



# HIDDEN IN PLAIN SIGHT

A LOOK AT THE \$335 BILLION FEDERAL ASSET-BUILDING BUDGET



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The Corporation for Enterprise Development (CFED) fosters widely shared and sustainable economic well-being by promoting asset-building and economic opportunity strategies—primarily in low-income and distressed communities—that bring together community practice, public policy, and private markets in new and effective ways.

CFED is a nonprofit organization that creates economic opportunity by helping the poor save and invest, succeed as entrepreneurs, and participate as contributors to and beneficiaries of the economy. By helping individuals and communities harness latent potential, CFED builds long-term models to help people move from poverty to prosperity while strengthening the overall economy. CFED identifies and researches promising ideas, collaborates with the private and public sectors to test them, and helps drive the application and adoption of proven concepts.

Established in 1979, the Corporation for Enterprise Development works nationally and internationally through its offices in Washington, DC, Durham, NC, San Francisco, CA, and St. Louis, MO.



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# HIDDEN IN PLAIN SIGHT:

## A Look at the \$335 Billion Federal Asset-Building Budget

### EXECUTIVE SUMMARY

For generations, federal policies have helped Americans build assets. Millions of individuals and households have taken advantage of these policies to plan for the future, buy homes, prepare for retirement, send their children to college, and weather unexpected financial storms.

Today – through a diverse array of initiatives—the federal government spends billions of dollars to foster asset-building. Lawmakers of various political stripes have helped craft policies that encourage Americans to build assets. Yet, for all the analyses of the federal budget, there has never been a comprehensive look at these policies in total.

Now, for the first time, the Corporation for Enterprise Development has analyzed spending and tax policy to determine how much American asset-building initiatives cost, where the money goes, and who benefits.

The study reveals that, in Fiscal Year 2003:

- ▶ Federal asset policies cost \$335 billion (conservatively measured).
- ▶ Federal asset policies include both direct spending (outlays) and preferences and incentives (tax expenditures) that reward specific types of behavior. For every dollar spent on asset-building outlays, the government gives up \$642 in revenue through tax expenditures that reward asset-building behavior.
- ▶ Federal policies disproportionately benefit those who already have assets. Analysis of the largest spending categories shows that over a third of the benefits go to the wealthiest 1% of Americans—those who typically earn over \$1 million per year. In contrast, less than 5% of the benefits go to the bottom 60% of taxpayers.
- ▶ Federal spending to stimulate asset building results from many uncoordinated policies. There is no coherent strategy, no explicit asset budget, and little public scrutiny.
- ▶ Many benefits of federal asset policies can only be realized by people with certain types of assets or levels of tax liability.

*How big is this asset-building budget?* Even by the standards of the federal government, \$335 billion is a lot of money. It is nine times more than it spends on building roads, bridges, and mass transportation systems (\$37 billion). It is almost 10 times more than what Washington spends on housing assistance programs (\$35 billion). It is 15 times more than the government invests in higher education (\$23 billion). And, to put it in perspective, this \$335 billion compares to a national defense budget of \$405 billion.<sup>1</sup>

*Where does the money go?* More than 98% of it goes to support homeownership, reward retirement savings, and subsidize certain kinds of savings and investments.

*Who benefits?* Many of the programs are theoretically universal, and there are some specifically aimed at the middle class and the poor. In practice, however, the data show the major beneficiaries are those who already have the most assets.

Assets provide families with stability and protection against the unexpected. Yet in the event of the sudden loss of a job, for example, one in four American families lacks sufficient net assets to survive even at the poverty line for more than three months. The critical importance of assets in stabilizing American families and the vast amount spent to help them accumulate assets calls for a more rational and transparent approach to this federal investment. Robust public debate and an explicit asset-development budget are needed to inform policymaking and to frame national decisions about how scarce dollars are spent.

Given the scope of federal spending on asset building, it is surprising that no attempt has been made to examine these programs in a coordinated way and consider what they mean together. No comprehensive analysis, for instance, has been done on the relative effectiveness of different kinds of asset-building policies or on the returns (to the economy or to society) they represent. Since there is no unified vision of just what the government intends as its asset-building goals, it is difficult to measure whether or not they are the most effective tools to use.

In particular, it is important to decide intentionally who should benefit from these policies: the wealthy, who pay the most in taxes (yet still benefit disproportionately from asset-building policies) or the middle class and the poor, who have fewer assets to begin with and are less able to take advantage of many of the existing programs.

There is little debate that assets are an important element in any household's economic equation. Given the billions of federal dollars devoted to asset-building, however, there should be a coherent strategy that drives policies on assets. It should be intentional, and it should be open to public scrutiny.

This study provides a clearer picture of what impact these federal policies are already having. This is a starting point for a more coherent understanding of—and intentional decision-making about—asset-building at the federal level.

## HIDDEN IN PLAIN SIGHT:

### A Look at the \$335 Billion Federal Asset-Building Budget

For most of American history, lawmakers across the political spectrum have enacted policies that encourage individuals to accumulate assets.<sup>2</sup> Various federal programs have helped millions of Americans plan for the future, buy a home, prepare for retirement, send their children to college, and weather unexpected financial storms.

Today, the federal government spends billions of dollars on asset-building, through a wide variety of programs. Yet, for all the analyses of the federal government's budget, no one has taken a comprehensive look at these programs as a whole.

The purpose of this study is to document the extent to which federal policy currently encourages the acquisition, control, and maintenance of assets. Further, it analyzes, to the extent possible, the distribution of benefits for these policies. In short, this paper analyzes spending and tax policy to determine *how much federal asset-building policies cost, where the money goes, and who benefits.*

Since the time of Adam Smith, economists have recognized the important role that assets<sup>3</sup> play in a capitalist economy. In many respects, they are a critical underpinning of household economic security, opportunity, and progress. They represent the ability to invest in the future—to build skills, to earn living incomes, to acquire the security of a home, to enter the marketplace with a new idea or venture, to invest in one's children or oneself.

Recent scholarship<sup>4</sup> and community practice show that having even a small amount of assets—in the form of savings, home equity, business ownership, and/or human capital—is critical to the well-being of all families, regardless of income group. At an individual or household level, assets can:

- Provide greater household stability,
- Foster long-term thinking and planning,
- Lead to greater effort in maintaining assets,
- Lead to further development of human capital,
- Provide a foundation for taking prudent risks,

- Increase personal efficacy and a sense of well-being,
- Increase social status and social "connectedness,"
- Increase community involvement and civic participation, and
- Enhance the well-being and life chances of children.

Assets are important to all families, although they are not, of course, evenly distributed. Data show that the current distribution of assets is far less equitable than income. For example, while the top 20% of wage earners commands 43% of earned income, they control 86% of net financial assets.<sup>5</sup> Assets provide families with stability and protection against the unexpected. Yet in the event of the sudden loss of a job, for example, one in four American families lacks sufficient net assets to survive even at the poverty line for more than three months. This “asset poverty rate” is twice as high as the “income poverty rate.”<sup>6</sup>

Given the importance of assets, and the U.S. government’s long history of creating incentives for their creation, it is time to analyze these disparate policies as a whole. No quantification of these policies has been done to date.

Because these are a collection of individual policies rather than a coherent whole, little public debate has taken place over the simple *purpose* of asset-building incentives. Are they to return benefits to high-income Americans, who pay the most in taxes, or are they to provide mechanisms for the middle class and the poor, who have fewer assets to begin with?

Such a dialogue has yet to take place. To frame the conversation, this study provides a conservative baseline of what is already happening—what Washington is already spending to promote asset-building and where this money is currently going. This is a starting point for an ongoing, more thorough analysis of the “functional federal asset-building budget,”<sup>7</sup> and for more intentional decision-making about how that money is spent.

## THE SCOPE AND LIMITATIONS OF THE STUDY

This study is restricted to a narrow subset of federal policies and a well-defined set of assets. Spending included in this study meets three criteria:

1. They are related to specific, explicit federal policies that reward asset-building. Policies aimed at asset protection are not included, nor are programs that strictly provide technical assistance.



2. They are directed at individuals or households. Policies that promote asset-building among corporations, for instance, are not included.
3. They are available to most of the general public, but also are the result of some personal action that benefits a specific individual or household. (They cannot, in other words, result in a “public good” that benefits most of the population more or less equally.) Policies aimed at unique subgroups, such as veterans, that have access to exclusive programs are not included.

Further, analysis focuses on four main categories of assets:

- ▶ homeownership
- ▶ retirement accounts
- ▶ savings and investment
- ▶ small business development

This sort of analysis is inherently—and fairly—open to debate about what to include, where to draw appropriate demarcations, and, in those cases in which data are not available or exact, how to count the costs. By and large, this study errs on the side of caution, excluding spending that could be potentially controversial. This analysis, therefore, is a conservative estimate of the value of such programs, and should be treated as a baseline figure.

The study counts direct outlays, the “actual dollars that either have been or will be spent on a particular activity.”<sup>8</sup> These are usually available as line-items in the federal budget, although certain disaggregation and assumptions, described in the text, had to be made to count only those policies that fit the criteria above. Wherever possible, precise outlays for the five fiscal years 1999-2003 are reported. All figures cited in this study are in nominal dollars.

The study also counts tax expenditures, which are essentially spending programs channeled through the tax system. Called tax preferences, tax breaks, and tax incentives, they reward certain types of behavior over others, but do so through preferential taxation rather than through direct spending. (Tax expenditures have been called “spending programs in disguise” because they have the effect of direct outlays but are less visible.) Both the U.S. Treasury Department and the U.S. Congressional Joint Committee on Taxation provide annual estimates of tax expenditures; this study follows the assumptions of the latter throughout.<sup>9</sup> A discussion of the issues around direct outlays vis-à-vis tax expenditures is provided in Appendix 1.

## I. WHAT IT COSTS

In the sections that follow, direct outlays (where applicable) and tax expenditures are tallied for the four main categories of asset-building spending. In short, this study includes eight main direct outlays, and thirteen tax expenditures, across these categories:

### ASSET-BUILDING POLICIES INCLUDED IN THIS STUDY

	Direct Outlays	Tax Expenditures
<b>Homeownership</b>	Community Development Block Grants  Home Investment Partnership Program (HOME)  U.S. Department of Agriculture's (USDA's) Section 502  Federal Home Loan Bank (FHLB) system's Affordable Housing Program  Individual Development Accounts	Exclusion on state and local bonds for owner-occupied housing  Deduction for mortgage interest on owner-occupied housing  Deduction for property taxes on owner-occupied residences  Exclusion of capital gains on sales of principal residences
<b>Retirement</b>		Net exclusion of pension contributions and earnings in employer plans  Net exclusion of pension contributions and earnings in individual retirement plans  Net exclusion of pension contributions and earnings in Keogh plans  Tax credit for certain individuals for elective deferrals and IRA contributions
<b>Savings and Investment</b>		Exclusion of investment income on life insurance and annuity contracts  Reduced rates of tax on long-term capital gains  Exclusion of capital gains at death  Carryover basis of capital gains on gifts
<b>Small Business Development</b>	Small Business Administration's (SBA's) MicroLoan Program  SBA's 7(a) Program  USDA's Business and Industry Guaranteed Loan Program	Amortization of business startup costs

Direct outlays are dollars allocated in the federal budget. Tax expenditures can take the form of exclusions, deferrals, carryovers, reduced rates, exemptions, deductions, or credits (see Glossary for definitions).

In sum, the costs for these policies look like this:

## DIRECT OUTLAYS

	Program	FY 2003 (\$ millions)
Homeownership	IDAs (Assets for Independence Act)	25.00
	USDA 502	236.00
	Federal Home Loan Bank Affordable Housing Program	91.00 (FY2002)
	HOME	74.50
	CDBG (Including SHOP)	40.80
Small Business Development	MicroLoan Program	3.78
	7(a) Program	18.90
	Business and Industry Guaranteed Loan Program	7.90

## TAX EXPENDITURES

	Program	FY 2003 (\$ millions)	Type
Homeownership	Mortgage Interest	69,900	D
	Property Taxes	22,100	D
	Interest on State and local bonds for owner-occupied housing	700	EC
	Capital Gains on sales of principal residence	17,800	EC
Small Business Development	Business startup costs	600	CO
Retirement	Contributions and earnings: Employer plans	83,500	EC
	Contributions and earnings: Individual plans	10,400	EC
	Contributions and earnings: Keogh plans	5,700	EC
	Elective deferrals and IRA contributions	1,600	C
Savings and Investment	Investment income on life insurance and annuity contracts	24,000	EC
	Long-term capital gains	55,300	R
	Capital gains at death	38,100	EC
	Capital gains on gifts	4,500	CO

D = Deduction; EC = Exclusion; C = Credit; EM = Exemption; R = Reduced Rate; CO = Carryover

Taken together, these policies cost \$335 billion in Fiscal Year 2003. The vast bulk of the cost comes through tax expenditures, which outweigh direct outlays \$642 to \$1.

This is the big picture. To understand what these numbers represent, this study now turns in more detail to each of the four asset categories (homeownership, retirement savings, savings and investment, and small business development) in turn.

## HOMEOWNERSHIP

The family home is the chief asset of many American households. It is an integral part of the American Dream and provides the family with both physical and financial security. Because mortgage payments can be substituted for rent, even households with very modest disposable incomes can nonetheless, over time, build assets through homeownership.

Washington's active involvement has been largely responsible for driving homeownership rates to an all-time high. Much of this investment has come in the form of institutional infrastructure. In particular, the creation of the Federal Home Loan Bank (FHLB) system, as well as government-sponsored secondary market institutions (Fannie Mae, Freddie Mac, and Ginnie Mae), has both expanded access to financing and reduced its cost. The cost of maintaining this infrastructure, while significant, does not meet the narrow definition of asset-building policies and so is not included in this analysis.

Other costs, however, do fit this definition. Most significant in terms of cost are incentives that reward the purchase and financing of homes through tax expenditures. Over the years, lawmakers have enacted a number of policies that shift the tax burden away from homeowners, providing valuable benefits to those who can and do purchase homes.

Four principal tax expenditures actively promote the building of assets through homeownership.

*First*, the interest paid on mortgages on a taxpayer's first or second home is generally deductible from taxes. This subsidizes homeownership and also favors mortgage debt over other forms of debt. This deduction totals \$69.9 billion, making it the single largest housing subsidy in the country.

*Second*, property taxes paid on owner-occupied homes are also generally tax-deductible. This provision represents an additional \$22.1 billion in revenue foregone.

*Third*, the relatively recent exclusion of capital gains earned on sales of principal residences allows individuals to realize \$250,000 in gains, and couples \$500,000 in gains, tax free. This provision costs an additional \$17.8 billion annually.

## HOME OWNERSHIP (IN MILLIONS OF NOMINAL DOLLARS)

	FY1999	FY2000	FY2001	FY2002	FY2003
Deduction for mortgage interest	48,500.0	55,200.0	62,700.0	66,500.0	69,900.0
Deduction for property taxes	17,800.0	18,900.0	21,000.0	21,400.0	22,100.0
Exclusion of capital gains on sales of principal residences	5,800.0	12,900.0	13,300.0	13,800.0	17,800.0
Exclusion of interest on State and local bonds for owner-occupied housing	1,400.0	600.0	800.0	700.0	700.0
Home Investment Partnership Program (HOME) *	—	—	—	—	74.5
Community Development Block Grants *	20.0	20.0	44.1	44.0	40.8
FHLB Affordable Housing Program *	59.5	70.7	90.9	91.0	91.0
USDA Section 502 IDAs	116.7	106.9	176.7	173.8	236.2
<b>TOTAL</b>	<b>73,706.2</b>	<b>87,807.6</b>	<b>98,136.7</b>	<b>102,733.7</b>	<b>11,0967.5</b>
Ratio of tax exp:direct exp	356.4	421.9	290.5	306.8	236.4

**Tax expenditure source:** Joint Committee on Taxation. Estimates of Federal Tax Expenditures for Fiscal Years, 1999-2003, 2000-2004, 2001-2005, 2002-2006, 2003-2007. (Washington, DC: U.S. Government Printing Office, 1998, 1999, 2000, 2001, 2002), Table 1.

### Direct expenditure sources:

**HOME Program.** [www.hud.gov/offices/cpd/affordablehousing/programs/home/index.cfm](http://www.hud.gov/offices/cpd/affordablehousing/programs/home/index.cfm)  
**CDBG.** [www.hud.gov/offices/cpd/communitydevelopment/budget/disbursementreports/index.cfm](http://www.hud.gov/offices/cpd/communitydevelopment/budget/disbursementreports/index.cfm)  
**FHLB.** [www.fhfb.gov/FHLB/FHLB\\_housing\\_stats.htm](http://www.fhfb.gov/FHLB/FHLB_housing_stats.htm) and FHFB staff.  
**USDA 502.** USDA staff and briefing books.

### Tax Expenditure

\* Only the portion of this policy that meets the study's narrow criteria is included in this total.

*Finally*, earnings from certain state- and municipal-issued bonds used for homeownership initiatives are exempt from federal taxes. Because the interest earned by the bond-holders is exempt from federal income tax, the bond-issuer can offer a lower interest rate (thereby saving the state or locality money, although this saving is less than the cost to the federal government).<sup>10</sup> These cost the federal government another \$700 million.

Combined, these four tax expenditures total \$110.5 billion.

In addition to these tax expenditures, support is provided through direct outlays that actively promote homeownership. Some of this comes through provisions of the U.S. Department of Housing and Urban

Development's (HUD's) HOME program that specifically targets homeownership; this portion of the HOME budget totals \$74.5 million. In addition, a portion of the Community Development Block Grant (CDBG) budget, which returns federal tax revenue to cities and states for certain broad purposes, is used to promote homeownership. This CDBG homeownership budget, including the \$25 million Self-Help Homeownership Opportunity Program, totals an additional \$40.8 million.<sup>11</sup>

The FHLB system sets aside funds every year to promote housing-related initiatives through its Affordable Housing Program (AHP). AHP subsidizes a number of housing activities, including rental housing. A portion of these funds is devoted to assisting homeownership for low- or moderate-income families, amounting to \$90.9 million.<sup>12</sup> The U.S. Department of Agriculture (USDA) also provides affordable mortgage financing to promote homeownership, especially among low- and moderate-income homebuyers, in rural areas. The principal vehicle for this is the USDA Section 502 program, which costs \$236 million per year.

The federal government also supports homeownership and other asset-building activities through Individual Development Accounts (IDAs). These relatively new vehicles are matched savings accounts that provide structure and incentive for low-income families to save for investments that build assets. (IDAs can be used for other activities such as small business development and for education, both discussed below, but more funds go toward housing than any other category.) The principal federal funding stream is the Assets for Independence Act, a five-year demonstration program that currently funds IDAs at \$25 million per year.<sup>13</sup>

Flexible mortgage financing is widely available through the Federal Housing Administration (FHA), principally through its 203(b) loan program that targets low- and moderate-income homebuyers. Although the volume on these loans is high, premiums collected from borrowers more than cover the costs of the program, so that there is currently no outlay required by the federal government. (In fact, this program consistently generates revenue for the federal government every year, as premiums paid by the low- and moderate-income homeowners outweigh the cost of the program, netting the federal government \$3 billion in 2003.)

A small portion of other federal programs—such as HUD's Section 8 program—can be used for homeownership, but the numbers are so small they are inconsequential in the context of this study. HUD also allocates funds for homeownership counseling, which provides help to individuals navigating their way through the homeownership process. In the interest of being conservative, however, programs like this that strictly provide technical assistance are excluded from the scope of this study.

While these direct outlays—many specifically targeted to the middle class and the poor—are significant, they are dwarfed by tax expenditures promoting homeownership. The latter outweigh direct outlays by \$236 to \$1.

## RETIREMENT ACCOUNTS

Most Americans need assets to retire. In its 1995 publication, *Who Will Pay for Your Retirement?*, the Committee for Economic Development described the looming retirement crisis. In the time since that came out, the picture has not improved much, and retirement savings has been a subject of considerable attention in Washington. While Social Security provides some measure of income flow once the paychecks have stopped, most people must supplement this stream. Toward this end, the federal government has created various tax incentives to encourage individuals and employers to save for retirement.

There are two principal groups of retirement policies at the federal level, both subsidized by tax expenditures.

*Employer-sponsored plans.* The first group of policies includes a variety of employer-sponsored pensions. Beginning in the 1920s, companies invested their assets to provide income to retired workers. These traditional pensions, called defined benefit plans, guarantee retired workers a regular income for the rest of their lives but are not transferable if the employee moves to a new employer. Companies are able to deduct the contributions to their employees' plans.

In the latter half of the twentieth century, companies began offering defined contribution plans, the most common one of which is the 401(k), in which employers guarantee their contributions but not the retirement income stream.<sup>15</sup> Other plans, such as the nearly identical 403(b) plans for employees of not-for-profit organizations, are also included in this category. For employers, the annual expenses of a defined contribution plan are predictable, making it easier to budget than a defined benefit plan. Further, employer contributions are subject to neither federal income nor payroll taxes<sup>16</sup> and are also deductible. The cost and responsibility for securing retirement funds are shifted to the employees. Under these pensions, employees have control of the investment of their retirement funds, which are transferable with changes in employment.

Employer-sponsored plans are widely used. About 42% of American workers participate in such a plan.<sup>17</sup> Tax expenditures for these sorts of plans total \$83.5 billion.<sup>18</sup>

*Individual-based plans.* The second group of policies offers tax benefits for retirement accounts that are structured by and for the individual, rather than being tied to an employer. The largest of these are traditional Individual Retirement Accounts (IRAs). These allow an individual to deposit up to \$3,000 (\$3,500 if over age 50) per year into an account. Part or all of the deposit is deductible depending on the

## RETIREMENT ASSETS (IN MILLIONS OF NOMINAL DOLLARS)

	FY1999	FY2000	FY2001	FY2002	FY2003
Employer-sponsored plans	76,100	76,000	85,000	87,900	83,500
Individual-based plans	11,400	12,200	13,300	14,000	10,400
Keogh plans	4,800	5,000	5,500	56,00	57,00
Tax credit for certain individuals for elective deferrals and IRA contributions	—	—	—	1,300	1,600
<b>TOTAL</b>	<b>92,300</b>	<b>93,200</b>	<b>103,800</b>	<b>108,800</b>	<b>101,200</b>

**Tax expenditure source:** Joint Committee on Taxation. Estimates of Federal Tax Expenditures for Fiscal Years, 1999-2003, 2000-2004, 2001-2005, 2002-2006, 2003-2007. (Washington, DC: U.S. Government Printing Office, 1998, 1999, 2000,

### Tax Expenditure

depositor's income,<sup>19</sup> participation in another retirement plan, and filing status. In 1999, IRA holdings were estimated at \$2.47 trillion, an amount that exceeded holdings in either private contribution retirement plans (such as 401(k)s) or traditional pension plans.<sup>20</sup> Similar accounts, called Keogh accounts, are available for self-employed individuals. In both traditional IRAs and Keogh plans, part or all of the contributions may be deductible depending on the depositor's income, participation in another retirement plan, and filing status.

In a Roth IRA, on the other hand, deposits are not deductible (so withdrawing them is not penalized), but the earnings on the deposits are tax-free. The Roth IRA's income limits are significantly higher than traditional IRAs: the maximum contribution does not begin phasing out until an individual's Adjusted Gross Income (AGI) reaches \$95,000, or \$150,000 for a married couple. There are no age limits on Roth IRAs, and they can be opened on behalf of minors.

Tax expenditures for traditional IRAs and Roth IRAs total \$10.4 billion. Together with \$5.7 billion spent on Keogh plans, these individual-based plans amount to \$16.1 billion. In addition, \$1.6 billion is spent through a tax credit that goes to qualifying individuals (over 18 and not full time students or dependents) for elective contributions to qualified plans or IRAs, depending on filing status and AGI.

All told, these tax expenditures in 2003 to reward asset-building for retirement totaled \$101.2 billion.

One final measure for future consideration is the after-tax contributions to an employer-sponsored 401(k) plan, over and above the allowed, pre-tax contribution. Currently, the earnings are taxable, which makes these contributions not very different from ordinary savings. However, beginning in 2006, they will be tax exempt. The limit on 401(k) pre-tax contributions is \$12,000 for 2003 and \$13,000 for 2004 and will



probably be even higher by 2006. A look at the cost of this new tax expenditure, as well as which income groups most benefit from it, will be warranted once this policy kicks in.

Ensuring financial security during retirement, as a complement to Social Security, is among the highest priorities for American families and the U.S. government. This variety of policies, totaling \$101.2 billion, encourages both employers and individuals to build assets for the future.

## SAVINGS AND INVESTMENT

Once people have accumulated assets, they have to decide what to do with them. The federal government has a number of policies that reward certain types of behavior over others when it comes to the saving and investing of assets.

Savings are financial resources that a household can use to cushion itself from changes in employment, health, or circumstances of fate. Some savings, as covered elsewhere in this study, are targeted to specific assets, but this section looks into the accumulation of wealth as its own end. Specifically, two sections of the tax code play significant roles in asset-building: capital gains and the treatment of certain forms of insurance and annuities. These fall under the category of tax expenditures.

## CAPITAL GAINS

Capital gains are similar to interest income, in that they represent income earned through means other than wages or salaries. While most interest income is taxed at the same rates as earned income, however, capital gains are not.

The different level of capital gains taxation influences the accumulation of assets. In 1997 and again in 1998, capital gains tax rates were reduced, making it more attractive for individuals and households to invest.<sup>22</sup> The differential between the capital gains rate and the top income tax rate creates large incentives for households to shelter their money in investments that are subject to this lower rate of taxation. Avoiding capital gains taxes<sup>23</sup> is much less of an issue than tax sheltering income. The cost of the reduced rate on capital gains totals \$55.3 billion. In most cases, capital gains taxes are not owed if they are part of an estate, and this exclusion costs an additional \$38.1 billion. Additionally, the so-called “gift tax” provision allows the recipients of gifts to carry-over the giver’s basis. This allows the recipient to continue deferral of unrealized capital gains. This provision adds an additional \$4.5 billion in tax expenditures.

## SAVINGS AND INVESTMENT (IN MILLIONS OF NOMINAL DOLLARS)

	FY1999	FY2000	FY2001	FY2002	FY2003
Reduced rates of tax on long-term capital gains	35,100	36,000	38,700	65,100	55,300
Exclusion of capital gains at death	19,200	23,700	26,000	37,300	38,100
Carryover basis of capital gains on gifts	1,900	2,300	2,600	4,200	4,500
Exclusion of investment income on life insurance and annuity contracts	22,600	22,900	23,000	23,600	24,000
<b>TOTAL</b>	<b>78,800</b>	<b>84,900</b>	<b>90,300</b>	<b>130,200</b>	<b>121,900</b>

**Tax expenditure source:** Joint Committee on Taxation. Estimates of Federal Tax Expenditures for Fiscal Years, 1999-2003, 2000-2004, 2001-2005, 2002-2006, 2003-2007. (Washington, DC: U.S. Government Printing Office, 1998, 1999, 2000, 2001, 2002), Table 1.

 Tax Expenditure

### LIFE INSURANCE AND ANNUITIES

Finally, one other federal policy significantly influences savings. In certain universal or variable universal life insurance policies, the cash value is tax-exempt. With these policies (as opposed to term life policies), an individual may pay over and above the insurance premium required for his or her coverage. The insured person has a host of investment options, not unlike a normal brokerage account, for that additional amount. The cash value of the policy grows, and it does so tax deferred. The amount may be withdrawn, tax free under certain circumstances, to augment retirement funds. The cost of this policy is \$24 billion.

All together, these four tax expenditures total \$121.9 billion.

## SMALL BUSINESS DEVELOPMENT

Small business development is a major asset-building avenue for entrepreneurs. As a significant driver of the U.S. economy, small businesses receive the support of lawmakers, and their development is encouraged by the federal government. Although the scale is much smaller than the other three categories, federal policies do direct resources to entrepreneurs to help them build businesses and assets. While businesses in general enjoy many benefits through U.S. policies, this study explicitly excludes support to corporations. Included here is support only to those businesses still small enough that the wealth-building is likely to accrue at the individual level; support to sole proprietors and partnerships is included in this analysis, but support to those businesses large enough to become incorporated is not.

A number of federal policies support the development of these small businesses.

The federal government encourages entrepreneurs to start and expand businesses through a number of policies, the most significant of which are funded through the Small Business Administration (SBA). The largest of these are loan guaranty programs provided to banks to encourage commercial lending. The most widely used is the SBA's 7(a) program. Businesses apply for 7(a) loans through a participating lender, and the SBA provides a significant level of guaranty, reducing the risk to the lender and making such a loan much more attractive. The lenders themselves actually originate and service the loans.<sup>24</sup> The cost of the guaranty (which leverages \$8.1 billion in lending) is \$85 million; of this, \$18.9 million of the cost is directed at unincorporated small businesses.

The U.S. Department of Agriculture's Business and Industry (B&I) program is modeled very closely after the 7(a) program. Designed to encourage business lending in rural areas, the B&I program guarantees up to 80% of the value of the loan, significantly reducing lenders' risk.<sup>25</sup> The cost of this guaranty is \$35.8 million, which supports \$901 million in lending. The distribution across business types is not available; however, assuming a similar distribution as its 7(a) cousin, 22.2% of this cost, or \$7.9 million, would be attributable to sole proprietors and partnerships.

The SBA also offers a MicroLoan program explicitly designed to provide specialized loan capital to microenterprises, or "mom and pop" businesses, that have no or very few employees. These funds are not large—they cost \$3.8 million—but they do provide important support to those entrepreneurs who can access the capital.

## SMALL BUSINESS DEVELOPMENT (IN MILLIONS OF NOMINAL DOLLARS)

	FY1999	FY2000	FY2001	FY2002	FY2003
SBA 7(a) Program *	24.0	24.0	25.5	17.3	18.9
USDA Business and Industry Program *	2.7	6.2	2.0	7.1	7.9
SBA MicroLoan Program *			2.9	1.9	3.8
Amortization of business startup costs	300.0	300.0	400.0	300.0	600.0
<b>TOTAL</b>	<b>326.6</b>	<b>330.2</b>	<b>430.4</b>	<b>326.3</b>	<b>630.6</b>
Ratio of tax exp:direct exp	11.3	9.9	13.2	11.4	19.6

**Tax expenditure source:** Joint Committee on Taxation. Estimates of Federal Tax Expenditures for Fiscal Years, 1999-2003, 2000-2004, 2001-2005, 2002-2006, 2003-2007. (Washington, DC: U.S. Government Printing Office, 1998, 1999, 2000, 2001, 2002), Table 1.

### Direct Expenditure Sources:

**SBA 7(a).** SBA Office of Financial Assistance.

**USDA B&I.** USDA Office of Budget and Program Analysis.

**SBA MicroLoan.** Association for Enterprise Opportunity staff and SBA staff.

\* Only the portion of this policy that meets the study's narrow criteria is included in this total.

### Tax Expenditure

The only tax expenditure directly tied to small business capitalization is the amortization of business startup costs. This allows entrepreneurs in the earliest stages of business development to carry-over their initial capitalization costs into future years in which they have more revenue to offset. The cost of this is a relatively modest \$600 million; nonetheless, this single tax expenditure is almost twenty times the value of the other small business programs combined.

All told, these outlays and tax expenditures total \$631 million (or, for easier comparison with other sections of this analysis, \$0.631 billion).

Some other programs are not included in this analysis. Another large SBA loan guaranty, the 504 program, provides businesses with long-term financing for major fixed assets, such as land and buildings. The 504 program is significant in size, but is essentially self-sustaining through program revenue and does not represent a significant net cost to taxpayers.

The SBA also offers a number of other programs to help entrepreneurs, such as the Small Business Center network, the Service Corps of Retired Executives, the Women's Business Centers, the Program for Investment in Microentrepreneurs, and non-loan elements of the MicroLoan program. These modestly

funded programs provide important support, but all fall under the category of technical assistance and so are not included in this analysis.

## OTHER SPENDING NOT COUNTED IN THIS TALLY

Together, these federal policies total \$335 billion.

This is a conservative calculation, as strong cases can be made to include a number of other types of policies. For instance:

### ASSET-BUILDING COSTS (IN BILLIONS OF NOMINAL DOLLARS)

	FY1999	FY2000	FY2001	FY2002	FY2003
<b>Direct Outlays</b>	0.2	0.2	0.4	0.4	0.5
<b>Tax Expenditures</b>	244.9	266.0	292.3	340.4	334.2
<b>TOTAL</b>	245.1	266.2	292.7	340.8	334.7
<b>Ratio of Tax Expenditures to Outlays</b>	1052:1	1118:1	803:1	886:1	642:1

- ▶ This study explicitly focuses on asset-building among individuals and households. Although it includes mom-and-pop businesses whose assets accrue to the individual owners, it stops short of looking at asset-building incentives for corporations. Federal policies provide incentives for corporations to build assets, as they do for individuals. For instance, the tax code provides for the accelerated depreciation of machinery and equipment. This provision alone costs an additional \$157.4 billion.<sup>26</sup> Were these and similar tax expenditures included, the final tally would be much higher.
- ▶ This study focuses on ordinary taxpayers, and so excludes certain distinct employment and other groups that have access to exclusive programs. The most notable in this regard is the group comprised of the active military and veterans. So, for instance, the cost of the Veterans Administration's popular mortgage program, or the SBA's Veterans Business Development program are not counted. Were these included, the total would rise again.

- This study focuses on specific federal policies but excludes the wide array of institutions that enable asset building in America. Many asset-building systems are institutionally supported by the federal government. The estimated cost to the federal government, for instance, of Freddie Mac, Fannie Mae, and the Federal Home Loan Banks—which make the modern mortgage industry possible—totals another \$14 billion per year.<sup>27</sup> A logical case could be made for including at least some portion of these costs in an asset-building budget.
- Investment in education and human capital is not included in this study. Education directly increases individuals' opportunity and earning power, improving their ability to build assets. There is a clear relationship between family income and education of the head of household.<sup>28</sup> If just that portion of federal spending on post-secondary education aimed at individuals were included, the total would rise by another \$28.4 billion. This represents \$16.9 billion in direct expenditures (the cost of grants and loans) and \$11.5 billion in tax expenditures (education tax credits and deductions). Because education and human capital are so closely tied to asset-building, but are qualitatively different than the other spending categories, they are not included in this study's tally, but are discussed separately in Appendix 3.

Any of these additions would likely drive the asset-building total higher. The figure of \$335 billion, therefore, should be treated as a conservative baseline estimate for federal asset-building policies, with the total possibly much higher depending on where the line is drawn.

## A LOOK AT WHO BENEFITS

That the government spends or forgoes \$335 billion each year to promote individual asset-building is, in itself, value neutral. Assets play a critical role in the economy and in the lives of families. Robust debate, however, is needed to critically evaluate who should benefit most from this collection of federal policies.

### WHAT IS ALREADY KNOWN

Data regarding the beneficiaries of these policies should inform the debate. Firm data, unfortunately, are not available for many of the programs cited in this report, but some inferences can be made based on broad issue categories. Based on these inferences alone, the picture generally suggests the likely beneficiaries are more probably upper-income, rather than middle- or lower-income, Americans. This appears true, to varying degrees, by looking at what limited information exists by each category:

***Homeownership.*** The vast bulk of homeownership incentives is funded through tax incentives. Because these have very high upper limits, they are likely—in dollar amounts—to most reward those with the largest assets. The home mortgage deduction can be taken not only on first, but on second, homes, a benefit that is not enjoyed by most low- or middle-income families.<sup>29</sup> The dollar value of this benefit is also largest for those with the most expensive homes. Further, the exemption from capital gains on home sales—which

benefits many Americans—applies up to \$250,000 gains for individuals and \$500,000 for couples, amounts likely to dwarf the gains realized by most homeowners. While the homeownership tax expenditures are likely by their structure to benefit those with the most assets, other federal policies specifically target the middle classes and poor. Most of the direct outlays described above are capped at relatively modest amounts based on income or purchase price. These policies clearly help those with fewer assets but, because they are outweighed \$236 to \$1 by tax expenditures, these effects are not likely to strongly compensate the probably regressive impact of the tax expenditures. Even tax-exempt housing bonds, typically created to provide housing opportunities to lower income Americans, are funded by a tax break that actually goes to the holders of the bonds, disproportionately higher-income individuals and corporations.<sup>30</sup>

*Retirement Accounts.* Federal policies promoting retirement savings also appear to be tilted toward those with more income and assets. Of employer-sponsored plans, for instance, the 63.2 million workers who participate are more likely to have higher incomes than those who do not.<sup>31</sup> (They are also statistically more likely to have higher levels of education; to work for more months out of the year; to be older, white, and male; and to work at larger firms.<sup>32</sup>) Similar patterns exist with IRAs, with the likelihood of account ownership increasing with income (as well as with education, age, and the likelihood of being white, male and married<sup>33</sup>), with the median income of IRA holders being significantly greater than the population at large.<sup>34</sup> The median income of those holding Roth IRAs is even higher than that of traditional IRAs.<sup>35</sup> It appears most federally-encouraged retirement policies, while theoretically available to many Americans, are more frequently accessed by those with more income to begin with. (This leaves lower-income Americans doubly vulnerable, since their Social Security checks, which are based on their lifetime earnings, will be lower than those of their better paid counterparts.<sup>36</sup>)

*Savings and Investment.* The federal policies that promote certain kinds of savings and investment share one thing in common – they all require assets to begin with to kick in. For that simple reason, this category of policies is almost by definition weighted toward those with more assets. Reduction in capital gains taxation only applies to those who are able to invest and thus realize capital gains. The carryover basis on gifts only helps those who are the beneficiary of another asset-holder's largesse. The tax-advantaged investment of income into life insurance and annuity contracts, likewise, assumes both the ownership of such policies and the additional disposable income to be able to take advantage of this provision. The exception of the probable regressive nature of this category is the exclusion from the estate tax, which applies to all heirs except those inheriting the very wealthiest estates.<sup>37</sup>

*Small Business Development.* By far the smallest of the four categories, small business development is also quite likely to benefit those who already have wealth, simply by virtue of business ownership. While this study confined the analysis to sole proprietors and partnerships—those businesses still closely held by individuals and households—even these are overwhelmingly owned by the wealthy. The top 1% of households control almost half (46.9%) of the unincorporated business net worth, while the middle 60% of Americans control only 8.8%.<sup>38</sup> Although some federal policies are aimed specifically at low-income entrepreneurs, these programs are a small fraction of the overall business support provided through outlays and direct expenditures. Purely by virtue of who owns the businesses, these benefits almost certainly accrue to those with the most assets.<sup>39</sup>

The data that do exist strongly hint that the benefits of federal asset-building policies are likely to benefit those with the highest incomes and the most assets. While compelling, this tentative conclusion is based on inferences and extrapolation from existing information. To test whether this conclusion is correct, this study takes an additional, more rigorous, step.

#### DATA-BASED MODEL

Because the desired data do not yet exist in fully accessible form, this study looked at the probable effects of the largest asset-building policies using a highly refined model based on the best data available. This was done using a model (known as a “microsimulation”) developed and tested by the Institute on Taxation and Economic Policy (ITEP). It calculates the revenue yield and tax incidence,<sup>40</sup> by income group, of federal, state, and local taxes. The model “relies on one of the largest databases of tax returns and supplementary data in existence... [Its] federal tax calculations are very similar to those produced by the congressional Joint Committee on Taxation, the U.S. Treasury Department and the Congressional Budget Office.”<sup>41</sup> A full description of the ITEP Model can be found in Appendix 2.

Data were available to capture the incidence of three of the largest tax expenditures: reduced rates on capital gains and dividends, the mortgage interest deduction, and the home property tax deduction. Although these represent a small number of the policies evaluated in this study, together they comprise 57% of the spending of federal asset-building policies. The detailed results of the analysis are available in Appendix 4.

For the three tax policies together, the distribution of benefits highly favors upper-income taxpayers.

The top 20% of taxpayers, those whose incomes exceed \$81,000, receive the lions’ share of the benefits. Roughly one-third (33.7%) of the tax savings is enjoyed by the top 1% of taxpayers; the taxpayers group have an average annual income in excess of \$1 million. In contrast, the bottom 60% of taxpayers, with



incomes below \$48,000, divides up 4.7% of the tax savings.

The average benefit to a taxpayer in the top 1% is \$38,107, which is:

- Seven times the average benefit of the next 4% of the population,
- 12 times the average benefit of the next 5% after that,
- 220 times the average benefit of the middle 20%, and
- 8,985 times the average benefit of the bottom 20%, who receive, on average, a benefit of \$4.

When we look at the assets individually, the distribution is also skewed. The most regressive asset categories are also those with the largest budgets.

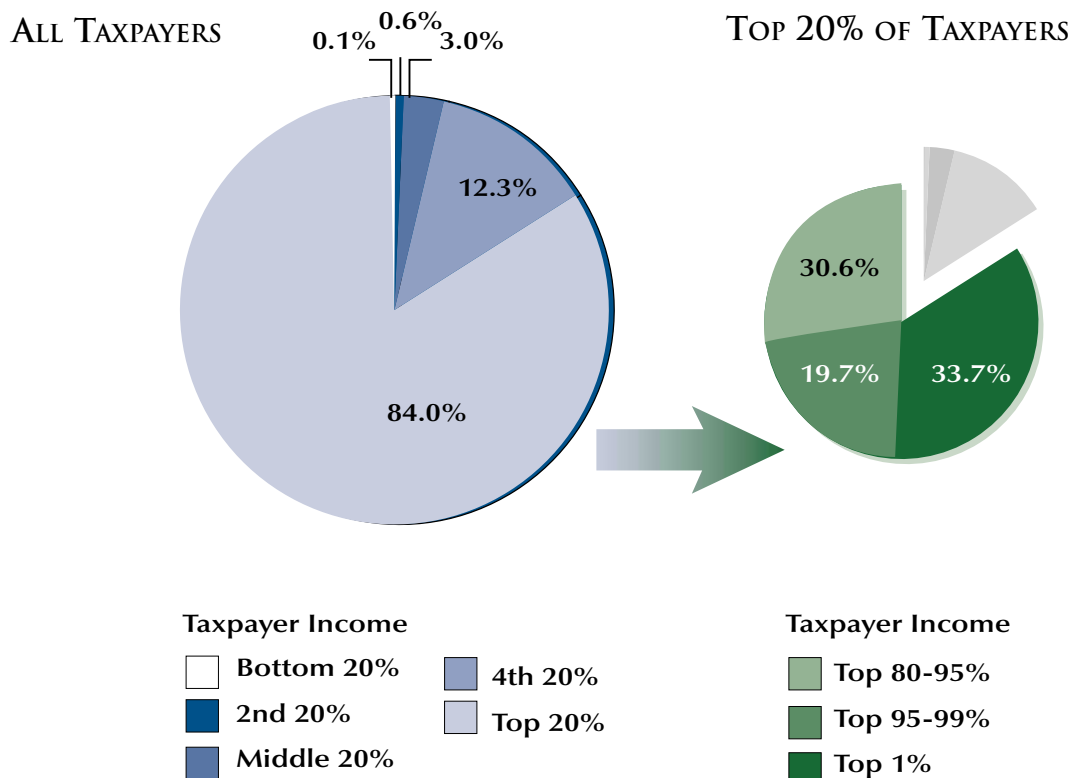
## AMERICAN ASSET-BUILDING POLICIES:

Mortgage interest, property tax deductions, and preferential rates on capital gains and dividends.

### BY AVERAGE DOLLAR AMOUNT

If a taxpayer's income is in the...	then their average benefit is...
Bottom 20%	\$4.24
2nd 20%	\$34.26
Middle 20%	\$173.45
4th 20%	\$705.64
Next 10%	\$1,959.68
Next 5%	\$3,060.69
Next 4%	\$5,528.64
Top 1%	\$38,107.10

### BY PERCENT OF TOTAL



The benefits of tax expenditures on *capital gains and dividends* present the most lopsided picture. The vast bulk (93.3%) of these tax benefits go to those taxpayers in the top income quintile. The top 1% of taxpayers receives 68.8% of the benefits from reduced tax rates on capital gains and dividends. The average tax benefit to these taxpayers is \$31,219—about enough, to put it in some perspective, to buy a 2004 Mercedes-Benz C240 sedan. Taxpayers in the lowest quintile (those with an average income of \$10,900) receive an average tax benefit of just \$1.53 from the lowered rate on capital gains and dividends—about enough for a cup of coffee at Starbuck’s.

The distribution of tax expenditures for *homeownership* is nearly as skewed. The bottom 60% of taxpayers receives 4.7% of the benefits from the mortgage interest deduction while the top 5% receives 36% of the benefits. The bottom 60% of Americans shares 8.3% of property tax deductions, while the top 5% shares 21.2% of the benefits. When the two are combined, the distribution is much closer to that of the mortgage interest deduction than the home property tax deduction.<sup>42</sup> 21.5% of the benefits are received by the bottom 80% of taxpayers; 35.5% of the benefits are shared by the top 5%.

#### IS THIS THE WHOLE PICTURE?

While these results are striking, are they representative of the broader set of policies outlined in this study? Absent more complete data, it cannot be known with absolute certainty. Some of the other policies, particularly some of the mortgage programs that have specific income limitations, are likely to be less regressive than these, which may temper the overall findings somewhat.

This said, it is highly likely that those with the most assets do, as the simulation numbers strongly suggest, benefit disproportionately from asset-building programs. This is true for four reasons.

*The bulk of federal asset-building programs are structured as tax incentives, the majority of which are deductions or nonrefundable tax credits.* Because most tax policies are not refundable tax credits, they do not help many lower-income families who may otherwise qualify but have relatively low tax burdens. (The mortgage interest deduction, for example, only helps a family if they already have a net tax liability.) For this reason, most of the tax expenditures cited in this analysis exclude the bottom tier of earners, by design skewing the distribution of benefits.

*Many asset-building policies require that the beneficiary already hold assets or have substantial income to begin with.* Middle-class and poor people are less likely, for instance, to have capital gains to be taxed at lower rates and less likely to be able to reach the limits on retirement plan savings.

*Many asset-building policies have no, or very high, upper limits.* This means, even if many families qualify for the benefits specified under any specific policies, upper income taxpayers enjoy a greater share in aggregate dollars. The capital gains exclusion on the sale of a primary residence, for example, may benefit a middle-class family who sells its house and realizes a modest gain. Only the wealthy, however, are likely to approach the half-million dollar cap. Further, the mortgage interest deduction claimed for second homes does little to benefit the average family working to pay the mortgage on their first (and only) home.

*Only a modest number of dollars support policies that specifically target middle-class and poor people.* The SBA funds programs that help microbusinesses, for instance, many of which are started by entrepreneurs of modest means. Individual Development Accounts are targeted to low- and moderate-income families to help them save for the future. Most of these programs are direct outlays in the millions, which are dwarfed by tax expenditures that favor the wealthy in the billions.

While parts of the picture remain to be filled in, this analysis does give us a good idea of who benefits from federal asset programs. The general message is clear—the federal government’s \$335 billion in asset programs most heavily favors those who already have the most assets. Whether that is desirable or not has never, in a comprehensive way, been debated.

#### WHERE TO GO FROM HERE?

Three conclusions can clearly be drawn from this analysis:

1. The federal government already provides spending and incentives to encourage individuals and households to build assets. While the precise number is open to debate, a conservative baseline is that this activity totals at least \$335 billion.
2. Federal policies disproportionately reward those who already enjoy the highest incomes and the most assets. In fact, the largest programs are among the most skewed toward the wealthy.
3. A clear articulation of the country’s asset-building goals, more study, better data, and better-informed decisions are needed.

Asset-building programs are not accidental. Each is the result of intentional decisions by lawmakers and civil servants, with the input and influence of citizens and interest groups. Yet, as a whole, these efforts are haphazard. While the direct expenditures and tax preferences add up to a staggering sum, they are not the result of deliberate vision. There is no federal assets budget. There is no federal assets policy. There is only a

hodgepodge of policies that happens to have the effect of encouraging asset-building on a massive scale. The benefits are tilted—intentionally or not—heavily to those who need that help the least.

In the meantime, important policy changes are being actively debated, and likely will be for some time. Proposals for changing the treatment of capital gains and dividends, for instance, are commonly put forward. The creation of new tax-advantaged savings plans and changes to retirement planning come up with regularity. But these vital (and expensive) debates are taking place in relative isolation, without regard to the big picture of how the collection of American policies can most effectively promote asset building to enhance the economy and stabilize families.

The Corporation for Enterprise Development conducted this analysis because this broader story had not yet been told. This is but the first chapter.

To begin to ensure federal asset-building policies are effective and the staggering investments made are well used, there should be vigorous public debate about what our national priorities should be. Policymakers, activists, academics, and others must ensure this includes both line-item outlays and less visible tax expenditures. If the current volume and distribution of programs continues as is, let it be the result of measured deliberation rather than benign neglect and lack of information.

The federal government should also publish an annual budget of all the federal government's asset-building policies. As this information gets more uniform and more reliable, more can be learned about this immense, but poorly understood, collection of federal policies.

Assets matter. People need them for security, and they need them to plan for and invest in the future.

Federal policies that promote asset-building, done well, can provide opportunities for families to realize the American Dream. Federal policies that promote asset-building, done poorly, can have effects few Americans would knowingly support at this level.

Today, the federal government devotes at least \$335 billion in intentional strategies to promote asset-building. Yet, there is no coherent asset strategy. There is no explicit asset-building budget. There is little public scrutiny of this spending.

It's about time to shed daylight on this vast investment and ensure that it supports the dreams of all Americans.

## ABOUT THE AUTHORS

**David Buchholz** is a Program Director at the Corporation for Enterprise Development, where he helps manage the Local Capital Markets Investment Fund, which invests in innovative products that development finance institutions create to better serve low-income communities.

Mr. Buchholz also serves on the management teams of the National Fund for Enterprise Development, which supports microenterprise development at the state level, and CFED-REAL, which provides entrepreneurial training and assistance nationwide. He provides consulting services to institutions engaged in community and economic development, and works on other projects concerning state and federal tax policy, affordable housing, and maximizing the impact of the community development finance field.

Previously, Mr. Buchholz worked at the Self-Help Ventures Fund, where he directed its \$2 billion secondary market program that has provided affordable mortgage financing to low-income families nationwide. Prior to that, he served as Executive Director of Good Work, a North Carolina nonprofit that provides training, loan capital, and support to low-income entrepreneurs. Mr. Buchholz holds a B.A. from Augustana College, and an M.A. and Ph.D. in political science from Duke University.

**William Schweke** is Research and Development Director at the Corporation for Enterprise Development in the Durham, NC office.

A specialist in development finance, plant closings, small and community business initiatives, local development planning, environmentally compatible development, and urban neighborhood development initiatives, Mr. Schweke has advised a variety of state and local governments, community-based organizations, foundations, trade unions, chamber of commerce, private utilities, and governmental authorities in the U.S., Europe and Great Britain. Mr. Schweke has also developed courses on rural development, community economic development, and local development planning.

Mr. Schweke is currently researching the potential impact of global trade, investment and procurement agreements on the future of domestic economic development, developing new state approaches for addressing plant closings and mass layoffs, and federal assets policy. Subsequently, he has co-authored Trade Agreements and Sustainable Development: 13 Reasons Why They Should Be More Compatible with Paige Brown, and Job Creation Alternatives in North Carolina with Lillian G. Woo. Mr. Schweke holds a Bachelors and Masters Degree in sociology from the University of Texas at Austin.

**Lillian G. Woo** is a Senior Program Manager for the Corporation for Enterprise Development in the Durham, NC office, where she is managing the measure construction and data analysis for CFED's annual Development Report Card for the States.

Additionally, Ms. Woo is studying the environment of entrepreneurship in rural North Carolina and researching federal asset policies. She is also co-author of CFED's Job Creation Alternatives in North Carolina with William Schweke.

Ms. Woo's previous experience with economic development has been in the international context. Doing field work in Sri Lanka and in Malaysia, under the auspices of the Luce Scholars program, Ms. Woo worked on policies and projects designed to create opportunities for rural communities. Returning from Asia, she worked at the International Food Policy Research Institute, organizing an international conference on poverty research, and the World Bank, serving as primary analyst of Malaysia's New Economic Policy. Ms. Woo has an A.B. in economics from Davidson College, a Master of Public Policy from Harvard University, and a doctorate in economics from the University of North Carolina at Chapel Hill.

## APPENDIX 1: DIRECT SPENDING VERSUS TAX EXPENDITURES

Public finance experts typically distinguish direct spending (outlays) and tax expenditures.

Direct spending requires an authorization and appropriation. Tax expenditures are essentially spending programs channeled through the tax system. Called tax preferences or tax incentives, they create exceptions, shelters, or breaks for households and businesses. They can take the form of deductions, credits, deferrals, and abatements. Among the most familiar examples are the tax deductions for home mortgage interest and for charitable contributions. There are a multitude of such incentives at the federal and state levels, paralleling direct spending programs and targeted to business, research and development, agriculture, income security, health care, oil drilling, nuclear power, employment and training, housing, social services, education, veterans' benefits, and so on.

There has been a lively debate about tax code measures, and their pros and cons, relative to direct spending approaches.

### TAX FAIRNESS

The starting point in the debate is the importance of tax fairness. According to this view, the best principle for allocating the tax burden is ability-to-pay (or progressivity). Adam Smith took this position: "The subjects of every state ought to contribute towards the support of the government as nearly as possible in proportion to their respective abilities."<sup>43</sup> The more one has, the more one can spare; the more one's stake in the social order, the more one has to protect. The less one has, then the less one has for necessities and for giving one's offspring a fair shake. Or, as economist Alan Blinder puts the matter, "The poor are needier than the rich."<sup>44</sup>

In addition, tax experts generally support tax systems with a broad base, few loopholes, progressive rates and few brackets. Tax expenditures create problems. They distort economic behavior. They make the code more complicated and easier to manipulate by the sophisticated. They create horizontal inequities by not treating the same household or business income the same. And they can undermine progressivity. Why?

Progressive rates create large payoffs for tax credits, exemptions, abatements and deductions. For instance, if a family is in the 28% tax bracket and receives a \$1,000 raise, their taxes will go up \$280; that is, taxes will absorb 28% of the raise. Similarly, if their taxable income goes down \$1,000, because they received a new \$1,000 tax deduction, they pay \$280 less in taxes. But the same \$1,000 tax deduction is worth only



\$150 to someone in the 15% tax bracket. Tax deductions constitute subtractions from gross income, while credits are even more valuable. They are subtracted from the actual tax. This feature, depending on the specific design, makes them potentially useful to some less affluent taxpayers. Indeed, a tax credit is worth the same amount to all taxpayers, regardless of the tax rate they pay. Credits for which all taxpayers are eligible are progressive since, for instance, a \$65 credit is a much greater share of income for a family earning \$20,000 than for a family earning \$100,000.

But if a family's income is so low that they have no taxable income, then the credit is unusable unless it is made refundable. Thus, the overall effect of all tax preferences is to create a gap between the nominal tax rates listed in tax tables and the effective or real tax rates paid by the taxpayer, whether measured by the rate of taxation on the last dollar of income or by the percentage of income actually paid in taxes. This often creates vertical and horizontal inequities.

Furthermore, the affluent more typically make the sorts of investments (e.g., stock purchases, real estate acquisition, etc.) and engage in the types of business activities that are generally rewarded by tax preferences. They are also more likely to itemize, because they have more complex income sources and tax returns and are eligible for a greater variety of tax deductions, credits, exemptions, and so on.

The results are a less progressive tax code and less tax revenue collected.

## COST

Big bucks are involved in tax incentives. Tax incentives also operate as hidden entitlements—often growing unpredictably over time. A study by the Institute on Taxation and Economic Policy for the Century Foundation presented this portrait of federal tax expenditures:

Tax expenditures . . . will total \$3.4 trillion over the next five years . . . Of the \$3.4 trillion in tax expenditures projected over the next five years, \$2.94 trillion reduce personal income tax collections and \$440 billion reduce corporate income tax collections.<sup>45</sup>

Because they do not require reappropriation every year, tax expenditures are a favored class of spending. Only those tax expenditures subject to sunset provisions – these are exceptions – must be periodically approved by Congress.

## POLITICAL SUPPORT

Christopher Howard, in his important book, *The Hidden Welfare State: Tax Expenditures and Social Policy in the United States*, argues that tax expenditures enjoy an increasing amount of political popularity. His historical narrative documents the growth of their importance over time. Indeed, “whereas the visible welfare state was built in two short, intense bursts, the hidden welfare state was built steadily over nine decades.”<sup>47</sup>

Tax expenditure use has accelerated in the last few decades for a number of reasons. Tax policies do not have to go through a separate appropriations process. Unlike appropriations which have to be authorized by one committee and funded by another, tax expenditures can be created by one committee and then attached as a rider to an omnibus revenue bill. This makes it easier for them to be enacted. Tax incentives can also seem like the perfect tool for policy innovation: they appear costless and pro-market.

Despite their political resonance, some, such as Howard, worry about their lack of transparency and oversight, their growing costs, and the increasing complexity of the tax code.

## PROS AND CONS

Tax preferences are generally harder to police and monitor than direct spending programs. In Congress and in state legislatures, they get less scrutiny during the appropriations phase than direct expenditures. It is often harder to estimate their potential costs. The budget process segregates them from spending decisions. It is, therefore, harder to weigh the trade-offs between spending on direct programs or tax incentives for the policy priority. They are often not subject to sunset laws. In many state legislatures, super-majorities are required to make any tax changes. Closing loopholes is considered a “tax increase,” making them hard to abolish. Lastly, they often subsidize behavior that would have happened anyway.

Tax expenditures have some advantages over direct spending programs. Eric Toder, a senior official at the IRS, makes a number of other important points along these lines.

The standard rhetoric of tax reform argues against special tax benefits and for a tax system with low rates and a broad tax base . . . Yet if these provisions are really expenditures in disguise, whether or not they violate tax policy principles is irrelevant. No general principles require that spending programs should treat all taxpayers with the same income equally or that they be neutral with respect to resource allocation. Instead, public spending programs explicitly aim to alter the allocation of resources and the distribution of income from what the market system would otherwise produce. Moreover, while costs to agencies of administering programs and to potential recipients in claiming benefits are important in program evaluation, what matters is the total cost of government programs—not whether the costs are born by the IRS and taxpayers instead of by a spending agency and its potential beneficiaries.<sup>48</sup>

Toder also suggests some guidelines for wise use of tax incentives. Meeting equity goals will principally happen if tax credits, not deductions are used, and these should be made refundable.<sup>49</sup> Moreover, the disbursements might need to be made more frequently than just annually. If clear and objective eligibility can be established, then tax-based approaches are probably preferable. Next, if maximizing access, rather than minimizing fraud is the prime imperative, then a tax measure might be the better way to go. Toder also notes “tax incentives are a better subsidy mechanism than direct spending if eligibility criteria are linked to data already reported on the returns.”<sup>50</sup> However, if a great deal of administrative discretion is required and the IRS and another agency must both be involved, a direct spending approach will likely lower the overall costs of the effort. Fiscal accountability also can be further enhanced by requiring sunset reviews and by setting a cap on total revenue losses.

Both direct outlay and tax expenditure approaches have their roles, and their own set of pros and cons.

#### DIRECT OUTLAYS

##### *Pros:*

1. They can be targeted effectively to people and places most in need.
2. They are very transparent.
3. They can have strong oversight mechanisms in place—budget processes, sunset requirements and reviews.
4. They can provide timely resources to citizens in relationship to cash spending.
5. They can finance services, not just provide cash.

##### *Cons:*

1. Service delivery, bureaucracy, and management are often large issues.
2. They are often slower to set up.
3. There is a strong political taboo against tax and spending increases. Therefore, they are hard to enact.
4. They are probably more vulnerable to cut-backs than tax-based measures.

## TAX EXPENDITURES

### *Pros:*

1. They can be simpler and entail fewer administrative costs and hassles.
2. They can be made progressive by using credits and refundability.
3. They can grow with demand without new appropriations.
4. They can be less stigmatizing.

### *Cons:*

1. They can be costly.
2. They often benefit those least in need.
3. They can reward behavior that would have happened without it.
4. They are usually entitlements – not subject to annual budgeting.
5. They are less transparent and receive less scrutiny than direct spending.
6. Eliminating them is often regarded as a tax increase.
7. They can make a tax code less horizontally and vertically equitable.
8. They can undermine the fiscal base, leading to regressive tax shifts or spending cuts.
9. At present, it is difficult politically to secure enactment of expansions of new refundable credits.

Based on these, general rules of thumb can be used in determining which tool is best for advancing a particular purpose. In general, tax expenditures are preferable when:

- Tax credits are useable.
- Refundability is an option for assisting low-income households directly.
- The ultimate beneficiary and recipient are the same.
- An indirect approach helps to engage a big commitment by the private sector.

- Maximizing access, rather than minimizing fraud is the imperative.
- Eligibility criteria are linked to already reported data on returns.
- A great deal of administration discretion/oversight is not needed.
- Programs deliver cash, not services.
- Tax or expenditure limits are in place.
- Strong political hurdles for any new spending initiative exist.
- Fiscal accountability can be enhanced by requiring sunset reviews and setting revenue cap on total losses.

On the other hand, direct outlays tend to be better when:

- Certification of an allowable tax expenditure would be complex.
- Services, not income, are required.
- Fraud is a major possibility.
- Refundable tax credits are not a viable political/fiscal option.
- The tax credit cannot be large enough to make a difference.
- Citizens need significant funds when they are expended, not when annual tax returns are filed and processed.
- A tax approach cannot be sufficiently targeted to low- or moderate-income recipients without high costs.

In either case, transparency and sunlight are critical to ensure that the policies – whether through direct outlays or tax expenditures – are being advanced in appropriate, accountable fashion.

## APPENDIX 2: ITEP MODEL

Reprinted from Institute on Taxation and Economic Policy, *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States, 2nd Edition*, January 2003, pp.120-121.

The Institute on Taxation and Economic Policy (ITEP) has engaged in research on tax issues since 1980, with a focus on the distributional consequences of both current law and proposed changes. ITEP's research has often been used by other private groups in their work, and ITEP is frequently consulted by government estimators in performing their official analyses. Over the past several years, ITEP has built a microsimulation model of the tax systems of the U.S. government and of all 50 states and the District of Columbia.

### WHAT THE ITEP MODEL DOES

The ITEP model is a tool for calculating revenue yield and incidence, by income group, of federal, state, and local taxes. It calculates revenue yield for current tax law and proposed amendments to current law. Separate incidence analyses can be done for categories of taxpayers specified by marital status, the presence of children and age.

In computing its estimates, the ITEP model relies on one of the largest databases of tax returns and supplementary data in existence, encompassing close to three quarters [sic] of a million records. To forecast revenues and incidence, the model relies on government or other widely respected economic projections.

The ITEP model's federal tax calculations are very similar to those produced by the congressional Joint Committee on Taxation, the U.S. Treasury Department and the Congressional Budget Office (although each of the four models differs in varying degrees as to how the results are presented). The ITEP model, however, adds state-by-state estimating capabilities not found in the government models.

Below is an outline of each area of the ITEP model and what its capabilities are.

**The Personal Income Tax Model** analyzes the revenue and incidence of current federal and state personal income taxes and amendment changes in:

- rates—including special rates on capital gains,
- inclusion or exclusion of various types of income,
- inclusion or exclusion of all federal and state adjustments,
- exemption amounts and a broad variety of exemption types and, if relevant, phase-out methods,
- standard deduction amounts and a broad variety of standard deduction types and phase-outs,

- itemized deductions and deduction phase-outs, and
- credits, such as earned-income and child-care credits.

**The Consumption Tax Model** analyzes the revenue yield and incidence of current sales and excise taxes. It also has the capacity to analyze the revenue and incidence implications of a broad range of base and rate changes in general sales taxes, special sales taxes, gasoline excise taxes and tobacco excise taxes. There are more than 250 base items available to amend the model, reflecting, for example, sales tax base differences among states and most possible changes that might occur.

**The Property Tax Model** analyzes revenue yield and incidence of current state and local property taxes. It can also analyze the revenue and incidence impacts of statewide policy changes in property tax—including the effect of circuit breakers, homestead exemptions, and rate and assessment caps.

**The Corporate Income Tax Model** analyzes revenue yield and incidence of current corporate income tax law, possible rate changes and certain base changes.

**Local taxes:** The model can analyze the statewide revenue and incidence of aggregate local taxes (not, however, broken down by individual localities).

## DATA SOURCES

The ITEP model is a "microsimulation model." That is, it works on a very large stratified sample of tax returns and other data, aged to the year being analyzed. This is the same kind of tax model used by the U.S. Treasury Department, the congressional Joint Committee on Taxation and the Congressional Budget Office. The ITEP model uses the following micro-data sets and aggregate data:

### *Micro-Data Sets:*

IRS 1988 Individual Public Use Tax File, Level III Sample, IRS Individual Public Use Tax Files 1990 and later; Current Population Survey: 1988-93; Consumer Expenditure Survey, 1988-90 and 1992-93; U.S. Census, 1990.

### *Partial List of Aggregate Data Sources:*

Miscellaneous IRS data; Congressional Budget Office and Joint Committee on Taxation forecasts; other economic data (Commerce Department, WEFA, etc.); state tax department data; data on overall levels of consumption for specific goods (Commerce Department, Census of Services, etc.); state specific consumption and consumption tax data (Census data, Government Finances, etc.); state specific property

tax data (Govt. Finances, etc.); American Housing Survey 1990; 1990 Census of Population Housing, etc.

*A more detailed description of the ITEP Microsimulation Tax Model can be found on the ITEP internet site at [www.itepnet.org](http://www.itepnet.org).*



## APPENDIX 3: POST-SECONDARY PROGRAMS

Investment in education and human capital is not included in this study.

Education directly increases individuals' opportunity and earning power, however, improving their ability to build assets. There is a clear and documented relationship between family income and education level of the head of household. Investment in education is often seen as a primary vehicle in programs like Individual Development Accounts to assist low-wealth families to build assets.

For these reasons, a strong argument could be made for inclusion of education and human capital in an asset-building budget. Erring on the conservative side, this study does not include education, but it is analyzed in this Appendix.

While the federal government spends considerable money on education in general, much of it is K-12 spending and, since that is beneficial essentially universally, it would not meet the criteria for inclusion set out in this analysis. Post-secondary education, on the other hand, does more clearly fit the narrow definition of asset-building policy.

The federal government assists post-secondary education through both tax expenditures and direct outlays.

### *Educational Tax Expenditures*

A wide variety of tax incentives exists that defray the expenses of post-secondary education. These include:

- ▶ **Hope Scholarship Credit:** A maximum, nonrefundable tax credit of \$1,500 for the first two years of post-secondary education in a degree program available, in full, to taxpayers whose modified adjusted gross income is less than \$41,000 (reduced credit for taxpayers whose income is between \$41,000 and \$51,000, unavailable for taxpayers whose income exceeds \$51,000). The income limits are higher for couples filing a joint return: the full tax credit is available for household incomes less than \$83,000, reduced credit if between \$83,000 and \$103,000, no credit if income exceeds \$103,000.<sup>51</sup> This eligibility cap distinguishes the Hope Scholarship Credit from many other programs.
- ▶ **Lifetime Learning Credit:** A tax credit equal to 20% of the first \$10,000 in tuition and qualified expenses (up to \$2,000), per taxpayer, for all students in the family if the family's modified adjusted gross income is under \$41,000, with a modified credit for families whose income is between \$41,000 and \$51,000 and no credit for families whose income exceeds \$51,000. The income limits for couples filing joint returns are identical to those for the Hope Scholarship Credit.

- ▀ *Coverdell Education Savings Accounts (ESAs)*: Up to \$2,000 per year per student may be deposited in an ESA where the earnings grow tax-deferred. If the earnings withdrawn are used for qualified educational expenses, they are tax-free. Taxpayers with modified adjusted incomes less than \$95,000 may open Coverdell ESAs. Contributions are reduced for taxpayers whose incomes are between \$95,000 and \$110,000; taxpayers with incomes over \$110,000 may not contribute to ESAs. Income limits for married couples are \$190,000 and \$220,000.
- ▀ *IRA withdrawals for higher education expenses*: Withdrawals from IRAs for qualified educational expenses are not subject to the 10% tax penalty for early withdrawal.
- ▀ *Student loan interest deduction*: Up to \$2,500 in interest paid on student loans for qualified educational expenses can be deducted from taxable income for households with less than \$50,000 (\$100,000 if filing jointly).
- ▀ *529 Plans*: Taxpayers can either prepay post-secondary tuition or open an account the deposits to which grow tax deferred until distributed. For prepaid accounts, the earnings are tax-free if used for qualified education expenses. Under the savings plans, the earnings are currently tax-free if used for qualified education expenses. Beginning in 2011, the student will pay taxes on the distributed earnings.

Taken together, these educational tax expenditures total \$11.5 billion.

### *Direct Educational Outlays*

Unlike the other four asset categories in this analysis, the federal government spends more through direct outlays for post-secondary education than it does through tax expenditures. The direct outlays take several forms. The principal outlays include:

- ▀ *The Pell Grant Program* provides need-based grants to low-income undergraduate (and certain post-baccalaureate) students to promote access to postsecondary education. The Pell Grant program "is the single largest source of grant aid for postsecondary education attendance funded by the federal government, estimated to provide \$11.7 billion in FY2003 to over 4.9 million undergraduate students [roughly twenty percent of undergraduates]" (Stedman, 2003, Summary). "In FY1999, an estimated over 90% of Pell Grant recipients considered to be dependent on their parents had total parental income below \$40,000. Of Pell Grant recipients considered to be independent of their parents, over 90% had total income below \$30,000" (Stedman, 2003, Summary). Pell Grants do not need to be repaid. Grant amounts vary, depending on the student's expected family contribution, the cost of attending the



institution, whether the student attends full-time or part-time, and whether the student attends for a full academic year or less. Pell Grants range from \$400 - \$4,000 per student.

- ▶ *Stafford Loans* can either be subsidized or unsubsidized. If subsidized, the interest on the loan is paid by the government while the student is in school as well as while s/he is in a grace period or period of deferment. Students must demonstrate financial need to receive a subsidized Stafford. With an unsubsidized Stafford, interest on the loan is capitalized while the student is in school and added to the loan amount; unsubsidized Stafford loans are not awarded on the basis of need. Both Stafford loan types are provided directly by the educational institution or through the Federal Family Educational Loan (FFEL) program that involves private lenders. The total debt that can be outstanding from all combined loans can run from \$23,000 to \$138,500 depending on economic status, graduate versus undergraduate status, and so forth. (Hope Scholarship and Lifetime Learning tax credits for tuition expenses can be used in tandem with such loans.)
- ▶ *PLUS Loans* are made to parents to help them pay the education expenses of a dependent undergraduate student. These loans can be used to fill the gaps in financing tuition if other sources of aid come up short.
- ▶ *Consolidation Loans* allow student and parent borrowers to simplify loan repayments by combining a number of loans into one with a single repayment schedule.
- ▶ Other outlays are included in the table below.

Taken as a group, these direct outlays total \$16.9 billion.

## COST OF AMERICAN POST SECONDARY EDUCATION POLICIES

Education	FY1999	FY2000	FY2001	FY2002	FY2003
Pell Grants	7,704	7,639.7	8756	10,314	11,364.6
Stafford, PLUS, and Consolidation Loans (FFEL)	2782	3,7626	30,683	4,311.74	5540.5
Tax credits for tuition for post-secondary education	5600	5400	4200	4300	4300
Deduction for interest on student loans	100	300	400	600	600
Deduction for higher education expenses				1500	2100
Exclusion of interest of earnings of trust accounts for higher education ("education IRAs" or Coverdell ESAs)	300	*	*	300	400
Deferral of tax on earnings of qualified State tuition plans	200	100	100	100	200
Exclusion of scholarship and fellowship income	900	1,100	1,200	1,300	1,400
Exclusion of employer-provided education assistance benefits	200	300	400	500	700
Exclusion of interest on educational savings bonds	*	*	*	*	*
Exclusion of interest on State and local government student loan bonds	200	200	300	200	300
Parental personal exemption for students age 19 to 23	800	700	800	1,000	1,500
<b>TOTAL</b>	<b>18,786</b>	<b>19,502.3</b>	<b>19,224.3</b>	<b>24,425.74</b>	<b>28,405.1</b>

 Direct Outlays  
 Tax Expenditures

\* less than \$50 million

Direct expenditure source: U.S. Department of Education. Education Department Budget History Table. <http://www.ed.gov/about/overview/budget/history/index.html?src=rt>.

Tax expenditure source: Joint Committee on Taxation. Estimates of Federal Tax Expenditures for Fiscal Years, 1999-2003, 2000-2004, 2001-2005, 2002-2006, 2003-2007. (Washington, DC: U.S. Government Printing Office, 1998, 1999, 2000, 2001, 2002), Table 1.

### *Who Benefits?*

Using the same data and microsimulation model that were used elsewhere in this analysis and described in Appendix 2, two of the most significant higher education tax expenditures were analyzed. These are the tax savings from the student loan deduction and the Hope and Lifetime Learning Credits. Together, these total \$5.3 billion in tax expenditures.

The result is a picture that is skewed toward those with higher incomes, though not as strikingly as the other asset-building policies included in this analysis.

The top 20% of earners received a slightly disproportionate share of the benefits – about one-quarter (25.8%). The greatest share of benefits (42%) go to upper-middle class Americans (the next quintile below the wealthiest group). That the top quintile enjoys fewer benefits than the next-to-top quintile is clearly driven by the fact that these particular programs are income-capped, so that the most wealthy are not eligible: the top 5% of earners receive no benefit, and the average dollar benefit actually lessens for the wealthiest Americans who are eligible – a pattern seen in none of the other categories in this study.

While the income caps reduce the skewing toward the wealthy, it does not prevent what happens at the other end of the spectrum: the poorest families still receive relatively little benefit. Only 1.7% of the benefits go to the poorest 20% of Americans, a group that receives a dollar benefit (\$3.27) significantly smaller than that of the most-rewarded group (the 80-90% decile, at \$92.19). Only 10.3% of the benefits go to the poorest 40% of Americans.

It appears, based on this limited analysis, that tax expenditures funding post-secondary education are more evenly distributed than other categories, though they are still notably skewed. In particular, they do very little to benefit the very poor – the bottom 40% of the population in particular – or the very rich, the top 10%.

## TAX SAVINGS FROM SELECTED EDUCATION TAX BREAKS

### Student Load Deduction

2006	Total # of Taxpayers (mil)	Millions of tax-payers who receive benefit	Billions of \$ of benefit for tax expenditures	% of income category that receives benefit	Average benefit to those who receive it	% of total to income	Benefit Category
Low 20%	27.5	0.2	\$ 0.0	0.7%	47	0	1.0%
2nd 20%	27.6	0.5	0.1	1.7%	105	2	6.0%
Mid 20%	27.5	1.2	0.2	4.5%	140	6	20.7%
4th 20%	27.6	1.7	0.4	6.2%	240	15	48.8%
Nxt 10%	13.8	0.6	0.2	4.6%	244	11	18.5%
Nxt 5%	7.0	0.2	0.0	3.1%	192	6	4.9%
Nxt 4%	5.6	—	—	—	—	—	—
Top 1%	1.4	—	—	—	—	—	—
ALL	139.7	4.5	\$ 0.8	3.2%	188	6	100.0%

### Hope & Lifetime Learning Education Credits

2006	Total # of Taxpayers (mil)	Millions of tax-payers who receive benefit	Billions of \$ of benefit for tax expenditures	% of income category that receives benefit	Average benefit to those who receive it	% of total to income	Benefit Category
Low 20%		0.2	\$ 0.1	0.7%	415	3	1.8%
2nd 20%		0.5	0.4	1.9%	765	15	9.1%
Mid 20%		1.2	1.0	4.3%	840	36	22.1%
4th 20%		1.9	1.8	6.8%	968	66	40.7%
Nxt 10%		1.3	1.1	9.7%	833	81	25.2%
Nxt 5%		0.1	0.0	1.0%	717	7	1.1%
Nxt 4%		—	—	—	—	—	—
Top 1%		—	—	—	—	—	—
ALL		5.2	\$ 4.5	3.7%	859	32	100.0%

### Education credits & Student Load Deduction

2006	Total # of Taxpayers (mil)	Millions of tax-payers who receive benefit	Billions of \$ of benefit for tax expenditures	% of income category that receives benefit	Average benefit to those who receive it	% of total to income	Benefit Category
Low 20%		0.4	\$ 0.1	1.4%	242	3	1.7%
2nd 20%		1.0	0.5	3.5%	472	16	8.6%
Mid 20%		2.3	1.2	8.2%	513	42	21.9%
4th 20%		3.1	2.2	11.2%	721	81	42.0%
Nxt 10%		1.7	1.3	12.6%	730	92	24.1%
Nxt 5%		0.3	0.1	3.9%	333	13	1.7%
Nxt 4%		—	—	—	—	—	—
Top 1%		—	—	—	—	—	—
ALL		8.7	\$ 5.3	6.2%	609	38	100.0%

Source: Institute on Taxation and Economic Policy Microsimulation Model

These results are consistent with what is already known about post-secondary education. Likelihood of enrolling in a degree program is positively correlated with income.<sup>52</sup> For those who do enroll, cost is clearly an issue. Because of the cost of higher education, relatively poor families must find resources, in part through direct outlays such as Pell Grants.

While the income caps exclude the wealthiest Americans from enjoying the benefits of these tax expenditures, the structure of the policies themselves also precludes most low-income families from enjoying them as well. Because none of the tax expenditures are structured as refundable credits, only those families with sufficient income (sufficient tax liability) may take advantage of them. Unless the tax expenditures can offset preexisting tax liability, they are useless to a family. As with other tax expenditures, their very structure makes them more useful the higher a taxpayer's income.

Recent research into these tax expenditures and direct outlays shows differing patterns of benefits. While 90% of recipients of Pell Grants and Stafford Loans grew up in families with less than \$40,000 in income, tax expenditures such as Hope Scholarships, 529 programs, and Coverdell programs provide more benefit the higher a family's income.<sup>53</sup>

Although spending on asset-building through post-secondary education is a fraction of the other policies, a case can be made for the inclusion of this spending. Based on the data available, it appears that the direct outlays are fairly progressive in nature, most benefiting those with modest incomes. Tax expenditures, on the other hand, most benefit the upper-middle class. Through their structure, they exclude the very wealthiest Americans, but also provide minimal benefit to the bottom 40% of Americans.

The distribution of benefits in education is closely tied to which mechanisms – direct outlays or tax expenditures – are used most broadly.

## APPENDIX 4: DETAILED RESULTS OF MICROSIMULATION

### TAX SAVINGS FROM LOW RATES ON CAPITAL GAINS & DIVIDENDS

2006	Total # of Taxpayers (mil)	Millions of tax-payers who receive benefit	Billions of \$ of benefit for tax expenditures	% of income category that receives benefit	Average benefit to those who receive it	% of total to income	Benefit Category
Low 20%	27.5	0.6	\$ 0.0	2.2%	\$ 71	\$ 2	0.1%
2nd 20%	27.6	2.0	0.3	7.2%	137	10	0.4%
Mid 20%	27.5	3.8	0.8	13.8%	203	28	1.2%
4th 20%	27.6	7.9	3.2	28.7%	399	114	5.0%
Nxt 10%	13.8	6.1	3.6	44.0%	586	258	5.6%
Nxt 5%	7.0	4.1	3.3	59.0%	810	478	5.2%
Nxt 4%	5.6	4.3	8.7	75.7%	2,043	1,547	13.7%
Top 1%	1.4	1.3	43.8	91.1%	34,263	31,219	68.8%
ALL	139.7	30.1	\$ 63.6	21.5%	\$ 2,117	\$ 455	100.0%

### TAX SAVINGS FROM SPECIAL LOWER RATES ON CAPITAL GAINS AND DIVIDENDS, AND DEDUCTIONS FOR MORTGAGE INTEREST AND PROPERTY TAXES

2006	Total # of Taxpayers (mil)	Millions of tax-payers who receive benefit	Billions of \$ of benefit for tax expenditures	% of income category that receives benefit	Average benefit to those who receive it	% of total to income	Benefit Category
Low 20%	27.5	0.8	\$ 0.1	2.9%	\$ 145	\$ 4	0.1%
2nd 20%	27.6	2.9	0.9	10.4%	328	34	0.6%
Mid 20%	27.5	7.2	4.8	26.1%	666	173	3.0%
4th 20%	27.6	15.6	19.5	56.4%	1,252	706	12.3%
Nxt 10%	13.8	11.4	27.1	82.6%	2,371	1,960	17.1%
Nxt 5%	7.0	6.5	21.4	92.3%	3,315	3,061	13.5%
Nxt 4%	5.6	5.4	31.1	95.5%	5,791	5,529	19.7%
Top 1%	1.4	1.4	53.4	97.7%	38,990	38,107	33.7%
ALL	139.7	51.1	\$ 158.4	36.6%	\$ 3,101	\$ 1,134	100.0%

Source: Institute on Taxation and Economic Policy Microsimulation Model



## TAX SAVINGS FROM HOMEOWNER DEDUCTIONS

Mortgage Interest Deduction							
2006	Total # of Taxpayers (mil)	Millions of tax-payers who receive benefit	Billions of \$ of benefit for tax expenditures	% of income category that receives benefit	Average benefit to those who receive it	% of total to income	Benefit Category
Low 20%	27.5	0.2	\$ 0.1	0.6%	\$ 291	\$ 2	0.1%
2nd 20%	27.6	1.0	0.6	3.6%	564	20	0.6%
Mid 20%	27.5	4.0	3.5	14.5%	882	128	4.0%
4th 20%	27.6	10.4	14.3	37.5%	1,383	519	16.2%
Nxt 10%	13.8	8.8	21.3	63.7%	2,413	1,536	24.1%
Nxt 5%	7.0	5.2	16.7	74.1%	3,231	2,395	19.0%
Nxt 4%	5.6	4.3	23.2	75.6%	5,444	4,115	26.2%
Top 1%	1.4	1.0	8.7	68.0%	9,074	6,172	9.8%
ALL	139.7	34.7	\$ 88.3	24.8%	\$ 2,543	\$ 632	100.0%
Home Property Tax Deduction							
2006	Total # of Taxpayers (mil)	Millions of tax-payers who receive benefit	Billions of \$ of benefit for tax expenditures	% of income category that receives benefit	Average benefit to those who receive it	% of total to income	Benefit Category
Low 20%		0.1	\$ 0.0	0.5%	\$ 172	\$ 1	0.2%
2nd 20%		0.9	0.2	3.2%	208	7	1.3%
Mid 20%		3.8	1.0	13.9%	257	36	6.9%
4th 20%		10.2	3.9	37.0%	385	143	27.6%
Nxt 10%		7.5	4.0	53.9%	535	288	27.9%
Nxt 5%		3.2	2.1	46.0%	669	308	15.0%
Nxt 4%		1.2	1.0	21.2%	861	182	7.2%
Top 1%		0.6	2.0	40.7%	3,514	1,432	14.0%
ALL		27.5	\$ 14.3	19.7%	\$ 520	\$ 102	100.0%
Mortgage Interest & Property Tax Deduction							
2006	Total # of Taxpayers (mil)	Millions of tax-payers who receive benefit	Billions of \$ of benefit for tax expenditures	% of income category that receives benefit	Average benefit to those who receive it	% of total to income	Benefit Category
Low 20%		0.2	\$ 0.1	0.9%	\$ 297	\$ 3	0.1%
2nd 20%		1.1	0.7	4.1%	577	24	0.7%
Mid 20%		4.4	4.0	15.9%	908	144	4.1%
4th 20%		11.2	16.3	40.5%	1,458	590	16.7%
Nxt 10%		9.4	23.6	68.1%	2,505	1,706	24.2%
Nxt 5%		5.5	18.3	79.2%	3,309	2,622	18.8%
Nxt 4%		4.5	24.0	79.4%	5,358	4,256	24.6%
Top 1%		1.1	10.7	76.8%	9,903	7,609	10.9%
ALL		37.4	\$ 97.6	26.8%	\$ 2,606	\$ 698	100.0%

Source: Institute on Taxation and Economic Policy Microsimulation Model

## GLOSSARY

Definitions in this Glossary are adapted from *The Guide to the Federal Budget: Fiscal 2000; Tax Expenditures: Compendium of Background Material on Individual Provisions; The Encyclopedia of Taxation and Tax Policy; Assets for the Poor; and The MIT Dictionary of Modern Economics, Fourth Edition.*

**Appropriation:** An act of Congress that provides the legal authority for federal agencies to incur obligations and make payments from the Treasury for specified purposes. An appropriation is the most common means of providing budget authority and usually follows the passage of an authorization.

**Asset:** A marketable good. For most American households, principal sources of assets include owned homes and real estate, cash and savings, stocks and bonds, retirement and life insurance plans, and any business ownership.

**Authorization:** An act of Congress that establishes or continues the operation of a federal program or agency either for a specified period of time or indefinitely; specifies its general goals and conduct; and often sets a ceiling on the amount of budget authority that can be provided in an appropriation. An authorization for an agency or program usually is required before an appropriation for that same agency or program can be passed.

**Budget authority:** The permission granted to a federal agency to enter into commitments that result in immediate or future outlays. Budget authority is not necessarily the amount of money an agency or department actually will spend during a fiscal year but merely the upper limit on the amount of new spending commitments it can make. The four basic types of budget authority are appropriations, borrowing authority, contract authority, and the authority to obligate and expend the proceeds of offsetting receipts and collections.

**Expenditures:** Actual spending, generally interchangeable with outlays.

**Functional budget:** sum of all direct program expenditures and tax incentives that serve the same purpose, e.g. asset-building, economic development.

**Outlay:** Often used interchangeably with spending, dollars spent or expected to be spent on a particular activity.

**Private saving:** That portion of income that is not consumed or taxed that can be used to insulate a household from loss of work or health or circumstances of fate.

**Progressive tax:** A tax rate whose percentage increases as income rises.

**Public good:** A commodity or service which, if supplied to one person, is available to others at no cost; examples: police protection, national defense.

**Public saving:** A sum of budget surpluses (deficits) for federal, state, and local governments

**Regressive tax:** A tax rate whose percentage falls as income rises.

**Tax expenditure:** Revenue loss resulting from tax provisions that grant special tax relief designed to encourage certain kinds of behavior by taxpayers or to aid taxpayers in special circumstances. These provisions may, in effect, be viewed as spending programs channeled through the tax system.

Types of tax expenditures:

Carryovers: Certain losses or credits that can be used in a future tax year rather than the tax year in which they are incurred.

Credits: Subtractions from taxes as ordinarily computed; do not depend on the taxpayer's marginal tax rate; can be refundable (earned income tax credit is currently the only refundable tax credit) meaning the taxpayer receives a check if the credit exceeds the taxes owed.

Deferrals: Delayed recognition of income or allowing in the current year deductions that are properly attributable to a future year.

Exclusions, Exemptions, and deductions: Reduce taxable income.

Reduced or preferential rates: Lower rates that apply to part or all of a taxpayer's income.

**Tax incidence:** The distribution of the burden of a tax; it refers to those who suffer a reduction in their real income from the imposition of a tax.

## END NOTES

1. Historical Tables of the proposed FY2005 U.S. Budget, available at <http://www.whitehouse.gov/omb/budget/fy2005/pdf/hist.pdf>, pp. 58 and 64.
2. Federal asset-building policy dates back at least as far as the Homestead Act of 1862.
3. For the purpose of this report, assets are defined in a traditional, strictly financial sense – those that can be quickly converted into financial assets and that typically appreciate in value.
4. For an excellent compilation of research and thinking on the importance of assets for low-income families, see *Assets for the Poor: The Benefits of Spreading Asset Ownership*, Thomas M. Shapiro and Edward N. Wolff, editors, (New York, NY: Russell Sage Foundation, 2001). A thorough review of the research findings on asset-building initiatives is in *Building Assets: A Report on the Asset Development and IDA Field*. Ray Boshara, editor. (Washington, D.C.: Corporation for Enterprise Development, December 2001).
5. Oliver and Shapiro 1997.
6. 25% compared to 12.7%. Haveman and Wolff 2001.
7. This report compiles data from various parts of the federal budget to create the "functional federal assets budget." Constructing such budgetary reports is an increasingly common policy endeavor. A variety of such tools have been created on the state level to look at, for instance, policy commitments to children. They can provide a view across agencies and programs and then be used to identify trends and priorities and to develop greater transparency. Moreover, when combined with performance-based measures, such as the Government Performance and Results Act (GPRA), a functional budget can start focusing on the outcomes and outputs that policymakers want to "buy" with each sum they appropriate, thereby tracking progress, cutting weak programs, and redirecting monies for higher returns.
8. Collender 1999.
9. Any tax expenditure calculation relies on certain assumptions, which may differ. Treasury's and the Joint Committee's numbers frequently conflict, sometimes producing estimates that differ by tens of billions of dollars. For consistency's sake, this analysis uses only the Joint Committee's assumptions.
10. Slemrod and Bakija, 2000. See also Lav 2003, Ettlinger 2002, and McIntyre 1996 for further discourse on the cost and benefits of such bonds.
11. U.S. Department of Housing and Urban Development, n.d.
12. Fiscal Year 2003 data are used throughout this analysis. The last figures available for the FHLB AHP system, however, were for FY 2002 at the date of this writing. Because these numbers do not typically change dramatically from year to year, 2002 numbers are cited here as a proxy for actual 2003 outlays.
13. Provisions of other federal programs or agencies, such as Temporary Assistance to Needy Families, HOME funds, Federal Home Loan Banks, and the Treasury Department's Bank Enterprise Award program allow funds to be used for IDAs, but the usage and amounts are still quite small.

14. Research and Policy Committee of the Committee for Economic Development, 1995.
15. Russell, n.d.
16. Terry, n.d.
17. Copeland, 2003.
18. Joint Committee on Taxation, 2002.
19. The full contribution is deductible if the taxpayer is single and has a modified adjusted gross income (MAGI) less than \$33,000. If the taxpayer's MAGI is between \$33,000 and \$43,000, the contribution is partially deductible. If the taxpayer's MAGI exceeds \$43,000, the contribution is not deductible at all. For married couples filing joint returns, the income limits are: \$53,000 for full deductibility, between \$53,000 and \$63,000 for partial deductibility, and over \$63,000 for no deductibility at all.
20. Devine and Copeland, 2001.
21. One interesting point is that retirement tax expenditures may be different from other tax expenditures because they can contribute to national savings, which in turn may increase future capacity and economic growth, although this is matter of some debate among pension researchers (see Research and Policy Committee of the Committee for Economic Development 1995). The most widely-held belief is that national savings is unaffected by retirement savings by high income households, because they tend to use retirement accounts as substitutes for other savings vehicles with no additional monies being saved. Further, savings by these households can "crowd out" public savings; larger IRA limits reduce tax revenues which increase the deficit which lowers public saving. Retirement savings by low or moderate income households, on the other hand, are generally believed to increase national savings.
22. The Taxpayer Relief Act of 1997 and the IRS Restructuring and Reform Act of 1998 lowered the capital gains tax rates, redefined the period defined as "long term," and virtually eliminated tax on sales of primary residences, as discussed above.
23. Even with the tax-minimizing strategy of offsetting capital gains with capital losses, economic research has shown that far less avoidance of capital gains taxes occurs than would be predicted (Auerbach, Burman, and Siegal, 2000). "[L]osses do not offset more than a fraction of gains, even for very high-income taxpayers" (Gravelle, 2000).
24. SBA, n.d.
25. USDA, n.d.
26. *Bad Breaks All Around*, 2002, pp. 117-120.
27. Collins 2003.

28. The more education completed by the head of household, the higher the family income. In 1999, a high school dropout earned, on average in the US, \$19,000 while a high school graduate had average earnings of \$26,200. An associate's degree increased that average to \$33,400, and a bachelor's degree raised average income again (to \$42,200). [Diane Stark Rentner and Nancy Kober. *higher learning=higher earnings: what you need to know about college and careers*. (Washington, DC: Center on Education Policy and American Youth Policy Forum), [www.aypf.org/publicatons/HigherLearning.pdf](http://www.aypf.org/publicatons/HigherLearning.pdf), accessed 11/14/03]
29. Of the most wealthy 1% of Americans, 26.8% have second homes, while only 3.6% of the bottom 60% have second homes (Wolff, 1998).
30. See Ettlinger 2002, McIntyre 1996.
31. 69.7% of those with incomes of \$50,000 or more participate (Copeland, 2003). Using the March 2003 Current Population Survey, Copeland states that just 12.2% of workers who earn \$5,000-\$9,999 a year participate in their employer-based pension plan (Copeland, 2003). (This is slightly higher than the 11% participation of individuals with incomes under \$10,000 that the Federal Reserve Board's 1998 Survey of Consumer Finances reported (Entrust Administration, n.d.).) The percentage falls to a mere 5.7% when income is less than \$5,000 annually.
34. Copeland 2003, General Accounting Office 2000.
35. Devine and Copeland 2001.
36. \$62,500 compared to \$42,000. (Roth 2000 and U.S. Census, 2000a).
37. \$64,000. Roth, 2000.
38. The overall picture of the progressive dimensions of social security benefits is a bit complex: "Lower-wage workers get a higher percentage of their wages replaced when they retire than higher-wage workers." (Bergmann, 2000, p.16.) Despite the increased percentage (the maximum rate is 53% for those whose earnings are half of the average), low-income workers still receive smaller checks. For example, a worker whose wage earnings are \$20,000 will get 53%, or \$10,600, replaced by Social Security when he retires. In contrast, a worker whose salary earnings are \$100,000 will get 28%, or \$28,000, replaced by Social Security.
39. A repeal of the estate tax altogether, a subject of sporadic debate in Washington, would benefit the heirs of only the wealthiest 0.5% of estates. (Estate Tax Myths and Facts, n.d.)
40. Wolff 2001.
41. For more on this subject, see also Wolff 2004, Bowles and Gintis 1998.
42. Tax incidence refers to the distribution of the burden of a tax; it refers to those who suffer a reduction in their real income from the imposition of a tax.
43. Institute for Taxation and Economic Policy, 2003
44. The effect of combined expenditures is not the sum of the individual expenditures because of interactions between them and taxpayer behavior.

45. Smith 1776, p. 313.
46. Blinder1987, p. 25.
47. Ettlinger 2002.
48. Ettlinger 2002.
49. Howard 1997.
50. Toder, 2000.
51. Toder, furthermore, states that "tax expenditures need not provide a larger per-unit subsidy to high-income than to low-income taxpayers. They can provide the same subsidy rate to all qualifying taxpayers if they are designed as credits against tax liability instead of reductions in taxable income and if they are refundable." (Toder, 2000)  
According to Laurence Seidman, "refundable means that if the amount of the credit exceeds the household's tax liability, the excess is payable to the household as a direct transfer payment." (Seidman, 2001).
52. Toder, 2000.
53. These income limits are for 2003. They were originally \$40,000 and \$50,000. They rise again in 2004.
54. Rentner and Kober, 2003.
55. Dynarski 2000; Dynarski 2003.

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