RETURN ON INVESTMENT?

Getting More From Federal Asset-Building Policies

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and
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This report is based on "Subsidies for Assets: A New Look at the Federal Budget," L. Woo and D. Buchholz, 2006, presented at the 2006 Assets Learning Conference, available for free download at http://www.cfed.org/go/assetbudget. That paper contains, in greater detail, the data and methodology cited in this report.

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Dating back at least as far as Lincoln's time, the United States has provided incentives to its citizens to accumulate savings and build financial assets. From the Homestead Act through modern retirement incentives, the federal government has crafted many kinds of policies to help households become more financially self-reliant.

This is, generally speaking, a good thing. Financial assets help provide stability for families, help them plan for the future, and help them weather tough times. Providing incentives for people to build nest eggs strengthens the economy and fortifies the fabric of society.

Given these benefits, one would think the nation would be best served by spreading the benefits of such policies as broadly as possible. In fact, a strong case can be made, on the grounds of both equity and effectiveness, that those with the fewest resources to begin with ought to be offered the strongest incentives to save. Those with low wages and few intergenerational resources are those who struggle the hardest, but have the most to gain, by building a nest egg. Public policy could help them do so more effectively.

The biggest beneficiaries of asset-building policies are those households who need the least help in saving and investing. Meanwhile, low-income families who could use the most help, and even solidly middle-income families, receive a very low level of benefits from these policies.

In fact, the U.S. devotes a huge amount of resources to asset-building incentives. These policies cost at least $367 billion at the federal level in Fiscal Year 2005. Yet the biggest beneficiaries of this largesse are those households who need the least help in saving and investing. A disproportionate share of many of these incentives go to very high-income households, at double the rate of what they pay into the system. Meanwhile, low-income families who could use the most help, and even solidly middle-income families, receive a very low level of benefits from these policies. Is this the best return on our national investment?

Relatively simple shifts in public policy could make the benefits of these incentives available to a greater percentage of households, and could make them work much more effectively for those who are living paycheck-to-paycheck but are trying to get ahead.

What Are Asset-Building Policies?

In 2004, in the first comprehensive study of its kind, CFED analyzed federal spending and tax policy to determine how much American asset-building initiatives cost, where the money went and who benefited.[1]

In Fiscal Year 2005, the federal government allocated $367 billion to asset building. This represents a 3.4% increase from Fiscal Year 2003 after adjusting for inflation.

These policies, as it turned out, were extensive. Counting conservatively, the report found $335 billion in such incentives for the year studied, a number that had steadily increased since 1999. The distribution of benefits highly favored upper-income citizens over middle- and lower-income people. Of the largest incentive programs, over one-third of the benefits went to the wealthiest 1% of Americans, while less than 5% of the benefits went to the poorest *60%* of taxpayers.

For Fiscal Year 2005, following the methodology of the earlier study, we analyzed the costs associated with subsidies for four main categories of assets:

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

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

1. They were related to specific, explicit federal policies that reward asset-building behavior. 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. Policies aimed at unique subgroups, such as veterans, that have access to exclusive programs, were not included.

Using these definitions, in Fiscal Year 2005, the federal government allocated $367 billion to asset building. In real terms, this represents a 3.4% increase from Fiscal Year 2003 after adjusting for inflation.

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

Homeownership

The family home is the single largest asset for most American households. Numerous federal policies, from the Homestead Act signed by President Lincoln to more recent initiatives such as the 2003 American Dream Downpayment Initiative, have made this part of the American dream attainable for more families than ever before. Today, at just below 70 percent, homeownership in the United States is at an all-time high.[2]

Some programs provide direct assistance in the form of loans, loan guarantees, grants, construction costs and flexible mortgage financing.[3] 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. 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.

Cost of American Homeownership Policies

in billions of dollars*

Direct Outlay / Tax Expenditure	FY2005
Self-help Homeownership Opportunity Program (SHOP)	0.03
Home Investment Partnership Program (HOME) – American Dream Downpayment Initiative	0.05
Community Development Block Grants (less SHOP)	0.02
USDA Section 502	0.17
Affordable Housing Program	0.25
Section 504 Loans	0.01
Section 504 Grants	0.03
Rural Housing and Economic Development (RHED)	0.01
Exclusion of interest on state and local bonds for owner-occupied housing	0.90
Deduction for mortgage interest	72.60
Deduction for property taxes	19.60
Exclusion of capital gains on sales of principal residences	22.90
TOTAL	**116.55**

***Individual program costs may not equal total due to rounding**

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 and have the highest rates of homeownership. The bottom half of earners receive 2.9% of the tax benefits while the richest 10% receive 59.4%.[4] According 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 whose incomes exceed $100,000. The same report showed that nearly half (46%) of homeowners who pay mortgage interest receive no benefit from this deduction.[5] Similarly, for the $19.6 billion property tax subsidy, the bottom half of taxpaying households receive just half a billion dollars ($534 million).

Savings and Investment

Savings and investment are a critical, and liquid, 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. Federal policies provide subsidies to encourage some kinds of savings and investment.

Cost of American Savings And Investment Policies

in billions of dollars*

Direct Outlay / Tax Expenditure	FY2005
Assets for Independence Act	0.03
Office of Refugee Resettlement (ORR)	0.01
Exclusion of investment income on life insurance and annuity contracts	25.00
Reduced rates of tax on long-term capital gains	57.80
Exclusion of capital gains at death	38.00
Carryover basis of capital gains on gifts	4.60
TOTAL	**125.43**

***Individual program costs may not equal total due to rounding**

To promote savings, certain types of saving behavior are particularly encouraged through the tax code. Preferential rates 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.

To promote savings, certain types of saving behavior are particularly encouraged through the tax code.

The bulk of the subsidies in this category, again, go 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 that exceeds 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, on average, of these incentives. Collectively, the bottom half of Americans receive 0.2% of the benefits of the capital gains and dividend tax incentives.

Retirement Accounts

Federal policymakers have long provided incentives to individuals saving for retirement. Household retirement savings are increasingly seen as a critical supplement to Social Security. Federal subsidies for retirement have also increased as more and more employers shift from traditional pension (defined-benefit) plans to defined-contribution plans like 401(k)s. Among workers in the United States, roughly 40% participate in employer-sponsored retirement plans spurred on, in part, by the tax advantages of doing so.[6]

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In general, higher-income people are more likely to benefit from a retirement plan than lower-income people. Almost three-quarters of workers (73.2%) who earn $50,000 or more enroll in their employer-sponsored plan, while fewer than 1 in 10 workers (9.6%) who earn less than $5,000 participate in their employer-sponsored plans.[7] When businesses do not or can not offer retirement accounts, workers use Individual Retirement Accounts (IRAs), representing the largest component of the U.S. retirement market. IRAs are more likely to be held by those with higher income, wealth, and education.[8]

Low-income workers are the least likely to have jobs that offer employer-sponsored retirement plans, and they will receive small Social Security checks once they do retire. The current structure of retirement incentives does little to help those who have the fewest resources.

Cost of American Retirement Asset Policies

in billions of dollars

Direct Outlay / Tax Expenditure	FY2005
Employer Plans	102.8
Individual retirement plans	11.6
Keogh plans	8.3
Tax credit for certain individuals for elective deferrals and IRA contributions	1.7
TOTAL	**124.4**

Small Business Development

Business development can be a critical element to financial security for many families. In fact, business equity is second only to homeownership as a share of total household wealth.[9] 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 (SBA).

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For some of these reasons, public policies have been developed to encourage small business development. Relative to other subsidies for asset-building, however, policies that explicitly offer financial benefits to small business owners receive little funding.[10]

Cost of American Small Business Development Policies

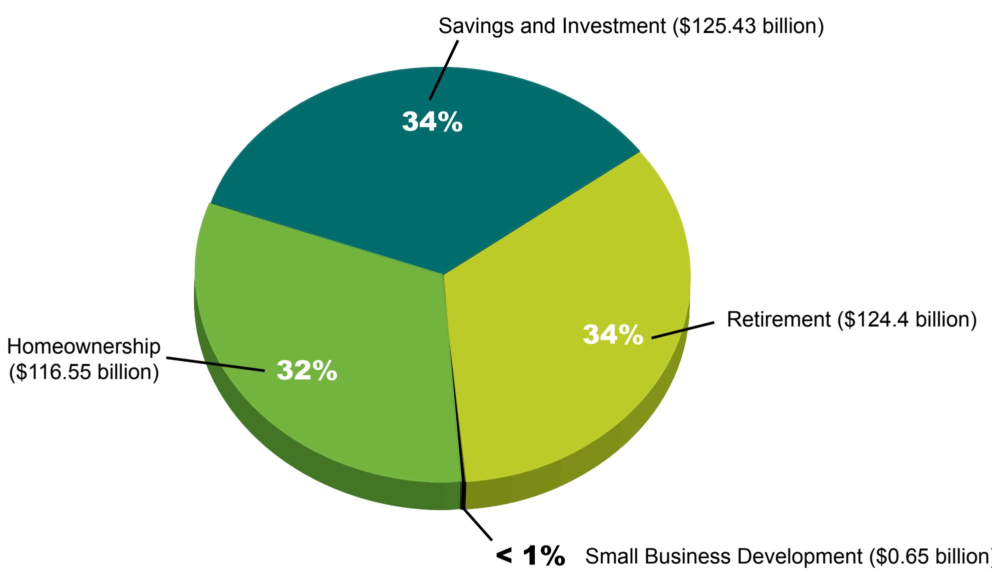
in billions of dollars*

Direct Outlay / Tax Expenditure	FY2005
SBA's MicroLoan Program	0.001
SBA's 7(a) Program	0.000
USDA's Business and Industry Guaranteed Loan Program	0.005
Job Opportunities for Low-Income Individuals (JOLI)	0.005
Urban/Rural Community Economic Development Program	0.027
Intermediary Loan Program (IRP)	0.008
Amortization of business startup costs	0.600
TOTAL	**0.648**

***Individual program costs may not equal total due to rounding**

Federal Asset Budget Categories (Fiscal Year 2005)

This chart shows the division of the federal asset building budget among the four catergories of assets in this study.



Who Benefits?

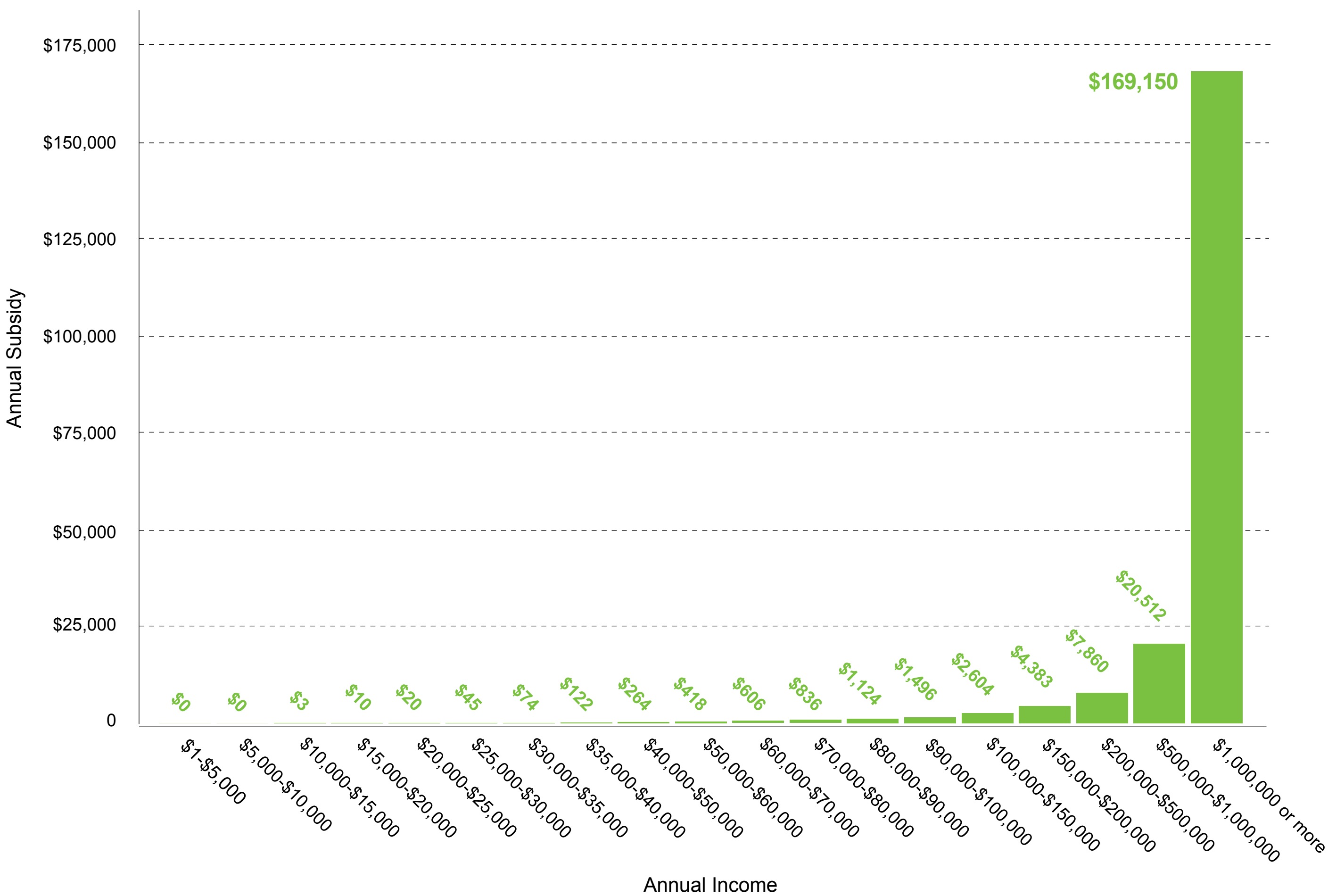
Federal policies and programs that provide subsidies for individual asset-building behavior are expensive, and the benefits are highly skewed by income.

Of the three largest asset-building policies — the mortgage interest deduction, the property tax deduction, and preferential rates on capital gains and dividends — over 45% of the subsidies go to the top 1% households, whose average income exceed $1.25 million. The top fifth of taxpayers (those with incomes greater than $80,000) receive the vast bulk (88.7%) of asset-building benefits. In contrast, the rest of the population share 11.6% of the tax benefits, and *the lowest 60% of households* get a bit less than 3% of the benefits.

Put another way, the poorest fifth of the population 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.

Distribution of Asset-Building Subsidies (Fiscal Year 2005)

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



Source: ITEP Tax Model, June 2006.[11]

Although the federal investment in these subsidies 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 seen a benefit.

In a progressive tax system like that of the United States, higher-income households pay taxes at higher rates than lower-income taxpayers, so some might argue that the wealthy deserve to benefit more because they pay more. Upper-income households, however, benefit vastly more from these incentives than they pay into the system. The top 1% of earners received 45.3% of the benefits of these policies, double their contribution (22.6% in 2003) to the federal tax rolls.[12]

Can we get more from these policies?

Many of these programs and policies have positive effects. They help families save, invest, start businesses, plan for retirement, and buy homes. But are these incentives working? Are we getting the best return on our investment?

The goals of many of these policies are good ones: to encourage the kind of individual behavior that helps households and helps society. But how to do that best?

Some would argue that the benefits of these policies ought to be spread more broadly on the grounds of fairness and equity, given the massive discrepancy in benefits generally and especially in relation to tax contribution.

Issues of equity aside, we believe that a recalibration of these policies ought to be explored on the grounds of *impact and effectiveness*. The goals of many of these policies are good ones: to encourage the kind of individual behavior that helps households and helps society. But how to do that best?

The goal of homeownership policy, for instance, is grounded in a widely shared belief that homeownership has positive personal and social benefits, and that it is worth a national investment (in the form of direct spending and tax breaks) to help more households own homes. Likewise, the goal of retirement policy is grounded in an understanding that families need to supplement income and Social Security with targeted savings, and that it is worth a national investment (in the form of tax breaks) to help more families do so.

Wouldn't tools better aimed at lower- and middle-income earners be more effective in attaining the social goal of helping more families own homes?

One would think, then, to maximize impact, these policies would be most targeted to those who do not already own homes, or are not already saving for retirement. Surprisingly, the reverse is true: the bulk of the benefits of policies encouraging homeownership go to those who already own homes. The lion's share of these benefits go to the top wage earners, but nearly all (94.7%) of the top 10 percent of taxpayers already own their homes. Only four in 10 earners in the bottom 20 percent, by contrast, own their homes.[13] Yet they get little benefit from federal incentives. Wouldn't tools better aimed at lower- and middle-income earners be more *effective* in attaining the social goal of helping more families own homes?

Likewise, if society has a goal of encouraging families to open and add to retirement accounts, one would imagine that the biggest impact would go to targeting those with the lowest levels of account ownership, and the lowest levels of capitalization. But we know that the benefits of these policies go disproportionately to higher-wage households. Only 10 percent of the bottom fifth have accounts, with a median retirement savings value of only $5,000, compared with 88 percent and $182,700 for the top 10 percent.[14] Policies meant to encourage this kind of saving could be more effectively targeted to the segments of the population that have the most growth potential.

Because of the structure of many of these tax breaks, many families receive no benefit whatsoever, a fact that would be largely addressed by caps and conversions to refundable credits.

There are a number of ways this could be done. Lower caps, for instance, could be implemented on some policies, or limiting the maximum benefit that any household could enjoy and reallocating the savings to policies that more explicitly target those who currently receive little benefit.

One particular area that deserves analysis is the role of tax expenditures. For every $1 spent on direct asset-building outlays, the federal government gave up $582 in tax revenue through preferential rates, deductions, exemptions and credits in FY2005. While direct outlays are subject to annual review through the appropriations process, tax expenditures often escape scrutiny and endure with little debate. Some experts, including a former IRS Commissioner and the current Director of the Congressional Budget Office, have recently assailed the form of most of these tax expenditures — as deductions rather than refundable tax credits — as inherently inefficient.[15]

We believe that good policies can be improved, and help more and more American families become financially secure.

Because of the structure of many of these tax breaks, many families receive no benefit whatsoever, a fact that would be largely addressed by caps and conversions to refundable credits. Technically easy and budget-neutral fixes such as these could go far toward improving the effectiveness — and equity — of these policies.

These policies, on average, promote good goals that help families and society. The price tag, however, is high enough that attention needs to be paid to what we are getting for our money. We believe that good policies can be improved, and help more and more American families become financially secure.

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

2 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.]

3 In the interest of erring 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.

4 All data reflecting the distribution of benefits, except where noted otherwise, are generated from a microsimulation model developed and performed by the Institute on Taxation and Economic Policy. A full explanation of the model is found in Appendix A of *Subsidies for Assets.*

5 Data are from 2002. The President’s Advisory Panel on Federal Tax Reform. (2005, November). Simple, Fair, and Pro-Growth: Proposals to Fix America’s Tax System. p. 72. Accessed 9/10/06 from http://www.taxreformpanel.gov/final-report/.

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7 Copeland, p.9.

8 S. Holden, 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.

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10 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.

11 See *Subsidies for Assets* for a full description of the ITEP Tax Model.

12 Congressional Budget Office as cited by Tax Policy Center. Accessed 9/11/06 from http://www.taxpolicycenter.org/TaxFacts/TFDB/TFTemplate.cfm?Docid=447.

13 Federal Reserve Board, 2004 Survey of Consumer Finances

14 Ibid.

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

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