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ROTH IRAS FOR KIDS:
Little Savers, Big Results

by

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A conversation is occurring on Capitol Hill about the opportunity to build wealth in America and the difficulty for families to climb the economic ladder to join or remain in the middle class. As policymakers, we must steer the discussion to what can be done and to what works.

Studies consistently show the short- and long-term benefits of savings. Young people with their own savings accounts are up to seven times more likely to attend college than similar young people without accounts of their own, even when controlling for factors such as parental education, family income, race, and school achievement.[1]

Low-income families that save set the stage for intergenerational economic mobility. Children from low-income families that save are more likely to climb the economic ladder as they age than children from similar families that do not save; 71 percent of children from high-savings, low-income families rise out of the lowest income quartile over their lives, compared with just 50 percent of children from low-income, low-saving families.[2] Not all the benefits of savings are economic in nature, however. Children participating in the child development account program of the Saving for Education, Entrepreneurship, and Downpayment (SEED) experienced such nonfinancial benefits as improved future orientation and self-esteem.[3] The future well-being of our children depends in part on their ability to build at least modest assets as they transition to adulthood.

However, many modern Americans refrain from saving as much as they should to prepare for financial shocks, to invest in education, and for retirement. An unsustainable 45 percent of working Americans do not have any retirement savings,[4] and just over half of Americans do not have enough savings to cover three months of expenses, the amount that experts recommend.[5] The current lack of household savings threatens not only the financial stability of American families but also the future of the American economy.

The Financial and Economic Literacy Caucus (FELC), a bipartisan caucus of members of the U.S. House of Representatives, was founded in 2005 by former Congresswoman Judy Biggert, a Republican from Illinois (R-IL), and current Co-Chair, Congressman Rubén Hinojosa (D-TX), Democrat from Texas.[6] The message of the Caucus is a nonpartisan one and remains the same with the new Republican Co-Chair, Congressman Steve Stivers (R-OH)from Ohio: policymakers need to empower consumers with the information they need in order to make healthy financial decisions and have access to the financial tools to build a secure future. A focus on financial literacy makes sense for lawmakers from all points on the ideological spectrum; —financial empowerment can alleviate poverty and reduce inequality, while also providing Americans with the tools to be financially independent and self-reliant.

As the co-chairs of the Financial and Economic Literacy Caucus (FELC), we came together to find simple proposals with broad appeal that would encourage savings for young people and improve their financial capability. Studies have shown that pairing a savings account with financial education acts as a force multiplier.[7] Intuitively, we know that learning about financial concepts from a book pales in comparison to engaging with an account of your own. This idea led us to a proposal that has had many proponents over the years in the financial literacy and asset-building fields—that is, to eliminate the Roth Individual Retirement Agreement (IRA) earned-income requirement for young people.

Roth IRAs have become the darling of financial planners; they are tax-preferred, long-term accounts that have high growth potential. With modest income caps, Roth IRAs are limited to low- and moderate-income workers. Unlike traditional IRAs, Roth funds can be withdrawn penalty-free prior to retirement for higher education, a home down payment, or financial emergencies.

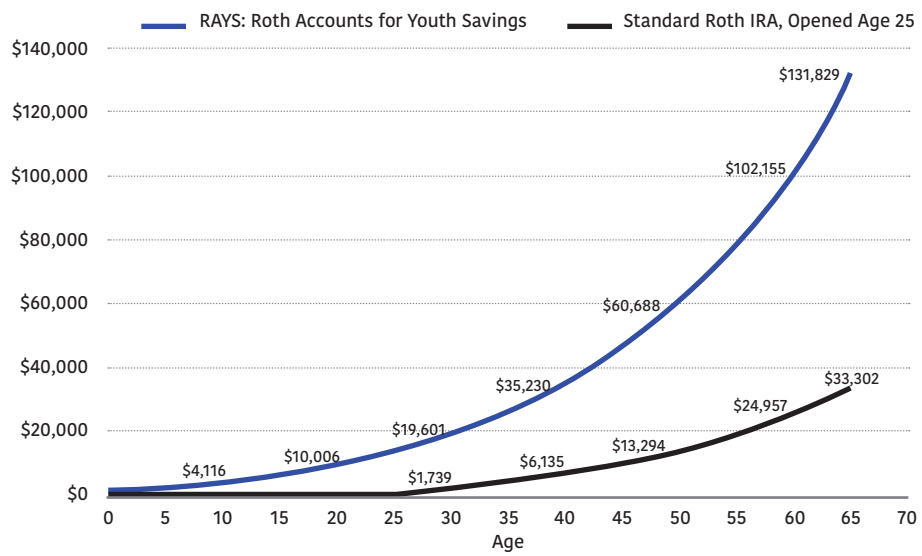
Recognizing the broad appeal of creating a Roth IRA for young people, we recently introduced H.R. 4129, the Roth Accounts for Youth Savings (RAYS) Act. This act proposed removing the earned-income requirement, which would open the door for RAYs to be set up for very young children. Funding for RAYs could come from multiple sources: parents, other family, or organizations. RAYs would use the parents' Roth IRA contribution limits, requiring no new federal spending.

Nonprofit organizations and local governments have expressed interest in seeding child development accounts for low-income children in their communities. For example, in 2010, the city and county of San Francisco launched K2C (Kindergarten to College), the nation's first universal child savings accounts involving seeded child savings accounts for all entering kindergartners.[8] In Cuyahoga County, Ohio, county officials plan on starting a similar program. RAYs would offer better long-term growth potential for these programs than standard savings accounts. RAYs would also offer more flexibility than other savings products aimed at children, such as the state-based 529 plans, Coverdell education savings accounts, and basic savings accounts. Whereas Coverdells and 529s can be used only for education expenses, RAYs could be used for higher education, homeownership, medical expenses, and retirement.

The biggest appeal of RAYs can be found in the simple concept of compound interest and the time value of money. By limiting the Roth IRA to those with earned income, we are truncating the years available for investment growth, which can drastically affect the final account balance. For example, with an initial deposit of $500 at birth and a subsequent $250 annual deposit (about $21 per month), a RAY would be worth $131,829 at age 65 (assuming a 5 percent return). If opened at age 25 with the same $500 deposit and $250 annual contribution, the Roth IRA would only be worth $35,229 at age 65. Future savers should have the opportunity to accrue up to 25 extra years of compound interest, which, in our example, equates $96,600.[9]

Figure 1

Why RAYs?



*$500 initial deposit, $250 annual deposit, 5% average rate of return

The RAYS Act calls for a simple change in the tax code and no new federal spending. Nonworking spouses currently have the ability to open a Roth IRA; this bill would simply expand the exemption to dependents. Although the bill makes only a small policy change, it could have a big impact. The current market for tax-preferred, long-term financial products for youth is very limited. Removing an unneeded restriction allows financial institutions to offer new products that would boost the asset-building power of child savings. The result is a win-win for families and financial institutions. There is no reason that Congress should not remove the Roth earned-income barrier for youth.

Undoubtedly, RAYs are no panacea for income inequality, and their availability will not automatically lead to participation. Currently, only 7 percent of workers (and 2 percent of workers who make less than $20,000 per year) have an IRA of any kind, even though IRAs have been available for decades.[10] In fact, too many Americans lack a basic checking or savings account, not to mention retirement and investment accounts. The Federal Deposit Insurance Corporation (FDIC) has found that 17 million Americans lack a checking or savings account, and an additional 51 million have an account but still use costly alternative financial services. Indeed, we need a broader discussion about bringing underserved communities into the financial mainstream.[11]

Access to quality savings products must be coupled with financial education; otherwise, participation will continue to stagnate. It is imperative to teach our young people about the time value of money, the most important financial concept, so they can take advantage of their relative youth. When it comes to the size of retirement savings, time is on their side. The bipartisan RAYS Act would create one very valuable option.

Notes

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2. R. Cramer, R. O'Brien, D. Cooper, and M. Luengo-Prado, "A Penny Saved Is Mobility Earned: Advancing Economic Mobility Through Savings," Economic Mobility Project, Pew Charitable Trust, 2009, http://www.pewtrusts.org/uploadedFiles/wwwpewtrustsorg/Reports/Economic_Mobility/EMP_Savings_Report.pdf.
3. D. Adams et al., *Lessons from SEED: A National Demonstration of Child Development Accounts* (Washington, DC: Corporation for Enterprise Development, September 2010).
4. N. Rhee, "The Retirement Savings Crisis: Is It Worse Than We Think?" National Institute on Retirement Security, 2013, http://www.nirsonline.org/storage/nirs/documents/Retirement%20Savings%20Crisis/retirementsavingscrisis_final.pdf.
5. FINRA Investor Education Foundation, "Financial Capability in the United States: Report of Findings from the 2012 National Financial Capability Study," Financial Industry Regulatory Authority, 2013, http://www.usfinancialcapability.org/downloads/NFCS_2012_Report_Natl_Findings.pdf.
6. For more about the caucus, visit http://financialandeconomicliteracycaucus-hinojosa.house.gov/.
7. C. Baker and D. Dylla, "Analyzing the Relationship Between Account Ownership and Financial Education," The Financial Services and Education Project—New America Foundation, 2007.
8. For more information, visit http://sfofe.org/programs/k-to-c.

9. T. Beck and R. Boshara, "Roths at Birth: Building Financial Capability and Putting the Time Value of Money to Work for Young Americans," concept note prepared for the President's Advisory Council on Financial Capability, 2011, http://www.stlouisfed.org/household-financial-tability/assets/TheRothAtBirth_December2011.pdf.
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