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## **Spending Entitlements and Tax Entitlements**

by

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The AARP Public Policy Institute, formed in 1985, is part of the Policy and Strategy Group at AARP. One of the missions of the Institute is to foster research and analysis on public policy issues of importance to mid-life and older Americans. This publication represents part of that effort.

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## EXECUTIVE SUMMARY

American social policy is largely the product of two types of federal programs, one that operates directly through the federal budget, and another that operates more indirectly through the tax code. The first set of spending programs, commonly known as “entitlement” programs, are the subject of much of the debate about the current and future cost of government programs and their implications for America’s fiscal and economic future. More than \$1.5 trillion of federal budget dollars were spent in 2006 for this first type of federal benefit programs, including Social Security, Medicare, and Medicaid.

The second set of programs, which are commonly known as “tax expenditures” in the language of tax policy, also represent a direct benefit to the individual taxpayer but are far less visible as a budgetary expense than the large spending programs. Nearly \$1,000,000,000,000 in tax benefits went to individuals through this second type of program, including such tax benefits as the mortgage interest deduction and the tax exclusion for employer-provided health insurance.

Tax entitlements represent an entirely distinct and “hidden” part of our social welfare system. Nevertheless, they are conceptually equivalent to entitlements—they confer direct benefits automatically, require no advance appropriation under the law, and they have the same impact on the federal budget deficit that direct expenditures do. Because of these similarities, these programs are referred to here as “tax entitlements.”

They also have very different distributional effects from spending entitlements. Direct spending entitlement programs are often criticized as benefiting the middle class or more affluent households as much as they benefit the poor. This shouldn’t be surprising in that programs like Social Security and Medicare were designed to be universally available for the older population. Although their benefits are spread broadly across the income spectrum, they are in fact targeted far better than are tax entitlements, which are highly skewed to the most affluent 20 percent of the U. S. population.

It is also commonly assumed that entitlement benefits are predominantly old-age benefits because the three largest programs—Social Security, Medicare, and Medicaid—are primarily or largely targeted to older Americans. Although it is true that a majority of entitlement spending goes to older age groups, when we incorporate tax benefits into the overall entitlement concept, we find that tax benefits are far more skewed to younger age groups than spending entitlements are skewed to older groups. Roughly 62 percent of major entitlement spending benefits are received by households aged 65 and older. However, these households receive less than 14 percent of tax entitlement benefits. When we combine spending and tax benefits together, we find that a majority of combined direct and tax entitlement spending—54 percent overall—actually flow to the under age 65 population, while 46 percent flow to the 65 and older population.

Some would make the point that tax benefits do not accrue to older households today largely because many older households do not pay income taxes or do not itemize, and that many older households enjoyed these benefits in the past. However, precisely the same argument applies to Social Security and Medicare—these programs will ultimately benefit workers when they age and are eligible to receive them, even though they may be received predominantly by those over 65 at a given time.

Perhaps more important than the distribution of spending and tax entitlement benefits is that concern about our fiscal future should focus equally on these two large policy instruments—spending and tax benefits—since both are large and growing rapidly, and both have similar impacts on the budget and the macroeconomy.

## INTRODUCTION

The rapid shift in our fiscal picture since 2001 from surpluses to deficits and the forecast of worse deficits to come has put the issue of entitlement spending front and center in the debate over our economic future. The president, in the 2006 State of the Union address, called for a new commission that would examine the impact these programs have on the federal budget and the economy.<sup>1</sup> But the President's address, like much of the policy debate, ignored the fact that we routinely make social policy through both the budget and the tax code.

More than \$1.5 trillion of federal dollars was spent in 2006 for various federal benefit programs called "entitlements." These highly visible programs occupy most of the attention of budget experts and the media. Another set of federal programs—those that operate through the tax code—provide similar entitlement benefits worth close to \$1 trillion to individuals, but they are far less visible than spending programs. These programs, commonly known as "tax expenditures"<sup>2</sup> in the language of tax policy, represent a direct benefit to the taxpayer and are conceptually equivalent to entitlements. Like spending entitlements, they confer direct benefits automatically under the law to those individuals who meet the legal requirements without any advance appropriation. Because they have the same effect on the budget deficit as spending entitlements do,<sup>3</sup> they are referred to here as "tax entitlements."

Tax entitlements represent an entirely distinct and "hidden" part of our social welfare system.<sup>4</sup> They also have very different distributional effects from spending entitlements. Direct spending entitlement programs are targeted much more broadly across the income spectrum, bringing about dramatic changes in economic and social well-being for Americans of all ages. Tax entitlement benefits have in some cases also brought about dramatic economic changes, such as high rates of homeownership and broad health insurance coverage, but they are much more highly skewed toward more affluent households. We also know that spending entitlements are skewed sharply toward older Americans, but we know much less about the age distribution of tax entitlements.

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<sup>1</sup> The White House, State of the Union Address, January 31, 2006, retrieved at <http://www.whitehouse.gov/stateoftheunion/2006/>. Accessed December 7, 2006.

<sup>2</sup> Tax expenditures are defined in the Congressional Budget Reform and Impoundment Control Act of 1974 as "revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability" (P. L. 93-344, sec. 3(3)).

<sup>3</sup> To quote the Congressional Joint Committee on Taxation, "Special income tax provisions are referred to as tax expenditures because they may be considered to be analogous to direct outlay programs, and the two can be considered as alternative means of accomplishing similar budget policy objectives. Tax expenditures are similar to those direct spending programs that are available as entitlements to those who meet the statutory criteria established for the programs (U.S. Congress, Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2006-2010*, April 25, 2006).

<sup>4</sup> C. Howard, *The Hidden Welfare State: Tax Expenditures and Social Policy in the United States* (Princeton, NJ: Princeton University Press, 1997) and J. Hacker, *The Divided Welfare State: The Battle Over Public and Private Social Benefits in the United States* (Cambridge: Cambridge University Press, 2002).

Analysis of tax entitlements by the congressional Joint Committee on Taxation and other experts have examined the distribution of tax entitlement benefits by income. And some experts have compared tax expenditures with direct expenditures as ways of accomplishing similar policy objectives.<sup>5</sup> But no analysis has examined the distribution of tax entitlements in terms of both age and income or compared the distribution of spending and tax entitlements by age and income together. In this report, spending and tax entitlements are compared in terms of a) aggregate size, b) growth, and c) distribution by income, age, and income and age simultaneously.

## WHAT ARE ENTITLEMENTS?

The term “entitlements” is shorthand for a category of benefits defined in the Congressional Budget Reform and Impoundment Control Act of 1974 that are conferred directly by legislation on any person or unit of government that meets the eligibility requirements established by such legislation.<sup>6</sup> In budgetary terms, entitlements are programs that generally carry permanent authorizations and are not subject to annual appropriations, thereby sealing them off from congressional appropriations scrutiny. Rhetorically, the term “entitlements” has become synonymous with automatic spending that is “uncontrollable,”<sup>7</sup> especially those benefits that are targeted at older citizens—Social Security, Medicare, and a substantial portion of Medicaid.

Entitlements are often thought of as synonymous with the three largest of those programs—Social Security, Medicare, and Medicaid—because the three compose more than 75 percent of entitlement outlays. But there are actually more than 400 distinct entitlements.<sup>8</sup> Although most are very small, the largest 10 totaled \$1.457 trillion in 2006, as shown in Figure 1. In this report, CBO’s “mandatory spending”<sup>9</sup> budget category is

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<sup>5</sup> Eric Toder, “Evaluating Tax Incentives as a Tool for Social and Economic Policy,” in *Bad Breaks All Around*, a report of the Twentieth Century Fund Working Group on Tax Expenditures (New York: The Century Foundation Press), 2002.

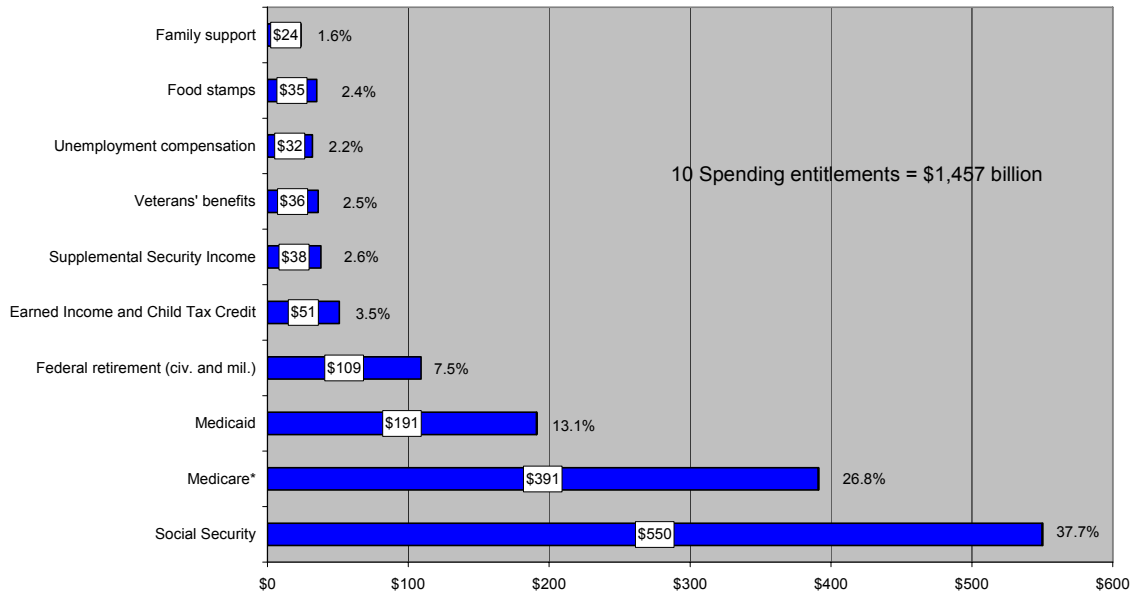
<sup>6</sup>The Congressional Budget Act defined “entitlement authority” as “authority to make payments (including loans and grants), the budget authority for which is not provided for in advance by appropriations Acts, to any person or government if, under the provisions of the law containing such authority, the United States is obligated to make such payments to persons or governments who meet the requirements established by such law.” (P.L. 93-344, 88 Stat. 297, July 12, 1974).

<sup>7</sup> As a term of art, “relatively uncontrollable” means lying outside of the traditional Congressional appropriations process, but it has sometimes come to mean something less precise like being “out of control” or “growing too fast.”

<sup>8</sup> U.S. General Accounting Office, *Budget Policy: Issues in Capping Mandatory Spending*, GAO/AIMD-94-155, Report to the Chairman, Committee on Government Operations, House of Representatives, (Washington, DC: July 18, 1994).

<sup>9</sup> The CBO mandatory spending category is virtually synonymous with total entitlement spending. It includes the largest entitlements—Social Security, Medicare, and Medicaid—and also smaller entitlements such as the payments for black lung benefits and some other payments (e.g., agricultural subsidies) that are not typically thought of when the term “entitlements” is used.

**Figure 1. Ten Largest Spending Entitlements in Billions of 2006 Dollars and Each Item as Percent of Top Ten Spending Entitlements, 2006**



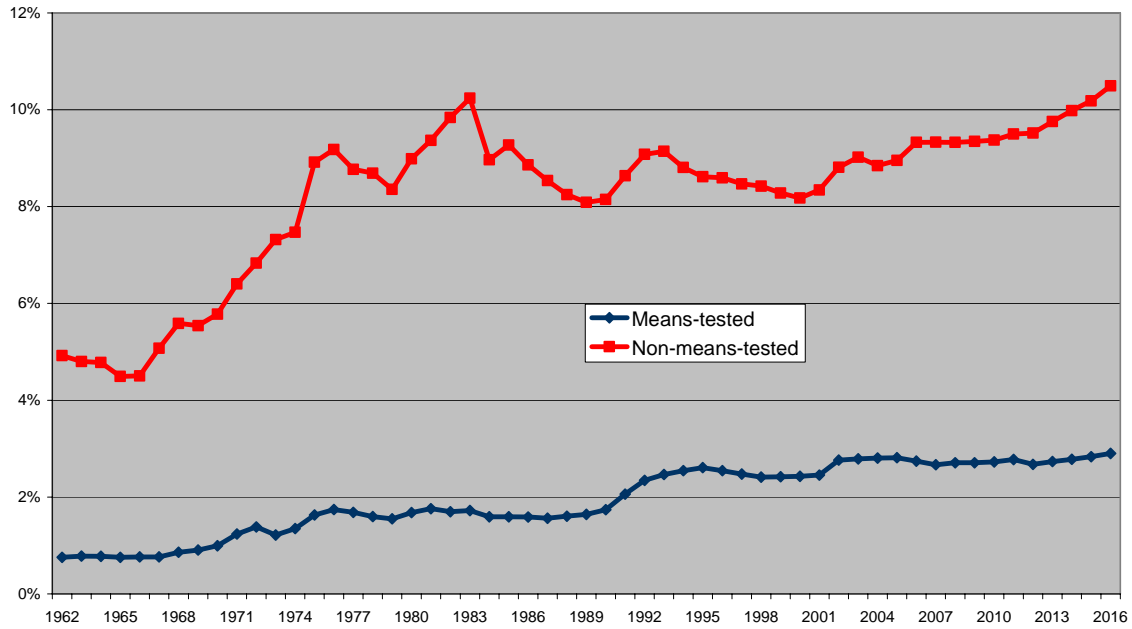
Source: Congressional Budget Office, *The Budget and Economic Outlook, Fiscal Years 2007 to 2016*, U.S. Government Printing Office, January, 2006, Appendix F, Historical Budget Data  
\*Excludes offsetting receipts

used to refer to total entitlement spending. That excludes another item of required spending in the budget—net interest payments. Net interest is not typically considered an entitlement because it is not a benefit program.<sup>10</sup>

Some entitlements are “non-means-tested,” meaning there are no income or wealth tests to determine who is eligible for benefits. The “non-means-tested” terminology encompasses social insurance programs, including Social Security, Medicare, unemployment insurance, and civilian and military retirement programs, which all provide benefits based on work histories rather than need. Other entitlements, such as Supplemental Security Income (SSI), food stamps, or Medicaid, are “means-tested,” which means they have income and/or asset tests limiting eligibility for the benefits. Non-means tested programs are four to five times as large as means-tested benefits, and grew much faster over the 1960s and 1970s, but have not grown relative to the economy for the past two decades, and will surpass their 1983 level only by 2016 (see Figure 2).

<sup>10</sup> Interest on the debt is a contractual agreement, and not technically an entitlement, but it should be included in any discussion of budget items not *controllable* through the normal congressional appropriations process.

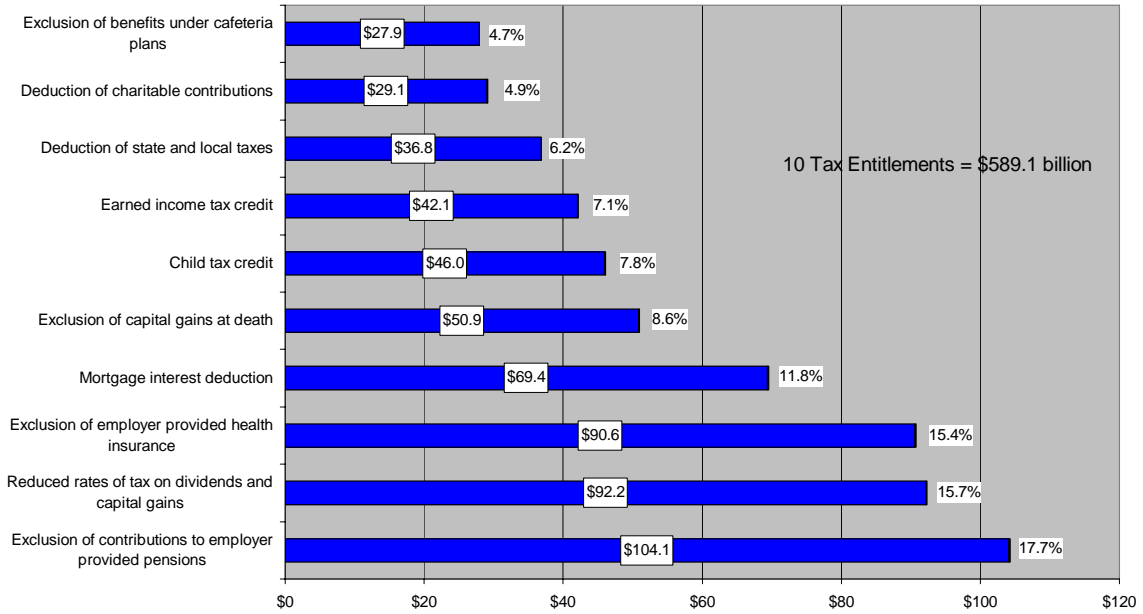
Figure 2. Means-Tested and Non-Means-Tested Entitlements as Percent of GDP, 1962-2016



Source: Congressional Budget Office, *The Budget and Economic Outlook, Fiscal Years 2007 to 2016*, U. S. Government Printing Office, January 2006, Appendix F, Historical Budget Data

Besides these programs, spending entitlements also include the outlay portion of the Earned Income and Child Tax Credits. Although these are tax provisions, they result in direct spending because they are “refundable” credits. If a tax filer’s credit exceeds his or her income tax liability, the Internal Revenue Service (IRS) pays a cash refund. The refundable amount is the entitlement outlay. In truth, however, the entire amount of the tax reduction, not just the direct outlay, represents a benefit to the taxpayer, so it is conceptually equivalent to a spending entitlement.

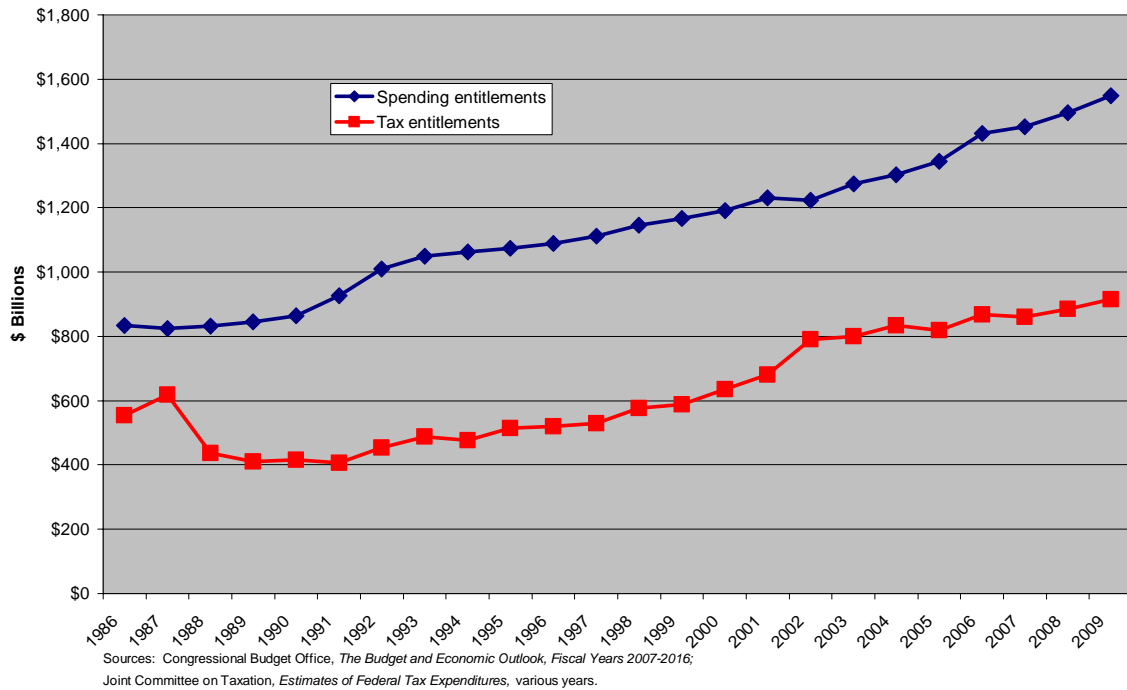
**Figure 3. Ten Largest Tax Entitlements in Billions of 2006 Dollars and as Percent of Total Top Ten Tax Entitlements, 2006**



Source: U. S. Congress, Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2006-2010*.

Figure 3 reports the 10 largest tax entitlements in 2006. After the Tax Reform Act of 1986 closed many tax loopholes and temporarily reduced the overall cost of special provisions, tax entitlements began to increase again as a percentage of total spending entitlements, growing from just over 50 percent of spending entitlements in 1988 to nearly 60 percent today (see Figure 4).

Figure 4. Aggregate Amounts of Spending and Tax Entitlements, 1986-2009 (\$2006)



The total estimated revenue loss from individual tax expenditures was more than 7 percent of GDP in 2006, and more than three times the federal budget deficit.<sup>11</sup> Strictly speaking, tax entitlements are not additive. Each one is estimated separately as though all the others are in place. They interact, and the sum of all tax entitlements would not precisely equal the amount of revenue gained if they were all repealed.<sup>12</sup> However, many experts have added them together to provide a rough approximation of their combined effect.

<sup>11</sup> See T. Hungerford, *Tax Expenditures: Trends and Critiques*, Congressional Research Service, Report for Congress, September 13, 2006; and T. Hungerford, *Tax Expenditures: Good, Bad, or Ugly?* *Tax Notes*, October 23, 2006.

<sup>12</sup> One analyst has estimated the interaction of 12 tax entitlements (including 5 of the 10 in figure 6) by modeling the revenue loss among all 12 simultaneously and comparing that with the sum of the 12 as estimated individually by the Joint Committee on Taxation. He found that the sum of the 12 was 17.5 percent greater than the revenue gain from eliminating all 12 provisions at once. However, two of the largest tax entitlements—the exclusion of employer-provided pension contributions and the exclusion of employer-provided health insurance payments—were not included in that analysis, and might partially compensate for the differential because these two provisions would place some people in higher marginal tax brackets and subject some of them to the alternative minimum tax (AMT). T. Hungerford, *Tax Expenditures: Trends and Critiques*, CRS Report for Congress, September 13, 2006.

## HOW ARE ENTITLEMENT BENEFITS DISTRIBUTED?

Some have claimed that entitlement spending provides excessive benefits to the affluent, and that they should be means-tested.<sup>13</sup> However, Social Security has contributed to a much-reduced poverty rate, a redistribution of income, greater equality of income,<sup>14</sup> and a greater independence of living arrangements among the elderly.<sup>15</sup> In fact, as shown below, spending entitlement benefits in general are distributed much more equally than are tax entitlement benefits.

### *Distribution of Spending Entitlements by Income*

Social Security and Medicare redistribute income toward lower-income retirees. According to data from the U.S. Current Population Survey, over 80 percent of Social Security and Medicare benefits are received by people in families with pre-transfer incomes below \$20,000. The chart below shows that the largest entitlement spending programs (Figure 5 encompasses more than three-fourths of all spending entitlement dollars) are fairly evenly distributed by income, with the highest percentage of dollars going to the third and fourth income deciles.<sup>16</sup>

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<sup>13</sup> Peter G. Peterson, *Will America Grow Up Before It Grows Old?* (New York: Random House, 1996) and *Gray Dawn* (New York: Times Books, 1999).

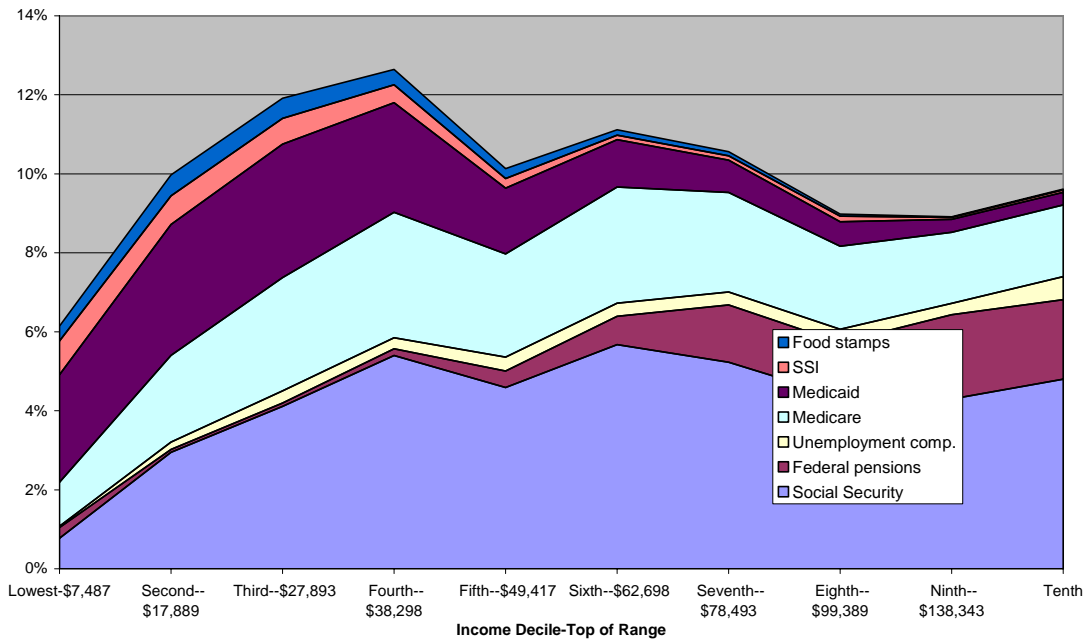
<sup>14</sup> U. S. Bureau of the Census, *The Effects of Government Taxes and Transfers on Income and Poverty: 2004*, February 14, 2006. Accessed at <http://www.census.gov/hhes/www/poverty/effect2004/effectofgovtandt2004.pdf> on February 26, 2008.

<sup>15</sup> McGarry, K. and Schoeni, R., "Social Security, Economic Growth, and the Rise in Independence of Elderly Widows in the 20th Century," NBER Working Paper #6511, National Bureau of Economic Research, November 1998.

<sup>16</sup> The estimates were provided using a microsimulation tax and income transfer model developed by Chainbridge Inc., a tax and transfer pricing consulting firm. Their proprietary individual income tax model starts with a Public Use Statistics of Income (SOI) tax microdatabase merged with the Current Population Survey (CPS). The merge procedure was performed without replacement to ensure that the characteristics of both the SOI and CPS microdatabases were preserved. The merged microdatabase was then extrapolated (grown) to 2006 levels based on a non-linear optimization procedure. Control totals for over 200 targets were obtained from SOI, Census, and the Bureau of Economic Analysis and these control totals and the predicted SOI income distribution were achieved through the application of the extrapolation algorithm. The resulting microdatabase represented 2006 values for a number of tax, income transfer, other economic, and demographic variables as well as the predicted 2006 SOI income distribution.

The income definition used to classify individuals starts with Adjusted Gross Income and adds in tax-exempt interest, the employer share of Medicare and Social Security payroll taxes, workers' compensation, and untaxed Social Security benefits. The cutting points for the ten deciles, which are for the entire population, are \$7,487 (between first and second deciles), \$17,889, \$27,893, \$38,298, \$49,417, \$62,698, \$78,493, \$99,389, and \$138,343.

**Figure 5. Percent Distribution of Selected Major Spending Entitlements, All Ages, by Income Decile, 2006**



Source: Chainbridge Inc. Individual Income Tax Model

### ***Distribution of Tax Entitlements by Income***

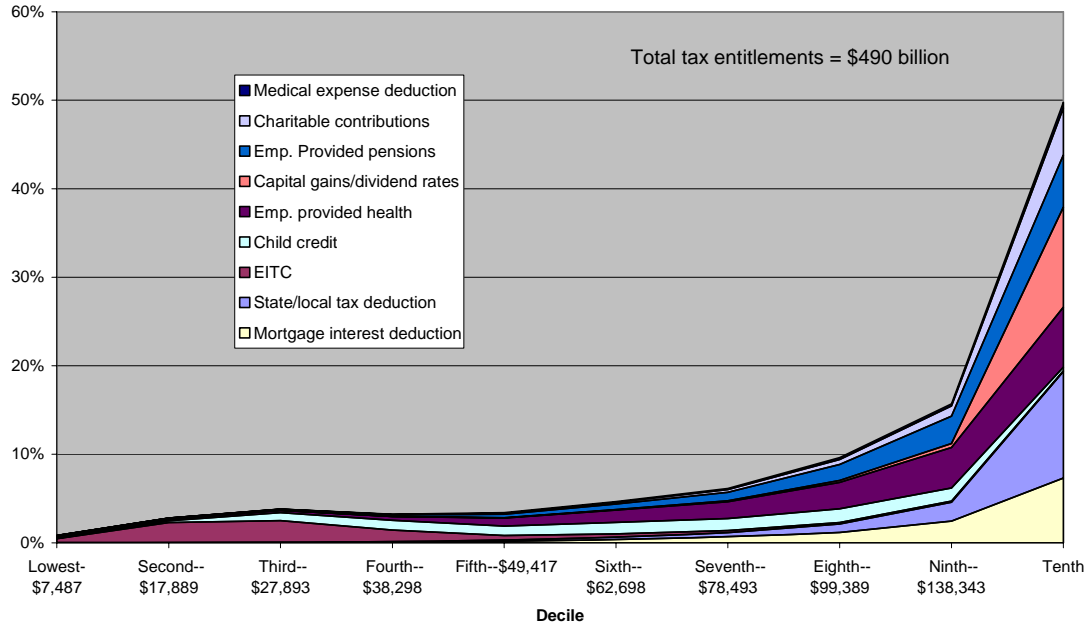
Figure 6 includes the largest tax entitlements, and the nine entitlements encompass more than half of all tax entitlement dollars. Using the same income framework as with spending entitlements demonstrates the extreme concentration of tax entitlements in the top two income deciles, which receive almost two-thirds of all the tax benefits for these selected items, half going to the top decile alone.

The highly skewed nature of the largest tax provisions is truly remarkable, in light of the commonly-held perception that the large tax entitlements such as the deferral of taxes on employer-provided pensions, the exclusion of employer-provided health insurance, and the mortgage interest deduction are broad middle-class benefits. The capital gains preferential rate suggests that only the top 10 percent receive any benefit at all from this provision. On the other hand, Figure 6 shows that the most evenly distributed provision is the child credit, which provides fairly equal benefits across the third through the ninth deciles. The health insurance exclusion also extends noticeably as low as the fifth income decile. But the other tax provisions are heavily weighted toward the most affluent households.

What accounts for the extreme skewness of tax benefits? The concentration of benefits results from the tax system's reliance on deductions and exclusions, which provide larger benefits to those high in the income distribution than to those in the middle because they are directly related to income. The sharp increase in inequality has also skewed incomes

over the past 20 years, especially within the top one percent of the income distribution.<sup>17</sup> In addition, a large number of households do not itemize deductions because they are actually better off with the standard deduction. And there are many individuals and couples, especially retirees, who do not file tax returns at all because their incomes are too low.

**Figure 6. Percent Distribution of Selected Tax Entitlements, All Ages, by Income Decile, 2006**



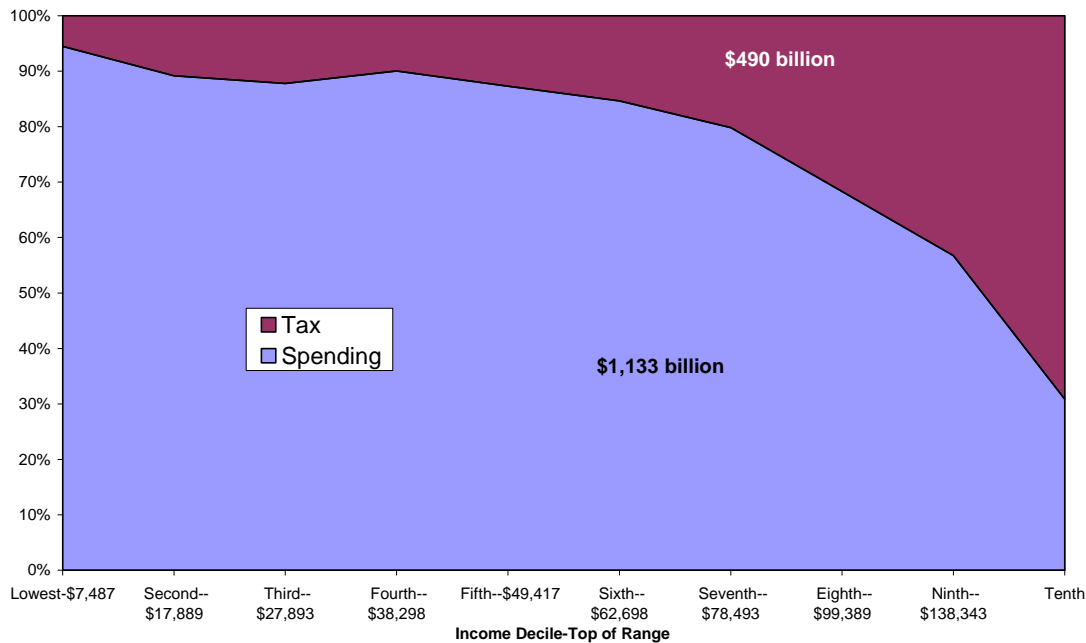
Even those tax entitlements that are fairly widely received, such as the mortgage interest or state and local tax deductions, disproportionately benefit the highest income classes. Nearly 80 percent of mortgage interest deduction benefits go to the top 20 percent of households. An even larger percentage of state and local tax deductions—nearly 90 percent—go to households in the top 20 percent.

***Joint Distribution of Spending and Tax Entitlements by Income***

We can get an idea of the relative size and the distribution of the selected spending and tax entitlements by combining them by income class, as in Figure 7 below. The chart illustrates the relative size of the two groups of entitlements, and it also demonstrates the difference in the shape of the distribution of spending and tax benefits. The former skew toward the lower-income end of the spectrum, and the latter tilt considerably toward the high-income end.

<sup>17</sup> T. Piketty and E. Saez, “How Progressive is the U.S. Federal Tax System? A Historical and International Perspective,” *Journal of Economic Perspectives*, 21 (1), Winter, 2007, 3-24.

**Figure 7. Relative Proportion of Selected Spending and Tax Entitlements, All Ages, by Income Decile, 2006**



***Distribution of Spending Entitlements by Age and Income***

Fiscal experts have come to recognize the advantages of looking at government taxes and benefits from a lifetime, rather than a single year, perspective.<sup>18</sup> Although no data set exists that would allow us to determine the entitlement benefits that people receive over their lifetimes, we can examine the benefits, both spending and tax entitlements, that people of different ages receive at a given point in time. Comparing benefits at different ages might suggest how benefits are distributed across the life cycle.

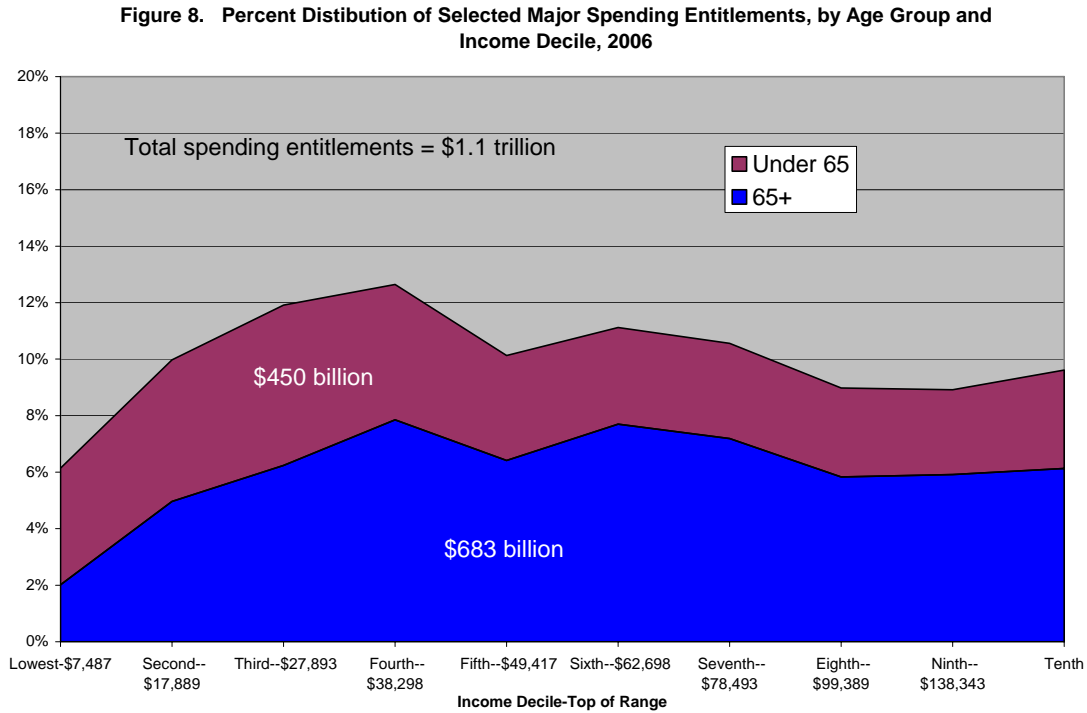
The CBO has estimated that the average person between the ages of 20 and 64 pays about \$8,100 in federal taxes and receives about \$1,500 in benefits, whereas the average person between the ages of 65 and 79 pays about \$4,800 in taxes and receives about \$12,000 in benefits.<sup>19</sup> But these estimates don't take into account what both younger and older groups might receive in tax entitlements, how they are distributed by age, and whether

<sup>18</sup> D. Fullerton and D. Rogers, *Who Bears the Lifetime Tax Burden?* (Washington: The Brookings Institution, 1993); G. Metcalf, "Lifecycle v. Annual Perspectives on the Incidence of a Value-Added Tax," *Tax Policy and the Economy*, Vol. 8, 45-64, 1994; A. Reschovsky and H. Chernick, "Measuring Consumption Tax Burden: Revisiting the Annual Income-Lifetime Income Debate," presented at the 88<sup>th</sup> Annual National Tax Association conference, October 8-10, 1995.

<sup>19</sup> Congressional Budget Office, *Long-Term Budgetary Pressures and Policy Options*, Washington, DC, USGPO, May, 1998. As the CBO has noted, it is risky to attribute the benefits of entitlement spending to specific age groups because the ultimate beneficiaries may not be the ones receiving the direct cash or in-kind benefits. The income support provided to retirees by Social Security benefits not only them but also their children, both financially and psychologically.

the tax benefits for younger age groups might balance the benefit distribution between the age groups.

First, in terms of spending entitlements, Figure 8 below shows the distribution of spending by age group for seven large entitlement programs included there.



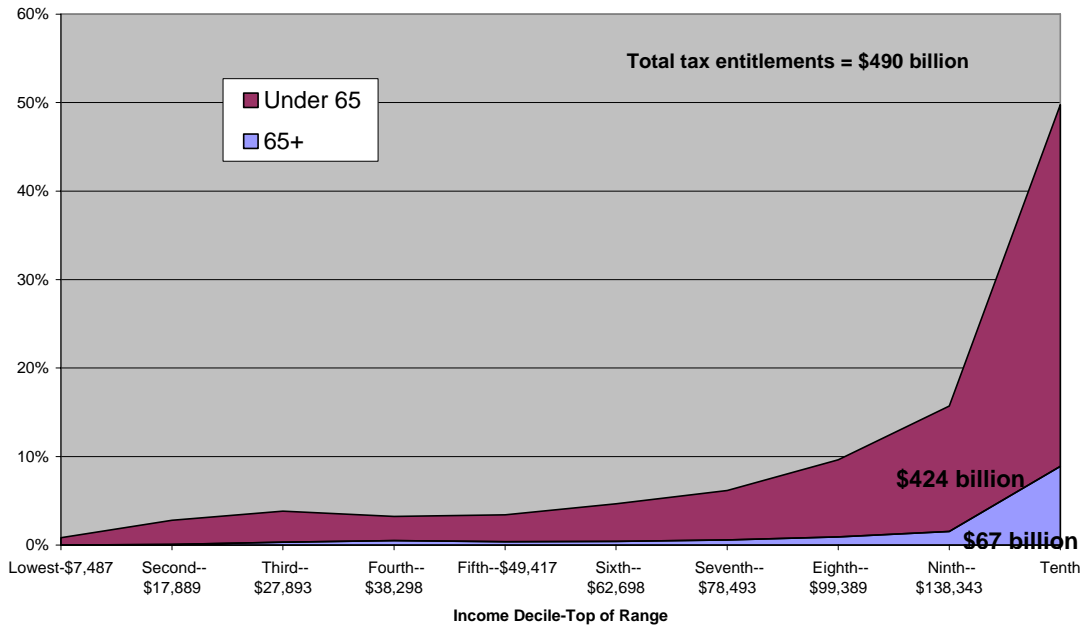
Spending entitlements are fairly broadly distributed across income deciles, for both the 65 and older and the under 65 age groups. Spending entitlements overall are divided roughly 60-40 between the 65+ and under age 65 groups, but benefits for the younger age group skew more toward the lower-income end (4 percent of the total in the lowest decile going to those under age 65 and 2 percent to those 65 and older), because those spending programs are all means-tested. Benefits for the 65+ age group, which are by design nearly universal for this age, tend to peak roughly in the middle of the income distribution. Whereas roughly two-thirds of the benefits in the lowest decile go to the under 65 age group, those percentages are roughly reversed in the top five deciles.

***Distribution of Tax Entitlements by Age and Income***

Tax benefits show a dramatically different distribution by age from that of spending entitlements. The concentration of tax benefits by income was shown above, but Figure 9 demonstrates the concentration of tax benefits by age. Although roughly 6 in 10 federal *spending* dollars benefit the older population, the population under age 65 received 7 of 8 federal *tax* benefit dollars (Figure 9 below). The three largest tax entitlements—the exclusion of employer-provided pension contributions, the exclusion of employer-provided health insurance, and the deductibility of home mortgage interest—totaled

about \$220 billion in 2006, and are designed to benefit workers and younger families. It is certainly true that these tax benefits do not accrue to older households today because many do not pay income taxes or do not itemize, and that many older households enjoyed these benefits in the past. Precisely the same argument applies to Social Security and Medicare—these programs will ultimately benefit workers when they age and are eligible to receive them, even though they may be received predominantly by those over 65 at a given time.

**Figure 9. Percent Distribution of Selected Tax Entitlements, All Ages, by Age and Income Decile, 2006**



Source: Chainbridge Inc. Individual Income Tax Model

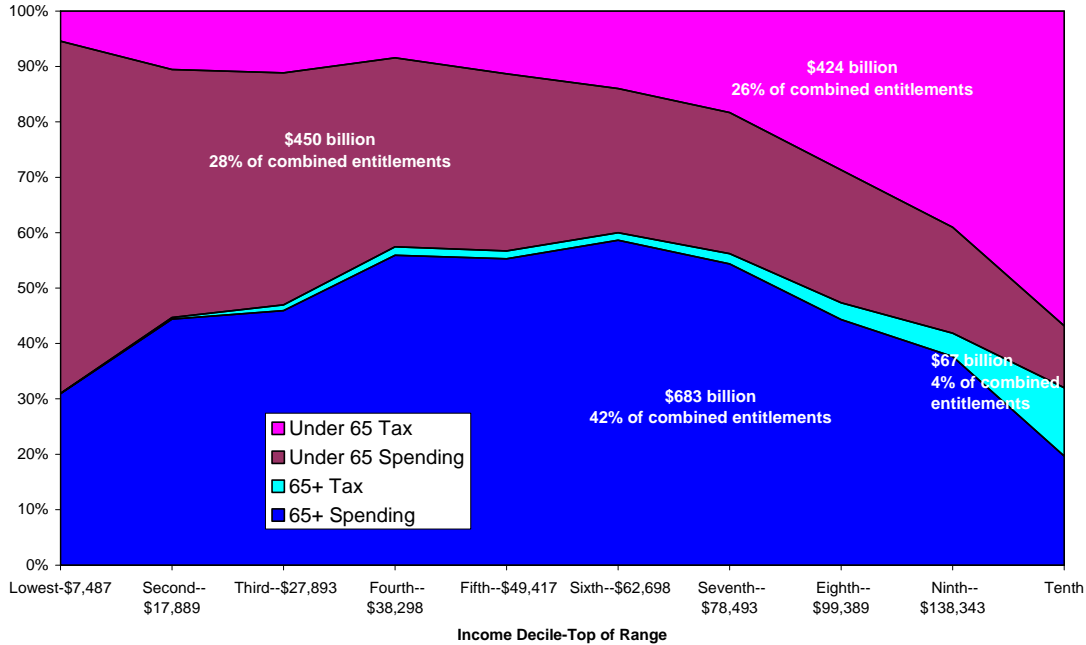
***Joint Distribution of Spending and Tax Entitlements by Age and Income***

Figure 10 below combines the distribution of both spending and tax entitlements by age and income. Overall, about 54 percent of all entitlement dollars are received by the under age 65 population, represented by the top two areas in Figure 10. The 54 percent is roughly equally divided between spending and tax entitlements. Only 46 percent of all the entitlement benefits represented in Figure 26 are received by the 65+ population, 42 percent coming from spending and 4 percent from tax entitlements. While this is clearly disproportionately large relative to the 12.4 percent share of the population aged 65 and older, the focus of attention on the distribution of spending entitlements appears to have overlooked that the older population receives a minority of all entitlement benefits.

The share of entitlements received by older Americans tends to be more concentrated in the middle of the income distribution. By contrast, the entitlement benefits received by the under 65 age group occur at the two extremes of the income distribution. The low-income extreme is due mainly to means-tested benefits, whereas the high-income extreme

is due mainly to tax benefits for the affluent. If this suggests anything about the lifetime distribution of entitlement benefits, it suggests that they are likely to be spread fairly evenly across the life cycle.

**Figure 10. Shares of Combined Spending and Tax Entitlements Received by 65+ and Under 65 Age Groups, by Income Decile, 2006**



## CONCLUSION

Our social welfare system consists of two types of programs—highly visible spending entitlements, including Social Security, Medicare, and Medicaid, and less visible tax entitlements, like the exclusion for employer-provided health insurance or the deduction for mortgage interest payments. Both sets of programs operate somewhat automatically without annual appropriations review. Spending entitlements are almost two thirds larger than tax entitlements and have received considerably more attention in the debate over our current and future budget problems. The greater focus on spending entitlements has led to the impression that entitlements benefit mainly the old and that the benefits are poorly targeted because they don't target just the poor and the low-income but spread across the middle class and more affluent as well.

A more comprehensive look at entitlements to include tax benefits shows that spending and tax entitlements are both very large (although spending entitlements are larger) and that overall entitlements are closely divided between those who are age 65 or older and those under 65. Even though spending entitlements broadly span the middle class, they are more closely targeted on those in need than tax entitlements.

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