Emergency savings for low-income consumers

J. Michael Collins and Leah Gjertson

J. Michael Collins is Associate Professor of Public Affairs and Consumer Science, Director of the Center for Financial Security at the University of Wisconsin–Madison, and an IRP affiliate. Leah Gjertson is a doctoral candidate in Social Work at the University of Wisconsin–Madison and an IRP Graduate Research Fellow.

The recent economic downturn has highlighted the financial fragility of many U.S. households. The foreclosure crisis, high consumer debt, and depleted retirement savings have all focused significant attention on household balance sheets. The reality for many households, regardless of the economic cycle, is that finding liquid financial assets in order to address unexpected expenses is a major economic burden. Households may prepare by setting aside modest amounts of emergency savings, but such saving is difficult for low-income families, and most do not do so. There are few policies or programs that encourage such unrestricted savings, and in fact, some even discourage such savings. This leaves household financial balances in a condition that has been dubbed "financially fragile" by some observers.[1] Households without timely access to financial liquidity when an unexpected event occurs may experience economic and material hardships that threaten household well-being, including housing instability, food insecurity, or failure to access needed medical care. Beyond unexpected negative events, a financial reserve fund can also aid households to take advantage of opportunities that may enhance economic mobility, such as training that increases wages, or the purchase of a vehicle. The importance of unrestricted savings for unexpected contingencies, especially among low-income households, is an important consideration for researchers and policy advocates. In this article, we make the case that even small amounts of emergency savings are an important form of liquidity for low-income consumers, and that policies that encourage such unrestricted savings can help low-income families maintain financial stability and economic well-being.

The need for liquidity

Emergency savings, also called rainy day savings or contingency savings, act as a form of insurance against unexpected, irregular, and unpredictable expenses. Most households will at some point face an unexpected financial event that current income cannot support, leaving the household to scramble to find liquid financial resources to make ends meet. Adequate preparation for a financial emergency is especially important for those in low-income households, who have less access to traditional credit, and whose tighter budgets make saving more difficult.

Without access to liquidity, families might delay paying bills, sell possessions, or seek a formal or informal loan. This need for liquidity is evidenced by research on policy changes that restrict access to higher cost credit products. One study found that restrictions on federal income tax refund anticipation loans for military personnel resulted in a sizeable transition to a close substitute that also provided liquidity, refund anticipation checks.[2] Another study, using state prohibitions of payday lending, also found that restricting access to payday loans resulted in shifts to potentially higher cost alternatives, as well as increases in financial hardship among former borrowers.[3] Recent surveys indicate that low-income households are worried about how their ability to manage economic resources can negatively affect their families.[4] For low-income households, even relatively small shocks can have significant effects on long-term financial stability.

Responding to economic shocks

In 2009, about half of U.S. households reported that they could come up with $2,000 in 30 days.[5] Just over 23 percent of people with incomes below $20,000 and 33 percent of people with incomes between $20,000 and $30,000, could do so. Among those who could find $2,000, 50 percent suggested a savings account as the source, 30 percent suggested borrowing from family or friends, 21 percent suggested a credit card, and about 12 percent suggested a payday or pawn loan.

Recent Federal Reserve data show that, with the exception of the top 10 percent of earners, all households saw their net worth decline meaningfully between 2007 and 2010 during the Great Recession. While median net worth declined nearly 40 percent between 2007 and 2010 across all households, younger, non-college educated, and non-white households lost the greatest proportion of their wealth and have experienced the weakest post-recession recovery.[6] Meanwhile, households indicated in 2010 that acquiring liquidity was their top saving priority, even though the number of families reporting having at least $3,000 in liquid savings dropped to 48 percent in 2010 from 53 percent in 2007.[7]

Families typically respond to unanticipated income shocks or unplanned expenses by consuming less. They may reduce consumption beforehand to accumulate savings, or they may reduce consumption afterward in order to pay back the debt. In the absence of adequate savings, households must turn to formal or informal sources of credit, often using alternatives that come at higher costs than conventional credit.[8] But there remain a range of strategies low-income households can employ, including:[9]

- *Bank Overdrafts:* For those people with a transactional account, if that financial institution offers overdraft features, they can take out a short-term loan just by writing a check and letting it bounce, with the financial institution extending a line of credit to cover the shortage (typically charging fees).

- *Borrowing from friends or family:* Someone who knows a borrower personally may benefit from having information about the borrower's ability to repay, and may have additional influence to collect payments that may not be available to formal lenders. The non-monetary costs for this type of lending can be steep, however, and people with low-income friends and family will not likely be able to borrow large amounts.
- *Late or skipped payments:* One simple way for an individual to deal with an unexpected expense is to delay or skip a payment for another bill. This will likely result in additional fees, may result in service shut-offs or repossession, could threaten housing stability, and could undermine an individual's credit history.
- *Payday loans:* Payday lenders are often convenient and may cost less than missed payments, but can become very expensive if the borrower extends the loan by rolling it over at the end of the short loan period for additional fees.
- *Pawnshops:* One of the oldest forms of household liquidity, pawn shops are relatively convenient for smaller loans if there is something of value to pawn, although the borrower risks losing their pawned possession.
- *Auto title pawn:* This is a form of pawn, with the benefit that the borrower can still use their automobile during the loan term. While often convenient and transparently priced, the borrower risks the loss of their vehicle, which may be their only transportation to work and other vital destinations.
- *Income tax refund loan*: Refund anticipation checks can be sizable but are only available once per year, and are thus more likely to be used to recover from a recent unexpected expense.
- *Credit cards*: A convenient option if the borrower is qualified to have a credit card. Many households cannot qualify for a card or have trouble managing revolving credit accounts.
- *Retirement savings loan or liquidation*: Withdrawals from retirement savings are only available to workers that have accumulated assets in a retirement account, and can be costly in terms of taxes and lost returns when retirement assets are needed later.

Unrestricted saving may be key to preventing material hardships

Low-income households are especially vulnerable to unexpected expenses and other financial shocks. In a recent survey of low- and moderate-income households, respondents reported that if faced with a financial crisis, they were most worried about skipping a housing or utility bill, having to scale back on food, and losing access to health care.[10] In the same study, the majority (62 percent) reported having experienced an economic emergency in the previous year. The risk for multiple emergencies among this population was significant; 60 percent of those with any shock reported experiencing more than one. Although households with savings may have been better prepared to cope with emergencies, they were only slightly less likely to experience emergencies than those without savings.

Saving promotes economic mobility

The potential for savings to improve economic mobility among low-income individuals and families has been the focus of research and program development since the 1990s.[11] There is some evidence that accumulating modest financial assets can assist families to exit poverty. One study is suggestive that low-income individuals with savings above the median significantly increase their chances of moving to a higher income quartile within two decades.[12] Families with savings also improve the likelihood their children will move up the economic ladder in adulthood.[13] Accumulating modest levels of financial assets has been found to have beneficial effects on the well-being of children and families.[14] Of course, the possibility remains that people who save may be more likely to achieve positive economic outcomes for other reasons, but these associations illustrate the potential importance of encouraging savings, especially unrestricted savings.

Policies such as Individual Development Accounts (IDAs) offer matched savings accounts that encourage low-income families to save for activities like home ownership, higher education, and starting small businesses. However, these are restricted-use assets, and many programs find that families cash out the account to obtain cash for an emergency, thus incurring penalties. Less studied is whether small pockets of unrestricted liquid assets have the potential to improve their financial stability or upward economic mobility by generating stabilizing household finances, supporting efforts to increase lifetime earnings, or investing in children. Examples of such opportunities include additional education or work certifications that result in higher wages, a home computer, access to job-search resources, and enrichment activities for children. A mobility-enhancing opportunity could also be a mechanism that allows households to be more efficient with existing resources. For example, in many regions, purchasing a used vehicle for transportation can mean spending much less time in transit, and also allow families to travel in order to obtain food and household goods at lower prices. Low-income households with liquid savings are likely in a better position to act on such opportunities as they become available. However, families may or may not consider them an appropriate use of funds that have been set aside for an emergency.

New research on the effects of emergency savings

Prior research has primarily focused on threshold amounts of net wealth or assets, regardless of the liquidity of available

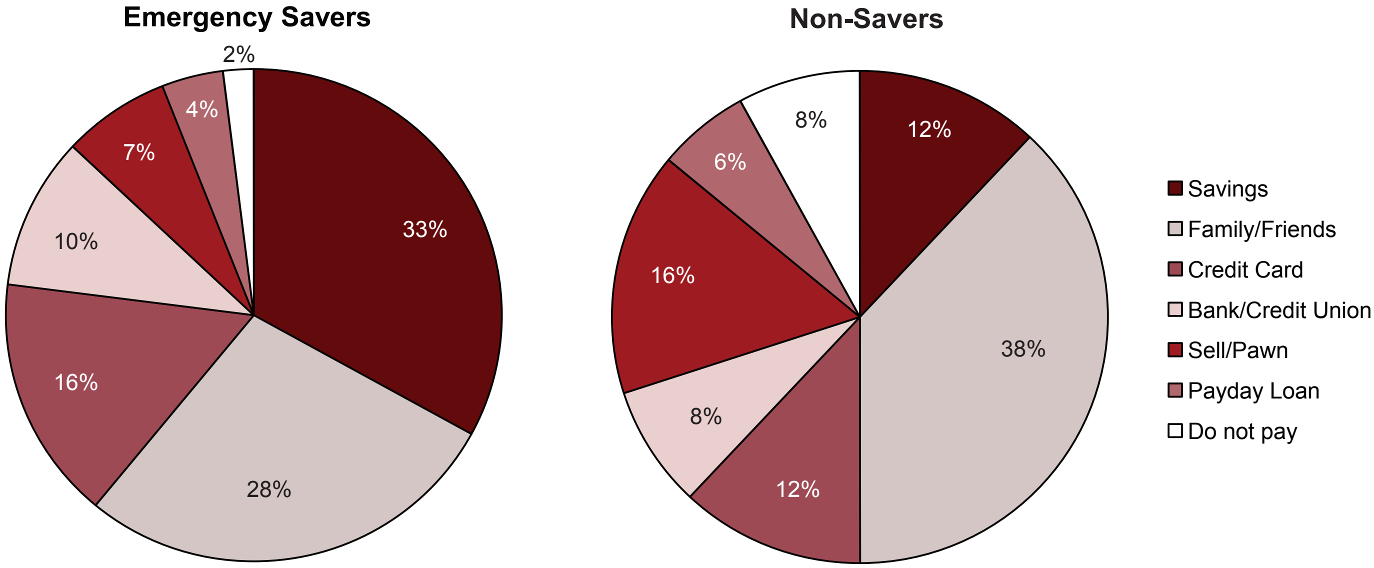

Figure 1. Plan to cope with an unexpected expense for emergency savers and non-savers.

Source: Author calculations from the Annie E. Casey Foundation's Making Connections database.

assets. We argue that some forms of wealth offer more flexibility to address contingencies, and therefore may be more important for people at or near poverty income levels. Using a 10-city, three wave longitudinal survey, we recently looked at whether the act of saving for an emergency provides similar protection against hardship.

We found predictable differences in demographic characteristics between those saving for an emergency and non-savers.[15] Savers tend to have higher incomes than non-savers and more likely have a spouse present in the home. Savers have higher levels of education and employment, consistent with potentially higher lifetime or permanent income. Saving for an emergency is also correlated with high levels of other assets, including home equity, as well as debt. More assets and more debt or access to credit seem to go hand in hand: a greater proportion of savers also have a savings account and a credit card. Emergency savings is also typically a complement to saving for other more specific or restrictive purposes such as saving for a home, schooling, and retirement. Notably, emergency savers tend to be younger, which is consistent with emergency savings as one of the first asset-building activities people engage in, as well as with younger people not yet having had an economic shock to deplete their emergency savings.

As shown in Figure 1, emergency savers and non-savers plan to use different mechanisms for coping with an unexpected expense. Non-savers indicate greater reliance on high-cost financial services such as pawn and payday loans, or on simply not paying for the expense. Figure 2 shows that non-savers report experiencing more subsequent hardships than emergency savers.[16]

Overall, we found that over time families saving for an emergency are, using a variety of techniques such as propensity score matching and controlling for other variables, less likely to experience as many material hardships as non-savers. Emergency savers may be better prepared to cope with economic shocks over time as they are able to use reserved funds to meet expenses and reduce hardships. Saving for an emergency appears to have an effect on hardship distinct from the effects of other types of saving. While our research model does not provide an indication about causality (respondents who report saving for an emergency are different from those not saving in ways our data may not observe), there is clearly enough of an association between unrestricted emergency savings and later household hardships to raise important research and policy questions. Encouraging households to accumulate emergency savings may contribute to economic stability and household well-being.

Barriers to accumulating emergency savings

Saving for a rainy day is of course a bedrock concept taught in most personal finance or budgeting education programs. Since the exact timing of unanticipated expenses cannot be known, putting off emergency saving is easy to do. People may fail to save for an emergency because they lack financial knowledge, fail to adequately assess the risk of an emergency, or simply because they procrastinate. There are a range of barriers that discourage the accumulation of savings among low- and moderate-income households, including economic constraints, policy restrictions, and psychological or behavioral biases.

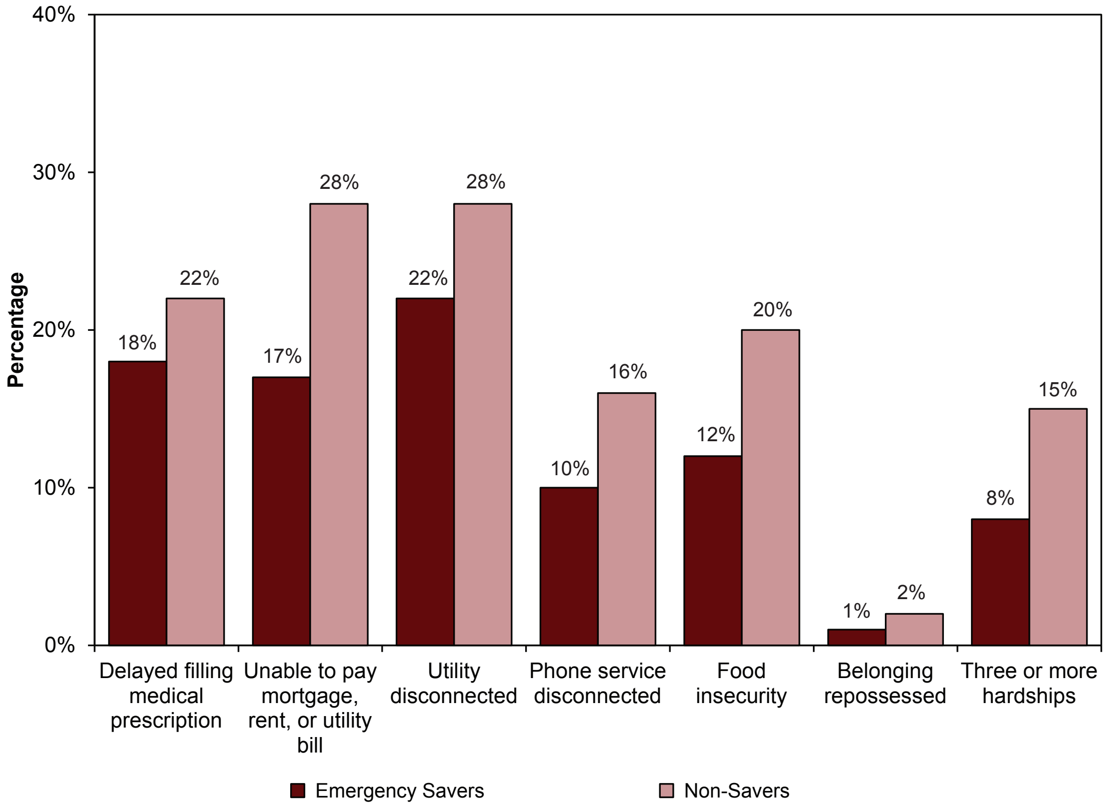

Figure 2. Hardships for emergency savers and non-savers.

Source: Author calculations from the Annie E. Casey Foundation's Making Connections database.

Structural barriers

Saving can be exceptionally difficult for the low-income population, because basic living expenses use a large proportion of available resources, leaving little or nothing left over to save. Income amounts often fluctuate, making it a challenge to smooth spending and allow for saving. The necessary focus on economic survival may shorten the planning horizon of people living at or near poverty, and thus make saving a low priority.[17] Like most Americans, the low-income population is also influenced by the overall economy; as discussed in the introduction, data from the Federal Reserve indicates that disadvantaged households were especially hard hit by loss of wealth during the recession.[18]

In addition, the savings product market is underdeveloped because the financial industry has been reluctant to offer savings products for low-income people. These accounts tend to have small balances and high fixed costs and then these customers are less likely to take on other financial products with revenue potential. There may simply be insufficient economic or market incentives for firms to enter markets catering to underserved consumers.[19]

Governmental policies and programs are another barrier. Some means-tested public benefit programs have asset limits as part of the eligibility criteria that act to discourage savings for households that depend on the benefits. For example, SSI (Social Security's Supplemental Security Income program) benefits restrict a single person to a savings balance below $2,000 and a married couple below $3,000.[20] Some SNAP (Supplemental Nutrition Assistance Program) and TANF (Temporary Assistance for Needy Families) programs also have similar restrictions. Medicaid and other programs also require a review of household assets. Even if program managers offer flexibilities on these rules, beliefs and myths about the asset restrictions of benefit programs may discourage any form of saving.[21] There is an opportunity for innovations that allow recipients of means-tested benefits, to save without losing access to income supports or other valuable benefits. Programs can also go further by deliberately setting up contingency funds for clients in programs, as has been piloted in some housing and temporary assistance programs. Setting up simple systems to set aside portions of federal income tax refunds for a designated emergency fund may also be a useful strategy to test. There are likely a number of innovative ideas that could be tried at the state and local level as well.

Psychological and behavioral biases

Any new strategies being developed around emergency savings goals should be thoughtfully designed to incorporate evidence from the social sciences. Many people—at all income levels—lack skills related to financial planning and forecasting.[22] People may underestimate the need to set aside resources for unexpected expenses. It may also lead people to not seek out beneficial financial products or services because they do not know about them or how to use them. At least one study suggests that among the lowest income quintile households, people perceive their annual emergency savings needs at about $1,500, yet these households typically spend around $2,000 annually on unexpected expenses.[23] People also fail to predict how hard repaying loans will be in the future, and end up overcommitting future resources as a result. Behavioral studies show unrealistic optimism is associated with less prudent financial behaviors, such as short planning horizons and saving less.[24]

People tend to be present-biased, meaning they prefer rewards now, such as the instant gratification of spending, and put off difficult tasks with delayed rewards, like saving.[25] Some people would actually prefer to save more, but fail to predict that they will not follow through with their own stated preferences. Some consumers realize their self-control problem, and correct for it using "commitment devices," such as promising today to save more tomorrow, while others will forever put off saving into the future, with the end result of never saving at all.[26] A commitment device like an automatic deposit into a savings account works only if people are proactive enough to enroll in it, or if they are enrolled into the account automatically.[27] People have only a limited supply of attention that can feasibly be applied to household financial management.[28] Essentially, they neglect to pay attention in the absence of reminders or other mechanisms. Behavioral researchers suggest that self-control is in many ways like a muscle, in that it can be exhausted after repeated exertions within a period of time.[29] It can also be strengthened over time, with experience. Ongoing studies of behavior in a variety of domains, including health and nutrition, suggest that focusing people on concrete goals and then helping them form implementation intentions can serve as powerful incentives or reinforcements for behaviors. A lack of goals can leave people unfocused and with little accountability for failing to take planned actions.[30]

Strategies to encourage savings

In May 2013, with support of the Charles Stewart Mott Foundation, we invited more than 40 thought leaders in industry, government, and the nonprofit and philanthropic sector, to a two-day salon in Chicago, Illinois.[31] There, more than a dozen innovative ideas were presented with the goal of promoting emergency savings for low-income families. These ideas were very much in formative stages, but offer promise for the future. Much of the literature in economics regarding household savings levels emphasizes the importance of long-term savings for goals including home ownership, education, and most prominently retirement. Less is known about saving for short-term needs and unexpected expenses. Federal policies currently have no specific policy or program that supports the development of emergency savings.[32] This is also not an area of vigorous policy research or discussion. Still, many low-income households continue to lack a personal safety net, leaving them vulnerable in the face of unexpected financial emergencies. Policy innovations that fill the void may result in significant effects.

Many prior asset building efforts focused on savings for a home, small business or education. These are important goals, but also imply planning and well developed expectations. Most programs have paternalistic restrictions which prevent using savings for a non-approved purpose. The fact that participants in matched savings programs will forfeit matching funds in order to access savings early highlights the need for liquidity.[33] Innovations in asset building that account for emergency liquidity needs and incorporate mechanisms to encourage rebuilding of tapped savings may be beneficial.

We remain optimistic about strategies that can help low-income people to systematically develop emergency savings. However, it is also important to help people form realistic expectations regarding regular and unexpected expenses as well as income variability. Commitment devices and automatic transfers can help improve self-control and mitigate impatience but there must be a sufficient market of products and services with these capacities available to low-income consumers. An effective policy to encourage savings should target specific types of expenses or contingencies that households typically underestimate, including occasional large items, as well as smaller but more frequent ones. Finally, it is essential that any new strategy recognize behavioral biases and over-optimism about future resources, focus on goals and implementation intentions, and create a way to systematically encourage adequate savings for an emergency.■

---

[1]A. Lusardi, D. Schneider, and P. Tufano, "Financially Fragile Households: Evidence and Implications," Technical Report, National Bureau of Economic Research, Cambridge, MA, 2011.

[2]B. Theodos, R. Brash, J. F. Compton, N. M. Pindus, and C. E. Steuerle, "Who Needs Credit at Tax Time and Why: A Look at Refund Anticipation Loans and Refund Anticipation Checks," Urban Institute, November 2010.

[3]J. Zinman, "Restricting Consumer Credit Access: Household Survey Evidence on Effects around the Oregon Rate Cap," *Journal of Banking & Finance* 34, No. 3 (2010): 546–556.

[4]Lusardi, Schneider, and Tufano, "Financially Fragile Households"; S. Abbi, "A Need for Product Innovation to Help LMI Consumers Manage Financial Emergencies," D2D Fund Doorways to Dreams, 2012.

[5]Lusardi, Schneider, and Tufano, "Financially Fragile Households."

[6]J. Bricker, A. B. Kennickell, K. B. Moore, and J. Sabelhaus, "Changes in U.S. Family Finances from 2007 to 2010: Evidence from the Survey of Consumer Finances," *Federal Reserve Bulletin* 98, No. 2 (June 2012).

[7]Bricker, Kennickell, Moore, and Sabelhaus, "Changes in U.S. Family Finances from 2007 to 2010."

[8]L. Rawlings and K. Gentsch, "How Households Expect to Cope in a Financial Emergency," *Opportunity and Ownership Facts*, No. 9, Urban Institute, March 2008.

[9]S. Chase, L. Gjertson, and J. M. Collins. *Coming Up with Cash in a Pinch: Emergency Savings and Its Alternatives*, CFS Issue Brief 6.1, Center for Financial Security, Madison, WI: University of Wisconsin. Available at http://www.cfs.wisc.edu/briefs/ChaseGjertsonCollins2011_CashBrief.pdf.

[10]S. Abbi, "A Need for Product Innovation."

[11]M. Schreiner and M. Sherraden, *Can the Poor Save? Saving and Asset Building in Individual Development Accounts* (Piscataway, NJ: Transaction Publishers, 2007).

[12]D. Cooper and M. Luengo-Prado, "Savings and Economic Mobility," in *A Penny Saved is Mobility Earned: Advancing Economic Mobility Through Savings*, eds. R. Cramer, R. O'Brien, D. Cooper, and M. Luengo-Prado, Economic Mobility Project, An Initiative of the PEW Charitable Trust, 2009.

[13]Cooper and M. Luengo-Prado, "Savings and Economic Mobility."

[14]See for example, M. Grinstein-Weiss, K. Wagner, and F. M. Ssewamala, "Saving and Asset Accumulation among Low-Income Families with Children in IDAs," *Children and Youth Services Review* 28, No. 2 (2006): 193–211.

[15]The data for this study came from the Annie E. Casey Foundation's Making Connections project, a longitudinal survey of families in disadvantaged neighborhoods in ten U.S. Cities. More information about the project is available at http://www.aecf.org/majorinitiatives/makingconnections.aspx

[16]While these results are simple means, many of these statistical differences are maintained after controlling for economic and demographic factors.

[17]Schreiner and Sherraden, *Can the Poor Save?*

[18]W. Emmons and B. Noeth, "Household Financial Stability: Who Suffered the Most From the Crisis?" T*he Regional Economist*, St. Louis Fed, July 2012. Available at http://www.stlouisfed.org/publications/pub_assets/pdf/re/2012/c/financial_stability.pdf

[19]C. Hachikian, "Turning Today's Economic Inflection Point Into Tomorrow's Savings Behavior," Center for Financial Services Innovation, 2009.

[20]Social Security Administration. Accessed on July 19, 2013 at: http://www.socialsecurity.gov/ssi/spotlights/spot-resources.htm

[21]R. O'Brien, "Savings Policy and Eligibility Rules for Public Assistance," in *A Penny Saved is Mobility Earned: Advancing Economic Mobility Through Savings*, eds. R. Cramer, R. O'Brien, D. Cooper, and M. Luengo-Prado, Economic Mobility Project, An Initiative of the PEW Charitable Trust, 2009.

[22]A. Lusardi and O. Mitchelli, "Financial Literacy and Retirement Preparedness: Evidence and Implications for Financial Education," *Business Economics* 42, No. 1 (2007): 35–44.

[23] S. Brobeck, "The Essential Role of Banks and Credit Unions in Facilitating Lower-Income Household Saving for Emergencies," Washington, DC: Consumer Federation of America, 2008.

[24] M. Puri and D. Robinson, "Optimism and Economic Choice," *Journal of Financial Economics* 86, No. 1 (2007): 71–99.

[25]D. Laibson, "Golden Eggs and Hyperbolic Discounting," *The Quarterly Journal of Economics* 112, No. 2 (1997): 443–478.

[26] T. O'Donoghue and M. Rabin, "Doing it Now or Later," *American Economic Review* 89, No. 1 (1999): 103–124.

[27]N. Ashraf, D. Karlan, and W. Yin, "Tying Odysseus to the Mast: Evidence from a Commitment Savings Product in the Philippines," *The Quarterly Journal of Economics* 121, No. 2 (2006): 635–672.

[28]V. Stango, and J. Zinman, "Limited and Varying Consumer Attention: Evidence from Shocks to the Salience of Bank Overdraft Fees," Technical report, National Bureau of Economic Research, 2011.

[29]R. Baumeister, K. Vohs, and D. Tice, "The Strength Model of Self-Control," *Current Directions in Psychological Science* 16, No. 6 (2007): 351–355.

[30]P. Gollwitzer, H. B. Kappes, and G. Oettingen, "Needs and Incentives as Sources of Goals," In *Goal-Directed Behavior*, eds., H. Aarts and A. J. Elliot, (New York: Psychology Press, 2011).

[31]For a description of the Emergency Saving Project Salon event, see http://emergencysavings.org/.

[32]Lusardi, Schneider, and Tufano, "Financially Fragile Households."

[33]G. Mills, W. G. Gale, R. Patterson, G. V. Engelhardt, M. D. Eriksen, and E. Apostolov, "Effects of Individual Development Accounts on Asset Purchases and Saving Behavior: Evidence from a Controlled Experiment," *Journal of Public Economics* 92, No. 5 (2008): 1509–1530.