Financial Services and Savings: Theory and Evidence from the American Dream Demonstration

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Abstract

The American Dream Demonstration, based on the pioneering work of Michael Sherraden and his colleagues, has changed the way we think about low- and moderate-income households’ financial decision-making. Low-income families can and do save, and their saving is shaped in part by the institutional design of programs to encourage saving. The evidence from the demonstration provides support for behavioral economic models of household decision making. At the same time, the demonstration suggests the need for a new focus on cost-effective policies that integrate savings policies for low- and moderate-income households into a universal, progressive, national savings policy.

I. Introduction

For most of us, getting our paychecks directly deposited into our bank accounts, writing a check, or storing our money in an account as savings can be taken for granted. We often struggle to save for longer-term goals, our children’s education, or retirement, but most of us, most of the time, do not worry whether our savings or insurance will be enough to get us through an illness, or even loss of a job.

For most low- and moderate-income households, the picture is quite different. How many of us walk by the signs for “Checks Cashed Here,” “Money Orders for Sale,” and “Payday Loans: Get Cash Quick” without thinking about the implications of those signs for the daily lives of lower-income households. High cost financial services, barriers to saving, the lack of insurance, and credit constraints may contribute to poverty and other
socio-economic problems. Low-income individuals often lack access to financial services from banks and thrifts, and turn to alternative financial service providers such as check cashers, payday lenders, and money transmitters.¹ Low-income households may face high costs for these kinds of services, and high cost financial services may reduce the value of government income transfer programs such as the Earned Income Tax Credit. Some households may find it more difficult to save and plan financially for the future. Living paycheck to paycheck may leave them vulnerable to emergencies that may endanger their financial stability, given the lack of insurance for key life events, and the lack of longer-term savings may undermine their ability to invest in human capital, purchase a home, and build assets.

Despite these differences, all of us rely on financial services in our daily lives. Yet economists often have a difficult time figuring out why all behave the way we do. Many of us save less than we should, borrow more than we ought, and get ourselves entangled in financial transactions that make little sense to an outside observer. Recent research in behavioral economics has challenged many of the central assumptions of economic theory regarding household financial decision making. In the next section, I explore how empirical research can contribute to this theoretical inquiry.

II. Theoretical Inquiry

Basic assumptions about how people behave shape our understanding of economics and our views about the role of law. Traditional economic models of rational choice view decisions as made by optimizing rational agents with perfect foresight. Research in psychology and behavioral economics provides alternative explanations for

¹See generally, Michael S. Barr, Banking the Poor, 21 Yale Journal on Regulation 121 (2004).
Behavioral economists focus on the limits of our rationality. By contrast, the public debate is largely consumed by “culture of poverty” theories of social deviance, laziness, imprudence, and impatience as descriptions for the behavior of the poor.

These differing frameworks affect how one views a wide range of phenomena, such as savings behavior, risk-taking in investment, and insurance. The behavioral economic insight, for example, regarding default rules, can be used not only to understand individual choice, but also, perhaps, to design institutions to influence individual decision-making. That is, our understanding of how individuals make decisions can have profound implications for differing approaches to the role of law in such areas as consumer protection, disclosure, bankruptcy, and national savings policy.

Little empirical work has attempted to translate these theories into the world inhabited by low-income households in the United States. Bertrand et al. argue that “the poor may exhibit the same basic weaknesses and biases as do people from other walks of life, except that in poverty, with its narrow margins for error, the same behaviors often manifest themselves in more pronounced ways and can lead to worse outcomes.”

By contrast, Duflo suggests that the stresses of poverty “almost certainly affects the way people think and decide” and that “[w]hat is needed is a theory of how poverty influences decision-making, not only by affecting the constraints, but by changing the decision-

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2 See, e.g., Daniel Kahneman and Amos Tversky, Choices, Values, and Frames (2000).
These theories can and should be informed by empirical studies that provide information on household financial behavior and attitudes, and the constraints that such households face. I would like to suggest how further empirical research could contribute in five key areas: savings, credit, insurance, transactional services, and preference formation.

One important area for analysis of these differing frames involves savings. The dominant rational choice model is the “life cycle” theory, which suggests that savings are used to smooth consumption over one’s life. An extension of the rational choice model posits that precautionary motives also influence saving; that is, rational individuals with full foresight save as a form of insurance in the face of uncertainty. Behavioral models suggest that, although these rational choice theories may be useful at the aggregate level, individual choices regarding saving are profoundly affected by psychology: mental accounting, starting points, endowment effects and other frames. For example, groundbreaking empirical research by Richard Thaler at the University of Chicago has demonstrated the importance of framing, starting points, and default rules in determining whether and how much individuals will save in employer-sponsored retirement plans.

Little empirical research is directed at savings among low- and moderate-income households in the United States. How and why do low-income households save? Which

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households are able to save? A “culture of poverty” theory would suggest that low-income households that do not save have different preferences, or values (thrift, prudence, work ethic) from other households. A behavioral theory would suggest that access to different forms of financial institutions or the opportunity for direct deposit at work might affect saving by affecting individual choices through institutional channels. That is, having a bank account, or using direct deposit at work, may contribute to saving apart from rational choice models of saving. The life cycle theory predicts higher savings-to-income ratios than data suggest that the poor exhibit, but failures in measuring how low-income people save may be at fault. Moreover, under plausible assumptions regarding the hard budget constraints of poverty, a rational choice theory would explain that low-income households do not save because they are poor; there are simply insufficient funds to set aside each month after necessities. Put another way, no current savings could be the rational choice in smoothing consumption over one’s life. Other rational choice models predict lower savings because social safety net programs reduce the need to save as a precautionary measure against income shocks.⁹

Yet the rational choice model is confronted with a puzzle: Lots of households—at all income levels—that should save don’t, and evidence from other studies suggests that some low-income households do save. Why do these households save and how are the able to do so? Do families save out of a precautionary motive, to build human capital through education, to save for retirement, or for other goals? What is the effect of saving on the ability of households to weather hardships, such as job loss or injury? How are households able to save? What is the role of “mental accounting,” in which different

sources of income are used for different functions? Are tax refunds, including from the Earned Income Tax Credit, an important form of saving, and do households view tax refunds a time to commit to future saving? Answers to these questions can inform debates over pension law reform and Social Security, as well as private sector initiatives to encourage savings.

A second important area involves credit. Liquidity constraints can affect consumption, savings, work incentives, insurance, and time horizons for financial decision-making. Yet little empirical work has been done until recently on the credit constraints facing low-income households. What kind of liquidity constraints do low- and moderate-income households face? What are the causes and consequences of such constraints? To what extent do the choices among different credit channels used by households, for example, banks, payday lenders, pawnshops and refund anticipation lenders, reflect credit constraints, different preferences (for example, convenience), or other factors? Why do such households borrow? For example, do households take out refund anticipation loans because they are impatient, need to pay off their bills, or have to pay the tax preparer? What are consumer attitudes towards credit, the consequences of delinquency, and bankruptcy and to what extent are differing attitudes, if any, reflected in behavior? To what extent do consumers understand credit terms, such as minimum payment terms on credit cards? Answers to these questions could lead to better disclosures and could inform the debate over bankruptcy reform.


A third important area involves transactional services. One theory suggests that use of check cashers is simply a rational response to those with preferences for convenience and impatience. A behavioral economics approach focuses on the role of social networks in a neighborhood in conditioning individual choice. Economic network theory suggests instead a focus on conflicting payments systems: Employers pay by check while landlords and other businesses in low-income communities accept cash. An institutional focus combines these insights to suggest looking at the structure of banking to explore these transaction costs.

Welfare economics largely treats income as if it were cash (or a fully liquid intangible) for purposes of determining utility. What happens to the model if the transaction costs of converting income into usable form are high relative to income? As a normative matter, as I argued in Banking the Poor, the costs of converting income into cash may be grounds for a non-income form of redistribution of financial services. But these theories require knowing the size and direction of some key parameters. For example, does proximity to different types of financial services affect financial services usage patterns, preferences, and needs? Do price and product offerings explain such matters? Are other factors, such as hassle, habit, or employment patterns what is really at work? Does access to a bank account affect saving and credit?

Fourth, low- and moderate-income households face risks to their health, income, employment, household structure, and the like. To what extent are such households insured against such risks? Measures of insurance include formal insurance mechanisms, such as unemployment, disability, and health insurance, as well as informal mechanisms and credit, such as borrowing from friends and family, or self-insuring through savings,
holding durables, or other means. Empirical research can contribute to our understanding of the extent to which low-income households are under-insured, and can begin to tease out the links among insurance, savings, and credit as substitutes in providing a cushion against hardship for low- and moderate-income households. To what extent can financial hardships be understood as insurance failures?

Fifth, empirical research can contribute to a better understanding of household preference parameters, such as risk tolerance and future-orientatedness, and their influence on decision-making with regard to savings, insurance, credit and the like. To what extent does heterogeneity of preferences explain behavior? Alternatively, to what extent are household preferences and behaviors shaped by how available choices are framed for them? How predictive are economic measures of risk tolerance? What is the relationship between risk tolerance and income? Are low-income households more risk tolerant because they have little to lose, or more risk averse because they have no cushion to fall back on? Does risk aversion contribute to lower levels of borrowing and lower returns to capital? Are low-income households more impatient than others as measured by time preference and inter-temporal rates of substitution? Do households save more because of an underlying propensity to plan or because of the savings choices they are offered? Is the lack of self-control an important factor explaining saving and borrowing decisions or are such matters driven by hard budget constraints? Understanding heterogeneity in preferences can lead to better modeling of economic behavior under both rational choice and behavioral models.

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I have begun an empirical project to study these issues with an in-depth household survey in the Detroit metropolitan area. I was selected by the University of Michigan’s Institute for Social Research, Survey Research Center to be the Faculty Investigator for the Detroit Area Study (DAS) for 2005. This summer, I will survey low-, moderate-, and middle-income households from the Detroit metropolitan area about how and why they use a wide array of financial services, as well as the costs and benefits of such services; and how they would respond to new types of cost-effective financial products tailored to their needs. In addition, I have geo-coded financial services firms in the three-county area, including more than 1300 check cashers, pawn shops, payday lenders and tax preparation firms, and over 350 banks, thrifts, and credit unions. I will be gathering information about the prices and products offered by this wide range of firms. Broadly speaking, my research aim is to develop a comprehensive understanding of the financial services behaviors of low- and moderate-income households and the financial services constraints that they face. My goal is both to inform the theoretical debates on key questions regarding household financial decision-making and to contribute to the development of policies to expand access to financial services.

III. The American Dream Demonstration and Other Evidence on Financial Services and Saving

Sherraden and his colleagues launched the American Dream Demonstration to lay the foundations for a universal, progressive national savings policy. The context for the study was (and is) the large-scale exclusion of low-income families from society’s basic
mechanisms to encourage savings. Low income families lack access to institutional savings vehicles. Two thirds of tax benefits for pensions go to the top 20% of Americans, while the bottom 40% gets only 2% of the tax benefit.\textsuperscript{14} Most low-income workers work for firms without savings plans or are not covered by such plans.\textsuperscript{15} Twenty-two percent of low-income households—over 8.4 million families earning under $25,000 per year—lack a bank account that can be an important entry point for saving.\textsuperscript{16} Bank accounts are not structured to be low-cost and low-risk for low-income households. High minimum balances, credit checks to open accounts, high bounced check and overdraft fees, and long check-holding periods are not designed for the lives and finances of low- and moderate-income households.\textsuperscript{17} And given their low levels of assets, most banks have historically not wanted them. The lack of sufficient income to afford saving and lack of supply in savings products for the poor, coupled with low rates of return offered to the poor given their low levels of wealth, all contribute to depressing saving among low-income households.

Yet evidence suggests that some low- and moderate-income households can save. For example, 44% of low- and moderate-income workers participate in 401(k) plans if offered the chance to participate.\textsuperscript{18} Some 73% of federal employees earning $10,000 to $20,000 participated in the thrift savings plan and 51% of those earning under $10,000 did.\textsuperscript{19} About 30% of families in the bottom income quintile saved in the year prior to

\textsuperscript{14} Treasury.  
\textsuperscript{16} Barr (2004), \textit{supra}.  
\textsuperscript{17} Id.  
\textsuperscript{18} Orszag & Greenstein (2001), \textit{supra}.  
\textsuperscript{19} Treasury (1998).
As discussed above, automatic enrollment in employer-sponsored pension plans boosts participation and asset accumulation among low-income, as well as Black and Hispanic employees.\textsuperscript{21} When welfare benefit asset limits are raised, low-income households respond by saving more.\textsuperscript{22} This evidence provides support for the notion that low-income households can save, and that savings are at least in part shaped by institutional mechanisms that encourage saving.

The American Dream Demonstration project involving “Individual Development Accounts” for low- and moderate-income households provides three central lessons that build on these insights: First, low-income people can and do save. Second, institutional structure affects savings.\textsuperscript{23} Third, using non-profits and de-centralized infrastructure for accounts is not an efficient way to expand savings for these families. I explore these three central lessons below.

The American Dream Demonstration has provided us with a good deal of practical knowledge that can help to flesh out the theoretical concept that institutional channels matter to saving behavior. Sherraden has posited a more detailed institutional model that he and I explored recently together.\textsuperscript{24} The institutional model comprises access, information, incentives, facilitation, expectations, restrictions, and security. Access measures whether a savings opportunity is available, for example, by being

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\textsuperscript{21} Choi et al, supra; see also Madrian & Shea (2000), supra.


\textsuperscript{23} See Sherraden and Barr, supra.

\textsuperscript{24} Sherraden and Barr (2005), supra.
\end{flushleft}
eligible for a pension plan at work. Information includes financial education. Incentives include tax-advantaged plans as well as IDAs with matched contributions. In the savings literature, evidence regarding incentives are mixed, given the offsetting income and substitution effects and the likelihood of reshuffled assets for higher-income households; among the poor, reshuffling is less likely and incentives are likely to matter more. Facilitation focuses on the paths by which “good” savings choices are made easier, as in opt out savings plans and the experiment run by Thaler to increase savings contributions in the future. Restrictions make it easier to keep savings as savings, and rely on the behavioral insight that individuals keep “mental accounts” of different income streams and savings buckets. The notion of security includes both physical protection (not under a mattress) as well as investment security.

In the American Dream Demonstration, evidence is consistent with these theories, although researchers have not been able to separate out theses effects from heterogeneity in the saving population and variations in program design. Average monthly net deposits were $25 and average annual accumulations totaled $900. Financial education increased savings. The presence of a match was associated with better participation and targeted uses of savings, perhaps because participants sought to meet program expectations and because the match provided an incentive to save. Higher match rates were associated

with lower dropout rates but not with higher savings. This evidence is consistent with theory regarding the offsetting effects of incentives coupled with expectations. The higher cap on matched contributions was associated with better saving outcomes, again, possibly because of program expectations. Program participants cited facilitation through direct deposit as improving their ability to save. In sum, ADD evidence suggests that low income households can save, and that institutional channels can affect saving behavior.

Program costs were still much too high, however, to go to scale on a non-profit, labor-intensive driven model of financial services. The key lesson from program administration is the need to shift from an ad-hoc, non-profit driven model to a model that is integrated into the mainstream financial services system and that relies on technology to reduce costs. Peter Tufano’s innovative “Doorways to Dreams” project, an internet-based back office platform for IDA programs is one way to decrease transaction costs for IDA programs. More fundamentally, we need to shift the whole paradigm from a focus on exciting but marginalized programs to financial products at the core of our financial system.

IV. Financial Services and Saving Policy

A. Policies to Expand Access to Financial Services and Encourage Saving

1. Tax Credits to Financial Institutions

What will it take to do that? We need to find ways to integrate savings policies for the poor into the product offerings of financial institutions. Financial institutions need to be able to earn a profit from these activities, and lower income households are unlikely to

29 Margaret Sherraden et al., (2004).
be the first place firms look for assets and cross-selling opportunities. One approach is to provide tax credits to financial institutions to increase their incentives to provide low-cost banking accounts and savings products for low- and moderate-income households.

IDAs are becoming more widespread. Most states have some type of IDA policy, and in addition to the American Dream Demonstration, the federal government enacted the Assets for Independence Act in 1998. Despite this policy activity, IDA programs today are small and community-based. The next step is to connect IDA programs and principles with large policy systems. In this regard, tax credits to financial institutions could help to overcome barriers to widespread adoption of IDAs.

The Savings for Working Families Act is a promising approach. Under the Act, financial institutions offering IDAs would receive tax credits annually offsetting up to $500 in match funds and $50 in account administration costs. The current legislation, drafted with an overall cap on accounts, would provide for up to 300,000 new IDAs at a cost of under $500 million. The cap on the number of accounts may limit financial institution interest in developing the infrastructure necessary to support these accounts, and should be removed. If permitted to operate without a cap, this legislation could help to transform financial services for the poor, by moving from small-scale, non-profit focused efforts to a large-scale, financial-institution driven financial product that meets the longer-term savings needs of low-income families. Non-profits could continue to play an important role, by providing for financial education and recruiting and screening participants.

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To transform the market for low-income financial services, I have proposed a tax incentive for financial institutions to offer low-cost electronic accounts for low-income persons.\textsuperscript{31} Financial institutions could receive a tax credit equal to a fixed amount per account opened. Roughly speaking, the amount of the credit would be calculated to cover the average administrative cost to an average bank of offering the account, taking into consideration research and product development, account opening and closing costs, marketing and financial education, and the training of bank personnel. Using Treasury’s analysis conducted for ETAs would suggest that the tax credit be set at an amount between $20 and $50 per account opened.

Banks, thrifts, and credit unions could, under the First Accounts Tax Credit, experiment with a wide variety of techniques to expand access to banking services to low-income households.\textsuperscript{32} Banks could obviate concerns about individuals with credit problems by offering electronically based accounts that pose little risk of overdraft. Banks may experiment with accounts with savings features, including separate savings “buckets” within accounts. Similarly, banks could provide low-income individuals with a convenient and low-cost means of paying bills and wiring funds. Automated money orders, online bill payment, debit-card-based foreign country remittance, and other low-cost payment methods can help to reduce the cost of transactional services to the poor. Treasury estimated that adding a savings feature to an electronic account would cost

\textsuperscript{31} See Barr (2004); see also Michael Stegman, \textit{Savings for the Poor: the Hidden Benefits of Electronic Banking} (Brookings Institute, 1999).

\textsuperscript{32} Credit unions, which are not-for-profit corporations, could not directly take advantage of tax credits. It is possible to structure the tax credit so that for-profit subsidiaries or credit union service organizations could receive the tax credit for their services on behalf of the credit unions in offering the accounts. It would also be reasonable, however, to take the position that credit unions, which are tax exempt, 12 U.S.C. § 1768 (2000), because their mission is to serve “people of modest means,” 12 U.S.C. § 1751 (2000), should pass on the benefits of tax exemption to low-income persons by offering accounts tailored to their needs.
approximately $0.06 per month. ACH bill payment would cost $0.65 per month. Accepting direct deposits would decrease costs by $0.11 per month because of float income.\textsuperscript{33}

In addition, the First Accounts Tax Credit has the potential to help spur “leapfrogging” in technology for low-income financial services. To offer a few examples that could be subjected to the test of market feasibility: ATM networks and financial institutions could develop shared technological platforms to serve low-income households or create “surcharge free alliances” among debit networks in order to serve low-income customers. As access to the Internet expands in low-income communities, e-finance can increasingly be made available at Internet kiosks. Companies that are exploring ways to expand the use of cellular phones to transact financial services for high-income clientele could be encouraged to focus attention on expanding bank account access through pre-paid cellular phones used by low-income persons. Stored value cards could be used by the unbanked to conduct an array of transactions at low cost.

A First Accounts Tax Credit could also help to spur employer or union strategies to expand access to banking services. Banks using the tax credit could market new, low-cost banking services to employers for the firm’s employees. Employer-driven strategies to bank the unbanked have three potential strengths: large-scale, consistent access to workers, a structure for providing regular savings through direct deposit, and the ability to offer financial education. Large employers can reap significant benefits from moving more of their workers to direct deposit. Direct deposit would drive down their payroll processing costs, increase the effective take-home pay of their workers, and reduce

problems from theft or fraud associated with checks. Payroll cards might serve as useful starting points towards an increasing range of financial services—including bill payment, savings, and bank accounts—for low-income persons. Employers could work with banks utilizing a First Accounts tax credit to make available all-electronic bank accounts through which they could use their payroll cards.

2. The Earned Income Tax Credit

EITC recipients can become a central focus of efforts to bank the unbanked. Treasury should expand its Electronic Transfer Account (ETA) program to permit use of ETAs for EITC receipt. Congress should appropriate more funds for Treasury’s First Accounts program to support innovative efforts to reach EITC recipients without bank accounts. The IRS should establish partnerships with large employers to encourage employees to open bank accounts and establish direct deposit of paychecks and tax refunds. Moreover, the tax preparation firms themselves—as H&R Block has now begun to do in a recent pilot—should partner with banks to develop and offer individual, low-cost, electronically based bank accounts for their clients. Their clients could use the accounts to receive direct deposit of their income tax refunds, to pay for tax preparation services, to withdraw funds at ATMs and POS using debit cards, to save as a cushion for financial emergencies, and for their other financial services needs throughout the year. Tax preparers would gain a new marketing tool and might see better client retention.

Moreover, Treasury has now indicated in its FY 2005 budget that the IRS has the technical capacity to split refunds. The IRS should permit refunds to be direct deposited into more than one bank account. If refunds are permitted to be split into more than one account, tax preparers could compete by offering tax preparation services that are paid
not out of the proceeds of RALs, but paid directly to them electronically out of tax refunds through direct deposit to them of a portion of the refund, diminishing the risk to the preparer and eliminating one reason to take out a RAL. If this reform is combined with public and private sector efforts to bring EITC recipients into the banking system, the remaining portion of the refund could be direct deposited into the client’s own bank account or other saving vehicles. Initial results from a pilot savings program using refund splitting jerry-rigged by the Community Action Project of Tulsa County and the Doorways to Dreams Fund should promising savings results.34

3. State Policies and Welfare Reform

States should integrate access to financial services as a core element of welfare-to-work strategies. High cost alternative financial services undermine efforts to improve workforce participation by reducing effective take-home pay. Lack of structured savings mechanisms, such as direct deposit into a bank account, makes it less likely that new entrants into the workforce will save against liquidity crises from job loss, injury, or other family emergencies, and makes it more likely that such crises will push families back onto the welfare rolls. Moreover, lack of saving will reduce the ability of low-income families to save for homeownership, skills development, or their children’s education.

States should encourage account ownership. First, states should shift EBT to individually owned accounts. With many contracts now up for renewal, there is a narrow window within which states could choose to restructure contracts to use EBT to develop banking relationships. States could move towards providing EBT through individually

34 Beverly, Schneider, and Tufano (2004).
owned bank accounts and negotiate with networks for surcharge-free alliances for EBT-card holders. In so doing, states would be increasing the effectiveness of their welfare-to-work strategies by bringing low-income families into the banking system in preparation for their entry into the workforce.

Second, states should permit former welfare recipients to retain accounts after they move into the workforce. This step may decrease the likelihood that new labor force entrants will turn to check cashing services once employed and increase the likelihood that they will arrange for direct deposit of their income. Given the high turnover rates of households on and off welfare, permitting families to retain EBT-issued bank accounts may be important to those families’ financial stability. Owning a bank account would also enable these working families to access their tax refunds via direct deposit, reducing their costs for receiving the EITC quickly.

Third, state welfare initiatives should increasingly include Individual Development Account (IDA) programs, and exempt the full array of IDA programs from state asset limits. As part of the federal reauthorization of the 1996 Welfare Reform law, Congress should make funds available to states for these financial services initiatives.

4. Employer Sponsored Savings Plans

Employer based savings plans are also critical. As mentioned above, employers can encourage savings among low- and moderate-income workers by changing default rules. Treasury could expand tax incentives to small businesses offered under SIMPLE plans. Moreover, in 2001, Congress enacted a “Saver’s Credit,” which provides a progressive tax credit matching up to 50% of up to a $2,000 annual contribution to a low- or
moderate-income person’s retirement account. But 80% of those eligible for the 50% credit cannot take advantage of it because the credit is not refundable, and large portions of somewhat better off low- and moderate-income households cannot take advantage of the full credits for which they would otherwise qualify. A small but useful step would be to make the Saver’s Credit refundable, so that low- and moderate-income households with little or no income tax liability could benefit.

5. A National Savings Policy

More fundamentally, we need a real Ownership Society Proposal, one that is universal, progressive, earned by working, and provides savings opportunities in addition to the essential social insurance embodied in Social Security. President Clinton’s USAs and RSAs provided for such a savings plan, and variants of these approaches are still a good idea. The federal government should provide a progressive match through the tax code for households who save. Larger matches should be provided to those at the lower end of the income spectrum, rather than the approach taken in our current system, where the biggest tax benefits go to the wealthiest taxpayers, whose saving behavior is least affected by tax incentives. Progressive matches can be provided through refundable tax credits, as were the matches under USAs, or through tax credits to financial institutions that provide the match, as under RSAs. Experience suggests that the latter approach is more likely to be politically feasible, and such an approach may also induce larger numbers of financial institutions to participate in the savings plans. Higher participation by financial institutions may increase participation by more households.

35 See generally, Orszag and Greenstein (2003).
36 Orszag and Hall (2004).
B. Implications for Social Security Reform

The current Administration has proposed a dramatic expansion of tax advantaged savings vehicles and privatization of a portion of Social Security into individual accounts. These “ownership society” proposals share some of the rhetoric associated with the asset-building movement and “individual development accounts” in particular, but the similarity between these proposals and IDAs ends there. The essential normative claim of IDA advocates is that all of us ought to be included in this ownership society, and that policies that undermine our common stake in society go in the wrong direction. Sherraden’s call for a “universalist, progressive” savings policy is opposite from Social Security reform proposals that undermine social insurance in the name of individual accounts.

Individual accounts diverted from Social Security, as Peter Orszag and Peter Diamond have shown, will undermine the progressivity and social insurance functions of Social Security. Moreover, it will expose households to individualized market risk, significantly increase administrative costs, and harm the solvency of the Social Security Trust Fund, in whose name the proposal is offered. Moreover, as Orszag has elsewhere argued, the structure of the Administration’s proposal for individual accounts amounts to a 6% variable-rate loan to households to permit them to play the stock market. If they hit a six percent return, they break even. If they don’t hit that return, they have to pay back the shortfall in reduced benefits from the combined individual and Social Security accounts.

V. Conclusion

Recent research in behavioral economics supports the view that institutional structures affect individual decisions to save and that rational choice models provide incomplete explanations for behavior. The American Dream Demonstration broke new ground by examining how institutional factors affect savings among low-income households. The Demonstration provides further evidence regarding the importance of institutional design to household financial decision-making. In doing so, the Demonstration has contributed to our understanding not only of the constraints facing low-income households, but also the opportunities private sector employers and national policy makers have to increase the likelihood that households can save. That deeper understanding will prove critical as we debate the future of Social Security and tax reform in the years ahead.