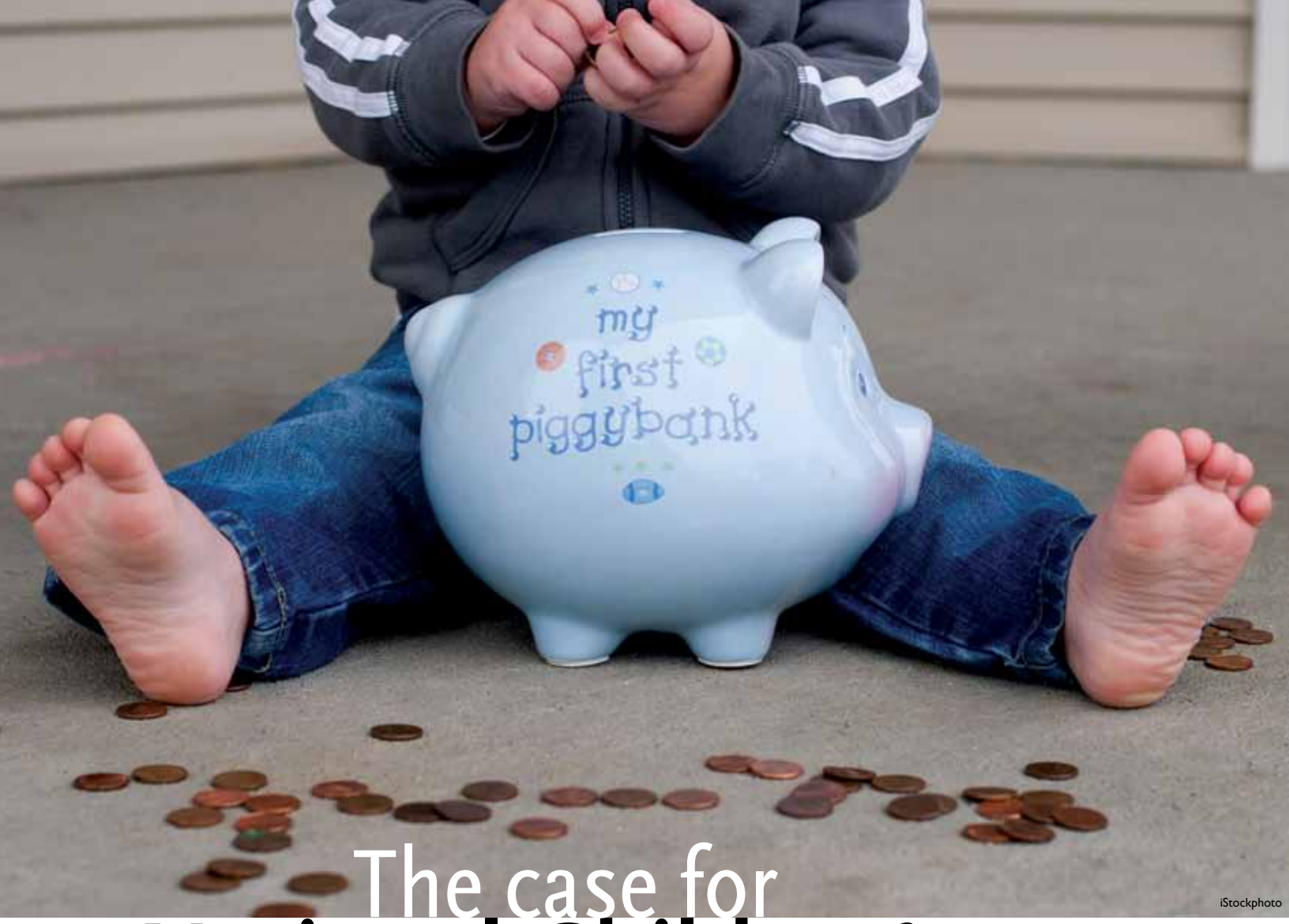

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The case for National Children's Savings Accounts

by Barbara A. Butrica, The Urban Institute

On June 17, 2009, Senator Blanche Lincoln (D-AR) and the Aspen Institute Initiative on Financial Security launched a campaign to create Child Accounts, a savings program for every American child. In recent years, strong interest in children's savings accounts (CSAs) has emerged. The accounts are being promoted to improve financial literacy, increase the number of low-income households that are banked, and encourage saving for education, homeownership, or retirement.

What Are Children's Savings Accounts?

CSAs are savings accounts opened in children's names to help them develop a strong social and economic footing. The accounts are rooted in the idea that asset accumulation is key to improving the lives of low-income people.[1]

Although they vary in design and objective, most CSAs are established with an initial government deposit. CSA proponents prefer to provide all participants with the same seed amount, but the seed could be means-tested—for example, it might decline with income and eventually fall to zero for those with income above some threshold. Since families are not obligated to contribute, the seed encourages private saving simply by providing bank accounts and financial education.

Some CSAs also include a supplemental means-tested grant that the government would make in the initial year only or, alternatively, periodically throughout the years. Like seed funding, supplemental grants aim to improve welfare gains and require no additional private saving.

Studies suggest that matches provided against private contributions might encourage additional private saving. Accordingly, some CSAs include government matching funds, with match rates that decline with household income.[2]

Current Programs

Countries such as the United Kingdom, Canada, Singapore, and South Korea have already implemented or are considering implementing CSAs.

The United Kingdom began its Child Trust Fund in 2005. Accounts receive a government deposit of £250 (approximately $500) at birth and are administered through the private sector. Children in the poorest families receive an additional £250. The government makes another deposit of £250 to children's accounts on their seventh birthday, and an additional £250 to children in low-income families. Families and friends can make tax-deferred contributions up to £1,200 (approximately $2,400) each year. The account accrues tax-free interest until the child's 18th birthday, when it automatically becomes an adult savings account. Withdrawals before age 18 are prohibited, but there are no restrictions on how the funds can be spent once the accounts mature. As of April 2008, the program had created 3.42 million accounts valued at £1,765 million.

Canada began offering children's savings accounts in 1998. Canada's accounts are provided through Registered Education Savings Plans (RESPs), in which the savings are earmarked for postsecondary education. They are opened through financial institutions and feature lifetime tax-deferred private contribution limits of $50,000. Through the Canada Education Savings Grant (CESG), the government annually matches up to $600, depending on income level, for private contributions of at least $2,500. The lifetime limit for those grants is $7,200.

In addition, the government deposits Canada Learning Bonds (CLBs) worth $500 into accounts of children in low-income families. As long as the family is eligible, the child's account will receive annual $100 supplements up to age 15. There are no age limits for RESPs, but the savings incentives are available only to children under age 18. As of March 2007, the program had created 2.94 million accounts. The government paid $3.4 billion in CESGs and $24 million in CLBs. Combined assets in RESPs, which include accounts for people age 18 and older, were valued at $22.3 billion.[3]

Although the United States lacks a national CSA program, proposals are under consideration, including one from the Aspen Institute Initiative on Financial Security, which recommends giving every newborn a savings account of $500.[4] Families and friends could make after-tax contributions of up to $2,000 a year, and the government could make dollar-for-dollar matches of up to $1,000 a year, depending on family income. Accounts would not be accessible until age 18, after which the balances could be used for any purpose.

The New America Foundation's proposal for the America Saving for Personal Investment, Retirement, and Education Act (The ASPIRE Act) has features similar to the Aspen proposal. At birth, children would receive a $500 government deposit in a Kids Account. Depending on family income, some children would receive a supplemental contribution of up to $500. After-tax private contributions would be permitted up to $2,000 a year and would be matched by the government up to $500 a year, depending on income level. Withdrawals would not be permitted until age 18. Between ages 18 and 25, account balances could be used only for higher education. After age 25, balances could be used for homeownership or retirement in accordance with Roth Individual Retirement Account regulations.

What Can Be Achieved?

The Center for Social Development is leading a demonstration project on children's savings accounts and has some early results. The Saving for Education, Entrepreneurship, and Downpayment (SEED) demonstration, which enrolled its first participants in 2003, currently operates in 10 sites across the United States and Puerto Rico and includes 1,171 participants. All SEED accounts received an initial deposit of up to $1,000. Match dollars are available to encourage private contributions. Many programs also use benchmark incentive dollars—for example, for staying in the program or attending financial education classes—to increase account balances. By December 31, 2007, SEED account balances were $1,518 in nominal dollars at the mean and $1,093 at the median.[5]

Analysis of the longer-term effects of such policy options requires computer simulation techniques such as the Urban Institute's Dynamic Simulation of Income Model (DYNASIM3).[6] The author and co-researchers used projections from DYNA-

SIM3 to estimate the impact of CSAs on families' savings. The simulation assumes an initial federal deposit of $500 for all newborns, a supplemental grant up to $500, private contributions up to $1,000 per year, and as much as a dollar-for-dollar government match on private contributions. Government grants and interest earnings are not taxed. They find that such CSA account balances will be modest.[7] Considering inflation, their purchasing power will average only $2,413 in 2008 dollars at age 18.[8]

More important, however, are three observations relevant for any asset-building program. First, a government match significantly increases both the rate and level of private contributions to CSAs. Second, a significant portion of CSA means-tested benefits will accrue to higher-income families because of economic mobility. Two-thirds of children born into the lowest income group will end up in an income group above that when their accounts mature. Third, exempting CSA savings from taxation will distribute significantly more benefits to higher-income groups than to lower-income groups.

Undoubtedly, CSAs can increase savings. However, the benefits accruing specifically to low-income children will depend on such design features as matching contributions, targeting, and taxability. Some people may question why CSAs are even being discussed in the midst of a recession. But every dollar saved makes a difference. Compound interest alone can have a significant impact on the size of future account balances.

Although CSA balances will likely be modest and not enough to pay for college, a house, or retirement, such accounts can serve important purposes. They can improve financial security by helping young adults weather emergencies, job losses, and even future recessions. They also can improve financial literacy by getting children, especially in low-income families, into financial instruments which, in demonstrating the value of saving and compound interest, may actually encourage them to save more.

Barbara Butrica *is a senior research associate with the Urban Institute in Washington, DC.*

Endnotes

[1] See Michael Sherraden, *Assets and the Poor: A New American Welfare Policy* (Armonk, New York: M.E. Sharpe, 1991).

[2] Esther Duflo, William Gale, Jeffrey Liebman, Peter Orszag, and Emmanuel Saez, "Saving Incentives for Low- and Middle-Income Families: Evidence from a Field Experiment with H&R Block," *Quarterly Journal of Economics*, forthcoming.

[3] "Review of Registered Education Savings Plan Industry Practices" (Informetrica Limited report, prepared for Human Resources and Social Development Canada, Ottawa, Ontario: 2008).

[4] Lisa Mensah, Pamela Perun, and Elena Chavez Quezada, "The Case for Child Accounts" (Washington, DC: Aspen Institute, 2007).

[5] Lisa Reyes Mason, Yunju Nam, Margaret Clancy, Vernon Loke, and Youngmi Kim, *SEED Account Monitoring Research: Participants, Savings, and Accumulation* (St. Louis: Center for Social Development, 2009).

[6] See Melissa M., Favreault, and Karen E. Smith, "A Primer on the Dynamic Simulation of Income Model (DYNASIM3)," (The Urban Institute Retirement Project discussion paper 02-04, Washington, DC, 2004). DYNASIM3 uses a representative U.S. population, starting with individuals from the 1990-to-1993 Survey of Income and Program Participation. It ages the sample in yearly increments to 2080, using parameters estimated from longitudinal data sources, and integrates important trends—in birth, death, schooling, leaving home, first marriage, remarriage, divorce, disability, work, and earnings. DYNASIM3 also simulates major sources of wealth and income, and federal and state income tax liabilities.

[7] Barbara A. Butrica, Adam Carasso, C. Eugene Steurele, and Desmond J. Toohey, "Children's Savings Accounts: Why Design Matters" (The Urban Institute Opportunity and Ownership Project Report 4, Washington, DC, 2008).

[8] This assumes a nominal interest rate of 5.8 percent and inflation of 2.7 percent for a real growth rate of approximately 3.0 percent.