

Part 5 of 6

# THE REGRESSIVE DELIVERY OF SOCIAL WELFARE BENEFITS IN THE U.S.

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VALUABLE RESEARCH ASSISTANCE FOR THIS SERIES PROVIDED BY BENJAMIN KOLANSKY

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The Great Recession has exposed numerous flaws in our social contract – weaknesses that existed prior to the economic downturn – highlighting the need for changes in our system. This series of policy briefs explores the stresses on our social contract, and the policy changes that must be made to mend it. The six-part series includes:

- Overview: The Great Recession exposes weaknesses in the American social contract
- Economic security policies are too closely tied to employment
- The safety net for unemployed Americans is inadequate
- Problems with a state-based social welfare system
- The regressive delivery of social welfare benefits in the U.S.
- The ownership society is vulnerable during downturns: Pensions and home ownership

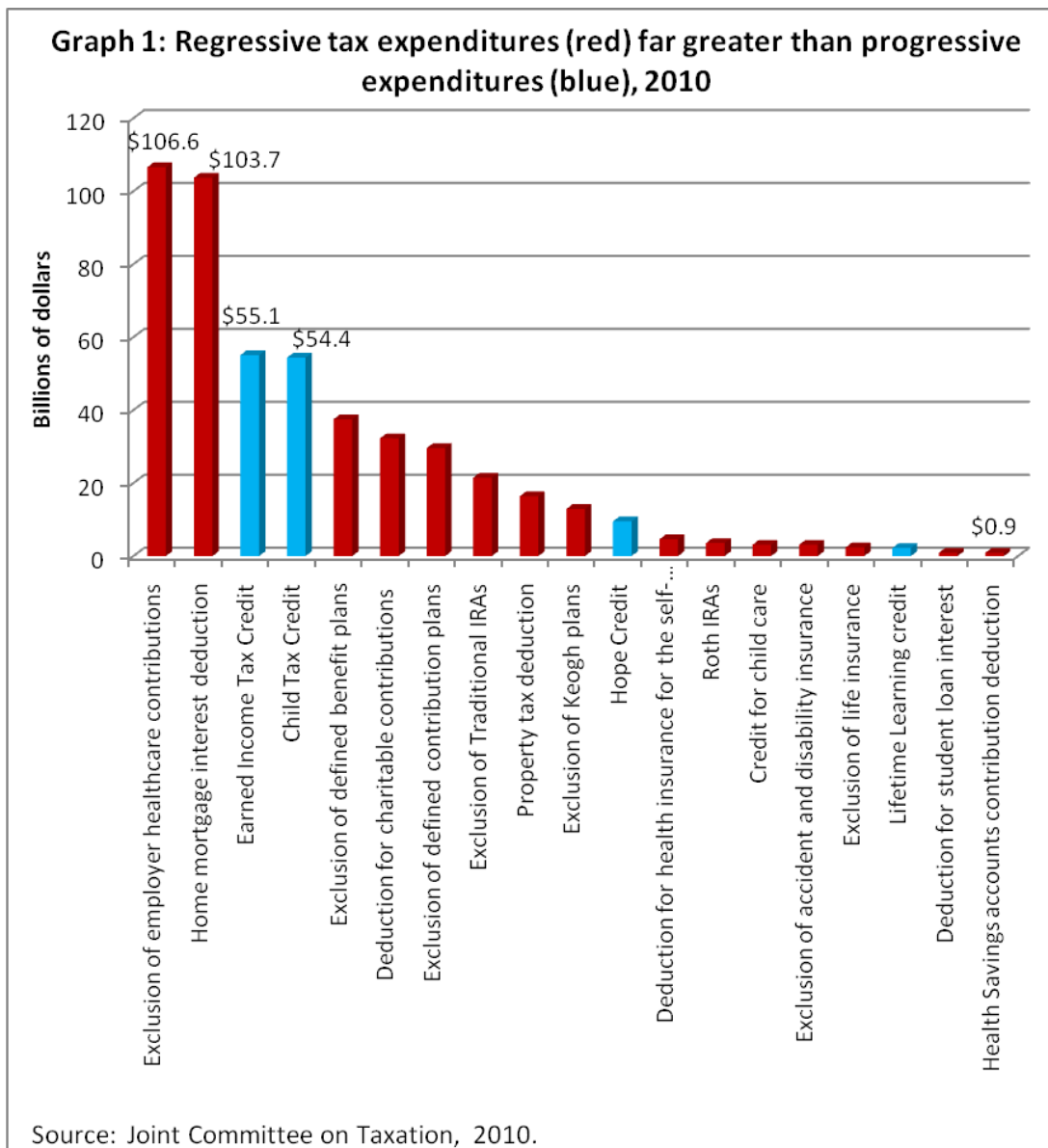


## Introduction

Last week, we examined the difficulties presented by our state-based delivery system of social safety net programs. This week, we show how the delivery of social welfare benefits through the tax code is regressive, creating a system that disproportionately benefits the wealthy and leaves lower-income families behind.

## Social Support Based on Regressive Deductions

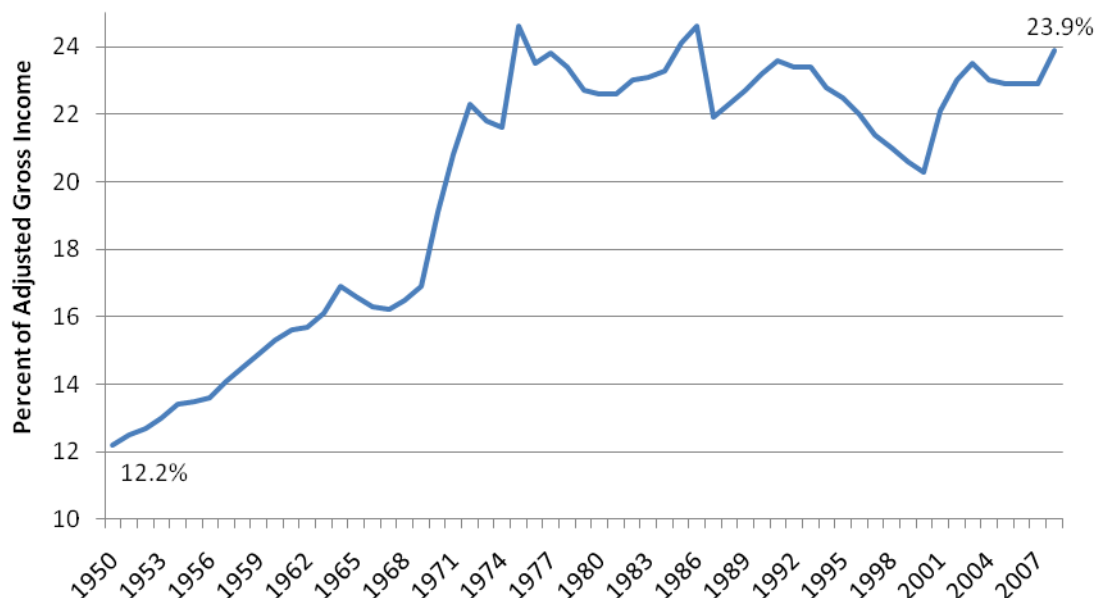
Many of America's most important social welfare benefits relating to home ownership, retirement, health care, education, and raising children are delivered through the tax code as deductions or exclusions against income. Graph 1 below provides an overview of the size of these tax expenditures, which represent a loss of federal revenue. The dark red expenditures are regressively distributed, and those in light blue are generally progressive expenditures. Overall, the federal government spends much more through regressive deductions and exclusions than through more progressive tax breaks.



## Deductions

Deductions have become an increasingly popular way for Congress to deliver social benefits without appearing to spend money or add to the national deficit. Since 1950, tax deductions have grown from 12.2 percent of Americans' adjusted gross income (AGI) to 23.9 percent of AGI.<sup>1</sup>

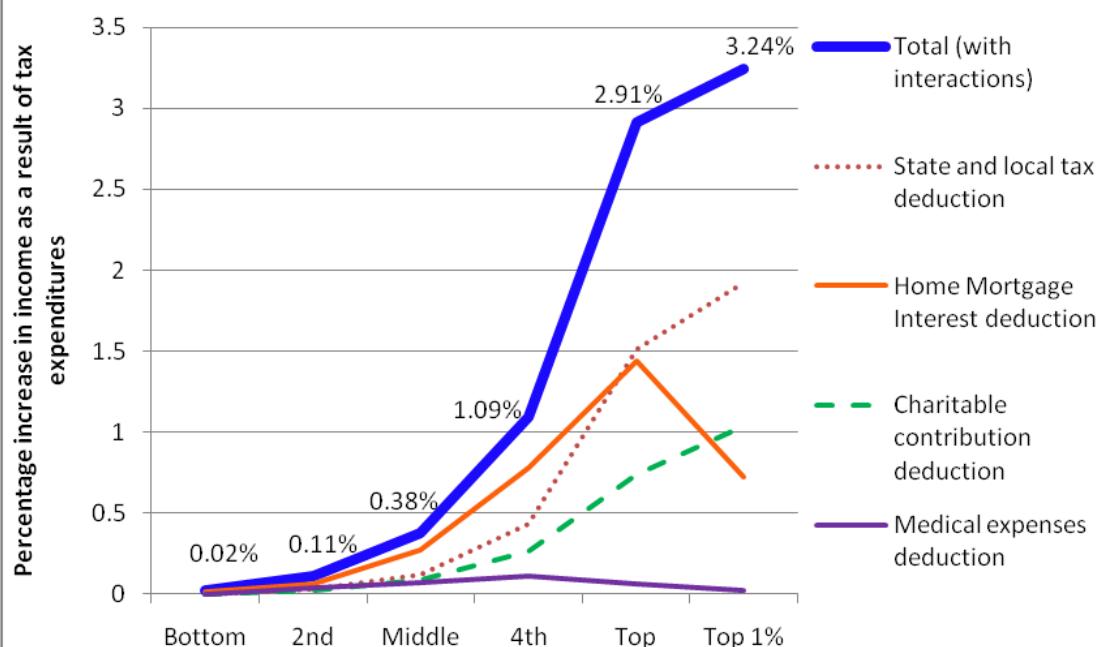
**Graph 2: Deductions increase as a percentage of adjusted gross income, 1950-2008.**



Source: IRS Statistics of Income Bulletin, Summer 2010.

However, wealthier Americans benefit much more from these breaks than the lower income groups, because lower-income groups pay less tax. In 2007, 60 percent of Americans earned under \$50,000 per year, and almost 80 percent earned less than \$75,000 per year.<sup>2</sup> Yet those in the top two income quintiles – those earning over \$57,295 per year in 2009 – benefit disproportionately from itemized deductions, as shown below.<sup>3</sup> The richest one percentile is 3.25 percent richer from itemized deductions, while the bottom quintile gains just a .02 percent increase in income as a result of itemized deductions.<sup>i</sup>

**Graph 3: Regressive Impact of Selected and Total Itemized Deductions on Income levels, by Quintile, 2007.**

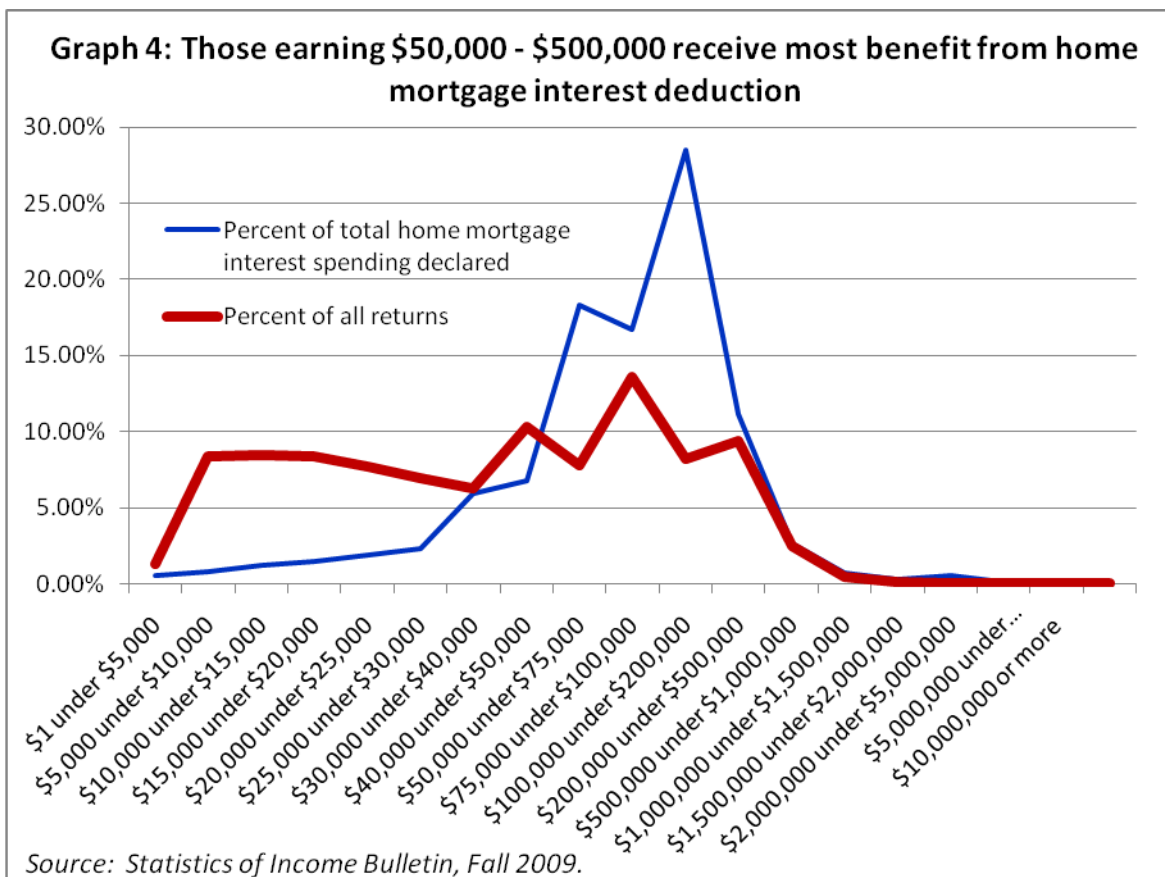


Source: Burman, Toder & Geissler. Tax Policy Center. Dec. 2008.

<sup>i</sup> In 2007, the U.S. Bureau of Labor Statistics defined household earning quintiles as: Lowest quintile: \$0 - \$19,300; Second: \$19,301- \$36,069; Middle: \$36,070- \$57,943; Fourth: \$57,944-\$91,296; Top: \$91,297 or more.

The Home Mortgage Interest Deduction is the largest of these deductions, representing \$85.46 billion in government tax expenditures in the tax year 2008.<sup>4</sup>

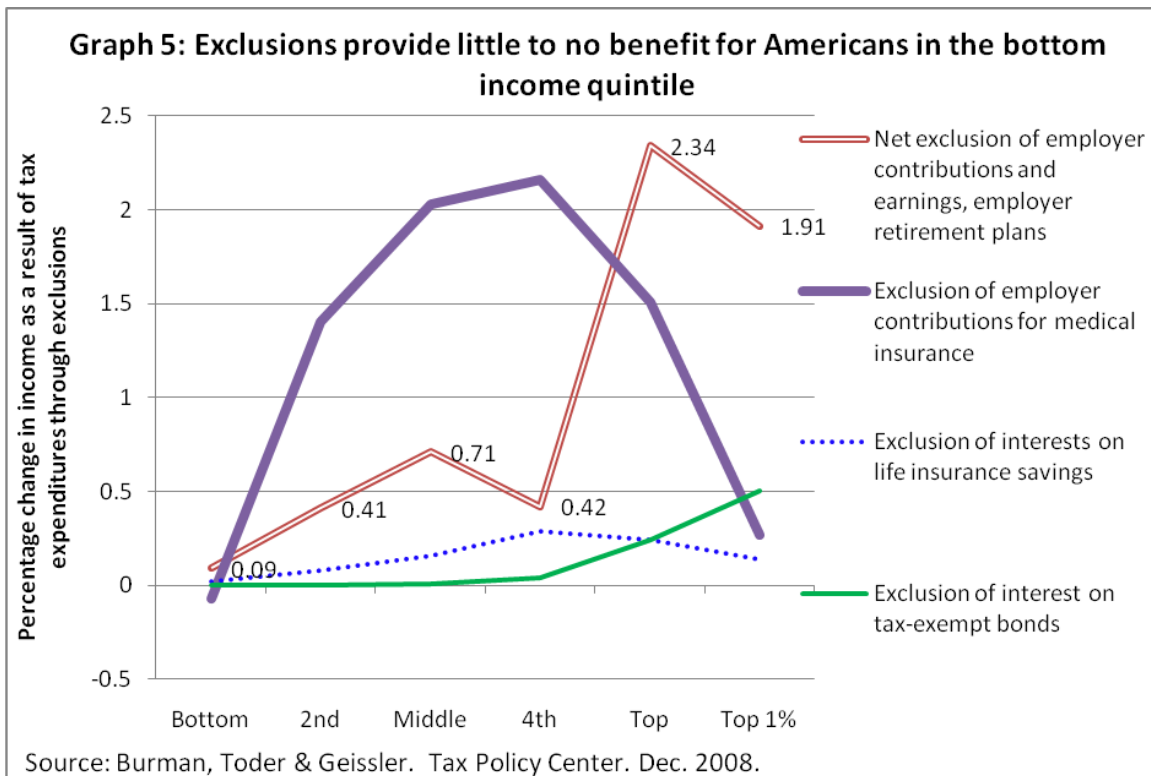
A more detailed look shows just how skewed the Home Mortgage Interest deduction is toward high earners. Those earning under \$40,000 per year are unlikely to benefit, while those earning over \$50,000 benefit disproportionately from the deduction. One group – those earning \$100,000 to \$200,000 – declares 28.5 percent of all home mortgage interest spending values but represents only 8.2 percent of returns.<sup>5</sup> In contrast, those making under \$40,000 per year make up 56 percent of all returns, but deducted just 14 percent of all 2007 home mortgage interest spending deductions.<sup>6</sup>



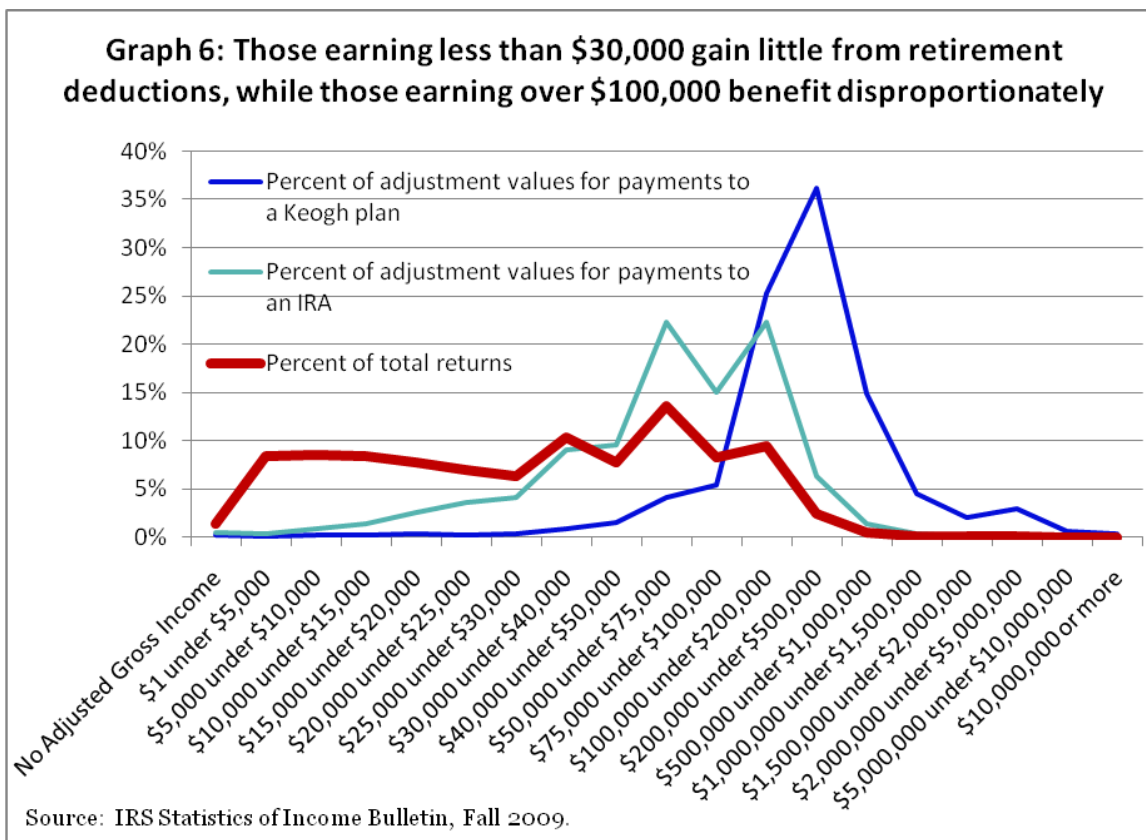
## Exclusions

The exclusions of employer contributions to retirement and health insurance plans are also highly regressive tax expenditures, and represent major outlays for the federal government. For example, the exclusion of employer contributions for health care, health insurance premiums, and long term care insurance premiums will cost the government an estimated \$106.6 billion in lost revenue in 2010.<sup>7</sup> The government will forego an additional estimated \$106 billion in revenue as a result of excluding contributions to retirement plans, including IRAs, Keogh plans, and other defined benefit and defined contribution plans.<sup>8</sup>

These expenditures are regressive because lower income and part time earners are often excluded from employer-sponsored health insurance and retirement plans, and therefore see few benefits from tax breaks encouraging employer sponsorship of health and retirement plans. In 2008, the tax exclusion of employer contributions to retirement plans made the top quintile 2.34 percent richer, while the bottom quintile benefited by just .09 percent.<sup>9</sup>



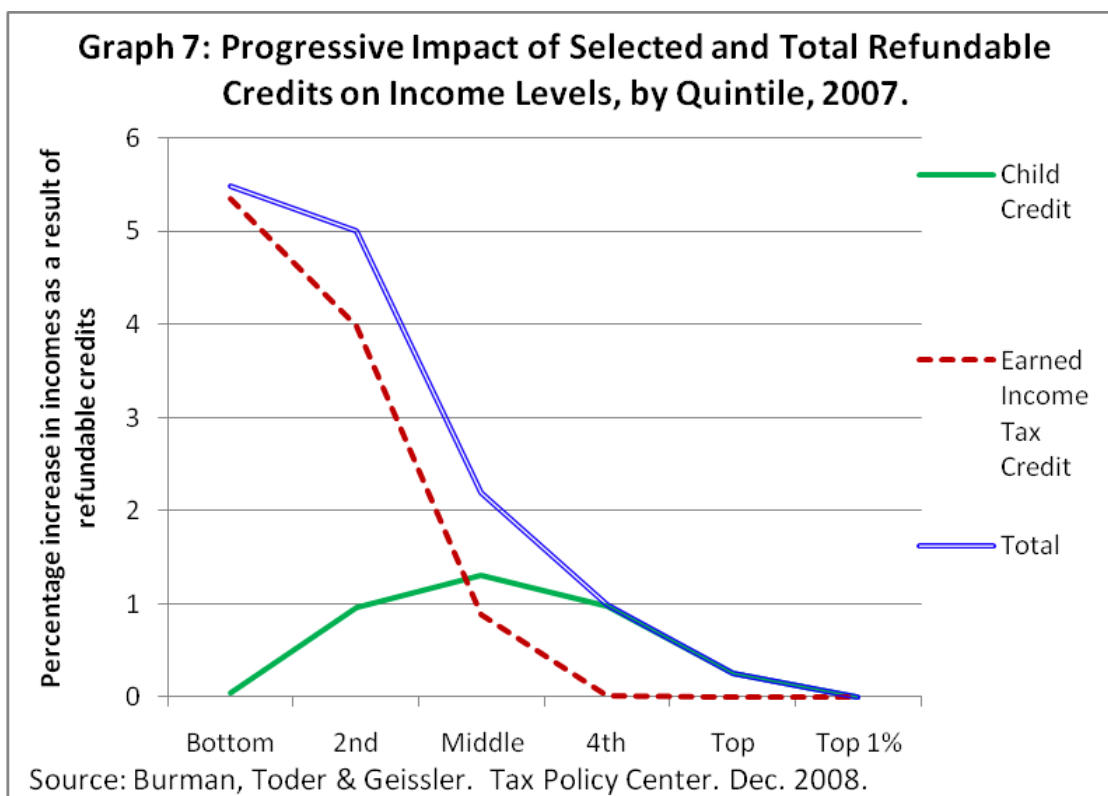
Looking more closely at retirement contribution tax breaks, one can see that those earning \$50,000 - \$1,000,000 per year benefit disproportionately from tax-advantaged Individual Retirement Account (IRA) contributions. Earners reporting adjusted gross income of \$50,000 - \$200,000 represented 31 percent of all returns, but claimed 60 percent of the value of all IRA contribution deductions in 2007.<sup>10</sup> This will cost the federal government an estimated \$21.5 billion in 2010.<sup>11</sup>



Keogh plans – the IRS calls them “Qualified Plans” – are retirement savings vehicles for the self-employed and those working for unincorporated small businesses with fewer than 10 employees. As opposed to IRAs, which have a deduction limit of \$5,000 (\$6,000 if you are age 50 or older)<sup>12</sup>, Keogh plans allow higher tax-advantaged contributions. In 2010, this is the lower of either 100 percent of one’s average income from the past three years, or \$195,000.<sup>13</sup> Because Keogh plans are more complex than simplified employee pensions (SEPS) and 401(k)s and require more administrative time (and perhaps actuarial assistance), those earning and saving less do not benefit from using these plans as opposed to SEPs or 401(k)s. As a result, in 2007 over 36 percent of the value of all Keogh plan contribution deductions was claimed by the 2.44 percent of the population earning \$200,000 - \$500,000 per year.<sup>14</sup> The government will spend an estimated \$12.9 billion on Keogh contribution exclusions in 2010 and \$16.2 billion in 2011.<sup>15</sup>

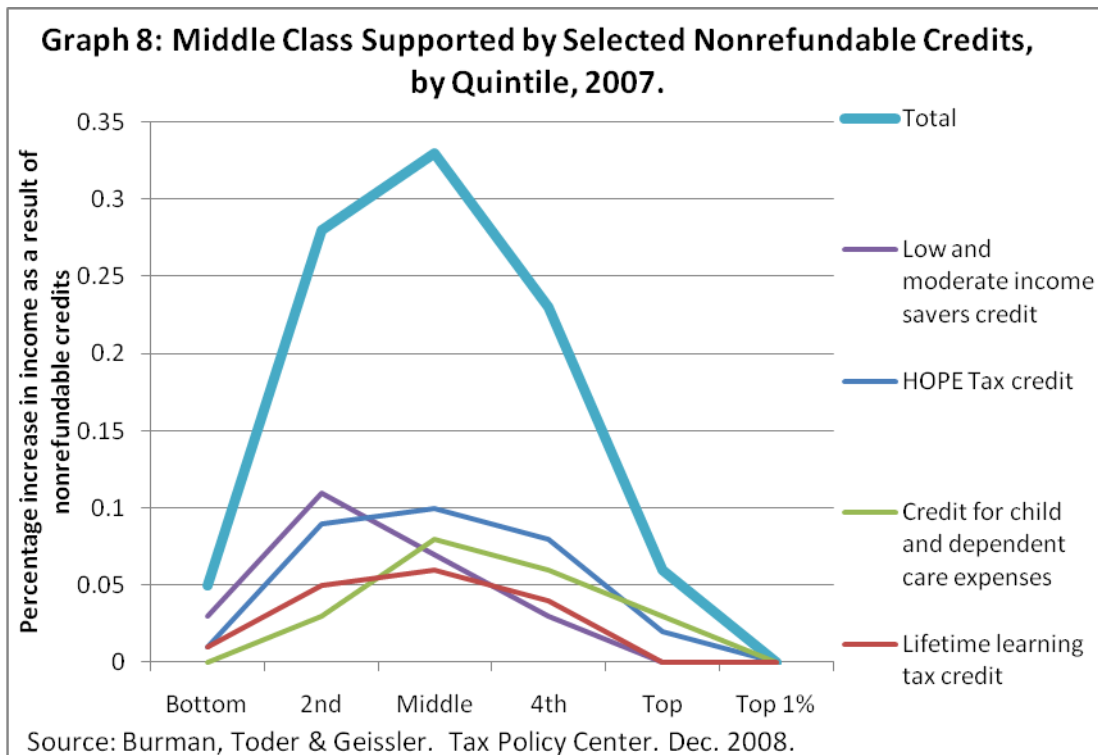
## Credits benefit the middle class, but are smaller than other tax expenditures

The Child Tax credit and the Earned Income Tax Credit (EITC) are the two largest refundable credits, at an estimated \$54.4 billion and \$55.1 billion in tax expenditures in 2010, respectively, and have a huge progressive impact on overall tax expenditures.<sup>16</sup> The impact of the Child tax credit and the EITC on low and middle income earners is shown below as the percent increase in incomes as a result of the credits.<sup>17</sup> The EITC is especially progressive, increasing the bottom two quintiles’ income levels by 5.35 and 3.99 percent, respectively.<sup>18</sup>



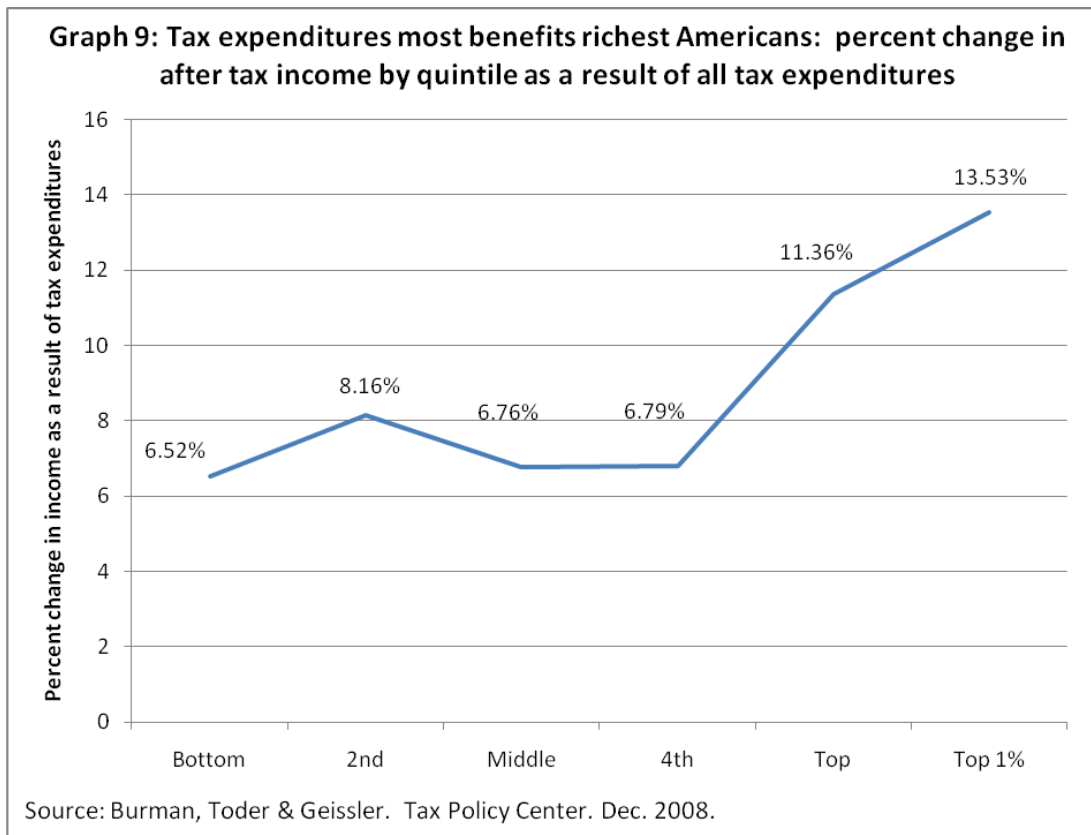
Non-refundable credits support the middle class – namely the second, third, and fourth income quintiles – but are dwarfed in comparison to the deductions, exclusions, and refundable credits outlined above. Whereas the EITC increased the 2008 incomes of the bottom and second quintiles by four to five percent, the cumulative impact of non-refundable credits ranged from .05 to .33 percent. While the EITC and Child tax credits represent around \$55 billion in spending each, the Hope credit for higher education spending (to be replaced by the smaller American Opportunity Credit for most Americans) represents an estimated \$9.5 billion in tax expenditures in 2010, the credit for child and dependent care - \$3.1 billion, and the lifetime learning credit represented just \$2.2 billion.<sup>19</sup>





## Overall delivery of social benefits: Regressive

Progressive tax expenditures are smaller than those of the more regressive deductions, and are outweighed in the overall tax expenditure picture. Graph 9 below shows the impact of government tax expenditures on the incomes of each earning group, including most substantial credits, deductions, and exclusions. Our system benefits the very highest earners, whose incomes are 13.5 percent greater as a result of tax expenditures, more than twice as much as it benefits the lowest income quintile, whose incomes are 6.52 percent higher as a result of tax expenditures.<sup>20</sup>



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In addition to awarding fewer benefits to those who most need assistance with saving for retirement and paying for health care and education, a tax-based system of benefits awards more benefits during periods of rising economic growth (individuals can deduct more when there is more income to deduct against) and fewer benefits during recessions, when there is greater need for support. The current system therefore adds to income volatility: as unemployment increases and incomes shrink, social benefits for education, health care, and retirement shrink as well.

## Conclusion

Social benefits should redistribute wealth and promote equality, but our tax-based system favors those earning over \$50,000 per year, while the other 60 percent of the population sees far fewer benefits from the system. As opposed to a tax or income-based system, a citizen-based system to support educational attainment, adequate healthcare, and retirement security would be less discriminatory towards lower income families and provide a broader and stronger safety net for all Americans.

In the sixth and final installment in this series, we will explore how the Great Recession has shown the vulnerability of the American ownership society in providing secure retirement for American families.



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<sup>1</sup> Internal Revenue Service. Statistics of Income Bulletin. Summer 2010.

<sup>2</sup> Internal Revenue Service. Statistics of Income Bulletin. Summer 2010. Also see:

Joint Committee on Taxation. Estimates of Federal Tax Expenditures for Fiscal Years 2009-2013. JCS-1-10. January 11, 2010.

<sup>3</sup> U.S. Bureau of Labor Statistics. Consumer Expenditure Survey. Table 45. Quintiles of income before taxes: Shares of average annual expenditures and sources of income, 2007.

<sup>4</sup> Joint Committee on Taxation. Estimates of Federal Tax Expenditures for Fiscal Years 2009-2013. JCS-1-10. January 11, 2010.

The Home Mortgage Interest deduction expenditure was \$79.9 in 2007 according to Burman, L., Toder, E., & C. Geissler. How big are total individual income tax expenditures, and who benefits from them? Tax Policy Center. Discussion Paper No. 31. December 2008.

<sup>5</sup> Internal Revenue Service. Statistics of Income Bulletin. Fall 2009.

<sup>6</sup> Internal Revenue Service. Statistics of Income Bulletin. Fall 2009.

<sup>7</sup> Joint Committee on Taxation. Estimates of Federal Tax Expenditures for Fiscal Years 2009-2013. JCS-1-10. January 11, 2010.

<sup>8</sup> Joint Committee on Taxation. Estimates of Federal Tax Expenditures for Fiscal Years 2009-2013. JCS-1-10. January 11, 2010.

<sup>9</sup> Burman, L., Toder, E., & C. Geissler. How big are total individual income tax expenditures, and who benefits from them? Tax Policy Center. Discussion Paper No. 31. December 2008.

<sup>10</sup> Internal Revenue Service. Statistics of Income Bulletin. Fall 2009.

<sup>11</sup> Joint Committee on Taxation. Estimates of Federal Tax Expenditures for Fiscal Years 2009-2013. JCS-1-10. January 11, 2010.

<sup>12</sup> Internal Revenue Service. Publication 590. Available at:

<[http://www.irs.gov/publications/p590/cho1.html#en\\_US\\_publink1000230433](http://www.irs.gov/publications/p590/cho1.html#en_US_publink1000230433)>

<sup>13</sup> Internal Revenue Service. Publication 560. <<http://www.irs.gov/pub/irs-pdf/p560.pdf>>

<sup>14</sup> Internal Revenue Service. Statistics of Income Bulletin. Fall 2009.

<sup>15</sup> Joint Committee on Taxation. Estimates of Federal Tax Expenditures for Fiscal Years 2009-2013. JCS-1-10. January 11, 2010.

<sup>16</sup> Joint Committee on Taxation. Estimates of Federal Tax Expenditures for Fiscal Years 2009-2013. JCS-1-10. January 11, 2010.

<sup>17</sup> Joint Committee on Taxation. Estimates of Federal Tax Expenditures for Fiscal Years 2009-2013. JCS-1-10. January 11, 2010.

<sup>18</sup> Burman, L., Toder, E., & C. Geissler. How big are total individual income tax expenditures, and who benefits from them? Tax Policy Center. Discussion Paper No. 31. December 2008.

<sup>19</sup> Joint Committee on Taxation. Estimates of Federal Tax Expenditures for Fiscal Years 2009-2013. JCS-1-10. January 11, 2010.

<sup>20</sup> Burman, L., Toder, E., & C. Geissler. How big are total individual income tax expenditures, and who benefits from them? Tax Policy Center. Discussion Paper No. 31. December 2008.



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