Building Middle Class Wealth with American Development Accounts

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INTRODUCTION

U.S. social policy traditionally has emphasized supporting income for low-income families, to the neglect of wealth-building strategies.[1] While income supports are essential for covering daily expenses, upward mobility depends on saving and building personal assets, especially completing post-secondary education, purchasing a home, or creating a business.[2]

Moreover, inequality of *wealth* in America is worse than *income* inequality. That's why it's time for a new approach to empowering low-income and working Americans. U.S. social policy in the 21st century should stress social investment and wealth creation, not just income transfers to support consumption. This report proposes a new policy – American Development Accounts (ADAs) – intended to help younger workers and blue-collar households rise into the middle class by enabling them to save and accrue assets.

> Inequality of *wealth* in America is worse than *income* inequality.

ADAs would be available to all workers contributing to a defined contribution savings plan, funded by reducing tax breaks that favor wealthy individuals, who stand to benefit enormously from the Trump-GOP tax cuts passed last year. Specifically, this report proposes a return to reasonable estate tax exemptions and rates, as well as trimming or eliminating tax preferences that

disproportionately favor the wealthy and thereby deepen economic inequality in America.

By progressively matching workers' contributions to ADA savings accounts, both public programs and private employers could accelerate their accumulation of valuable personal assets. As the wealth gap closes, more working families would rise into the middle class and reclaim the American Dream.

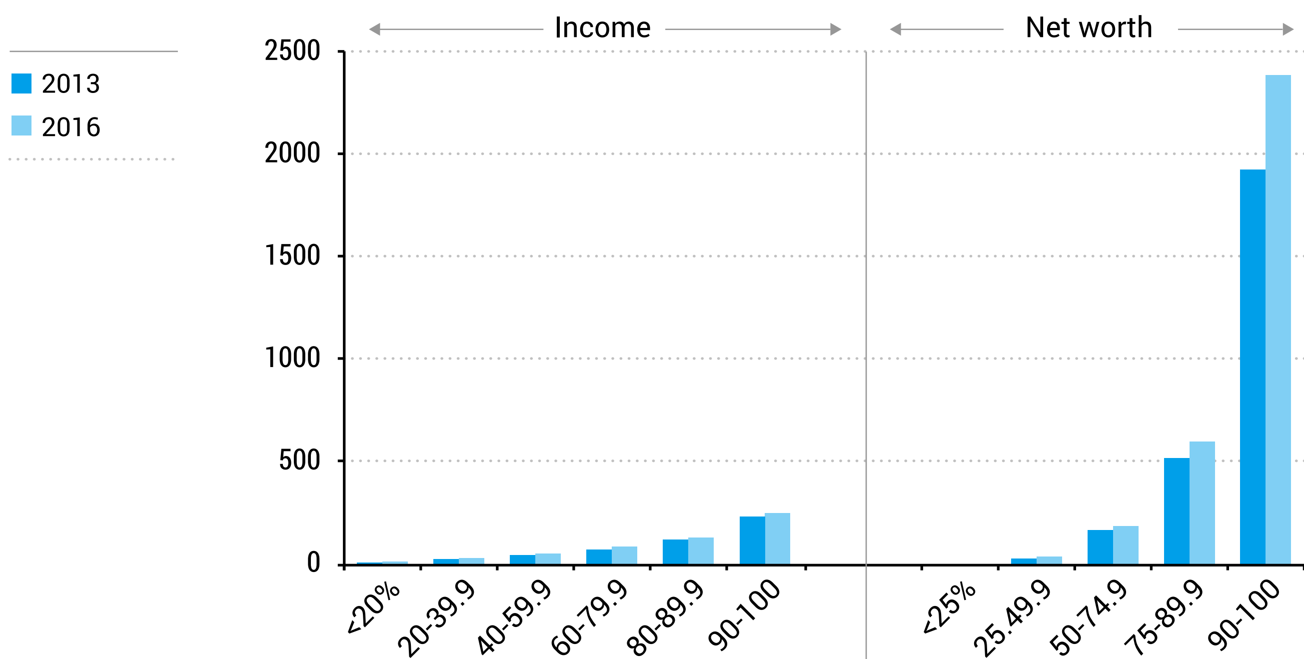
Field experiments have demonstrated that incentives increase savings of low-income households significantly while making sizable reductions in financial hardship and dependence on subprime lenders.

Moreover, ADAs reflect a larger movement to increase the savings rate of Americans, which has declined by more than half since 1950,[3] as well as more specific initiatives to instill thrift in youngsters, evident in the proliferation of Child Savings Accounts.[4]

THE WEALTH GAP

The American promise of prosperity for all has foundered on the shoals of slow productivity growth and rising economic inequality. While considerable attention has focused on income inequality, wealth disparities are far worse, especially for blue-collar households. The Great Recession of 2008 erased the savings of many working class families; between 2005 and 2009 the median wealth of white families fell 16 percent, but plummeted 53 percent for African Americans and 66 percent for Hispanics.[5] Well into the recovery from the Great Recession, disparities in wealth continue to widen, as depicted in Figure 1. Promising minimal income benefits to most American households over the coming decade, the 2017 Tax Cuts and Jobs Act vastly increases the wealth controlled by affluent families.[6]

FIGURE 1: Median Household Income and Net Worth in Thousands of Dollars[7]



While the top 10 percent's income and wealth grows rapidly, the lower 40 percent of households experience marginal improvement. The average income of families in the top tenth has increased 9 percent from 2013 to 2016, rising to $251,500, compared to 3 percent for the bottom 20 percent, growing to $16,200. The wealth gap is even greater: From 2013 to 2016 the top tenth's wealth increased 24 percent, rising to $2.4 million per household, while the bottom quartile's rose from zero to only $200. Among lower income groups, whites have lost significant wealth following the Great Recession, their net worth plummeting from $42,700 in 2007 to $22,900 in 2016. For 2016, the net worth of Hispanics was $7,900 and for blacks $5,000, the approximate value of a used car.[8] The minimal income gains of the bottom two quintiles of families, in other words, translate to negligible wealth for the bottom quarter of American households.

Americans also have experienced less upward mobility than have citizens of many developed countries, including Danes, Germans, Canadians, and Britons.[9] While 90 percent of American children born in 1940 earned higher incomes than their parents, only 50 percent of those born in 1980 fare as well.[10] One-third of children growing up in the bottom quintile are still there as adults, while 60 percent remain stuck in the bottom two quintiles. Only one-tenth of children born in the lowest quintile migrate to the top quintile as adults.[11] Seventy percent of families earning less than $40,000 expect low income to continue into the future, while 9.1 percent expect their income to drop.[12]

Adults hoping to improve their lot through higher education often borrow to pay for tuition, but become saddled with increasing educational loan debt, which grew 15 percent from 2013 to 2016, from $29,800 to $34,200.[13] Adverse household finances and diminished upward mobility depress aspirations: 15 percent of Americans who have completed some college say that the American Dream is "out of reach,"[14] as do 24 percent with a high school diploma or less.

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Plummeting prosperity has left many working class families struggling to reconcile static incomes with rising expenses, leaving them shuttling between low-wage work and social assistance. Among workers between 25 and 60, nearly 35 percent experience economic insecurity (welfare receipt, poverty-level wages, and unemployment benefits) for five or more years.[15] Households operating on the economic margin experience greater financial volatility compared to more affluent families: Of households reporting less than $40,000 in annual income, 19 percent have expenses exceeding income, and 13 percent report no income at all; 54 percent struggle to pay bills on time, and 46 percent do not have sufficient savings to cover a $400 emergency.[16]

Families experiencing chronic or episodic economic hardship often confront a lose-lose scenario: either sacrifice savings or resort to subprime lenders. More than one-fourth of individual retirement accounts are depleted for non-retirement purposes.[17] More than one-fifth of households with less than $40,000 in income seek loans with high fees and interest, which carry APRs of over 300 percent, to keep their financial boats afloat.[18] Subprime loans further

subtract from the fragile family finances of lower-income households, effectively stripping the meager wealth of working class families.[19]

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Dwindling opportunity for working class families has reverberated in many ways. Between 1979 and 2009, 8 million manufacturing jobs were lost to automation or overseas outsourcing, consigning many blue-collar workers to lower-paying service sector jobs.[20] As households have struggled with stagnant incomes, the mortality rate of white men has increased compared to Hispanic and African American males. "Deaths of despair among those without a university degree are primarily the result of a 40-year stagnation of median real wages and a long-term decline in the number of well-paying jobs for those without a bachelor's degree," say Anne Case and Angus Deaton.[21]

Deindustrialization has political consequences as well. In 2016 many disillusioned workers reacted to scarce opportunity by defecting from the Democratic to the Republican Party. Well before their allegiance shifted and vaulted Donald J. Trump into the White House, voters of previously competitive states in the industrial heartland – Ohio, Wisconsin, Illinois, Michigan, and Indiana – had been voting increasingly for GOP legislatures and governors. The political lesson is clear: Repairing the damage to working class families in the Rust Belt, in low-income urban neighborhoods, and in rural and small-town America will require a robust policy response.

BUILDING WEALTH: THE PATH TO ECONOMIC SECURITY

Accumulating assets is crucial for any family's prosperity. It enables us to stabilize volatile finances, make house and car payments during periods of financial distress, translate tax subsidies into savings, facilitate long-range planning, and pass on something to our heirs. Regardless of metaphor – ant v. grasshopper or teaching people to fish v. giving them one – thrift is a common sense virtue since it prepares households for an unpredictable future. Michael Sherraden, founder and director of the Center for Social Development, notes the multiple benefits of building wealth:

> **Simply put, people think and behave differently when they are accumulating assets, and the world responds to them differently as well. More specifically, assets improve economic stability; connect people with a viable, hopeful future; stimulate development of human and other capital; enable people to focus and specialize; provide a foundation for risk taking; yield personal, social, and political dividends; and enhance the welfare of offspring.**[22]

Yet, most U.S. social programs do not encourage saving. The bulk of federal funding for lower-income households goes to support their ability to consume rather than their ability to save. Consider these pillars of the U.S. welfare state: Social Security, unemployment insurance, the Personal Responsibility and Work Opportunity Reconciliation Act (also known as cash welfare), the Supplemental Nutrition Assistance Program (SNAP, formerly food stamps), and Supplemental Security Income, which together cost $2.3 trillion

in 2011.[23] Not only are conventional social insurance and public assistance programs predicated on consumption of benefits as opposed to savings, but most welfare programs also terminate benefits once minimal asset limits – often $2,000 – have been breached.

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To be sure, other federal policies do encourage savings and asset building, indirectly and directly. Indirectly, tax expenditures for pensions, mortgage interest, capital gains on assets transferred at death, and preferential tax rates for capital gains and dividends totalled $411 billion in 2013. However, these tax breaks overwhelmingly benefit upper-income Americans. Over half the value of such tax expenditures flows to the top 20 percent of households, while the bottom fifth gets only 8 percent.[24] Such tax breaks help affluent families augment their wealth by purchasing vacation homes, paying tuition for private schools or college for their children, and adding to their investment portfolios. Direct funding to encourage lower-income families to accrue assets has been anemic by comparison.

What form should new wealth-building strategies take? One model is Singapore's Central Provident Fund, which requires workers to save for retirement, housing, and healthcare. The Fund is credited with helping the city-state become one of the wealthiest jurisdictions on the planet.[25] On a far more modest scale, the Clinton administration in 1998 pioneered the Assets for Independence program, which created Individual Development Accounts (IDAs) to encourage low-income families to build assets. While IDAs showed promise through the American Dream Demonstration in the 2000s,[26] funding was limited to $25 million a year and then lapsed altogether in 2017.[27] Some states have tried similar approaches. For example, workers in Illinois can contribute up to 3 percent of wages into Secure Choice, an Individual Retirement Account,[28] and California plans to implement a similar initiative in 2018.[29] However, such pension reform does nothing to encourage workers to build wealth they can use *before* they retire.

AMERICAN DEVELOPMENT ACCOUNTS

IDAs point in the right direction, but we need a far more powerful policy lever to help younger and blue-collar workers start narrowing the wealth gap. Recent developments in behavioral economics, asset building, and tax policy provide the template for a robust and innovative initiative for enhancing the wealth of working class households. A large-scale system of American Development Accounts (ADAs) would enable more workers to contribute to a tax-exempt account they could use for a variety of asset-building purposes: paying for college or skills certificates, buying their first home, or launching a business. Employers could make matching contributions on a sliding-scale basis to augment workers' savings.

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Here's how ADAs would work. Workers would establish ADAs in two ways: eligible first-time workers would be enrolled automatically in ADAs, unless they opt out, electing to have 2 percent of

wages diverted to a tax-exempt asset-building account. Or, low-wage earners who already are working could establish ADAs when they apply for the Earned Income Tax Credit (EITC).

For low-income workers, government would match contributions progressively. Matching would be set in relation to the median wage, now $18/hr., so workers earning up to five-sixths of the median wage, or $15/hr., would have savings matched 1:1, while those earning less than half that, or $7.50/hr., would be matched 2:1. Workers earning from five-sixths to 150 percent of the median wage, or $27/hr., would be able to claim an ADA savings credit limited to 3 percent of annual income.[30] In this way, the matching of workers' savings would track wage growth, delivering the greatest benefit to lower-wage workers and declining as they move up the economic ladder.

Progressive matching has been shown to increase savings significantly. A 2005 field experiment where low-income recipients of the EITC were offered 20 and 50 percent incentives to save their refunds to augment an Individual Retirement Account found tax filers saving $1,102 and $1,108, respectively.[31] A 2016 field experiment of low-income adults found that IDAs not only increased pre-match savings an average of $799 per year; they also reduced financial hardship 34 percent and reliance on subprime financial services 39 percent.[32]

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As with IRAs, workers and the self-employed would manage their ADAs, which would be invested in index funds with low investment costs. Workers would be apprised of the status of their accounts monthly.

Matching ADA savings of lower-wage workers would directly reduce America's wealth gap. At $7.25/hr., a single minimum wage worker earns about $13,500/yr., just above the federal poverty level of $12,060 — barely enough money to live day-to-day, let alone put anything aside to meet future expenses. Even at $15/hr., a parent with two children earns $27,000, low enough to leave them eligible for SNAP and Medicaid in many states.[33]

Thanks to matches and compound interest, workers with ADAs would experience significant savings, although amounts would vary with earnings. Including matching funds, minimum wage workers earning $7.25/hr. would save $783/yr., while those earning $15/hr. would save $1,080/yr. Households with two workers having ADAs would double these amounts, which could also promote family stability. These savings would not only increase with subsequent pay raises, but also grow in relation to the performance of index mutual funds, currently yielding 15.54 percent over five years.[34] Within a few years, savings under ADAs would be sufficient for the 42.4 percent of workers (48.1 percent of women, 54.1 percent of African Americans, and 59.5 percent of Latinos) earning less than $15/hr. to upgrade their skills, save for a down payment on a home, or become entrepreneurs.[35]

Employers could also match their workers' ADA savings as a way to attract and keep good employees. And charities and nonprofit groups could also augment ADA accounts to accelerate upward mobility in their communities. Because of volatility from income loss and expense shocks,[36] lower-income households often deplete savings accounts, so ADAs would be penalized for withdrawals for the first two years.

HOW TO FINANCE WEALTH-BUILDING ADAS

The public cost of ADAs would vary with workers' take-up rate. Assuming a 70 percent participation rate,[37] ADAs would benefit 41.3 million workers. Federal spending on ADA matches for minimum wage workers would cost $2.8 billion per year, while subsidies for workers earning up to $15/hr. would cost $22.9 billion, totaling $25.7 billion annually. An ADA tax credit for workers earning up to $27/hr., limited to 3 percent of income, would represent a minor revenue loss to the Treasury.

Although an ADA program would be a significant new social investment, its cost pales in comparison to the $1.5 trillion price tag on the Trump/GOP tax bill. In fact, the best way to fund ADAs is to close tax loopholes that concentrate wealth among a relatively small number of highly affluent individuals. For example, the tax bill's estate tax exemption for couples of $11.2 million and top tax rate of 40 percent are projected to benefit the wealthy to the tune of $6.8 billion in 2018. If instead Congress returned the estate tax to 2009 provisions, with a $3.5 million exclusion and 45 percent top tax rate, it would generate $24.5 billion.[38] Eliminating the "carried interest" loophole – which the new Trump/GOP tax bill somehow failed to do – would generate $2 billion per year,[39] while terminating 529 plans, which overwhelmingly benefit wealthy families, would produce $3 billion annually.[40]

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That's more than enough to cover the initial cost of ADAs. But, if we need more money to support the program's future growth, we could turn to tax rates on capital gains, which disproportionately flow to affluent Americans. The tax rate for capital gains is limited to 20 percent, a windfall for the wealthy who would otherwise pay as much as 39.6 percent (plus a surcharge of 3.8 percent on high-income taxpayers). For 2017, the tax expenditure for capital gains was $110.3 billion. Reducing the preferential rate for capital gains by 10 percent would produce $11 billion.[41] In short, modest adjustments to the Trump/GOP tax bill can generate more than enough money to build working class assets without impairing U.S. economic performance.

CONCLUSION

A progressive response to rising economic inequality, which focuses only on income support and household consumption, is insufficient to accelerate the upward mobility of working class families. The American Dream used to promise that workers could earn decent wages or start businesses – permitting their children a good education, their families decent homes, and a secure retirement at the end of a life of hard work. Eight decades later, the American Dream has become more elusive as work is unpredictable, high wages are elusive, and debt is corrosive for many working families. By contrast, the wealth building strategy of ADAs offers blue-collar families a ticket back into the middle class.

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