Savvy Saving For All

Brian Kelly and Dijohney Lyn

NAF Future Ready Lab

BE FUTURE READY

Abstract

It is possible for low- to moderate-income individuals to save for short- and long-term endeavors, despite the fact that they have minimal income. The research team sought to prove it feasible for LMI individuals to have saving options and propose ways in which individuals can better their financial situation. The team scoured the internet for articles and talked with the founder of a financial counseling program to begin to understand the basics of being able to save money.

Introduction

It can seem like poverty is an endless trap. It is not. Low- to moderate-income individuals can escape the cycle of poor finances, but it does not happen overnight. For an LMI individual to save for the short and long term, it takes way more than just the influx of income that most of them are currently longing for. It takes a willing individual, a determined mindset and an implemented budget. Once someone can tackle these three big aspects of starting the savings process, they will be well on their way to financial freedom.

Who Is LMI?

Low- to moderate-income individuals can be classified by their annualized income. There is a simple formula to determine an individual as LMI or not. The first step is to obtain a specific number for the median household income of the county of residence. This can be found on the U.S. Department of Housing and Urban Development website. On their website, they have listed every county's median household income; so an individual is considered to be LMI if their annualized income is below 80 percent of their county's median. To further break this down, any individual whose income falls within 50 to 80 percent of this county median is a part of the moderate-income bracket of LMI, while any individual under 50 percent is deemed low-income.

LMI Currently

An individual who is currently considered to have low- to moderate-income most likely lives paycheck-to-paycheck with no room each month to save, which means they are making just enough to get by. When someone has to live like this, it can create many follow-up challenges and negative mindsets. When individuals lead a lifestyle where all they ever do is put all their money toward bills and have never been able to save or spend excess money, they can fall in the trap of learned helplessness. This psychological phenomenon is where one feels like because nothing is working for them, they are not capable of it. The research that has been conducted was aimed to produce the reasoning behind how individuals can start saving short and long term with low- to moderate-income.

Why LMI Individuals are Living the Way They Are

At first, it is not readily understandable why LMI individuals cannot just simply put away some money every month. It seems like such an easy solution. But in fact, the real problem here is much deeper than that, and there is not a simple solution that is end-all, be-all. A major contributing factor is the presence of scarcity. A field study conducted by behavioral scientists Eldar Shafir and Sendhil Mullainathan sought to prove this. They tested sugar cane farmers in India for their psychological performance on a standardized test before and after a big harvest.

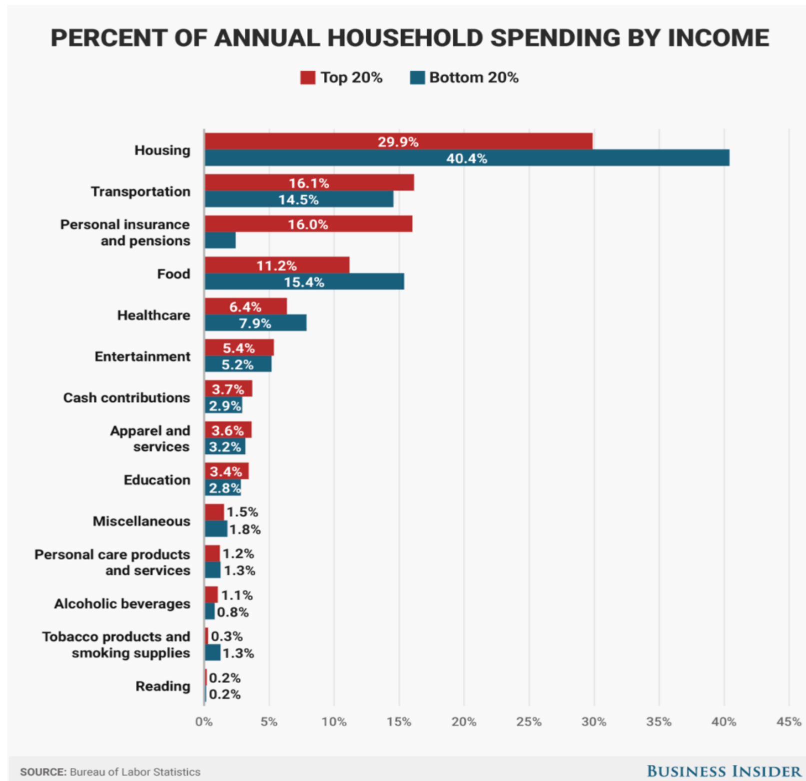
Before the harvest, the farmers had very little money and conversely scored much lower than after the harvest when they were temporarily affluent. These farmers fell victim to the presence of scarcity. The presence of scarcity in someone's mind can greatly cloud decision making, as tunnel vision sets in and any longer-term aspirations, appointments, and obligations are not prioritized in the minds of those people with a limited amount of income. They are much more susceptible to temptation, and lose devotion to longer-term goals when they have scarcity on their mind. This psychological effect completely translates to LMI individuals who have the intimidating idea of lacking money looming over their heads at all times.

Where is the Money Going?

One of the first steps in being able to save and budget is not only having a positive mindset, but also to be saving for something specific, because an individual is more likely to actually successfully save when they know what they are saving for. If an individual can create an emotional attachment to the end savings goal, it immensely enhances their motivation and ability to save. 8 Cents In a Jar founder, Lashea Reaves, stated "make savings personal" when the research team asked her what was the biggest contributing factor to someone not being able to be disciplined with their savings. But there is a gap between what an individual may want and what they think they need. A low- to moderate-income consumer should be saving for a home, car, retirement, schooling, an emergency or simply just to save money. Instead of saving for these things, they will often spend their money on things they may think they need, such as cable and other sorts of entertainment. These are not human needs, but rather wants. Once the consumer is able to distinguish between the two, they can cut out unnecessary expenses. Having enough money for an unexpected emergency is a much higher priority than paying the ten-dollar fee for Apple Music every month. Other times, individuals spend money on things that may mean something to them, but that thing may be putting them at a disservice. For example, a parent that is paying for their child's college tuition may be thinking that they are doing a good thing, which they are; but they are also putting themselves at a disservice when they do not invest in themselves. Paying for college is some thing good, but having retirement money is a bigger priority. Besides, one can be given a loan for school, but when it comes to retirement, and there is no loan option available, you are expected to loan to yourself.

Deterrents of Saving

Because LMI individuals have low incomes, inherently the major expenses of life eat up a much greater chunk of their income. This can make it much harder to have a solid budget with excess money every month to save. As can be seen in the graph to the right, the bottom 20% of households have to spend a big proportion of their income on housing. While that is already a setback on its own, it gets deeper than that. These people that are having to allocate 40% of their income to housing are making these payments in the form of rent. They do not own the homes that they live in. So, that being said, when they make this payment, they are not building any equity in a home, and therefore never see that money they are paying again. This does contribute to the perpetual trap of not having the funds to save, but it is not by any means a complete inhibitor.



Out With the Old, In With the New

Individuals that have a low- to moderate-income most likely have been living at that standard of living for a long period of time. This leads to learned helplessness, which is very often developed over the lifetime of an LMI individual. Often times, it can start to develop during the time of their upbringing, when they see a repeated struggle with finances in their home. This can lead an LMI consumer to not believe they have any chance of escaping their current lifestyle into financial freedom, because impoverished living is all they know. So, the first step in being able to even think about saving is overcoming the negative mindset of not being capable, because all incomes are capable of saving. Once the consumer finally has a positive and strong mentality, half the battle is won. Being able to save is more a mental game than anything else. Once the consumer believes they have the ability, it only takes some modest lifestyle changes and the discipline to stay motivated.

The Process

Once the consumer has overcome the hurdle of mindset, they can begin to form the new essential habits that are needed to finally save. This is where a consumer must incorporate some form of a budget into their life. A budget can take many shapes and forms. Someone who is more tech-savvy can have multiple savings accounts and checking accounts where they can allocate their money digitally. Others might need a hands-on, putting money in different labeled envelopes, approach. Either way, a physical budget must be established to save. Without a budget, saving money is almost impossible. That being said, starting a budget is not easy. It takes an individual knowing and understanding where their money goes every month.

How to Budget

Just because a consumer knows that they need to budget, does not mean they know how. The first step is to track expenses. The easiest and most widespread budget plan is monthly. The initial focus is a consumer tracking their expenses for a month. This includes whenever any money leaves the LMI individual's pocket, virtually or physically. Once the consumer knows how much they truly are spending, it will become very clear to them what is a need and what is a want. They will very soon see what is unnecessary in their life. Once this realization has been made, the next step can begin. They must compare this to their monthly income and make their income exceed expenses with enough room for extra money. This will put the consumer in control of their money. Bestselling financial author Dave Ramsey said, "Tell your money where to go rather than wondering where it went." He is speaking on the fact of being proactive with money. This puts the consumer in control. Once the budget is in place, the consumer can make big strides in saving.

* Allocating excess money each month to paying off debt and expediting the process of payback is a form of saving.

What Now?

Once an LMI individual is able to generate monthly savings, they have a multitude of options. A person that has even 20 dollars a month to put towards a savings goal can make their money work for them in many ways.

- Savings Account
- Mutual Funds
- Certificate of Deposits
- 401k Contributions

Savings Accounts

Savings accounts offer very low to non-existent interest rates, but are very liquid and are federally insured. This means that while the money in a savings account is not making more money for the future, it is always accessible and will always be there, granted the consumer does not take it out for unnecessary reasons. This is a great place to keep any short-term savings or emergency funds, because most savings accounts allow a few withdrawals a month, so a consumer is deterred from touching the money often, but can easily access it if needed.

Another account that can be looked at is a money market account, which offers the same service but at a slightly higher interest rate.

Mutual Funds

Mutual funds offer a safe way for savers to be able to grow their money in an easy fashion. If an LMI individual is able to cut expenses enough to have any leftover money each month, a mutual fund is the perfect place to watch the money grow for long-term savings. Mutual funds are well diversified, so that means they have very minimal risk. The drawback to mutual funds is that they have initial costs and fees that might be too high for a first-time saver to handle. This makes mutual funds a great place for LMI individuals who have finally tackled the concept of consistent savings, but a bad starting place for initial savers.

Certificate of Deposits

A certificate of deposit, or CD, offers a different approach to savings. Instead of putting savings away monthly, in a CD a saver puts away money one time. Then, the money is essentially untouchable for a year. So, the clear drawback here is that the money is not liquid, or easily accessible, at all. The upside, however, is a higher interest rate than a savings account or money market account, and a CD is risk-free. Even though the pros of a CD outweigh the cons, it is not a recommended savings strategy for LMI individuals starting the savings process. They would need all the money up front, which is unrealistic. The fact that the money is untouchable for a year would greatly help with the discipline of saving, but is not ideal for a consumer with little savings. If they needed to withdraw the money in the CD, and see the majority of their interest disappear, it would defeat their whole savings plan.

401K Contributions

A great way for LMI individuals to save is through 401k plans. When the individual has a salaried job, they can most likely opt into a 401k contribution plan. This would be the most ideal option of a savings vehicle for an LMI individual. If an individual decides to utilize a 401k, they would have a specific amount pulled from their checks pre-tax. That means they would be taxed on a smaller income each year, and are saving at the same time. Another bonus would be if their company offered an employer match. That means the employer would match any contributions the worker makes up to a said amount. That is essentially “free” money they are handing out, and it should be taken advantage of. Using a 401k plan would greatly help an LMI individual with the discipline of saving because the money is pulled out for them. They are saving without the trouble of having to allocate themselves. That said, the research team deemed 401k contributions the most important aspect of saving for long-term needs of LMI individuals. The only problem with the 401k plan is that it is not offered to wage workers, which would then exclude most LMI individuals from this aspect of being able to save. But, to counter this, an IRA plan may be a way to get around this because anyone, regardless of income, is able to contribute to an IRA account. They are very similar as they are both retirement accounts for long term.

Big Ideas

Throughout the search for information about saving options for low- to moderate-income individuals, the research team deduced that the psychology behind habits and the knowledge of how saving works were the main components to being able to save effectively. The research team believes that saving is a habit, and it is important to start young instead of waiting until it is almost time to retire for one to start saving, but that is difficult when one is not aware of the saving options that are available to them.

Solution

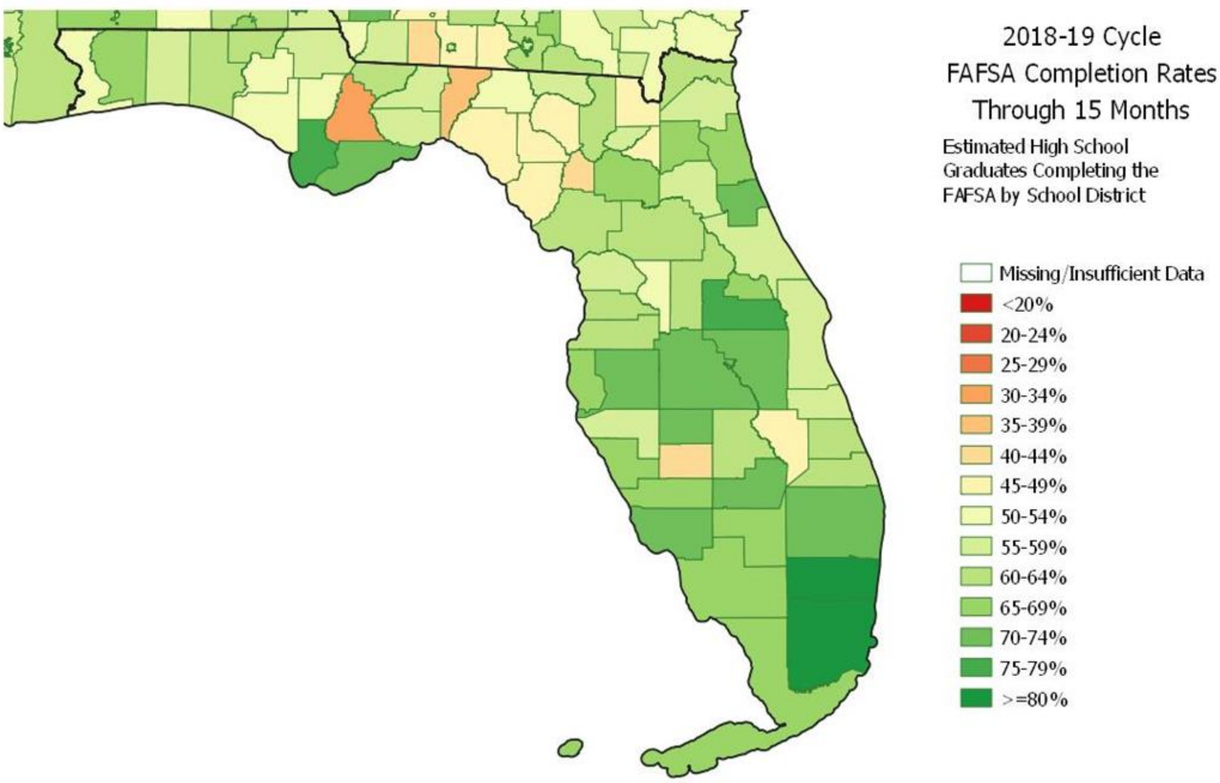
The proposed solution the research team came up with is to create a mandatory savings system through the Free Application for Federal Student Aid, also known as FAFSA, which is an application that high school and college students fill out to determine their eligibility for federal financial aid. When students fill out the FAFSA, they would also be required to go through this short informational lesson about saving and budgeting. It is already a requirement that students register for social services when they fill out the FAFSA, so it is possible to have an add-on to the FAFSA process. This system would be designed to walk individuals through different types of savings options, and educate them on the potential their money has to grow when it is in a savings account. Similar to when an individual is filling out an application to receive a loan, it is mandatory to participate in the loan counseling that is embedded into the application process, where there are terms and definitions that the applicant has to answer correctly before the rest of the application can be completed. This educates them on terms of the financial world so they are aware of what they are doing. Much like the tool used on the website, Bank Rate, seen in Appendix A, the applicant will be able to put all of their credentials into a savings calculator, such as how much money an individual is trying to save, the time period in which to have that money saved, and an annual percentage yield or the amount of interest earned while saving. The results individuals can look forward to getting back is the amount of money that one's money made, or in other words, the amount of interest that was made, the total amount of money the individual themselves put in, and the individual's total savings after a certain time period. This can spark intrinsic motivation and interest in the savings process. These are two key factors in the savings process, so to be able to instill that in the upcoming young adult population would be a big advancement. It is beneficial to implement this savings system with the FAFSA because a large majority of high school students go through the process of filling out the application every year. Appendix B shows the percentage breakdown of how many high school students in Florida filled out the FAFSA for the 2018/2019 school year. An estimated 70 percent of the state's high school seniors filled out the application, and therefore would be exposed to the savings program. This data does not even include the thousands of college students that would also be filling out the form and using this system each year. Soon-to-be high school graduates are the perfect audience age to learn about savings and why it is important, because they are old enough to understand the information, and when they are exposed to it, they can start to implement these habits into their lives.

Appendix A


$ 10,000
Initial deposit
Monthly contribution:
$ 200
Over a period of:
10
Months
Years
APY
2.4
%
40000
30000
20000
10000
0
Total savings breakdown:
Interest earned $ 5,734.72
Total contributions + $24,000
Initial deposit + $10,000
Your total savings
$ 39,734. 72
The average APY in the U.S. is 0.08%. Some banks pay as low as 0.01% or as high as 2.25% or more. Enter an APY to see how much you can save, or choose an APY from on of our partners.

Appendix B

Public School District 2018-19 Cycle FAFSA Completion Rates for Florida



Please refer to https://studentaid.ed.gov/sa/about/data-center/student/application-volume/fafsa-completion-data for details on the data and https://studentaid.ed.gov/sa/about/data-center/student/application-volume/faq for frequently asked questions. Graduation rates are estimated using the most recent Regulatory Adjusted Cohort Graduation Rate multiplied by the largest reported enrollment for this cohort beginning in the 9th grade (http://nces.ed.gov/ccd/ccddata.asp).

References

FindCRA. (2017, August 29). What is considered low- or moderate-income or LMI? Retrieved from https://www.learncra.com/knowledge-base/what-is-considered-low-or-moderate-income-or-lmi/

Hiebert, P. (2013, September 18). How Being Poor Makes You Poor. Retrieved from https://psmag.com/economics/poor-makes-poor-66414

How does living paycheck-to-paycheck affect your health? A lot. (n.d.). Retrieved from https://www.nbcnews.com/better/health/most-us-live-paycheck-paycheck-what-it-does-your-health-ncna816411

I Spent 5 Years Studying Poor People and Here Are 4 Destructive Money Habits They Had. (2015, September 22). Retrieved from http://richhabits.net/i-spent-5-years-studying-poor-people-and-here-are-4-destructive-money-habits-they-had/

Morrell, A. (2017, December 04). Seeing how the highest and lowest-earners spend their money will make you think differently about 'rich' vs 'poor'. Retrieved from https://www.businessinsider.com/how-high-income-and-low-income-americans-spend-their-money-2017-3

Orange County, FL. (n.d.). Retrieved from https://datausa.io/profile/geo/orange-county-fl

Orlando-Kissimmee-Sanford Florida Household Income. (n.d.). Retrieved from https://www.deptofnumbers.com/income/florida/orlando/

Reiner, M. (2019, March 12). Why People Aren't Saving and How to Overcome Excuses. Retrieved from https://www.thebalance.com/overcome-excuses-and-save-money-4129534

Simple Savings Calculator - Savings Interest & Investment Growth. (n.d.). Retrieved from https://www.bankrate.com/calculators/savings/simple-savings-calculator.aspx

Sydlansky, P. (2017, December 11). The Psychology of Saving Money: Why some do it successfully and others struggle. Retrieved from https://www.lakeroadadvisors.com/lra-blog/2017/12/11/the-psychology-of-saving-money-why-some-can-do-it-successfully-and-others-struggle

User, S. (n.d.). 54 Ways to Save Money. Retrieved from https://americasaves.org/for-savers/make-a-plan-how-to-save-money/54-ways-to-save-money