

POLITICAL ECONOMY RESEARCH INSTITUTE

PERI

University of Massachusetts Amherst

**Public Policy Options to Build Wealth
for America's Middle Class**

Christian E. Weller & Amy Helburn

November 2009

**POLITICAL ECONOMY
RESEARCH INSTITUTE**

Gordon Hall
418 North Pleasant Street
Amherst, MA 01002

Phone: 413.545.6355
Fax: 413.577.0261
peri@econs.umass.edu
www.peri.umass.edu

WORKINGPAPER SERIES

Number 210



Public Policy Options to Build Wealth for America's Middle Class

Christian E. Weller, Ph.D.
Associate Professor
Department of Public Policy and Public Affairs
McCormack Graduate School
University of Massachusetts Boston
100 Morrissey Boulevard
Boston, MA 02125

and

Senior Fellow
Center for American Progress
Washington, DC

and

Amy Helburn
Ph.D. candidate
Department of Public Policy and Public Affairs
McCormack Graduate School
University of Massachusetts Boston

I. Introduction

The financial crisis of 2007 and thereafter has taken a toll on family wealth. About \$15 trillion (in 2008 dollars) were lost in the first 18 months of the financial crisis which started in the spring of 2007.¹ This drop equaled a relative loss of 22.8% -- the sharpest such drop since the Federal Reserve started to collect these data in 1952.

The loss of household wealth deserves public policy attention. Wealth serves critical economic security functions in an economy that relies heavily on individual initiative, such as the United States. It is a store of future income, in the case of retirement, unemployment, illness or injury and thus allows families to smooth consumption over their lifetime, even when incomes and expenses change. The worst financial crisis since the Great Depression has frayed this economic security blanket and contributed to a sharp rise in household economic distress.

Families with sufficient wealth also need not worry about the basic necessities of life and may focus on longer term economic opportunity. They are better situated to send kids to college and to choose a degree that suits their abilities. Family members can more easily switch jobs to match their particular skills or let their creative spirits take hold and start a business. Everybody wins when people are able to gain and effectively apply new skills in their careers.

There are three goals for public policy to help families build stable and sustainable wealth. These are greater savings rates, lower costs of building wealth, and less risk exposure. In this chapter, we highlight a few policy examples in each of these categories.

II. Policy focus

The data indicate that moderate-income to middle-income families were the group that likely lost the most in terms of economic security during the recent crisis. Higher-income families had more wealth relative to their income and thus more income support, while lower-

income families still enjoyed some income support from social safety nets, although this support is gradually eroding. Many of the policy proposals that we discuss below are thus intended to help moderate-income and middle-income families build wealth, but they will likely also have a strong positive impact on low-income families' ability to build stable, sustainable wealth.

The most comprehensive data on family wealth comes from the Federal Reserve's Survey of Consumer Finances (SCF). The SCF is a triennial survey of a nationally representative sample of households, summarizing all of their assets and debts. The latest data year is 2007.

The data show that wealth inequality increased from 2004 to 2007. A larger share of wealth became concentrated among the top decile of income earners. This largely reflected the fact that fewer families outside of the top decile saved and that debt grew faster than income for families with less income (Bucks et al, 2009).

Wealth inequality also rose across and within a range of demographic groups. Wealth grew fastest for older families, faster for whites than for non-whites, and faster for single headed households than for married couples (Bucks et al, 2009). Data from the SCF further show that typically, mean wealth grew faster than median wealth for each group from 2004 to 2007, suggesting that wealth in each demographic subcategory became more concentrated.

Our discussion will thus largely focus on proposals that could especially benefit lower-income and moderate-income families, given that wealth disparities have increased over time.²

Before delving into the policy proposals, it is useful to understand the aggregate data trends during the crisis that started in 2007. A number of factors, besides price declines, made a bad situation worse. The personal saving rate fell to historic lows before the crisis, families were exposed to substantial market risk, and often incurred high costs in building wealth.

From the middle of 2007, when wealth started to decline, to the end of 2008, American families lost \$15 trillion (in 2008 dollars) due to the crisis in the housing market and the stock market (Weller and Lynch, 2009).

The more relevant context for household wealth, though, is a comparison to after-tax income since wealth is primarily meant as a store of future income. Wealth to after-tax income has trended up over time, although the crisis since 2007 has eliminated most of the gains of the past fifteen years. Total net worth as a percent of after-tax income was more than 30 percentage points lower on average in 2008 than during the previous business cycle – from March 2001 to December 2007. Two-thirds of this loss was due to declines in housing wealth and the rest was caused by financial market losses (Weller and Lynch, 2009).

Families' financial buffer for emergencies narrows when wealth declines. Measures of economic distress have thus risen alongside wealth declines to historically high levels. For instance, at the end of 2008, 11% of mortgages were either delinquent or in foreclosure (MBA, 2009). Also, the share of credit card debt that was in default at the end of 2008 climbed to 6.3% of all credit card loans, 52.4% higher than a year earlier (BOG, 2009).

Low saving and high leverage

One important contributing factor to the erosion in middle class economic security was the historically low saving rate. Families did not build as much of a buffer for their economic security as would have been the case if the personal saving rate had not dropped. For the entire last business cycle, from March 2001 through December 2007, the personal saving rate averaged 1.4% or less than one-third of the 1990s (Weller and Lynch, 2009).

The companion to the low saving rate was a debt boom. Beginning in the 1980s, U.S. families borrowed increasing amounts (Weller and Lynch, 2009). In 2007, over 77% of families owed some type of debt (Bucks et al, 2009).

Several factors have contributed to rising consumer debt. Household debt, for instance, has grown because income has not kept up with consumption needs (Warren and Warren Tyagi, 2002). Lenders were willing to extend more credit to previously credit constrained borrowers since they could simultaneously shift risk to other stakeholders due to debt securitization (Baily, Elmendorf, and Litan, 2008). The increases in both credit supply and demand led to an unprecedented expansion of debt among low-income and middle-income families (Fellows and Mabanta, 2007).

In 2001, total credit became greater than disposable income for the first time in the collection of the data (Weller, 2006). And, the increase in debt to after-tax income was substantially larger in the 2000s than during previous business cycles (Weller and Lynch, 2009). This debt boom was largely fueled by a growth in debt secured by private homes (Weller, 2006).

Leverage during an upswing in asset prices means that families can invest with little of their own money at stake and experience substantial gains in wealth. Using leverage thus enables families to acquire assets with other people's money, opening the door to homeownership or greater college attendance than otherwise would be the case.

Leverage, though, magnifies the effect of changes in price of the original investment. When asset prices fall, what little equity stake a family has in an investment is quickly wiped out. Leverage is hence inversely related to home equity relative to home values. The share of home equity as a percent of home values has, with few exceptions, been steadily declining from 70% in 1982 to 43% in 2008 (Weller and Lynch, 2009).

The policy-relevant conclusion is that the debt boom was closely related to the low saving rate. Increasing personal saving rates should reduce the need for families to borrow money to acquire assets as well as pay for basic goods and services since they will have more of a financial buffer despite stagnating and declining income levels.³

A significant obstacle to raising the saving rate is the U.S. tax code. The primary saving incentive under the U.S. tax code is the deductibility of contributions to tax advantaged savings vehicles, such as qualified retirement saving plans, but also of mortgage interest. This means that higher-income earners disproportionately benefit from the existing saving incentives, while lower-income earners receive fewer benefits. All families respond as expected to tax incentives by saving more in tax advantaged savings, but only low-income families actually save more money overall, while high-income families simply shift savings from non-tax advantaged savings to tax-advantaged savings (Engen and Gale, 2000; Poterba et al., 2007).

Another partial explanation for the low personal saving rate may be the so-called wealth effect, whereby families save less because they feel wealthier due to unexpected increases in asset prices (CBO, 2007; Poterba, 2000). The asset market booms of the 1990s and 2000s propelled people's wealth beyond expectation and thus they saved less, as overall wealth goals were met. This may also explain the increase in the saving rate after 2007 that corresponded to asset price declines. Large swings in asset prices can hence have an adverse impact on wealth creation by inducing people to save less than they otherwise would have. Stabilizing individuals' exposure to asset market fluctuations could thus help boost personal saving rates.

Increased concentration of assets in risky asset classes

The fact, though, is that wealth has become increasingly less diversified. With home prices rapidly rising during the housing bubble, families were required to invest more of their

wealth in their homes (Weller, 2006). The simultaneous rise in stock prices had a similar effect, with financial wealth increasingly concentrated in stocks (Weller and Lynch, 2009). Historically, real estate and corporate equities made up 43% of total assets on average, as compared to comprising more than 50% of total assets on average during the 2000's (Weller and Lynch, 2009). When the crisis in the housing and stock markets struck, families stood to lose more of their total assets than was previously the case when families were better diversified.

Economic research has long documented that savers are not optimally diversifying their assets according to their own risk preferences. Participants in retirement savings plans, such as 401(k)s, often do not rebalance their assets, even after large price changes in one asset class have led to increasing asset concentration (Mitchell, Mottola, and Utkus, 2005). Many participants also use “naïve diversification” when making decisions about what type of assets to invest in. Benartzi and Thaler (2007) and Huberman and Jiang (2006) conclude that participants often divide their assets evenly across all available options. For instance, more choices of equity funds can result in a greater allocation towards equities, all else equal.

Alternatively, if there are many available investment options, participants seem to choose one item from each category and then evenly diversify across categories (Bernartzi and Thaler, 2007). In fact, if the range of available options becomes too confusing, participants in 401(k) plans may reduce their equity exposure (Iyengar and Kamenica, 2006). Finally, 401(k) participants tend to hold a relatively high share of their assets in their employer's stock, often because they feel that they know the company (Benartzi and Thaler, 2007). The result of all of these phenomena is that, over time, savers can become exposed to greater market risk than is appropriate given their circumstances and preferences.

Costs associated with building wealth remain high

Building wealth comes with substantial fees for managing assets and borrowing debt that can reduce the rates of return on assets and increase the costs of a loan. Very high cost loans include payday lending, car title loans, and overdraft loans. Interest rates on payday loans average typically about 400% (CRL, 2006). Fox and Guy (2005) estimate that the median annual interest rate for a car title loan is about 300% and Duby, Halperin, and James (2005) argue that overdraft fees can quickly translate into triple-digit annualized interest rates. Moreover, credit card debt often costs more than other forms of credit (Manning, 2000) due to higher interest rates and additional fees (Westrich and Bush, 2005). Finally, subprime mortgages are by definition higher cost loans. The evidence indicates that all these forms of higher-cost credit are more prevalent among minorities and lower-income families than among their counterparts.⁴

Cost differences of loans may also arise due to segmented markets and limited services. Markets may be segmented due to: lenders tailoring their products to specific groups, regulatory restrictions such as limits on credit union activities, and lenders restricting their geographic scope due to limited resources or discriminatory practices, such as red-lining (Munnell et al., 1996; Newman and Wyly, 2004; Wyly and Hammel, 2004).

Additional costs exist on the asset side. A broadly studied example is the so-called 401(k) plan.⁵ Fees of 401(k) plans can substantially reduce the savings that will be available for retirement. Even fees as low as one percent of assets annually – typical for 401(k) plans (GAO, 2006) -- can lower total savings over a career by more than 20% (Weller and Jenkins, 2007; Munnell and Sunden, 2004). Fees can be lower if there are fewer investment choices, investments are not actively managed, and if the size of the plan is relatively large (CII, 2006; Collins, 2003; Holden and Hadley, 2008; Bogle, 1999).

Role of Financial Education

Financial education can be an important tool for wealth creation, especially for minority and low-income families (Fox and Hoffman, 2004; Hilgert, Hogarth, and Beverly, 2003; Weinberg, 2006). Individuals and families must be able to understand and apply relevant information to become better savers and investors. Families rely on a number of sources of financial information to make saving and investment decisions. Almost three quarters of families said in 2004 that they collected information themselves, from the newspaper, from radio and television programs, from the internet, from friends and colleagues, among other sources (Weller, 2007a). At the same time, people were increasingly relying on professionals, such as lawyers, accountants, insurance agents and less so on advertisements than in the past. There is little variation by race and ethnicity, when it comes to obtaining financial information, but there are substantial differences by income. Only 65.4% of families in the bottom fifth of the income distribution gathered information themselves, while more than 80% in the top 40% of the income distribution did in 2004 (Weller, 2007b). Financial education is a vital, albeit complex, component that serves to support the saving and wealth-building policies outlined in this chapter.

Effective financial education, though, is still developing, especially since consistent and comprehensive evaluation tools are not yet available (Fox and Hoffman, 2004; Fox, Bartholomae, and Lee, 2005; Lyons et al.2006). We do not include specific recommendations on financial education because of these complexities. Readers are instead referred to the literature cited herein.

III. Wealth Building Policies

Here are a few principles and examples that could guide wealth building policies. They focus on the three policy goals supported by the data: a) helping families to save more money, b)

reducing the risk exposure, and c) lowering the costs associated with wealth building. Several principles laid out here address more than one goal.

Turn tax deductions into credits

Current saving incentives are skewed towards higher-income earners. The Tax Policy Center, for instance, reports that the top income quintile could expect to receive 72.2% of the benefits of ongoing changes in the federal retirement saving incentives in 2006 (Tax Policy Center, 2007). This unequal distribution of tax incentives has no measurable impact on saving (Orszag, 2008). Lower-income savers tend to increase their total savings in response to saving incentives, while higher-income ones tend to shift savings from non-tax advantaged to tax advantaged savings without an increase in the overall amount of saving. Therefore, shifting more incentives to lower-income earners could increase total personal saving (Engen and Gale, 2000).

Savings incentives are thus more likely to be effective if they are designed as refundable tax credits instead of deductions. Refundable credits treat each dollar saved equally and do not depend upon a family's federal income tax liabilities. Policy experts, such as Gene Sperling (2004), former director of the National Economic Council under President Clinton, have hence proposed to replace the existing system of income tax deductions with a uniform saving credit. A proposal by Gale, Gruber, and Orszag (2006) would replace existing tax deductions with a flat government matching contribution. The match would comprise 30% of both employer and employee contributions to retirement saving accounts, regardless of employee level of income. The employer's contribution would be taxed as a form of income to employees. According to simulations conducted by these researchers and the Tax Policy center, this proposal would be roughly revenue neutral (Batchelder, Goldberg, and Orszag, 2006).

It is likely that policymakers, faced with long-term budget deficits, will investigate the effectiveness and efficiency of the existing system of savings incentives. One consequence of such a policy analysis may not comprise a wholesale replacement of tax deductions with tax credits, but rather improvements upon existing additional saving incentives for lower-income workers. Many of these improvements could center on the existing Saver's Credit.

The Retirement Savings Contributions Credit, also known as the *Saver's Credit*, was enacted in 2002 as a temporary provision and became permanent in 2006. Non-refundable income tax credits are given on the first \$2,000 that filers contribute to a Roth IRA, traditional IRA or voluntary pension plan (Duflo et al., 2006).

The Saver's Credit is structured like an employer matching contribution to an IRA. The credit rate is 50% for very low-income earners, 20% for filers with slightly higher incomes, and 10% for moderate-income earners. The income limits are inflation adjusted (IRS, 2008).

A common problem with the Saver's Credit is the low take-up rate. Among the 10.5 million taxpayers that could benefit from the maximum credit rate, the take-up rate was only 50.5% (Gale, Iwry, and Orszag, 2004). This low take-up rate is explained to a large degree by the fact that the credit is non-refundable (Duflo et al, 2006). Many low-income filers cannot receive the credit because they have little or no federal income tax liability.

Proposed improvements to the Saver's Credit go towards making the credit refundable and making more people eligible for the credit. There is an argument in favor of raising the income limits, such that middle-income families, whose retirement wealth has been decimated by the crisis, can benefit. An income limit of about \$70,000 would reach approximately everybody in the 15% and 10% marginal federal income tax rate brackets and thus reach many families who currently do not qualify (Gale, Iwry, and Walters, 2007).

Other saving incentives could be similarly restructured. One of the main tax advantaged saving options entails buying a house with a mortgage since the interest on the mortgage is tax deductible. A first step towards turning tax deductions for owner-occupied housing into tax credits could be a mortgage credit as proposed by President Obama during the presidential election campaign of 2008 (Burman et al., 2008). The proposal would give those tax payers who do not itemize their mortgage interest payments as tax deductions a flat credit of 10% of the interest payment, up to a maximum credit of \$800.

Streamline saving incentives

Incentives for people to build wealth should be streamlined. Rather than a range of government incentives for many asset building purposes, there should be one incentive to save for current needs and one for their future needs. Current needs include such near term issues as education, business formation, and housing, while future needs refer to retirement savings.

Streamlined savings incentives would promote efficiency by offering savers more choice to use their savings as they see fit, rather than the current range of targeted savings incentives does. The efficiency gains – more saving and less economic distortions for the same amount of tax incentives – arise for three reasons. First and most importantly, people can determine their own savings goals based on their own circumstances, which means that, homeownership wouldn't be prioritized over renting, education over working, etc. Tax incentives would thus have less influence than is currently the case in steering savers towards specific savings goals. Second, savers may be inclined to save more if they have more choice over what to do with their savings in the future. For instance, research on 401(k) plans indicates that savers will contribute slightly more if such plans offer a loan option. (GAO, 1997; VanDerhei, 2001). Third,

streamlined incentives reduce the complexity of the current system and would thus likely reduce administrative costs and increase participation (PAPFTR, 2005).

A number of policy experts have discussed the need for streamlining retirement savings. President Bush's Advisory Panel on Federal Tax Reform, for instance, met in 2005 to develop and recommend tax reforms in order to remove obstacles to saving, among other aims (PAPFTR, 2005). The panel's final report, released in November 2005, recommended several reform options for savings incentives. These would consolidate tax incentives into three programs: Save at Work, Save for Retirement, and Save for Family. Defined contribution plans would be consolidated into Save at Work plans with simple rules and then-current 401(k) contribution limits (PAPFTR, 2005). In a similar vein, Perun and Steuerle (2008) propose to streamline and simplify the rules governing retirement savings plans at work and increase available government matches for savers. Save for Retirement accounts, proposed by President Bush's tax panel, would be an addition that would replace retirement savings plans, such as IRAs, Roth IRAs, Non-deductible IRAs, deferred executive compensation plans, and tax-free "inside build-up" of life insurance and annuities cash values, in exchange for higher contribution limits than existing retirement savings plans allow and expanded availability to all tax payers (PAPFTR, 2005).

The logic of streamlined saving incentives can be extended to establish another tax credit for non-retirement, universal and unrestricted savings. Families can decide how to use their wealth to fit their needs. Save for Family accounts, as proposed by President Bush's tax panel, would be available to all Americans to save \$10,000 annually for a range of goals, including health care, education, training, and home purchase (PAPFTR, 2005).⁶ This incentive could replace the plethora of existing savings incentives for a range of purposes, including 529 accounts for education and mortgage interest deductions to promote homeownership.

Automated savings and investment decisions to make it easier to save

Saving should be made easy. Behavioral economics has taught us that public policy can use people's inherent inertia to build wealth, rather than impede wealth creation, as is currently the case (Bernartzi and Thaler, 2007).

Automatic enrollment in workplace retirement savings vehicles, for instance, is a good way to encourage participation and thus encourage people to save regularly. This approach attempts to close the gap between the number of people who are offered the opportunity to save in an employer-sponsored retirement plan and those that actually participate.

Congress attempted to make it easier for employers to automatically enroll employees in defined contribution plans in passing the Pension Protection Act of 2006. It is too soon to reach any conclusions about the law's effectiveness on increasing automatic enrollment in defined contribution plans. Early figures, however, show that automatic enrollment is a feature of a growing share of defined contribution plans. For instance, a survey by Hewitt Associates LLC showed that 44% of responding firms offered automatic enrollment and 30% of those who did not yet offer it were considering implementing it in 2008 (Hewitt, 2008).

The automatic enrollment features that were passed with the Pension Protection Act of 2006, though, only affect employers who either already offered a qualified retirement savings plan or those who plan on offering one soon. A number of policy proposals would expand so-called "auto solutions" to workers who do not work for an employer who offers a retirement savings plan. First, there is the opportunity to automatically enroll more workers in individual retirement savings plans. Iwry and John (2006), for instance, suggested in 2006 that every employer with ten or more employees should offer employees the opportunity of automatic payroll deductions into designated IRAs. Second, there is the option to have participating

workers automatically save more as their incomes increase, known as automatic escalation. This is a feature of the Pension Protection Act of 2006 that automatically adjusts employee contributions, as a share of earnings according to changes in employee age and/or salary (Gale, Iwry, and Orszag, 2005). Third, retirement savings plans can be set up so that savings are automatically invested in a default investment option, unless the saver decides otherwise.

The Pension Protection Act of 2006 required that the Department of Labor establish rules that guide such default investment options. Automatic investments can significantly increase the probability that savers will diversify their retirement savings, which currently is rarely the case (Mitchell, Mottola, and Utkus, 2005). Greater diversification could contribute to increased savings and wealth building due to reduced risk exposure of retirement assets. Finally, withdrawals from retirement savings plans could also be automated. Gale, Gruber, and Orszag (2006), for example, propose an approach similar to the Thrift Savings Plan, under which the federal government facilitates an arrangement between private insurers and employees to establish annuities that keep a pace with inflation.

Most proposals to automate savings also include a provision that could lower the costs of savings. This provision would offer publicly administered, but privately managed investment options to private sector employers. If adopted, this approach could substantially reduce fees associated with individual accounts for smaller employers with low-income workers and could also reduce investment risks in defined contribution plans, depending on how investment options would be regulated (Baker, 2006).

The options that we have discussed so far leave out ways in which to get savers to contribute something to their own savings accounts. Public policy could mandate contributions or offer new incentives for employers and employees to contribute to retirement savings. Several

experts have proposed a mandate on employers and employees (with some including an opt-out provision), to contribute at least a minimum of earnings, typically 2% to 5%, to their retirement savings plans (Emmanuel, 2007; Ghilarducci, 2007; Munnell, XXXX; Weller, 2007b).

Alternatively, there could be new incentives for voluntary contributions, such as tax form check-off boxes. Savers could check a box on their tax returns that indicates they want their tax refunds to go to a designated savings account (Iwry, 2005). This type of proposal could be expanded to direct tax refunds into low-cost savings options, such as savings bonds. It could also be used to couple savings from tax refunds with existing savings matches, such as the Saver's Credit or Individual Development Accounts.

Increased transparency for savings and credit products

Comprehensive, concise and comparable information on the costs and risks of different forms of wealth needs to be available to all consumers. Currently, required information is often presented in a way that makes it harder for consumers to comparison shop, e.g. by presenting some costs as percent of assets and others as dollar fees. Moreover, some financial information is presented in legal and technical jargon, as is often the case on credit card statements, and hidden in the fine print of lengthy documents, such as mortgage documents. Increased transparency of financial products could help consumers by generating more financial competition and lower costs.

There are theoretically three broad approaches to increase the information flow to consumers. First, policymakers can offer financial service providers incentives to better disclose costs associated with their products. An oft-used "incentive" for financial service providers to improve transparency of their products is the threat of legislative requirement of greater disclosure if the product information is not improved voluntarily.

Second, policymakers can establish rules that target particular costs of specific products, e.g. interest rates on credit cards or investment fees on 401(k) plans. The primary shortcoming of such targeted proposals is that they will require revision as financial products evolve and new fees and other costs are added, or outdated ones are eliminated.

Third, policymakers could establish a regulatory process that would allow regulators to set comprehensive disclosure rules that could be adapted to changes in financial product markets. Elizabeth Warren (2007) goes furthest on comprehensive disclosure for financial products by proposing a Financial Products Safety Commission that would set disclosure rules for all regulated consumer financial products. This newly created agency would set guidelines on the information that needs to be disclosed and how it is disclosed to the consumer. The commission would have the authority to collect information on all regulated financial products, review the safety features of each product, and require revisions to products that are considered too dangerous for the consumer (Warren, 2007).

Increased credit market competition

Policymakers could take additional steps to encourage more financial market competition. Much of the financial service industry today is an uneven playing field that is skewed against the consumer. What economists call “monopolistic competition” ends up costing consumers billions of dollars in fees and interest, lack of access to stable and sustainable credit, and investments inappropriate to their needs. Financial market regulation needs to encourage the elimination of segmented markets to promote access to more affordable credit and investments to foster more savings and allow families to borrow on more advantageous terms.

The primary policy approach is to increase the number of banks that operate in underserved market segments. Two examples of such a policy approach are 1) industrial loan

banks, which are sometimes referred to as “Wal-Mart banks” since this retailer has in the past sought a charter to operate such a bank, and 2) expanded operations of credit unions.

Industrial loan banks (ILB) and industrial loan companies (ILC) are FDIC-supervised financial institutions that may be owned by commercial firms, such as GM, Target, Nordstrom’s, and Harley-Davidson. Such financial institutions have existed since the turn of the 20th century, and the ILC management -- the parent corporation -- is held accountable for ensuring that bank operations and business functions are performed in compliance with banking regulations imposed by the state and FDIC (West, 2004). Other corporations, namely Home Depot and Wal-Mart, have also previously tried to obtain an ILC charter.

The logic of expanding financial services through retailers, such as Wal-Mart, is that it expands financial services to communities where such services may be limited. At the time of the Wal-Mart ILC attempt in 2006, Wal-Mart CEO Lee Scott estimated that 20% of Wal-Mart shoppers did not have a checking account. The flipside, though, is that banking through a retailer can build an affinity relationship that could be exploited by the retailer.

Wal-Mart already offers check-cashing services, money-order and money-transfer services, and even an Easy Investing program that consists of stock market investing and a money market fund, provided via *ShareBuilder* of ING Direct. The typical minimums and fees apply. An ILC charter, if permitted, would handle Wal-Mart’s credit card, debit card and electronic transactions, saving fees that Wal-Mart currently pays to a third party.

Wal-Mart has also sought to establish its own banking services in other countries. In 2008, Wal-Mart moved into banking in Mexico, as Banco Wal-Mart, which has banking facilities in 425 stores in 125 cities with plans for an aggressive expansion this year (Evans, 2009). In September 2008, Wal-Mart applied for official bank status with the Canadian

government to operate Wal-Mart Canada Bank/La Banque Wal-Mart du Canada which would offer credit cards and low-cost loans to Canadian customers, similar to the services its Canadian competitors Loblaw Cos. (supermarket) and Canadian Tire Co. offer (Bell and Burritt, 2008). Wal-Mart considered in the spring of 2009 opening its own bank in Chile (DowJones, 2009).

Expanding ILC charters to popular retail outlets could also expand the savings options available to market segments that are often underserved in the financial market, especially lower-income earners, and who thus face higher costs than their higher-income counterparts do in building wealth. ILCs typically cannot offer checking accounts, but they can take deposits and make loans (Pulliam-Weston, 2005).

Such a policy approach of using existing, geographically dispersed retail outlets to offer lower-cost financial services to underserved communities, though, has to address the primary objection from opponents to such ILC charters. These entities would be exempt from consolidated supervision and regulation (Dodd, 2006). The lack of proper regulatory oversight opens the door to greater systemic risk and conflicts of interest between the retail and the banking business. Regulation of ILCs must be strengthened to avoid these unintended consequences before any expansion of ILC charters among retail outlets is considered.

An alternative approach may be to gradually expand the scope of credit unions. Credit unions may be chartered at the federal or state level. As a non-profit, cooperative financial institution owned and operated by its members, most credit unions are organized to serve people in a particular community, groups of employees, or members of an organization or association. Credit unions differ from banks and other for-profit financial institutions in that members are also owners and directly elect the board of directors in a democratic system. Credit unions provide members with a safe place to save and borrow at reasonable rates. Since profit is not the

primary motivation, interest rates have been historically more favorable for consumers at credit unions, as compared to banks (Credit Unions Online, 2009).

Limitations on credit unions' scope with respect to personal finance have decreased over time. For instance, in the 1980s, credit unions were permitted to offer first mortgages and in the late 1990s, credit unions have been allowed to offer membership to multiple groups (Leggett and Strand, 2002; Tripp and Smith, 1993). Following this expansion in scope, credit unions have experienced strong growth (Goddard, McKillop, and Wilson, 2002; Kaushik and Lopez, 1994).

Even if families are not credit union members, they may enjoy the benefits of this strong growth. Competition with credit unions seems to have lowered the costs of financial services at other banks (Emmons and Schmid, 2000; Feinberg, 2001; Feinberg and Rahman, 2001).

A possible next step for credit unions is to further expand their scope of activities, e.g. by increasing their ability to make small business loans. Currently existing limits on the share of total assets that a credit union can hold in business loans could be raised (Lehrer, 2007, 2009). The total size of credit union loans will likely remain relatively small because credit unions tend to be small. Raising the limits on the share of credit union assets that are invested in small business loans, though, may make it easier for some communities to build more wealth by reducing the costs of starting and expanding a business.

Public support for underdeveloped credit markets

Some holes in credit markets may persist, even with the best policy efforts to increase credit market competition. Some credit markets do not exist or involve large costs, such as markets for new technologies, affordable student loans, infrastructure financing, among others.

Public policy must first identify gaps in credit markets. Credit markets are typically underdeveloped when lenders cannot fully assess the expected return and risks involved in

financing a project, as in the case of financing new, untested technologies, such as the Internet. Alternatively, the rate of return and risk that are involved in a project may be known, but are so far off in the future that lenders are unwilling to commit their money for long periods of time, as is often the case with infrastructure projects. Finally, some markets do not exist because lenders cannot write complete contracts, as is the case with private investment in higher education.

Lenders cannot fully assess an individual's future ability and willingness to repay a student loan. A student of economics, for example, may instead decide to pursue his luck in writing poetry, even though his student loans were contingent on potential earnings as a financial analyst. The lender of a student loan has incomplete knowledge of the borrower's future behavior – a common problem in credit markets – and also limited recourse, which is not the case when loans are given based on an individual's current income or assets.

Thus, policymakers need to consider tools available to address these problems. There are three such approaches in the U.S. context: loan guarantees by the public in the event of borrower default, direct loans underwritten by the public, and lending requirements for private sector lenders to extend credit to particular types of projects and borrowers. An example of loan guarantees and direct loans is the National Infrastructure Bank proposed by the Obama administration for fiscal year 2010 (OMB, 2009). The proposal is to offer seed funding of \$5 billion in 2010 and total funding of \$25 billion from 2010 to 2014, so that the newly created bank can provide guarantees and loans to infrastructure projects.

A typical requirement of lending requirements is the Community Reinvestment Act (CRA), which serves to encourage depository institutions, such as banks, to meet the credit needs of surrounding communities, particularly low- and moderate-income neighborhoods (Bucks et al, 2009). The CRA promotes the availability of credit and other banking services to underserved

communities. The CRA, in addition to other measures, seems to have increased credit access and reduced the costs of credit for previously underserved communities, especially minorities and lower-income borrowers (Bates, 2000; Bostic et al., 2002).

A challenge in designing policies to fill credit market gaps is to know when such measures should cease. New technologies will not always remain such, the time horizon of infrastructure projects may be shortened, and institutional changes may make it possible to write more complete contracts. In such circumstances the rationale for public policy intervention disappears and public support for particular credit markets could be reduced or eliminated. Policymakers should regularly consider the circumstances under which their involvement may be reduced or eliminated in response to the inception of a new public financial product.

Conclusion

Wealth plays a critical role in the United States economy as responsibility for accessing education, health care, and retirement security has been increasingly shifted onto individuals. American families have lost \$15 trillion during the first year and a half of the current financial crisis that began in 2007. Public policy should thus intervene to help families repair their private economic security blanket by increasing their assets and reducing their debts. The specific public policy goals to be achieved include increased saving rates, reduced risk exposure, and lower costs. These goals can be accomplished by following the principles outlined in this chapter.

References

- Baker, D. 2006. "Universal Voluntary Accounts: A Step Towards Fixing the Retirement System." Washington, DC: Center for Economic and Policy Research.
- Baily, M., Elmendorf, D.W., and R. E. Litan. 2008. "The Great Credit Squeeze: How It Happened, How to Prevent Another." Washington, DC: Brookings Institution.
- Batchelder, L., Goldberg, F., and P. Orszag. 2006. "Efficiency and Tax Incentives: The Case for Refundable and Tax Credits." *59 Stanford Law Review* 23.
- Bates, T. 2000. "Financing the Development of Urban Minority Communities: Lessons of History." *Economic Development Quarterly* 14(3): 227-41.
- Bell, K. and C. Burritt. 2008. "Wal-Mart Canadian Unit Seeks to Offer Bank Services" (Update3), Bloomberg Last accessed September 15, 2008 [Available at <http://www.bloomberg.com/>]
- Benartzi, S. and R. Thaler. 2007. "Heuristics and Biases in Retirement Savings Behavior." *Journal of Economic Perspectives* 21(3): 81-104.
- Board of Governors, Federal Reserve System. 2009. "Charge-off and Delinquency Rates." Washington, DC: BOG.
- Bostic, R., Mehren, H., Paulson, A. and M. Saldenberg. 2002. "Regulatory Incentives and Consolidation: The Case of Commercial Bank Mergers and the Community Reinvestment Act." Federal Reserve Bank of Chicago, Working Paper Series WP-02-06, Chicago, IL: Federal Reserve Bank of Chicago.
- Bogle, J. 1999. *Common Sense on Mutual Funds: New Imperatives for the Intelligent Investor* (New York, NY: John Wiley and Sons).

Bucks, B., Kennickell, A.B., Mach, T.L. and K. B. Moore. 2009. "Changes in U.S. Family Finances from 2004 to 2007: Evidence from the Survey of Consumer Finances." Federal Reserve Bulletin. Washington: Federal Reserve.

Burman, L., Khitatrakun, S., Leiserson, G., Rohaly, J., Toder, E., and B. Williams. 2008. "A Preliminary Analysis of the 2008 Presidential Candidates' Tax Plans." Washington, DC: Tax Policy Center.

Center for Responsible Lending. 2006. "Financial Quicksand: Payday Lending Sinks Borrowers in Debt with \$4.2 billion in Predatory Fees Every Year." Durham, North Carolina: CRL.

Collins, S. 2003. "The Expenses of Defined Benefit Pension Plans and Mutual Funds" Investment Company Institute Perspective, Washington, DC: ICI 9(6).

Congressional Budget Office. 2007. "Housing wealth and consumer spending." Washington, DC: CBO 2007.

Council of Institutional Investors. 2006. "Protecting the Nest Egg: A Primer on Defined Benefit and Defined Contribution Retirement Plans." Washington, DC: CII.

Credit Unions Online. 2009. Last accessed July 22, 2009 [Available at <http://www.creditunionsonline.com/>]: (Credit Unions Online 2009)

Dodd, R. 2006. Testimony Before the Federal Deposit Insurance Corporation, Washington, DC: Economic Policy Institute, April 2007.

Dow Jones. 2009. "Wal-Mart Mulls Opening Bank in Chile through D&S – Report", April 30 2009. Last accessed July 22, 2009 [Available at <http://online.wsj.com/article/BT-CO-20090430-714186.html>]: (Dow Jones 2009).

- Duby, J., Halperin, E., and L. James. 2005. "High Cost and Hidden From View: The \$10 Billion Overdraft Loan Market." CRL Issue Paper No. 9, Durham, NC: Center for Responsible Lending.
- Duflo, E., Gale, W., Liebman, J., Orszag, P. and E. Saez. 2006. "Saving Incentives for Low- and Middle-Income Families: Evidence from a Field Experiment with H and R Block." *The Quarterly Journal of Economics* 121(4):1311.
- Emmanuel, R. 2007. "Supplementing Social Security", Wall Street Journal, September 13: A17.
- Emmons, W.R. and F.A. Schmid. 2000. "Bank Competition and Concentration: Do Credit Unions Matter?" Federal Reserve Bank of St. Louis Review 82, (3):29-42.
- Engen, E. M. and W.G. Gale. 2000. "The Effects of 401(k) Plans on Household Wealth: Differences Across Earnings Groups." Washington, DC: The Brookings Institution.
- Evans, B. 2009. "Wal-Mart Plans Rapid Expansion Of Retail Bank Business", InformationWeek.com, March 17 2009. Last accessed July 22, 2009 [Available at <http://informationweek.com>].
- Feinberg, R.M. 2001. "The Competitive Role of Credit Unions in Small Local Financial Services Markets." *Review of Economics and Statistics* 83, (3): 560-563.
- Feinberg, R.M., and A.F.M.A. Rahman. 2001. "A Causality Test of the Relationship between Bank and Credit Union Lending Rates in Local Markets." *Economics Letters* 71, (2): 271-75.
- Fellows, M. and M. Mabanta. 2007. "Borrowing to Get Ahead, and Behind: The Credit Boom and Bust in Lower-Income Markets." Washington, DC: The Brookings Institution.
- Fox, J., Bartholomae, S., and J. Lee. 2005. "Building the Case for Financial Education", *Journal of Consumer Affairs* 39, (1):195-214.

- Fox, J., and E. Guy. 2005. "Driven into Debt: CFA Car Title Loan Store and Online Survey." Washington, DC: Consumer Federation of America.
- Fox., L., and J. Hoffman. 2004. "Federal Reserve Personal Financial Education Initiatives." Federal Reserve Bulletin 90, (4): 447-457.
- Gale, W., Gruber, J., and P. Orszag. 2006. "Improving Opportunities and Incentives for Saving by Middle and Low-Income Households." The Bookings Institution: The Hamilton Project Discussion Paper 2006-02.
- Gale, W., Iwry, M., and P. Orszag. 2004. "The Saver's Credit: Issues and Options." *Tax Notes* 103(5): 597-612.
- Gale, W., Iwry, M. and P. Orszag. 2005. "The Automatic 401(K): A Simple Way to Strengthen Retirement Saving ." *Tax Notes* 106 (10): 1207-1214.
- Gale, W., Iwry, M., and S. Walters. 2007. "Retirement Saving for Middle- and Lower-Income Households: The Pension Protection Act of 2006 and the Unfinished Agenda." Washington, DC: Retirement Security Project.
- Ghilarducci, T. 2007. "Guaranteed Retirement Accounts: Toward Retirement Accounts." EPI Briefing Paper No. 204, Washington, DC: Economic Policy Institute.
- Goddard, J.A., McKillop, D.G., and J.O.S. Wilson. 2002. "The Growth of US Credit Unions." *Journal of Banking and Finance* 26, (12):2327-2356.
- Government Accountability Office. 1997. "401(k) Pension Plans: Loan Provisions Enhance Participation But May Affect Income Security for Some." Washington, D.C.
- Hewitt Associates LLC. 2008. "Survey Findings: Hot Topics in Retirement 2008." Lincolnshire, IL: Hewitt Associates LLC.

- Hilgert, M.A., Hogarth, J.M., and S.G. Beverly. 2003. "Household Financial Management: The Connection between Knowledge and Behavior." *Federal Reserve Bulletin* 89, (7):309-322.
- Holden, S., and M. Hadley. 2008. "The Economics of Providing 401(k) Plans: Services, Fees, and Expenses." Washington, DC: Investment Company Institute.
- Huberman, G. and W. Jiang. 2006. "Offering versus Choice in 401(K) Plans: Equity Exposure and Number of Funds." *Journal of Finance* 61(2): 763 – 801.
- Internal Revenue Service. 2008. "Retirement Savings Contributions Credit." Washington, DC: IRS.
- Iwry, M. 2005. "Using Tax Refunds to Increase Savings and Retirement Security." Retirement Security Project Policy Brief No. 2005-9, Washington, DC: Retirement Security Project.
- Iwry, M. and D. John. 2006. "Pursuing Universal Retirement Security through Automatic IRAs" Washington, DC: The Retirement Security Project of the Brookings Institution.
- Iyengar, S., and E. Kamenica. 2006. "Choice Overload and Simplicity Seeking," Working paper. New York, NY: Columbia University.
- Kaushik, S.K., and R.H. Lopez.1994. "The Structure and Growth of the Credit Union Industry in the United States: Meeting Challenges of the Market." *American Journal of Economics and Sociology* 53, (2): 219-243.
- Leggett, K.J., and R.W. Strand. 2002. "Membership Growth, Multiple Membership Groups and Agency Control at Credit Unions." *Review of Financial Economics* 11, (1): 37-46.
- Lehrer, E. 2007. "Taxi Cab Medallions and Heirloom Tomatoes to the Rescue: How Expanding Credit Union Lending Can Help Small Business to Survive the Credit Crunch." Washington, DC: Competitive Enterprise Institute

- Lehrer, E. 2009. "Let Credit Unions Lend More: A Modest Proposal to Increase the Availability of Capital to Small Businesses." Washington, DC: Competitive Enterprise Institute.
- Lyons, A.C., Palmer, L., Jayaratne, K.S.U., and E. Scherpf. 2006. "Are We Making the Grade? A National Overview of Financial Education and Program Evaluation." *Journal of Consumer Affairs* 40, (2):208-235.
- Manning, R. 2000. *Credit Card Nation: The Consequences of America's Addiction to Credit* (New York: Basic Books).
- Mitchell, O., Mottola, G.R., and S. Utkus. 2005. "The Inattentive Participant: Portfolio Trading Behavior in 401(k) Behavior." Pension Research Council Working Paper 2006-5, Philadelphia, PA: Pension Research Council, Wharton School, University of Pennsylvania.
- Mortgage Bankers Association. 2009. National Delinquency Survey, (Washington: MBA.)
- Munnell, A., Tootell, G. M.B., Browne, L.E., and J. McEneaney. 1996. "Mortgage Lending in Boston: Interpreting HMDA Data," *American Economic Review*. 86, (1):25-53.
- Munnell, A. and A. Sunden. 2004. "Coming Up Short: The Challenge of 401(k) Plans." Washington, DC: Brookings Institution Press.
- Munnell, A., XXXXX, this volume**
- Newman, K., and E. K. Wyly. 2004. "Geographies of Mortgage Market Segmentation: The Case of Essex County, New Jersey." *Housing Studies* 19 (1): 53-83.
- Office of Budget and Management, 2009. "A New Era of Responsibility: Renewing America's Promise", Washington, DC: OMB.
- Orszag, P. 2008. "The Effects of Recent Turmoil in Financial Markets on Retirement" Testimony before the Committee on Education and Labor of the U.S. House of Representatives, October 7, 2008. Washington, DC: Congressional Budget Office.

- Perun, P., and E.C. Steuerle. 2008. "Why Not a "Super Simple" Saving Plan for the United States?", Washington, DC: Urban Institute
- Poterba, J. M. 2000. "Stock market wealth and consumption." *Journal of Economic Perspectives* 14(2): 99-118.
- Poterba, J., Rauh, J., Venti, S., and A. Wise. 2007. "Defined Contribution Plans, Defined Benefit Plans, and the Accumulation of Retirement Wealth." *Journal of Public Economics* 91 (10): 2062-86.
- President's Advisory Panel on Federal Tax Reform. 2005. "Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System." Washington, DC: PAPFTR.
- Pulliam-Weston, L. 2005. "National Bank of Wal-Mart?." Last accessed May 31, 2009
[Available at <http://moneycentral.msn.com/content/Banking/Betterbanking/P109171.asp>.
- Sperling, G. 2004. "A Progressive Framework for Social Security Reform." Washington, DC: Center for American Progress.
- Tax Policy Center. 2007. "Table T07-0290, Tax Benefits of the Exclusions and Deductions for Retirement Savings, Distribution of Federal Tax Changes by Cash Income Percentile, 2006." Washington, DC: Tax Policy Center.
- Tripp, J.D., and S.D. Smith. 1993. "U.S. Credit Union Motivation for Involvement in the First-Mortgage Market." *Journal of Real Estate Finance and Economics* 7, (3):229-236.
- VanDerhei, J. 2001. Contribution Behavior of 401(k) Participants, EBRI Issue Brief No. 238, Washington, DC: Employee Benefits Research Institute.
- Warren, E. 2007. "Unsafe at Any Rate." *Democracy: A Journal of Ideas*, (5): 8-19.
- Warren, E. and A. Warren Tyagi. 2002. *The two-income trap: why middle-class mothers and fathers are going broke*. (New York: Basic Books).

- Weinberg, J.A. 2006. "Borrowing by U.S. Families." *Federal Reserve Bank of Richmond Economic Quarterly* 92, (3):177-194.
- Weller, C. 2006. "The End of the Great American Housing Boom." Washington, DC: Center for American Progress.
- Weller, C. 2007a. *Access Denied*, Washington, DC: Center for American Progress
- Weller, C. 2007b. "PURE: A Proposal for More Retirement Income Security." *Journal of Aging and Social Policy*, 19, (1): 21-38 (Winter 2007).
- Weller, C. and S. Jenkins. 2007. "Building 401(k) Wealth One Percent at a Time: Fees Chip Away at People's Retirement Nest Eggs." Washington, DC: Center for American Progress.
- Weller, C. and J. Lynch. 2009. "Fraying the Private Safety Net: Household Wealth in Freefall." Washington, DC: Center for American Progress.
- West, M. 2004. "The FDIC's Supervision of Industrial Loan Companies: A Historical Perspective." Washington, DC: Federal Deposit Insurance Corporation
- Westrich, T., and M. Bush. 2005. "Blindfolded into Debt: A Comparison of Credit Card Costs and Conditions at Banks and Credit Unions." Chicago, IL: Woodstock Institute.
- Wyly, E.K., and D. J. Hammel. 2004. "Gentrification, Segregation, and Discrimination in the American Urban System" *Environment and Planning*. Vol. 36, No.7:1215-1241.

¹ Authors' calculations based on BOG, 2009. Our data discussion includes data through the end of 2008, although many trends continued afterwards. The end of 2008 marks the end of the sharpest downturn in financial wealth and the end of the first year of the economic recession.

² We do not delve into retirement wealth since this is discussed in Alicia Munnell's chapter in this volume.

³ There are several additional contributing factors to the low saving rate, such as rising income inequality and decline of employer sponsored pensions. These issues are addressed in other chapters in this volume and thus are not further considered here.

⁴ See Weller (2009) for a detailed literature review.

⁵ For a detailed recent discussion of the fees associated with 401(k) plans see Holden and Hadley (2008).

⁶ President Bush's tax panel largely maintained the tax deductibility of contributions to savings accounts and added tax-free withdrawals from savings accounts. Such a move would exacerbate the existing inequality of savings

incentives and thus likely make savings incentives less efficient. The tax panel's proposals are mentioned here to highlight the fact that experts generally agree that simplification of savings incentives is a worthwhile policy goal.