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The Effect of Asset Tests on Saving

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The trend over the past two decades away from traditional, employer-managed pension plans and toward retirement saving arrangements directed and managed largely by employees themselves, such as 401(k)s and IRAs, is in many ways a good thing. But for too many middle- and low-income households, the 401(k) and IRA revolution has fallen short.[2] In this paper, we focus on one of the explanations for this failure: for the vast majority of middle- and low-income households, existing incentives to save for retirement are weak or non-existent.

As a new research analysis from The Retirement Security Project (RSP) documents, federal policy actually often *penalizes* those who save for retirement in a 401(k) or IRA by disqualifying them from means-tested benefit programs, like food stamps, Supplemental Security Income, cash assistance for poor families with children, or Medicaid.[3] The rules associated with the asset tests were largely written before the dramatic shift in the pension system toward 401(k)s and IRAs, and the rules have not adequately been updated since then. As a result, the asset tests often impose surprisingly steep implicit taxes on saving undertaken through 401(k)s and IRAs (even though they generally exempt defined benefit plans).

This policy brief reviews the relevant economics literature on the effects of the asset tests within means-tested benefit programs. The asset tests represent perhaps the most substantial financial disincentive for many families to save in retirement accounts.

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[2] For a broader discussion of these issues, see William G. Gale and Peter. R. Orszag, "Private Pensions: Issues and Options," in Agenda for the Nation, edited by Henry J. Aaron, James M. Lindsay, and Pietro S. Nivola (Brookings, 2003), pp. 183-216; Peter R. Orszag, "Progressivity and Saving: Fixing the Nation's Upside-Down Incentives for Saving," Testimony before the House Committee on Education and the Workforce, February 25, 2004; and J. Mark Iwry, "Defined Benefit Pension Plans," Testimony before the House Committee on Education and the Workforce, Subcommittee on Employer-Employee Relations, June 4, 2003. These and other related publications are available on The Retirement Security Project website (www.retirementsecurityproject.org).

[3] Zoë Neuberger, Robert Greenstein and Eileen Sweeney. "Protecting Low-Income Families' Retirement Savings: How Retirement Accounts Are Treated in Means-Tested Programs And Steps to Remove Barriers to Retirement Savings" Retirement Security Project Policy Brief No. 2005-6. June 2005.

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Both theory and the available evidence suggest that this disincentive can reduce and distort saving among moderate- and lower-income families. Reforms to the current asset tests would thus be not only fair but may also have a positive effect on saving among moderate- and low-income families.

Background

To be eligible for Supplemental Security Income, food stamp benefits, cash assistance benefits under the Temporary Assistance for Needy Families block grant, Medicaid, or low-income subsidies for the new Medicare prescription drug benefit, applicants generally must meet an asset test as well as an income test. Historically, the purpose of the asset tests has been to restrict means-tested benefits to those who have little or no resources to draw upon. As the new research brief from The Retirement Security Project shows, these asset tests are often confusing and inequitable. The asset tests are also a potential disincentive to save in the first place.

Any saving that lower- or moderate-income families undertake runs the risk of disqualifying them for means-tested benefits, since the resultant assets may exceed the asset limits in various means-tested programs. The asset tests thus effectively act as a steep implicit tax on saving. Families with incomes low enough to qualify for a means-tested program under the income test -- along with families whose incomes are currently above the threshold but who are concerned that their incomes may fall in the future -- may respond to this implicit tax by saving less. The implicit tax imposed on saving by the asset tests may thus reduce saving and impair retirement security among lower- and moderate-income households.

The asset tests

Asset tests in means-tested programs tend to be stringent. For example, the food stamp asset limit for most households (those not containing an elderly or disabled person) is $2,000; for households with an elderly or disabled member, the limit is $3,000. In SSI, the limits are $2,000 for a single individual and $3,000 for a couple. The limits in both programs are not indexed to inflation and have not been adjusted for more than a decade. The food stamp asset limit was last raised in 1985. The SSI limit was last increased in 1989.

Some resources are excluded from these asset tests. For example, under the food stamp program, excluded assets include an individual's home, household goods, and anywhere from a portion to the full market value of a car, as well as assets that are not accessible, such as defined benefit pension plans.[4]

[4] Individual states have some latitude with regard to what counts as an asset in the food stamp program; in particular, states may set their own vehicle asset test policies. For a detailed explanation of new state options with regard to asset rules, see "Implementing New Changes to the Food Stamp Program: A

Saving by low-income families

Low-income families tend to have very low levels of assets. According to data from the 2001 Survey of Consumer Finances,[5] families with incomes below $20,000 (and whose head of household was under age 65) had mean assets in a 401(k) account or IRA of only $2,200 (see Table 1). The vast majority of such families -- 86 percent -- had zero assets in such retirement accounts. Among higher-income families, median retirement assets are much higher and the percentage of families with no retirement assets are much lower.

Table 1: Assets held in 401(k)-type accounts and IRAs by families (with head of household under age 65) in different income ranges, 2001

Income range	Mean retirement assets	Median retirement assets	% with no retirement assets
<$20,000	$2,200	$0	86%
$20,000-$39,999	$9,900	$0	59%
$40,000-$59,999	$22,600	$2,000	41%
>$60,000	$120,100	$36,000	17%

Source: Survey of Consumer Finances and authors' calculations.

Low savings and the asset tests: Is there a connection?

Several recent pieces of research examine whether the low observed rates of saving and holdings of wealth among lower-income families are due in part to the implicit tax imposed on saving through the asset tests under means-tested benefit programs.

One paper by former Chair of the Council of Economic Advisers Glenn Hubbard (who is now at Columbia University), Jonathan Skinner of Dartmouth College, and Stephen Zeldes of Columbia University emphasized that on the basis of economic theory, "programs with asset-based means testing can discourage saving by households with low expected lifetime income. The implicit tax bias against saving in this context is significant relative to other areas of tax and expenditure policy, since saving and wealth

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Provision by Provision Analysis of the Farm Bill," Center on Budget and Policy Priorities, January 2003, and "New State Options to Improve the Food Stamp Vehicle Rule," Center on Budget and Policy Priorities, January 2001. For a description of each state's vehicle asset policy, see "Vehicle Asset Policies in the Food Stamp Program," Center on Budget and Policy Priorities, revised February 2005. All three papers are available at www.cbpp.org.

[5] Ana M. Aizcorbe, Arthur B. Kennickell, and Kevin B. Moore. "Recent Changes in U.S. Family Finances: Evidence from the 1998 and 2001 Survey of Consumer Finances," *Federal Reserve Bulletin*, vol. 89 (January 2003), pp. 1-32.

are subject to an implicit tax rate of 100 percent in the event of a sufficiently large earnings downturn or medical expense."[6] In other words, the asset tests can impose particularly potent disincentives to save.

Economists have recently explored whether this theoretical prediction -- that asset tests discourage saving by lower-income families -- is corroborated by real-world evidence. These studies have confirmed that families likely to receive benefits from such programs do respond to changes in limits on asset tests, decreasing their saving when such limits are instated and increasing their holdings of assets (in particular, automobiles) when limits are loosened.

Elizabeth Powers of the University of Illinois was the first to empirically test whether changes in asset tests attached to benefit programs affected levels of savings among lower-income individuals. Powers examined the changes in the asset tests under the Aid to Families with Dependent Children (AFDC) program, which changed significantly in 1981. Before 1981, states had considerable latitude in setting asset tests, just as they now do under the Temporary Assistance for Needy Families (TANF) program enacted in 1996. The 1981 legislation substantially reduced that latitude and imposed more stringent federal rules. Powers studied the savings behavior of low-income female-headed families in states that had relatively generous asset tests before 1981 (and therefore were forced by the new guidelines to impose more restrictive asset tests) relative to the savings behavior of low-income female-headed families in other states. This provides insight into the impact of changing the asset tests, since the change in the restrictiveness of the asset tests varied significantly across states. Thus, if saving by low-income families in states that had been generous before 1981 in their asset tests fell by more (after 1981) than saving among low-income families in other states, a reasonable conclusion would be that the restrictions in the asset tests may have been the cause. Powers found that for each $1 decline in assets allowed under the asset tests, saving was about 25 cents lower.[7]

Jonathan Gruber of MIT and Aaron Yelowitz of UCLA examined the impact of the asset tests imposed under Medicaid on families and children.[8] For example, families with children traditionally had to enroll in AFDC in most states to qualify for Medicaid, and thus Medicaid implicitly imposed the AFDC asset tests.[9] During the late 1980s and

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[6] R. Glenn Hubbard, Jonathan Skinner, and Stephen Zeldes, "Precautionary Saving and Social Insurance," *Journal of Political Economy*, Vol. 103, No. 2, 1995, page 360.

[7] Elizabeth Powers, "Does means-testing welfare discourage saving? Evidence from a change in AFDC policy in the United States," *Journal of Public Economics*, Vol. 68, 1998, pages 33-53. It is possible that Powers' results are biased by her use of nominal figures when analyzing changes in savings during a period in which inflation was high.

[8] Jonathan Gruber and Aaron Yelowitz, "Public Health Insurance and Private Savings," *Journal of Political Economy*, Vol. 107, No. 6, 1999.

[9] Medicaid also explicitly imposed the AFDC asset test as an eligibility criterion for families that were *not* on AFDC but qualified under another Medicaid eligibility category.

early 1990s, however, the federal government allowed states to expand eligibility for Medicaid to children and pregnant women in families that did not qualify for AFDC either because of their income or their family structure.[10] Gruber and Yelowitz studied the effects of changes in program requirements over time as well as the differential pace at which various states implemented such changes. They analyzed changes in savings behavior from 1984 to 1993 and expected to find a decrease in savings stemming from two possible sources. First, a family that receives Medicaid payments will have a lower risk of future unexpected health costs; in theory, this should decrease the incentive to save precautionary funds. Second, attaching an asset test to these payments may further discourage savings to prevent disqualification and a loss of benefits. Using data on wealth in households and participation in Medicaid, Gruber and Yelowitz found a 1.8 percent decline in assets for every $1,000 increase in Medicaid benefits. In the presence of an asset test, the reduction in assets grew to 4.4 percent, more than twice the effect of the benefits alone.

Alex Maynard of the University of Toronto and Jiaping Qiu of Wilfrid Laurier University expanded on Gruber and Yelowitz's analysis by investigating the disincentive effects of Medicaid on saving across the wealth distribution.[11] They examined the same sample and time period as Gruber and Yelowitz, but they separated their households into ten distinct groups based on net worth. They then analyzed whether the depressing effect on savings caused by the asset tests varies by wealth. For those households with initial assets well below the asset limit and those households well above the limit, they did not find a significant decrease in savings after the imposition of an asset test. They found a large decline in saving, however, among households whose assets were only slightly above the limit once the limits where applied. This confirms the idea that moderately poor households with enough assets to be at risk of failing to meet eligibility requirements will decrease their savings to avoid losing access to benefits.

A paper by James Ziliak of the University of Kentucky took a slightly different approach to studying the effects of asset tests for benefit programs on levels of saving.[12] Like Maynard and Qiu, Ziliak separated the sample of households into groups, although he did so based on the predicted probability of entering welfare (low, moderate, and high risk). Rather than looking at changes in wealth in response to policy changes, Ziliak examined the gap in the ratio of liquid wealth to income between poor, near-poor, and rich households. He decomposed this gap into factors including demographics, labor market income, and both asset-tested and non-asset-tested benefit payments, and found

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[10] Some non-AFDC children (the so-called Ribicoff children) already qualified. The expansions greatly increased the number who did.

[11] Alex Maynard and Jiaping Qiu, "Public Insurance and Private Savings: Who Is Affected and By How Much." Paper presented at the University of Albany, April 29, 2005. http://www.albany.edu/economics/Research/insurance.pdf

[12] James Ziliak, "Income Transfers and Assets of the Poor," *The Review of Economics and Statistics*, Vol. 85, No. 1, 2003

that the primary cause of the gap between poor and rich households was the presence of specifically asset-tested income from welfare programs.

Another paper written by Ziliak and Erik Hurst of the University of Chicago took yet another approach to studying changes in levels of saving in response to asset tests in benefit programs[13]. During the 1990s, the federal government made major changes to the welfare program; what had formerly been referred to as Aid to Families with Dependent Children (AFDC) became Temporary Assistance for Needy Families (TANF) in 1996 with the passage of the Personal Responsibility and Work Opportunity Reconciliation Act (PRWORA). Under PRWORA, states were given more control of program regulations. Many states loosened limits on liquid assets and vehicle wealth after this change. The authors studied savings responses among single mothers with less than a college degree in states where the asset limits increased by a relatively large amount ($1000 or more) and those in states where the changes were not as large. Under the model set forth by Glenn Hubbard and his coauthors, one would expect to see a larger increase in saving among single mothers in states with larger changes in the limits than among single mothers in other states. Another unique feature of Hurst and Ziliak's study is their use of a comparison group; they compared saving responses among single mothers to those of childless female heads of household and male heads of household (who would not be affected by changes in TANF policy since they do not qualify for the program) over the same period. Hurst and Ziliak did not find significant increases in liquid assets among single mothers in response to the loosening of asset limits, but they did find a significant effect on vehicle ownership. For every $1,000 increase in a state's asset limit level, single mothers were 13 percentage points more likely to own a car.[14]

James Sullivan of Notre Dame conducted a similar study of changes in vehicle ownership following changes to limits on vehicle assets in AFDC/TANF.[15] Between 1992 and 1996, nearly half of all states loosened restrictions on vehicle wealth, and seven of those exempted the full value of one vehicle from asset limits altogether. By 1999, 21 states had instated a full one-vehicle exemption. Over the period of 1992 to 1999, vehicle ownership among single mothers increased by 7.5 percentage points, and among the least educated of these mothers, vehicle ownership increased by 10.6 percentage points. Sullivan found a significant relationship between state welfare policies and car ownership in the state; a single mother without a high school degree who lived in a state with a $1,500 vehicle limit was 12.2 percentage points less likely to own a car than a similar single woman in a state with no vehicle limit. Additionally, among states that had

[13] Erik Hurst and James Ziliak, "Do Welfare Asset Limits Affect Household Saving? Evidence from Welfare Reform,"NBER Working Paper 10487, National Bureau of Economic Research, May 2004.

[14] When the authors studied the effects of changes to a state's vehicle-specific asset limit, however, they did not find an increase in the probability of car ownership.

[15] James Sullivan, "Welfare Reform, Saving, and Vehicle Ownership: Do Asset Limits and Vehicle Exemptions Matter?" University of Notre Dame Working Paper. November, 2004.

vehicle limits, every $1,000 increase in the limit led to a 2.3 percentage point increase in ownership rates.[16]

The studies above are thus suggestive that the asset tests discourage either overall asset accumulation (Powers, Gruber and Yelowitz, Maynard and Qiu, and Ziliak) or vehicle ownership specifically (Hurst and Ziliak, and Sullivan). The latter result is potentially quite important, since vehicle equity is a crucial asset for many low-income households. A number of recent empirical studies have shown a link between car ownership and employment outcomes: vehicle ownership increases the probability of employment, hours worked per week, and monthly earnings among relatively poor households.[17] Thus, vehicle ownership may also indirectly affect other kinds of saving.[18]

Conclusion

The asset tests under means-tested benefit represent perhaps the steepest implicit tax on retirement saving imposed by the federal government. Although the results from studies on the effects of asset tests on saving are varied and more research is required, our overall conclusion is that households likely to be eligible for means-tested benefit programs and thus subject to asset limits respond to changes in such limits.

The implicit tax imposed by the asset tests on saving through 401(k)s and IRAs can reduce and distort saving among moderate- and lower-income families. Reforms to the asset tests, many of which are described in a new Retirement Security Policy research brief, would not only be fair but also could raise saving among moderate- and low-income families.

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[16] Sullivan compared the trend in car ownership in the single mother sample to car ownership among childless single women, and the relationship between changes in welfare vehicle asset limits and rates of ownership remained strong. Unlike Hurst and Ziliak, Sullivan did not find that changes in the general asset limit had effects on car ownership and equity.

[17] See, for example, Paul Ong, "Work and Automobile Ownership Among Welfare Recipients," Social Work Research, 20(4), 1996, 255-262, and Marilyn Lucas and Charles Nicholson, "Subsidized Vehicle Acquisition and Earned Income in the Transition from Welfare to Work", Cornell University Working Paper 2002-24, 2002. A few authors have additionally controlled for the fact that the relationship could result from a third factor, for instance that an unobservable characteristic such as motivation could improve the chances of owning a car as well as those of being employed. Using instrumental variables to substitute for car ownership, three sets of authors have found that the positive relationship between vehicle ownership and these employment outcomes persists (Steven Raphael and Lorien Rice, "Car Ownership, Employment, and Earnings," Journal of Urban Economics, 52, 2002, 109-130; Paul Ong, "Car Ownership and Welfare-to-Work," Journal of Policy Analysis and Management, 21(2), 2002, 239-252.

[18] In his paper on gaps between the rich and poor in liquid-assets-to-income ratios, Ziliak found that asset-tested income was the driving factor; however, the primary factor explaining gaps in *net-worth*-to income ratios between near-poor, poor, and rich households was differences in labor-market income. Therefore, it is not unlikely that if a single mother were able to purchase a car and thereby expand her labor-market opportunities and thus increase her employment income, she would be more likely to save over time.