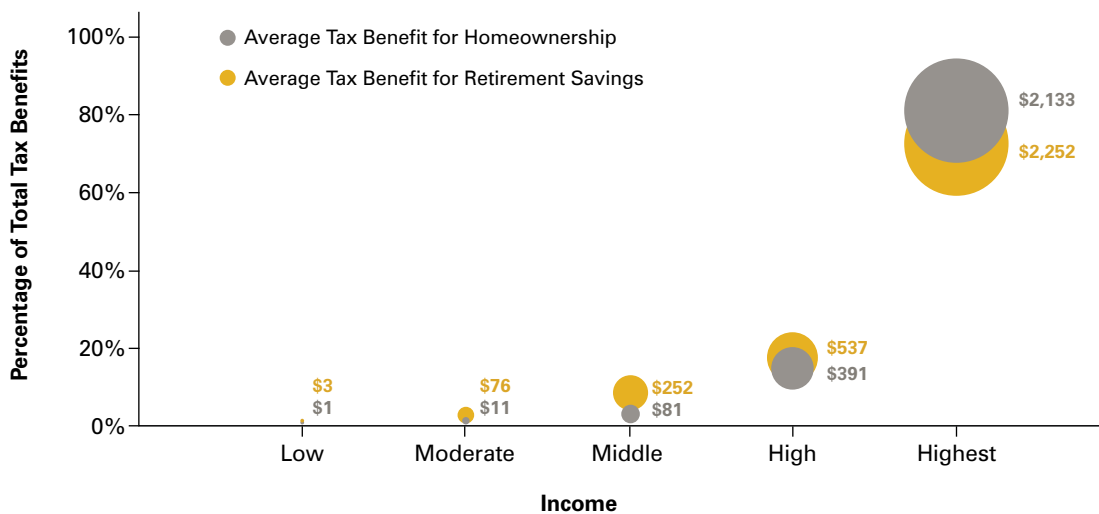
U.S. Savings and Asset-Building Policy

Income differences only explain part of the asset gap between high- and low-income households. As Peter Orszag, Director of the Office of Management and Budget has argued, U.S. asset-building policy strongly favors middle- and upper-income families—those families with the greatest capacity to save. By contrast, there are no federal incentives for short- to mid-term security savings, including savings for emergencies in transaction accounts, CDs, and other similar low-risk financial assets. Savings incentives embedded within the income tax code implicitly favor higher-income families and include tax deferred savings accounts, tax sheltered savings accounts, tax deductions, and low tax rates on investment income.

- **Tax deferred accounts:** Tax deferred accounts include defined contribution retirement plans like 401(k)s and 403(b)s. Employee contributions made to these accounts are excluded from earnings for income tax purposes. For instance, if an employee who earns \$50,000 a year contributes \$5,000 to a 401(k), she will pay income taxes on at most \$45,000 of earned income. She will pay taxes on the contributions and investment gains once she reaches retirement age and begins to draw down the account.
- **Tax sheltered accounts:** Like tax deferred accounts, tax sheltered accounts (for example, the Roth 401(k) and Roth IRA) are designed primarily for retirement. The difference is that savers make after-tax contributions to tax sheltered accounts, but they do not owe taxes when they begin to make withdrawals at retirement age.
- **Tax deductions:** The mortgage interest deduction and the deduction for state and local property taxes subsidize homeownership by lowering the amount of income taxes that homeowners pay.²⁰
- **Tax rates:** Profits resulting from investments in stocks, bonds, real estate, and other capital assets (capital gains) that are held for at least a year and from payments made by corporations to their shareholders (dividends) are taxed at a maximum of 15%. Even high-income earners in the top 35 percent income tax bracket pay a 15% tax on capital gains and dividends.

Retirement savings and homeownership subsidies that primarily benefit middle- and upper-income families literally cost the government billions of dollars in forgone tax revenues. The mortgage interest deduction alone will cost \$80 billion in 2009, while individual and employer-sponsored retirement plans will cost an additional \$126.5 billion. LMI families—those who stand to benefit the most from asset ownership and savings—remain outside of the subsidy umbrella. Figure 4 illustrates that **72% of retirement savings and 82% of homeownership tax subsidies go to the wealthiest families (those making over \$82,316). Meanwhile, moderate-income families (income less than \$26,417) receive an average tax benefit of \$11 for homeownership and \$76 for retirement savings.**

20. The mortgage interest deduction requires taxpayers to itemize deductions. Even with mortgage interest, many low- and moderate-income families do not have enough deductions to make itemization worthwhile. Taking the standard deduction may result in a lower income tax bill for these families, but it also means that they receive no benefit from the mortgage interest deduction.



Source: Tax Policy Center, *Tax Benefits of the Exclusions and Deductions for Retirement Savings, Distribution of Federal Tax Change by Cash Income Percentile, 2006*, Table T07-0290, 16 August 2007; Tax Policy Center, *Tax Benefits of the Home Mortgage Interest Deduction Distribution of Federal Tax Change by Cash Income Percentile, 2006*, Table T07-0262, 13 August 2007.

Figure 4. Federal Tax Incentives for Retirement Savings and Homeownership by Income, Tax Year 2007

One reason LMI families are excluded from federal asset-building policy is that an estimated 75 million workers—many of whom earn low wages—do not have access to employer-sponsored retirement plans. But, providing access to these plans is only part of the solution. The greater problem is that *income tax* subsidies do not benefit LMI taxpayers, who generally owe little or no income tax, but pay a substantial amount of payroll and sales taxes. Existing savings and asset-building incentives provide a limited benefit and therefore a negligible incentive for LMI families.

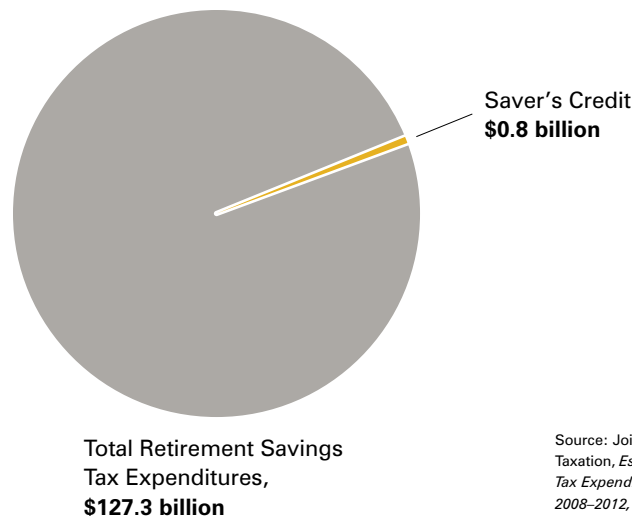
U.S. SAVINGS AND ASSET-BUILDING POLICY TARGETED AT LOW- AND MODERATE-INCOME HOUSEHOLDS

The Saver’s Credit

In 2001, Congress created the Saver’s Credit to address the “upside down” nature of the income tax code. The non-refundable Saver’s Credit rewards LMI workers with either a 10%, 20%, or 50% tax credit (the percentage becomes more generous as income diminishes) on the first \$2,000 they contribute to a retirement savings account. Non-refundable tax credits only benefit workers with income tax liabilities, meaning at best, the credit provides a modest incentive to millions of potential savers who owe little or no federal income tax. As Figure 5 illustrates, the Saver’s Credit accounts for less than 1% of total federal retirement savings tax expenditures.

Savers who are eligible must claim the credit through the federal income tax return. Due to the credit’s complicated incentive structure, it is difficult for potential savers to determine eligibility and the amount of the credit prior to tax time. Savers who are eligible for the credit receive it as part of their lump-sum tax refund and are likely to see the credit as a tax benefit rather than a savings incentive. And, unlike a direct savings match, savers are free to spend the credit once they receive it.

The Saver's Credit accounts for less than 1 percent of retirement savings tax expenditures.



Source: Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2008–2012*, Washington DC: Government Printing Office, Oct. 31, 2008.

Figure 5. Saver's Credit as a Percentage of Total Retirement Savings Tax Expenditures

Individual Development Accounts

Like the Saver's Credit, IDAs are one of the few federal programs designed specifically to increase savings among low-income families. IDAs are matched savings accounts for families hoping to buy a first home, pay for post-secondary education, or start a small business. The accounts are offered through partnerships between nonprofit agencies and financial institutions with matching funds being provided by private sector sponsors and government agencies. President Obama's Fiscal Year 2010 budget allocated \$24 million for the IDA program—less than 1% of the cost of the \$108 billion mortgage interest deduction.

PRESIDENT OBAMA'S SAVINGS PROPOSAL

Americans who work hard their entire lives have earned the right to retire with dignity and security. That's the promise that each of us wants to be realized within our own families, and it's a promise that we must keep for all American families.

—Barrack Obama, *President of the United States of America*²¹

An obvious starting point for developing a federal savings policy is President Obama's Fiscal Year 2010 budget, in which he proposes to create an Automatic IRA and to improve the Saver's Credit. With retirement security being the primary goal, President Obama's proposal draws heavily on insights from behavioral economics and the real-world results of making savings a default for workers.

21. Barack Obama, Retirement security speech in Gresham, Oregon, May 18, 2008, Transcript available at, http://www.democraticunderground.com/discuss/duboard.php?az=view_all&address=132x6018850.

Automatic IRA

An estimated 75 million workers (or half of all workers) do not have access to an employer-sponsored retirement plan, for example, section 401(k) cash or deferred arrangements, section 403(b) programs for public schools and charitable organizations, section 457 plans for governments and nonprofit organizations, and simplified employee pensions and SIMPLE IRAs for small employers. To expand access to workplace retirement accounts, President Obama's proposal would create an Automatic IRA for businesses with ten or more employees that do not currently offer a retirement plan.

Like existing defined contribution plans, employees would make regular payroll-deduction contributions to their IRAs. Not only would the proposal improve access to workplace retirement plans, it would also increase the number of workers taking advantage of the plans. Unlike the majority of current plans, the Automatic IRA would employ automatic enrollment—an innovative feature that enrolls employees in the plan by default, establishes a contribution rate, and selects a default investment strategy. At any time, employees could leave the plan or make changes to the contribution rate or investment portfolio. Businesses would receive a maximum tax credit of \$250 to offset the cost of facilitating payroll deductions—the only real expense to employers for providing the Automatic IRA.

Saver's Credit

President Obama proposes a fully refundable Saver's Credit that offers potential LMI families a savings incentive regardless of their income tax liability. The improved Saver's Credit would replace the current incentive structure with a simple 50% match on up to \$1,000 of contributions to retirement plans and IRAs (for a maximum credit of \$500). Similar to employer matching contributions, the credit would be deposited directly into the saver's retirement plan or IRA. Workers currently receive the Saver's Credit as part of their total tax refund where it is less likely to be saved and indistinguishable from other refundable credits as well as refunds that result from over-withholding.

The Saver's Credit would also be available at much higher income levels and replace the current abrupt eligibility threshold with a gradual phase-out. For example, in tax year 2009, head of household filers earning over \$41,625 will be ineligible for the credit, whereas the proposed Saver's Credit would begin phasing out for head of households at \$48,750. And, because President Obama's proposal replaces the current three-tiered incentive (a 10%, 20%, or 50% credit that decreases with income) with a flat 50% match, moderate-income savers could see their maximum credit available increase from \$200 to \$500.

U.S. Savings Bonds

During his September 5, 2009 weekly address to the nation, President Obama announced several administrative actions that will make it easier and more straightforward for Americans to save. Perhaps the most significant action for LMI workers is that all taxpayers will be able to purchase U.S. Savings Bonds directly through the federal tax return starting in 2010. By simply checking a box on the federal return, savers will be able to order between \$50 and \$5,000 worth of Series I Bonds with their tax refunds. The Savings Bond initiative grew from a three-year pilot program at free tax preparation sites and is an example of how direct service providers can play an important role in designing and testing public policies.

Choosing to Save: Lessons Learned

LESSONS FROM BEHAVIORAL ECONOMICS

Insights from the relatively new field of behavioral economics shed light on a variety of other less rational drivers of economic behavior. Unlike conventional economic theory, which assumes that individuals make decisions about financial matters in a way that is hyper-rational, extremely forward-thinking, and extraordinarily self-controlled, behavioral economists have found that financial decision-making is just as compromised as other forms of decision-making by behavioral factors like procrastination, lack of self-control, and various sorts of departures from strict rationality. These insights have had considerable influence on retirement policy, but relatively little impact on other savings-related policies.

Two important sets of ideas with particular relevance to savings policy for LMI families are reviewed below: defaults and channel factors; and framing, mental accounting, and loss aversion. In addition, a third idea that remains relatively unexplored by behavioral economics, the goal-gradient hypothesis, is briefly reviewed.

The Importance of Defaults and “Channel Factors”: Perhaps the most influential finding is that making savings a default can have a substantial impact on savings rates. For instance, a number of studies have found that making enrollment in a retirement plan automatic for new employees and allowing them to opt-out of the plan rather than requiring them to opt-in can more than double enrollment by new employees in such plans.

Of particular note is a study finding that the shift to an automatic enrollment plan by a large U.S. corporation had particularly large impacts on participation among subgroups that were least likely to save under the company’s previous opt-in plan. Participation more than doubled overall, and more than tripled among lower-compensated workers (those earning under \$20,000 or \$30,000); workers under 30, and black and Hispanic workers.²² The researchers note that one of the likely reasons for this strong effect is that automatic enrollment “decreases the complexity of 401(k) savings decisions by decoupling the participation decision from [an] investment decision... that requires evaluating a ‘myriad of options.’”²³

22. Brigitte C. Madrian and Dennis F. Shea, “The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior,” *Quarterly Journal of Economics* 116, no. 4 (2001): 1149-1187.

23. *Ibid.*, 1177-78

A related idea is that savings decisions can be heavily influenced by “channel factors.”

As Marianne Bertrand and colleagues explain:

In opposition to major interventions that often prove ineffectual, seemingly minor situational changes referred to as channel factors can have a large impact. The opening up of a channel (such as an a priori commitment, or a first step) may facilitate some behaviors, whereas other behaviors can be blocked by closed channels.²⁴

The researchers go on to cite a study finding that college seniors given information about the importance of getting a tetanus shot were much more likely to actually get the shot if they were asked to decide on a time to get the shot and given a campus map with the location of where to get it.

Bertrand and her colleagues found evidence of the importance of a channel factor in a study of a program operated by the Center for Economic Progress that sought to reduce the number of low-income people who were unbanked. They compared two types of financial education workshops, one in which participants received a referral letter to take to the bank to obtain an account, and another in which a bank representative was on site and helped them complete most of the paperwork for opening an account before going to the bank. They found that participants in the bank representative subgroup were much more likely to go to the bank, obtain an account and use it.

Framing, Mental Accounting, and Loss Aversion: The conventional model of savings assumes that money is fungible, that a dollar will be spent the same way regardless of where it comes from. But, in fact, people tend to treat money differently depending on where it comes from; they effectively put it in different “mental accounts” and are more or less willing to consume or save it depending on which account it ends up in.²⁵

A related issue is that people tend to prefer avoiding losses much more than they do obtaining similar-sized gains. One implication of such loss aversion is that people who have gotten used to a particular income level will likely view a reduction in current income that goes to savings as a loss that is not offset by the potential gains from saving and investment.

Applying both of these ideas, behavioral economist Richard Thaler argues that people may be more willing to save part of their tax refunds than to put the same amount aside out of their “regular” income. **The tax refund occupies a different mental account than one’s regular paycheck, and putting part of it aside for savings may feel less like a “loss” than a reduction in one’s paycheck.** The same ideas undergird Thaler’s “Save More for Tomorrow” (SMarT) plan, which gives employees the opportunity to commit in advance to saving an increasing share of their future salary increases. In tests of the SMarT plan, Thaler found about 78% of those offered the plan decide to participate.²⁶ Most of them stayed in the plan through the four pay raises that the study covered. Participants roughly quadrupled their savings rates during the trial.

24. Marianne Bertrand, Sendhil Mullainathan, and Eldar Shafir, “A Behavioral Economics View of Poverty,” *American Economic Review* 94, no. 2 (2004): 419-42.

25. Richard Thaler, “Mental Accounting Matters,” *Journal of Behavioral Decision Making* 12 (1999): 183-206.

26. Richard Thaler and Shlomo Benartzi, “Save More Tomorrow: Using Behavioral Economics to Increase Employee Savings,” *Journal of Political Economy* 112, no. 1 (2004): 164-187.

Goal Gradients: The “goal gradient” hypothesis holds that the closer people are to a goal, the greater effort they will make to reach it. Originally formulated in the 1930s and 1940s by behavioral psychologists, the hypothesis appears to have received relatively little attention from economists.²⁷ In one of the few recent studies, researchers found that participants in a coffee shop reward program purchased coffee more frequently the closer they were to earning a free coffee. This was even the case if the progress was illusory—customers who received a twelve-stamp reward card with two preexisting stamps were more likely to purchase the ten coffees required to earn a free coffee than those who received a ten-stamp card. **One implication is that savings program participants may be more motivated and likely to save for small goals that seem closer, say saving \$2,000 as an emergency fund, than for large goals that seem distant (like meeting a retirement savings goal or saving \$20,000 for a down payment on a home).**

LESSONS FROM COMMUNITY-BASED INITIATIVES

Behavioral economics research has considerable potential to inform savings policy for LMI workers, but the research to date has generally focused on boosting retirement savings, rather than the kinds of precautionary and emergency savings prioritized by most LMI workers. Moreover, little of this research has focused specifically on low-wage employers and their workers.

However, there are a number of community-based savings initiatives that have focused on low-wage workers and promoted more general forms of savings. Many of the strategies employed by community-based programs are consistent with the findings of behavioral economics and have implications for federal savings policy.

- **Tax Time is the Time to Save:** Consistent with the mental-accounting concept that most people will find it easier to save out of an “irregular” lump-sum payment rather than their regular paychecks, nearly all of the local initiatives discussed below focus on increasing savings at tax time.
- **“Channel Factors” Make Saving Easy:** All of these experiments aim to open savings channels—typically by making it easy for tax filers to immediately open a savings or other financial account at the tax site and direct deposit all or a portion of their tax refund into it. Making savings simple helps to overcome real and psychological barriers that otherwise discourage workers from saving a portion of their tax refund or paycheck.
- **Savings Incentives Work:** Some of the community-based programs also provide savings incentives, either as a match for dollars saved or in the form of low-cost versions of normally high-cost alternative credit products like payday and refund anticipation loans, on the condition that a savings account is opened.

27. The authors of a recent study note that the goal-gradient hypothesis has been understudied even though it “provides considerable insights into the psychology of rewards and the optimal design of customer, employee, and sales force incentive systems.” Ran Kivetz, Oleg Urminsky, and Yuhuang Zheng, “The Goal-Gradient Hypothesis Resurrected: Purchase Acceleration Illusory Goal Progress, and Customer Retention,” *Journal of Marketing Research* 43 (2006): 39-58.

TAX TIME IS THE TIME TO SAVE

D2D Fund Savings Bond Pilot: During the 2007 tax season, the D2D Fund operated two sets of pilots that made U.S. Savings Bonds available at tax preparation sites. One set of pilots made bonds available at commercial tax preparation sites (H&R Block); the other at community-based tax sites. At the time of the pilots, the bonds offered (I Bonds) paid 4.5% interest (the rate is adjusted every six months based on inflation). I Bonds cannot be redeemed during the first year after they are purchased.

The pilot program made U.S. Savings Bonds easily available to over nearly 5,000 LMI tax filers at tax preparation sites operated by community-based tax programs in five cities (Baltimore, Boston, Denver, New York City, and Tulsa). In four of the cities, no match or incentive was offered (other than the interest provided by the bonds); in one site, Tulsa, bonds were offered to filers at a 20% discount for a one-week period. Bonds were offered to all filers with a tax refund of at least \$50 (the cost of a single bond).

At the commercial tax preparation sites, bonds were offered to about 3,700 clients with federal refunds of more than \$500. The process was somewhat more complicated at these sites. To purchase bonds, clients had to open an H&R Block Easy Savings Account with a minimum \$300 deposit. If they wanted to purchase less than \$300 in bonds they could leave any remaining funds in the account, direct deposit the funds in another bank account, or receive the balance in a paper check mailed to them.

Results:

- At the community sites, 6% of clients bought bonds.
- The take-up rate (9.6%) was somewhat higher among filers who used direct deposit (bonds must be purchased using direct deposit, which some filers who were offered bonds either lacked or did not want to use).
- The median refund amount used to buy bonds was \$100.
- Take-up was similar at the commercial sites—5.9% purchased bonds—even though income levels were higher on average. Observation and focus group evidence suggests that take-up was depressed by the more cumbersome process.
- At the commercial sites, EITC beneficiaries were more likely than non-beneficiaries to purchase savings bonds. In addition, purchasers were more likely to have had a savings account in the past but relied on check cashing services at the time the pilot took place.
- At the community site offering a 20% incentive, the take-up rate was about twice as high as the community sites that did not offer an incentive. Some 15% of clients with a tax refund of at least \$50 opted to buy one or more savings bonds, and 18% of those using direct deposit did so.
- At both community and commercial sites, over eight out of 10 bonds were purchased as gifts, typically for children or grandchildren.

“CHANNEL FACTORS” MAKE SAVING EASY

Refunds to Assets Pilot: Since the 2007 tax season, tax filers receiving refunds have had the ability to split their refunds between two or three different accounts using direct deposit.²⁸ This option was made available in part based on evidence that split refunds make it easier for families to save a portion of their refund. A key study was the 2003 Refunds to Assets pilot in Tulsa, Oklahoma. The pilot was operated by the D2D Fund and the Community Action Program of Tulsa County (CAPTC). Using a prepared script, staff approached 556 tax filers at CAPTC community tax sites.

Results:

- Among those clients who anticipated receiving a refund (516), more than one in four said they wanted to enroll in the split refund program.
- The median participant directed \$203 into a savings account representing 39% of her or his refund.
- 11% of potential participants were disqualified (because they did not pass the participating bank’s ChexSystem test).

SAVINGS INCENTIVES WORK

\$ave NYC: The City of New York piloted the \$ave NYC program during the 2007 and 2008 tax years at various free tax preparation sites throughout the city. \$ave NYC provided tax filers who deposited part of their tax refund into a \$ave NYC account for at least one year with a match equal to 50% of the amount deposited, with a maximum match of \$250. Savers could withdraw their deposits before the end of the year, but would not receive any match if they did so.

Available funding for the match, which came from private donations, allowed for only a very limited number of accounts to be opened each year (177 in 2007 and 1,050 in 2008), and potential participants were not randomly assigned to treatment and control groups. As a result, it is not possible to determine how many eligible filers would have participated in the program, or the difference that the match rate made. However, the results of the program still provide some insight into the potential for these kinds of savings incentive programs.

Results:

- In 2007, 152 accounts were funded. About half (75) remained open for the full year and received the match.

28. Taxpayer split their refunds by filing Form 8888 along with their return. If they use Form 8888, the entire refund must be direct deposited (they cannot receive a portion of it as a paper check). Deposits can be made to any account with a valid routing number and account number that is accessible through the electronic funds transfer system, including checking and savings accounts, and many IRAs.

- Just under one-third of people who opened an account were unbanked at the time; incomes were low, averaging about \$15,000 in the 2007 and \$16,000 in 2008.
- Nearly 80% of participants had previously been unable to save money from their tax refund for a full year.

North Carolina State Employees' Credit Union Salary Advance Loan: Since 2001, the North Carolina State Employees' Credit Union (SECU) has offered a Salary Advance Loan (SALO) as an alternative to expensive payday loans. Members can receive a loan of up to \$500. The APR is currently 12%. The principal is repaid by an automatic deduction from the borrower's next paycheck. In addition to its lower cost, the SALO includes an ingenious commitment device that counters the potential that the product might have to actually increase reliance on advance borrowing—**5% of each loan is deposited in a separate savings account. If these funds are withdrawn by the borrower, he or she is ineligible for another SALO for six months.**

City of San Antonio's Refund Express: San Antonio's Refund Express provides a low-cost alternative refund anticipation loan (ARAL). Filers pay a \$10 fee to process the loan, \$5 of which goes to establish a new account with the San Antonio City Employees Federal Credit Union. The loans are zero-interest and have no other costs. Credit union accounts are opened at the free tax preparation site, and the advance loans are funded as soon as the Credit Union receives IRS acceptance.

Results:

- During the 2007 tax season, about 1,100 ARALs were funded (since then the program has more than doubled).
- Two months after the end of the 2007 tax season, more than half of these accounts had savings remaining in them (i.e., more than the \$5 minimum for the account).
- Filers receiving loans were very low-income (average income was about \$14,000) and almost one-third had been unbanked.

A key lesson from these local initiatives is that many low-income tax filers will save if they are affirmatively given the opportunity to do so as part of the tax filing process. The trusted products and face-to-face interaction that free tax preparation sites offer have proven to be key factors in increasing savings. Findings from the local initiatives also suggest that low-income filers are more likely to save for shorter-term precautionary purposes than they are for retirement, and that incentives to save can have a substantial impact on their savings rates.

Conclusion

A lack of short- and mid-term security savings leaves workers and their families vulnerable to minor financial setbacks and may prevent them from getting ahead. The billions of dollars spent each year to access payday and refund anticipation loans is evidence that many LMI workers frequently find themselves short of cash. For families struggling to get by, a small amount of security savings—\$500 to \$2,000—could make a big difference. Easy access to savings helps workers to avoid the payday loan debt trap or a missed workday due to a car repair they cannot afford. Having security savings gives workers the confidence they need to begin saving for mid- and long-term goals like homeownership, education, and retirement.

While accumulating precautionary savings is not easy, community-based savings initiatives clearly demonstrate that LMI workers want to save and are willing to take advantage of savings opportunities. Workers should ideally save throughout the year, but the reality is that tax refunds are the largest payment most low- to moderate-income families will see all year long. Each tax season, easy savings options and incentives offered by community tax preparation programs enable LMI individuals and families to use tax refunds to invest in U.S. Savings Bonds, CDs, and savings accounts. Access to safe financial products and the convenience of direct deposit make it easy for LMI taxpayers to save a portion of their tax refunds.

Policymakers can apply the lessons learned from community-based initiatives to design federal savings policies that meet the unique needs of LMI individuals and families. President Obama's proposal to create Automatic IRAs and to improve the Saver's Credit, along with his decision to put Savings Bonds back on the tax return, are steps in the right direction. Building on the President's proposal, our plan, Universal Savings for Economic Security (USES), would provide incentives to reward a *full range* of savings activities, including savings for financial security and economic opportunity. Our plan would:

1. Offer nearly all workers access to **direct deposit** and the potential to automatically save a portion of each paycheck.
2. Enable unbanked workers to take advantage of direct deposit through **prepaid debit cards**.
3. Permit LMI workers to use Automatic IRAs and other employer-sponsored plans to accumulate **security savings** and to save for **non-retirement goals**, while applying the key features of the Automatic IRA—opt-out and default investment options—to all employer-sponsored **retirement plans**.
4. Redesign the **Saver's Credit** to offer a dollar-for-dollar match up to \$500 on contributions made to retirement and non-retirement savings products.
5. Create a **Tax Time Innovations Fund** to support innovative community-based savings initiatives.

As community-based savings initiatives have shown, LMI individuals and families have both the desire and capacity to save. This untapped potential has gone relatively unnoticed by federal policymakers who continue to concentrate efforts solely on retirement savings and tax incentives that favor middle- and upper-income households. Fortunately, many of the mechanisms needed to encourage LMI households to save are already in place. It is now a matter of improving access to benefits like direct deposit as well as applying what we know about automatic enrollment features and savings incentives to existing products in order to solidify the recent significant increase in the U.S. savings rate.

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