

Subsidies for Assets: A New Look at the Federal Budget

Lillian Woo and David Buchholz¹

Most people understand the importance of building a nest egg. Setting resources aside and moving beyond a financial system of paycheck-to-paycheck is important for the financial health of any household. Household nest eggs—financial assets—can take many forms, such as retirement accounts and home equity. Regardless of the form they take, these assets are what allow families to plan for the future, get through unexpected events such as layoff or illness, send kids to college, and look forward to retirement.

People understand this, although recent evidence about how much households are actually saving is troubling: The nation as a whole has begun exhibiting a negative personal savings rate on a regular basis.² Nearly one in five American households owes more than it owns.³ And levels of consumer debt and loan delinquencies are on the rise.⁴

Given how important assets can be, and given the apparent challenge many families seem to have in setting money aside for a rainy day, it is perhaps not surprising that policymakers have crafted incentives over the years to make it easier. The provision of public incentives to promote individual asset-building has a long history in the U.S., going back to at least the 19th century. Today, a substantial collection of federal policies promote asset accumulation among households. Until recently, however, they have not been analyzed as a cohesive whole.

These policies do not make up a comprehensive, intentional asset-building policy. Rather, they represent a patchwork of policies that collectively provide financial incentives for asset-building behavior by individuals and families. As public policy, they represent a set of societal decisions that some activities should be encouraged and are therefore worthy of public subsidy, thus rewarding households who buy homes, save for retirement, start small businesses, and pursue certain types of savings and investment strategies. Some of these policies are direct outlays in the federal budget, but the lion's share of them are structured as tax expenditures, which can be relatively efficient but which also receive relatively little scrutiny.

¹ The authors would like to thank James Nguyen, Carol Wayman, Genevieve Melford, and Bob McIntyre for their invaluable assistance.

² See Lansing, K. (November 2005) "Spendthrift Nation," *FRBSF Economic Letter*. (San Francisco, CA: Federal Reserve Bank of San Francisco).

³ Woo, L., Thomas, J., Buchholz, D., and J. Uher. (2005) *Assets and Opportunity Scorecard: Financial Security Across the States*. (Washington, DC: CFED).

⁴ Fellowes, M. (2006) *Credit Scores, Reports, and Getting Ahead in America*. (Washington DC: The Brookings Institution).

In 2004, in the first comprehensive study of its kind, CFED analyzed spending and tax policy to determine how much these American asset-building initiatives cost, where the money went and who benefited.⁵

These policies, as it turned out, were not cheap. Using conservative measures, the report found \$335 billion in such incentives for the year studied, a number that had steadily increased over the preceding five-year period. Because tax expenditures outweighed direct outlays (\$642 to \$1), and because of the way many policies were structured, the distribution of benefits highly favored upper-income citizens over middle- and lower-income people. Over one-third of the benefits went to the wealthiest 1% of Americans, while less than 5% of the benefits went to the lowest 60% of the country.

This study was the first to put a clear price tag on such policies and analyze patterns of the beneficiaries. At a time of a ballooning budget deficit and shrinking available resources, understanding the costs and benefits of such policies is, we believe, critical to make informed decisions. This study updates the 2004 study with newly available data.⁶

The Price Tag

For Fiscal Year 2005, we analyzed, following the earlier study, four main categories of assets:

- Homeownership
- Retirement accounts
- Savings and investment
- Small business development

Within these categories, we counted both direct outlays and tax expenditures that met *all* of the three strict criteria:

1. They were related to specific, explicit federal policies that reward asset building. Policies aimed at asset protection were not included.
2. They were directed at individuals or households. Policies that promote asset building among corporations, for instance, were not included.
3. They were available to most of the general public, but also are the result of some personal action, rather than benefiting broad segments of the population more or less equally. Policies aimed at unique subgroups, such as veterans, that have access to exclusive programs were not included.

⁵ Woo, L., Schweke, W., and D. Buchholz. (2004) *Hidden in Plain Sight: A Look at the \$335 Billion Federal Asset-Building Budget*. (Washington, DC: CFED).

⁶ Unless otherwise noted, this study follows the same data and methodology as *Hidden in Plain Sight*, technical discussions of which are included in the full report, available for download at www.cfed.org.

Using these definitions, in Fiscal Year 2005, the federal government allocated \$362 billion to asset building. In real terms, this represents a 1.9% increase after adjusting for inflation.⁷

This price tag reflects a significant societal investment in household-level asset-building activities, although it does not represent a cohesive, intentional national strategy but rather the cumulative effect of many discrete policies and programs. Further, a handful of activities account for the vast bulk of this cost. And, by a ratio of over 500 to 1, the bulk of this total comes through tax expenditures rather than direct outlay, which receive much lower scrutiny and are easier to continue year after year.

The cost of these programs can be broken down into the four principal categories mentioned above.

1. Homeownership

The family home is the single largest asset for most American households. Numerous federal policies, from the Homestead Act to the American Dream Downpayment Initiative, have made this part of the American dream attainable for more families than ever before. Today, homeownership in the U.S. is at an all-time high.⁸

Policies that subsidize homeownership have rested on a widespread belief in the personal and societal benefits of homeownership and have, by and large, enjoyed bipartisan support. Some such programs provide direct assistance in the form of loans, loan guarantees, grants, construction costs and flexible mortgage financing.⁹ These policies, in the millions of dollars, are dwarfed by the billions of dollars directed at homeownership through tax expenditures.

The mortgage interest deduction is one of the largest single tax expenditures in the tax code. It was designed to lower the cost of borrowing money to buy a home. Totaling \$72.6 billion, it is the biggest federal subsidy for homeowners. The cost of owning a home is further subsidized through the property tax deduction and the exclusion of capital gains taxes upon the sale of a primary residence.

⁷ The FY2003 figure of \$334.7 billion would have a value of \$355.25 billion in FY 2005 dollars.

⁸ Currently hovering just below 70%. [U.S. Census Bureau Press Release, April 28, 2006; accessed 7/21/06 at <http://www.census.gov/hhes/www/housing/hvs/qtr106/q106prss.pdf>.]

⁹ In the interest of airing on the conservative side, this study consistently excludes programs that are principally education or technical assistance. In this case, for instance, funds for home buying counseling services and other technical assistance to family are not included. Additionally, the HUD Family Self-Sufficiency (FSS) Program was omitted from this study due to the lack of budgetary data available.

Homeownership

In Billions of Dollars	FY1999	FY2000	FY2001	FY2002	FY2003	FY2004	FY2005
Direct Outlays							
Self-help Homeownership Opportunity Program (SHOP)	0.02	0.02	0.02	0.02	0.03	0.03	0.03
Home Investment Partnership Program (HOME)					0.07	0.09	0.05
Community Development Block Grants (less SHOP)			0.02	0.02	0.02	0.02	0.02
USDA Section 502	0.12	0.11	0.18	0.17	0.24	0.24	0.17
Affordable Housing Program	0.06	0.07	0.09	0.09	0.09	0.23	0.25
AFIA					0.03	0.03	0.03
American Dream Downpayment Initiative					0.07	0.09	0.05
Section 504 Loans					0.02	0.01	0.01
Section 504 Grants					0.03	0.03	0.03
Rural Housing and Economic Development (RHED)							0.01
Tax Expenditures							
Exclusion of interest on state and local bonds for owner-occupied housing	1.40	0.60	0.80	0.70	0.70	0.80	0.90
Deduction for mortgage interest	48.50	55.20	62.70	66.50	69.90	61.40	72.60
Deduction for property taxes	17.80	18.90	21.00	21.40	22.10	18.70	19.60
Exclusion of capital gains on sales of principal residences	5.80	12.90	13.30	13.80	17.80	17.90	22.90
TOTAL	73.70	87.80	98.11	102.71	111.09	99.55	116.63

Clearly, the benefits provided to U.S. taxpayers qualifying for these programs and policies are significant. However, these policies are not, as they are sometimes framed, principally helping first-time homebuyers and those who need a hand up to become homeowners. The bulk of the benefits of the mortgage interest deduction and the property tax deduction are captured by those who earn the most. The bottom half of earners receive 2.9% of the tax benefits while the richest 10% receives 59.4%.¹⁰ According to the President's Advisory Panel on Federal Tax Reform, well over half (55%) of the value of the mortgage interest deduction is enjoyed by taxpayers

¹⁰ All data reflecting the distribution of benefits, except where noted otherwise, are generated by a microsimulation model developed and performed by the Institute on Taxation and Economic Policy. A full explanation of the model is described in detail in *Hidden in Plain Sight*.

whose incomes exceed \$100,000, and the vast bulk¹¹ of tax filers received no benefit from this deduction whatsoever. Similarly, for the \$19.6 billion property tax subsidy, the bottom half of taxpaying households receive just half a billion dollars (\$534 million).

2. Savings and Investment

Savings and investment—the most liquid of households’ nest eggs—are a critical part of the financial security picture. Indeed, the vivid images following Hurricanes Katrina and Rita in 2005 put a very human face on what can happen when families lack the immediate financial safety cushion to do something as simple as get out of harm’s way, much less rebuild lost homes and businesses.

To promote savings, certain types of saving and investment behavior are particularly encouraged through the tax code. Preferential rates¹¹ on long-term capital gains and the exclusion of capital gains at death encourage some forms of saving, and the transfer of savings, over others. These, along with the reduced tax rates on dividend income, have the greatest benefit for those families with disposable income beyond basic living expenses.

Savings and Investment

In Billions of Dollars	FY1999	FY2000	FY2001	FY2002	FY2003	FY2004	FY2005
Direct Outlays (through Individual Development Accounts)							
Assets for Independence Act	0.01	0.01	0.03	0.03	0.03	0.03	0.03
Office of Refugee Resettlement (ORR)		0.01	0.01	0.01	0.02	0.02	0.01
Tax Expenditures							
Exclusion of investment income on life insurance and annuity contracts	22.60	22.90	23.00	23.60	24.00	24.70	25.00
Reduced rates of tax on long-term capital gains	35.10	36.00	38.70	65.10	55.30	66.10	57.80
Exclusion of capital gains at death	19.20	23.70	26.00	37.30	38.10	35.90	38.00
Carryover basis of capital gains on gifts	1.90	2.30	2.60	4.20	4.50	4.30	4.60
TOTAL	78.81	84.92	90.34	130.24	121.94	131.04	125.43

These tax expenditures account for the bulk of the federal subsidy in this category. At a much smaller level, there are modest federal incentives that intentionally target lower-income

¹¹ Over 70% in 2002. The President’s Advisory Panel on Federal Tax Reform. (2005). “Simple, Fair, and Pro-Growth.” P. 72.

Americans through Individual Development Accounts (IDAs),¹² matched savings accounts. Again, these efforts are dwarfed by the tax expenditures.

The bulk of the subsidies in this category, again, accrue to those at the highest income level. Of the special exclusion from capital gains and dividends, 95% of the benefits go to the top 10% of earners—those with incomes of at least \$133,000. Those households with incomes exceeding \$1 million receive, on average, an annual tax benefit of \$155,000, a figure more than the total income for 70% of Americans. In contrast, the poorest 30% of households (those with incomes less than \$20,000) receive \$5 or less in average of these incentives. Collectively, the bottom half of Americans receive 0.2% of the benefits of the capital gains and dividend tax incentives.

3. Retirement Accounts

Federal policymakers have long provided incentives to individuals saving for retirement, and this form of subsidy has increased as more and more employers shift from traditional defined-benefit plans to defined-contribution plans. Among workers in the U.S., roughly 40% participate in employer-sponsored retirement plans spurred on, in part, by the tax advantages of doing so.¹³

When businesses do not or can not offer retirement accounts, workers use Individual Retirement Accounts (IRAs), also accorded incentives through tax expenditures. IRAs have no employer contributions and lower annual contribution ceilings than employer-sponsored accounts. They represent the largest component of the U.S. retirement market. Again, the IRAs are more likely to be held by those with higher income, wealth, and education.¹⁴

In general, participation in an employer-sponsored retirement plan increases with income, as well as other socioeconomic factors, meaning that higher-income Americans, in general, are more able to enjoy the benefits from these policies than those with lower incomes.¹⁵ Almost three-quarters of workers who earn \$50,000 or more (73.2%) enroll in their employer-sponsored plan, while less than one in ten workers (9.6%) who earn less than \$5,000 participate in their employer-sponsored plans.¹⁶

¹² IDAs are offered to low-income savers who pledge to meet a monthly savings goal. Matching deposits are provided from a variety of sources, including the federal government. This is the only targeted program that provides incentives for savings aimed principally at lower-income citizens.

¹³ Copeland, C. (2005, October). *Employment-Based retirement Plan Participation: Geographic Differences and Trends*, 2004. EBRI Issue Brief No. 286. (Washington, DC: Employee Benefit Research Institute), p.1. Accessed 7/28/06 from http://www.ebri.org/pdf/briefspdf/EBRI_IB_10-20051.pdf.

¹⁴ Holden, S., K. Ireland, V. Leonard-Chambers, and M. Bogdan. (2005, February). *The Individual Retirement Account at Age 30: A Retrospective. Investment Company Institute Perspective, Vol. 11, No.1.*, p.1. (Washington, DC: ICI). Accessed 7/28/06 at <http://www.ici.org/pdf/per11-01.pdf>.

¹⁵ Individuals who are nonwhite, younger, female, never married, less well educated, of poorer health status, and not working full time, among other things, were all less likely to participate in a retirement plan. Copeland, p. 9.

¹⁶ Copeland, p.9.

Retirement Assets: Net exclusion of pension contributions and earnings

In Billions of Dollars	Tax Expenditures						
	FY1999	FY2000	FY2001	FY2002	FY2003	FY2004	FY2005
Employer plans	76.1	76	85	87.9	83.5	94.6	102.8
Individual retirement plans	11.4	12.2	13.3	14	10.4	13	11.6
Keogh plans	4.8	5	5.5	5.6	5.7	6.2	8.3
Tax credit for certain individuals for elective deferrals and IRA contributions				1.3	1.6	2.5	1.7
TOTAL	92.3	93.2	103.8	108.8	101.2	116.3	124.4

4. Small Business Development

Although business development is less common an activity than the other asset-building activities subsidized at the federal level, it can be a critical element to financial security for many families. In fact, business equity was second only to homeownership as a share of total household wealth (17%) in 2001.¹⁷

As a result, small business creation has often been a route into America's middle class. Today, over 93% of businesses are small businesses, according to the Small Business Administration.

Relative to other subsidies for asset-building, however, there are relatively few federal policies that explicitly offer financial benefits to small business owners.¹⁸

¹⁷ "Changes in Household Wealth in the 1980s and 1990s in the U.S.," Edward N. Wolff, Editor, *International Perspectives on Household Wealth*, Elgar Publishing Ltd., forthcoming.

¹⁸ Includes only Sole Proprietorships and Partnerships. See *Hidden in Plain Sight* for further details on this distinction.

Small Business Development

In Billions of Dollars	FY1999	FY2000	FY2001	FY2002	FY2003	FY2004	FY2005
Direct Outlays							
SBA's MicroLoan Program			0.003	0.002	0.004	0.002	0.001
SBA's 7(a) Program	0.024	0.024	0.026	0.017	0.019	0.016	0.000
USDA's Business and Industry Guaranteed Loan Program	0.003	0.006	0.002	0.007	0.008	0.008	0.005
Job Opportunities for Low-Income Individuals (JOLI)		0.006	0.006	0.006	0.006	0.006	0.005
Urban/Rural Comm. Economic Development Program	0.030	0.022	0.025	0.027	0.027	0.027	0.027
Rural Economic Development Grants (REDG)			0.003	0.003	0.004	0.011	0.008
Intermediary Loan Program (IRP)			0.017	0.014	0.018	0.010	0.008
Tax Expenditures							
Amortization of business startup costs	0.300	0.300	0.400	0.300	0.600	0.600	0.600
TOTAL	0.057	0.057	0.075	0.097	0.103	0.068	0.048

Who Benefits?

Federal asset policies and programs that provide subsidies for individual asset-building behavior amount to big bucks. This has been eminently clear since, at least, the first comprehensive study of these policies in 2004. A current price tag of \$362 billion is, by any standard, a significant sum of money.

One of the most important measures of such a collection of policies, of course, is who benefits from them. An examination of the lion's share of these policies reveals that, all summed, the benefits of these are highly skewed. Examining the data available for the three largest asset-building policies—the mortgage interest deduction, property tax deduction, and preferential rates on capital gains and dividends—reveals a widely tilted pattern.

Of these policies reported in Fiscal Year 2005, over 45% of the benefits went to households whose average income exceeded \$1 million. Representing 1% of the population, this group got the lion's share of the federal asset subsidies. The top fifth (those with incomes greater than \$80,000) received the vast bulk (88.7%) of the asset-building benefits. In contrast, the rest of the population shared 10.5% of the tax benefits, and the lowest 60% of households got a bit less than 3% of the benefits.

Since the 2004 study, the disparity in asset subsidies has grown; those with assets are getting a larger share, and those with few or no assets are getting a smaller share. Put another way, the poorest fifth get, on average, \$3 in benefits from these policies, while the wealthiest 1% enjoy, on average, \$57,673. Households with incomes of \$1 million or more receive an average benefit of \$169,150. The benefits to upper-income households also far outstrip their share of federal tax liability.¹⁹

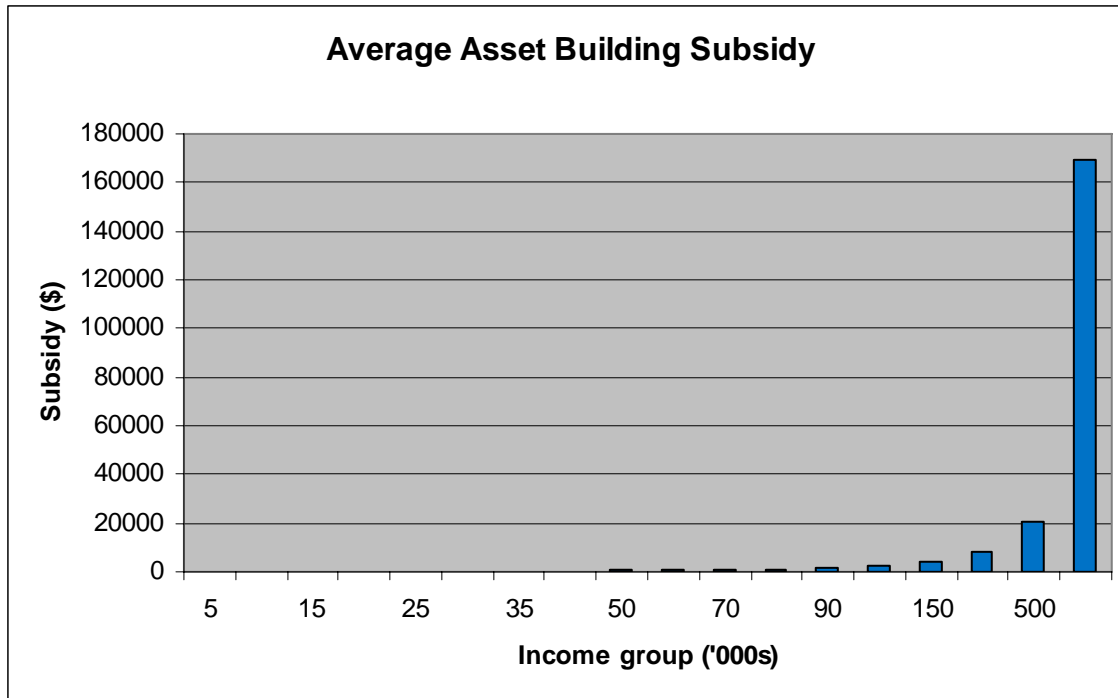
Tax benefit, in dollars, from the mortgage interest deduction, property tax deduction, and preferential rates on capital gains and dividends to households of different income levels.

Income	Tax Benefit
\$1–5,000	\$0
\$5,000–10,000	\$0
\$10,000–15,000	\$3
\$15,000–20,000	\$10
\$20,000–25,000	\$20
\$25,000–30,000	\$45
\$30,000–35,000	\$74
\$35,000–40,000	\$122
\$40,000–50,000	\$264
\$50,000–60,000	\$418
\$60,000–70,000	\$606
\$70,000–80,000	\$836
\$80,000–90,000	\$1,124
\$90,000–100,000	\$1,496
\$100,000–150,000	\$2,604
\$150,000–200,000	\$4,383
\$200,000–500,000	\$7,860
\$500,000–1,000,000	\$20,512
\$1,000,000 or more	\$169,150

Source: ITEP Tax Model, June 2006.

Although the sum total has increased since the last study, not all have felt the effects: For all but the richest 5%, average benefits from tax-based federal asset policies *decreased* between FY2003 and FY2005. Federal policies and programs that subsidize asset-building have increased, but the average taxpayer has not felt this upturn.

¹⁹ Total benefit from asset policies for the top 1% of tax filers was 45.3% of the total pie, while these households paid 21.4% of all federal taxes (for 2002 and 2003, Congressional Budget Office as cited by Citizens for Tax Justice, www.ctj.org).



Of particular note, and concern, in this study is the role of tax expenditures. For every \$1 spent on asset-building outlays, the federal government gave up \$506 in tax revenue through preferential rates, deductions, exemptions and credits. While direct outlays are subject to annual review through the appropriations process, tax expenditures often escape scrutiny and endure with little debate. Some experts have recently assailed the form of most of these tax expenditures—as deductions rather than refundable tax credits—as inherently inefficient.²⁰

By any measure, however, these benefits are skewed. Households that earn less than \$17,000 receive, on average, \$3 in benefits. Perhaps more startling is that households with incomes below \$80,000 receive average benefits of less than \$1,000 from these policies. At low levels of income, benefits from tax-based asset incentives are small. Increased income brings increases in benefits, though the amount of benefits may not induce a change in asset-building behavior. For example, a family that earns between \$30,000 and \$35,000 has an average asset subsidy of \$74. The pattern of benefits resembles an exponential function with small changes at low-income levels growing faster and faster as income continues to rise.

Now, more than ever before, it is time to analyze these policies to make informed decisions about whether, and to what degree, they are advancing societal goals. At a cost of \$362 billion in a single year, these policies are too big to ignore. Although these subsidies continue to be, to

²⁰ See Batchelder, L, Goldberg, F., and P.Orszag. (2006) "Reforming Tax Incentives into Uniform Refundable Tax Credits." (Washington, DC: Brookings Institution).

a large extent, hidden in plain sight, it is time for a vigorous debate about such a substantial allocation of national resources.