

FROM **LEFT-SIDE DOWN** TO **RIGHT-SIDE UP**

**REDEPLOYING \$540 BILLION IN FEDERAL SPENDING TO
HELP ALL FAMILIES SAVE, INVEST, AND BUILD WEALTH**



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Note that views and recommendations represented in this report are those of the authors and CFED, but not necessarily of our external reviewers. Any errors are the authors' own.

The Corporation for Enterprise Development (CFED) is a national nonprofit 501(c)3 organization that empowers low- and moderate-income households to build and preserve assets by advancing policies and programs that help them achieve the American Dream, including buying a home, pursuing higher education, starting a business and saving for the future. As a leading source for data about household financial security and policy solutions, CFED understands what families need to succeed. We promote programs on the ground and invest in social enterprises that create pathways to financial security and opportunity for millions of people.

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From Upside Down to Right-Side Up

Redeploying \$540 Billion in Federal Spending to Help All Americans Save, Invest, and Build Wealth

A new policy agenda to transform wealth inequality into economic opportunity

Savings, investments, and wealth are crucial components of economic opportunity. Taken together the four papers in this *Right-Side Up* series propose a sweeping federal policy agenda to boost savings, investments, and wealth—or “assets”—for millions of Americans. In particular, this series focuses on four types of assets: savings, higher education, retirement accounts, and homeownership.

Why these four assets? First, each of these is closely linked to financial security and economic opportunity. Reachable or “liquid” savings helps families weather financial shocks and move up the economic ladder.¹ Children with savings are more likely to attend and graduate from college and excel later in life.² Personal retirement savings are increasingly necessary to guarantee a secure retirement.³ And homeownership remains a large portion of personal wealth, even in the wake of the housing crash.⁴

Second, the federal government itself focuses on these assets. In 2013, the federal government spent more than \$540 billion to help Americans acquire these assets in 2013—a truly enormous sum by almost any measure.

The vast majority of this spending comes through upside-down tax programs. This federal spending comes through tax programs (often called “tax expenditures”) rather than through traditional programs. But this is a difference without distinction. Policy experts of all political persuasions agree that tax programs are just government spending by another name.

FIVE TAKEAWAYS

1. Savings, investment, and wealth are crucial components of financial security and economic opportunity.
2. Policy experts of all stripes agree that tax programs are simply government spending programs by another name.
3. The federal government spent \$540 billion in 2013 on tax programs to boost savings, investments, and wealth.
4. Most of these tax programs are “Upside Down.” The more a family needs support, the less support they get.
5. By turning these tax programs right-side up, Congress can make an historic investment in economic opportunity without committing additional funding.

These programs are not flawed because they are tax programs, but rather because they do little for most American workers. We call these programs “upside down,” because the more an individual or family needs support, the less support they get. Most of these programs effectively help the wealthiest Americans build more wealth. At a time when wealth inequality is at record levels, tax programs are concentrating that wealth further at enormous cost to the federal government.⁵

An agenda to expand financial security and economic opportunity. Liberals and conservatives disagree about whether the increase in inequality is a catastrophe for American democracy and economy, or a shrug-worthy phenomenon.⁶ But this is the wrong way to think about the issue. This half-trillion dollars of poorly-directed federal investment is an opportunity. Rather than inflaming wealth inequality further with these programs, we can make an historic investment in financial security and economic opportunity. The four papers in this series propose federal reforms to turn these tax programs right-side up, redeploying existing spending to help *all* Americans save, invest, and build wealth.

This summary is followed by four policy papers that stand on their own and as constituent parts of a comprehensive analysis of federal tax programs to boost savings, investments, and wealth. Each of these papers brings together new and old data to analyze the size of federal tax programs; *who* receives support from these programs; *why* these tax programs are upside down; and *how* federal reforms can turn the programs right-side up. The remainder of this summary draws from each of these papers, providing both a top-level view of these tax programs, as well as a sketch of potential federal policy reforms.

I The \$540 billion budget to help Americans save, invest, and build wealth

The hidden spending of social policy tax programs. What is a “tax program?” These programs, often called “tax expenditures,” take the form of tax credits, deductions, exclusions, exemptions, deferrals, and reduced tax rates. But quite simply, a federal tax program is a federal spending program.

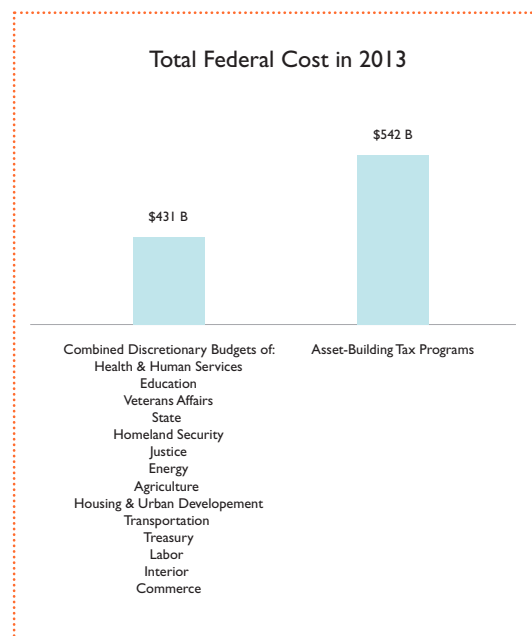
This is not ideologically motivated framing. Both sides of the political aisle largely agree that tax programs are spending programs. Stanley Surrey, the Assistant Secretary of the Treasury in the 1960s, coined and defined the term “tax expenditures” as “government spending for favored activities or groups, affected through the tax system.”⁷ A member of President George W. Bush’s Council of Economic Advisors described tax programs as “spending in disguise.”⁸ Two tax experts who each served as President Clinton’s Deputy Assistant Secretary for Tax Analysis, took the same view.⁹ So does Sen. Coburn, the Republican conservative stalwart.¹⁰

The fact that tax programs are effectively spending programs should significantly inform debates around social policy and economic opportunity. For too long, policy debates on expanding opportunity have focused almost exclusively on traditional spending programs. The Earned Income Tax Credit (EITC)—one of the largest “antipoverty” programs in the country—is often seen as an anomalous tax program in the economic opportunity policy space. But the reality is that the EITC is just one of several social policy programs run through the tax code. In fact, when it comes to helping Americans build wealth, federal spending is *mostly* run through tax programs rather than through traditional spending programs.

The four papers in the *Right-Side Up* series examine more than 30 federal tax programs focused on the four types of assets described below. Combined, these tax programs cost the federal government more than \$540 billion in 2013. This is an enormous sum compared to almost any other sort of federal spending on social programs. In fact, this is larger than the *combined* discretionary budgets of 14 of the 15 cabinet level agencies.

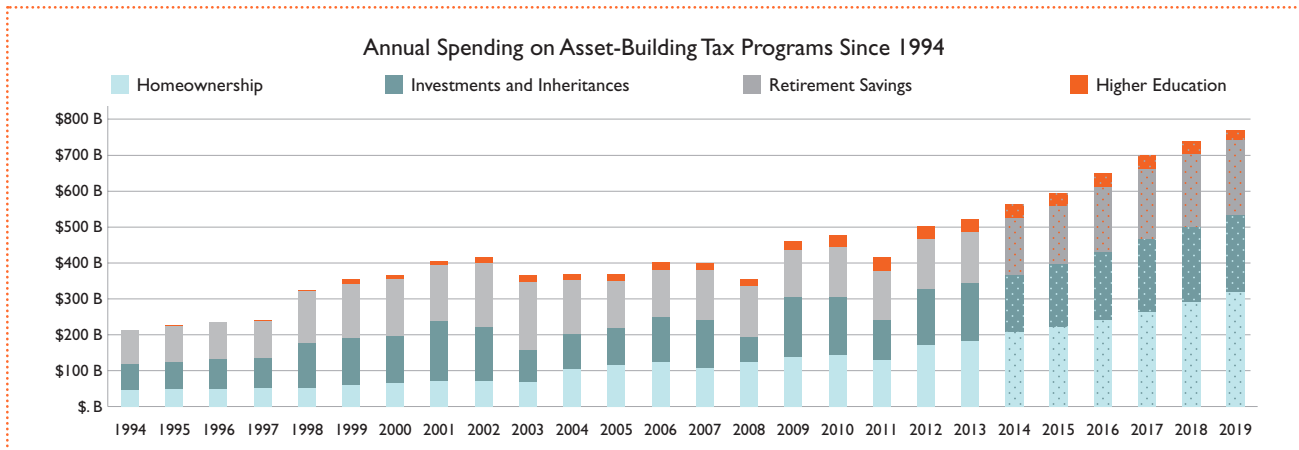
- **\$211 billion – Homeownership.** Home equity represents 70% of the total wealth of low- and moderate-income households.¹¹ Even in the wake of the Great Recession, millions of Americans continue to view homeownership as a viable route towards developing a long-term source of wealth.¹² These tax programs primarily give support to households to take on more mortgage debt and buy bigger homes.
- **\$171 billion – Savings.** Nearly all families experience income fluctuations, and low- and moderate-income families are more likely to experience significant income interruptions. Reachable “liquid” savings helps families weather these economic storms. A family can build this type of savings in two ways: save and invest their own income in accessible accounts or receive the savings and investments of someone else as a gift or inheritance. Federal tax programs actively boost these investments and inheritances.
- **\$128 billion – Retirement Accounts.** Just half of working-age Americans are confident that they will have enough money to retire.¹³ Even among households with savings, the median balance is \$40,000, still far less than many workers will need to maintain their standard of living in retirement.¹⁴ The federal government primarily supports retirement savings through tax-preferred retirement plans, like defined benefit plans, 401(k) plans, and IRAs.
- **\$32 billion – Higher Education.** Higher education is one the surest pathways out of poverty. There are two ways the federal tax programs support higher education: through after-purchase tax subsidies (like the deduction for higher education expenses), and through support for college savings (namely 529 and Coverdell education accounts).

Federal spending on asset-building tax programs outweighs the discretionary budgets of 14 cabinet agencies



Author's calculations based on data from the [Office of Management and Budget](#) (2014) and [Tax Policy Center](#) (2013). Asset-building tax programs include tax expenditures for homeownership, investments and inheritances, retirement, and higher education, as well as the foregone revenue from reduced estate taxes.

From 2014-2019, the federal government will spend more than \$4 trillion on tax programs to boost savings, investments, and wealth



Author's calculations based on [Office and Management and Budget](#) data compiled by [National Priorities Project](#). Inflation-adjusted 2015 dollars. American Opportunity Tax Credit data updated to include refundable portion. Excludes forgone revenue from reduced rate on estates.

Spending on these tax programs is projected to grow rapidly in the next few years. In 2019, spending is scheduled to be 40% greater than it was in 2013 (controlling for inflation). From 2014 to 2019—the projections available in the most recent estimates by the Office of Management and Budget—these programs are estimated to cost the federal government a total of more than \$4 *trillion*, a mind-boggling sum. Who is receiving the benefits from this federal largesse?

2 The upside down shape of these tax programs means most families benefit little

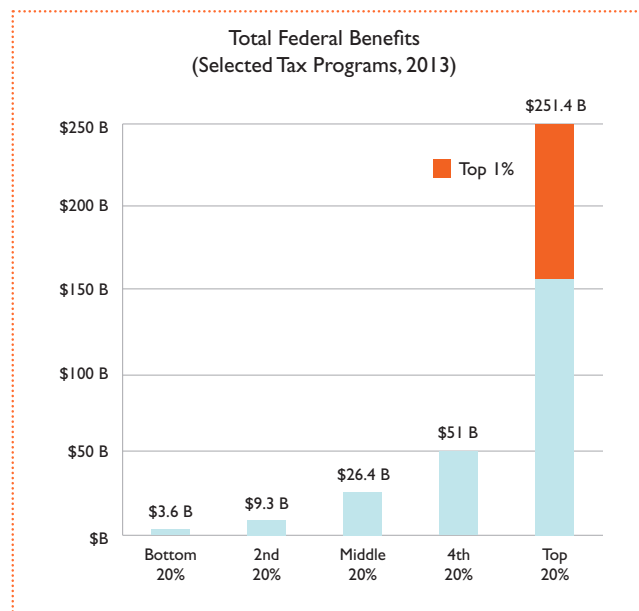
What does “Upside Down” mean? It means the less income you have, the less these tax programs help you build wealth. It means the \$540 billion in federal spending on these programs is, with a few exceptions, largely serving to expand the wealth of the wealthy. Working families who need help the most get helped the least.

The four papers in the *Right-Side Up* series use data from several sources—chiefly the Urban Institute, Tax Policy Center, Congressional Budget Office, and the Internal Revenue Service—to describe in quantitative terms *who* receives support from this \$540 billion in federal spending.

The short answer is: not most working families. Using data from the different sources, we are able to estimate who receives support for the majority of these tax programs, accounting for about \$340 billion in federal spending in 2013.¹⁶ Most individuals and families—those in the bottom 60%—receive less than 12% of the benefits from these programs. Households in the top 20% receive about 70 times as much support from these programs as do households in the bottom 20%. These benefits are incredibly focused on the highest-income households. The top 1% receive more than a quarter of all support from these programs—more than the entire bottom 80% combined.

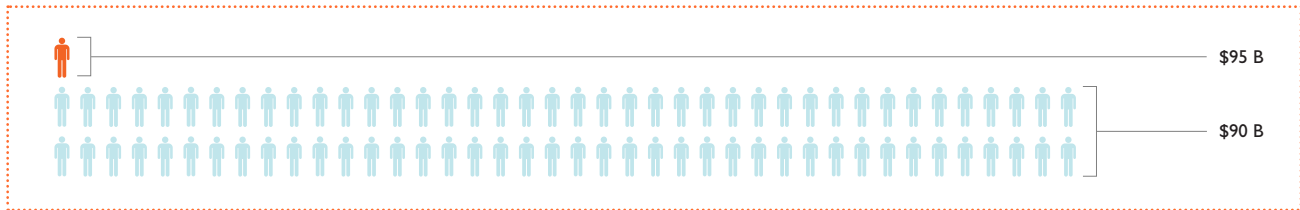
And what about the remaining spending on tax programs *not* included in this summary statistic? There is reason to believe that adding those programs in would only make the picture worse. Consider some of the Upside Down facts not included in this summary:

Upside Down: Most Americans receive little support from these tax programs



Author's analysis based data from the [Tax Policy Center](#) (2014) and [Congressional Budget Office](#) (2013). Includes roughly 60% of total federal spending on asset-building tax programs.

The top 1% receive more support than the bottom 80% combined

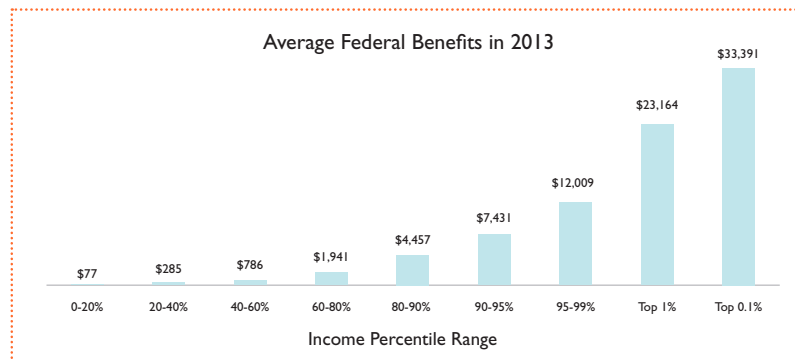


Author's analysis based data from the Urban Institute (2014) and [Congressional Budget Office](#) (2013). Includes roughly 60% of total federal spending on asset-building tax programs.

- The top 5% of households receive more than half of the benefits from federally-supported state and local bonds. Cost to the federal government: \$29.4 billion.
- The median inheritance is less than \$100,000, but recent cuts to the estate tax allows for a \$5.34 million exclusion and applies a reduced tax on the remainder. Cost to the federal government: \$23.5 billion.
- The bottom half of households own only about 1% of all savings in federally-supported 529 and Coverdell education savings accounts. Top-half households own 98.9%. Cost to the federal government: \$1.75 billion.

How does this translate into actual, real-world dollar benefits for Americans? The Urban Institute examined ten of these tax programs for retirement, homeownership, and higher education.¹⁷ Most working households get very little support from these programs. In contrast, millionaires can count on tens of thousands of dollars in support to build wealth. A top-income family could buy a Cadillac with their annual benefits. A bottom-income family could barely fill the gas tank.¹⁸

A top-income family could buy a Cadillac with their annual benefits A bottom-income family could barely fill the gas tank



Author's calculations based data from the [Tax Policy Center](#) (2014). Includes selected tax programs for homeownership, retirement and higher education. Note that this analysis does not include any tax programs for investment and inheritances, which are even more upside down than other tax programs.

Most but not all of these tax programs are upside down. There are a few small but significant examples of right-side up policy among these programs:

- The Saver's Credit, which helps low- and moderate-income families build retirement savings, focuses the entirety of its support on the bottom 60%.
- The short-lived First Time Homebuyer tax credit also focused support on the low- and moderate-income households.
- Though not included in this analysis, the Earned Income Tax Credit (EITC), often functions as a "forced savings" mechanism for low- and moderate-income workers.

These right-side up tax programs demonstrate that the problem with upside down tax programs is not that they're tax programs—it's that they're upside down. It is perfectly possible to structure a tax program to help most working families build wealth. The next section explains the four reasons why tax programs so often fail to do this.

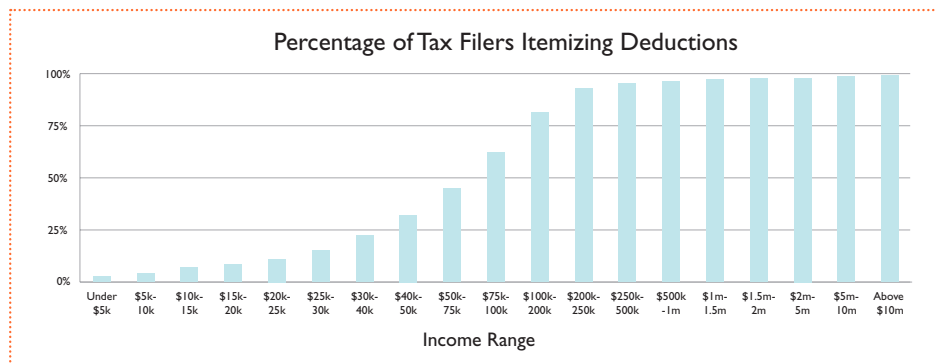
3 The four flaws that make these tax programs upside down

Flawed tax programs produce inequitable benefits. In general, these tax programs suffer one or more of four flaws that limit their usefulness for individuals and families who need the most help saving, investing, and building wealth.

1. **Itemized deductions exclude most households from benefits.** Two of the largest asset-building tax programs, the mortgage interest and real estate tax deduction, are available only to taxpayers who itemize deductions. Together, these programs cost \$98 billion in 2013, accounting for one out of every six dollars spent on asset-building tax programs.

The problem with these programs is that low- and moderate-income households are far less likely to itemize than high-income households. More than 95% of tax filers with income over \$200,000 itemized their deductions instead of claiming the standard deduction in 2011. By comparison, only 13% of tax filers with annual income of \$50,000 or less itemized their deductions.¹⁹

Providing support exclusively to itemizers denies support to most Americans



Author's calculations based on 2012 data from the [Internal Revenue Service](#).

2. **Most tax programs increase support as a household's tax rate increases.** Deductions, exclusions, and deferrals account for the majority of federal wealth-building tax programs. The problem with these programs is their support is directly tied to a household's tax rate. As a household's tax rate decreases, the support provided by these programs decreases as well.

How does this work in the real world? Consider an example scenario of the Hendersons, a middle-income household (15% tax rate) and the Hamptons, a high-income family (39.6%). Both families buy the same house with same mortgage, so they deduct the same amount for mortgage interest and real estate taxes. They also both contribute the same amount to retirement accounts, and incur the same amount of loan interest from old school loans. In total, both the Hendersons and the Hamptons deduct a total of \$16,500. But their tax refunds are impacted in different ways. The Hendersons can expect an additional \$2,475 back because of these deductions—\$16,500 times their tax rate of 15%. But the Hamptons will receive an additional \$6,534—\$16,500 times their tax rate of 39.6%.

Moderate-income workers get less than half the support as high-income workers who claim the same deductions

Example Tax Filing	Moderate-Income Family	High-Income Family
Income Tax Bracket	15%	39.6%
Mortgage Interest		\$10,000
Real Estate Tax		\$3,500
IRA Contributions		\$2,000
Student Loan Interest		\$1,000
Total Deductions		\$16,500
Increase in Tax Refund	\$2,475	\$6,534

Author's calculations.

Both families bought the same house, paid the same mortgage interest and real estate taxes, contributed the same amount to retirement accounts, and incurred the same interest on student loans. But the Hendersons receive less than half as much support as the Hamptons.

3. **The larger the asset, the more the support.** For example, consider that real estate tax deductions are tied to the value of the home. The more expensive the home, the higher the taxes, and so the greater the real estate tax deduction. In 2013, households making less than \$200,000 deducted an average of about \$3,500 in real estate taxes. By comparison, the highest-income taxpayers (with income over \$10 million) deducted an average of more than \$77,000.²⁰ Similarly, high-income households are much more likely to have significant investment income and very large estates.

Some tax programs limit support for assets above a certain size, but even these programs subsidize extraordinarily large assets. For instance, at a time when the median total retirement savings is just \$40,000,²¹ federally-supported retirement accounts can subsidize more than \$50,000 in savings every year. Similarly, estates can currently exclude up to \$5.34 million from taxes, an enormous amount that allows the vast majority of estates to avoid taxes altogether.

Even these generous caps are often circumvented through loopholes. A recent report found that high-income workers can shelter about \$170,000 from taxes by combining various retirement accounts.²² The scheme costs a few thousand dollars in accountant fees, but it produces tens of thousands of dollars in federal tax benefits. Similarly, some analysts have labeled the estate tax a “voluntary tax” because of the many loopholes that allows some to shelter millions of dollars from the tax.²³

Tax programs subsidize enormous assets for high-income households

Example Annual Tax Filing	High-Income, Modest Spender	High-Income, Big Spender
Income Tax Bracket	39.6%	
Mortgage interest	\$10,000	\$40,000
Real Estate Tax	\$3,500	\$15,000
Retirement Savings	\$2,000	\$50,000
Student Loan Interest	\$1,000	\$5,000
Total Deductions	\$16,500	\$115,000
Increase in Tax Refund	\$6,534	\$43,560

Author's calculations.

4. **Timing and structure of benefits prevents many families from benefiting.** Many tax programs time support in a way that cuts off access to low- and moderate-income households. For example, the American Opportunity Tax Credit provides support to students only after they have already paid for higher education expenses. Similarly, homeownership tax programs spread out support over years or decades of homeownership, for instance through a subsidy for mortgage interest or real estate taxes. High-income households with adequate savings can invest today and receive support next year or years later. But many would-be students and homeowners cannot afford to pay college enrollment costs or home closing costs today, and so they won't receive support from the tax program next year.

The structure of support serves as a barrier to many households as well. Consider that in order for a worker to benefit from retirement tax programs, she must have access to a retirement savings accounts. But roughly half of workers do not have access to an employer-sponsored retirement savings account. Similarly, in order to take advantage of the tax benefits from saving and investing, a worker needs access to a savings or investment account.²⁴ But millions of unbanked and under-banked households across the country lack even a simple checking account, let alone a savings or investment account. When benefits are dependent on use of certain accounts, easy account access becomes crucial for ensuring that all workers benefit.

4 Federal reforms to turn this upside-down spending right-side up

An agenda to expand financial security and economic opportunity for millions of Americans. The flaws discussed above are not required features of these tax programs—they're flaws that can be fixed. The four papers in this *Right-Side Up* series propose reforms to turn this \$540 billion in annual spending right-side up, so that all Americans can save, invest, and build wealth. These papers go into detail for each for the policy reforms summarized in the table below.

Federal policy reforms to boost savings, investment, and wealth by turning tax programs right-side up

HOMEOWNERSHIP

- Replace the mortgage interest and real estate tax deductions with a simple, flat refundable homeownership credit.
- Establish a first-time homebuyer's credit to help new homebuyers afford closing costs of a first home.
- Help families save for a first home down payment.
- Institute meaningful caps on homeownership tax support and use savings to promote primary homeownership for all Americans.

SAVINGS

- Establish a regenerating "Opportunity Fund," by reinstating historical tax rates on estates and inheritances. The fund would link two generations, with the wealth of one investing in the opportunity of the next.
- Support liquid savings through an add-on to the EITC or a new credit for low- and moderate-income workers.
- Reform taxation of investment income, and use the federal revenue to support wealth-development programs for all workers.

RETIREMENT ACCOUNTS

- Replace existing upside down support for retirement savings with a flat refundable retirement savings credit; and reform the Saver's Credit.
- Establish universal, automatic enrollment retirement savings accounts for all workers.
- Apply meaningful caps to tax-supported retirement accounts and use the saved federal revenue to expand retirement savings support for all workers.

HIGHER EDUCATION

- Eliminate the higher education deduction and use savings to create a college savings account for every child at birth.
- Reform the American Opportunity Tax Credit to support college savings directly.
- Eliminate public benefit asset limits for savings into children's savings accounts.
- Expand the Saver's Credit to support college savings.

Conclusion

An opportunity to transform wealth inequality into economic opportunity. One of the most striking economic trends in America over the last several decades has been the rise of wealth inequality, particularly among the very wealthiest Americans. While income inequality has received a great deal of attention, it's dwarfed by the growth of wealth inequality.²⁵ The top 1% of Americans now own roughly 40% of the wealth in America, more than at any time since the 1930s.²⁶ At the same time, we know that nearly half of Americans are "liquid asset poor," meaning they lack even the most basic levels of savings.²⁷ The Great Recession has only made this picture bleaker.²⁸

The federal government is not sitting on the sidelines. Recognizing the importance of assets both to the American Dream and the American economy, the federal government spent more than \$540 billion in 2013 alone to promote savings, retirement accounts, higher education, and homeownership. But these programs do little to promote these worthy causes for most Americans. Instead, this federal largesse primarily helps the wealthiest Americans build more wealth. In short, these tax programs are upside down, more often than not failing to expand financial security or economic opportunity.

There's a silver lining to this misdirected investment. For policymakers interested in reform, \$540 billion is on the table ready to be redeployed in ways that will expand financial security and economic opportunity for millions of Americans.

The four papers in the *Right-Side Up* series bring together scores of data in order to both paint an accurate picture of this upside down spending, and also to provide options for reform. Without committing any additional federal dollars, we can help millions of families save, invest, and build wealth. We can make a truly historic investment in expanding economic opportunity. We just have to turn these upside down policies right-side up.

¹ Pew Charitable Trust, [Moving On Up: Why Do Some Americans Leave the Bottom of the Economic Ladder, but Not Others?](#), November 2013.

² Ezra Levin, [Scholarly Research on Children's Savings Accounts](#), June 2014.

³ Alicia Munnell et al., [The National Retirement Risk Index: After the Crash](#), October 2009.

⁴ Michal Grinstein-Weiss & Clinton Key, [Homeownership, the Great Recession, and Wealth: Evidence from the Survey of Consumer Finance](#), January 2013.

⁵ Thomas Piketty & Gabriel Zucman, [Wealth and Inheritance in the Long Run](#), April 2014.

⁶ For a liberal take on the negative effects of growing inequality, see Paul Krugman, [Why Inequality Matters](#), December 2013. For a conservative take, see Scott Winship, [Overstating the Costs of Inequality](#), 2013.

⁷ Leonard Burman, [Is the Tax Expenditure Concept Still Relevant?](#), September 2003.

⁸ Donald Marron, [Spending in Disguise](#), 2011.

⁹ Leonard Burman et al., [How Big Are Total Individual Income Tax Expenditures, and Who Benefits from Them?](#), December 2008.

¹⁰ Tom Coburn, [Back in Black](#), July 2008.

¹¹ Michal Grinstein-Weiss & Clinton Key, [Homeownership, the Great Recession, and Wealth: Evidence from the Survey of Consumer Finance](#), January 2013.

¹² Michal Grinstein-Weiss et al., [Homeownership and Wealth among Low- and Moderate-Income Households](#), April 2013.

¹³ Ruth Helman et al., EBRI Issue Brief, no. 384, [2013 Retirement Confidence Survey: Perceived Savings Needs Outpace Reality for Many](#), March 2013.

¹⁴ Nari Rhee, National Institute on Retirement Security, [The Retirement Savings Crisis: Is It Worse than We Think?](#), June 2013.

¹⁵ Ron Haskins et al., [Promoting Economic Mobility by Increasing Postsecondary Education](#), 2009.

¹⁶ Note that this analysis is based on data from the Tax Policy Center and the Congressional Budget office. While the two organizations use 2013 data, they use different methodologies for their distributional analyses. For this reason, our combined estimate should be viewed as precisely that—an estimate—but one that is built on two rigorous analyses of the available data.

¹⁷ Benjamin Harris et al., [Tax Subsidies for Asset Development An Overview and Distributional Analysis](#), August 2014.

¹⁸ The MSRP of a 2014 Cadillac ATS, a “luxury sport sedan,” is \$33,065—less than the \$33,391 in average annual benefit in 2013 for a top 0.1% tax filer. See Cadillac’s website on the vehicle, [The Cadillac ATS: Built to Be the World’s Best](#), 2014. The vehicle’s fuel tank size is 16 gallons. At the time of this writing, the average cost of gasoline was \$3.87 per gallon. See Consumer Reports, [Average gas prices Tracking the fuel prices nationwide](#), August 2014. To fill the Cadillac’s 16-gallon tank would cost \$61.92, about fifteen dollars less than the average benefit for a tax filer in the bottom 20%.

¹⁹ Author’s calculations based on 2012 [IRS Statistics of Income](#), 2014.

²⁰ Ibid.

²¹ Nari Rhee, [The Retirement Savings Crisis: Is It Worse than We Think?](#), National Institute on Retirement Security, June 2013.

²² Ashlea Ebeling, Forbes, [How Entrepreneurs Can Get Big Tax Breaks for Retirement Savings](#), March 2013.

²³ See George Cooper, [A Voluntary Tax? New Perspectives on Sophisticated Estate Tax Avoidance](#), March 1977; and Edward J. McCaffrey & Linda R. Cohen, [Shakedown at Gucci Gulch: A Tale of Death, Money & Taxes](#), 2004.

²⁴ Jennifer Brooks et al., [Treading Water in the Deep End](#), 2014.

²⁵ Catherine Rampell, [Inequality Is Most Extreme in Wealth, Not Income](#), March 2011.

²⁶ See Thomas Piketty & Gabriel Zucman, [Wealth and Inheritance in the Long Run](#), April 2014.

²⁷ Jennifer Brooks et al., [Treading Water in the Deep End](#), 2014.

²⁸ See Jesse Bricker et al., [Changes in U.S. Family Finances from 2010 to 2013: Evidence from the Survey of Consumer Finances](#), September 2014; Richard Fry & Paul Taylor, [A Rise in Wealth for the Wealthy; Declines for the Lower 93%](#), April 2013; and Edward Wolff, [The Asset Price Meltdown and the Wealth of the Middle Class](#), November 2012.

Upside Down: Homeownership Tax Programs

Homeownership remains the largest source of wealth for the majority of Americans

Even in the wake of the Great Recession's housing crash, a family's home is still their most valuable asset. For low- and moderate-income households, their home represents 70% of their total wealth.¹ Many believe that homeownership remains a viable route towards building wealth for low- and moderate-income families.² The forced savings feature of a mortgage can lead families to build wealth into retirement, even without a rise in home values.

There is also a bevy of research suggesting that homeownership has a positive impact on communities and families. Lower crime, higher community engagement, greater academic achievement, fewer teenage pregnancies—these are but a few of the positive effects linked loosely or strongly to homeownership.³

This may explain why the Great Recession has not greatly dampened American enthusiasm for homeownership. While some have argued that families should stop buying homes,⁴ 89% of Americans still believe that owning a home is an important part of the American Dream. This is true across races, income levels, genders, and age groups.⁵

And regardless of where you stand on homeownership, one thing is undoubtedly true: the federal government devotes large sums promoting homeownership. The vast majority of this spending is delivered through homeownership tax programs (also called "tax expenditures"), which totaled over \$200 billion in 2013.

Unfortunately, very little of this spending helps low- or moderate-income families become homeowners. Top income families receive tens of thousands of dollars in housing support from these tax programs. Families in the bottom 20% receive, on average, practically nothing. Middle-income households don't fare much better.

This is Upside Down.

If the federal government is going to continue devoting billions of dollars to promote homeownership, these dollars should actually go to promote homeownership. But existing homeownership tax programs tend to subsidize expensive homes and mortgage debt rather than homeownership. Congress needs to reorient these programs and ensure that low- and moderate income families have both equal access to homeownership tax programs and support to build their own savings towards buying a home.

The remainder of the paper is organized as follows:

1. Size of homeownership tax programs
2. Distribution of homeownership tax programs
3. The four reasons homeownership tax programs are upside down
4. Federal policy reforms to turn homeownership tax programs right-side up

I The multi-billion dollar investment in homeownership tax programs

Tax programs are by far the largest source of federal support for housing. In 2013 alone, homeownership tax programs totaled over \$200 billion. This is nine times as large as the discretionary budget of the U.S. Department of Housing and Urban Development. It is, in fact, larger than the combined discretionary budgets of ten federal cabinet-level agencies. And this spending is growing. Since the housing crash six years ago, total federal spending on homeownership tax programs has totaled just over \$1 trillion. Over the next six years, spending is projected to be nearly \$1.7 trillion.⁶

In 2013, the largest federal homeownership tax programs were:

\$72.4 billion – Tax Preference for Homeowners Over Renters, also known as tax expenditure for “net imputed rental income.” This tax preference amounts to a tax benefit for owning a home over renting. If you pay \$1,000 to a landlord for rent, the landlord has to pay tax on that \$1,000 of rental income. If you instead own your home, that \$1,000 doesn’t go to your landlord—you keep it. Your home is acting as an investment, providing you with \$1,000 in income that no longer has to go to a landlord. But this “imputed” rental income is not taxed. Since 2004, the Office of Management and Budget has calculated the total value of this tax break, and it has grown rapidly during these years, making it the most expensive homeownership tax break today. But while the OECD has recommended⁸ that all countries tax imputed rental income, few countries have actually done so, and few policymakers have seriously proposed such a reform for the U.S.⁹

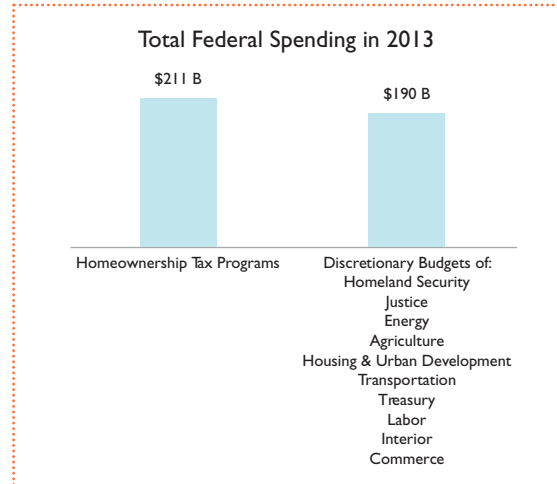
\$69.0 billion – Mortgage Interest Deduction, an itemized deduction for interest paid on a principal residence and a second home. Among those who claim the deduction, the average amount deducted in recent years has been about \$11,000.¹⁰

Married homeowners can deduct interest from the first \$1 million of mortgage debt (unmarried taxpayers can claim up to \$500,000). For instance, a family with a \$250,000 mortgage can deduct the entirety of the mortgage interest. A two-parent family with a \$1.5 million mortgage can only deduct the interest incurred on the first \$1 million of their mortgage, not the entire amount of interest incurred. In practice, this limit affects only a very small proportion of the population.

It is important to note that the Mortgage Interest Deduction subsidizes home *debt*, which is not the same as home ownership. In fact, the deduction can also apply to the first \$100,000 of interest on a home equity line of credit. This effectively allows a family with sufficient equity to turn their home into a tax-preferred credit card. They receive a loan from a bank based on the equity of their home, and they are able to deduct the interest on that loan.

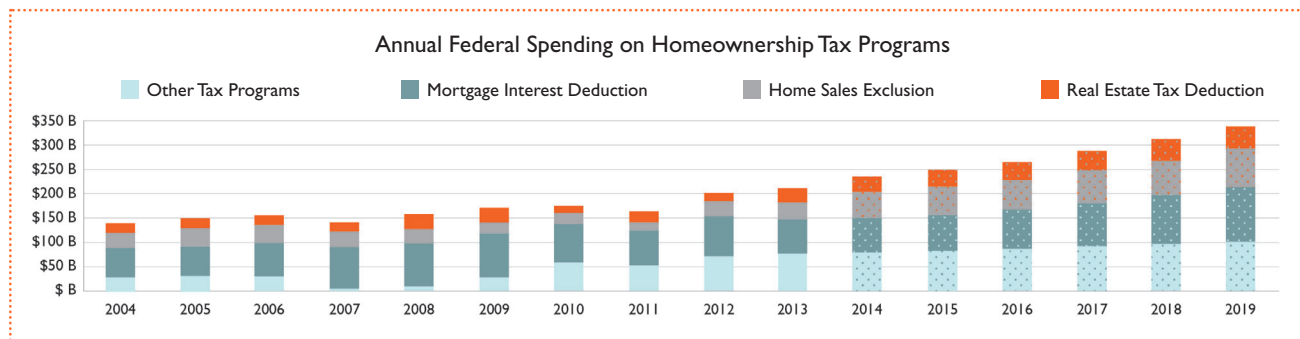
\$34.3 billion – Exclusion for Home Sales. This exclusion (available to both itemizers and non-itemizers) allows a couple to deduct up to \$500,000 in capital gains from the sale of a principal residence. For example, if a couple buys a home for \$200,000, and sells it for \$700,000, they will pay no capital gains tax on the \$500,000 increase in home value. If they instead were able to sell the home for \$1 million they would pay capital gains tax on \$300,000—\$500,000 less than the \$800,000 increase in value.

Federal spending on homeownership tax programs outweighs the discretionary budgets of 10 federal cabinet-level agencies



Author's calculations based on data from the [Office of Management and Budget](#) (2014). Agency budgets reflect total outlays in FY2013. "Other Tax Programs" includes: imputed net rental income; exclusion of interest on owner-occupied mortgage subsidy bonds; deferral of income from post 1987 installment sales; and discharge of mortgage indebtedness.

From 2009 to 2019, annual spending on homeownership tax programs is projected to double to \$337 billion



Author's calculations based on Office of Management and Budget (Appendix, Budget of the United States Government) data for fiscal years 2004 through 2019. Note 2014-2019 is projected spending. "Other Tax Programs" includes: Imputed Net Rental Income; Exclusion of interest on owner-occupied mortgage subsidy bonds; Deferral of income from post 1987 installment sales; Discharge of mortgage indebtedness; and the credit for first-time homebuyer.

Compare this to a different kind of investment, stocks. If the family bought \$200,000 in stock and then sold it years later for \$700,000, they would owe capital gains tax on the \$500,000 of investment income. The Exclusion for Home Sales allows homeowners to avoid this sort of tax on capital gains from home sales.

It's worth noting that many policy analysts argue the exclusion is an efficient way to improve worker mobility, as it eliminates some of the costs associated with selling a home and moving.¹¹

\$29.3 billion – Real Estate Tax Deduction for state and local taxes paid on owner-occupied homes. In recent years, the average amount of real estate taxes deducted has been about \$4,000.¹² Like the Mortgage Interest Deduction, the Real Estate Tax Deduction is only available to taxpayers who forego the Standard Deduction and choose to itemize deductions. Unlike the Mortgage Interest Deduction, there is no income limit and no deduction maximum, though the value of the deduction is often reduced for those affected by the Alternative Minimum Tax.¹³

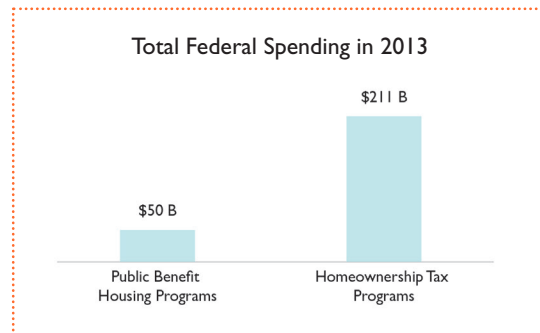
\$5.7 billion – Other Homeownership Tax Programs. The three programs described above accounted for more than 95% of federal spending on homeownership tax programs in 2013. Three smaller homeownership tax programs totaled nearly \$6 billion:

- **\$3.4 billion – Exclusion of discharged mortgage debt.** Mortgage debt may be forgiven (or “discharged”) through mortgage restructuring or foreclosure, but this debt is normally counted as income and is taxed as such. This program allows homeowners to exclude this sort of income from taxation.
- **\$1.2 billion – Exclusion of interest on owner-occupied mortgage subsidy bonds.** State and local governments may issue bonds to provide lower-rate mortgages to low-income and veteran homebuyers. Bondholders receive income from interest on these bonds, but this exclusion allows bondholders to exclude this income from taxation.
- **\$1.1 billion – Deferral of income from installment sales.** In some cases, a home may be sold and paid for over the course of several years rather than in a single lump sum. This deferral allows these sellers to delay paying taxes on profits from the sale of a home.

Not included in this list is the expired federal tax credit for first-time homebuyers. This program existed from 2008 to 2011, peaking at a cost of \$13.7 billion in 2010. While specifics of the program varied over time, at its most generous the program offered a maximum tax credit of \$8,000 for first-time homebuyers with annual income below \$225,000 (\$125,000 for single homebuyers). The credit was refundable, meaning that even the lowest-income home buyers benefited.

Spending on homeownership tax programs far outweighs spending on rental housing programs. In his 2012 testimony on public benefit programs, Heritage Foundation Senior Research Fellow Robert Rector, outlined more than twelve low-income (or “means-tested”) housing programs.¹⁴ In 2013, these programs totaled just under \$50 billion.¹⁵ This may seem like a hefty sum, but it pales in comparison to federal spending on homeownership tax programs, which totaled over \$200 billion in the same year — four times as much as the federal government spent on low-income housing programs.¹⁶

Homeownership tax programs cost four times as much as low-income rental programs



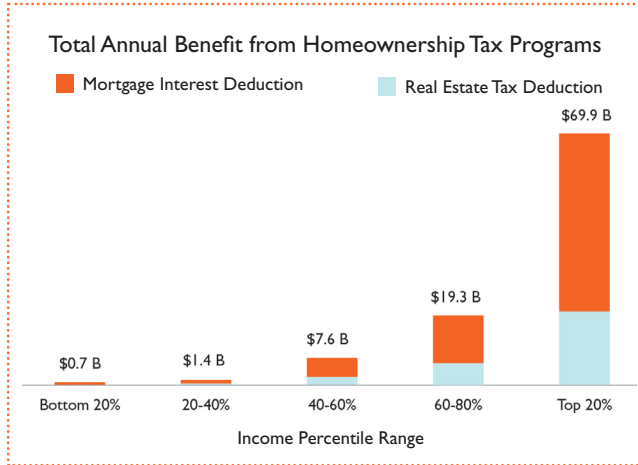
Author's calculations based on [Office of Management and Budget](#) (2014) and [Heritage Foundation](#) (2012). Heritage programs updated to FY2013 spending levels.

2 Homeownership tax programs focus benefits on the highest-income households

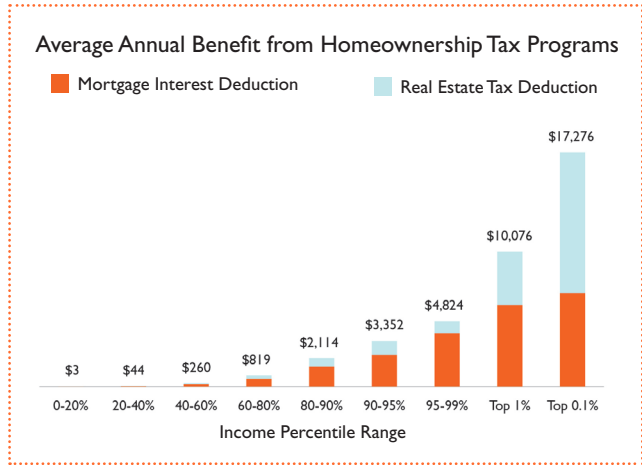
In early 2014, the Urban Institute produced new data on two of the largest homeownership tax programs, the Mortgage Interest Deduction, and the Real Estate Tax Deduction. Combined, these two tax programs accounted for a near-majority of all homeownership tax programs, costing the federal government \$98.3 billion in 2013.¹⁷ In short, this data shows that homeownership tax programs mainly work to help the wealthy build more housing wealth.

It's not just the very top versus the very bottom. The federal government spends more on programs to help the top 5% than they spend on the entire bottom 80% combined, and these homeownership tax programs are upside down at every level of analysis. Without exception, as you move down the income scale, you receive less support from these homeownership tax programs.

Upside Down Homeownership Tax Programs
Top 20% get \$69.9 billion
Bottom 20% gets \$0.7 billion



Upside Down Homeownership Tax Programs
Average Top 0.1% household gets \$17,276
Average Bottom 20% household gets \$3



Author's calculations based on data from [Urban Institute](#) (2014).

- The Top 1% receives \$7,200 less than the Top 0.1%.
- The Top Quintile receives \$6,711 less than the Top 1%.
- The 4th Quintile receives \$2,546 less than Top Quintile.
- The 3rd Quintile receives \$559 less than the 4th Quintile.
- The 2nd Quintile receives \$216 less than the 3rd Quintile.
- The Bottom Quintile receives \$41 less than the 2nd Quintile.

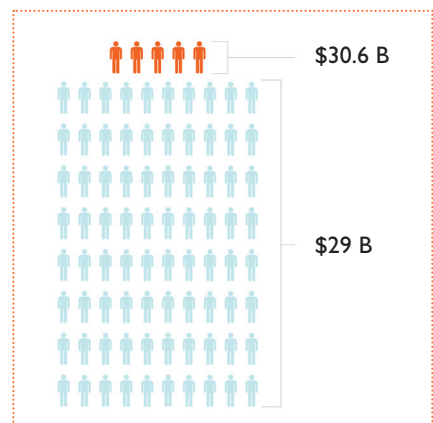
In other words, those who need the most help affording homeownership receive the least support. *This is Upside Down.*

Low- and moderate-income households get almost zero support from these programs. While these programs are supposed to expand homeownership, they do almost nothing for most low- and moderate-income Americans. In 2013, the average benefit for a household in the bottom 20% was just \$3. Not \$3,000. Just three dollars—a coffee at Starbucks. By comparison, the average benefit for a top 0.1% household was \$17,276. Or, in Starbucks terms, a Venti Caramel Macchiato every day of the week for ten straight years.

The Urban Institute data shows that both the Mortgage Interest Deduction and Real Estate Tax Deduction are both upside down. For both programs, the highest-income fifth of earners receive the roughly the same lopsided majority share of federal spending on each program: 72% (\$59.5 billion) of the Mortgage Interest Deduction; and 70% (\$20.4 billion) of the Real Estate Tax Deduction. The average benefit for a tax filer in the middle of the pack (annual income \$59,000) was only \$260—about 1.5% of the average benefit for someone at the very top. In short, neither program does much, on average, for households below the upper ends of the income distribution.

The highest-income earners benefit most from the Real Estate Tax Deduction. While all homeownership tax programs do little for low- and moderate-income families, the Real Estate Tax Deduction is uniquely focused on benefiting multi-millionaires. The Mortgage Interest Deduction—while inequitable in its own right—somewhat flattens off its benefits at the top end of the income spectrum. This is no doubt because only the interest on the first \$1 million of a mortgage can be deducted. But federal housing support through the Real Estate Tax Deduction is not capped and does not plateau. Rather, it skyrockets as incomes reach the multi-millions.

The top 5% get more from homeownership tax programs than the bottom 80% combined

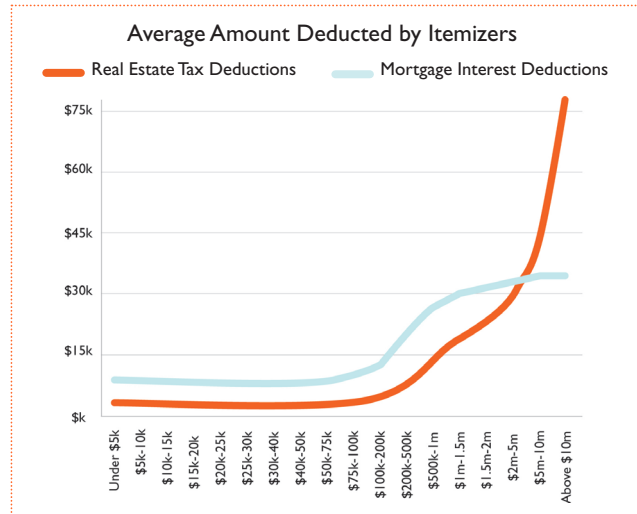


Calculations based on data from [Urban Institute](#) (2014). Includes Mortgage Interest Deduction and Real Estate Tax Deduction.

A further analysis conducted for this paper confirms that this inequity continues up the income ladder even beyond the top 0.1%.¹⁸ This analysis uses four years of IRS tax filings and includes 571 million tax returns with incomes ranging from zero dollars to over \$10 million. Three observations from this data corroborate the story told by the Urban Institute's analysis:

1. Both deductions grow with income. The average amount of deduction claimed for both real estate taxes and mortgage interest increases as income increases.
2. Deductions of mortgage interest plateau. The average amount deducted for mortgage interest peaks for tax filers with income between \$500,000 to \$1 million. The average benefit remains roughly the same for incomes even in excess of \$10 million.
3. Deductions of real estate taxes don't plateau. Beginning with the \$1.5-\$2 million group, the value of the Real Estate Tax deduction exceeds the value of the Mortgage Interest Deduction. Those with income over \$10 million (the top 0.0078%) deducted over \$75,000 on average.

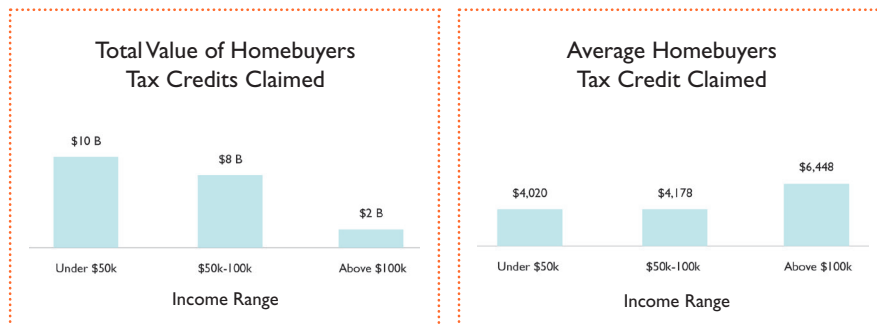
Mortgage interest deductions plateau, but real estate tax deductions continue rising rapidly with income



Author's calculations based on 2008, 2009, 2010, and 2011 data from the [Internal Revenue Service](#).

The expired First-Time Homebuyer Tax Credit was right-side up. The only homeownership program structured to focus benefits on low- and moderate-income families was the short-lived First-Time Homebuyers Tax Credit. Congress created the credit to operate during the height of the recession, 2008-2011. The program was intended to stem the tide of falling house prices, though as a macroeconomic stimulus program it received middling reviews.¹⁹ But the credit proved that it is indeed possible to run a homeownership tax program that primarily benefits low- and moderate-income households. In the four years of its existence, the spending on the credit primarily went to those with income under \$100,000. And these tax filers received, on average, only 35% less than from the credit as those with income over \$100,000.²⁰

The Homebuyer Tax Credit benefited low- and moderate-income families, and the average benefit for these families was substantial



Author's calculations based on 2008, 2009, 2010, and 2011 data from the [Internal Revenue Service](#).

3 The four reasons homeownership tax programs are upside down

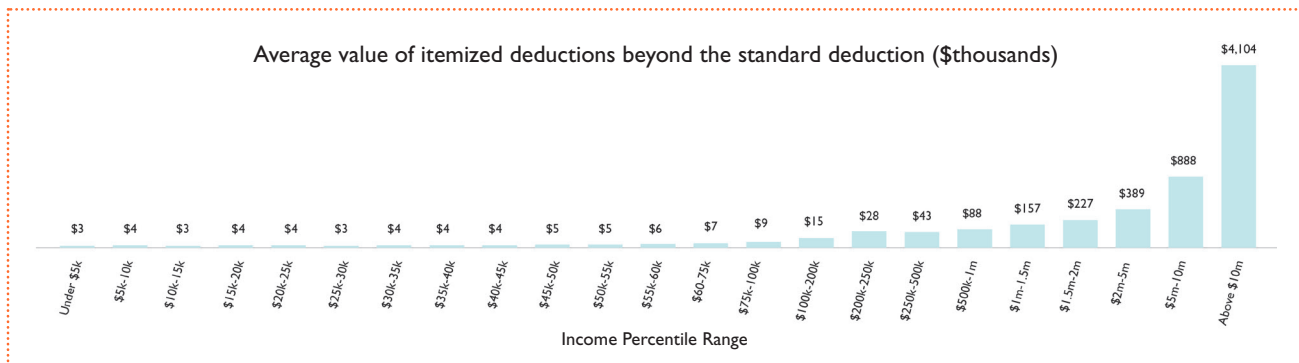
So why does the federal government spend over \$200 billion annually mainly to help house the wealthy? The reason comes down to the structure of homeownership tax programs. There are four structural flaws causing the problem:

1. **Homeownership tax programs are largely only available to households that itemize deductions.** Of the more than \$200 billion spent on homeownership tax programs in 2013, \$98 billion (roughly half) came in the form of two itemized deductions, the Mortgage Interest Deduction and Real Estate Tax Deduction. But only households who opted to itemize their deductions could access these programs.

Households must choose between itemizing deductions and taking the standard deduction, which was \$12,200 for married couples in 2014 (\$6,100 for singles). If the sum total of itemized deductions is less than \$12,200, tax filers stick with the standard deduction. High-income households are far more likely to itemize than low- and moderate-income households. More than 95% of tax filers with income over \$200,000 itemized their deductions instead of claiming the standard deduction in 2011. By comparison, only 13% of tax filers with annual income of \$50,000 or less itemized their deductions.²¹

What does it take to reach the \$12,200 threshold for a low- or moderate-income family? Consider that the median home in 2013 sold for about \$269,000.²² With a 20% down payment and reasonable interest rate for a 30-year loan, a homebuyer can expect about \$8,860 of mortgage interest in the first year, and about \$3,090 in real estate taxes. This is a total of \$11,950 in deductions, not enough on its own to justify itemizing.

**Most taxpayers who itemize deductions
receive little benefit beyond the value of the standard deduction**



Author's calculations based on 2008, 2009, 2010, and 2011 data from the [Internal Revenue Service](#). Note that calculation assumes a Standard Deduction for a couple of \$11,600.

Furthermore, the itemized deductions are only worth as much as they exceed the standard deduction. In the previous example, let's assume the family's interest over the course of the year was \$300 more, putting the total value of itemized deductions at 12,250. This is over the Standard Deduction line—so does the family get a \$12,250 windfall? Of course not. Before itemizing, the family was able to take the \$12,200 standard deduction. With the extra interest, the family was able to deduct \$12,250—a net benefit of \$50 more to deduct. High-income families with tens of thousands of dollars of deductions to itemize don't face such limitations. The average filer with income under \$100,000 itemized \$9,000 beyond the value of the Standard Deduction. By comparison, millionaires on average deducted \$441,000. Those with income over \$10 million deducted \$4.1 million on average.

2. **Homeownership tax support increases as a household's tax rate increases.** The dollar value of a deduction is based on a household's tax rate. There are currently seven income tax rates based on income, ranging from 10% to 39.6%. As a household's income grows, so does its tax rate. As a household's tax rate decreases, the value of deductions decreases as well—meaning that these programs are structured to provide less support to low- and moderate-income families.

How does this work? As an example, let's imagine that both a middle-income family, the Hendersons (15% tax rate), and a high-income family, the Hamptons (39.6% tax rate), bought homes that cost \$300,000. Over the course of the year, both the Hendersons and the Hamptons paid \$13,452 in mortgage interest and property taxes. Because this amount is greater than the \$12,200 Standard Deduction (by a total of \$1,252), they both opted to itemize their deductions in lieu of taking the Standard Deduction. But the value of this additional \$1,252 in deductions differs for the two households. The Henderson family's tax refund will be \$188 bigger -- \$1,252 times their tax rate, 15%. The Hampton household's refund will be \$496 bigger -- \$1,252 times their tax rate, 39.6%. Both bought the same value house. Both chose to itemize deductions. Both deducted the same amount of mortgage interest and real estate taxes. And yet, the Hamptons get more than 2.5 times as much help from homeownership tax programs as the Hendersons.

3. **Homeownership tax programs encourage bigger homes and more debt, not homeownership.** An often overlooked fact about both the Mortgage Interest Deduction and the Real Estate Tax Deduction is that neither program directly encourages homeownership. The Mortgage Interest Deduction supports *mortgage debt*—the more debt, the more support. The Real Estate Tax Deduction supports buying more expensive homes—the more property tax, the more support. Researchers are largely in agreement that these programs do not encourage non-homeowners to become homeowners.²³ Instead, they encourage more debt and more expensive homes particularly for high-income families.

High-income families get 2.5 times the benefit of moderate-income families who buy the same home.

	Moderate-Income Family	High-Income Family
Income Tax Bracket	15%	39.6%
Cost of Home	\$300,000	
First Year's Mortgage Interest	\$10,002	
First Year's Real Estate Tax	\$3,450	
Value of Deductions Beyond Standard Deduction	\$188	\$496

Author's calculations. Assumes 20% down payment, 4.2% mortgage interest rate, 1.15% property tax rate (on purchase price of home), and homebuyer is a married couple filing jointly (\$12,200 Standard Deduction).

The mortgage interest deduction is capped only for interest on the first \$1 million of a mortgage—this is roughly four times the size of the median home sale price, let alone mortgage size. The real estate tax deduction is not capped at all. The effect of this is to pass on significant support to those who can afford to buy bigger homes.

To illustrate, let's return to the Hamptons family. Imagine that the Hamptons didn't purchase a \$300,000 home, but instead opted for a \$1.25 million home. Putting 20% down for the home, the Hamptons can deduct all of the interest on their \$1 million mortgage, and they can deduct all of their real estate taxes. As a result, their total tax support from homeownership programs increases from just \$369 to \$17,365 beyond the Standard Deduction. In other words, these two homeownership tax programs spend an additional \$17,000 in service of housing the Hamptons in the \$1.25 million home instead of a \$300,000 home.

If you take on a huge debt load to buy a mansion, your support from homeownership tax programs will skyrocket

	High-Income Family "Modest Spender"	High-Income Family "Big Spender"
Income Tax Bracket	39.6%	
Cost of Home	\$300,000	\$1.25 M
First Year's Mortgage Interest	\$10,002	\$41,677
First Year's Real Estate Tax	\$3,450	\$14,375
Value of Deductions Beyond Standard Deduction	\$369	\$17,365

Author's calculations. Assumes 20% down payment, 4.2% mortgage interest rate, 1.15% property tax rate (on purchase price of home), and homebuyer is a married couple filing jointly (\$12,200 Standard Deduction).

4. **Homeownership tax benefits are poorly timed for most families.** If the above inequities weren't enough, the homeownership tax programs are also very poorly timed for low- and moderate-income families.

In short, buying a home is expensive. For the median house sold in 2013, a 20% down payment would be over \$50,000. Add to this the credit reports, loan origination, appraisals, inspections, title insurance, surveys, underwriting, recording fees—combined the average closing costs are 2-5% of the purchase price of home.²⁴ This adds as much as \$13,445 to the up-front cost of purchasing the median home, for total cost of around \$65,000—an astronomical amount of savings for most families. But existing homeownership tax programs don't address this issue. These programs spread support over the lifetime of homeownership, not the expensive first step toward becoming a homeowner. A 30-year mortgage on a \$300,000 home, for instance, will result in around \$200,000 in interest over the life of the loan. For a middle-income family facing a 15% tax rate, that's \$35,000 in benefits from the Mortgage Interest Deduction. But if a family can't afford the down payment and closing costs to begin with, they will never purchase the home, and they will never receive any benefit. For high-income families with a large amount of savings, this isn't a problem. But for low- and moderate-income families without much savings, this barrier can cut off their path to homeownership.

4 Federal reforms to turn homeownership tax programs right-side up

The defenders of homeownership tax programs argue that they “help make owning a home affordable and accessible to millions of Americans.”²⁵ But the evidence shows that these programs often don’t incentivize homeownership, and don’t provide much support to low- and moderate-income families. Instead, these programs largely incentivize debt and bigger homes, and they concentrate support on the highest-income households. If we want most working Americans to receive meaningful support from these programs, Congress has to address the four structural issues described above.

There is a long history of bipartisan proposals to reform the three largest housing tax programs. Numerous analysts and policymakers on both the left and right have called for reforming the Mortgage Interest Deduction and Real Estate Tax Deductions. In 1976, Senator Edward Kennedy proposed replacing the deductions with credits, arguing that “a program that automatically excludes 75% of the people from participation and provides the greatest aid to the richest families is indefensible.”²⁶ In 1984, President Reagan proposed eliminating the Real Estate Tax Deduction as well.²⁷ In the last decade, the calls for reform have been bipartisan:

For decades, congressional leaders have called out the inequity of upside down homeownership tax programs

“A program that automatically excludes 75% of the people from participation and provides the greatest aid to the richest families is indefensible.”

—Senator Edward Kennedy (D-MA), 1976

“Those benefiting from this tax break are among the most well off...Instead, this deduction should be directed to help those in the middle own their home”

—Senator Tom Coburn (R-OK), 2011

Reform the upside down structure of homeownership tax programs. History proves that there’s widespread agreement that the existing homeownership tax programs aren’t working for most families. There are several options for replacing the existing system with a more equitable credit. Each of these options would be an improvement over the existing system. All would put the more than \$200 billion currently spent on inefficient and inequitable homeownership tax programs to better use:

REFORMS TO HELP LOW- AND MODERATE-INCOME AFFORD THEIR FIRST HOME

- **Create a permanent first-time homebuyer’s tax credit.** Unlike existing homeownership tax programs, the short-lived First-Time Homebuyer’s Tax Credit of 2008-2011 was successful in directing homeownership tax benefits to low- and moderate-income homebuyers. While the temporary credit was enacted as a macroeconomic stimulus program—and was only marginally effective as such³⁴—this reform would replace the existing deductions with a permanent First-Time Homebuyer’s Tax Credit. Such a credit would address the high down payment and closing costs that prevent many families from purchasing a home.³⁵
- **Help families save for a first home down payment.** The First-Time Homebuyer’s Tax Credit is one idea to address high down payment and closing costs. A complimentary or alternative solution would be to help families save for their first home down payment. Researchers at the Brookings Institute have proposed creating a “first time home buyers saving plan.”³⁶ The program would essentially function as a federally matched Roth retirement savings account. In practice, a worker would use after-tax dollars to save up to \$5,000 per year in a special account (\$10,000 for couples). Savings would be matched at 30%. For instance, \$1,000 of savings would be supplemented with \$300 of match. The accounts would grow tax free, and withdrawals used to pay for a first home purchase would be tax free as well (like a Roth retirement savings account).

It’s worth noting that such a program already exists, though in a very complicated and suboptimal form. Workers are currently allowed to withdraw up to \$10,000 (\$20,000 for couples) from a Roth retirement account to buy a home, penalty and tax-free. For low-income families, matches are provided for savings into Roth accounts by the Saver’s Credit—up to \$1,000 per year. This solution is far from perfect. It requires sacrificing retirement savings to finance a home down payment. And because the Saver’s Credit is non-refundable, it fails to support workers who have little or no tax liability.

Support is growing to reform the Mortgage Interest and Real Estate Tax Deductions

Year	Entity Making Recommendation	Mortgage Interest Deduction	Real Estate Tax Deduction
2005	President George W. Bush's Advisory Panel on Federal Tax Reform ²⁸	Replaced with refundable credit	Eliminated
2010	Bipartisan Policy Center's "Domenici-Rivlin" Debt Reduction Task Force ²⁹	Replaced with refundable credit	Eliminated
2010	President Obama's "Simpson-Bowles" Commission ³⁰	Replaced with non-refundable credit	Eliminated
2011	Republican Senator Tom Coburn (R-OK) ³¹	Replaced with credit	N/A
2013	Alan Viard, scholar at the conservative American Enterprise Institute ³²	Replaced with refundable credit	N/A
2013	Republican Ways and Means Chairman, Dave Camp (R-MI) ³³	Made more progressive	Eliminated

REFORMS TO ENSURE HOMEOWNERSHIP TAX PROGRAMS SUPPORT ALL WORKERS

- **Replace the Real Estate and Mortgage Interest Deductions with a Homeowner's Tax Credit.** Several reformers have called for converting the Mortgage Interest Deduction and the Real Estate Tax Deduction into a credit.³⁷ Consider how a refundable 15% credit would work: a family that pays \$5,000 in mortgage interest would get \$750 in support--\$5000 times the 15% credit. The support would be same for high-income and low-income households.

Practically any proposal that ends the practice of using itemized deduction as a tool for expanding homeownership would be a step in a right direction. For this reason, the mortgage interest and real estate tax credit proposals are clearly an improvement over the existing programs. But these proposals suffer from the significant flaw that plagues the existing deductions: the credits would continue to encourage more debt rather than more homeownership, and they would still benefit high-income households who can afford to buy more expensive homes.

A better reform would replace the two deductions with a simple Homeowner's Tax Credit. Rather than incentivizing bigger homes and more debt, a Homeowner's Tax Credit would support homeownership directly. The most recent proposal of this kind would replace the Mortgage Interest Deduction with a flat refundable credit worth \$536 for all homeowners.³⁸ In another construction, the credit would provide as much as a \$1,300 credit to all homeowners, with the credit phasing out gradually as income increases.³⁹ Yet another homeowner's credit proposal would create a credit worth 1.03% on the first \$100,000 of a home value.⁴⁰ A family that bought a home worth \$100,000 or more could claim a credit for \$1,030 every year. The size of the homeownership credit for these proposals could be increased by also replacing the Real Estate Tax Deduction and using the cost savings to plus up the credit.

Each of these proposals would stop the practice of incentivizing greater mortgage debt or more expensive home purchases. Instead, they would simply support homeownership and would focus support on low- and moderate-income homeowners.

- **Reduce subsidies for excessive mortgage debt and mansions.** The average Real Estate Tax Deduction for the highest-income taxpayers was over \$77,000 in 2011. What size home allows for a \$77,000 Real Estate Deduction? Assuming a property tax of 1.2%, the homes involved would have to be worth \$6.4 million. Why is the federal government sending tax dollars to millionaires to house them in country manors and Park Avenue penthouses? Likewise, the existing Mortgage Interest Deduction provides benefits for second homes rather than just primary residences, a feature that even Republican Presidential candidate Mitt Romney proposed eliminating.⁴¹ Limiting the size of these deductions for the largest homes will not directly help low- and moderate-income people to become homeowners, but it would free up valuable federal funds for programs that would actually expand the opportunity for homeownership.

Conclusion

For most Americans, their home still accounts for the vast majority of their wealth. For them and for millions of aspiring homebuyers, homeownership represents a pathway to economic stability and an essential feature of the American Dream. Many also see homeownership as a broader benevolent force, improving communities and boosting the national economy.

Whether or not you agree about the importance of homeownership to personal economic stability and society writ large, it is undeniably true that the federal government has decided to invest heavily in homeownership tax programs. These investments are poorly made.

Two programs in particular, the Mortgage Interest Deduction and the Real Estate Tax Deduction, are strikingly flawed. Rather than promoting homeownership, they promote debt and pricier homes. Rather than helping low- and moderate-income Americans, they focus support on the wealthiest among us. *This is Upside Down.*

To encourage homeownership for American families, Congress needs to reform these programs. Many policymakers on both sides of the aisle agree with this sentiment. Democrats and Republicans have proposed laudable reforms to homeownership tax programs for decades. And yet the years go by while billions of dollars in government resources go wasted every year and millions of potential low- and moderate-income homebuyers get left behind.

In these programs, Congress has an opportunity. More than \$200 billion is on the table. Most of these dollars are now poorly invested, but they could be redeployed to have a greater positive impact on homeownership. This new investment would not require any additional federal expense. Increasing the efficiency and equity of homeownership is as simple as turning our homeownership tax programs right-side up.

¹ Michal Grinstein-Weiss & Clinton Key, [Homeownership, the Great Recession, and Wealth: Evidence from the Survey of Consumer Finance](#), January 2013.

² Michal Grinstein-Weiss et al, [Homeownership and Wealth among Low- and Moderate-Income Households](#), April 2013.

³ William M. Rohe & Mark Lindblad, [Reexamining the Social Benefits of Homeownership after the Housing Crisis](#), August 2013.

⁴ Matt Yglesias, [Is buying a house a better investment than buying stock?](#), April 2014.

⁵ Washington Post, [Post-Miller Center poll: American Dream and economic struggles](#), November 2013.

⁶ Author's calculations based on Office of Management and Budget (Appendix, Budget of the United States Government) data for fiscal years 2008 through 2019. Tax expenditures include the following: Deductibility of mortgage interest on owner-occupied homes; deductibility of State and local property tax on owner-occupied homes; exclusion of capital gains on home sales; Exclusion of interest on owner-occupied mortgage subsidy bonds; Deferral of income from post 1987 installment sales; Discharge of mortgage indebtedness; and the Credit for first-time homebuyer.

⁷ Funding amounts from Office of Management and Budget, [Estimate of Total Income Tax Expenditures for Fiscal Years 2013-2019](#), 2014.

⁸ OECD, [Housing and the Economy: Policies for Renovation](#), 2011.

⁹ For more information on the economics and politics of the net imputed rental income, see: Bruce Bartlett, [Taxing Homeowners as if They Were Landlords](#), September 2013.

¹⁰ Author's calculations based on [IRS Statistics of Income](#), 2008-2011.

¹¹ Jane Gravelle & Pamela Jackson, [The Exclusion of Capital Gains for Owner-Occupied Housing](#), December 2007.

¹² Author's calculations based on [IRS Statistics of Income](#), 2008-2011.

¹³ Note that the Alternative Minimum Tax reduces the value of the real estate tax deduction for some homeowners. For more information, see Tax Policy Center, [State and Local Tax Policy: How does the deduction for state and local taxes work?](#), April 2008.

¹⁴ Robert Rector, [Examining the Means-tested Welfare State: 79 Programs and \\$927 Billion in Annual Spending](#), May 2012.

¹⁵ Note that Rector provided FY2011 budget levels. For this paper, the author updated the budget levels for the same programs to FY2013.

¹⁶ For a more in-depth discussion of how the federal government supports more rental and homeownership, see Adam Carasso et al., [How to Better Encourage Homeownership](#), June 2005.

¹⁷ Funding amounts from Office of Management and Budget, [Estimate of Total Income Tax Expenditures for Fiscal Years 2013-2019](#), 2014.

¹⁸ Author's calculations based on [IRS Statistics of Income](#), 2008-2011.

¹⁹ See Karen Dynan et al., [An Evaluation of Federal and State Homebuyer Tax Incentives](#), June 2013; and Douglas Rice and Robert Greenstein, [Proposed Expansions of Homebuyer Tax Credit Would Be Highly Inefficient and Squander Federal Resources](#), October 2013.

²⁰ Author's calculations based on [IRS Statistics of Income](#), 2008-2011.

²¹ Author's calculations based on [IRS Statistics of Income](#), 2011.

²² U.S. Census, [Median and Average Sales Price of Houses Sold by Region](#), 2014.

²³ Mark P. Keightley, [The Mortgage Interest and Property Tax Deductions: Analysis and Options](#), March 2014.

²⁴ Zillow, [What Are Closing Costs and How Much Are They Typically?](#), 2014.

²⁵ Robert Dietz, [Testimony of Dr. Robert Dietz On Behalf of the National Association of Home Builders Before the United States Senate Committee on Finance](#), October 2011.

²⁶ Dennis Ventry, Jr., [The Accidental Deduction: A History and Critique of the Tax Subsidy for Mortgage Interest](#), 2009.

²⁷ Ibid.

²⁸ The President's Advisory Panel on Federal Tax Reform, [Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System](#), November 2005.

²⁹ Bipartisan Policy Center, [Restoring America's Future](#), November 2010.

³⁰ The National Commission on Financial Responsibility and Reform, [The Moment of Truth](#), December 2010.

³¹ Tom Coburn, [Back in Black](#), July 2011.

³² Alan Viard, [Proposal 8: Replacing the Home Mortgage Interest Deduction](#), February 2013.

³³ Committee on Ways and Means, [Tax Reform Act of 2014](#), 2014.

³⁴ Dean Baker, [First Time Underwater The Impact of the First-time Homebuyer Tax Credit](#), April 2012.

³⁵ For further discussion of this type of proposal, see William Gale et al., [Encouraging Homeownership through the Tax Code](#), June 2007; and Benjamin Harris, [New Perspectives on Homeownership Tax Incentives](#), December 2013.

³⁶ For further discussion of this type of proposal, see William Gale et al., [Encouraging Homeownership through the Tax Code](#), June 2007.

³⁷ See Will Fischer and Chye-Ching Huang, [Mortgage Interest Deduction Is Ripe for Reform Conversion to Tax Credit Could Raise Revenue and Make Subsidy More Effective and Fairer](#), June 2013; and Adam Carasso et al., [Making Tax Incentives for Homeownership More Equitable and Efficient](#), June 2005.

³⁸ Amanda Eng, [Updated Options to Reform the Deduction for Home Mortgage Interest](#), May 2014.

³⁹ Benjamin Harris, [New Perspectives on Homeownership Tax Incentives](#), December 2013.

⁴⁰ Adam Carasso et al., [Making Tax Incentives for Homeownership More Equitable and Efficient](#), June 2005.

⁴¹ Sara Murray, [Romney Specifies Deductions He'd Cut](#), April 2012.

Upside Down: Tax Programs to Boost Savings Through Investments and Inheritances

Federal tax policy is crucial for helping families develop savings

Savings is the bedrock of financial stability. We know that nearly all families experience fluctuations in income from year to year, and low- and moderate-income families are more likely to experience significant income interruptions. One in three of these families see their income drop 50% or more over the course of a year,¹ and there's evidence that income volatility is growing.² A family with "liquid" savings in an accessible account is in a better position to absorb the impact of these income fluctuations.³ But nearly half of Americans are "liquid asset poor," meaning they lack even a modest amount of savings to tap into in the case of an emergency.⁴

Creating a personal source of savings is different than saving for a long-term asset. Using long-term savings as liquid savings has consequences. Unauthorized withdrawals from retirement or education savings accounts often come with significant penalties. Likewise, the forced savings of a home mortgage is a poor option, as home equity is often difficult to access in the short-term. In the case of an emergency, households without savings have to rely on the kindness of family or friends, or the harsh terms of pawn shops, predatory lenders, and debt collectors.

There are two ways a family can build their own liquid savings: save and invest their income in accessible accounts or receive the savings and investments of someone else as a gift or inheritance. The federal government is an active participant when it comes to these strategies. In 2013 alone, the federal government spent more than \$170 billion on tax programs (also known as "tax expenditures") to boost the size of investments and inheritances.

The problem with these tax programs is that they almost entirely benefit the highest-income households. Rather than helping low- and moderate-income families build savings, these government programs divert billions of dollars to grow the wealth of the already-wealthy.

This is Upside Down.

If we want low- and moderate-income families to build liquid savings, we should provide them with the same level of support that we provide to those at the top of the income distribution. Of course no realistic policy will guarantee every American thousands of dollars of investment income or a multi-million dollar inheritance. But federal policy can guarantee savings opportunities for every child born in the country, and it can ensure that all families have the support they need to save, invest, and build wealth. These types of reforms need not require new federal spending. Congress can expand financial security and economic opportunity for millions of Americans simply by turning existing tax programs right-side up.

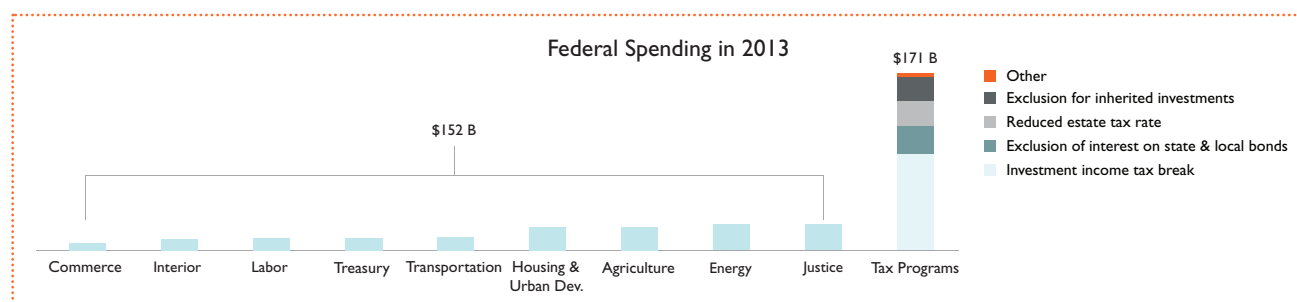
The remainder of the paper is organized as follows:

1. Size of investment and inheritance tax programs
2. Distribution of these tax programs
3. The three reasons these tax programs are upside down
4. Federal policy reforms to turn the tax programs right-side up

I The multi-billion dollar federal tax boost for investments and inheritances

22 Federal tax programs devote billions to help Americans build wealth. The combined cost of tax programs for investments and inheritances was over \$170 billion in 2013. This spending is more than the discretionary budgets of nine U.S. cabinet-level agencies *combined*. From 2013 to 2019, spending on these programs is scheduled to grow by more than a third, with spending over these years totaling more than \$1.25 trillion.⁵ Identifying tax programs that boost savings is a subjective process, and this analysis takes a conservative approach. In other words, if anything, this analysis actually *understates* the total cost of these types of tax programs.⁶

Federal spending on investment & inheritance tax programs outweighs the combined discretionary budgets of 9 cabinet-level agencies



Author's calculations based on data from the [Office of Management and Budget](#) (2014). Compiled by [National Priorities Project](#). "Other Tax Programs" include carryover basis of capital gains on gifts and deferral of interest on U.S. savings bonds.

In 2013, the largest investment and inheritance tax programs were:⁷

\$92.5 billion – Investment income tax break. Also known as the “preferential tax treatment of capital gains and dividends.” When an investor buys a stock and later sells it for more than the purchase price, they’ve made income from a “capital gain.” Similarly, stocks sometimes issue a cash “dividend” to stockholders based on the number of shares they own. Both capital gains and dividends are types of investment income, which can be distinguished from “earned” income received through salary or wages.

When the federal income tax was originally enacted, investment income and earned income were treated the same. Today, earned income is taxed at a rate between 10% and 39.6%. But income from capital gains now gets preferential treatment, with a top tax rate of only 20%, roughly half the top tax rate for earned income.⁸ This reduced tax rate on capital gains cost the federal government \$68.9 billion in foregone revenue in 2013. Before 2003, dividends were taxed at the same rate as earned income, but today dividends receive the same preferential treatment as capital gains, at a cost of \$23.7 billion to the federal government in 2013.⁹

The investment income tax break includes an oft-criticized provision for investment fund managers called the “carried interest rule.”¹⁰ This provision enables highly-paid executives to treat what is essentially labor income as investment income, allowing them to avoid taxes through the tax break on investment income. The Congressional Budget Office has estimated that eliminating this provision would save the federal government about \$1.2 billion in 2014.¹¹ This is a significant sum to be sure, but only a small portion of the \$92.5 billion tax break for all types of investment income.

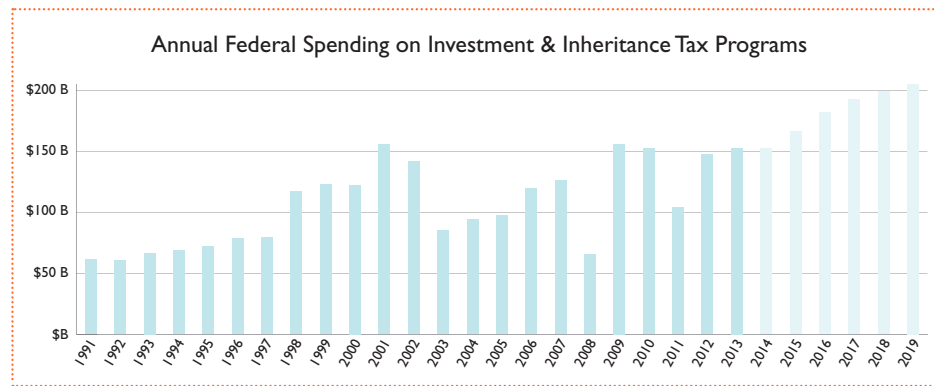
\$28.4 billion – Exclusion of interest on state and local bonds. Almost all state and local governments issue debt in the form of bonds to pay for investments, such as road construction, municipal buildings, hospitals, schools, and sewage treatment facilities. This tax program makes these bonds tax-exempt, meaning that the interest earned is tax free. In contrast, an investor who purchases a corporate bond does have to pay tax on the interest from those bonds. As the size of this tax program indicates, these state and local bonds are very popular with investors, and the tax benefit they receive accounts for the high price tag of the program.

\$23.1 billion – Exclusion for inherited investments. Often called the “Step-Up Basis at Death,” this program reduces taxes on inherited investments. As an example, imagine that Mary’s grandfather buys \$1,000 worth of stock in 2004. The \$1,000 purchase price is known as the “basis.” In his will, he leaves Mary the stock, which has now increased in value to \$2,500. Had Mary’s grandfather been able to sell the stock then, he would have owed tax on the \$1,500 increase in stock value. This \$1,500 increase in value over the \$1,000 basis is his “capital gain.” But when Mary inherits the stock, the basis is “stepped up” to \$2,500, the stock value at the time of inheritance. This means that Mary can sell the stock when she inherits it without reporting any capital gain at all. Her capital gain is the new basis (\$2,500) minus the sale price (\$2,500)—which is zero. By avoiding \$1,500 in capital gains altogether through the exclusion for inherited investments, Mary gets to sidestep hundreds of dollars in taxes.

\$23.5 billion – Reduced estate tax rate. Unlike the other items on this list, the reduced tax rate on estates is not a traditional tax program (or “income tax expenditure”) because it does not apply to income. The estate tax is levied on high-value estates, rather than on income. But like the exclusion for inherited investments, this reduced tax rate directly benefits inheritors of wealth at significant expense to the federal government.¹² The majority of this transferred wealth is in liquid form—cash, bonds, and stocks.¹³

We include this in the list because estate and gift taxes have been cut dramatically in recent years, far out of line with the history of the estate tax. For 2014, estates can exclude the first \$5.34 million in taxable value (\$10.68 million for couples). The taxable value is the total value of the estate minus deductions, such as costs of administering the estate and the cost of debt. Any taxable value over the \$5.34 million exemption is taxed at a 40% rate. The cited \$23.5 billion figure represents the reduction in federal revenue for 2013 that occurred as a result of the most recent cut to estate tax,¹⁴ which increased the exclusion amount and reduced the tax rate.¹⁵

Federal spending on investment and inheritance tax programs is projected to expand rapidly and will set a new record in 2015



Author's calculations based on Office of Management and Budget data for fiscal years 2001 through 2019; data compiled by [National Priorities Project](#). All values in constant 2015 dollars. 2014-2019 is projected spending. Tax expenditures include: investment income tax break (on capital gains and dividends), exclusion of interest on state and local bonds, exclusion for inherited investment ("Step-Up Basis at Death"), and deferrals for investment gifts ("carryover basis of capital gains on gifts") and interest on U.S. Savings Bonds. Note that this does not include forgone revenue from reduced estate tax rates.

\$3.9 billion – Other investment tax programs. The above programs account for more than 95% of all federal dollars spent on investment and inheritance tax programs. Two relatively small programs that allow investors to defer tax payments on their investment income account for the remainder:

- **\$2.9 billion – Deferral for investment gifts.** Also known as the "carryover basis of capital gains on gifts." The tax code treats gifts of investments differently than bequeaths of investments. In short, this is similar to (but much smaller than) the inherited investment exclusion described above. Instead of the stock being inherited, it's a gift. And instead of the capital gain being excluded, it's just deferred.

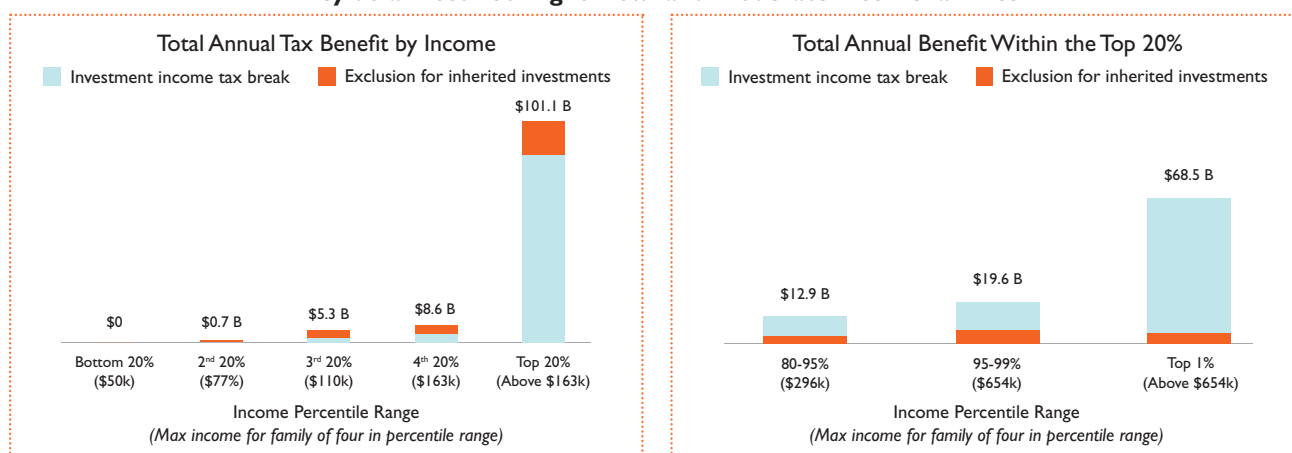
Let's return the earlier scenario of Mary, except now her grandfather is alive and well. Instead of bequeathing stock to Mary, he simply gives her the stock that he originally bought for \$1,000. Without the deferral for investment gifts, Mary would be expected to pay tax on the total capital gain up to that point, \$1,500 (the \$2,500 current value minus the \$1,000 initial cost to her grandfather). This program allows her to defer paying any taxes as long as she holds the stock. For instance, if she sells the stocks several years later for \$4,000, she will have a capital gain of \$3,000 (the \$4,000 sale price minus the \$1,000 initial cost). By deferring tax payments on the inheritance, Mary deprives the federal government of this revenue.

- **\$1.0 billion – Deferral of interest on U.S. savings bonds.** When a taxpayer buys a U.S. savings bond, she earns interest on the bond every month. For instance, given the current interest rate of 0.5%, \$1,000 in EE Bonds will earn \$5 in interest over the course of a year. Bondholders have the option of paying income tax on this \$5 dollars when they receive it, or they can defer payment until they cash in the bond (often decades later). As with the deferral of investment gifts, the deferral of taxes on interest cost the federal government over a billion dollars in 2013.

2 Investment & inheritance programs focus support on high-income households

Tax programs for investments and inheritances are even more upside down than other asset-building tax programs. They are more lopsided than higher education tax programs, homeownership tax programs, or retirement tax programs. The following analysis uses data from the Congressional Budget Office, the Tax Policy Center, and the Internal Revenue Service to illustrate exactly how much the tax programs concentrate benefits on the top-income households.

Investment and inheritances tax programs give most support to the top 1% They do almost nothing for low- and moderate-income families



Author's calculations based on data from [Congressional Budget Office](#) (2013).

The more income you have, the bigger the boost for investments and inheritances. It is difficult to overstate the extent to which tax programs for investment and inheritances really are upside down. The Congressional Budget Office examined which households receive benefits from the reduced tax rate on investment income (capital gains and dividends) as well as the tax break on inherited investments (the “step-up basis”). Combined, these tax programs cost the federal government \$119 billion in 2013, which amounts to a majority of total spending on investment and inheritance tax programs.

The data reveals a set of programs that are extremely tilted towards boosting the wealth of the already-wealthy. The bottom 40% of households receive less than 1% of the total benefits divvied out in 2013. Not only do the top 1% of households receive more than all other households in the top 20%, this top percentile of households receives more than the entire bottom 99% *combined*.

The investment income tax break targets high-income workers more than the Earned Income Tax Credit (EITC) targets low-income workers. Policy analysts on all sides of the political spectrum agree that the EITC is focused on low- and moderate-income workers.¹⁶ Few would disagree with the recent New York Times article that referred to the EITC as an “antipoverty tax program.”¹⁷

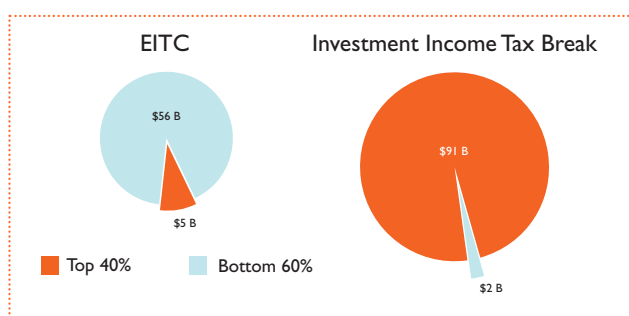
With this in mind, consider how the support from the investment income tax break is distributed between low- and high-income households.

The CBO data allows us to ask the question: how much support did the EITC and the tax break for investment income direct to low- and moderate-income households (those in the bottom 60%). And how much did these programs direct to upper-income households (those in the top 40%)?

In short, the investment income tax break does a better job of focusing support on upper-income households than the EITC does of focusing support on low- and moderate-income households. For the EITC, the bottom 60% of households receives 91% of the program’s benefits. This makes sense—an antipoverty program *should* focus support on the bottom 60% of households. By comparison though, the investment income tax break directs 98% of its benefits to upper-income households. Only 2% goes to low- and moderate-income households.

Federal spending on the investment income tax break in 2013 cost about 50% more than the EITC that year—\$93 billion versus \$61 billion. This means that the upper-income households receive significantly more from the investment tax break than low- and moderate-income households receive from the EITC. In fact, the top 1% of households received more from the investment income tax break than the entirety of federal spending on the EITC.

The investment income tax break targets high-income households more than the EITC targets low-income households

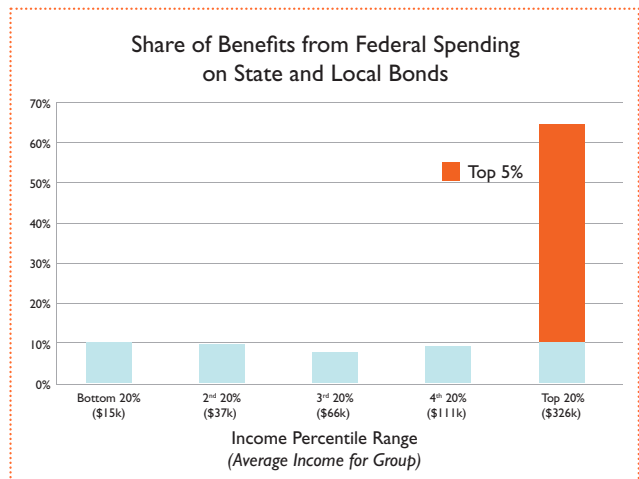


Author's calculations based on data from [Congressional Budget Office](#) (2013).

Given this data, it's reasonable to ask whether the New York Times and others should start referring to the investment income tax break as the "unearned income tax break" or a "pro-inequality tax program." These descriptions would be just as accurate as referring to the EITC an "antipoverty tax program."

Federal spending on tax-exempt bonds is also upside down. It's not only the investment tax break and reduced rate on inherited investments that are upside down. A Tax Policy Center analysis paints a similar picture of the federal spending on state and local bonds, which cost \$28.4 billion in 2013.¹⁸ In theory, these bonds help state and local governments pay for needed investments for their citizens. In practice, the federal spending on these bonds gives high-income investors an enormous tax break that far outweighs any benefit for the low- and moderate-income households in these cities and states. The Tax Policy Center analyzed several scenarios, and under the one that is least-friendly to high-income households, the top 5% of households receive more than half of the total benefit from this tax program. Under another analysis, those in the top 0.1%—with incomes of about \$10 million or more—received an average benefit of more than \$32,000 from this program. Other analyses have revealed a similarly upside down program.¹⁹ In short, these tax-exempt bonds can best be described as a taxpayer-backed investment for the top-income households.

Most benefits from federal spending on state and local bonds go to the highest-income households



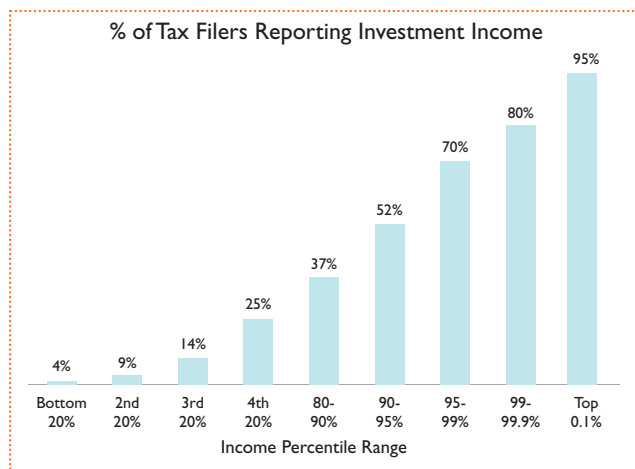
Author's calculations based on data from [Tax Policy Center](#) (2013).

3 The three reasons investment and inheritance tax programs are upside down

Flawed tax programs produce inequitable benefits. As the data above illustrates, the tax programs for investments and inheritances mainly serve to help the wealthy build more wealth. But the mere fact that these benefits flow through tax programs is not the problem. As the EITC demonstrates, it is quite possible to structure a tax program to benefit low- and moderate-income households. There are four reasons why the existing investment and inheritance tax programs fail to support low- and moderate-income households.

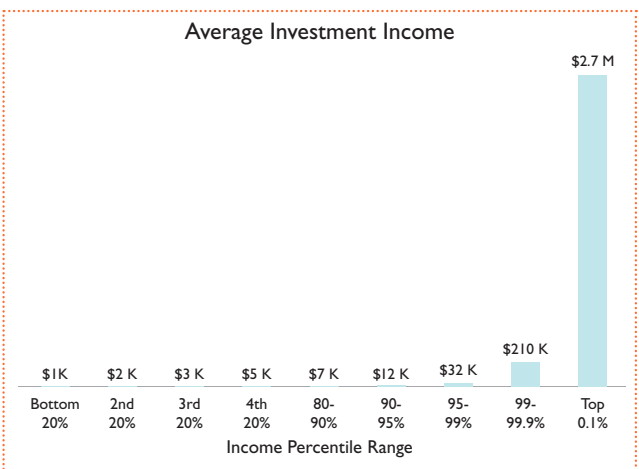
1. **High-income households are much more likely to have significant income from investments and large estates.** The tax breaks for investment income only go to those who have investment income, and this mostly means high-income households. Fewer than one in ten households in the bottom 60% reported any investment income from capital gains or dividends. By comparison, 95% of the taxpayers in the top 0.1% reported investment income.²⁰

Most households don't have any investment income at all

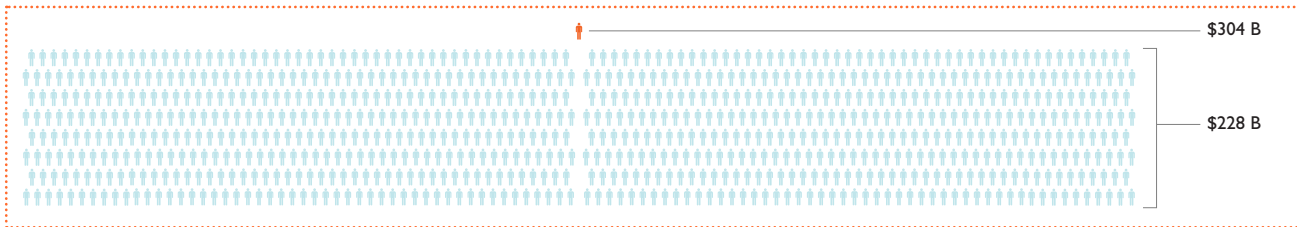


Author's calculations based on data from the [Tax Policy Center](#) (2013).

The top households earn an enormous amount of investment income



The top 0.1% get more income from capital gains and dividends than the bottom 99% combined



Author's calculations based on data from the [Tax Policy Center](#) (2013).

It's not just that high-income households are more likely to have investment income. The investment income they do have is usually much greater than the investment income of low- and moderate-income households. In 2013, the average investment income for someone in the top 0.1% was \$2.7 million. By comparison, households in the bottom 90% had average investment income of less than \$5,000.

For very high-income households, investments are a more important source of income than all sources of earned compensation, including wages, salaries, and employer-sponsored benefits. Among the top 0.1% of households, more than a third of their income comes from investments. By comparison, the bottom 80% of households depends on investments for less than 4% of their income.²¹

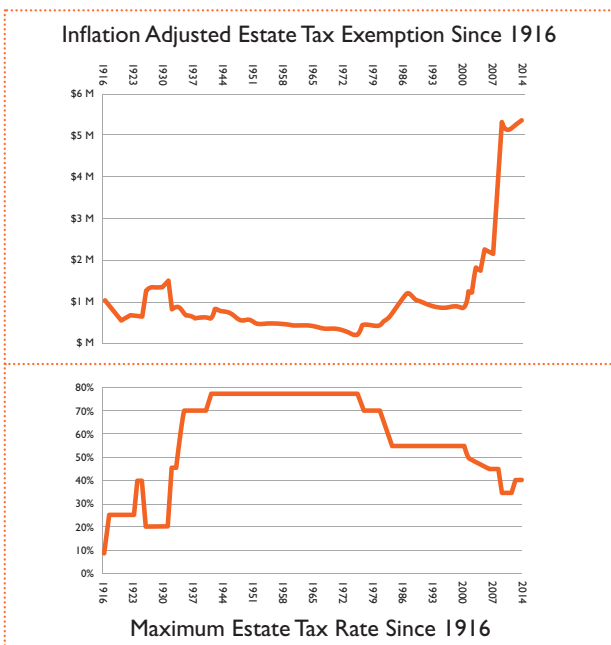
The higher rate of investment income and the higher average size of investment income combine to produce a shocking inequity in *who* receives investment income. The bottom 60% of taxpayers claimed less than 3% of all investment income in 2013. The top 0.1% of taxpayers, received more income from investments than the entire bottom 99% combined.

A similar, though somewhat less extreme story emerges for estates. In 2011, the top 1% of taxpayers accounted for roughly half of all estates that were large enough to be taxable. The highest-income 10% of taxpayers accounted for more than 9 in 10 of these estates.²² Unsurprisingly, higher-income households also have the largest estates. The average size of a taxable estate for someone in the top 0.1% of income was more than 7 times as large as someone even in the 90-95% range, and larger still than the earners below 90th percentile of earners. There is a significant racial element to the estate tax as well: whites are more likely to inherit than blacks; and white's inheritances are much larger than black inheritances.²³

2. **Taxation of estates is at historic lows.** There are three features that affect how an estate gets taxed: the deductions, the exemption, and the tax rate.²⁴ Policy changes in recent years have made the exemption and tax rate more generous to large estates than at any time since the since the 1930s.²⁵

- **Estate tax deduction.** Estates are rarely if ever taxed on their full value. Instead, deductions reduce the total amount that can be taxed. For instance, any value left to a spouse can be deducted, as can donations to charities, the cost of mortgages and debt, and the estate's administrative costs.
- **Estate tax exemption.** As long as the estate tax has existed, the federal government has allowed for an estate tax exemption. For instance, if the estate was worth \$1.5 million (after deductions), and the exemption is \$1 million, only \$500,000 would be taxable. Between 1916 and 2001, the exemption was almost always below \$1 million (in inflation-adjusted dollars). The median exemption over this period was about \$666,000. But starting in 2002, Congress began to increase the exemption significantly. For 2014, the exemption is \$5.34 million, about 8 times the median exemption for the first 85 years of the estate tax.

The estate tax has been eviscerated in recent years and is far out of line with historical standards



Author's calculations based [Tax Foundation](#) (2014) data. Exemption inflation adjusted to 2013 dollars.

This \$5.34 million exemption is enormous compared to the size of an average estate. The median inheritance in 2007 was just under \$74,000.²⁶ Low-wealth and low-income households, unsurprisingly, tend to receive much less. But even the very highest-income and highest-wealth households don't often inherit millions. The median inheritance of someone in the wealthiest top 1% was \$872,000. This is a significant sum, but it's significantly less than the existing \$5.34 million exclusion on estates.

- **Estate tax rate.** Taxes are only applied to estates after the value of the estate is reduced through deductions, and then only after a large portion of the estate is exempted. This is where the estate tax rate comes in. Between 1916 and 2001, the estate tax rate was almost always above 60%, and the median tax rate was actually 70%. But as the size of the exemption began growing in 2002, the estate tax rate began shrinking. In 2014, the tax rate was 40%, which is lower than at any point in history since 1931 (save for a two-year span from 2011-2012).²⁷

Consider the combined effect of these features. Suppose an estate is worth \$20 million. \$10 million is left to a surviving spouse; \$3 million is divided to charities; \$1 million pays off debt; and \$700,000 goes to accountants and lawyers who administer the estate. After those deductions, \$5.3 million in "taxable" value is left from the \$20 million estate. Because this amount is less than the \$5.34 million exemption, the estate is not taxable.

This example is typical in today's policy environment. As a result of recent policy changes, the number of taxable estates dropped by more than 90%—down to about 3,600 estates from 43,500 estates.²⁸ In 2012, estates worth more than \$10 million were more likely than not to be tax-free.²⁹ In other words, estates worth tens of millions of dollars often paid no tax at all.

3. **Significant tax loopholes allow high-income earners to shelter transferred wealth and earned income from taxes.** Several of the tax programs for investments and inheritances combine to create significant and costly tax loopholes.

Consider the exclusion for inheritances and the enlarged estate tax exclusion. The combined effect of these programs is that a large amount of investment income is never taxed at all. Imagine that granddad George bought \$500,000 of stock, and it increased in value to \$5 million. If granddad George sells the stock, he'll owe tax on the investment income—\$4.5 million. But let's imagine that granddad George instead bequeaths the stock his son, Sonny. Because of the value of the estate (\$5 million) is less than \$5.34 million, no estate tax is owed. And because of the exclusion for inheritances ("stepped-up basis"), the son doesn't have to pay any tax on the inheritance either. As result of these two programs in the tax code, \$4.5 million in investment income avoids taxes altogether.³⁰

The loopholes for investment income and inheritances stretch far beyond estates in the mere multi-million dollar range. Forbes Magazine reported that three Facebook executive billionaires exploited loopholes in the estate tax to shelter as much as \$200 million of transferred wealth from all taxes.³¹

It is because of these loopholes, and the large exclusion and deductions allowed to the estate tax, that some have argued that the estate tax is a "voluntary" tax.³² Only those who choose to *not* exploit the large loopholes pay any tax at all.

4 Federal reforms to turn investment and inheritance tax programs right-side up

Expand economic opportunity by reforming upside-down tax programs. Several bipartisan tax and debt commissions have recommended reforms of varying size and scope to investment and inheritance tax programs.³³ No doubt some portion of the federal tax dollars saved by addressing these issues will go towards reducing income and corporate tax rates, but this should not be the only result from reforming these programs. Government *should* help families build wealth, but it should stop focusing that support almost exclusively on the highest-income families. The reforms discussed below would help turn the investment and inheritance tax programs right-side up so that all Americans can build savings and wealth.

Establish a regenerating economic opportunity fund to help children start building wealth early. Currently, revenue from estate and inheritance taxes go into the federal government's general revenue fund to pay for all types of expenses—health care, war planes, prisons, and every other part of the federal budget. Reforming the existing estate and inheritance tax programs provides the chance to create a guaranteed-source of funding for expanding economic opportunity. Such a system would be built on the principle of creating a link between successive generations—a portion of the wealth of one generation would go directly towards investing in economic opportunity for the next generation.

This type of proposal has precedent, and has been suggested, for instance, as a strategy for funding early childhood programs in America.³⁴ There are several ways to structure the economic opportunity fund, and one laudable goal would be to provide a Children’s Savings Account to every one of the four million children born in America every year. While Children’s Savings Accounts are often restricted-use accounts for education or other long-term assets, several proposals would provide flexible accounts for use once children reach adulthood.³⁵

Reforms to two existing tax programs could provide the annual funding for the economic opportunity fund, using a modest tax on large estates and inheritances to ensure that all children are able to save, invest, and build wealth:

- **Eliminate the exclusion for inherited investments:** This tax program (also known as the “step-up basis”) allows inheritors of large sums of wealth to avoid all taxes. It amounts to a multi-billion dollar tax subsidy for high-income households to grow their wealth. Two recent bipartisan commissions, the Bowles-Simpson debt commission and the Domenici-Rivlin Debt Reduction Task Force, recommended repealing the program.³⁶
- **Reform the estate tax to bring it in line with historical standards:** Throughout the 20th Century, the estate tax had a median exclusion of about \$666,000 and maximum tax rate of about 70%. It is only in the past few years that Congress eviscerated the estate tax, and estate tax revenues have plummeted.³⁷ Returning the estate tax to a \$1 million exemption and a 55% tax rate (both conservative parameters by historical standards) would raise tens of billions of dollars annually that could greatly expand wealth-building opportunities for all working families and their children.

Opponents of the estate tax often argue that it raises relatively little revenue.³⁸ But while it is true that ending these tax breaks for the highest-income households won’t change the American fiscal policy landscape, such a reform could fund a significant investment in economic opportunity. Reforming these tax programs would raise tens of billions of dollars on an annual basis—more than enough to create universal Children’s Savings Accounts, widespread financial education, and a flurry of pilots programs to test other evidence-based policies for expanding financial security for millions of Americans.

Reform the EITC to support wealth-building for low- and moderate-income workers. The EITC was not created to directly support wealth-building, but because of its structure, this is often what it does. Workers become eligible for an EITC wage boost for every hour they work, but they cannot access that wage boost until they file their taxes after the end of the year. As many researchers have pointed out, the EITC effectively forces low-income workers to use the U.S. Treasury as a safe but zero-interest savings account to build up savings once per year.³⁹

Counterintuitively, for most EITC recipients this forced savings is a valued feature of the program, not a bug. Several scholarly studies and anecdotes from the field reveal that the vast majority of EITC recipients *prefer* the forced savings mechanism of the EITC to an alternative monthly wage boost.⁴⁰ For low-income families who are unbanked, a zero-interest “savings account” with Treasury Department may be the best option they have. In fact, in addition to the EITC, many low-income workers routinely increase the amount of withholdings from their paycheck in order to boost their eventual lump-sum tax refund check.⁴¹

But while the EITC is often used as a makeshift savings tool, it was not built to function as one. Congress needs to make reforms to ensure that low- and moderate-income households are able to build savings. Two laudable reforms—one an expansion of the EITC, and another the creation of a new type of credit—would accomplish this goal.

- **Create a Financial Security Credit.** This proposal is inspired by the work of SaveUSA, a pilot program that has been implemented in the last few years in New York City and other communities. The SaveUSA program incentivizes EITC-eligible workers to save a portion of their EITC refund for several months. Critically, the program also provides tax assistance to participants through Volunteer Income Tax Assistance (VITA), a federally-supported program which ensures that low- and moderate-income workers have support to file their taxes.

Rigorous evaluation of SaveUSA has found that low- and moderate-income workers do indeed save in accessible accounts through the program.⁴² The Financial Security Credit legislation would cost \$4 billion a year—less than 5% of the cost of the tax break for investment income.⁴³

- **Create Savings and Emergency Fund (SAEF) Accounts as an add-on to the EITC.** A law professor at Duke University crafted this proposal based on in-depth interviews with nearly 200 EITC recipients.⁴⁴ For this program, 20% of the existing EITC (or an additional amount paid for by the reforms above), would be deposited automatically into an interest-bearing savings account held by the IRS. Workers could choose to withhold additional amounts and would

receive a match for doing so. Access to the funds would be provided with a fee-free debit card, presented as an “emergency” card. To discourage non-emergency use of the card, additional savings matches would be available annually based on the amount of savings left in the SAEF account at the end of each year.

This program would ensure that low- and moderate-income workers do not simply receive a lump sum at tax time through the EITC, but are actually supported in building a source of safe, accessible savings. A 20% increase in the EITC would cost around \$12 billion annually, which amounts to slightly less than one eighth of the cost of the tax break for investment income.

Either of these programs could be paid for by taxing investment income at the same rate as earned income. The tax break for dividend income alone cost nearly \$24 billion in 2013. This is double the cost of the most expensive version of the proposed reforms above.

Proponents of the investment tax break often say that taxes on investment income are “double taxation,” but objective analysts agree that this argument applies to labor income as well.⁴⁵ Supporters of the tax break also argue that taxing investment income leads to lower rates of saving and economic growth, but empirical evidence does not bear this out.⁴⁶ In short, the federal government currently spends nearly \$100 billion every year on a program that theoretically helps the economy, but in practice can only be proven to help the highest-income households in the country.

There are several options for reigning in this spending either in whole or in part, and such a reform would have historical precedent.⁴⁷ When the income tax was first created, it taxed earned income and investment income equally. President Reagan’s landmark tax reform in 1986 returned to this precedent of taxing investment and earned income equally. And the tax break for dividend income was only created in 2003.

Taxing investment income at the same rate as earned income will not by itself help low- and moderate-income families build savings and wealth. But the revenue raised from this reform could go toward financing a significant investment in wealth-building opportunities for all Americans.

Conclusion

“Liquid” savings is a crucial component of financial security. Nearly all families—and especially low- and moderate-income families—experience sudden declines in income. Parents lose their jobs, children get sick, cars break down—life events interrupt income. Savings help families avoid the material hardship that often follows these economic shocks.

Families build savings in two ways, by saving and investing their own money, or by receiving the savings and investments of others through gifts and bequests. The federal government actively boosts these investments and inheritances through tax programs that cost more than \$170 billion in 2013 alone. The problem with these programs is that they increase the wealth of high-income families while providing little or no support to low- and moderate-income families. *This is Upside Down.*

If we want low- and moderate-income families to develop their own liquid savings, we should ensure that all families receive support from these tax programs. We can’t guarantee that every American will earn a livable income from investments or inherit millions of dollars from relatives. But we can ensure that every child born in America has a fair shot at developing savings and building wealth at an early age. Making this type of commitment to American children and families does not require any new commitment of federal funds. Congress can expand wealth-building opportunities without spending an additional dime simply by turning our existing tax programs right-side up.

¹ 41.5% of workers in the bottom 20% of earners, and 19% of workers in the 20-40% range of earners experienced a loss of earnings of 50% or more between 2002 and 2003. See Congressional Budget Office, [Recent Trends in the Variability of Individual Earnings and Household Income](#), June 2008.

² Jacob S. Hacker, [Universal Insurance: Enhancing Economic Security to Promote Opportunity](#), September 2006.

³ Leah Gjerston, [Emergency Saving and Household Hardship](#), May 2014; and Gregory Mills and Joe Amick, [Can Savings Help Overcome Income Instability?](#), 2010.

⁴ Jennifer Brooks et al., [Treading Water in the Deep End](#), 2014.

⁵ Author’s calculations based on Office of Management and Budget data for fiscal years 2004 through 2019. Tax expenditures include the following: deductibility of mortgage interest on owner-occupied homes; deductibility of State and local property tax on owner-occupied homes; exclusion of capital gains on home sales; exclusion of interest on owner-occupied mortgage subsidy bonds; deferral of income from post 1987 installment sales; discharge of mortgage indebtedness; and the credit for first-time homebuyer. Note that these estimates exclude the forgone revenue from reduced estate taxes (\$23.5 billion in 2013) and so somewhat underestimate the total cost.

- ⁶ In particular, this analysis does not include the tax program supporting life insurance “inside buildup,” which some convincingly argue subsidize similar types of savings at a cost to the federal government of \$18.9 billion in 2013. For an overview of this tax program, see Seth Hanlon & Jordan Eizenga, [Tax Expenditure of the Week: Tax-Free “Inside Buildup” of Life Insurance](#), March 2011.
- ⁷ Funding amounts from Office of Management and Budget, [Estimate of Total Income Tax Expenditures for Fiscal Years 2013-2019](#), 2014.
- ⁸ Note that capital gains are taxed at different rates depending on if the investment has been held for a less than a year (a “short-term capital gain”) or more than a year (a “long-term capital gain”).
- ⁹ For a discussion of these tax cuts, including treatment of qualified dividends, see Greg Leiserson and Jeffrey Rohaly, [Distribution of the 2001-2006 Tax Cuts: Updated Projects, July 2008](#), July 2008.
- ¹⁰ For a readable explanation of the details behind the carried interest rule, see Lily Batchelder & Steve Rosenthal, [Business Taxation: What is carried interest and how should it be taxed?](#), February 2013.
- ¹¹ Congressional Budget Office, [Options for Reducing the Deficit: 2014 to 2023](#), November 2013.
- ¹² For an overview of estate tax policy, see Chye-Ching Huang and Nathaniel Frentz, [Myths and Realities About the Estate Tax](#), August 2013.
- ¹³ See Internal Revenue Service, [Estate Tax Statistics](#), 2012; and Internal Revenue Service, [Estate Tax Returns Filed for Wealthy Decedents, 2003–2012](#), 2014.
- ¹⁴ According to the Tax Policy Center, these tax cuts reduced 2013 estate tax revenue from by \$23.5 billion (from \$37.7 billion to \$14.2 billion). See Tax Policy Center, [Estate Tax Returns and Liability Under Current Law and Various Reform Proposals, 2011-2022](#), January 2013.
- ¹⁵ For the sake of simplicity, I include this estate tax break in among the group of “tax programs” referenced throughout the remainder of the paper.
- ¹⁶ The progressive Center on Budget and Policy Priorities describes the EITC as a “federal tax credit for low- and moderate-income working people.” See Center on Budget and Policy Priorities, [Policy Basics: The Earned Income Tax Credit](#), January 2014. The centrist Tax Policy Center writes that the program “subsidizes low-income working families.” See Tax Policy Center, [Taxation and the Family: What is the Earned Income Tax Credit?](#), 2014. The conservative American Enterprise Institute calls it a “federal income-transfer program — structured as a refundable tax credit — for working-class families,” and lauds its effectiveness at lifting families and children out of poverty. See Michael R. Strain, [More than the minimum wage](#), December 2013.
- ¹⁷ Sabrina Tavernise, [Antipoverty Tax Program Offers Relief, Though Often Temporary](#), April 2012.
- ¹⁸ Harvey Galper et al., [Who Benefits from Tax-Exempt Bonds? An Application of the Theory of Tax Incidence](#), September 2013.
- ¹⁹ Robert S. McIntyre, [The Hidden Entitlements](#), May 1996.
- ²⁰ Calculations based on data from the [IRS 2012 Statistics of Income](#), 2014.
- ²¹ Calculations based on data from the Tax Policy Center, [Measuring Income for Distributional Analysis](#), June 2013.
- ²² Jeffrey Rohaly & Katherine Lim, [Wealth Transfer Taxes: Who pays the estate tax?](#), June 2011.
- ²³ See Thomas Shapiro et al., [The Roots of the Widening Racial Wealth Gap: Explaining the Black-White Economic Divide](#), February 2013; and Hannah Thomas et al., [The Web of Wealth: Resiliency and Opportunity or Driver of Inequality?](#), July 2014.
- ²⁴ For a concise summary of how the estate, gift, and generation-skipping tax work, see Jeffrey Rohaly, [Wealth Transfer Taxes: How do the estate, gift, and generation-skipping transfer taxes work?](#), June 2011.
- ²⁵ For a history of estate tax exemptions and estate tax rates since 1916, see Tax Foundation, [Federal Estate and Gift Tax Rates, Exemptions, and Exclusions, 1916-2014](#), February 2014.
- ²⁶ Edward N. Wolff & Maury Gittleman, [Inheritances and the Distribution of Wealth: Or Whatever Happened to the Great Inheritance Boom?](#), January 2011.
- ²⁷ Tax Foundation, [Federal Estate and Gift Tax Rates, Exemptions, and Exclusions, 1916-2014](#), February 2014.
- ²⁸ Tax Policy Center, [Taxable Estates, Estate Tax Liability, and Average Estate Tax Rate, By Size of Gross Estate, Multiple Baselines, 2011](#), December 2010.
- ²⁹ Internal Revenue Service, [SOI Tax Stats - Estate Tax Statistics Filing Year Table 1](#), 2014.
- ³⁰ The Center on Budget and Policy Priorities has estimated that these unrealized and untaxed capital gains account for more than half of the value of the largest estates. See Chye-Ching Huang and Nathaniel Frentz, [Myths and Realities About the Estate Tax](#), August 2013.
- ³¹ Deborah L. Jacobs, [Zuckerberg, Moskovitz Give Big Bucks To Unborn Kids](#), March 2012.
- ³² See George Cooper, [A Voluntary Tax? New Perspectives on Sophisticated Estate Tax Avoidance](#), March 1977; and Edward J. McCaffrey & Linda R. Cohen, [Shakedown at Gucci Gulch: A Tale of Death, Money & Taxes](#), 2004.
- ³³ See Bipartisan Policy Center, [Restoring America's Future](#), November 2010; and The National Commission on Financial Responsibility and Reform, [The Moment of Truth](#), December 2010.
- ³⁴ Kate Bell et al., [Lessons for the United States from Other Advanced Economies in Tackling Child Poverty](#), 2008.
- ³⁵ For example, for information on the United Kingdom’s flexible, universal “Child Trust Fund” accounts, see William Zichawo, [Child Trust Funds: Renewing the Debate for Long-Term Savings Policies](#), March 2014; in the U.S. Representative Joseph Crowley has similarly proposed creating universal, flexible “USAccounts.” See Joseph Crowley, [Congressman Crowley Announces Plan to Create a Savings and Investment Program for American Families](#), March 2014.
- ³⁶ For a more in-depth review of the step-up in basis at death, see Harry Stein, [How the Government Subsidizes Wealth Inequality](#), June 2014.
- ³⁷ Internal Revenue Service, [Estate Tax Returns Filed for Wealthy Decedents, 2003–2012](#), 2014.
- ³⁸ Edward J. McCaffrey & Linda R. Cohen, [Shakedown at Gucci Gulch: A Tale of Death, Money & Taxes](#), 2004.
- ³⁹ Ruby Mendenhall et al., [The Role of Earned Income Tax Credit in The Budgets of Low-Income Families](#), January 2012.
- ⁴⁰ For example, see: Damon Jones, [Information, Preferences, and Public Benefit Participation: Experimental Evidence from the Advance EITC and 401\(k\) Savings](#), April 2010; Bruce Meyer and Douglas Holtz-Eakin, [The Earned Income Tax Credit and Its Impact on America's Families](#), January 2002; and Sara Sternberg Greene, [The Broken Safety Net: A Study of Earned Income Tax Credit Recipients and a Proposal for Repair](#), August 2012.
- ⁴¹ Katharine Edin et al., [Tax Code Knowledge and Behavioral Responses Among EITC Recipients: Policy Insights from Qualitative Data](#), December 2013.
- ⁴² Gilda Azurdia, [Encouraging Low- and Moderate-Income Tax Filers to Save](#), April 2014.
- ⁴³ New America Foundation, [The Financial Security Credit: Tax Reform that Supports Savings for Hard-Working Americans](#), September 2012.
- ⁴⁴ Sara Sternberg Greene, [The Broken Safety Net: A Study of Earned Income Tax Credit Recipients and a Proposal for Repair](#), August 2012.
- ⁴⁵ The Tax Policy Center has estimated that 20% of the corporate income tax falls on labor. Jim Nunns, [How TPC Distributed the Corporate Income Tax](#), September 2012.
- ⁴⁶ See Leonard E. Burman, [Statement of Leonard E. Burman Daniel Patrick Moynihan Professor of Public Affairs Maxwell School Syracuse University Before the House Committee on Ways and Means and the Senate Committee on Finance](#), September 2012.
- ⁴⁷ For an explanation of the pros and cons of investment income taxation reform, see [The Committee for a Responsible Federal Budget, The Tax Break-Down: Preferential Rates on Capital Gains](#), August 2013.

Upside Down: Retirement Tax Programs

All Americans deserve a fair shot at retirement security

Just half of working-age Americans are confident that they will have enough money to retire.¹ They have good reason to worry. Traditional pensions are fading out of existence, and only about half of workers have access to any sort of employer-sponsored plan. Half of households have no retirement savings at all.² Even among households with savings, the median balance is \$40,000, still far less than many workers will need to maintain their standard of living in retirement.³ And while Social Security provides critical support for millions of retired Americans, it's expected to make up a smaller proportion of the income needed to maintain their standard of living in the future.⁴

In short, America is facing a retirement security crisis.

Yet the federal government spends nearly \$130 billion annually on retirement tax programs (also known as “tax expenditures”) to encourage Americans to save for retirement. With so much being spent on these federal tax programs, why do so many Americans still lack adequate retirement savings? A large part of the answer is that the vast majority of spending on retirement tax programs does little for the millions of working Americans who need the most help building a nest egg. Every year, top-income workers can expect to receive thousands of dollars in tax support for retirement savings. A low- or moderate-income worker can expect to receive little or nothing at all.

This is Upside Down.

The problem with retirement tax programs is one of both savings support and adequate account access. If we expect low- and moderate-income workers to save for retirement, we should at least provide them with the same level support provided to high-income households. Ensuring that all workers can take advantage of this support requires automatic enrollment in affordable, simple, safe retirement savings accounts.

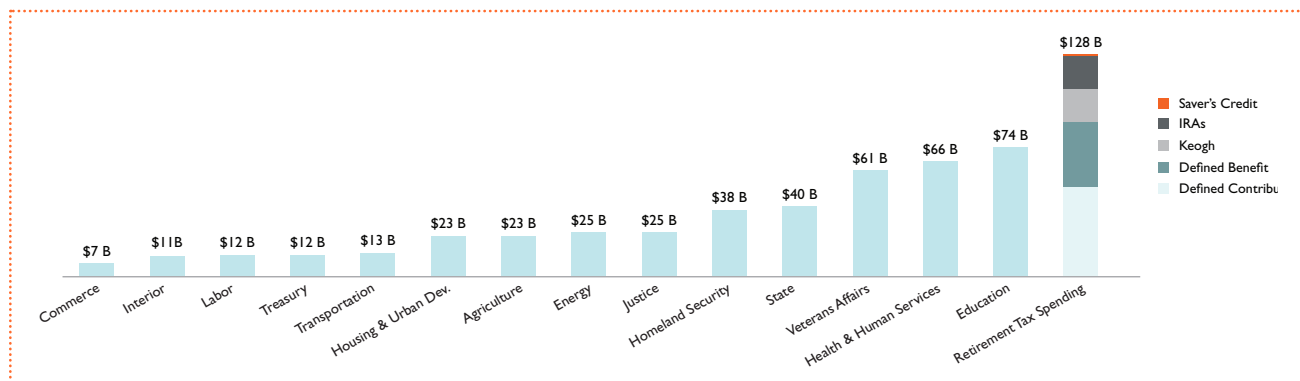
The remainder of the paper is organized as follows:

1. The size of retirement tax programs
2. The distribution of retirement tax benefits
3. The three reasons why retirement tax programs are upside down
4. Federal policy reforms to turn these programs right-side up

I The federal government spends billions of dollars on retirement tax programs

Tax programs are the main source of retirement savings support in the country. In the last ten years, the federal government has spent over \$1 *trillion* on these retirement tax programs.⁵ To put this number in perspective, the current annual spending—\$128 billion—is larger than the discretionary budgets of fourteen U.S. cabinet-level agencies—more than all but the Department of Defense.

Billions in Perspective: federal retirement tax spending in 2013 outweighed the discretionary budgets of 14 federal cabinet-level agencies



Author's calculations based on data from the [Office of Management and Budget](#) (2014)

In 2013, the largest retirement tax programs were:⁶

\$50.7 billion - Defined Contribution (DC) Employer Plans. Workers can claim an exclusion for contributions to these employer-provided retirement savings accounts. Workers must wait until age 59½ to make withdrawals or face penalties. Traditionally, DC plan benefits function as “tax deferrals” because the income deposited into these accounts and accrued gains are taxed when withdrawn rather than when earned. In contrast to traditional DC plans, workers get no immediate tax benefit for contributions to Roth-style DC plans, but the accounts grow tax free and are not taxed when withdrawn.

The most common DC plan is the 401(k), but this category also includes the 403(b), the Federal Thrift Savings Plan, and other similarly structured plans. For 2014, annual exclusions are limited to \$17,500 for the employee, and a total of \$52,000 from both the employer and employee.⁷

\$37.9 billion – Defined Benefit (DB) Employer Plans, often referred to as “traditional pensions,” guarantee workers a steady stream of benefits as long as they live. Similar to DC plans, workers don’t pay taxes on DB benefits until they are withdrawn, at which point these benefits are taxed as income. DB plans face maximum annual benefit limits (\$210,000 in 2014) rather than maximum annual contribution limits.⁸ But particularly high-income workers can build up more tax-supported retirement savings by combining a DB plan with an additional DC or IRA plan.

\$19.4 billion – Keogh Retirement Plans were created for sole-proprietors and other small business owners, and they can be structured as either DB or DC plans. While these plans are considerably more complex than alternative options, they are favored by high-income business owners and self-employed entrepreneurs who can take advantage of the higher contribution limits.

\$19.3 billion – Individual Retirement Accounts (IRAs) function similarly to DC plans but are usually set up by workers themselves rather than employers. IRAs also offer greater early withdrawal flexibility to pay for a home, education, and medical expenses. In addition to making normal contributions to IRA plans, workers are allowed to transfer (or “rollover”) savings from a DC plan into an IRA. This is in fact the largest source of IRA contributions.⁹

There are four types of IRAs that offer tax benefits directly to workers, each of which differ by contribution limit and level of tax benefit:

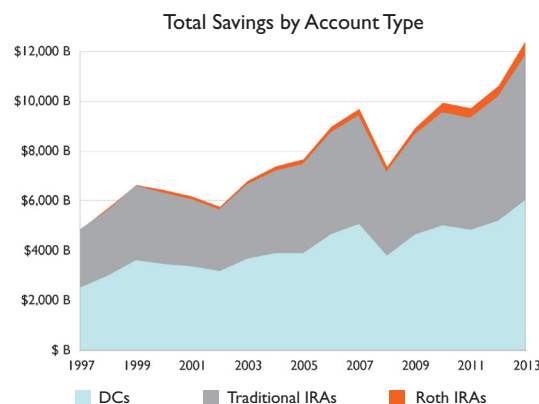
- **Traditional IRAs** are the most common IRA and function similarly to DC plans. Typically, workers can deduct contributions of up to \$5,500 every year. Depending on filing status and access to other employer-sponsored retirement plans, income limits may apply.
- **Roth IRAs** face the same \$5,500 contribution limit as traditional IRAs but deposits are taxed as normal income and withdrawals are tax-free. All Roth IRAs also face income limits.
- **Savings Incentive Match Plan for Employees (SIMPLE) IRAs**, are targeted to small businesses and the self-employed. The accounts provide the same tax benefits as traditional IRAs, but are established by the employer.
- **Simplified Employee Pension (SEP)** function very similarly to SIMPLE IRAs but feature higher contribution limits in some cases. Unlike SIMPLE IRAs, only the employer may contribute to a SEP IRA.

\$1.2 billion – The Saver’s Credit, unlike each of the tax programs described above, is not a type of account, but rather a tax benefit for making deposits into qualified DC and IRA plans. Depending on level of annual income, a saver can receive between 10 and 50 cents for every dollar saved, up to a maximum non-refundable credit of \$1,000. The credit is geared toward low- and moderate-income savers, with an income eligibility cutoff of \$30,000 (\$60,000 for couples filing jointly). Because the credit is non-refundable, individuals with income tax liability of less than \$1,000 (common among the credit’s target population) can’t receive the maximum credit.

TRADITIONAL vs ROTH PLANS

Traditional 401(k), 403(b), 457, and IRA plans each have Roth counterparts. The key difference is tax treatment of contributions. Contributions to traditional plans are deductible, but future withdrawals are taxed as income. For Roth plans, workers use their after-tax income to make contributions, but future withdrawals are tax free.

Retirement savings in DCs & IRAs has grown rapidly



Author's calculations based on IC data. Note traditional IRAs include standard IRAs, SIMPLE, and SEP DC plans include 401(k), 403(b), 457, and other DC plans. All figures inflation-adjusted to 2013 dollars.

2 Most retirement tax spending goes to the highest-income households

A large majority of the nearly \$130 billion spent every year on retirement savings programs goes to the highest-income households. The Urban Institute recently analyzed spending on DB and DC plans (including Keogh plans), IRAs, and the Saver's Credit.¹⁰ This new data reveals that the primary impact of retirement tax programs is to help the wealthy build more wealth through retirement savings.

The less income you have, the less the federal government spends to help you build retirement savings. In 2013, an average taxpayer with income less than about \$60,000 (in the bottom 60%) received \$200 or less from federal tax spending on DC plans, DB plans, IRAs and the Saver's Credit. By comparison, the average taxpayer in the top 1%, who had income of \$1.6 million, received more than \$13,000 from these programs. The unequal distribution of retirement tax support continues all the way up the income spectrum. A typical top 0.1% household received even more—\$16,115.

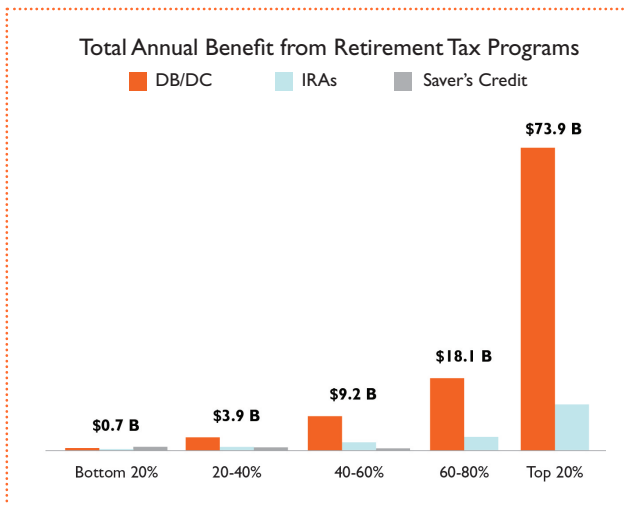
Lower-income households get almost no benefit from retirement tax programs. Compared to the average bottom 20% taxpayer, the average top 20% taxpayer receives 150 times as much support from retirement tax programs. The wealthiest taxpayers receive astronomical sums. The typical top 0.1% taxpayer received more from retirement tax programs (\$16,115) than the entire annual income of a typical bottom 20% taxpayer (\$13,607). *This is Upside Down.*

The Top 1% Get More From Retirement Tax Programs than the Bottom 60%

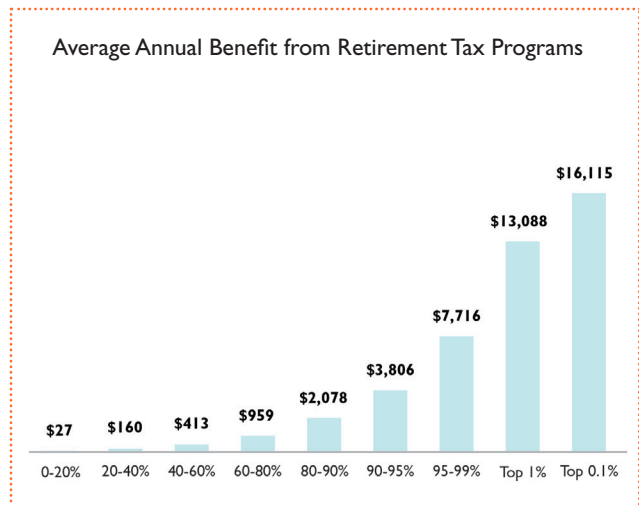


Author's calculations based on data from [Urban Institute](#) (2014). Includes tax benefits for DB plans, DC plans, IRAs, and the Saver's Credit.

Upside Down Retirement Tax Programs Top 20% get \$74 billion Bottom 20% get \$0.7 billion

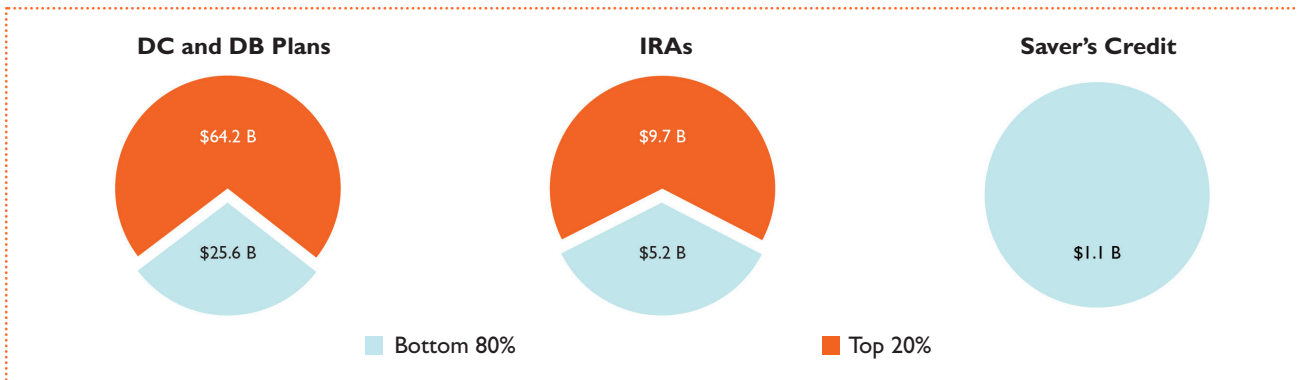


Upside Down Retirement Tax Programs Average Top 0.1% household gets \$16,115 Average Bottom 20% household gets \$27



Author's calculations based on data from [Urban Institute](#) (2014). Analysis includes tax benefits that all tax filers receive from DB plans, DC plans, IRAs, and the Saver's Credit.

Retirement tax spending on DB plans, DC plans, and IRA plans mostly goes to high-income households, but the Saver's Credit goes entirely to low and moderate-income households



Author's calculations based on data from [Urban Institute](#) (2014). Analysis includes tax benefits that all tax filers receive from DB plans, DC plans, IRAs, and the Saver's Credit.

Most retirement tax programs are upside down, but the Saver's Credit is largely right-side up. The highest-income 1% receives more support from DC plans, DB plans, and IRA tax benefits (\$15.9 billion) than the entire bottom 60% of the population combined (\$12.7 billion). The Saver's Credit, however, does not fit this upside down picture. Every dollar of support from the Saver's Credit goes to a household in the bottom 60%. A majority of Saver's Credit support (\$730 million) went to families in the bottom 40%. The Saver's Credit is proof that federal retirement tax programs can indeed focus support on moderate-income and even very low-income households.

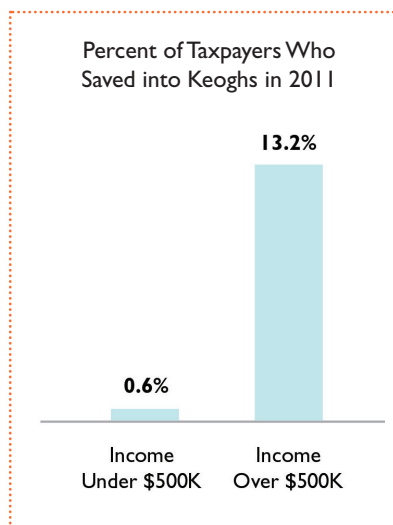
Positive though the Saver's Credit is, it is not without its flaws. Because the credit is non-refundable, it fails to help low-income workers who have little or no tax liability. For instance, if a worker qualified for \$100 in credit but only had a tax liability of \$80, they would only receive \$80 of the credit. A worker with no tax liability receives no support.

And the Saver's Credit is minuscule compared to the other tax benefit programs. For every dollar the federal government spends on the Saver's Credit to help a household in the bottom 60% build retirement savings, it spends more than \$67 to help a household in the top 20% build wealth through DC plans, DB plans, and IRAs. In fact, the federal government spends more than 15 times as much on retirement tax deductions for the top 1% as it spends on the Saver's Credit for the bottom 60%.

Keogh plans are particularly tilted toward high-income households. Public IRS data sheds light on who is making contributions to these plans, and the data reveals a program that is even more upside down than other retirement tax programs.¹¹

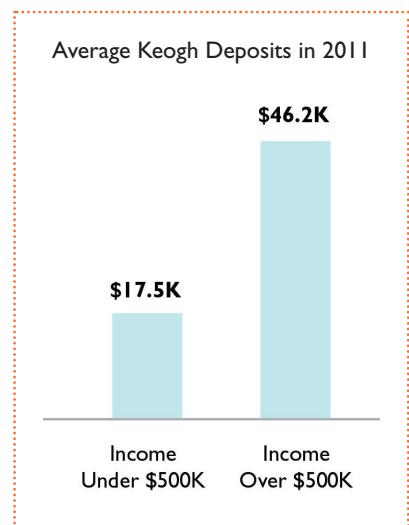
Keogh plans are upside down in two ways. First, high-income households are much more likely than low- and moderate-income households to make deposits into these plans. Only a vanishingly small proportion of low- and moderate-income, and upper-middle income households use Keoghs, which are administratively burdensome compared with other retirement savings options. In 2011 only 0.6% of tax filers with income less than \$500,000 reported deposits in Keogh plans. Households with income over \$500,000 were twenty times more likely to use these plans than households with income below \$500,000.

Who saves into Keoghs? High income taxpayers.



Author's calculations based on data from [IRS Statistics of Income](#) (2013).

How much do they save? A lot.



Second, the high-income households who use Keoghs deposit very large amounts of wealth into these tax-supported accounts. Taxpayers with income below \$500,000 reported saving an average of about \$17,500 in Keogh plans in 2011. A hefty sum to be sure, but higher-income workers make even more out of Keogh's generous deposit limits. The average Keogh deposit for filers with income of \$500,000 or more was just over \$46,000. This level of savings is not random—it is strikingly close to the 2011 maximum Keogh deduction, \$49,000. These households are maximizing their federal tax benefit by maxing out their deposits into these accounts.

3 The three reasons retirement tax programs are upside down

As the above analysis shows, retirement tax programs mainly operate to help wealthy workers save for retirement. This is no accident. Each of these programs is structured to focus benefits on the highest-income households. In particular, there are three structural defects that make retirement tax programs upside down:

1. **The higher a household's tax bracket, the larger the retirement tax benefit.** A household's tax bracket is their "marginal tax rate"—the amount of tax they owe for every additional dollar of income earned. There are currently seven tax brackets ranging from 10% to 39.6%. As a household's income increases, their marginal tax rate increases as well—this is what makes our income tax system progressive. But this also means that tax deductions are worth more to higher-income households.

How does this work in practice? As an example, imagine two families in two different tax brackets, the Hendersons and Hiltons. The Hendersons have an annual income of \$70,000, which places them in the 15% tax bracket. The Hiltons have an annual income of over \$500,000, which places them in the 39.6% bracket. Now let's assume that both families coincidentally decided to save \$5,000 into a traditional IRA or DC plan. As a result of this savings, the Hendersons' tax refund check next year will be \$750 bigger—\$5,000 times their tax rate, 15%. But the Hiltons' benefit will be even bigger, \$1,980—\$5,000 times 39.6%. Both families chose to save for retirement. Both saved into the same type of account. Both qualified for a tax benefit. But the Hiltons received more than 2.5 times the support from the retirement tax program, simply because they had more income.

High-income households get more support for every dollar they save

The lower your income, the less these retirement tax programs help. If the Hendersons had a marginal tax rate of only 10%, their benefit from \$5,000 of retirement savings would be only \$500. If they had no income tax liability at all, then they would receive no tax support for having saved for retirement.

	LOW INCOME		MODERATE INCOME	HIGH INCOME	
Example Tax Bracket	No Tax Liability	10%	15%	39.6%	39.6%
Example Retirement Savings	\$5,000	\$5,000	\$5,000	\$5,000	\$52,000
Retirement Tax Benefit	\$0	\$500	\$750	\$1,980	\$20,592

2. **Retirement tax programs subsidize very high levels of annual savings.** At a time when roughly half of American households have no retirement savings at all, the federal tax code is spending billions of dollars on retirement tax programs to subsidize annual retirement savings of \$50,000 or more for the highest-income earners.

Let's return to the Hiltons and the Hendersons. It's actually unrealistic to assume that the Hiltons would only save the same amount as the Hendersons, because we know that households at the very top save much more for retirement than most families. While the annual \$52,000 contribution limit for a Keogh and other plans is astronomical compared to what many families can save, high-income households are able to circumvent this limit and save even more into tax-preferred accounts. A 2013 article in Forbes Magazine described how a worker with income of \$300,000 can combine various tax-preferred plans to shelter nearly \$170,000 of income from taxes.¹² The scheme costs a few thousand dollars in accountant fees, but the taxpayer stands to gain tens of thousands of dollars in retirement tax benefits. In short, not only do the highest income households benefit more from every dollar saved; they're also saving more dollars with the help of pricey accountants, high contribution limits, and federal subsidies.

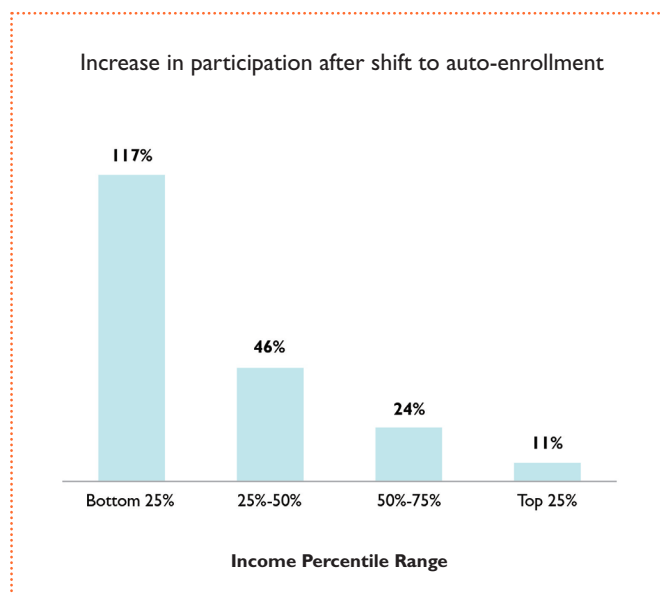
3. **Most low- and moderate-income workers lack access to an adequate retirement savings account.** A household can't benefit from retirement tax programs if they don't save; and they can't save without access to an account. While Keoghs, 401(k)s and other tax-supported retirement plans cater to the wealthiest households, millions of workers lack access to a safe, simple, and affordable retirement savings account. Only about half of working Americans have access to a workplace retirement plan.¹³ Employees of color are even less likely to have access to these employer-sponsored

plans.¹⁴ For employees with access to an employer-sponsored plan, saving for retirement can still be burdensome. Employment may be short-term, and enrollment procedures are often complex. IRAs are an option for those without access to an employer-sponsored plan, but this option is not working well. Among Americans who have access solely to private IRAs, only a small percentage open and regularly contribute to these plans.¹⁵

A key feature of an adequate retirement savings plan is automatic enrollment. Auto-enrollment programs switch the default from “opt-in” to “opt-out.” Strong empirical evidence shows that automatic enrollment in retirement savings plans has a very large impact on participation, especially for low- and moderate-income workers. The results are astounding. The bottom half of workers are **81% more likely** to participate in an auto-enrollment plan compared to an opt-in plan.¹⁶

Interestingly, workers at the top of the income distribution are only slightly more likely to participate in auto-enrollment plans than in opt out plans. For these high-income households, there is simply too much money on the table to *not* traverse the barriers to save for retirement.

Auto-enrollment dramatically increases retirement savings rates for low- and moderate-income workers



Based on simulation by EBRI (2005)

4 Federal reforms must turn retirement tax programs right-side up

The model for retirement tax programs shouldn’t be accounts with large barriers to entry, but rather targeted support for working families who need help the most. In other words, the model should be the Saver’s Credit rather than the 401(k) or Keogh. But simply providing incentives will never be enough—workers also need access to simple, safe, and affordable retirement accounts in order to save at all. With these two goals in mind, there are several options for reforming the existing retirement savings system to make it work for all Americans:

Turn existing retirement tax programs right-side up. As currently structured, the deductions, exclusions, and deferrals for retirement savings exacerbate wealth inequality and do little to combat retirement insecurity for millions of working Americans. Without adding a dime to the deficit, replacing these programs with a more equitable refundable credit would shift the system from spending billions on the wealthy to boosting retirement security for all working Americans.

The Urban Institute analyzed one such proposal to replace the current retirement savings incentives with a 25% refundable credit.¹⁷ Returning to the example of the Hendersons and the Hiltons, if they both chose to save \$1,000 for retirement, they would both receive \$250 in support—25% of the \$1,000 saved. Under this plan, the entire bottom 80% of taxpayers would see an increase in after-tax income, while gaining federal support for retirement savings. Former Chair of the National Economic Council, Gene Sperling, has made a similar proposal to replace existing retirement tax programs with a 28% credit.¹⁸

Expand and reform the Saver’s Credit. The Saver’s Credit proves that many low- and moderate-income workers can and will take advantage of tax support to build retirement savings. But the credit is far too complicated in structure and limited in size, currently accounting for less than 1% of spending on retirement tax programs. Positive reforms would:

- Make the credit fully refundable to provide additional support to low-income workers
- Expand the income thresholds so that the credit reaches further up the income spectrum
- Replace benefit cliffs with a gradual benefit phase-out, similar to the Earned Income Tax Credit

There are several strategies for accomplishing these three goals. The Urban Institute analyzed one new configuration of the Saver's Credit that would create a refundable \$1,000 credit for incomes up to \$36,400, and that would gradually phase out as income increases above that level. This reform would expand support for the entire bottom 80% of earners.¹⁹

Reduce contribution limits for retirement savings. While the median level of retirement savings in the U.S. is only \$3,000,²⁰ the *annual* contribution limit for tax-preferred retirement plans is as high as \$52,000. Who benefits from these astronomical contribution limits? Those at the very top of the income spectrum. Not only are the highest-income households saving more into Keoghs and other retirement savings products due to these high limits, they're getting more federal support for each dollar they deposit.

There are several proposals to limit contributions to tax-preferred retirement accounts. In his 2014 budget, President Obama proposed limiting total savings into these accounts to \$3.4 million, a massive sum compared to what most Americans have saved or would be able to save.²¹ This proposal would raise \$9 billion in revenue over ten years.

The Urban Institute analyzed another proposal that would limit annual contributions to the lesser of \$20,000 or 20% of the worker's earnings.²² This would reduce federal spending on the top 1% and top 0.1% of households, and it would have little or no impact on those in the bottom 80%.

Creating reasonable contribution limits for tax-supported retirement accounts will not itself expand retirement security, but the tax dollars saved from this reform could be redeployed to fund retirement tax programs that support all working families.

Create a universal, simple, safe, and affordable retirement savings account for all Americans. We know that low- and moderate-income workers are less likely to have access to an employer-sponsored retirement plan. And as important as federal savings incentives are, they are of little use to workers who have no access to a retirement savings account.

A partial solution to this reality is the myRA program, a proposal developed out of the work of the Retirement Security Project, which was a joint effort by the Heritage Foundation and the Brookings Institute. Now sponsored by the U.S. Department of Treasury, the myRA program is launching as a pilot program to help working families build retirement savings even if they lack access to an employer-sponsored retirement plan.²³ The myRA was designed by Treasury with three features:

- **SIMPLICITY:** Workers make contributions to their myRA through after-tax payroll deductions. Like a Roth program, contributions can be withdrawn at any time without penalty (although withdrawn interest earnings may be subject to penalties), providing a level of flexibility that is crucial for low- and moderate-income working families who often have little or no emergency savings.²
- **SAFETY:** Because myRA account balances are invested in U.S.-backed securities, the principle is guaranteed and savings will grow with little risk.
- **AFFORDABILITY:** A worker can start saving through myRA with as little as \$25 and can save as little as \$5 through each payroll deduction. The accounts are also fee-free for the consumer—every dollar saved is a truly a full dollar saved for the future.

Ensure automatic enrollment in retirement savings programs to boost participation. We know that auto-enrollment greatly increases retirement savings of low- and moderate-income workers. Based on this knowledge, the Retirement Security Project proposed automatically enrolling workers into an IRA, an "Auto-IRA." Automatically enrolling workers in a workplace retirement savings plan eliminates a key barrier to savings—complexity. Although opting out is always possible, examples from the private sector indicate that few workers choose to do so. Research shows that moving to automatic enrollment could boost participation rates above 90%.²⁵

Automatic enrollment proposals are already being considered in 17 states.²⁶ At the federal level, the Obama Administration and members of the House and Senate have advanced various versions of Auto-IRA legislation. These proposals would require or encourage all but the smallest firms to automatically enroll employees in retirement savings plans with a low minimum contribution. Paired with an affordable, simple starter account like myRA, Auto-IRA can ensure that all employers comply without undue administrative or financial burden. These employer-friendly and employee-supportive Auto-IRA proposals have garnered support on both sides of the aisle.

Conclusion

Americans believe that a lifetime of hard work should guarantee workers the dignity of a financially secure retirement. The federal government's annual \$130 billion investment in retirement tax programs reflects how fundamental this belief really is.

But this enormous investment is poorly structured to promote retirement security for most working Americans. At a time when half of working Americans rightfully fear that they do not have enough savings to retire, the federal government is sending multi-thousand dollar tax refund checks to millionaires in support of their retirement savings every year.

The problem with our upside down retirement tax programs is one of both access and support. Millions of working Americans lack access to a safe, simple, and affordable retirement savings account. But even those workers that do participate in employer-provided or private retirement plans receive little benefit from our existing retirement tax programs.

At the very least, our retirement tax programs should provide low- and moderate-income families the same level of support offered to high-income families. Reforms built on this principle need not devote billions of dollars of new federal resources to the goal. We can expand retirement security for millions of working Americans simply by turning our existing upside down retirement tax programs right-side up.

¹ Ruth Helman et al., [2013 Retirement Confidence Survey: Perceived Savings Needs Outpace Reality for Many](#), March 2013.

² John Topoleski, [U.S. Household Savings for Retirement in 2010](#), July 2013.

³ Nari Rhee, [The Retirement Savings Crisis: Is It Worse than We Think?](#), June 2013.

⁴ Alicia Munnell et al., [The National Retirement Risk Index: After the Crash, October](#), 2009.

⁵ Author's calculations based on Office of Management and Budget (Appendix, Budget of the United States Government) data for fiscal years 1994 through 2013. Inflation adjusted to 2013 dollars. Tax expenditures include the following: Defined Benefit, Defined Contribution, 401(k)s, IRAs, Saver's Credit, and the small business retirement plan credit.

⁶ Funding amounts from Office of Management and Budget, [Estimate of Total Income Tax Expenditures for Fiscal Years 2013-2019](#), 2014.

⁷ IRS, [IRS Announces 2014 Pension Plan Limitations](#), October 2013.

⁸ IRS, [IRS Announces 2014 Pension Plan Limitations](#), October 2013.

⁹ Victoria L. Bryant, [Accumulation and Distribution of Individual Retirement Arrangements 2008](#), 2012.

¹⁰ Benjamin Harris et al., [Tax Subsidies for Asset Development An Overview and Distributional Analysis](#), August 2014.

¹¹ IRS, [Individual Income Tax Returns 2011](#), August 2013.

¹² Ashlea Ebeling, [How Entrepreneurs Can Get Big Tax Breaks for Retirement Savings](#), March 2013.

¹³ Nari Rhee, [The Retirement Savings Crisis: Is It Worse than We Think?](#), June 2013.

¹⁴ Nari Rhee, [Race and Retirement Insecurity in the United States](#), December 2013.

¹⁵ Brigitte Madrian & Dennis Shea, [The Power of Suggestion: Inertia in 401\(k\) Participation and Savings Behavior](#), 2001.

¹⁶ Author's calculations based on Sarah Holden and Jack VanDerhei, [The Influence of Automatic Enrollment, Catch-up, and IRA Contributions on 401\(k\) Accumulations at Retirement](#), July 2005.

¹⁷ Barbara A. Butrica et al., [Flattening Tax Incentives for Retirement Saving](#), May 2014.

¹⁸ Gene B. Sperling, [A 401\(k\) For All](#), July 2014.

¹⁹ Barbara A. Butrica et al., [Flattening Tax Incentives for Retirement Saving](#), May 2014.

²⁰ Nari Rhee, [The Retirement Savings Crisis: Is It Worse than We Think?](#), June 2013.

²¹ Office of Management and Budget, [Fiscal Year 2014 Analytical Perspectives: Budget of the U.S. Government](#), 2013.

²² Barbara A. Butrica et al., [Flattening Tax Incentives for Retirement Saving](#), May 2014.

²³ U.S. Treasury Department, [myRA FAQ](#), 2014.

²⁴ Jennifer Brooks et al., [Treading Water in the Deep End: Findings from the 2014 Assets and Opportunity Scorecard](#), January 2014.

²⁵ William Gale et al., [The Automatic 401\(k\): A Simple Way to Strengthen Retirement Saving](#), March 2005.

²⁶ John Ikel, [State Auto IRA Bills Face an Inconvenient Wrinkle](#), July 2014.

Upside Down: Higher Education Tax Programs

Every family should be able to save and invest in their child's education

Income helps families get by; savings and investments help them get ahead. There is no better investment that families can make to break the cycle of poverty than to invest in the talents and aspirations of their children. Higher education is one the surest pathways out of poverty and one of the most effective strategies for securing a foothold in the middle class.¹

As a nation, we believe in this transformative power of education. Our federal budget reflects this belief, devoting large sums to help millions of Americans afford higher education. This support is especially important to the less than 10% of low-income students who graduate from college by their mid-20s.² Federal investments in these students' education are an investment in economic opportunity.

In the last several years, federal tax spending programs (also known as "tax expenditures") have become an increasingly large source of support for higher education. Unfortunately, most of the billions of dollars we now spend on higher education tax benefits fails to support the families who need support the most. Federal reforms are necessary to turn this upside-down tax spending right-side up. This report provides an overview of the size and shape of higher education tax spending, the distribution of these benefits, the tax support for college savings in particular and federal policy recommendations that can expand educational opportunity for all Americans.

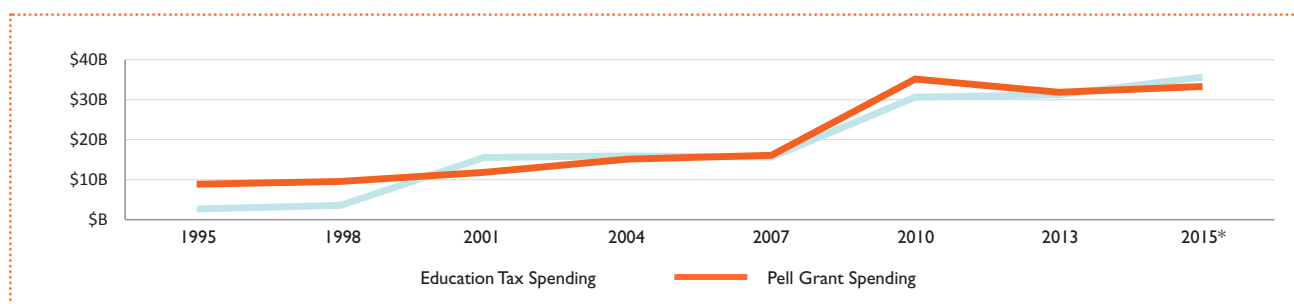
The remainder of the report is organized as follows:

1. Size of higher education tax spending
2. Distribution of tax spending for higher- and lower-income households
3. Tax support for college savings
4. Federal policy recommendations to turn higher education tax spending right-side up

I The tax code spends billions of dollars to support higher education

Tax spending is one of the largest sources of support for higher education. The federal government spent more than \$60 billion in the form of non-loan aid to help students pay for higher education in 2013. While spending on Pell Grants for low-income students accounts for a significant percentage of that support, federal tax spending accounts for an even greater share.³ This is not a new phenomenon. Although most higher education tax spending programs came into existence only in the last twenty years, they have grown quickly. Between 1995 and 2003, Pell Grant spending increased 258% (adjusted for inflation), while higher education tax spending increased more than 1,050%. Given this rapid pace of expansion, it is no surprise that tax spending on higher education has regularly matched or exceeded Pell Grant spending since the early 2000s.

For 20 years, higher education tax programs has regularly matched or exceeded Pell Grant spending



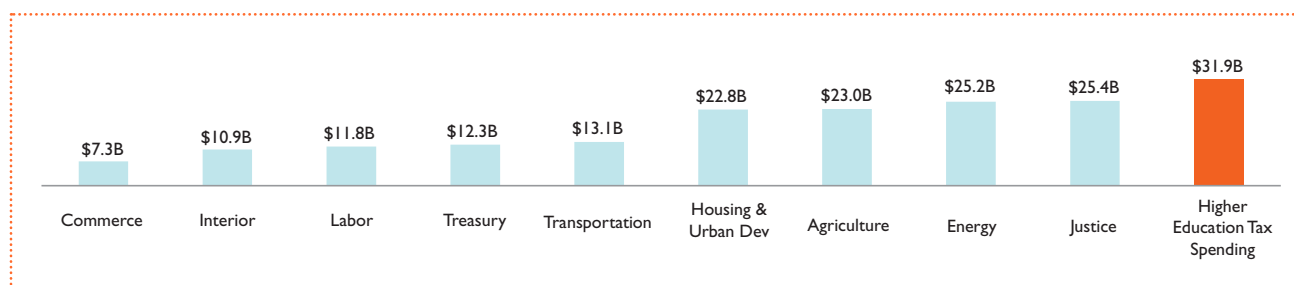
Author's calculations based on Office of Management and Budget (Appendix, Budget of the United States Government) data for fiscal years 1997, 2000, 2003, 2006, 2009, 2012 and 2015. Inflation adjusted to 2013 dollars. Values for 2015 are presidential budget requests, not actual outlays. Tax expenditures include the following: exclusion of scholarship and fellowship income, the HOPE tax credit, the Lifetime Learning Credit, the American Opportunity Tax Credit (including refundable portion), Coverdells, 529s, deduction for student loan interest, deduction for higher education expenses, parental personal exemption for students and exclusion of employer-provided educational assistance.

In 2013, the largest sources of this tax spending were:⁴

- **\$16.6 billion – American Opportunity Tax Credit (AOTC)**, a \$2,500 partially refundable credit for tuition, fees and books for students at degree-granting postsecondary institutions. The AOTC can be claimed for up to four years of undergraduate education, and families without tax liability can claim as a refund up to \$1,000 of the credit each year.
- **\$5.2 billion – Parental personal exemption for students**, which allows families to reduce their taxable income by claiming a student aged 19-23 as a dependent. Without this provision, most students over the age of 18 cannot be claimed as dependents by their parents.
- **\$2.9 billion – Exclusion of scholarship income**, which allows students who use academic scholarships to pay for qualified expenses—generally tuition, fees and course materials—to reduce their tax liability by excluding those scholarship dollars from their taxable income.
- **\$1.8 billion – Lifetime Learning Credit (LLC)**, a \$2,000 nonrefundable credit that applies to tuition and fees. Unlike the AOTC, the LLC can be claimed for graduate school expenses (in addition to undergraduate expenses) and can be claimed for an unlimited number of years.
- **\$1.75 billion – 529s and Coverdells** allow families to deposit after-tax savings into a restricted savings account that grows tax-free, similar to a Roth IRA. An account’s designated beneficiary can use the savings to pay for qualified higher education expenses (and K-12 expenses in the case of Coverdells).
- **\$1.7 billion – Deduction for student loan interest**, a \$2,500 above-the-line deduction that can be claimed for loans taken out to pay for tuition and fees, course materials, room and board, and other expenses like transportation.
- **\$0.7 billion – Exclusion for employer-provided education assistance**, a \$5,250 exclusion for education benefits provided to employees by their employers, covering tuition, fees and course materials.
- **\$0.6 billion – Deduction for higher education expenses**, a \$4,000 above-the-line deduction that can be claimed for tuition and fees. Neither room and board nor course-related materials are eligible expenses for this deduction.

To put this funding in perspective, the amount of tax spending on higher education is larger than the discretionary budgets of nine cabinet-level departments. From another perspective, spending through the tax code for higher education is roughly equal to the primary sources of federal support for special education (IDEA), K-12 (Title 1-A) and Pre-K (Head Start) *combined*.

Billions in Perspective: federal higher education tax programs in 2013 outweighed the discretionary budgets of 9 federal cabinet-level agencies



Author's calculations based on data from the [Office of Management and Budget](#) (2014) and [Tax Policy Center](#) (2014).

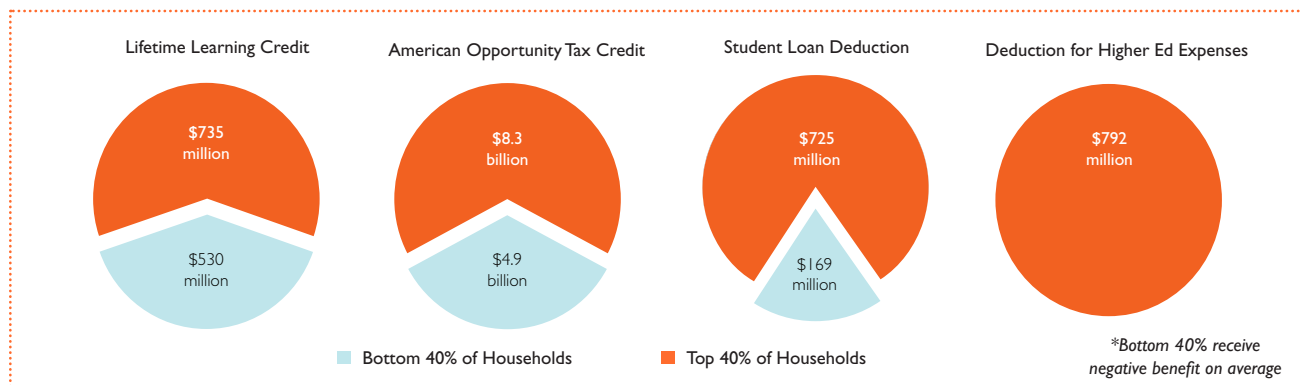
2 Education tax programs focus support on high-income households

Federal investment in education should aim to expand opportunity regardless of whether the investment is made through direct or tax spending. Aid may come through tax spending, such as the AOTC, or direct spending, such as Pell Grants. But the most important feature of higher education support is not the mechanism through which it is provided, but the effectiveness with which it expands opportunity.

Pell Grants, for instance, clearly target aid to working families and students who need support the most. Among dependent students who received Pell Grants in the 2011-2012 school year, 95% came from families that made less than \$60,000 per year.⁵ Pell Grants primarily helps working families and individuals afford college, expanding opportunity for students who might otherwise not attain a higher education degree. Tax support may reach further up the income spectrum, but the focus of *all* higher education aid policy should be to expand opportunity in this way.

A simple test of equity and efficiency: do the bottom 40% of households receive as much aid as the top 40%? For a four-person household, the bottom 40% make less than about \$70,000 annually on average; the top 40% make more than \$100,000.⁶ An education aid program that fails the 40/40 test clearly fails to focus support on expanding educational opportunity. The Urban Institute analyzed four of the largest sources of higher education tax spending, the American Opportunity Tax Credit (AOTC), the Lifetime Learning Credit (LLC), deduction for interest on student loans and deduction for higher education expenses.⁷ Combined, these four credits cost the federal government \$20.4 billion in 2013—accounting for the vast majority of all spending on higher education tax spending. Not one of these tax credits passes the 40/40 test. In fact, for all but the LLC, the top 40% of households receives more than all other households combined.

Upside Down: Higher education tax programs focus support on high-income households



Author's calculation based on data from [Urban Institute](#) (2014).

Poorly targeted tax spending leaves working families behind. For every dollar of aid a top 40% household receives from one of these tax benefits, a bottom 40% household receives less than 52 cents. The largest of these programs, the AOTC, is partially refundable, increasing the benefits it provides to low-income households. But even with this commendable feature, the top 40% of households received \$8.3 billion from the program in 2013—more than half of all AOTC spending.

While smaller in size, the most lopsided of these higher education tax spending programs is the deduction for higher education expenses. On average, the bottom 40% of households receives *negative* support from the deduction because it increases tax code complexity. Many families accidentally claim the deduction instead of an alternative higher-value credit (like the AOTC or LLC), thus reducing their overall tax benefit. A [2012 GAO report](#) found that over 200,000 households claimed the deduction for higher education expenses instead of the more valuable LLC in 2009.⁸ Because of its structure, the deduction for higher education expenses is essentially a Pell Grant for the wealthy, providing support almost exclusively to those at the very top.

3 Existing tax incentives fail to help most families save for college

Most higher education tax spending is poorly timed for working families. More than 90% of higher education tax spending comes in the form of after-purchase subsidies, meaning households receive the tax benefit months after paying for tuition, buying books or financing some other qualified education expense. This structure of support naturally benefits high-income households who can tap existing savings for educational purchases today while counting on support in the future after they file taxes. This does very little for the [44% of Americans who are liquid asset poor](#) and do not have the financial resources necessary to front these costs.⁹

But there is another way to help families afford college: help them save for college. Families with savings for college can use those savings at the time they incur education expenses. Investments made today grow every year—boosting the ultimate amount of savings and maximizing its impact. Furthermore, [evidence suggests](#) that the act of saving for college itself can significantly improve educational outcomes.¹⁰

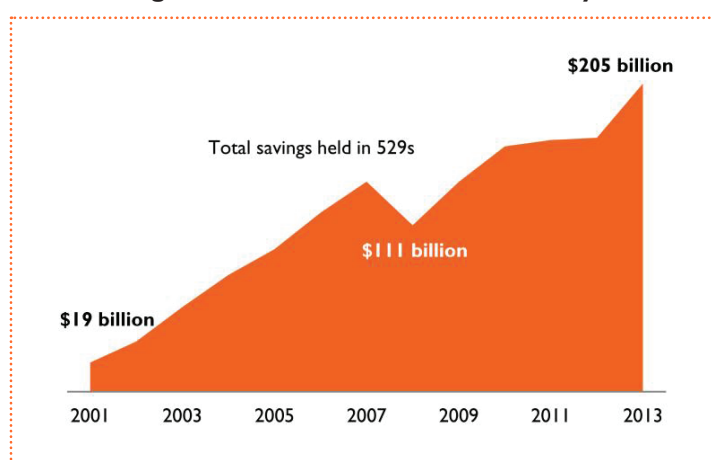
Saving for college can have a big effect on college access and completion. Not only do college savings programs solve the timing problem presented by traditional tax-based aid, college savings can also expand educational expectations and increase college success.¹¹ We know that even small savings can make a big difference. The [Assets and Education Initiative](#) at the University of Kansas found that low- and moderate-income children with less than \$500 saved for college were three times more likely to enroll and four times more likely to graduate than those without savings.¹²

529s and Coverdells were created to increase college savings. Created in the mid-1990s, 529s function similarly to Roth IRAs but for education rather than retirement. Deposits are not tax deductible on federal tax returns, but the accounts grow tax-free and qualified withdrawals are not counted as taxable income. Thirty-four states also provide a state tax deduction for 529 contributions.¹³ In the most common version of 529s, parents, children or others make deposits into state-administered “Qualified State Tuition Plan” savings accounts. Students can make qualified withdrawals to pay for tuition, fees, books, supplies, and room and board. Withdrawals made for non-qualified expenses are subject to a 10% penalty, and the earnings of those withdrawals are subject to normal income taxation. Fueled by generous tax treatment of these investments, total savings in 529s has exploded from \$19 billion in 2001 to more than \$200 billion in 2013.¹⁴

Coverdells are also tax-advantaged savings accounts for higher education, but they function slightly differently than 529s. Coverdells can invest in a more diverse array of assets, including stocks and bonds. And unlike 529 accounts, withdrawals from Coverdells can also be used to pay for K-12 expenses, such as prep school.

The structure of 529s and Coverdells tilts benefits toward high-income households. Coverdell and 529 tax benefits accrue at the top of the income distribution for two reasons. First, these benefits take the form of deductions and exclusions rather than refundable credits, so higher-income families who have greater tax liability receive greater tax benefit. Second, several features of 529s act as barriers to low- and moderate-income families, including minimum deposits, account fees and [public benefits asset limits](#) that actively discourage saving.¹⁵ [Several states have reformed 529s](#) in order to close the gap in college savings, but the fact remains that these federally-supported savings accounts are, by and large, structured to widen that gap, helping the wealthy grow their wealth further while doing little for the vast majority of working families.¹⁶

Savings in 529s have increased 954% in 12 years



Authors calculations based on data from [Government Accountability Office](#) (2009), [Savings for College](#) (2013) and [Savings for College](#) (2014).

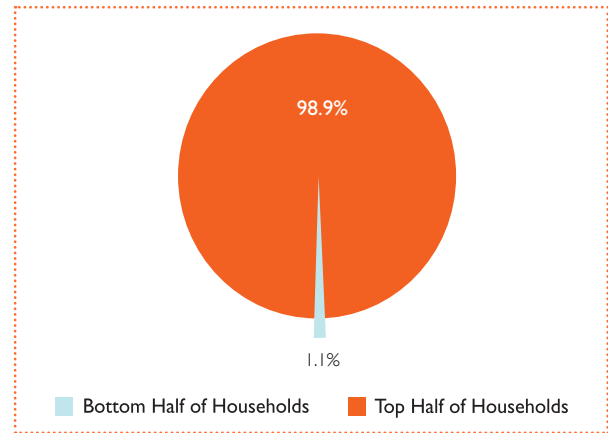
529s and Coverdells do little to help most working families save for college. Less than 3% of U.S. families use 529s or Coverdells.¹⁷ Those families that do use these programs tend to be high-income, while working families who need the most help to build savings get left behind.¹⁸ In fact, support for college savings is even more focused on high-income families than is the support provided through higher education tax spending programs like the AOTC or LLC.

In Kansas, more than 80% of the 529 state tax spending goes to the top 11% of households, those with more \$100,000 in income. In Louisiana, households earning more \$100,000 hold more than 70% of the total savings in 529s.¹⁹

This state-level experience is not an anomaly. A [2009 Treasury report](#) found that the top half of households hold 98.9% of 529 and Coverdell savings. Similarly, the Government Accountability Office [analyzed households who use 529s or Coverdells](#) and found that across the country, these households:

- **Have higher income.** Families with 529s or Coverdells had about three times the income of those without these accounts.
- **Have greater wealth.** Those who saved in 529 or Coverdell accounts had financial assets worth \$413,500—more than 25 times the average family’s assets.
- **Receive more in tax benefits.** Among families that use 529s to pay for higher education, those making less than \$100,000 per year received \$561 in tax benefits, while those making over \$150,000 a year received an average of \$3,132 in tax benefits.²⁰

Top 50% of earners own nearly all 529 and Coverdell savings



Authors calculations based on data from [U.S. Department of Treasury](#) (2009).

4 Federal reforms to turn higher education tax programs right-side up

Congress has acted before to improve higher education tax benefits for working families. Tax spending is not the enemy in the fight to expand educational opportunity, but a potentially potent policy tool. Today, however, this tool exacerbates inequality of opportunity, focusing direct support and savings incentives on high-income households. Congress can change this. Past federal reforms have helped make these programs work better for all working families:

- The 2008 Farm Bill ended the practice of counting 529 savings against asset limits for SNAP (previously known as Food Stamps), ensuring that families that use 529s to save for their children’s future do not risk losing support that helps them put food on the table today.
- In 2009, Congress converted the 12-year-old HOPE tax credit into the AOTC. The new AOTC became partially refundable, and so for the first time, those without tax liability could receive some benefit from the credit. Largely as a result of this change, the bottom 20% of households now receives a greater share of AOTC than they do from any other source of higher education tax spending.

Congress needs to do more to turn upside-down tax spending right-side up. The reforms above are small steps, but they are steps in the right direction. Congress should go further down this road. This does not necessarily require new spending, but rather a restructuring of existing spending. The following reforms would make strides in the direction of turning our upside-down higher education tax spending right-side up:

- **Eliminate the deduction for higher education expenses and create a savings account for every child at birth.** The deduction for higher education expenses has three strikes against it. First, it is the most upside-down source of higher education spending, directing almost all support to high-income households. Second, it actively makes most

- families worse off by adding complexity to the tax code. Third, it provides support in the form of an after-purchase subsidy, which benefits higher-income households, rather than a forward-looking savings incentive.

Instead of wasting \$600 million on a poorly targeted deduction, we could provide a \$100 savings account for every one of the four million babies born in the country every year. The \$200 million remaining could provide matches to help low- and moderate-income families build savings faster. The [recently proposed myRA](#) program, which aims to create a simple, safe and affordable option for retirement savings, could serve as inspiration for development of a new universal Children’s Savings Account program.²¹ Teachers across the country could use the account as tool for teaching financial education early in life, knowing that every student in their classroom would have access to an account. Given the [proven impact of matching a savings product with early financial education](#), and the big effect that even small college savings can have on future college success, this funding would be well spent.²²

- **Reform the AOTC to support college savings directly.** Families that use 529 savings to pay for higher education expenses cannot claim the AOTC for those expenses. In other words, a dollar saved today for education may reduce education support in the future. This policy quirk can actively discourage families from saving for college, but simply removing this restriction would mainly benefit the high-income households that are currently most likely to use 529s.

A better reform would make deposits into 529s—or into the education myRA accounts proposed above—eligible for the AOTC, allowing the credit to function as a college savings match. Similar to proposals that would advance a portion of the Pell Grant in order to support college savings,²³ this proposal would advance a portion of the AOTC. Both strategies would deploy existing federal spending on higher education more effectively.

The AOTC reform would not expand the credit, nor would it raise the \$10,000 lifetime cap per student. Rather, instead of only providing support months after families incur costs, the reformed credit would also support savings years before children go to college. Use of the savings matches provided through the AOTC would only be allowed for higher education expenses, ensuring that this reform does not divert AOTC dollars to non-education purchases. The reform could be done independently or in addition to the reform of the deduction for higher education expenses proposed above.

Limiting this new AOTC savings credit to \$250 per year—roughly \$20 per month in savings—would encourage regular saving over the course of the child’s life. A family maxing out this credit starting at birth of the child would have nearly \$15,000 saved by age 18 (assuming a modest 5% rate of return). This child would have used only \$4,500 of her AOTC and so would remain eligible for \$5,500 in additional support from the credit. All this is possible without expanding the maximum size of the credit by a dime.

- **Exempt children’s savings from public benefit asset limits.** In some states, as little as \$1,000 in children’s savings can make a family ineligible for TANF benefits. The 2008 Farm Bill excluded 529 savings from SNAP asset limits, but other Children’s Savings Accounts still count towards SNAP asset limits (which are often as low as \$2,000 for a family).²⁴ Furthermore, both 529 and non-529 Children’s Savings Accounts count against asset limits for other public benefits programs. A parent who saves for her child’s education should not be punished by being forced off of TANF, SNAP, LIHEAP, SSI or any other income maintenance program.
- **Expand the Saver’s Credit to support college savings.** As currently structured, the Saver’s Credit only supports retirement savings. The Savings Enhancement for Education in College Act (H.R. 529), introduced by Representative Lynn Jenkins (R-KS) and Representative Ron Kind (D-WI), would expand eligible saving products to include 529s. Additional reforms could make the credit fully refundable and make deposits into all Children’s Savings Accounts eligible for the credit, greatly increasing the impact of the Saver’s Credit for working families.

Conclusion

Access to higher education is critical for ending the cycle of poverty and expanding economic opportunity. Children who are educated to reach their potential are best able to become self-sufficient contributors to the national economy. These are the moral and economic grounds that justify government investment in higher education.

Yet, while the federal government now spends more than \$60 billion every year in non-loan support for higher education, college enrollment and graduation rates of America's low-income students remain disastrously low. We need to rethink how we're supporting higher education.

As this report illustrates, one of the largest sources of support for higher education is federal tax spending, which has regularly matched or exceeded federal spending on Pell Grants since the early 2000s. Unlike Pell Grants, this tax spending disproportionately goes to the households who need help the least—to parents who could already finance the education of children who were already college bound. This is no way to expand opportunity.

A large new federal investment in educational opportunity need not require a large new influx of federal dollars. We are spending billions through the tax code that could be spent more equitably and more efficiently. Instead of paying back wealthy families who settled college expenses months ago, we could ensure that every family has the chance to save and invest in their children's future. We can expand access to the American Dream by expanding educational opportunity—we just need to turn our upside-down tax spending right-side up.

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