

The Roth at Birth

Building Financial Capability and Putting the Time Value of Money to Work for Young Americans

Ted Beck, President and CEO, National Endowment for Financial Education
Ray Boshara, Senior Advisor, Federal Reserve Bank of St. Louis¹

Concept note prepared for
The President's Advisory Council on Financial Capability
December 2011

Starting Children on the Road to Financial Stability

There is a national opportunity now to leverage a simple fact: early savings in a child's name promotes financial capability, college graduation, and retirement security. And one of the greatest resources of youth is the time value of money. Embedding wealth accumulation at birth into tax-favored savings accounts can add 18 to 30 additional years of compounded interest to the value of young Americans' net worth, as well as create and improve positive financial behaviors over their lifetimes. Accordingly, we recommend the creation of a "Roth at Birth" account, a voluntary financial product that could easily be created by a simple modification to the earned income rules of existing Roth IRAs—allowing children to use their parents' earned income limits to make contributions. Early savings in a Roth account would help introduce the importance of self-responsibility for one's financial future at a young age and embed engagement during the formation of the child's financial behaviors. No new federal funding would be required to create a Roth at Birth.

The Proposal: Roths at Birth

The Roth at Birth account would be a distinct financial product that uses the parents' earned income to determine allowable contributions levels (presently \$5,000, and \$6,000 for those 50 and older). This would allow contributions to an account owned by a child to come from that child, the child's parents or grandparents, and any others provided that the contributions from all sources combined (as well as contributions to other Roth IRAs the parents may own) do not exceed the current allowable annual contribution levels—that is, overall contribution levels would not change with the creation of the Roth at Birth. A legislative precedent exists for the Roth at Birth: the Young Savers Account proposal of Senator Max Baucus, which we further discuss below.

Precedent for modifying the earned income rules. There also is precedent for modifying the earned income rules (that is, the requirement that contributions come from "taxable compensation") in Roths. These rules—which do not allow contributions from investment income, dividends and interest payments, capital gains, pensions, Social Security, annuities, inheritances, and insurance proceeds—were designed to encourage work and to limit (along with contribution and income caps) contributions from higher-wealth households that are less likely to need tax incentives to save and build retirement wealth. However, Congress did carve out one exception to the earned income requirement: non-working spouses can have Roth accounts in their names if the family otherwise qualifies. Roths at Birth would, then, extend the ability of qualifying households to create Roths for other family members generally lacking taxable compensation—children under the age of 18.

¹ The views expressed here are my own views and not necessarily the views of the Federal Reserve Bank of St. Louis or the Board of Governors of the Federal Reserve System.

Added benefit: a national financial education opportunity. Years of experience and recent conversations suggest that a national mechanism for Roths at Birth would allow communities and schools to build locally-relevant financial education programs and create local support for making those programs available to everyone throughout their life stages and events. This community-based focus also could include local matching funds from nonprofit and other sources aimed at low-income individuals.

Evidence that Early Savings Improves Financial Outcomes

Research suggests that saving and asset ownership lead to many positive social and economic outcomes:

Economic and educational benefits:

- Youth who own an account are seven times more likely to attend college than those lacking accounts—even after controlling for parental education, family income, race, academic achievement and other factors. (William Elliot and Sondra Beverly, 2011)
- Financial capital, along with family structure and educational attainment, are the three strongest predictors of economic mobility in America. (Stuart Butler, William Beach and Paul Winfree, 2008)
- Controlling for other factors, net worth is the strongest driver of opportunity for the next generation. (Dalton Conley, 2009)
- Controlling for family income and other characteristics, financial and non-financial assets are positively related to children’s educational achievement, while unsecured debt is negatively related. (Min Zhan and Michael Sherraden, 2009)

Financial capability benefits of combining accounts and financial education:

- Some studies show that financial know-how is the *result* of regular saving, instead of the source. (Marianne Hilgert, Jeanne Hogarth, and Sondra Beverly, 2003)
- Research and literature reviews found that “combining financial education and accounts seems to have a number of positive effects for some consumers, including active use of accounts; enrollment in financial education; demonstrated acquisition of knowledge; and changed behaviors.” While the researchers caution that it is hard to determine what, exactly, generates those outcomes, their review suggests that it is “...the goal- and action-oriented aspects of combining education and accounts, whereby consumers are provided with a vision, or financial goal, and provided a practical way to apply the knowledge and skills gained from financial education to reach that goal.” (Christi Baker and Doug Dylla, 2007)

Benefits of accumulating assets early in life, and at the right times:

- The presence of even small amounts of wealth at the right times can have a "transformative" effect on the life course. (Thomas M. Shapiro, 2004)
- Child development accounts in the U.S. SEED Initiative instill a sense of security, reduce stress, encourage thrift, and provide a sense of hope for the future. (Michael Sherraden and Julia Stevens, 2009)
- Several recent studies report that children who grow up in homes with financial assets have lower rates of teen pregnancy, fewer behavioral problems, better self-esteem, more confidence, and a future orientation. (Trina Williams Shanks, 2005)

Saving Early: Realizing the Power of the Time Value of Money

Roth IRA accounts, with their requirement that contributions come from taxable compensation, effectively prevent children from receiving the long-term benefits of tax-advantaged savings until they enter the workforce one or two decades later. In practice, many young Americans put off opening and

contributing to Roth accounts even longer, giving up another 10 or 20 years of habitual savings and effortless compounded interest. Table 1 illustrates the enormous benefit of starting early with relatively modest initial and annual deposit amounts for families with earnings below the Roth contribution income caps.

Table 1.

Age Begin Saving	Initial Deposit	Annual Deposit	Rate of Return	Balance at Age 65
25	\$500	\$250	5%	\$35,229
Birth	\$500	\$250	5%	\$131,829
			<i>Difference</i>	<i>\$96,600</i>
25	\$500	\$250	7%	\$60,889
Birth	\$500	\$250	7%	\$347,393
			<i>Difference</i>	<i>\$286,504</i>

Questions Regarding Roths at Birth

Is the financial services industry interested in these accounts? Preliminary conversations with financial services providers indicate strong interest in the Roths at Birth product: They see the potential of this low-risk method to build customer relationships as early as birth while engaging the entire circle of a child’s parents and relatives. Already, according to Kiplinger, TD Ameritrade offers IRAs for children with no investment minimums or annual fees; Scottrade offers IRAs for minors with no annual fees or set-up costs and a minimum investment of \$500; and Charles Schwab allows minors to open Roths with no fees and a minimum balance of \$100.

Would the accounts qualify for CRA credit? Investments by financial institutions to support Roths at Birth for low- and moderate-income (LMI) children would likely qualify for CRA credit. Preliminary, although unofficial, analysis by the Federal Reserve indicates that such investments would be treated like investments in Individual Development Accounts (IDAs) and would thus likely trigger CRA credit under the “Investment” or “Service” tests. Possible qualifying investments aimed at LMI households include offering and holding Roths at Birth; providing matching or initial contributions to the accounts; or making grants to nonprofit organizations that support Roths at Birth.

Can the accounts be pledged as collateral? Although Roth at Birth accounts in a child’s name likely would require an adult custodian until the child reaches age 18, account funds would be protected solely for the child. Roths at Birth could not be pledged as collateral against loans or other debts, or subject to any other usage by the minors’ parents or guardians.

Are there restrictions on withdrawals? We would not modify existing Roth IRAs rules that allow owners to withdraw their own contributions (as distinct from earnings) at any time without taxes or penalties, although we hope that other efforts might be made to make the deposits “sticky”— i.e., hard to withdraw. We also would keep in place all existing Roth distribution rules that allow, with some restrictions, tax and/or penalty-free withdrawals for higher education, first-home purchase, medical expenses, retirement and other expenses.

How would the accounts affect eligibility for means-tested public assistance programs? Policymakers and states are gradually excluding savings and assets in determining eligibility for means-tested public assistance programs, but the progress has been uneven across states and programs. Retirement accounts (such as Roths and 401(k)s) and education accounts (such as 529s and Coverdells) are now excluded in determining eligibility for the food stamp (or SNAP) program, while all forms of savings count against the asset limits, which are very low, in the SSI program. TANF and Medicaid eligibility, meanwhile,

may or may not be affected by savings levels, depending on the state. To avoid confusion, save significant administrative dollars by public agencies, and allow struggling families to maintain much-needed assistance while saving for their financial independence, we suggest language at the creation of the Roth at Birth stating that *all* amounts in Roths at Birth be excluded from determining eligibility for any means-tested public program.

Would federal student aid be affected? Roths at Birth would be treated as retirement assets and therefore not assessed in family asset calculations for federal student aid on the FAFSA application.

Why Roths instead of other financial products aimed at children? In Table 2 we compare some of the main features of Roths to 529s, basic savings accounts, and Coverdells. While state-based 529 plans hold real potential for scalability and universality at the state level, including several features attractive to children in low-income households (see Center for Social Development materials available at <http://csd.wustl.edu/pages/default.aspx>), we believe this table illustrates that the Roth offers the flexibility, longer-term wealth-building features, and ease of scalability to achieve more widespread national use at this time. The Roth also is easily modified, would require no new federal funds, and already incorporates some features (such as the Savers Credit tie-in) attractive to lower- and moderate-income households.

Evidence that Children and Families Will Save in Roths at Birth

U.S. demonstration projects and other efforts suggest that even low- and moderate- income children and families will save in Roths at Birth, should they be offered:

- Both the American Dream Demonstration (ADD), which tested Individual Development Accounts, and SEED, which tested Child Development Accounts, found savings ranging from approximately \$10 to \$20 per month per household across all income ranges (up to 200% of poverty), with even greater rates of savings among the poorest in the ADD demonstration.
- The Center for Social Development found modest but meaningful savings in 529 accounts by low-income families in Oklahoma, while a dozen states currently offer matching deposits to low-income citizens who save in 529s.
- Various tax-time savings initiatives organized by the Doorways to Dreams Fund (D2D) generated savings among low-income taxpayers, including those with very low incomes. A recent D2D experiment with savings bonds, for example, found that “up to 10 percent of low-income tax filers ordered savings bonds with their tax refunds, when offered the opportunity in pilot tests conducted between 2006 and 2009. Most said they saved for their children and grandchildren; nearly a third developed a savings habit, buying bonds year after year.” Also, the newer “Refund to Savings Initiative,” a project of UNC-Chapel Hill, Duke and Intuit, has found lower-income taxpayers responsive to savings prompts.
- Experiments around the world, in both developed and developing countries, have demonstrated both a high demand for and an ability to generate savings by very low-income families.

The key insight gleaned from these efforts in the U.S. and worldwide is that income is *not* the most important predictor of who does and does not save. What matters more is who has access to a structured savings opportunity—whether that opportunity was set up by an employer (such as a 401(k)); by a community-based organization (such as IDAs); by a financial institution (such as a small-dollar lending program); by a VITA site (such as the D2D savings bond program); by a school; or by a state’s 529 college savings plan.

Scaling Up and Generating Deposits in Roths at Birth

Embedding Roths at Birth in existing institutional structures that facilitate savings will make the accounts more widely available while requiring no new federal funding. Simple changes to existing policies and procedures can build usage quickly:

- Enable Roth at Birth accounts to be opened automatically on tax returns. Encourage families to save a portion of their tax refund automatically into their Roth at Birth account(s) using IRS Form 8888, or the “split refund” option on the IRS 1040 forms.
- Encourage employers to set up automatic payroll deductions, possibly through an opt-out design.
- Explore how schools, in cooperation with participating financial institutions, could open a Roth at Birth account for every child entering kindergarten. (San Francisco’s Kindergarten to College (K2C) initiative provides a current model of this concept using basic savings accounts restricted for college expenses only. See www.k2csf.org.)
- Develop a mechanism for every child to automatically receive a Roth at Birth account at birth, tied to the issuance of Social Security numbers.

Significantly, these mechanisms require no new public subsidies. Rather, they create pathways that make it easy for families and others to contribute their own funds to the accounts. Slightly revised government policies and product offerings by financial institutions, coupled with local financial education, are what is needed to begin.

Legislative Precedent: The Young Savers Account

Congress would need to make a few small changes to existing Roth IRAs to create Roths at Birth. We would not, however, need to start from scratch: Senator Max Baucus, chairman of the Senate Finance Committee, proposed exactly such an account, called “Young Savers Accounts” (YSAs) in 2006 as part of his *Savings Competitiveness Act*. Specifically, the legislation stated that all rules governing Roth IRAs apply to YSAs except that (1) contributions to the child’s YSA will apply toward the parents’ contribution annual limit; (2) contributions to YSAs from low-income families would qualify for the Saver’s Credit, an existing federal matching program for low-income taxpayers who save in existing retirement accounts; and (3) savings in YSAs would be disregarded in determining eligibility for means-tested programs, such as TANF, SNAP (food stamps), and Medicaid.

We recommend that these provisions be adopted in the drafting of the Roth at Birth—which will ensure that Roths at Birth, while available to the Roth-eligible population, retain “progressive” features for LMI families while not conferring additional tax breaks for higher-income households. Specifically, YSA provision number (1) above ensures that the accounts are not regressive—that there are no new tax shelters for higher-income contributors; the legislation does not increase overall contribution limits but clarifies that the parents’ contribution limits include any contributions to YSAs. Provision numbers (2) and (3) above ensure that the accounts are progressive, clarifying that qualifying low-income families receive an existing federal match if they save in a YSA; and that low-income families who save in YSAs would not risk losing much-needed food, health and cash assistance for doing so.

Although the YSAs provision did not become law (it came very close to being included in the Pension Protection Act of 2006), there was support for the proposal among both Democrats and Republicans. Similar provisions, such as “401(K)ids,” have been proposed by Democrats and Republicans alike as well. In other words, the prospects for broad political support for Roths at Birth, especially if framed in terms of building financial capability, savings, and retirement security, are quite good.

For more information, please contact:

Ted Beck, President and CEO, National Endowment for Financial Education
Phone 303-224-3526; email: tbeck@nefe.org

Ray Boshara, Senior Advisor, Federal Reserve Bank of St. Louis
Phone 314-444-8747; email: Ray.J.Boshara@stls.frb.org

Table 2. Why Roths? How Roths Compare to Other Products Aimed at Children

	Roth IRAs	529s	Basic Savings Account	Coverdells
Tax benefits?	Yes	Yes	No	Yes, but possibly expiring
Contributions Qualify for the Federal Savers Credit?	Yes	No	No	No
Treatment of savings in TANF, SNAP, and Medicaid	Excluded in SNAP; otherwise, varies by state	Excluded in SNAP; otherwise varies by state	No categorical exclusions, most likely to be counted	Excluded in SNAP; otherwise varies by state
Treatment of savings for FAFSA	Not assessed	Assessed	Assessed	Assessed
Possibility of significant lifetime investment returns?	Yes	Yes, until withdrawn for college	No	Yes, but funds must be fully withdrawn by age 30 to avoid taxes and penalties
Contributions must come from earned income?	Yes, with an exception for non-working spouses	No	No	No
Flexibility of uses	Uses include higher education, homeownership, medical expenses, and retirement	Only post-secondary education expenses	No restrictions	Only K-12 and post-secondary education expenses
Easy to make deposits?	Yes	Limited	Yes	Yes
Minimum deposit requirements	Varies by provider (e.g., \$100 to \$3,000)	No or low minimum, depending on state	Often zero or low	Varies by provider (e.g., none to \$1,000)
Potential to scale up?	Yes	Yes, but state by state, likely to be uneven	Already widespread but offerings vary enormously	Yes, but future of product is in doubt, and funds must be used by age 30
Features to encourage asset accumulation	Uses allow pre-retirement asset building and retirement security; good investment options and low fees possible	Limited to post-secondary education and training; good investment options and low fees possible	Good for pre-cautionary and emergency savings, but less ideal for longer-term asset accumulation	Limited to post-secondary education; good investment options and low fees possible; but must use funds by age 30

REFERENCES

- Baker, C. and Dylla, D. (2007). Analyzing the relationship between account ownership and financial education. A report for the Financial Services and Education Project, an initiative of the asset building program at the New America Foundation.
- Butler, S., Beach, W., and Winfree, P. (2008). Pathways to economic mobility: key indicators (Washington: Pew Charitable Trusts, Economic Mobility Project).
- Conley, Dalton (2009). "Savings, Responsibility and Opportunity in America." Washington, DC: New America Foundation.
- Elliott, W. and Beverly, S. (2011). The role of savings and wealth in reducing "wilt" between expectations and college attendance. *Journal of Children & Poverty*, 17(2), 165-185. The paper was first published as CSD Working Paper 10-01. Center for Social Development, George Warren Brown School of Social Work, Washington University in St. Louis.
- Hilgert, M. A., Hogarth, J. M., & Beverly, S. G. (2003). Household financial management: The connection between knowledge and behavior. *Federal Reserve Bulletin*, 89(7), 309-322.
- Shanks, T. W., Kim, Y., Loke, V., Destin, M. (2009). Assets and child well-being in developed countries." St. Louis, MO: Center for Social Development.
- Shapiro, T.M. (2004). *The Hidden Cost of Being African American: How Wealth Perpetuates Inequality* (New York: Oxford University Press).
- Sherraden, M. and Steven, J. (2010) Lessons from SEED, a national demonstration of child development accounts.
- Zhan, Min and Michael Sherraden (2009). "Assets and Liabilities, Educational Expectations, and Children's College Degree Attainment." St. Louis, MO: Center for Social Development.