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KidSave
Real Problem, Wrong Solution

by Jagadeesh Gokhale and Michael Tanner

Executive Summary

There is growing bipartisan recognition that the pathway out of poverty is not through consumption but through saving and accumulation. That idea has led to a number of interesting and innovative experiments by state and local governments and by private charitable organizations and has helped fuel the drive for personal accounts as part of Social Security reform.

It has also, however, spawned a movement for some form of "children's allowance," or federally funded grant to children, known generally as KidSave accounts, that would be saved for education and retirement. Such proposals have drawn support from liberals and conservatives, Republicans and Democrats. These schemes are well intentioned and address a very real problem: the failure of Americans, especially low-income Americans, to save for their own and their children's futures. The push for KidSave accounts is also motivated by a perception that low-income Americans have access to fewer tax-favored savings plans than do other Americans.

There is ample reason to be skeptical of KidSave as an approach for increased saving, however. The proposal would create a massive new entitlement program, costing as much as $266 billion over the next 75 years (in present-value terms). If the program were to be expanded, as some observers have advocated, to all children instead of only newborns, the present-value cost would rise to $414 billion. And the cost to taxpayers would be even higher if the government were to adopt proposals to match future contributions made to KidSave accounts by low- and middle-income parents. With entitlement spending expected to skyrocket in the future, this is a burden we cannot afford.

We should make every effort to expand savings opportunities and wealth accumulation for low-income Americans. The proponents of KidSave have been asking the right questions. However, they have arrived at the wrong answer.

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It is important to think about the dynamic effects of a KidSave program on the economy—especially on working and saving by adults.

Introduction

Most modern welfare states have long offered cash grants to all families with children. Today, virtually every country in Europe, as well as Canada, Australia, New Zealand, and many African nations, provides "children's allowances." These programs are generally the same, with benefits unrelated to family income or parental behavior.[1] In contrast, the United States has avoided such a broad-based universal entitlement, offering instead a variety of tax preferences and needs-based programs for families with children, such as Temporary Assistance to Needy Families; the Women, Infants, and Children program; and Medicaid's State Children's Health Insurance Program.

Proposals for the creation of some form of children's allowance or savings accounts have floated around the U.S. political scene at least since the 1960s without gaining much political traction. In the late 1990s such programs found a champion in Sen. Robert Kerrey (D-NE), who saw in the idea a way to offset needed reductions in future Social Security benefits while increasing national savings and building wealth for low-income families. Kerrey pursued several variations of the proposal, some funded from Social Security payroll taxes, some from tax credits to parents, and some from family contributions. In some versions, funds could be used for education. In others, they offset traditional Social Security benefits. Kerrey's proposals attracted significant bipartisan interest, but none ever passed the Senate.

Although Kerrey has left the Senate, the combination of debates over welfare reform and Social Security has kept interest in his ideas alive. The New America Foundation has been one of the idea's leading proponents. The center-left organization's Asset Building Project draws on the expertise of some of the leading experts on the concept, including Michael Sherraden and Ray Boshara. Support for KidSave cuts across political and ideological lines.[2] Liberal Democrat Jon Corzine of New Jersey sponsored a KidSave bill in the Senate, but so did conservative Republican Rick Santorum of Pennsylvaia. Conservative columnist David Brooks likes the idea, and the liberal *American Prospect* has written favorably about it. The idea has also received favorable notice from scholars at conservative organizations such as the American Enterprise Institute and the Heritage Foundation.[3]

Currently, there are three major legislative proposals.

- **America Saving for Personal Investment, Retirement, and Education Act of 2005 (S 868/HR 1767).** Perhaps the most prominent of current KidSave proposals, ASPIRE is backed by a diverse group of legislators, including Sens. Rick Santorum (R-PA) and Jon Corzine (D-NJ) and Rep. Harold Ford (D-TN). The legislation would deposit $500 in an account for every newborn child. Children from families with incomes below the national median would receive an additional $500. Further contributions from any source could be added to the accounts and would grow tax-free. Contributions for low- and middle-income children would be matched by the government. Funds in the account could be withdrawn for postsecondary education, for the purchase of a home, or for retirement. At age 30, account holders would be required to repay the initial deposit that they received from the government on an inflation-adjusted but interest-free basis.
- **Social Security KidSave Accounts Act (HR 1041).** Sponsored by Rep. Jerry Weller (R-IL), HR 1041 would deposit $2,000 in an account for every newborn child. Families could contribute up to an additional $500 annually to the accounts, which would grow on a tax-free basis. At age 30, account holders would be required to repay the initial deposit that they received from the government on an inflation-adjusted but interest-free basis. Funds in the account could not be withdrawn until retirement.
- **Retirement Security Act (HR 1800).** Sponsored by Rep. Tom Petri (R-WI), HR 1800 would deposit $1,000 in an account for every newborn child. Families could

> contribute up to an additional $2,000 annually to the accounts, which would grow on a tax-free basis. At retirement, account funds would substitute for traditional Social Security benefits until the account was exhausted, after which traditional Social Security would kick in.

Although these proposals are well intentioned, they are seriously flawed.

A Real Problem

KidSave proposals are designed to respond to a real problem, the lack of saving opportunities for low-income Americans. As Michael Sherraden of Washington University in St. Louis has noted, "For the vast majority of households, the pathway out of poverty is not through consumption, but through saving and accumulation."[4]

By definition, poor people lack wealth. But there is a difference between "wealth" and "income," and in this sense, the lack of wealth among the poor may be a bigger long-term problem than their lack of income. Wealth is not just an amount of money that can be used to buy things, but, as Melvin Oliver and Thomas Shapiro wrote in their seminal book, *Black Wealth/White Wealth*:

> It is used to create opportunities, secure a desired stature and standard of living, and pass class status on to one's children. . . . The command of resources that wealth entails is more encompassing than is income or education, and closer in meaning and theoretical significance to our traditional notions of economic well-being and access to life chances.[5]

Furthermore, as Sherraden notes:

> When people begin to accumulate assets, their thinking and behavior change as well. Accumulating assets leads to psychological and social effects that are not achieved in the same degree by receiving and spending an equivalent amount of regular income. These behavioral effects are important for household "welfare" or well-being.[6]

For example, studies show that single mothers with savings are significantly more likely to keep their families out of poverty than are other single mothers, even after correcting for a variety of social and economic factors.[7] Not surprisingly, women with economic assets are far less likely to end up on welfare following divorce.[8] Other studies show that families with assets have greater household stability, are more likely to be involved in their community, demonstrate greater long-term thinking and planning, and provide increased opportunities for their children.[9]

Given the importance of asset ownership, recent news is not good. A recent report by the Federal Reserve reveals that the "wealth gap" in America may be the largest ever. According to the report, the difference in median net wealth between the wealthiest 10 percent of families and the poorest 20 percent jumped by nearly 70 percent between 1998 and 2001. The gap between whites and minorities grew by 21 percent.[10]

Some observers suggest that the approach to defining poverty should be revised to consider the accumulation of assets or the lack of them. One common definition of "asset poverty" would define people as asset poor if they lack sufficient savings or other assets to survive for three months at the poverty level. By this definition, more than 25 percent of the population would be considered asset poor, roughly double the official poverty rate.[11] Asset poverty is a particular problem for minorities, with as many 61 percent of African Americans and 70 percent of Hispanics among the asset poor.[12] Indeed lack of assets may be the biggest single reason for economic inequality between whites and minorities.[13]

The problems caused by asset poverty are multigenerational. The lack of asset ownership by low-income households implies unequal bequests that, in turn, transmit wealth inequal-

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A resolution of the fiscal imbalance would require the average wage-tax rate to go up by another 18 percentage points.

ity to the next generation.[14] Other studies show that intergenerational differences in economic well-being between whites and blacks are far more a function of wealth than of income.[15]

Studies are fairly clear in showing a variety of benefits from asset ownership. For example, Sherraden has studied recipients of individual development accounts (IDAs), a program that was started under the 1988 welfare reform whereby states encourage savings by low-income individuals through matching grants and other incentives. Among other things, he found the following:[16]

- Participants performed better educationally, and 60 percent said they were more likely to make educational plans for their children because they were saving.
- Eighty-four percent of participants felt more economically secure, and 57 percent said they are more likely to plan for retirement.
- Asset holding significantly improved long-term health and marital stability, even after controlling for income, race, and education. Half of account holders reported improved relationships with family members, and one-third believed that holding assets increased their community involvement or made them more respected by their neighbors.
- Perhaps most important, 93 percent of individuals with IDAs felt more confident about the future, and 85 percent felt more in control of their lives because they were saving.

It would seem, therefore, that it would be wise public policy to encourage asset ownership in general, and among the poor in particular. Despite such good intentions, however, there are several reasons to be concerned about KidSave proposals.

A Costly New Entitlement

Suppose we were to follow the recommendation of the KidSave Accounts Act (HR 1041) and award $2,000 to families in the name of each newborn child for initiating savings accounts beginning on January 1, 2006. Suppose, also, that the amount of seed money awarded each year were increased with the rate of inflation (to maintain the investment's real value). Projecting the federal budget cost of this annual outlay using the Social Security Administration's estimates of births in 2006 puts the cost for that year at $8 billion.[17] That cost would grow with the increase in the number of children born each year. Using the Social Security Administration's projections through the year 2080, the estimated present-value cost of this program would be $266 billion during the next 75 years.[18]

Once initiated for newborn children, there would be considerable political pressure to expand the KidSave program. After all, if today's newborns are endowed with a KidSave account, why shouldn't today's one-year-olds be provided with a similar windfall? Indeed, not doing so would create a marked difference in assets between people born before the program began and those born after. Carrying this argument forward, a case could be made for providing KidSave accounts for all children alive today. In fact, Sherraden, the intellectual godfather of KidSave, has already written about extending the program to all children under age 18.[19] And the cost to taxpayers would be even higher if the government were to adopt proposals to match future contributions made to KidSave accounts by low- and middle-income parents.

Suppose the age of eligibility for KidSave accounts were restricted to 18 years and younger. What would be the financial cost of awarding KidSave accounts to all of today's children? The answer, again based on the Social Security Administration's population estimates, is $414 billion.[20]

To see where this can lead, one need only look to Europe, where children's allowances on average consume 1.8 percent of gross domestic product, with many countries spending much more. Denmark devotes 3.3 percent of GDP to the program.[21]

Conceivably, expenditures of this magnitude could be justified if they would offset the expected future deficits in Social Security—that is, if account accumulations explicitly substituted for benefits under the traditional Social Security program. However, of the three main legislative proposals, only HR 1800 includes that feature.

The other two plans, ASPIRE and HR 1041, structure their account contributions as loans. In theory, as the loans are repaid, the program will, to a large degree, become self-sustaining, with repayments from one cohort funding contributions to another. However, there remains a 30-year gap before the first contributions are repaid, making for a substantial increase in government spending over that period. Moreover, the Congressional Budget Office estimates that about 10 percent of all recipients will never repay their "loan."[22]

Because the federal budget is in deficit, the government will have to borrow the money used to fund the accounts. In doing so, it will have to pay interest on the incurred debt, but the account loans themselves will be repaid on an interest-free basis. CBO estimates that for every $2,000 loaned in this interest-free manner, the government will incur a $1,700 cost.[23]

KidSave accounts are meant to redirect resources from retirees and workers to children. Although there is nothing wrong in principle with attempting to do that, it is important to think about the dynamic effects of such a policy on the economy—especially on working and saving by adults and on their provision to children of private inter vivos gifts and bequests upon death.

KidSave accounts would generate larger public transfers to children. However, that would be substantially neutralized by reductions in private resource flows toward children—both directly, through reduced bequests and inter vivos transfers, and indirectly, through the impact of KidSave accounts on capital and labor markets. Establishing such accounts would compound the fiscal challenge of funding federal entitlements for retirees and the poor.

Given that existing federal commitments to pay entitlement benefits to current and future retirees already imply massive tax burdens on present and future working generations, the scope for imposing additional burdens on taxpayers to finance KidSave accounts appears to be virtually nil. The ongoing debate on Social Security reform indicates that, as a society, we are unwilling to reduce future entitlement commitments. However, it is becoming increasingly clear that those commitments are unsustainable.

Recent estimates indicate that existing federal unfunded entitlement obligations are already impossible to finance—and not only through tax hikes. Alternative ways of financing the obligations—massive cuts in other government operations or huge increases in debt (each by itself or in combination) appear equally infeasible. Under such conditions, creating yet another entitlement whereby children would become the nominal but not the real beneficiaries of government-financed endowments would likely prove counterproductive.

First, let's consider the size of those imbalances and how they came into being: Federal entitlement spending has been rising at a rapid clip for more than 50 years. Ever since the first expansion of Social Security benefits in 1950, entitlement benefits have frequently been increased. The Medicare and Medicaid programs were implemented in 1965 to provide health benefits to retirees and low-income individuals. Subsequent liberalizations of eligibility criteria and care options have redirected federal outlays from traditional government functions toward providing retirement income and health care to retirees.

Federal outlays on Social Security and Medicare grew from 2 percent of total federal outlays in 1950 to 33 percent in 2004. The addition of prescription drug subsidies, scheduled to be fully implemented in 2006, will further increase the share of federal social insurance outlays in total federal outlays.

When taken as a share of taxable income, government (federal, state, and local) social insurance outlays equal 21.2 percent today.[24] The retirement of the baby-boom generation is expected to increase the fiscal burdens implied by such outlays on future workers by

Higher taxes to finance KidSave accounts would cause negative incentive effects on labor supply, capital accumulation, productivity, and output.

considerably more. The Congressional Budget Office calculates that the ratio of retirees (aged 65 and older) to the population of workers (aged 20 through 64) will increase from about 21 percent today to 38 percent by 2050. That unavoidable demographic change will trigger an explosion in government spending on entitlements under current rules. For example, the CBO estimates that outlays on Medicare and Medicaid alone will balloon from 3.6 percent of GDP today to 23 percent by 2050.[25]

Evaluating the U.S. fiscal position using the "fiscal imbalance" measure—the existing debt held by the public plus the present discounted value of future federal noninterest spending minus the present discounted value of future federal receipts—yields $63 trillion. That amount is almost entirely the result of shortfalls in the Social Security and Medicare programs.[26]

A KidSave accounts program would set up a conflict between the account owner—the child—and its initial custodians—the parents or guardians.

As a share of the present value of payrolls, $63 trillion equals 18 percentage points of the present discounted value of all future payrolls. Thus, a resolution of the fiscal imbalance would require the average wage-tax rate to go up by another 18 percentage points. By implication, the existing payroll tax base would have to be expanded by eliminating the Social Security taxable ceiling, and the current payroll tax rate of 15.3 percentage points would have to be more than doubled immediately and permanently. Alternatively, the average income tax rate—estimated at 9.2 percent of GDP over the next 10 years—would have to be more than doubled.[27]

Tax increases of this magnitude cannot succeed in resolving the fiscal imbalance embedded in current policies. If that were attempted, disincentives to work would become severe. Despite the consensus among economists that labor supply is relatively inelastic with respect to after-tax wages, the output- and revenue-reducing effects of such massive payroll or income tax increases would be enormous and would reduce both output and the tax base. That, in turn, would require still higher tax rates to generate the revenues necessary for paying promised entitlement benefits. Taxing other income sources—capital income, for example—would have similarly negative effects on output as investors would choose to avoid the tax by exporting savings abroad rather than investing it in the United States.

Similarly, steep cuts in federal spending—estimated at 50 percent for non–Social Security and non-Medicare outlays, or deficit financing for raising the required revenues, would also take a severe toll by increasing interest rates, causing high and sustained inflation, and reducing economic productivity.

Any future fiscal adjustment to resolve the existing imbalances in entitlements must involve a sizable reduction in federal payment commitments for entitlements. To the extent that we are unable or unwilling to reduce those commitments, national saving needs to be increased to improve the economy's productive capacity to pay projected retirement and health care costs. KidSave accounts are certainly motivated by the need to increase saving. The key question is whether establishing such accounts would help to do so. Unfortunately, mandating saving on behalf of children by imposing higher taxes on adults is unlikely to work. Why? For the same reason that imposing higher taxes for financing entitlement commitments will not successfully finance those outstanding commitments. As detailed in the next few sections, higher taxes would cause negative incentive effects on labor supply, capital accumulation, productivity, and output. For those reasons, KidSave accounts might achieve exactly the opposite of what is required.

Perverse Incentives

Impact on National Saving and Investment

There are two possibilities for how the KidSave accounts could be administered. They could be created and managed by a central authority and controlled by the federal government or controlled by parents or guardians until the child attains adulthood.

Under the first option, revenues earmarked or appropriated for KidSave accounts would be deposited with a central authority and allocated to accounts created in each child's name. The newborn child's parents or guardians would receive reports about how much was in the account and how it was invested. The central authority would make decisions on behalf of the children regarding how account assets were to be invested.

There are obvious pitfalls in this procedure. Just as the current Social Security and Medicare trust funds hold Treasury securities, the new KidSave fund would also hold government bonds if the operating authority were restricted in its investment choices. That would not necessarily result in higher national saving, because the funds would be made available to the federal government and would likely be spent on other federal operations. That is exactly what happens to Social Security payroll tax surpluses today. If some of the funds were invested in private market stocks and bonds, the federal government would be in the position of picking winners and losers, and investment policies would be dictated by political preferences instead of optimal returns. One has only to look at state and municipal pension funds to see the dangers of direct government investment. States have routinely attached a variety of politically oriented investment mandates and restrictions. Moreover, trustees of such funds have frequently been unable to resist the temptation to meddle in corporate governance.[28]

Proponents of KidSave accounts appear to recognize the inherent dangers in allowing the government to invest and manage the funds (although, curiously, some of the same policymakers and analysts refuse to acknowledge similar problems with investing the Social Security and Medicare trust funds in private securities). Hence, they specify that parents or legal guardians would serve as account custodians and make investment decisions on behalf of children until they reach age 18. Default investment in a life-cycle-type fund would occur if no explicit investment election were made.[29]

Account withdrawals would be restricted to ensure that accounts were used for productive, asset-building purposes. Withdrawals would be prohibited until the account owner turned 18. Thereafter, withdrawals would be governed by rules similar to those of Roth IRAs, which permit withdrawals without penalty prior to retirement for first-time home purchase and postsecondary education. (In the case of home purchases, however, whether a subsequent home sale would trigger a reversion of the released home equity into KidSave accounts remains unclear. If not, this loophole could be exploited for premature consumption of assets accumulated in KidSave accounts. But requiring such reversions would also entail greater complexity in the tax code.)[30] Other distributions would incur steep penalties against withdrawals of government contributions—that is, use of funds other than for asset building would trigger loss of all government matching funds.

Despite the apparently comprehensive safeguards against use of KidSave funds for preretirement consumption, the program would set up a conflict between the account's owner—the child—and its initial custodians—parents or guardians. Older generations—parents and guardians—are expected to finance the accounts through higher taxes. Without KidSave accounts, parents and guardians would ordinarily determine how much to save in anticipation of the child's future needs. However, KidSave accounts would provide an incentive for the parents and guardians to offset their own saving for their children's future. For families that receive a KidSave subsidy from the government, that offset would generally be larger than the family's tax cost for initiating the KidSave account and making subsequent contributions to it.

KidSave accounts would allow tax-free accumulations of assets until the money was withdrawn (for retirement or earlier for emergency spending needs). If parents were theretofore unable to access a tax-free investment vehicle to save for their children's future needs, such accounts would provide it. Access to a tax-subsidized account would enable the parents to save more for their children but also to consume more themselves by reducing their own saving on behalf of their children.

KidSave accounts would induce parents and guardians to offset their own saving for their children's future.

KidSave accounts would enable older generations to exploit the matching grants and spend more on themselves instead of allowing those resources to flow through to their children.

Offsetting this increase in consumption would be a reduction in consumption for those who would bear higher tax burdens but don't have children eligible for KidSave accounts. Such individuals tend to be older and wealthier and to save more. Their consumption would be unlikely to decline by much because of the higher taxes they would pay to finance KidSave accounts. It is quite possible, therefore, that total national consumption would increase as a result of introducing KidSave accounts and national saving would *decline*—ultimately causing lower investment, productivity, and output for future generations.

Thus, in spite of the seemingly elaborate safeguards included in KidSave proposals to prevent their early withdrawal for consumption, such accounts would only enable older generations to exploit the new government matching grants and spend more on themselves instead of allowing those resources to flow through to their children.

Empirical evidence that parents' consumption would increase following the introduction of KidSave accounts, although indirect, is quite strong. Studies have shown that "effective" transfers of resources from younger to older generations have, over time, increased the consumption of older generations—as would be expected in theory. The transfer itself is the result of the political process whereby older generations have voted for redistributing resources from younger and future generations toward themselves.

Such transfers have occurred in two ways: (1) directly, by providing older generations entitlement benefits greater than their past payroll tax contributions, and (2) indirectly, through the forced annuitization of benefits, which, by ensuring retirees against outliving their resources, enables them to consume more out of available resources, thereby reducing involuntary bequests. The studies also confirm that retirees have not undone their forced annuitization of resources through Social Security and Medicare by increasing their purchases of life insurance.[31]

It appears unlikely that a transfer in the reverse direction (that is, from older to younger generations) will be similarly effective, because older generations would retain control over the transferred resources directly (as account guardians and managers) or indirectly (through the political process), thereby dictating the future tax burdens to be imposed on children when they become adults.

Other studies have shown that the distribution of intra-extended-family consumption follows the distribution of intra-extended-family income and that a transfer of resources from children to parents prompts very small reverse private transfers.[32] If forced transfers in the oppostie direction (that is, from parents to children) crimp parents' budgets, they will provoke significant reverse private transfers—from children to parents—through parents' actions of reducing saving, increasing consumption, and limiting bequests and inter vivos gifts to children.

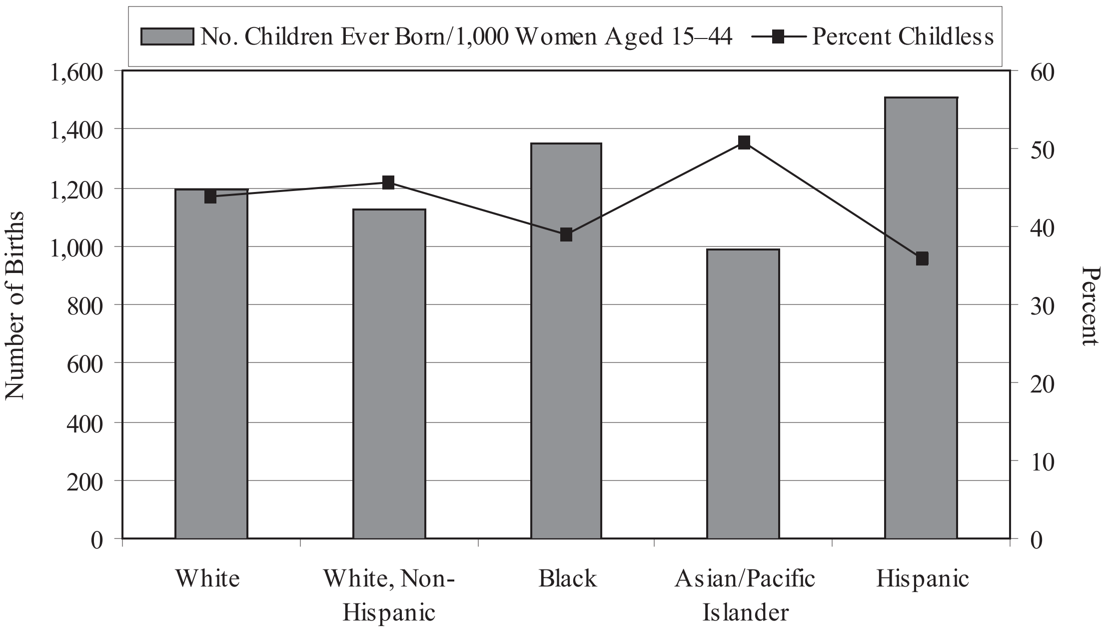
Impact of KidSave Accounts on Labor Market Efficiency

KidSave accounts would not treat all families equally. Groups that tend to have more children—e.g., blacks and Hispanics—would receive larger benefits (Figure 1). Groups with lower fertility rates and a larger proportion of childless women would receive fewer or no benefits but would still pay the cost of a KidSave program through higher taxes.

The windfall reaped by many families with children would be in addition to the already generous subsidies allowed in the tax code for such families (currently $1,000 per child), special state-based but federally subsidized programs for child health services, child nutrition programs, and monetary assistance to families with children.[33]

Apart from the uncertainty regarding the impact of KidSave accounts on national saving and investment, there is also the issue of the impact of such cross-family redistribution of resources on labor markets. Such accounts would be financed out of general revenues. The benefits of KidSave accounts would flow to families with children, but the taxes used to finance those accounts would increase for everyone. Thus, financing KidSave accounts

Figure 1
Fertility Statistics—June 2002



Source: U.S. Census Bureau.

would have a negative impact on labor markets in general, and the distortionary effect of the program would impose a net loss of economic welfare.

The labor market impact would be different for families with and without children. The latter would face higher taxes but would not receive any benefit from KidSave accounts. Recent literature on the impact of higher taxes on labor supply points to sizable (uncompensated) elasticities—as high as 0.5.[34] By implication, households facing higher taxes but receiving no benefits from KidSave accounts would reduce their labor-force participation and after-tax earnings in response to higher taxes.

Families with children would also face higher taxes. That group is likely to contain a sizable proportion of married households that generally take itemized deductions on their tax returns. The negative impact of higher taxes is likely to be even stronger on the labor supply and earnings of this group, because itemizers react strongly to tax changes, and the impact of higher taxes is strong on secondary earners' labor-force participation.[35] In addition, these households would reap benefits from the resources redistributed to them from childless families. The increase in their wealth is likely to induce an additional shift away from work and toward leisure for such households—reducing their labor supply and earnings by even more than predicted in the literature on labor supply elasticities.[36] Overall, therefore, the impact of financing KidSave accounts could be to reduce labor force participation, especially of households with children, and to worsen overall labor-market efficiency.

If forced transfers from parents to children crimp parents' budgets, they will provoke significant reverse private transfers—from children to parents.

KidSave Accounts and the Distribution of Tax Saving Incentives

All of the proposals call for a flat contribution by the government for each newborn child. Children born to rich or high-earning parents would be treated the same as those born to poor parents. Hence, an equal opportunity to save in a new tax-sheltered savings plan would be created for all families. However, studies on the impact of saving by households in 401(k) and IRA accounts show that the richest households would reap the most benefit from participating in these plans. If tax deductions or credits were made available for contributions to KidSave accounts, the highest earning households would reap the most benefits as they would reduce their tax liability at the highest marginal rate for each dollar of annual contributions to KidSave accounts.

Indeed, poorer households may not be able to contribute at the same rates as better-off households. Inevitably, calls for liberalizing the program by increasing the government contribution for poorer households would arise—expanding the size of the program and leading to higher taxpayer burdens.

KidSave accounts are intended for long-term saving. However, withdrawals may be permitted for use in acquiring more education and skills. Previous experience with college saving accounts —529 and Coverdell tax-saving accounts—has shown that participating households are penalized by college financial aid policies that deny aid to children with financial resources.[37] Hence, to the extent that poorer households saved in KidSave accounts, their efforts to achieve financial security for the child would be neutralized by the "college tax."

KidSave Accounts and Bequests

Data from the Survey of Consumer Finances point to a declining bequest ethic among Americans. Data from the 2001 survey suggest that, among those aged 65 and older, about 50 percent thought that it was important to leave a bequest to their offspring. But the share of those who believe in bequeathing to children appears to be declining. In 1989, for example, the share of those aged 65 and older was higher, 55 percent.[38]

Only about a quarter of retirees expect to leave a sizable bequest to their heirs. Whether they actually do so and the size of their bequest will be affected by their perception of how well off their children already are—a perception that would be revised were KidSave accounts implemented.

The process of private wealth transfers to younger generations through bequests and inheritances has been eroding over time for several reasons: Rising longevity means that the elderly must consume more of their resources before they pass away. Medical costs are rising and an increasing number of retirees are living independently from their children—which is costlier than joint living. If these trends continue, bequests will further decline as a share of total retiree resources.

How will initiating KidSave accounts affect this process? If anything, greater perceived self-sufficiency among children is likely to increase their parents' and grandparents' consumption, as the latter will feel less compelled to conserve resources for the benefit of their offspring. And this sentiment would be reinforced if the parents had earlier paid taxes to fund KidSave accounts. Indeed, as assets accumulated in KidSave accounts, parents' inter vivos gifts to children—whether by financing education or providing for down payments on homes—would likely decline.

In short, a handout to children in the form of KidSave accounts could be substantially offset by smaller private transfers. Families that enjoy a net gain would increase their consumption. And all families that experienced higher taxes would face reduced work incentives. Because families with a larger number of children and poorer families have higher consumption propensities, such a redistribution of resources would likely cause less overall saving.

As a result, children would suffer a further indirect reduction in their lifetime wealth: Greater consumption today by adult generations would reduce the national capital stock and future labor productivity—precisely when their children enter the workforce. Their reduced productivity and wages would mean, among other things, reduced ability of today's children to save for their own retirement.

Impact on Out-of-Wedlock Births

We do not understand what the impact of KidSave will be on the serious problem of out-of-wedlock births. Academic researchers have increasingly come to accept the link between the availability of traditional welfare benefits and increased out-of-wedlock birth rates. Of the more than 20 major studies of the issue, more than three-quarters show a

Households facing higher taxes but receiving no benefits from KidSave accounts would reduce their labor-force participation and after-tax earnings in response to the program.

significant link between levels of welfare and out-of-wedlock childbearing.[39]

There is clearly a difference between traditional welfare payments and KidSave. The former provide subsidies directly to parents and make those subsidies contingent in many ways on the parents not marrying. KidSave accumulations would theoretically only be available only for the child's use sometime in the distant future. Moreover, the subsidy would be unrelated to marital status.

Even so, parents of children receiving a KidSave subsidy are likely to feel wealthier. If so, KidSave could be perceived as a reward for having children regardless of whether or not the parents are married. Added to other welfare benefits, KidSave may increase out-of-wedlock births. At the very least, this question is deserving of more study.

Better Solutions

Social welfare initiatives such as KidSave are properly the province of state and local governments or, better yet, of private charity. And there is much that can be done at those levels.

The first and simplest approach would be to remove policy barriers that prevent low-income Americans from accumulating assets. For example, most states still impose a limit on the amount of assets a family may accumulate while remaining eligible for TANF assistance. These limits are usually quite low ($2,000–$3,000), meaning that families who save, rather than spend, the assistance they receive are penalized.[40] At the same time, poor families who have some assets may be encouraged to spend those assets down in order to qualify for government benefits. Those limits should be significantly liberalized.

Of course, this involves a delicate balance. Expanding the asset eligibility limits of welfare programs to preserve eligibility despite larger wealth accumulation would pose the risk of increasing the population receiving welfare. More people will qualify for benefits, and recipients may remain on the program longer. Aside from the many other problems associated with increased utilization, this would make it even more difficult to translate higher savings through KidSave programs into higher national savings, because the simultaneous expansion of welfare eligibility limits would generate saving disincentives for a broader population: inducing individuals at even higher earning and wealth levels to work less and spend down their assets in order to qualify for welfare benefits.

Still we believe this is a reasonable risk when talking about benefits that are "savable," such as TANF, since current rules create such perverse incentives not to save. Under current rules a person who spends every dollar of benefits retains eligibility for future benefits, but a person who acts responsibly and saves some of his benefits could lose eligibility. Since noncash benefits, such as Medicaid, cannot be saved, the same set of incentives is not present. Therefore, eligibility requirements for noncash or "in-kind" programs should not be weakened. Welfare benefits generally, but particularly "in kind" benefits such as Medicaid, should be time limited and linked to work requirements so that people feel that "dis-saving" to achieve eligibility is not worthwhile.

States that wish to experiment with savings-based programs for the poor are currently free to do so, and many already are. For example, the 1996 welfare reform bill authorized states to set up IDAs on behalf of TANF recipients and provided limited funding as well.[41] The individual funds must be used for accumulating capital for postsecondary education, for a first-time home purchase, or to start up a business. Individuals on the welfare rolls can contribute to IDAs from earned income, from matching funds coming from 501(c)3 non-profit organizations, or from state or local government agencies. Funds in an IDA will be disregarded for purposes of any asset tests for TANF or other forms of cash assistance.

Approximately 32 states have authorized IDAs as part of their state TANF plans, but only 15 have actually used their TANF funds for IDAs, and only 7 of those have allocated any significant amounts to IDAs.[42] States should

The richest households would reap the most benefit from KidSave accounts.

To the extent that poorer households saved in KidSave accounts, their efforts to achieve financial security for their children would be neutralized by the "college tax."

be encouraged to extend and expand these experiments.

Some states are also experimenting with KidSave-style accounts for newborns. For example, in Kentucky the state treasurer (a Democrat) and the secretary of state (a Republican) created the Cradle to College Commission, which is working with banks, colleges, businesses, and foundations to design a test program of accounts for children.[43]

Even better, private charities are becoming involved in savings promotion and asset accumulation programs. For example, several nonprofit organizations are contributing funds to a program known as SEED (Savings for Education, Entrepreneurship, and Downpayment), a partnership of the Aspen Institute Initiative for Financial Security, the Center for Social Development of Washington University, CFED, the New America Foundation, and the University of Kansas School of Social Welfare.[44] This program provides an initial deposit and then matches family contributions for four years—up to $1,200. So far, several hundred children in several dozen communities are participating. Among those funding the initiative are the Charles and Helen Schwab Foundation, Citigroup Foundation, Ford Foundation, MetLife Foundation, and Richard and Rhoda Goldman Fund.

In another example, the St. Louis–based Jim Casey Youth Opportunities Initiative offers "opportunity passports" to teenagers leaving foster care. The program, currently operating in 12 communities around the country, provides $1,000 in matching funds for money that these young people save for college, an apartment security deposit, or a car.[45]

Ironically, one of the barriers to these programs is state and federal welfare regulations that may consider contributions to the accounts and interest earned by the accounts as income to the family, thereby jeopardizing the family's continued eligibility for programs such as TANF, Supplemental Social Security Income, and Medicaid. The potential loss of such benefits discourages families from participating. Although there appear to be ways around most of the regulations—for example, establishing the accounts as an irrevocable trust—they needlessly complicate the programs.[46] As mentioned above, states should be encouraging asset accumulation by low-income workers, not setting up barriers.

At the federal level, there are several measures that would make it easier for low-income workers to save. For example, taxpayers should be allowed to split their refunds, with a portion being directed to retirement accounts. Currently, only a single refund option is allowed. If low-income workers perceive their only choice to be between spending and saving all of their refund, most will choose to spend it. However, the Treasury is currently considering a proposal to allow refunds to be split as many as three ways. It is hoped that the option of saving a portion of their refund, which could begin as early as 2007, would encourage low-income workers to save. This would be particularly attractive when applied to existing refundable tax credits, such as the Earned Income Tax Credit or the Child Tax Credit.[47]

Second, Roth IRA rules should be changed to allow parents to set up accounts in the names of their children. These accounts would not be accessible until the child's 18th birthday, after which the accounts would convert to standard Roth IRAs.

But the most important thing the federal government could do to increase savings among low-income families would be to allow workers to save and invest a portion of their Social Security payroll taxes.

The current Social Security system acts as a barrier to asset accumulation in two ways. First, workers are forced to pay 12.4 percent of their income into Social Security, despite the program's uncertain future and below-market rates of return. This regressive tax falls heaviest on low-income workers, depriving them of the income they need to save and invest privately. As we have said, lack of discretionary income is one of the biggest barriers that the poor face in trying to save. Additionally, the belief that Social Security is buying them some form of retirement protection may discourage people from saving on their own.[48] As Martin Feldstein puts it, low-income workers substitute

"Social Security wealth" in the form of promised future Social Security benefits for other forms of savings.[49]

Unfortunately, "Social Security wealth" is not real wealth. It is not, in any sense, saved or set aside either by the worker or by the government on the worker's behalf. All the worker really has is the promise that a Congress 20 or 30 years from now will raise taxes on future workers and pay benefits. And that is not even a legally binding promise. The Supreme Court has ruled in *Flemming v. Nestor* that workers and beneficiaries have no legal, property, or contractual right to Social Security benefits, even after a lifetime of paying Social Security taxes.[50]

Not only does Social Security contribute to asset poverty among current generations, it also helps perpetuate poverty for future generations. Social Security benefits are not inheritable. A worker can pay Social Security taxes for 30 or 40 years, but if that worker dies without children under the age of 18 or a spouse over the age of 65, none of the money he or she paid into the system is passed on to his or her heirs.[51] Social Security essentially forces low-income workers to annuitize their wealth, preventing them from making a bequest of that wealth to their heirs.[52]

President Bush has called for allowing younger workers to privately invest part of their Social Security taxes through individual accounts. This could be financed by scaling back future benefit promises to those whose payroll taxes are redirected to personal accounts. Individual accounts would, by definition, belong to the individual. Like any other asset, they would be fully inheritable. They would allow the current generation of low-income workers to accumulate real wealth and pass that wealth on to their children. In doing so, they would help reduce long-term inequality and provide a host of social benefits.

Conclusion

An effective anti-poverty strategy would include incentives to help low-income Americans save and accumulate assets. The proponents of KidSave have clearly been asking the right questions. However, KidSave does not appear to be the right answer.

The proposal would create a massive new entitlement program, costing as much as $266 billion during the next 75 years (in present-value terms). If the program were to be expanded, as some have advocated, to all children rather than just newborns, the present-value cost would rise to $414 billion. And the cost would escalate further if the federal government were to match future contributions by parents and guardians of children in low-income families. At a time of exploding entitlement costs, this is a burden we simply cannot afford.

In addition, KidSave may have a number of unintended consequences. Transferring resources from the young to the old—as we have witnessed during the last several decades—has been easy. Going the other way will be harder. That's because older generations will exercise de facto control over resources intended as children's savings: Private transfers to children would be adjusted downward in response to a larger public transfer to children. Older generations, especially those with children who receive the transfers, are likely to consume more by *directly* reducing inter vivos gifts and bequests to children. Thus, KidSave accounts would further reinforce the decades-long decline in private intergenerational transfers.

Moreover, KidSave accounts would redistribute resources from families without children to families with children. As a result, adults who face higher taxes and receive no benefit would reduce their labor-market participation. The reduction in the labor-market participation of adults with children would be even larger in response to the wealth effect on leisure consumption due to receiving KidSave subsidies. The reduced labor supply would reduce current output—again, negatively impacting capital accumulation.

If national saving were to decline, on net, as a result of the saving- and output-reducing effects of KidSave accounts, lower future capital intensity would reduce children's earnings when they enter the labor market—an indirect worsening of their economic position.

Greater consumption induced by KidSave accounts would reduce the national capital stock precisely when future generations enter the workforce.

If the federal government wants to become involved in asset building, it can do so without creating a broad new entitlement.

Social welfare initiatives such as KidSave are properly the province of state and local governments or, better yet, of private charity. In their role as "the laboratories of democracy," state and local governments can experiment, innovate, and find out what works. Many states are already carrying out such experimentation, and that should be encouraged. Even more important, private charities are beginning to recognize the importance of asset building and are starting programs to help low-income Americans accumulate wealth.

If the federal government wants to become involved in asset building, it can do so without creating a broad new entitlement, by allowing younger workers to privately invest a portion of their Social Security taxes through personal accounts.

Advocates of increasing savings opportunities for the poor have asked the right question. But KidSave is the wrong answer.

Notes

1. Jami Curley and Michael Sherraden, "The History and Status of Children's Allowances: Policy Background for Children's Savings Accounts," Center for Social Development, 1998; Jami Curley and Michael Sherraden, "Policy Lessons from Children's Allowances for Children's Savings Accounts," *Child Welfare* 76, no. 6 (2000): 661–87.

2. Throughout this paper, "KidSave" is used as a generic label to refer to all of the proposals described in the first section of this paper.

3. See, for example, Rick Santorum, "KIDS Accounts: To Nurture Investors," *The Hill*, July 25, 2005; Jon Corzine, "A Kids Account for Every Child," http://corzine.sentate.gov/priorities/kids_acct.html; David John, "Congress Should Revive KidSave as an Innovative Step toward Better Retirement Security," Heritage Foundation Executive Memorandum no. 899, September 17, 2003; Norman Ornstein, "Good (and Not Good) Reasons to Overhaul Social Security," *Roll Call*, February 2, 2005; David Brooks, "Mr. President, Let's Share the Wealth," *New York Times*, February 8, 2005; J. Larry Brown and Larry Beeferman, "From New Deal to New Opportunity," *American Prospect*, February 12, 2001.

4. Michael Sherraden, *Assets and the Poor: A New American Welfare Policy* (Armonk, NY: M .E. Sharpe, 1991).

5. Melvin Oliver and Thomas Shapiro, *Black Wealth/White Wealth* (New York: Rutledge, 1996).

6. Sherraden.

7. Cynthia Rocha, "Factors That Contribute to Economic Well-Being in Female-Headed Households," *Journal of Social Service Research* 23, no. 1 (1997): 1–17.

8. Esther Cho, "The Effects of Assets on the Economic Well-Being of Women Following Marital Disruption," Washington University in St. Louis, Center for Social Development Working Paper no. 99-6, 1999.

9. Deborah Page-Adams and Michael Sherraden, "What We Know about the Effects of Asset-Holding: Implications for Research on Asset-Based Anti-Poverty Initiatives," Washington University in St. Louis, Center for Social Development Working Paper no. 96-1, 1996.

10. Federal Reserve Board of Governors, "2001 Survey of Consumer Finances," January 2003.

11. Robert Havemann and Barbara Wolfe, "Who Are the Asset Poor? Levels, Trends, and Composition, 1983–1998," Paper presented to the Symposium on Asset Building: Research and Policy, Washington University in St. Louis, Center for Social Development, St. Louis, Missouri, 2000.

12. Ibid.

13. Dalton Conley, *Being Black, Living in the Red: Race, Wealth and Social Policy in America* (Berkeley: University of California Press, 1999).

14. However, recent studies suggest that in the absence of Social Security, bequests and inheritances would reduce rather than increase the degree of wealth inequality. Jagadeesh Gokhale and Laurence J. Kotlikoff, "Simulating the Transmission of Wealth Inequality," *American Economic Review* 92, no. 2 (2002). Interestingly, Social Security has been shown to increase wealth inequality among retirees. This is true even if income is held constant. Russell Cheng, "Asset Holding and Intergenerational Poverty Vulnerability in Female-Headed Families," Paper presented at the Seventh International Conference of the Society for the Advancement of Socio-Economics, Washington, April 7–9, 1995.

15. Rukmalie Jayakody, "Race Differences in Intergenerational Financial Assistance: The Needs of Children and the Resources of Parents," *Journal of Family Issues* 19 (1999): 508–34.

16. Cited in Andrew Biggs, "Fringe Benefits,"

American Enterprise, July–August, 2002.

17. According to population projections of the Social Security Administration, 4.05 million children will be born in 2006. That, multiplied by $2,000 per newborn child, yields $8 billion as the annual cost of the KidSave program (leaving out administrative costs for the sake of simplicity).

18. The cost would be proportionately smaller or larger depending on the size of the initial deposit for each newborn child. Present values are calculated at a discount rate of 3 percent, reflecting the government's opportunity cost of funds for long-term borrowing. Note: a risk-adjusted discount rate is used. Proponents of KidSave-type proposals may argue that the investments would earn returns at market rates—more than 5 percent per year. That would incorrectly suggest that a higher discount rate should be used to reduce the present value of the program's cost. The discount rate should reflect the government's long-term opportunity cost of funds.

19. Curley and Sherraden, "The History and Status of Children's Allowances."

20. This is the cost, in present-value terms, of providing a seed account of $2,000 for every child aged 18 and under alive today and every child (at birth) in the future.

21. Curley and Sherraden, "The History and Status of Children's Allowances."

22. Congressional Budget Office, letter to Rep. Jerry Weller, July 7, 2005.

23. Ibid. This represents the net present value of the borrowing cost of a $2,000 loan repaid interest free after 30–34 years.

24. Calculated for the year 2002.

25. See Congressional Budget Office, "The Long-Term Budget Outlook," December 2003.

26. Jagadeesh Gokhale and Kent Smetters, "Fiscal and Generational Imbalances: An Update," *Tax Policy and the Economy*, National Bureau of Economic Research, forthcoming, Spring 2006.

27. See Congressional Budget Office, "The Budget and Economic Outlook: Fiscal Years 2006 to 2015," January 2005.

28. See Michael Tanner, "The Perils of Government Investment," Cato Institute Briefing Paper no. 43, December 1, 1998.

29. For a detailed discussion of the administrative structure options for KidSave accounts, see Fred Goldberg and Jodi Berk Cohen, "The Universal Piggy Bank: Designing and Implementing a System of Savings Accounts for Children," Washington University in St. Louis, Center for Social Development, September 2000.

30. There are additional complications: For example, what would be the tax treatment of interest earned on KidSave accounts? Would it be tax free? If so, parents may exploit those accounts to hold their own savings in KidSave accounts and earn returns tax free. However, making interest earnings on KidSave accounts taxable to the parents (as is done in the United Kingdom, for example) would eliminate the benefits of child credits in the federal income tax and increase the complexity of the tax code.

31. See, for example, A. J. Auerbach et al., "The Annuitization of Americans' Resources: A Cohort Analysis," in *Essays in Saving, Bequests, Altruism, and Life-Cycle Planning*, ed. L. J. Kotlikoff (Cambridge, MA: MIT Press, 2001); and J. Gokhale, L. J. Kotlikoff, and J. Sabelhaus, "Understanding the Postwar Decline in U.S. Saving: A Cohort Analysis," *Brooking Papers on Economic Activity*, Winter 1996, pp. 315–407.

32. See, for example, J. G. Altonji, F. Hayashi, and L. J. Kotlikoff, "Is the Extended Family Altruistically Linked? Direct Tests Using Microeconomic Data." *American Economic Review* 82, no. 5 (1992): 1177–98; and J. G. Altonji, F. Hayashi, and L. J. Kotlikoff, "Parental Altruism and Inter Vivos Trans-fers: Theory and Evidence." *Journal of Political Economy* 105, no. 6 (1997): 1121–66.

33. The child tax credit was increased from $500 to $1,000 per child in the Economic Growth and Tax Relief Reconciliation Act of 2001, but the increase is scheduled to expire at the end of tax year 2010.

34. See Alan B. Krueger and Bruce D. Meyer, "Labor Supply Effects of Social Insurance," National Bureau of Economic Research Working Paper no. 9014, June 2002.

35. Berkeley economist Emmanuel Saez argues that itemizers react more (exhibit a larger "substitution effect") to tax changes than nonitemizers, not only in the amount itemized but also in the total income reported. See Emmanuel Saez, "Effects of Marginal Tax Rates on Income: A Panel Study of Bracket Creep," National Bureau of Economic Research Working Paper no. 7367, September 1999.

36. This is the "income effect" of the transfer that would increase leisure and reduce work effort.

37. See, for example, http://registeredrep.com/mag/finance_college_smarts/index.html; http://www.discovercolleges.com/college_tips/financial_aid_overview.cfm.

38. Authors' calculations from the Survey of Consumer Finances, 1989 and 2001.

39. For a fairly detailed survey of the research leading up to welfare reform in 1996, see Robert Moffitt, "The Effect of Welfare on Marriage and Fertility: What Do We Know and What Do We Need to Know?" University of Wisconsin, Institute for Research on Poverty Discussion Paper no. 1153–97, December 1997. For more recent discussions of the issue, see Jeff Groger and Stephen Bronars, "The Effect of Welfare Payments on Marriage and Fertility Behavior of Unwed Mothers: Results from a Twins Experiment," National Bureau of Economic Research Working Paper no. 6047, May 1997; Marianne Bitler et al., "The Impact of Welfare Reform on Marriage and Divorce," Federal Reserve Bank of Atlanta Discussion Paper no. 2002-9, May 2002; Francine Blau, Lawrence Kahn, and Jane Waldfogel, "The Impact of Welfare Benefits on Single Motherhood and Headship of Young Women: Evidence from the Census," National Bureau of Economic Research Working Paper no. 9338, November 2002; and Hilary Williamson Hoynes, "Does Welfare Play Any Role in Female Headship Decisions?" *Journal of Public Economics* 26, no. 3 (1991): 545–61; and Ron Haskins, "Does Welfare Encourage Illegitimacy? The Case Just Closed. The Answer is Yes." American Enterprise Institute, January 1996.

40. Ray Boshara, "The Rationale for Assets, Asset-Building Policies," and "IDAs for the Poor," in *Building Assets: A Report on the Asset Development and IDA Field*, ed. Ray Boshara (Washington: Corporation for Enterprise Development, 2001).

41. Although $125 million was appropriated for five years, Congress authorized only $10 million per year up to 2000; in 2001 Congress authorized the full $25 million appropriation.

42. Boshara, p. 102.

43. Amy Goldstein, "Initiatives to Promote Savings from Childhood Catching On," *Washington Post*, August 20, 2005.

44. Ibid. Although it is primarily privately funded, SEED does receive some government money.

45. Ibid.

46. Memorandum from Rene Bryce-LaPorte to Jennifer Mezey, "Treatment of Children Seed Accounts under Means-Tested Programs," Center for Law and Social Policy, March 5, 2002.

47. Dar Haddix, "Many Ways to Increase Savings," *Washington Times*, April 1, 2005.

48. Congressional Budget Office, "Social Security and Private Saving: A Review of the Evidence," 1998.

49. Martin Feldstein, "Privatizing Social Security: The $10 Trillion Opportunity," Cato Institute Social Security Paper no. 7, January 31, 1997.

50. 363 U.S. 603 (1960).

51. Survivors' benefits may be extended to age 21 if the child is enrolled in college.

52. Gokhale, "The Impact of Social Security Reform on Low-Income Workers." See also Jagadeesh Gokhale et al., "Simulating the Transmission of Wealth Inequality via Bequests," *Journal of Public Economics* 79 (2001): 93–128.