



The Ripon Society's Congressional Report: Public Policies for Debate 2005

Tax Reform
Health Care
National Security
Infrastructure
Education
Homeownership

IN CONGRESS, JULY 4, 1776,
A DECLARATION
BY THE REPRESENTATIVES OF THE
UNITED STATES OF AMERICA,
IN GENERAL CONGRESS ASSEMBLED

The
Ripon
Society



About The Ripon Society:

The Ripon Society, founded in 1962, is a nonprofit think tank, research, and grassroots outreach organization. Taking its name from the Republican Party's birthplace in Ripon, Wisconsin, The Ripon Society is dedicated to the Republican Party's founding principles and commitment to liberty. While times change, The Ripon Society believes that certain values are permanent. To this end, The Ripon Society promotes a common sense agenda that is committed to limited government, a vibrant free market economy, strong families, civil rights, and a foreign policy guided by America's national interests. Through its nationally recognized magazine, *The Ripon Forum*, State Policy Outreach events, policy breakfast, lunch, and dinner series, Listening Tours and public policy papers, The Ripon Society advances debate and dialogue within the Republican Party.

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The Ripon Society's
Congressional Report:
Public Policies for Debate
2005

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Table Of Contents

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- 4 Letter From the President Emeritus
- 5 Tax Reform and Economic Growth
—By Bruce Bartlett
- 15 The Perils of Drug Importation
—By Robert Goldberg
- 25 Does the Transatlantic Alliance Still Make Sense?
—By John O’Sullivan
- 33 Modernizing Our Nation’s Infrastructure
—By Adrian Moore
- 41 Closing the Racial Gap in Education
—By Abigail Thernstrom and Stephan Thernstrom
- 51 Minority Homeownership and the American Dream
—By Steven Hornburg
- 65 Biographies

The Honorable Bill Frenzel

January 2005

Dear Members and Friends:

The Ripon Society thanks you for your continued support and interest in the important work it is doing. As you are aware, The Ripon Society has been a prominent Republican think tank and policy outreach organization for over forty years. In the coming year, Ripon will further expand its role as a policy and grassroots Republican organization.

The re-election of President George W. Bush and Republican gains in both the House and Senate last November will offer Republicans a better opportunity to help shape an agenda during the 109th Congress. The Ripon Society intends to play a major role in influencing policy decisions by directing the dialogue towards better ideas based on our commitment to limited government, free market institutions, individual liberties, and a strong national defense.

Our First Annual Congressional Retreat and these six policy papers are designed, above all, to encourage vigorous policy debate and arrive at common-sense solutions. As always, The Ripon Society prides itself on seeking consensus through thoughtful debate. The GOP should be the party of the “Big Tent,” which is open to diverse points of view.

At least one common theme runs through each of these significant policy papers—namely the benefits of limited government. While government is necessary, our Republican principles warn us that unrestrained, expansive government should be avoided at all cost. When government makes the choices, it creates more losers than winners. The likely result is not only unfairness but also perverse incentives and an inefficient allocation of resources.

This favoritism is seen time and again wherever government intervenes. In our policy paper on drug importation, for example, government price controls are shown to create unreasonable incentives and stifle innovation in the pharmaceutical and medical technology industries. This, and other examples, should remind us of the effectiveness of free market institutions, and the need to structure legislative policies that promote the general welfare.

While these papers do not constitute an endorsement of a specific policy agenda, they do reflect The Ripon Society’s commitment to advancing thoughtful public policy debate. The Ripon Society will continue to be an engine of public policy and make contributions to the policy dialogue in this vital session of Congress. Only by identifying and enacting responsible solutions to our nation’s public policy dilemmas can the Republican Party hope to create a permanent majority.



Yours cordially,

Bill Frenzel
President Emeritus

Tax Reform Congressional Report

Photo by Alex Wong/Getty Images



Congresswoman Deborah Pryce

One of the things that I appreciate most about being a Republican is the diversity of opinions that we hold. It is a comfort to know that our party, and more importantly, our nation, can arrive at common-sense solutions to the most complicated public policy questions.

Over the years, The Ripon Society has played an essential role in fostering thoughtful policy dialogue to promote the public good on a wide range of issues. Tax reform is one of those issues where all people of good will can recognize a problem, but arriving at the best solution is not always as obvious.

I know that Americans are extremely hard working people. Simple fairness dictates that they deserve to keep more of their paycheck to care for their families. For this reason, tax relief is vital, not only to grow our economy and create more jobs, but to allow all Americans the opportunity to live out their greatest dreams. Burdensome taxes and an overly complicated tax code present significant barriers to the economic security of all citizens.

The importance of empowering Americans by creating greater opportunity can get lost in the debate over how to reform our tax code. The Ripon Society's commitment to open debate and consensus building is especially important today. With tax reform on the agenda in the next Congressional session, understanding the benefits and drawbacks of each reform model is essential. An informed citizenry is vital to a functioning democracy. Americans must know the differences between a flat tax, value-added tax, consumption tax, and all sorts of variations if they are to participate in our government.

By producing significant policy papers to encourage discussion and debate, The Ripon Society has made a great contribution to our nation's tax reform dialogue. Let the debate continue!



Tax Reform and Economic Growth

Bruce Bartlett

It is becoming increasingly clear that tax reform will—or at least should—be a key item on the political agenda in 2005. With nearly 20 years having passed since the last major tax reform effort, the Tax Reform Act of 1986, it seems appropriate to consider a new tax reform agenda for the future. This is especially true because the tax code has become immensely more complex and in dire need of simplification in the time since the Tax Reform Act. Moreover, growing tax evasion and glaring problems on the corporate side are eroding the tax base and creating gross unfairness, as individuals and businesses are taxed at widely different rates depending on how aggressively they engage in tax sheltering or evasion activities.

Unfortunately, there is no consensus on how to reform the tax code. Moreover, the need for reform and simplification may soon be overwhelmed by pressure to raise net federal revenue. The federal budget is in severe deficit and the impending retirement of the baby boom generation is going to increase the need for revenue to pay promised benefits. Even if Social Security is reformed soon, it will not reduce the growth of entitlement spending for many years to come.

Therefore, it seems probable that tax reform will have to take place in the context of raising taxes, rather than cutting them. This is not necessarily a bad thing from the point of view of tax reform. Political and economic pressure to raise revenue to reduce the deficit may force action on reform measures that might otherwise be politically impossible to enact. For example,

in exchange for increasing the tax burden on corporations, Congress might be willing to modernize our corporate tax system, making it more efficient and improving the ability of American firms to compete in the world market.

Following is a review of some general principles of tax reform, some suggestions for specific tax changes, and a discussion of the political and economic circumstances under which the debate on this issue is likely to occur.

Comprehensive Income Tax Option

Generally speaking, there are two basic approaches to fundamental tax reform that have long been debated among economists and tax theorists. The first is known as a comprehensive income tax. It is based on what is called the Haig-Simons definition of income, which is consumption plus the change in net worth between two points in time.¹

Under such a tax system, there would be no special treatment for dividends, capital gains or saving. All income would be taxed, but only once. There would be no place for any sort of special deductions, credits, 401(k) and Keogh accounts, or the corporate income tax, which constitutes a double tax on income generated in the corporate sector.²

The idea is to have gross income and taxable income be as close to each other as possible. Under our current system, the two can diverge dramatically. This creates unfairness, because two taxpayers in similar circumstances can pay quite different

Tax Reform

tax rates. And it creates inefficiency, because investment and other economic activities are being dictated by the tax code instead of the free market.

The Brookings Institution has long been associated with this particular approach to tax reform. Dating back at least 40 years, it has published innumerable books and conference proceedings with detailed analyses of ways in which the tax system diverges from a comprehensive income tax and ways in which it can be reformed along these lines.³ In 1969 and 1976, Congress passed major tax reform legislation designed to bring the tax code more into line with a comprehensive tax base.

The other major approach to tax reform would be a pure consumption tax.⁴ In 1976, the Treasury Department issued a report known as the Blueprints study that explained how a consumption tax could be implemented. (It also contained a proposal for a comprehensive income tax as well.)⁵

“The principal virtue of a consumption-based tax system is that it is much less burdensome to the economy than an income tax raising the same revenue. That is because saving, investment and risk-taking are especially critical to growth. Even small burdens in these areas can be very detrimental to economic growth. For this reason, it is probably safe to say that most economists these days favor a consumption-based tax system.”

Consumption Tax Option

It is often wrongly assumed that a consumption tax must necessarily take the form of a direct tax on consumption. In Europe, this is done via the value-added tax (VAT) and in the states by a tax on retail sales.⁶ The former is collected at each stage of production and distribution, and embedded in prices that consumers pay. The latter is collected only on final sales.

However, economists know that a consumption-based tax system need not look like a VAT or a sales tax. It can appear very much like an income tax. All that is really necessary is that saving be entirely exempted from taxation. If that is the case, then all that remains is consumption. Hence, the burden of taxation will necessarily fall on consumption even though consumption is not taxed directly.⁷

In the early 1980s, the idea of taxing consumption by eliminating taxation of saving was married to the idea of getting rid of progressivity and instituting a flat-rate tax schedule. The well-known Hall-Rabushka flat tax proposal is in fact a consumption

tax because there would be no taxation of saving or investment. However, there is no reason why we could not have progressive rates on a consumption base.⁸ Alternatively, we could have a flat rate on a comprehensive income tax base. In other words, the tax base and the rate structure are separate issues.

The principal virtue of a consumption-based tax system is that it is much less burdensome to the economy than an income tax raising the same revenue.⁹ That is because saving, investment and risk-taking are especially critical to growth. Even small burdens in these areas can be very detrimental to economic growth. For this reason, it is probably safe to say that most economists these days favor a consumption-based tax system.¹⁰

As one can see, there are certain similarities between a comprehensive income tax and a consumption-based tax system. Both would support elimination of the corporate income tax and the elimination of tax subsidies and other special interest provisions in the tax code. Supporters of each approach could travel down the road a long ways together before reaching a fork.

Tax Rates

The rate schedule is also an important factor in tax reform. Recent studies have found that most of the benefits of tax reform come from flattening rates, irrespective of the tax base.¹¹ Other studies also suggest that the economic cost of progressive tax rates is very high.¹² Thus growth would be enhanced by reducing progressivity even if no changes are made to the tax base.

The Tax Reform Act of 1986, which was enacted with wide bipartisan support, was in essence a marriage of the comprehensive income tax approach and the flat-rate idea. The former was embodied in the Bradley-

Gephardt bill and the latter in the Kemp-Kasten bill. After a Treasury study reviewed all the options, the White House sent a proposal to Congress in 1985 that largely split the difference between the two.¹³ Loopholes were closed and rates were cut in a revenue-neutral manner that was widely applauded across the political spectrum.

Unfortunately, under pressure to raise taxes for deficit reduction in 1990 and 1993, the deal that constituted the 1986 effort broke down. Taxpayers had been promised lower tax rates in return for giving up loopholes. With the top rate reduced to just 28 percent by the legislation, it was a deal people were willing to take. But when rates were raised in 1990 and 1993, putting the top rate up to 40 percent, the loopholes were not restored. Many taxpayers felt that they had been double-crossed. Consequently, it will be harder to put together the same sort of coalition today.

Any new tax reform effort must also contend with the fact that the 1997, 2001, 2002, 2003, and 2004 tax bills have radical-

ly changed the tax code. We now have a tax system that looks very different than the one we had in 1985. Rates are much lower, there are many new provisions like the child credit that didn't exist then, and the tax burden on capital is much lower—as is the overall burden of taxation—than it was in the mid-1980s.

It is important to understand that the tax code has in fact undergone a major reform over the last several years that has moved it considerably in the direction of a consumption base. Since 1997, the tax rates on capital gains and dividends have been sharply reduced, business depreciation allowances are much larger, and the estate tax has been abolished (at least temporarily in 2010), among other things. Consequently, we are much closer to a consumption tax base than we were before 1997.¹⁴

Objections

The main objection to a consumption-based tax system is distributional fairness. A direct consumption tax such as a VAT would take more out of the pockets of the poor than the rich in percentage terms, since the former consume a greater portion of their income.¹⁵ A switch from an income tax to a consumption tax would also penalize the elderly, whose incomes were taxed during their working lives and would then find their consumption taxed when they drew down their savings during retirement. Many would view this as a kind of double tax.

If a consumption-based tax system is achieved by eliminating taxes on saving and investment, most people would also view

this as extremely unfair. Allowing some people to receive rent, interest, dividends and rent tax-free while working people are fully taxed on their wages is not viable politically, regardless of the economic merits.

A pure income tax is equally unviable, however. If carried to its logical extreme, it would require people to be taxed on unrealized capital gains, the imputed rent homeowners receive for living in their own homes, and employee benefits such as health insurance, as well as the abolition of Individual Retirement Accounts, Keogh plans and 401(k) accounts. The annual tax expenditures list published by the Treasury Department essentially lists all of the deviations from a Haig-Simons tax base currently in the tax code.¹⁶

Thus the choice between an income tax and a consumption tax basically boils down to a choice between equity and efficiency. An income tax is generally viewed as more fair, but diminishes economic growth below what a consumption tax of the same magnitude would achieve, owing to the income tax's harsh treatment of capital income. A consumption tax would raise growth by encouraging more saving, investment and risk-taking, but at the cost of a tax system that would be viewed as grossly unfair to most people.

Hybrid System

In practice, the U.S. tax system has never come close to either ideal. It is and always has been a hybrid system with cer-



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Tax Reform

tain elements of an income tax and a consumption tax. It has swung back and forth from one ideal to the other depending on economic conditions and political circumstances. Republicans tend to favor consumption taxes, while Democrats support the income tax. In the 1960s and 1970s, Democrats made considerable progress in achieving their ideal. In recent years, Republicans have been successful in moving the tax system toward theirs.

One way of compromising between the goals of equity and efficiency is through the rate schedule. Although the flat tax is primarily associated with those favoring a consumption tax, there is no reason why the two are necessarily linked together. Similarly, there is no necessary linkage between progressive rates and an income tax base. We could have a flat rate on an income tax base and progressive rates on a consumption base.

A number of political liberals have suggested both approaches. As long ago as the 1950s, John Kenneth Galbraith suggested that it was socially desirable to tax sales more heavily in order to suppress conspicuous consumption, a view echoed more recently by economist Robert H. Frank.¹⁷ Other liberals have supported a single tax rate on an income base. For example, in 1982, then-Congressman Leon Panetta, Democrat of California, introduced such a bill.¹⁸ The great liberal philosopher John Rawls thought a proportional expenditure tax was the fairest tax system.¹⁹

Retail Sales Tax versus a VAT

Unfortunately, in recent years, the movement for consumption-based taxation has been overwhelmed by a group of activists whose principal interest is abolishing the Internal Revenue Service.²⁰ They believe that if virtually all federal taxes are abolished and replaced with a retail sales tax like those in the states, then the states can simply collect the federal government's revenue for it, thereby allowing for the abolition of the IRS.²¹

There are many reasons to oppose this particular system, but the most important is administrative. It simply will not work.²² It would require a minimum tax rate of 30 percent on all retail sales, with state and local sales tax on top.²³ But even this rate assumes far broader coverage than any existing sales tax and no evasion whatsoever. For example, new home sales, local government services (except education), and medical care would be taxed. Using more realistic assumptions of what could be taxed, economists have estimated that a rate twice as high would be necessary.²⁴ A long list of economists and tax experts have testified that a rate much more than 10 percent is simply not feasible and would quickly break down.²⁵

For this reason, every country that has seriously considered a national retail sales tax has concluded that a VAT makes more sense. A key benefit of a VAT is that it is embodied in prices at each stage of production or distribution and is thus collected incrementally, rather than being collected solely at the retail level. Thus if a retailer fails to collect the tax, all that

is lost is the rate that would apply to the final mark-up, whereas with a retail sales tax 100 percent of the revenue would be lost.

VAT in Practice

To see how a classic VAT works in practice, a farmer produces wheat and sells it to the miller. He pays VAT on the sale and gives the miller an invoice showing that the tax was paid and included in the sale price. The miller makes flour and sells it to the baker. The miller multiplies the VAT rate times the sale to calculate his tax and then subtracts the tax he paid when he bought the wheat, sending the balance to the government. The miller sells the flour to the baker, including his tax on the invoice, and so on. Thus the VAT is largely self-enforcing because there is always an invoice trail and because businessmen need to pay the tax in order to claim credits for taxes that were embodied in the goods and services they purchased.

A key benefit of the VAT is that it is rebated at the border on exports. That is, the exporter is able to claim a refund from the government for all of the taxes embodied in the goods he sells abroad without having to collect the tax himself. (Conversely, a VAT will apply at the border on imports.) This is allowed under World Trade Organization rules, but only for direct consumption taxes.²⁶ Indirect taxes such as the corporate income tax cannot be rebated. Many American exporters view this asymmetrical tax regime as a hindrance to them and a benefit to nations with VATs.²⁷

The benefits of a VAT on the trade balance tend to be misunderstood. Rather than subsidizing exports and penalizing imports, as it appears to do, rebating a VAT at the border on exports and applying it at the border on imports is necessary for tax neutrality and does not affect trade.²⁸ Indeed, that was the principal reason why the VAT was developed in the first place. And if it did create a trade advantage, exchange rates would adjust so as to eliminate it. In the end, the main benefit of a VAT on trade is that the revenue could be used to reduce taxes on capital, which would make U.S. firms more productive and therefore more competitive.²⁹

VAT Options

Another idea that has been put forward lately is to use a VAT to eliminate the Social Security payroll tax.³⁰ It is thought that the reduction in taxes on labor would expand employment. Research, however, indicates that the payroll tax is much less of a disincentive to employment than is commonly believed. That is because workers view it as more of a forced saving requirement akin to putting money in a 401(k) plan than a tax for which nothing specific in return is expected or received. Moreover, the benefit formula gives most workers more in future benefits than they pay in taxes, thus reinforcing work incentives.³¹

Consequently, the impact on economic growth of replacing the payroll tax with a VAT is likely to be minimal.

Moreover, one really cannot fiddle with the payroll tax without simultaneously making major changes to the Social Security benefit structure. Therefore, changes in the payroll tax should only be considered in the context of overall Social Security reform, rather than as part of tax reform.

What would make more sense is using a VAT to replace the corporate income tax. This is a proposal that has been made many times in the past.³² What has made the issue more acute is growing international investment, trade and capital mobility that is making it harder and harder for all governments to tax corporate income. It is too easy for companies to shift their assets around to take advantage of tax regimes that give them the best deal. Thus global tax competition is in the process of destroying the corporate income tax as a viable source of revenue.³³

Tax Evasion

At the same time that the corporate income tax is being undermined largely by legal tax avoidance, the personal income tax is increasingly being eroded by tax evasion. The best data we have on this comes from comparing the Internal Revenue Service's measure of adjusted gross income taken directly from tax returns to the Commerce Department's measure of AGI compiled from data on wages, interest and dividends paid by businesses. In 2002, the gap between these two figures reached \$961.1 billion or 13.7 percent of the Commerce Department's estimate of AGI. This is the largest gap since figures began to be collected in 1959.³⁴ It suggests that the federal government is losing at least \$100 billion per year just due to the non-reporting of taxable income on personal tax returns.³⁵

Moving toward a VAT could solve both problems. Replacing the corporate income tax with a VAT would utilize corporations as tax collectors rather than objects of taxation. Since the burden of the VAT is passed through to the final consumer, corporations really have no reason to evade it. And because the tax is collected incrementally at all stages of production and distribution, it is largely self-enforcing. It would even be possible to exempt most small retailers from collecting the tax without much revenue loss.

A VAT would also provide enough revenue both to fix glaring problems with the personal income tax, such as the rising burden of the Alternative Minimum Tax, and make a down payment on deficit reduction. I recently calculated that a broad VAT could raise about half a percent of GDP for each one per-

cent VAT rate. That means a 10 percent VAT would raise about \$550 billion per year. A 20 percent rate—the average rate in Europe—would raise over \$1 trillion. A narrower tax base covering 30 percent of GDP, which would allow things like food and medical care to be exempted, would raise \$330 billion per year from a 10 percent rate and \$660 billion from a 20 percent rate.³⁶

Even a 10 percent VAT on a narrow tax base could provide enough revenue to replace the corporate income tax, which will not raise more than two percent of GDP in revenue for the foreseeable future, according to the Congressional Budget Office. There would be enough revenue left over to reform the AMT and still leave almost \$100 billion per year for deficit reduction.³⁷ A VAT could also finance significant tax simplification, relieving millions of taxpayers from having to file any tax returns at all.³⁸

Deficit Reduction

Although there has not been much interest in tax increases or deficit reduction in recent years, this could change suddenly if interest rates were to spike or some other dramatic market event were to focus public attention once again on the deficit as was the case in the 1980s and early 1990s. Moreover,

“Eventually, financial markets will force some action on the deficit. And any significant deficit reduction will necessarily require higher revenues. This may make options like a VAT politically viable. Policymakers will inevitably be led toward adoption of this tax for the same reason that every other industrial country has done so—its proven ability to raise large revenues at a low economic cost.”

even if one takes a benign view of the short-run deficit situation, the longer-term situation resulting from the aging of society will clearly require higher revenues at some point.³⁹

A number of observers have suggested that the next major tax legislation will be to raise revenue.⁴⁰ Elsewhere, I have suggested that revenues are likely to rise by two percent of GDP on the grounds that revenues are only about 16 percent of GDP now, while 18 percent of GDP is the postwar average.⁴¹ In recent years, revenues have been as high as 21 percent of GDP.

In conclusion, there is a pressing need for tax reform. But,

Tax Reform

significant new revenue sources—to finance needed tax changes—will be required unless Congress is prepared to see a further reduction in federal revenues and a further rise in the deficit. This is unlikely. The deficit is already a serious problem and the impending retirement of the baby boom generation is going to put upward pressure on the federal budget for many years to come. It is completely unrealistic to think that tax increases can be avoided given this reality, not to mention the likelihood of higher defense spending for the foreseeable future to fund the war on terror.

A federal VAT is the best way to raise net new revenue to pay for tax reform and deficit reduction at the same time. This is an issue that has been debated on many occasions previously. It has always failed because liberals view a VAT as regressive and conservatives fear that it would be a money machine that would finance the expansion of government.⁴² However, it is clear that the latter argument is no longer valid since the whole point of adopting a VAT today would be to raise federal revenue to reduce deficits and pay for the growth of entitlement programs. It could also finance other tax or benefit changes that would minimize the impact on those with low incomes.

Tax Reform

Other reform options are also possible. One would be to, in effect, replicate the 1986 tax reform effort—close loopholes and use the revenue to cut tax rates. Flattening the rate system will be beneficial for growth even if there is no movement toward a consumption tax base. The problem with this approach is that it requires a bipartisan consensus that no longer seems to exist. Also, the fact that rates were raised so shortly after 1986 will undoubtedly make a similar deal much more difficult today.

Neither major party has had much to say about tax reform in recent years. Of course, in principle everyone is for reform. But as soon as any specific reform is put on the table, those who would lose out are much more vocal in stating objections than those who would benefit are in voicing support.⁴³

Eventually, financial markets will force some action on the deficit. And any significant deficit reduction will necessarily require higher revenues. This may make options like a VAT politically viable. Policymakers will inevitably be led toward adoption of this tax for the same reason that every other industrial country has done so—its proven ability to raise large revenues at a low economic cost.

The United States has been able to bear the cost of an inefficient tax system for a long time because we are a relatively low-tax country—according to the latest data, taxes as a share of GDP here are about 10 percentage points below the average for other industrialized countries.⁴⁴ Inefficient can be defined as provisions that have a high dead-weight cost—those that discourage a lot of economic activity for every dollar raised.⁴⁵ But as our tax/GDP ratio rises, such inefficiencies are a luxu-

ry that can no longer be afforded.

The conclusion that a VAT should be the foundation of a new tax reform effort is controversial. But given the twin problems of a large federal deficit and rising pressure for entitlement spending, on the one hand, and the need to fix glaring problems in the tax code that will require further reductions in revenue, on the other, there is no alternative except to add a significant new revenue source in order to deal with both simultaneously. ☞

The views expressed in this paper are solely those of the author and do not necessarily represent the opinion of The Ripon Society.

¹ The classic statements of a comprehensive income tax base can be found in Haig (1959) and Simons (1938). For a more recent restatement, see Goode (1977).

² The great tax theorist Henry Simons (1950: 20) stated flatly, “There should be no levies on business or concerns as such.” A recent winner of the Nobel Prize in economics, William Vickrey (1993: 3), has said that abolition of the corporate tax is one of the best tax reforms that could be enacted. Research has shown that the economic payoff could be significant (Fullerton, King, Shoven & Whalley 1981; U.S. Treasury Department 1992).

³ A good example is Break and Pechman (1975).

⁴ Classic statements of the case for a consumption-based tax system can be found in Fisher & Fisher (1942), and Kaldor (1955).

⁵ U.S. Treasury Department (1977). See Bradford (1984) for a revised edition with corrections by its principal author. Andrews (1974) was also influential.

⁶ See Ebrill, Keen, Bodin & Summers (2001) for a recent discussion of the VAT. The federal government has a few excise taxes on specific commodities such as gasoline, tobacco and alcohol.

⁷ See Council of Economic Advisers (2003), chapter 5.

⁸ See Bank (2004), Graetz (1979), McCaffery (2002), and Shaviro (2004a). A very early case for a progressive consumption tax can be found in Beale (1911). Fullerton, Shoven & Whalley (1983) estimate strong growth effects from a consumption tax even with progressive rates.

⁹ For a recent estimate of the growth effects of switching to a consumption-based tax system, see Altig, Auerbach, Kotlikoff, Smetters & Walliser (2001).

¹⁰ Pechman (1990: 1). A growing body of research says that the optimal tax on capital is zero. See Atkeson, Chari & Kehoe (1999), and Chamley (1986).

¹¹ Cassou & Lansing (2004), and Castaneda, Diaz-Gimenez & Rull (1998).

¹² Auerbach, Kotlikoff & Skinner (1983); Caucutt, Imrohroglu & Kumar (2000); Gruber & Saez (2002); Li & Sarte (2001).

¹³ U.S. Treasury (1984), and White House (1985).

¹⁴ See Altman (2004), Bartlett (2004a), and Cassidy (2004) for discussions of how the Bush tax cuts have moved the tax system toward a consumption base.

¹⁵ Actually, the regressivity of consumption taxes is usually overstated. Because lifetime consumption is proportional to income, a consumption tax would also tend to be proportional. See Fullerton & Rogers (1993), and Sabelhaus (1993).

¹⁶ See Bartlett (2001) for a discussion of how the tax expenditures budget is based on Haig-Simons.

¹⁷ Frank (1999: 211-226), Galbraith (1958: 315-321).

¹⁸ Panetta (1982). See also Cockburn & Pollin (1992), and Hitchens (1994).

¹⁹ Rawls (1999: 246).

²⁰ The Church of Scientology originated this legislation as part of a campaign against the IRS because it refused for many years to allow gifts to the church to be deducted as legitimate charitable contributions, on the grounds that it was not a true church. The IRS eventually relented. See Davis (1997) and Starobin (1995) for discussions of the Church of Scientology's role in the sales tax campaign.

²¹ This idea is currently embodied in H.R. 25, 108th Congress, 1st session. It had 54 cosponsors at the end of 2004.

²² See Bartlett (1995), Crossen (2002), Mikesell (1997), U.S. General Accounting Office (1998), and Zodrow (1999).

²³ Supporters of the sales tax claim that their rate is only 23 percent. But this is calculated as if the tax is part of the sale price, which they call the tax-inclusive rate. Calculating the rate conventionally, as with state sales taxes, yields a

tax-exclusive rate of 30 percent.

²⁴ See Gale (2004), and Joint Committee on Taxation (2000).

²⁵ See Hall (2004), McLure (1987: 107), OECD (1993: 78), Slemrod (1996: 370), Tait (1988: 18-19), and Tanzi (1995: 50-51).

²⁶ Hufbauer & Gabyzon (1996: 21-26).

²⁷ For a recent discussion, see Deal (1995).

²⁸ Feldstein & Krugman (1990).

²⁹ See Joint Committee on Taxation (1991), and U.S. International Trade Commission (1998).

³⁰ Halstead & MacGuineas (2004). Former House Speaker Newt Gingrich made this same suggestion back in 1986.

³¹ Blinder, Gordon & Wise (1980); Burkhauser & Turner (1985); and Disney (2004).

³² See Dresch, Lin & Stout (1977), Smith (1965), and U.S. General Accounting Office (1993).

³³ See Haufler (2001), Merrill (2004), Plender (2004), Razin & Sadka (2004), Sullivan (2004), and Tanzi (2000).

³⁴ The latest data can be found in U.S. Commerce Department (2004). Historical data is available in Ledbetter (2004).

³⁵ Recent estimates of the underground economy range between 8.2 percent of GDP and 13.9 percent of GDP (Schneider & Enste 2002: 35).

³⁶ Bartlett (2004c).

³⁷ Congressional Budget Office (2004).

³⁸ Graetz (2002).

³⁹ Congressional Budget Office (2003).

⁴⁰ Andrews (2004), Murray (2004), Shaviro (2004b), and Wessel (2004).

⁴¹ Bartlett (2004b).

⁴² Although the idea of the VAT as a money machine is widely assumed, the two most thorough studies of the subject found this not to be the case. See Furchtgott-Roth (1990), and Stockfisch (1985). However, Becker & Mulligan (2003) show that a more efficient tax system increases the growth of government.

⁴³ Tax preferences are capitalized into the value of existing assets, potentially leading to large losses in wealth if they are repealed. See Goetz (1978).

⁴⁴ In 2002, the total tax burden in the United States was 26.4 percent of GDP versus an OECD average of 36.3 percent (OECD 2004).

⁴⁵ Jorgenson & Yun (1991) estimate that the U.S. tax system discourages 18 cents of production for each additional \$1 raised. That is, the private sector loses \$1.18 for every dollar of tax. This estimate is consistent with earlier research. See Ballard, Shoven & Whalley (1985a, 1985b), and Stuart (1984).

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Health Care Congressional Report

Photo by Tim Boyle/Getty Images



Congressman Michael A. Ferguson

As prescription medication utilization has increased in recent years, consumers and governments at all levels have sought ways to reduce drug costs. Importing prescription drugs from other countries—from ostensibly “safe” countries like Canada and those in Western Europe—is seen as an easy and politically pleasing means to lower drug prices.

But at what cost?

As this study makes clear, by importing artificially lower prescription drug prices, the United States also would import those countries’ government-imposed price controls that have a track record of stifling innovation for the biotechnology and pharmaceutical industries. According to one study, published in the March 2004 *In Vivo: The Business & Medicine Report*: “As Europe introduced price controls on medication they have lost ground. From 1993 to 1997, 81 unique new drugs were launched in Europe, compared to 48 in the United States; but from 1998 to 2002, the European number had declined to 44 while the U.S. number rose to 85.”



Many academic studies—and leading officials in both the Bush and Clinton administrations—also warn that importation would lower safety standards for U.S. consumers of prescription drugs. In the wake of the September 11, 2001, terrorist attacks, is that a risk we are willing to accept? Or, put another way, would we be comfortable with our grandparents taking prescription medication ostensibly from Canada?

The Food and Drug Administration doesn’t think so. According to a recent Associated Press article: “The FDA reported in September [2003] that of 1,153 imported drugs checked by FDA and Customs agents, 1,019 were found to be illegal. They included drugs that had been withdrawn from the U.S. market, animal drugs never approved for human use, counterfeit drugs, drugs with dangerous interactions, drugs with dangerous side effects and narcotics.”

As a member of Congress, my first responsibility is to ensure the safety of my constituents and every American. As a representative of a New Jersey congressional district that is home to tens of thousands of scientists, clinicians and chemists who are developing the compounds today that will be the miracle, life-saving drugs of tomorrow, I also have a responsibility to ensure that U.S. drug innovation remains robust.

So how do we ensure consumers, particularly seniors, can afford the latest prescription medication without jeopardizing safety or stifling the innovation that has made the U.S. biotechnology and pharmaceutical industries the world’s leaders?

Congress took a major step forward in 2003. The law adding a prescription drug option to Medicare will particularly help seniors who are most vulnerable—those with low incomes and those with catastrophic drug costs. In advance of the 2006 full implementation of that benefit, federally backed prescription drug cards are providing millions of seniors with about \$8 billion worth of credits and discounts on drugs from American pharmacies.

While the new Medicare law is a good first step, more needs to be done to ensure that America’s consumers are not helping to subsidize the government-established price controls that Canada and many European countries have imposed. As our government negotiates trade agreements, U.S. officials must do more than give lip service to seeking to tear down these price controls. After all, centralized government planning in other countries jeopardizes the innovation of our country’s biotechnology and pharmaceutical industries and increases the political pressure within the United States to jettison legitimate innovation and safety concerns.

The fact that other wealthy nations impose price controls on our medicines means they are under-pricing America’s most innovative exports. As this study shows, we can make medicines affordable at home without importing price controls from abroad or jeopardizing the safety of our drug supply.

The Perils of Drug Importation

Robert Goldberg

If Americans liked the flu vaccine shortage, they will love drug importation. That's because flu vaccines—like all pediatric vaccines—were forced down to international levels through price controls and government bulk purchases as the cost of making old vaccines and investing in new ones increased. Vaccine production, research and distribution jobs—as well as related employment—have gone overseas. America's thirst for medicines made below American market prices has cost the nation high paying jobs, investment and a ready supply of essential shots. The only people profiting are distributors and wholesalers, not innovators.

The same phenomena will occur under any importation scenario. Drug prices will be forced down to price controlled levels of other countries. While the cost of drug development continues to rise, American companies will outsource manufacturing, development and drug discovery employment to India and China. That's because as of now, no country has enough medicine to meet market demand in America and no company will permit distributors to re-sell drugs at price controlled levels to America at a profit when they could keep the profit themselves. Indeed, the Canadian health minister has already asserted that he will not let Canada become "America's drugstore."¹

Rather than importing price controls from other countries, America should begin to tear them down. Congress should make the fact that people in Europe and Canada can afford to

pay higher prices—but don't—and can use more newer medicines—but don't—a trade issue.

Canada: The Disappearing Medicine Chest

Canadians are expressing growing concern that full-blown importation will affect the ability of their citizens to get the drugs they need. According to a recent article, pressure is building among consumers, pharmacists and health officials in the Canadian provinces to limit or ban importation.

"The size of the U.S. seniors market is about 45 million," said Brett Skinner, health policy analyst with the Fraser Institute, a Canadian free market think tank. "That's one-third larger than our entire population." Provincial health ministers are pressuring Canada's national government to assert more control over sales to the United States. The ministers have been backed by the Canadian Pharmacists Association, which has lobbied its government on the issue.

"When our doctors and pharmacists are serving U.S. patients, they are not available to meet the needs of Canadian patients," said Jeff Poston, executive director of the association. In October 2004, a coalition of Canadian groups representing seniors, pharmacies and patients urged Ottawa to ban drug exports. Indeed, according to a news report, "Health Canada is bracing for a drug shortage even as the department assures Canadians there is no evidence lucrative internet pharmacies have created one." In briefing notes prepared for fed-

Health Care

eral Health Minister Pierre Pettigrew, department officials warned of “likely implications for Canada’s health care system should there be no intervention to prevent/restrict cross-border drug sales.” Those consequences include pressure on Canada to “reduce price differentials” by raising federally controlled drug prices to come closer to substantially higher prices in the United States.

Documents obtained by The Canadian Press under the Access to Information Act indicate that the government expects pressure to mount by degrees and has a plan to monitor drug supply and act quickly if needed. Preparations include “a mock trial of steps to follow should a drug shortage be identified, and scenario options to reduce the shortage.”²

Several aren’t waiting for the government to act. The Canadian International Pharmacy Association, which includes the top internet and mail order groups, has told members not to accept bulk orders from U.S. states or cities, only individuals. “We can’t sustain that volume of trade. Not only that, but the customs officials would seize any bulk order,” said David MacKay, executive director of CIPA. “We’re being watched

very closely by the Canadian government. The moment there’s evidence that we’re causing a shortage for Canadians, this trade is over.”

Canadian doctors who fill out web prescriptions for U.S. consumers are also facing increased scrutiny. According to a story published in *The Globe and Mail*, doctors in Ontario, New Brunswick, Manitoba and British Columbia have recently faced disciplinary action, including suspensions. One received a \$25,000 fine. David McKay recently announced that CIPA members would refuse to honor any bulk purchases from states, drug stores, employee health plans or other large organizations from the United States.³

The Failure of Forced Drug Reimportation: The European Experience

Obviously, the only way Congress is going to get enough drugs to satisfy its legislative lust for importation is to force biotech and pharmaceutical firms to sell and ship as much of their products into price controlled countries as is demanded. That is exactly what the European Union forces drug and



“A London School of Economics study on Europe’s importation experience found that the practice transferred billions of dollars from inventors of drugs to drug distributors without saving consumers or government any money.”

biotech firms to do. The policies have led to an outsourcing of biomedical jobs and investment to the United States and India.

American politicians fail to see the connection between the European experience and the American experiment. In Europe, a combination of regulatory costs related to safety and wholesaler efforts to maximize profits have eliminated most of the price differentials that national governments had hoped to arbitrage. Duplicating parallel trade programs in America would have the same results and possibly even ignite a bidding war between Canadian, European and American consumers for the most popular prescription drugs—forcing global drug prices higher, not lower.

Contrary to the impression generated in the popular media, importation—or parallel trade as it is called in Europe—is not simply a matter of shipping an unlimited supply of medicines from countries with the lowest prices to those with the highest prices at the click of a mouse. Parallel trade is, like all other businesses, a profit-seeking enterprise, not a social welfare subsidy. Wholesalers constantly evaluate the range of products available in cheaper markets, compare it to demand in wealthy markets and decide which products will yield them the most profits over time.

Wholesalers have discovered that there are only a few drugs where the price spread is wide enough to justify parallel trade. Overall, parallel trade accounts for only about 5 percent of total pharmaceutical sales in Europe and is highly concentrated among the biggest selling products that offer the fattest profit margins for wholesalers. IMS, a highly reputed consulting company in the pharmaceutical sector, has released data demonstrating that “[in] the United Kingdom, for example, 50 percent of parallel imports were accounted for by just 12 brands, while just four companies experienced 55 percent of parallel imports.”⁴

Nonetheless, parallel trade has flourished because the largest European health systems have mandated that pharmacists dispense a certain percentage of lower priced imports in exchange for a higher dispensing fee. In Great Britain for example, imported drugs are now 14 percent of the total pharmaceutical retail market.

Still, on balance, does parallel trade save money and lives in Europe? The London School of Economics did a study of the bulk of parallel traded products identified by IMS. It found that in the United Kingdom’s National Health Service consumers saved *no money at all* since the retail price is essentially the same at the point of sale, and the cost is picked up by the government in any event.⁵

What did the NHS save thanks to its parallel trade policy? Not much. The NHS saved less than 7 million Euros (.3 percent of total drug spending) compared to the nearly 500 million euros in profits made by parallel importers thanks to a 50 percent markup on the products pharmacies were mandated to buy. The pattern is repeated throughout the EU, where health systems saved a total of 45 million euros (.3–2 percent of

“The FDA estimates that half the drugs currently obtained from foreign internet sites are counterfeit, tainted or outdated.”

national pharmaceutical spending) compared to parallel trade profits of about 650 million euros.

The LSE study concluded that “parallel trade implies a transfer of producer surplus and reduces the overall profitability of manufacturers, without necessarily increasing social welfare.” The Economic and Social Research Council in Britain found that “cheap pharmaceutical imports from Europe are costing U.K. drug firms about \$1.4 billion a year” and “had a negative impact on the U.K. economy.”⁶

Wholesalers in the United States are no less savvy than in Europe, and would inevitably focus on the same small subset of expensive drugs—eroding any expected savings from parallel trade. Consequently, even if U.S. restrictions on parallel trade were removed tomorrow, there is no reason to expect that American consumers would have access to a miraculous supply of low-cost prescription drugs.

Drug Importation: The Free Trade Imposter

The Cato Institute, known as a libertarian think tank, released a paper arguing that drug reimportation was free trade. It argued that “however varied or mistaken the different proposals may be, they all turn on the basic idea that free markets and the competition they encourage—not price controls—are the way to produce more and better drugs at lower prices.” Indeed, what is the reimportation ban if not an impediment to free trade and free markets?⁷

But the reasoning of the policy paper is convoluted and contradictory. Importation is based on restraint of trade and violation of contract rights. First off, there is no true free market in pharmaceuticals precisely because European states impose price controls on the pharmaceuticals sold within their boundaries. Prices differ among states because of administrative decisions made by health agencies about what price they will pay for pills. The creation of a single currency has eliminated currency fluctuations.

As U.K. Labor Party economist Stephen Pollard notes, “prices are lower in countries like Spain than in Britain simply because the Spanish government has decreed that they be lower. And because the rules of the single market as applied by the European Commission do not allow companies to protect themselves by restricting supply to those member states with the most severe price controls, we are now entering a world in which whatever country has the most restrictive price-control

Health Care

scheme will become the largest exporter of pharmaceutical products through parallel trade.”⁸ The consequences are obvious. Some drugs are simply not being made available in the EU market. That is, some drugs are not being made available in the lowest priced markets at all. Forced importation on either side of the Atlantic and price controls exist only when government fails to enforce a patent or threatens to seize it. Free trade operates under the exact opposite set of conditions.

The Counterfeit Cash Cow

Indeed, the real threat to the integrity of our medicine supply is not a terrorist poisoning pills but profiting by counterfeiting them. The defenders of importation claim that there is no evidence that anyone has died from an imported drug. While that may or may not be true, there is ample evidence that people have been bilked of billions of dollars and have suffered by taking medicines that look like the real thing but lack active ingredients.

And in an era when the internet is the primary pipeline for placing orders, our Food and Drug Administration, whose primary mission is and should be approving new and better medicines, would be overwhelmed with sorting through packages to determine whether old drugs coming from overseas are genuine or counterfeit. Right now, we have a hard enough time keeping the ‘honest’ mail order suppliers honest. In one recent scenario, federal officials noted that 439 packages of prescription drugs purportedly exported from Canada and intercepted

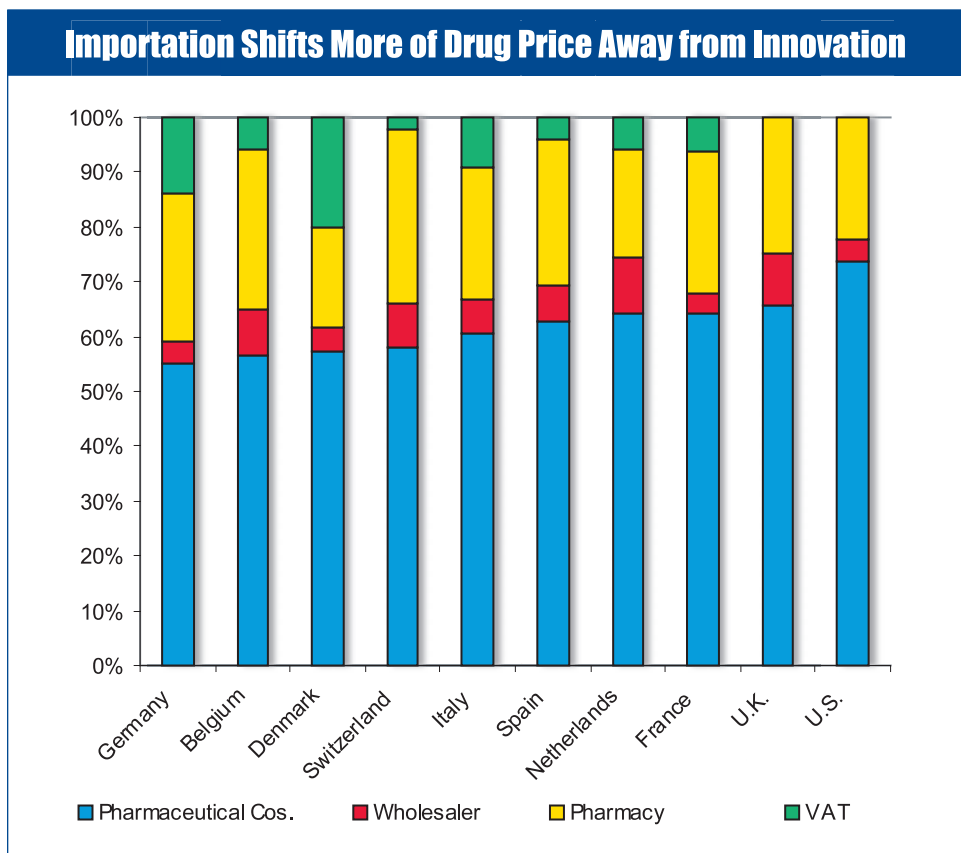
“Inaction ensures that the global drug market becomes a bigger opportunity for terrorists and their allies to profit and poison us with tainted drugs.”

by U.S. Customs and Border Protection officials in Miami were not manufactured in the United States and had been subject to Canadian recalls. The distributor of the drugs, CanadaRx.net, had set up an office in the Bahamas to avoid Customs and Border Protection detection—and to facilitate the importation of drugs that were both substandard and mixed with generic products not available in the United States.⁹

And those are the legitimate operations. Acting Food and Drug Administration Commissioner Lester Crawford expressed concern that terrorists might attack the nation’s medicine supply. Commissioner Crawford’s warning was far from the first indication of the potential threat. As reported in a congressional hearing held in March 2004, recovered Al-Qaeda training manuals recommend the sale of counterfeit products to raise funds. In April 2004, the Bush Administration froze the assets of an individual tied to a Hezbollah ring involved in the manufacture and export of counterfeit pharmaceutical products.¹⁰

To date, no importation advocate has proposed a way to address this legitimate concern. Some in Congress have proposed a technological solution to stem counterfeit and terrorist infiltration. One response is already being enacted by industry and the FDA: every bottle, case and pallet of medicines will have a radio frequency tag which contains encrypted information about the source, destination and movement of products linked to a secure server operated by a third party. Anyone along the supply chain—the manufacturer, distributor, wholesaler, or retailer—can use the technology to read the data to find out if more than one case has the same code, indicating that one of the cases is a fake.

But security experts believe that the system must be in place first here at home and then throughout the world for it to work. Such a system will require billions of dollars and years of work to become fully opera-



tional, something importation advocates are loath to accept. Still, these measures do nothing to crack down on the internet sale of prescription drugs.¹¹ The FDA estimates that half the drugs currently obtained from foreign internet sites are counterfeit, tainted or outdated. A recent General Accounting Office study confirms that internet drug purchasing is risky. Nearly half of the drugs purchased by the GAO in its 2004 study—including Canadian web sites—were ineffective or potentially dangerous.¹²

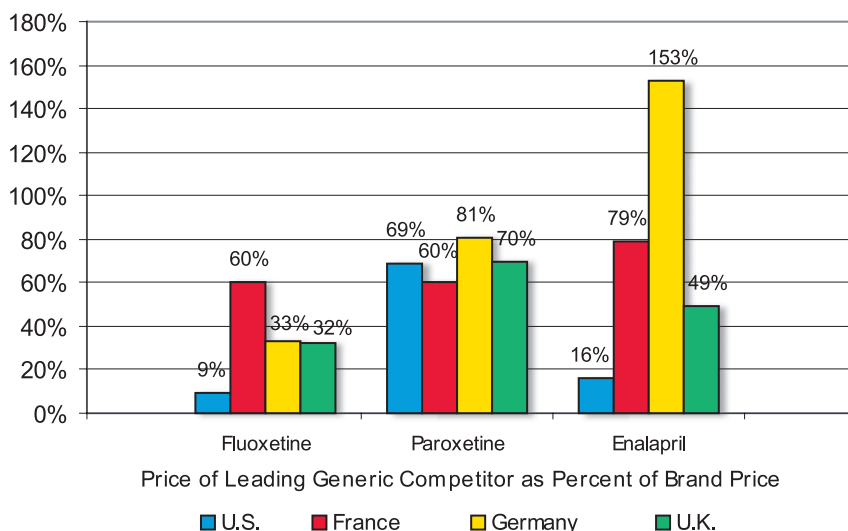
Over the past decade the FDA, as a recent agency report notes, “has found that many internet sites are actually comprised of multiple related sites and links, thereby making investigations much more complex and resource intensive. The global nature of the internet creates special problems for effective law enforcement.”¹³

Hence, before even considering wider importation of medicines, Congress must target the hiding places and criminal compatriots that allow terrorists to engage in these illegal and deadly transactions. As a recent *Washington Post* series on drug fraud observed, “federal prosecutors have shut down web sites, filed indictments and won guilty pleas from several owners. But it often takes years to prove a case. In the meantime, the pills move.”¹⁴

Congress must outlaw any internet pharmacy which does not require a prescription from a doctor unaffiliated with that web site who has not actually seen the patient. It should also adopt the recommendation of Senator Charles Schumer to establish a joint U.S. Drug Enforcement Administration (DEA)–FDA task force to monitor web site operators and go after illegal ones. And it should let the Treasury Department freeze all the U.S. assets of any individual, company or group indicted for aiding, conspiring or trafficking in illegal internet drug sales.

The CanadaRx.net scandal underscores just how difficult it will be for Congress to secure the nation’s drug supply before it even considers passing importation legislation. If “legitimate” pharmacies are evading the FDA, what are the criminals up to? Inaction ensures that the global drug market becomes a bigger opportunity for terrorists and their allies to profit and poison us with tainted drugs. And in an era when the pipeline for new medicines is clogged and the FDA needs more money to keep up with the science of next generation drug discovery, it seems absurd to give the agency billions to spot check UPS packages to see if they are really coming in from Canada.

European Generic Drugs Cost More



Source: IMS MIDAS

Importation: Another Name for Outsourcing

America’s biopharmaceutical companies are responsible for creating over 2.7 million jobs across the United States. Over 400,000 Americans are directly employed in the biopharmaceutical industry. On average, 5.7 jobs are created economy-wide for each biopharmaceutical job. The states benefiting most from pharmaceutical and biotech investment include: New Jersey, Maryland, Indiana, Pennsylvania, North Carolina, Rhode Island, Utah, Illinois, Washington, Connecticut, Missouri, Illinois, Massachusetts and California. Biotech and pharmaceutical job growth is double that of many other industries. And because they are such research intensive industries, such enterprises support job and income growth in universities and clinical trial centers, as well as cutting edge science-based employment in nano-technology, stem cell research, gene therapy and drug discovery.¹⁵

But importation will force deep cuts in the quest to commercialize biomedical insights and lead to a massive relocation of what would remain of drug discovery to India, Korea and elsewhere. As a result, American jobs and investment will be lost. A London School of Economics study on Europe’s importation experience found that the practice transferred billions of dollars from inventors of drugs to drug distributors without saving consumers or government any money. Importation also contributed to European firms pulling new investment from the continent and spending it in America. According to a study conducted by University of Connecticut economist John Vernon, importation would reduce pharmaceutical and biotech investment by \$300 billion over ten years. It would cost at least 46,000 jobs paying about \$70,000 a year in states like

Comparison of Brand Name Drug Prices

	Medicare Card Price	Canadian Price**
Lipitor 10*	\$ 193.00	220.00
Plavix	318.00	267.00
Fosamax	1,300.00	1,057.00
Norvasc 5*	116.93	136.80
Celebrex*	227.00	149.00
Zocor 20*	223.00	235.00
Prevacid	320.00	220.00
Protonix	248.00	210.00
Lipitor 20*	264.00	223.00
Norvasc 10*	160.00	198.00
Toprol XL	54.57	NA
Nexium	293.00	260.00
Xalatan	137.61	NA
Zocor 40*	266.00	250.00
Evista 60	212.00	195.00
Cozaar*	109.00	118.00
Combivent	56.44	35.00
Toprol XL	81.84	NA
Zocor 10*	161.00	202.00
Actonel 12 day supply	166.00	132.00
Diovan	120.00	144.00
Detrol LA	234.00	220.00
Pravachol*	216.00	196.00
Alphagan P	34.00	33.00
Aricept	367.00	460.00
Pravachol 40	320.00	208.00
Celexa*	197.00	145.00

Commonly Prescribed Life Saving Drugs

Arimidex 1 mg	522.00	531.00
Aromasin TAB 25mg	609.00	616.00
Avandia TAB 4mg	210.00	198.00
Crixivan 400mg Qty: 180	462.00	538.00
Gleevec TAB 100mg Qty: 30	554.00	660.00
Singulair 10 mg Qty: 30	213.00	210.00
Sustiva 200mg Qty: 90	391.00	443.00
Viracept 250mg Qty: 30	180.00	198.00
Zyprexa 10mg Qty: 30	765.00	686.00
Abilify	801.00	NA
Geodon	345.00	NA

Source: Medicare.gov website and Canadameds.com website

**All prices are for 90 day supply of medicine via mail order unless otherwise noted. Shipping costs are not included. Average shipping cost from Canada is \$10-12 per order. Average mail order shipping cost from American mail order companies is \$2.00

* Less expensive generic alternative available in the United States

California, New Jersey, Missouri, Florida, Connecticut and Massachusetts. That would kill job growth and investment in this country's biotech enterprise and certainly lead many firms to transfer much of their capital to more hospitable nations.

Importing Price Controls

Price control policies are really protectionism. Keeping brand drug prices artificially low allows companies to stay in business and inflates the margins of uncompetitive generic firms. Rationing benefits the lackluster domestic firms and trade unions that demand a share of the drug budget even though the products they produce are substandard. The rest of the world has essentially set up a quota system that restricts the use of our new medicines to prop up their failing pharmaceutical industries.

Worse, countries like France and Germany demand that our biotech and pharmaceutical firms sink jobs and money into their nations in exchange for the "right" to sell products. Finally, our companies' drug prices are driven low to give middlemen—wholesalers, shippers and pharmacists—their markups. Distributors and handlers of drugs make up a larger percentage of the retail drug price in Europe than they do in America. Thus, a redistribution of profits away from innovation and towards distribution will figure prominently in any importation scheme.

Germany, for example, uses a combination of rebates and quotas to limit spending on new drugs. German drug prices are half that of the United States, but pharmacists and wholesalers take home a larger share of drug profits in Germany. Hence, while it spends 16 percent of its health dollars on medicines, only 4 percent of funding is spent on breakthrough drugs, with nearly as much (3 percent) going to wholesalers and pharmacists.

To bolster their less competitive products, Europe and Canada also delay the launch of new drugs because of protracted price negotiations. Once the European Agency for the Evaluation of Medicinal Products approves a drug, European Union member states must still decide whether or not to make the drug available and then set reimbursement rates. European and Canadian patients pay for this protectionism with their health and their lives. The results of a comparative analysis of hypertension treatment in America and Europe, with a focus on Germany, demonstrates the danger of protectionism. Despite universal coverage of drugs and lower brand prices, undertreatment is a widespread problem in Europe.

While negotiations drag on, Germans suffering from depression, high blood pressure and cancer are half as likely to get the newest and best medicines as Americans. Taxol, one the most effective drugs for a wide range of cancers, particularly breast cancer, was approved for use in Europe in 1995, but British cancer patients had to wait



U.S. President George W. Bush, surrounded by lawmakers, (Left-Right) Sen. Max Baucus (D-MT), Sen. Charles Grassley (R-IA), Senate Majority Leader Bill Frist (R-TN), Speaker of the House Dennis Hastert (R-IL), Sen. John Breaux (D-LA), House Majority Leader Tom DeLay (R-TX), Secretary of Health and Human Services Tommy Thompson, Rep. William Thomas (R-CA) and Rep. Nancy Johnson (R-CT), smiles as he signs new Medicare legislation on December 8, 2003 at the DAR Constitution Hall in Washington, DC.

nearly five years until they could use it. The British National Health Service still hasn't decided whether or not to pay for the breakthrough cancer drug Gleevec for all patients with chronic myeloid leukemia.¹⁶

Policy Prescriptions

The bottom line is that if policymakers want to make medicines affordable, they should be providing coverage, not by importing failed international pricing schemes and their dangerous side effects to America. As a first step, seniors will save \$8 billion with the Medicare drug discount card, almost as much as the total Canadian drug market.¹⁷

Of the top 55 most commonly prescribed medicines for seniors (as measured by number of prescriptions) 34 were cheaper in the United States than in Canada. That includes important life saving drugs for cancer, AIDS, heart disease and high blood pressure. Eight of the top 30 brand name drugs used by the elderly were cheaper in Canada while twelve others had cheaper generic alternatives available with Medicare drug discounts. For example, a one month supply of Aricept (10 mg) is \$122 when purchased with a Medicare card, but \$164 if purchased from Canada. A three month supply of Gleevec, a drug for chronic myeloid leukemia, is \$550 per

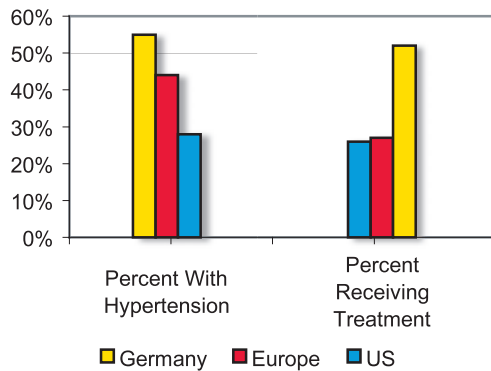
month with the Medicare card but \$660 from Canada (not including shipping). Many drugs for breast cancer and HIV are less expensive with the drug card than if purchased from Canada even before shipping charges. And when the Medicare drug benefit kicks in, price differentials won't matter.

Opening Pharmaceutical Markets Overseas: Real Free Trade

In the long term, our government and its trade representatives should make faster approval of new drugs, higher launch prices, and wider use of valuable new medicines a priority in future free trade talks with Europe and Canada.

The Bush administration's free trade agreement with Australia (recently passed by overwhelming margins in Congress) is a prototype for this new approach. Like Europe and Canada, Australia imposed quotas and price controls on American drugs. The free trade act inked with Australia will allow consumers and companies to know how Australia decides on a drug price and what evidence it uses to determine just how cost-effective a new drug is compared to another drug. In the agreement, Australia committed to the principle of appropriately recognizing the value of innovative pharmaceuticals. Indeed, Australia's Pharmaceutical Benefits Scheme has

Undertreatment of Hypertension Common in Europe



Source: Wolf-Maier et al., JAMA (2003); 289: 2362-2369

been criticized for using outdated and arbitrary methods for evaluating the cost-benefit of medicines and ignoring the most scientific and advanced ways for measuring the value of drugs. Australia, along with other countries has often limited the ability of consumers to purchase medicines on their own or for companies to respectfully appeal coverage decisions. The free trade agreement also created movement on these issues. The United States and Australia agreed to establish a Medicines Working Group to discuss emerging health policy issues. Finally, the agreement reaffirms that Australian law bans the export of pharmaceuticals if such drugs are purchased under Australia's Pharmaceutical Benefits Scheme.

Congress needs to be tougher and not retreat in its effort to dismantle price controls and open more markets to innovative American medicines throughout the world. The office of the U.S. Trade Representative (USTR) must, under Section 301 of the Trade Act, seek to revise the reference pricing systems in Germany and identify German health system drug purchases as unfair barriers to trade. Alternately, USTR could negotiate directly with the European Union to eliminate what are, under Section 301, "unreasonable and discriminatory burdens."

A recent article in *Foreign Affairs* notes that "policymakers must also reinforce the United States' entrepreneurial climate, its greatest asset. The building blocks of American innovation—flexible capital and labor markets, transparent government regulation, and a business environment that rewards risk—need to be strengthened."¹⁸ Policies that force biotechnology and pharmaceutical firms to sell products at price controlled levels and shift capital away from job creation and drug discovery to distributors are anti-competitive. By making pharmaceutical free trade agreements a central component of U.S. trade policy, the United States can promote global com-

petitiveness, lower prices at home and help improve patient health abroad. That's an export policy that is both compassionate and sensible—while drug importation is neither. 🕊

The views expressed in this paper are solely those of the author and do not necessarily represent the opinion of The Ripon Society.

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National Security Congressional Report

Photo by Jacky Naegelen/AFP/Getty Images



Senator Orrin G. Hatch

Sustaining an enduring transatlantic alliance must remain a key diplomatic goal of the United States. After World War II, the transatlantic alliance became an important bulwark of international peace, economic liberalization and prosperity, and stability. The United States' special relationship with its European allies played a central role in rebuilding the European continent after World War II, resisting the Soviet Union, and winning the Cold War. Today, our alliances with European nations are no less important.

In Afghanistan and Iraq, many of our European allies have fought bravely beside American patriots. In doing so, they have captured or killed thousands of terrorists, destroyed their ability to operate in many lawless regions, and contributed to the spread of liberty to millions of people. In addition, our allies have contributed important intelligence to U.S. authorities, helped intercept the financial assets of terrorist cells, and taken important steps to ensure the safety of air travel.



The mutual benefits of collective security and free trade, in an era of global terrorism, make the transatlantic alliance more vital than ever before. The process of European integration presents both challenges and opportunities for expanding the transatlantic alliance. John O'Sullivan's paper provides a useful outline to spark debate. The Ripon Society deserves special praise for encouraging vigorous debate and dialogue on this vital national security issue.

Does the Transatlantic Alliance Still Make Sense?

John O'Sullivan

Support for European integration has been a firm bi-partisan U.S. policy since the early fifties. Every American president from Eisenhower to George W. Bush has given a strong endorsement of the “European Idea.” Almost every concrete step towards integration from the European Coal and Steel Community to the Single European Act has been backed by the United States. It is hard to think of an American foreign policy that has a longer postwar pedigree. And it has largely survived the re-thinking of international commitments after the Cold War. Why?

European integration was seen as a means of strengthening and consolidating the West. It would create a bulwark of economic stability in Europe vis-à-vis the Soviet Union. It would create a stronger but still reliable American ally both in the Cold War and in the Third World. And it would simplify alliance diplomacy—the State Department would have to dial only one number in dealing with “Europe.”

These largely unexamined assumptions produced a complacent U.S. attitude towards a united Europe. If Europe became another superpower, it would likely remain a loyal American ally and assist U.S. policy worldwide. If it proved more independent, that would at least relieve the United States of some Cold War burdens. In no case, Americans felt, would it prove a serious obstacle to American values or interests.

Post-Cold War Realities

But many of the arguments for American support of Euro-

integration were rendered questionable by the collapse of communism. That created two major geo-political shifts. The first was military and diplomatic: it removed the Soviet threat and made the United States the sole superpower. The second was economic: the spread of globalization exposed First World economies to greater trade competition, notably from the “Asian tigers” and China.

Both of these changes subjected the Atlantic alliance to new pressures. The absence of a Soviet threat removed an important incentive for Western unity. It also released European resentment of America’s unique power. Throughout Western Europe but especially in France, the Soviet Union’s collapse began to shape policy in the direction of making Europe a “counterweight” to American power.

These political trends were aggravated by different responses to the heightened economic competition from Asia in world markets, including the U.S. market. In the United States (and in some European “outliers” such as Britain, Poland and the Baltics), economic policy encouraged competition, labor mobility, deregulation and flexibility. **In Europe, the response was to defend high levels of welfare and regulation (now increasingly harmonized upwards to a European level), to “deepen” existing European institutions, and to establish new ones such as the Euro. To ensure that its higher costs would not make its products uncompetitive in world markets, however, the EU sought to extend its regulations upwards to international levels. And that**

created tensions across the Atlantic.

Thus the EU and individual European nations increasingly diverged from U.S. policy in significant ways. For instance:

1. The Balkan Wars: European politicians sought to use the early stages of the Balkan wars to demonstrate that Europe was emerging as a great power, to advance the idea of a common European foreign policy, and to urge America to stay out. The United States initially welcomed these efforts; in any event, however, they failed miserably to halt or even ameliorate the crisis. And when the United States was eventually drawn in, it found itself seriously at odds with Western Europe on what to do.

2. Trade and Regulatory Disputes: Since 1989 there has been a series of trade disputes across the Atlantic. These have involved agricultural export subsidies, barriers to genetically modified foods, the Airbus, the French “cultural exception” over films, videos, and other cultural products, proposed EU regulations on the chemical industry, and the European response to the (admittedly mistaken) Bush protectionism of the steel industry.

3. The Kyoto accords and the International Criminal Court: In both cases, the EU united around strong support for these transnational initiatives; in both cases the United States expressed strong reservations, refused to ratify the treaties, and refused to be bound by them.

4. The Iraq War

These rifts revealed underlying tensions, differences and even antagonisms that had hitherto been unsuspected by most American observers.

Thus, the French had always been suspicious of NATO as an American project that, while necessary to hold the Soviets at

bay, nonetheless reduced the status of European states to vassals. They saw the end of the Cold War as the chance for Europe to develop as a power that, allied with others such as China, could check the U.S. “hyper-power” in a multi-polar world. They were not alone. An important but unstated motive for European integration among European politicians, especially the leaders of small countries, was always the desire to create a superpower that would exercise global power and influence equal to that of the United States.

In addition, Europe and America gradually developed different economic and political cultures. Europe became increasingly secular, social democratic in politics, interventionist in economics, and deferential to international rules and transnational bodies in international affairs; the United States became more openly religious, more liberal in politics, more free-market in economics, and more “instrumentalist” in its attitudes towards international rules and organizations. The more these differences became evident, the more anti-Americanism spread throughout Europe—mainly in the elites, but also among the general populations. At first this anti-Americanism was inchoate, reactive and episodic. But European elites have recently seen it as a way of popularizing and justifying European unity. In the absence of any genuine European patriotism, a self-conscious exploitation of anti-Americanism is seen as the “glue” of European unity. So political elites have set out deliberately to depict the development of a federal Europe as necessary to restrain the power and “unilateralism” of the United States.

More recently still, the EU has seen its “post-democratic” political structures and ideas as an ideological competitor to the liberal constitutionalism of the United States in world politics. Its admirers see the EU as the forerunner of a transnational

future in which nation-states like the United States are increasingly compelled to surrender sovereignty and conform to a new international regime of transnational rules enforced by organizations such as the ICC and policed by NGOs. And they depict America as a rogue nation that refuses to live by the multilateral rules others respect.

Hence a united Europe is likely to be anti-American—and the more united it is, the more anti-American it will likely be. But what is that likely to mean in practice?

An Anti-American Europe

When the subject of European anti-Americanism is

“In the absence of any genuine European patriotism, a self-conscious exploitation of anti-Americanism is seen as the ‘glue’ of European unity. So political elites have set out deliberately to depict the development of a federal Europe as necessary to restrain the power and ‘unilateralism’ of the United States.”

raised in international forums, European leaders (with the occasional exception of the French) instantly dismiss it as trivial and offer assurances of loyalty to Atlanticism. They seek in return assurances of U.S. support for the European project. Both sets of assurances are given, but the first one is contradicted by policy in numerous ways. What follows is a short and inevitably arbitrary list of how such anti-American attitudes shape EU policy:

1. Marginalizing America in Europe: This is best seen in the EU attempt to undermine NATO, replacing it gradually with a purely European security structure (ESDP.) After resisting the ESDP for years, Britain has been fully conscripted into this essentially French project. That is important both because an ESDP would be absurd without the participation of Europe's largest military power and because the United States is then persuaded that the British will prevent any serious damage to NATO.

That confidence is misplaced. If anti-Americanism continues to grow and if the shell of a European defense structure is built, then British governments will gradually transfer their military commitments to the European force. And the fact that EU countries insist on developing the structures of a separate European defense even when they are economizing on defense spending, and failing to meet their prior NATO obligations, is an eloquent statement of their long-term priorities.

2. Countering America in the world: Again, this is best seen in the hostile attitudes of major EU powers to U.S. policy in postwar Iraq even to the point of harming European interests. To be sure, only some EU members express such hostility—mainly France, Belgium and Germany—but they present it as a supposedly European point of view. By and large their tactic works. Even though a majority of EU member-states had troops in the Iraq coalition, no one thinks of it as a “European” policy. As the occupation drags on, more and more EU states are following Spain in withdrawing their forces. Not coincidentally, Zapatero's Spanish government explicitly linked the withdrawal of Spain's Iraq force to its preference for Europe over America. In light of this experience, the proposed European common foreign policy is a clear threat to U.S. interests. Reliable American allies such as Britain might find themselves restrained from joining with the United States in some future Iraq crisis. Such tactics have been employed so far mainly to differentiate Europe from the United States and even to frustrate U.S. policy on, for instance, the Middle East.

3. Regulatory competition aimed at undermining the economic role of America in the world economy: The EU seeks to establish the precautionary principle as an absolute international standard by which all products, no matter where they are produced, are determined to be safe or harmful; to embed it in health, safety, environmental regulations and in technical product standards; and then to export such regulations and standards via environmental treaties, international standardization bodies and bilateral technical assistance and aid programs

with developing countries.

Through the use of ‘soft power,’ the EU Commission persuades aid-dependent developing countries to adopt precautionary principle-based regulatory standards and to ratify environmental treaties incorporating the principle. And by exporting the resulting higher cost in these ways, the EU ‘levels the global economic playing field’ for its lagging and less efficient industries. In other words, it engages repeatedly in disguised protectionism against the United States and it seeks to impose its own regulatory standards on American industry in violation of well-established WTO rules.

4. Trade and aid as anti-American politics: When a recent free trade compact was reached with Mercosur, a European official confided that it had been a bad economic bargain for the EU but a good political one. It had served to weaken the hegemony of the United States over its own hemisphere and would hinder Washington in its attempts to establish the Free Trade Area of the Americas.

5. Technology substitution and defense procurement: There is now a clear pattern of the EU seeking to weaken America's technological pre-eminence in defense-related areas and, where possible, to develop substitutes for U.S. systems. First, satellite positioning technology has revolutionized military operations, effectively abolishing the concept of the “fog of war.” So far, this has been an effective U.S. monopoly with its GPS system, which is free to end users. The EU is now building a competitor technology that is objectionable on several grounds. Its Galileo satellites are likely to endanger American communication at times of war. China will be a partner in the system. And the system will be dual use civilian/military technology. In effect, the EU will share advanced military intelligence with China—in order to compete with a free system!

Second, FRES or Future Rapid Effects System is a European copy of the American Future Combat System (FCS), an armored vehicle family designed as a “system of systems,” equipped with the latest in electronics, combat systems and weapons, all inter-linked through satellite communications. Since FRES is technologically behind the United States, however, it is likely to be another costly Eurofighter fiasco. That does not make it harmless. In order to buy into FRES (and to show they are “good Europeans”), the British are cutting back their armed forces that have played a crucial part alongside America in the war against terrorism.

Third, Echelon is the world-wide electronic listening system maintained by the United States, United Kingdom, Canada, Australia and New Zealand. Pressure is steadily mounting on the Brits—in part as a result of a campaign in the European parliament, in part because of Britain's commitment to ESDP—either to share Echelon intelligence with its EU partners or to withdraw from it altogether. If the Brits share Echelon data with other EU countries, the United States will increasingly downgrade its intelligence-sharing with the United Kingdom. A uniquely valuable intelligence relationship for both countries will then be lost.

British Prime Minister Tony Blair makes a statement in the Rose Garden of the White House during a joint press conference with President George W. Bush. Blair is widely seen as Bush's closest European ally.



Photo by Jason Reed/Reuters/Corbis

6. Forging explicitly anti-American alliances with countries: In his recent state visit to China, President Chirac advocated a Euro-Chinese alliance to counterbalance America in a multi-polar world. Chancellor Schröder has called for reunifying the two Chinas—in effect the destruction of an American ally, Taiwan. And both France and Germany favor lifting the arms embargo on China imposed after Tiananmen Square. The EU has produced a new Code of Conduct on the sale of arms and, if the Chinese government signs it, there will be heavy pressure from both France and Germany to sign it.

Assessing The Threat

It is clear that the EU has a strong built-in tendency towards anti-Americanism. Does that, however, make it a threat to the United States? Two arguments say no. The first argument is that new entrants into the EU, principally eastern Europe and Turkey, will tilt the balance of EU opinion in favor of America; the second holds that Europe is so riven by major crises that it cannot pose a threat to anyone.

Neither argument stands up to examination, but by far the weaker one is the first. Even with the new entrants, Europe is finely balanced between those, generally federalists, who want a European counterweight to the United States and those, generally inter-governmentalists, who see the EU as a partner to America. Spain's recent election tipped the balance to the anti-American side, and a defeat for Berlusconi would entrench that shift. In addition, the EU Commission strongly favors common policies with an anti-American edge. The eastern European countries are likely to be "captured" by the Brussels Eurocracy, supporting its policies in return for subsidies and other economic benefits. The dominant ideology on the European Left currently is an anti-Americanism that, though encouraged by the political elite, is nonetheless rooted in popular opinion. And, finally, the more Euro-federalism advances, as it will if the proposed European treaty is adopted, the more powerful and entrenched anti-Americanism becomes. Other

things being equal, the EU will increasingly drift in the direction of pursuing anti-American policies.

The second argument has a great deal of weight—but it does not point to the complacent conclusion that its (neo-conservative) advocates believe. Europe at present is riven by four great crises and potential crises. Very briefly these are:

1. Structural Economic Stagnation: According to the European Commission's own 2002 report: "If policies do not change, and especially if labor market reforms are not systematically introduced, then the EU will experience a very sharp

downturn in the growth of living standards and its underlying potential growth rate." And other forecasts are gloomier.

2. The Demographic Crisis: UN figures suggest that countries such as Spain, Italy and Germany will lose up to one-third of their populations by 2050. Europe would need to accept 700 million immigrants by 2050 to continue paying its pensions and social benefits at current levels. That is about equal to its present population—and politically impossible anyway.

3. The Muslim Crisis: There are large Muslim minorities in Western Europe—about 12 percent of Holland is Muslim, for instance, and 7 percent of France. These minorities are largely unassimilated, owing in part to policies of multiculturalism and bilingualism; they will continue to increase as a proportion of the local population; and incidents such as the murder of Theo van Gogh suggest that minorities within the minority are susceptible to Islamist propaganda.

4. The Legitimacy Crisis: The EU has been built by political elites without the support of their populations which have never been called upon to make serious sacrifices for the EU. Because of the first three crises, however, they will now be called upon to make them. Will the EU survive this? Or will it crumble to be replaced by either new institutions or a return of powers to the nation-states?

Deep though these crises are, they do not establish that an anti-American EU would be no threat to the United States. They raise the question: what kind of threat would it be? A strong hostile threat? Or a weak resentful one?

It would be foolish to assume that the EU could not overcome these crises. Europe is the largest trading bloc in the world; it is composed of enormously talented and well-educated peoples; it is reasonably well-governed by the (admittedly lax) standards of the international community; it has an outstanding tradition of innovation in science and technology; and its governing elites have the ambition to dominate the world.

The example of America after Pearl Harbor shows that once a great economic power is roused, it can recover and rearm very quickly. Though the EU spends only 1.5 percent of its total GDP on defense, that amounts to almost 60 percent of America's defense budget. Unlikely though it may currently seem, if the EU were to generate strong reforming leaders and tackle its deep underlying problems, it might recover very rapidly and become a formidable rival to the United States.

The more probable result, of course, is that the EU will succumb to its difficulties. If Europe were to experience prolonged deflation, ethnic and religious unrest, declining public services, and falling incomes against the background of illegitimate public institutions, then all kinds of chaos and extremism would doubtless burst forth. But that would be no better for the United States. It would weaken a large market for U.S. exports and investments; create vast new breeding grounds for terrorism; push a still important power (or powers) towards a foreign policy based on a resentful anti-Americanism; and destabilize a now stable part of the world, perhaps drawing America into its murderous quarrels once again.

In both cases, the West would be divided—and its influence in world affairs and institutions proportionately weakened.

What is To Be Done?

U.S. policy is at present paralyzed. It no longer endorses any and every kind of European integration, but it has not yet discovered a better alternative. It cannot be a continuation of the traditional policy since that would mean dividing the West and actively assisting the build-up of what is now plainly a rival power with at least moderately hostile intentions. Nor can it mean actively seeking the break-up of the EU. That would be generally misunderstood, gain little support in America itself, intensify the current mood of anti-Americanism in Europe, and provoke a major crisis in the Atlantic alliance. Instead U.S. policy should seek to shape the future development of the EU in ways that suit U.S. interests.

It should have an active "European policy" that would aim, *inter alia*, to reduce the power of the EU's central authorities, to make it more open and decentralized, to subordinate its

defense capacity unmistakably to NATO, to involve it in joint EU-U.S. economic, trade and regulatory procedures, to strengthen and deepen bilateral links with European governments and peoples outside an EU framework, to obstruct the EU's efforts to obtain state status internationally, and to engage ideologically with the EU's underlying anti-Americanism. Where possible, we should do all these things in a positive and creative spirit rather than a negative and hostile one. But we must also make clear that anti-Americanism will have damaging consequences.

In practical terms, this overall approach might include such initiatives as:

1. Push for a Transatlantic Free Trade Area that would unite the present NAFTA with the EU. European countries outside the EU, and perhaps Turkey as well. Such a TAFTA was in fact agreed upon by most of the EU and America some years ago but scuttled by the French. It might be made appealing to them today by the inclusion of Turkey. That would allow them to postpone the difficult question of Turkey's EU membership. And TAFTA would not require Western Europe to accept Muslim immigration from Turkey. TAFTA is doable. **Once done, moreover, it would open the door to more important objectives such as smothering the EU's regulatory competition in joint EU-U.S. procedures and ending (or at least amending) the EU's role as sole European negotiator in trade talks.**

2. Offer firm opposition to EU policies that unfavorably impact America—above all the ESDP and the common foreign policy. The ESDP has proceeded quite far and reversing it will not be easy. But the United States has good standing in Europe to do so since it is draining scarce resources from NATO. We should therefore make plain to the Brits that intelligence and other defense sharing with them is dependent on their leaving ESDP. Some British politicians are actively opposing ESDP for that reason.

But how can they fight EU integration in defense policy if the Americans don't support them? Another inroad for America into this debate is via the new East European member states. While they cannot salvage the EU or turn it into a pro-American entity, they are at *present* pro-American and worried about

“U.S. policy is at present paralyzed. It no longer endorses any and every kind of European integration, but it has not yet discovered a better alternative. It cannot be a continuation of the traditional policy since that would mean dividing the West and actively assisting the build-up of what is now plainly a rival power with at least moderately hostile intentions...U.S. policy should seek to shape the future development of the EU in ways that suit U.S. interests.”

Franco-German games with Russia. This could be exploited—but subtly. Moving NATO bases was a goodish start.

3. Give greater attention to the Atlantic political institutions (e.g., the North Atlantic Council) that underpin NATO and the proposed TAFTA—and if necessary create new ones. If it is to survive, Atlanticism has to offer able young men and women the same kind of well-paid and prestigious careers that the EU offers.

4. Forge warmer bilateral links with European nation-states—especially the new democracies. If this is done well, the EU will look like an obstacle to the good relations

“The EU is pushing for a legal persona. This needs to be opposed. Indeed, all ideas of regional representation need to be opposed. Regionalization of the world is the enemy of democratic nation states.”

between them and the United States. (Which, incidentally, it is.) Such relationships might also be exploited to get their governments to vote in EU forums on lines favorable to U.S. policy. For that and other reasons, America should not be drawn into endorsing the proposed European Constitution. Its public position should be that this is a matter for the Europeans. But it should strongly criticize aspects of the Constitution that damage U.S. interests such as ESDP; quietly encourage Euro-skeptics like Vaclav Klaus to oppose it; and seek by various indirect means to secure its defeat.

5. Highlight the case for a NATO missile defense system. If, as seems likely, Iran develops deliverable nuclear weapons, this could win over a Europe more directly threatened than America by Iran. It is already winning over European defense industries that hope to participate in the procurement programs. Ideally, these industries should be unpaid spokesmen for NATO.

6. Oppose giving the EU—or any regional organization—any sort of state status in international bodies. There may even be a case for the United States supporting German claims to a seat on the Security Council. If Germany has a permanent place at the top table, she would be considerably less keen on a single EU foreign policy spokesperson. The EU is pushing for a legal persona. This needs to be opposed. Indeed, all ideas of regional representation need to be opposed. Regionalization of the world is the enemy of democratic nation states.

7. Stop discouraging the Euro-skeptics. There are no openly euro-skeptic governments at present. There are, however, euro-skeptic parties. Cold-shouldering the British Conservatives, for instance, annoying though they can be, is not a good idea. Such parties could be the foundation of a revived Atlanticism. They are generally the bedrock of pro-American support. And Tony Blair is a personal phenomenon with a short shelf-life.

8. Mount a strong public diplomacy campaign to oppose anti-Americanism in Europe. We did this from the forties to the eighties against communism with the Congress for Cultural Freedom. It was a great success and we need a successor organization and program for today.

9. Finance Euro-skeptic NGOs throughout Europe—and elsewhere. A properly financed and properly run euro-skeptic think-tank, not attached to any party, is badly needed. It would study and analyze all the aspects of EU development, rebut the ideas of the EU bureaucracy and produce its own alternative ones. Probably such a body could not today receive official U.S. funds, but AEI, Heritage

and Hudson might surely be encouraged to join together in establishing it.

These are some general ideas, not a fully thought-through program. But the result to aim for at the end of this process is obvious: the EU would merely be one European institution among many with which the United States has to deal. It would compete for our attention with national governments, the OECD, the OSCE, NATO, etc. It would not be “Europe.” And it would not therefore be capable of uniting the continent around any single policy, let alone an anti-American one. If this policy is tried and fails, then the United States will have to consider more radical and controversial approaches—seeking to detach Britain from the EU, shifting the weight of its alliances to India, Australia, etc.

But the first step is to wake up to what is happening in Europe. ☞

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The views expressed in this paper are solely those of the author and do not necessarily represent the opinion of The Ripon Society.

Infrastructure

Congressional Report



Congresswoman Sue W. Kelly

Our nation's transportation, water and energy infrastructure systems are assets which are too easily taken for granted. Yet we should always bear in mind that these systems are fundamentally important to the quality of our everyday life and, in a broader sense, to the strength of our nation's economy.

Infrastructure doesn't just make our lives easier—it provides our country with firm footing as we participate in an increasingly competitive global economy.

Therefore, programs designed to facilitate the ease of travel and ensure dependable sources of water and energy cannot be forgotten, despite the other, monumental challenges which currently face our country.

There is a broad collection of federal policymakers who clearly recognize this reality. In Congress, we've worked towards new policies that will modernize our methods for creating and transmitting energy. We've worked to build on the remarkable success of the landmark Transportation Equity Act for the 21st Century (TEA 21) of 1998, which has created unprecedented investment in our nation's highway and transit programs. And as the chief sponsor of the Clean Water Infrastructure Financing Act, I take great encouragement with the ever-growing support in Congress for strengthening the federal commitment to environmental infrastructure programs.

There's only one problem with all of these efforts: they've not yet been completed. So the question remains—how do we establish infrastructure policies which accurately reflect the depth of our needs? Only through continued discussion among those with different ideas will we make progress towards this common task. That's why forums such as those provided by The Ripon Society are so important to the national discourse. The piece which follows by Adrian Moore offers some compelling proposals about modernizing our infrastructure which deserve your attention.



Modernizing Our Nation's Infrastructure

Adrian Moore

Infrastructure is a vital element of a city or region's economic prosperity and viability. Roads, water, sanitation, and other types of public works constitute an integral component of municipal service delivery. City and regional transportation networks consisting of roads, railways, airports, and harbors foster a vibrant, interconnected business climate by providing the avenues through which trade takes place. In the digital economy, telecommunication links have reduced the importance of location, making the development of high-tech infrastructure vital to growth. Fiber-optic cables, spanning loops, and satellite farms are now as important as traditional public infrastructure. The Information Age has also created an increased emphasis on quality of life. Parks, schools, and recreational facilities that are meant to make a community more attractive to potential residents and businesses place further stresses on infrastructure. Yet delivering modern, quality infrastructure is fast becoming one of our nation's greatest public policy failings.

In 2003, the American Society of Civil Engineers estimated the cost of repairing and updating the nation's infrastructure to be \$1.6 trillion (see table on page 36).¹ Its estimates may be a bit self-serving, but similar figures come from a variety of sources:

- The U.S. Department of Transportation estimates that our highways and bridges need over \$56 billion per year in investment over the next 20 years.²
- The General Accounting Office in 1995 estimated \$112 billion in immediate needs for school maintenance and

upgrades.³ The National Education Association estimated school modernization needs at over \$262 billion.⁴

- The Water Infrastructure Network estimates that an additional \$23 billion per year for the next 20 years is needed to upgrade existing drinking water and wastewater treatment facilities to comply with environmental standards and to build new facilities to accommodate growth.⁵

In the face of such needs, a typical taxpayer might think infrastructure would be a high priority for policymakers. But in fact, the last two decades have been a story of infrastructure neglect.

How We Dug Ourselves into this Hole

Underinvestment in our nation's infrastructure is systemic. And we should not be surprised it is so. The demands for investment in infrastructure are always large, growing and widespread, so an effort to really tackle and solve the needs is overwhelmingly complex for any one person or committee. At the same time, infrastructure is but one item clamoring for elected officials' attention and for more resources, and infrastructure issues have a disadvantage in competing for resources against the hot button issues of the day. Putting off infrastructure investments is not likely to cause an immediate crisis. Too often governments at every level tackle tight fiscal times by deferring infrastructure maintenance and putting off new projects. And during boom

Infrastructure

times they don't make up the difference, distracted by the heady joys of creating new programs.

If that isn't enough pathology, infrastructure policy is also plagued by a politicized allocation of effort. Our system frowns on suggestions that state or regional funds be focused on the most pressing infrastructure needs; we tend to think regions should all get equal access to infrastructure and seek equal infrastructure funding regardless of how old a system is or how remote its location is compared to others. Worse, infrastructure spending is the filet mignon of pork, and resources go where the political clout is, not where the needs are the greatest. Thus, it is not uncommon to see heavily used roads left to rot while new "roads to nowhere" get built in the districts of powerful politicians.

Of course, we have tried to cut through these problems and establish rational infrastructure investment policies. The most common tool is some sort of "lockbox"—a transportation trust fund, a water fund account, or the like—often tied to the fees paid by users of the infrastructure. But they have been a failure. There is no legal or political barrier to opening these "lockboxes." They are like moving some of your cash to one side of your wallet from another. Infrastructure fees are diverted, trust funds are "borrowed" and infrastructure spending continues to fall far short of needs.

One bright spot on the horizon comes from no less likely a source than government accounting. Not long ago, new state and local government accounting standards were put in place that require all government entities to determine the value of their infrastructure facilities and reflect that value in their books. They then must either maintain the facilities to sustain their value or depreciate the value in their accounts.⁶ This is likely to create new incentives to avoid deferring maintenance.

But this still leaves us with a very Soviet-style method of handling our nation's infrastructure needs. Our system relies on centrally planned, top-down decision making on infrastructure priorities and funding, where all resources are allocated by political, not economic, criteria, and customers don't pay market prices for the use of facilities.

If we really want to turn around our course of declining infrastructure, to see new resources invested and a modern and thriving base for our economy, we have got to bring private investment, economic incentives, and market prices into the mix.

The Private Sector Role in Infrastructure Modernization

The magnitude of the importance of infrastructure delivery and the sharp decline in the condition of our infrastructure has led some public works agencies to seek new solutions. Private firms offer state and local governments an alternative to traditional project delivery through outsourcing and innovative partnerships. Governments are already starting to rely on the private sector for many facets of infrastructure projects—from design and engineering to construction, operation, and maintenance. These outsourcing arrangements, often called public-private partnerships, range from small contracts for a limited scope of services to very large contracts for turnkey delivery of completed facilities, and beyond. Their proliferation has increased participation by the private sector in infrastructure projects and changed the face of infrastructure delivery.

Policymakers need to understand the role that the private sector already plays, the increased need to create a more receptive set of circumstances for private sector involvement, and the potential to further expand the private sector's role in modernizing our infrastructure. Private sector involvement to date has

U.S. Infrastructure Condition and Investment Needs

Facilities	Condition	Investment Needs
Roads	D+	18% increase to \$76 billion cost to maintain 65% increase to \$106 billion to improve
Bridges	C	\$9.4 billion a year for 20 years to eliminate all bridge deficiencies
Transit	C-	100% increase to \$18.9 billion cost to maintain 362% increase to \$43.9 billion to improve
Aviation	D	\$2 billion each year to expand to meet growing demand
Schools	D-	\$127 billion to modernize and expand
Drinking Water	D	\$11 billion per year to meet standards
Wastewater	D	\$12 billion per year to meet standards
Dams	D	\$10.1 billion over the next 12 years to address all critical non-federal dams
Solid Waste	C+	No estimate
Hazardous Waste	D+	\$750 billion to clean up identified hazardous sites
TOTAL		At least \$1.6 trillion

Source: American Society of Civil Engineers, *Report Card for America's Infrastructure*, 1998, 2001, 2003, <http://www.asce.org/reportcard/index.cfm?reaction=full&page=6>

provided cost savings, time savings, project delivery guarantees, access to new skills, increased innovation, or many combinations of these and other benefits.

Like any policy tool, increasing private provision of infrastructure only works if it is properly conceived and structured. Some key considerations include the following:

- Congress and many states need to work on enabling legislation to lift barriers to private sector participation in infrastructure projects and shift toward market pricing of infrastructure facilities.
- Officials need a proper understanding of the goals being sought (cost savings, improved technology, speedier delivery, what have you) and matching them to the structure of private and public roles in the project.
- We have to recognize that core change is moving from monopoly to more competitive delivery of infrastructure so that competitive pressures will help determine the delivery time, quality, and costs of projects.

To get a sense of how all of this would help us modernize our infrastructure, let us look at changes that need to be made in how we manage roads, water and wastewater systems, and our electricity grid.

Getting our Roads Rolling

We have a love-hate relationship with our roads. All but a handful of us drive the roads to get where we need to go, and an ever larger share of our goods are moved on roads by trucks each year. But most of us know that our urban freeway systems are already nearing capacity, with massive congestion during ever-lengthening peak periods. Our gas taxes and other fees we pay to cover the road system are more than the costs of maintaining and improving the system, yet we see major problems:⁷

- 1. Traffic Congestion.** In the 68 largest U.S. metro areas, motorists lose a total of \$72 billion per year in wasted fuel and time, due to traffic congestion.
- 2. Lack of Expansion.** From 1987 to 1997, U.S. vehicle miles traveled increased 34 percent, yet only 3 percent more lane-miles were added.
- 3. Funding Shortfalls.** In 1997, the United States invested \$43 billion in rebuilding and capacity additions—but to simply maintain the system’s asset value, we should have spent \$51 billion—to keep pace with growth would have required \$83 billion.
- 4. Anti-highway Politics.** A large coalition of environmental, urban planning, and transit organizations opposes highway expansion and advocates shifting highway funds to public transit, bikeways, etc. Their mantra is: “We can’t build our way out of congestion.”

“In 2003, the American Society of Civil Engineers estimated the cost of repairing and updating the nation’s infrastructure to be \$1.6 trillion.”

For a typical story, just look at the metropolitan planning organizations in the three largest urban regions in California: Los Angeles, San Francisco, and San Diego. They plan to spend nearly \$400 billion over the next 30 years on transportation, and all their planning and money is focused on maintaining the current system, which won’t solve any of the problems we just mentioned. They are committed to a path of keeping things as they are. We are not happy with how things are now; think how angry we will be in 30 years!

Some fast-growing states are writing a different story, though. In Colorado, Florida, Texas, and Virginia, for example, officials have learned two important lessons from abroad, as urban regions in Europe and Australia have coped with similar pressures of growth versus limited public finances. First, they found that the global capital markets are willing to invest billions of dollars into highway transportation projects if those projects charge tolls to repay the investment. Second, they found that long-term public-private partnerships can deliver even large-scale “mega-projects” quicker and with less risk of cost overruns than traditional public sector methods.

Our Soviet-like approach to infrastructure policy is grinding our roads into dust. But what if we think about our road systems like telecommunications systems? Both are networks where users interconnect on systems developed and operated by various providers. But while our telecom system has become more market-driven in recent decades with for-profit firms using market prices to equate supply and demand and targeting investment to meet needs, our road system has continued its status quo. So we have telecoms with falling prices, exploding technological innovation, rapid proliferation of customer choices, and improving quality, while we have roads with rising costs, crumbling systems, and fewer options for a growing population. You’d think we would demand that our road system be at least as good as our phone system.

A network utility approach to roads would mean a lot of changes. It would mean private sector management of roads with a combination of innovative highway redesign, separation of types of traffic, toll financing, variable pricing, and electronic toll collection. All that would allow us to offer auto drivers and truckers real alternatives to gridlocked freeways.

Conventional wisdom says that “we cannot build our way out of congestion.” But we can do a much better job of using the existing rights-of-way to increase capacity and ease congestion.⁸ Since cars need a lot less room on the road than trucks, creating separate lanes for cars and trucks is one way to get more capac-

Infrastructure

ity out of the space we have. Additional cars-only lanes could be added either above or below currently congested stretches of roads, and special-purpose truck lanes could permit fewer, larger, heavier trucks and reduce congestion for goods movement as well.

Of course, this is expensive stuff and can't be done with current funding. But charging tolls for expensive new capacity is feasible. Electronic tolling lets users charge automatically and allows pricing based on time of day or levels of congestion, and it costs less and is more user-friendly than old-school toll plazas, which are a source of congestion in themselves.

Indeed, tolls should be considered the payment mode of choice for 21st century highways, gradually replacing fuel taxes. Since the average fuel economy of cars has doubled in the last 50 years, gas taxes today bring in a lot less revenue per mile driven than they used to. No one wants to contemplate a doubling of the gas tax to make up the difference, and that would still leave us short of revenue needs.

Tolls let us take a big bite out of the problem by charging for using specific projects that will produce direct benefits to users. Already about 10 percent of major U.S. highways are operated as toll roads, and a number of fast-growing urban areas—including Dallas, Denver, Houston, Miami, Orlando, and Orange County (Calif.)—have turned to toll roads to keep pace with their growth.

Tolls offer a number of advantages over gas taxes, including:⁹

- **Fairness:** only users of a toll road pay for it, and in direct proportion to their use.
- **Large Scale:** a toll revenue stream permits large sums to be raised in the capital markets, making it possible to build large-scale projects in a short period of time.
- **Less Pork:** having to prove to the bond market that a toll road is viable tends to weed out pork-barrel projects.
- **Greater Safety:** the accident rate on toll roads is one-third less than on comparable free roads.
- **Better Maintenance:** bondholders insist on legally enforceable requirements for proper ongoing maintenance, for which there is no counterpart on free roads.
- **Traffic Management:** time-variable tolls (high at rush hour, low at off-hours) smooth out traffic flows, greatly reducing rush-hour congestion.

As we shift to toll funding of facilities we have to avoid “double taxation” by giving rebates to toll road users for the amount of gas taxes they have paid for all miles driven on toll roads. At the same time, states would need to encourage greater use of tolling by putting in place gas-tax rebate programs and modern public-private partnership laws under which private consortia can finance, build, and operate tolled bridges, tunnels, and highways.

A private utility system for roads would address a large part of our road infrastructure challenge by bringing the market

forces of supply and demand to bear on increasing the resources available and directing them to where people get the most benefit from them.

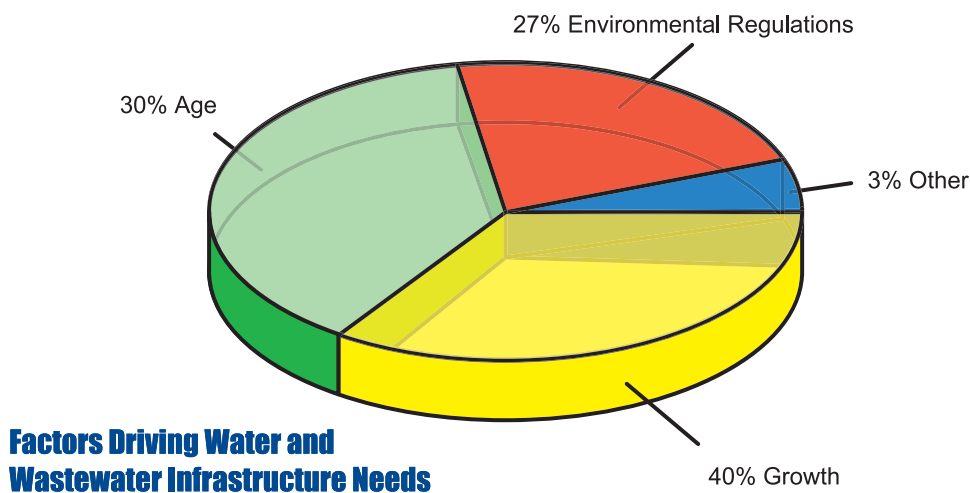
Getting our Water Flowing

A \$400 billion need for water and wastewater infrastructure investments does not come about overnight. A 1998 survey of local governments found that water and wastewater infrastructure needs are driven by:¹⁰

- **Growth—40%.** Extending systems either to cover more area or to handle increased demand is costly and complicated. Local governments must be proactive in anticipating stresses that growth places on systems rather than waiting for them to deteriorate.
- **Age—30.** Much water and sewer infrastructure dates back to the early 1900s. The most recent systems were built with federal funds during the 1970s, and even these now need upgrading or replacing.
- **Environmental regulations—27%.** Over the last two decades, through the Clean Water Act and the Safe Drinking Water Act and their subsequent amendments, standards governing the quality of drinking water and cleanliness of effluent discharged into waterways have become ever more stringent. To meet these increasing standards, many local water and wastewater systems require improved technologies and upgraded infrastructure.
- **Other—3%.** Water pipes and sewer mains are not visible and not perceived as immediately critical for adequate funding. It is easier for elected officials to ignore them in favor of expenditures for more visible services, such as police and fire. Additionally, water and sewer rates do not adequately cover the actual cost of providing services in many municipalities. But raising water and sewer rates to cover operations and maintenance, as well as capital replacement, is an unpopular move for elected officials.

These combined factors have led to a capital funding crisis for water and wastewater facilities. And an expanding role for private capital and private management has proven a key part of the emerging solution.

Privatization of water and wastewater facilities in the United States is not a new phenomenon. Converting government-owned facilities to private ownership or management goes back at least three decades.¹¹ When done right, with accountability assigned and performance measured precisely, contracting a utility can harness new technology and tap funds for improvements that yield a vastly superior product. More than 40 percent of drinking water systems nationwide are private, regulated utility systems. Of the 60 percent of systems owned by local governments, privatization by contracting for operations and management has grown rapidly in recent years. Privatization of water and wastewater services grew by 84 percent over the decade of the 1990s.¹²



A 1999 study examined public-private partnerships in water and wastewater systems in 29 cities serving over three million customers throughout the United States.¹³ It found that all of the privatizations resulted in lower rate increases than were planned prior to privatization, and at 17 percent (five) of the facilities, public-private partnering brought cost savings of between 10 percent and 40 percent, allowing local governments to avoid large increases in water rates. Case studies of savings abound. The EPA has collected a set of case studies where cities were able to meet water quality standards more efficiently thanks to privatization.¹⁴

The main barriers to expanding this opportunity are political and cultural. Despite the fact that one in five Americans gets water from a private utility, most people still think only the government can provide water and sewer services. At the same time, the fees we pay for water and especially for sewer are often hidden and are certainly not market-based, so supply is disconnected from demand. Indeed, many water and sewer fees are siphoned off by local governments for other spending purposes. Hence, officials are loathe to give up control of these systems either through ignorance of what the private sector can do, fear of public reaction, or an attachment to a cash cow.

But the status quo is allowing an infrastructure disaster to build up. We are already moving down a path of expanding private involvement in water and wastewater infrastructure to help us meet the vast needs for investment, innovation, and efficiency. We have to overcome the barriers to taking further steps down that path.

Getting our Electricity Sparking

The collapse of California's electricity system in 2001 and the 2003 blackout in the Midwest and Northeast highlighted the knife's edge we are walking with our electricity infrastructure. Cheap and reliable electricity is a lynchpin of economic development. But in spite of the fact that most electricity in the United States is provided by regulated private utilities, electricity suffers as much from the Soviet problem as do water and roads. Central planning, lack of competition, and rates based on

politics rather than economics plague the system—leading to inflexible systems that remain decades behind what current technology can accomplish while creating perverse instances of under and over-investment in infrastructures.

Indeed, at a congressional hearing on the California energy crisis, it was shocking to hear a VP of a private electric utility refer to his competition as “the private sector.” His world is so far removed from competition that he thinks of his business as a government entity.

Breaking that Soviet-style stranglehold on our electricity system means major change for both parts of the system. First, the power generation and distribution systems—the utilities we are familiar with—need to be brought into the world of competition. Pennsylvania and Texas followed the lead of countries like Australia and England in deregulating their electricity markets. The results have been very promising, especially in Texas, with lower prices, rapid growth in choices for customers, and increased investment and innovation.¹⁵

Yet some cite California's electricity restructuring as the cause of its virtual collapse. In reality, California's restructuring bears virtually no resemblance to deregulation or a move toward competition. Where else but in California would people call “deregulation” a process that created two new bureaucracies, established new price controls, forcibly reorganized company structures, and mandated where and when and under what terms buyers and sellers could trade? What California did was a fiasco, and looking at Pennsylvania, which actually did a fairly good job of deregulating and creating competition at about the same time California made its changes, demonstrates the difference.

Each of these efforts to improve the electricity system through competition taught us some lessons about what works:

- 1. Realize that pricing matters.** Real-time pricing, or charging consumers the real prices of power—higher during peak times and lower off-peak—harnesses the dramatic improvements in information technology of the past decade and gives consumers a tool for managing their energy use. Right now, almost all consumers pay prices that reflect the average cost of electricity

rather than prices that reflect the cost of the units they are actually using at the time. But a true market price would more accurately convey the nature of market scarcities in the here and now. With average cost pricing, industrial, household, and commercial consumers have little incentive to manage their consumption and use less electricity during peak hours when demand is exceptionally high and utilities have to bring their most expensive generating units on line or to buy additional power from the grid at peak rates. Real-time pricing's most enticing long-run benefit is its encouragement of an efficient level of conservation. Real-time pricing is already in place in several areas of the country, including Georgia and Washington. Georgia has seen peak summer demand fall by 5 percent since Georgia Power implemented real-time pricing for only 1,650 large users.

2. **Don't micromanage industry structure.** Arguments that existing utilities must be forced to sell all their power generation plants as a step to competition have been disastrous. Experience has shown that there will be plenty of competition to generate electricity if the market is opened up. And existing utilities will sell some assets anyway to improve their competitiveness.
3. **Let everyone play.** Although industrial consumers enjoy much of the benefit of deregulation, opening industrial, as well as commercial and residential markets, to competition more quickly enables customers to make their own choices of electricity providers and services.

The 2003 blackout in the Northeast and Midwest happened largely because the entire grid is running right on the edge of breakdown. There is no flexibility or slack in the system to cope with accidents. A competitive environment would encourage backup systems and alternative approaches, as a business has its well-being at stake if the grid shuts down. Currently, progress is only slowly moving toward changes to support competitive wholesale electricity markets. Existing long-distance transmission infrastructure is insufficient to support any dramatic increase in the trade of generated electricity.

Meeting future electricity challenges demands an increase in power by either building and upgrading transmission, building electricity generation closer to population centers, or reducing the demand for transmission services. Removing the monopoly franchises of utilities would allow the private sector to bring innovation to the industry, upgrading obsolete systems with the latest technology, building new generation facilities, and offering customers more choices about their service.

Conclusion

All around us technology has the potential to make our lives easier, streamline the way things are done, and provide faster, better services. While the private sector has taken up their cus-

tomers' demands for such technological breakthroughs, our government is mired in same-as-it-ever-was methods of service delivery and product quality. Our infrastructure could benefit greatly from these innovations. Implementing these changes, however, would require vast amounts of money to transform crumbling, obsolete government computer systems and reassign personnel in a vast old-world bureaucracy set against change and flexibility. Or would it?

Privatizing infrastructure, when done right to maximize competition and ensure accountability and oversight, can harness the free market's incentive to innovate and deliver a quality product at the most affordable price. Unlike government-funded (which means taxpayer-funded) schemes, to American industry, time is money. The private sector has every incentive to ensure a road or utility service is provided as cheaply, quickly, and efficiently as possible, with the customer's satisfaction as its benchmark. What better measure is there of success? ☞

The views expressed in this paper are solely those of the author and do not necessarily represent the opinion of The Ripon Society.

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¹⁴ U.S. Environmental Protection Agency, *A Guidebook of Financial Tools Section 4.B. Public-Private Partnerships* (Washington, D.C.: U.S. EPA, April 1999).

¹⁵ Lynne Kiesling, *Getting Electricity Deregulation Right: How Other States and Nations Have Avoided California's Mistakes*, Reason Foundation Policy Study No. 281, 2001.

Education Congressional Report

Photo by Paul Howell/Liaison



Secretary of Education Rod Paige

I want to thank The Ripon Society for focusing on education in its first annual policy report. In Abraham Lincoln's words, education is "the most important subject which we as a people may be engaged in."

President Bush's lifelong passion for education reform is well-known. He has often said that "every child can learn, and every child must be taught." We are working hard every day to make that goal a reality.

As your authors, Abigail and Stephan Thernstrom correctly noted, closing the growing academic "achievement gap" was one of our first priorities. That is the purpose of the *No Child Left Behind Act*. Nearly three years after it was signed, the law has contributed to rising test scores in states all across the country. And, I am proud to report, the students once at greatest risk are making the greatest gains. The percentage of African American and Hispanic fourth-graders who know their reading and math basics increased more between 2000 and 2003 than in the previous eight years combined.



We are beginning to foster a permanent culture of achievement in public education. For the first time, all 50 states have accountability plans in place governing their schools. All students in grades 3-8 are tested annually so educators know who needs extra help. We've invested \$4.3 billion in Reading First grants to train tens of thousands of teachers in scientifically proven instructional methods—not fads. And parents have been given more information and choices than ever before. This includes after school homework help for children in underperforming schools, and the option to leave that school for a better one—the ultimate accountability measure.

Quality schools can help strengthen the bonds of the American family and protect the safety and future of our children. We must never be afraid to put their needs ahead of the needs of the "system." I applaud The Ripon Society for supporting vital educational alternatives such as charter schools, which have received a substantial increase in aid under President Bush. Their long waiting lists testify to their need.

Our next objective is to introduce high standards and accountability for results in all high schools. Last year we launched the Preparing America's Future High School Initiative to help states develop world-class schools that challenge and engage their students. The President has also called for all students in grades 9-11 to be tested annually. Finally, we wish to see more challenging college-track coursework offered, and have awarded grants to encourage low-income students to take advanced placement courses.

In the end, a high school diploma must be more than a glorified certificate of attendance. It must be a meaningful road map to a fulfilling future. We believe that public education is up to the challenge of educating *all* of the public. Our future as citizens and as a nation depends on it. And we thank The Ripon Society for its strong support for reform.

Closing the Racial Gap in Education

Abigail Thernstrom and Stephan Thernstrom

The No Child Left Behind Act is awash in controversy, and amidst the hubbub, it's easy to forget what the statute was all about—namely, closing the gap in academic achievement. NCLB is, of course, the 2001 revision of the 1965 Elementary and Secondary Education Act, and that central aim, stated in the preamble, has been all but lost in the heated, largely partisan rhetoric that now surrounds the statute.

The preamble refers to an achievement gap that has a number of groups left behind: blacks and Hispanics, the limited-English proficient, children in poverty, and those with disabilities. And yet surely the core concern is *black* underachievement in the K-12 years. Black inequality remains the American Dilemma—the wound that never seems to heal. Leveling the educational playing field for blacks is thus the statute's unstated central aim. Ending the seemingly unending story of black inequality is a moral imperative in a class of its own. No other group has the same claims on the nation's conscience.

Not long ago, the racial gap in learning was a hush-hush topic—visible, in fact, only to a few academics. The civil rights organizations, if they knew the picture, were certainly not talking about it—perhaps out of fear that the data would be viewed through a racist lens. But problems not addressed are not solved, and the issue quite suddenly, in one of those mysterious historical turning points, suddenly acquired top billing in the national educational agenda.

In 1965, the Elementary and Secondary Education Act

(ESEA) was part of President Johnson's War on Poverty. By 2001, the White House, members of Congress in both parties, and important players in the business and educational communities had come to view the academic performance of black students as a distinct—and distinctively urgent—problem. Hispanic children, too, were a source of concern, although their history has been quite different from that of African Americans. Many of these non-Asian minority children do live in poverty. But close to half of black families are middle class, a third live in suburbia, and yet even in upscale communities like Shaker Heights, Ohio, black children are not faring well academically. No Child Left Behind broadcasts that long-unacknowledged truth, and says, in effect, forget the excuses. Teachers, administrators, parents and students: Get to work. The racial gap—in cities and suburbs—is a grave threat to our national well-being.

The Racial Gap in Education

Not long ago, black inequality had an obvious source: Persistent white racism. By now, however, classic discrimination in housing, employment, contracting, and education has almost entirely disappeared. America has changed; real progress has occurred in the status of blacks and the state of racial attitudes. And thus white racial hostility is no longer the central explanation for the racial gap in academic achievement. Race-related issues, in general, have become much more complicated, much more subtle, and much harder to talk about than they used to be.

“The racial gap—in cities and suburbs—is a grave threat to our national well-being.”

Today, unequal skills and knowledge are the main source of ongoing racial inequality, not white animus. It's often claimed that blacks and whites with similar levels of education still have very different earnings. Black high school graduates earn much less than those who are white. True, but at age 18, the typical black student knows much less than his or her white (or Asian) classmate. Years spent in school are a very poor and thus misleading measure of “education.” Look instead at actual knowledge, and a very different picture emerges. Students with equal skills and knowledge—whatever their color—will have equal earnings. School has become the key to racial equality.

The best evidence on how much children are learning comes from the National Assessment for Educational Progress (NAEP), often called “the nation's report card.” Created by Congress in 1969, NAEP regularly tests nationally representative samples of American elementary and secondary school students in fourth, eighth, and twelfth grades (or sometimes at ages 9, 13, and 17).

The NAEP results consistently show a frightening gap between the basic academic skills of the average African-American or Latino student and those of the typical white or Asian American. It's important to note that this is not, in our view, an IQ story. It's a story of kids who need to acquire skills and knowledge, but who have been tragically and needlessly left behind. It's also important to remember that we are dealing here with averages; obviously, in every group some students do well in school, while others flounder. And in absolute numbers, more whites than blacks are low performers, since 60 percent of America's schoolchildren are white. But group averages in education, as in employment, are important; racial disparities, particularly, are a cause for social concern.

Here is an abbreviated glimpse at the racial gap, based on the most recent twelfth-grade NAEP tests, which were administered between 1998 and 2000:

- At age 17, the typical black or Hispanic student is scoring less well than at least 80 percent of his or her white classmates. On average, these non-Asian minority students are four years behind those who are white and Asian. They are finishing high school with a junior high education. Thus, the employer hiring the typical black high school graduate (or the college that admits the average black student) is, in effect, choosing a youngster who has made it only through eighth grade.

- In five of the seven subjects tested by NAEP, a *majority* of black students perform in the lowest category—Below Basic. That means that a majority of black students do not have even a “partial” mastery of the “fundamental” knowledge and skills expected of students in the twelfth grade. Hispanics are doing only a tad better.
- The news is no happier when we switch our gaze from students at the bottom to those who are at the top. Take math. In math, only 0.2 percent of black students fall into NAEP's Advanced category; the figure is 11 times higher for whites and 37 times higher for Asians. Again, Hispanic students are only slightly ahead of blacks.

With so few blacks and Hispanics with superb academic skills by the end of high school, the pool of those ready to do the work demanded in highly selective colleges and likely to become part of the American professional and business elite is inevitably very small.

The picture was once worse. Black students were even farther behind three decades ago, when NAEP data first became available. But the modest progress that occurred through the 1970s and much of the 1980s came to an end around 1988, for reasons that no one can pinpoint (although there are many theories). There is, however, some recent evidence suggesting improvements in learning for grades four and eight. (Twelfth-grade students have not been reassessed.) For instance, in 4th grade math the white-black gap narrowed 13 percent between 2000 and 2003. In 8th grade math, the reduction was 10 percent. And in 4th grade reading there was a drop in the gap of 9 percent, although the fraction of blacks that scored Below Basic fell only from 65 to 60 percent. A little bit of good news, but not enough to change the basic picture—especially because it's the end of high school that really counts, and the gains in the early years may or may not be sustained.

What explains the gap? The conventional explanations include racial isolation, inadequate funding, class size, and uncredentialed teachers. None of them stand up to close scrutiny. What about social class, the most obvious explanation? Perhaps the racial gap is really nothing more than the old enemy that ESEA tried to address in 1965—namely, the poverty gap. Of course, parental education, income, and place of residence all make a difference in school achievement. But they account for only about a third of the gap. Group cultural differences seem to explain the remaining two-thirds—in part, at least.

“Culture,” it is important to stress, does not imply a fixed set of group traits. It is a loose and slippery term, easily misunderstood. We use the term to suggest values, attitudes, and skills that are shaped and reshaped by environment—an environment that includes schools. Culture matters, but it is fluid—open to change.

Creating a Culture of Achievement

Meeting the demands of school is harder for members of

some racial and ethnic groups than for others. Some group cultures are more academically advantageous than others—a point everyone knows and few want to discuss. Asian parents typically expect their children to work extraordinarily hard in school—and the children do so, cutting classes less often than their peers, enrolling in AP courses at triple the white rate, and spending twice as much time on homework as their non-Asian classmates. As one scholar has noted, they are the Benjamin Franklins of our time—the group that has most intensely embraced the traditional work ethic. As a result, on some math tests, the white-Asian gap is actually larger than the black-white gap. But hard work is obviously a habit that members of any group can acquire, and *schools* can play an invaluable part in shaping the values and habits that make for long-run success.

Hispanics are doing only slightly better than blacks on the National Assessment for Educational Progress, and the two groups are often treated as indistinguishable. They shouldn't be. Hispanics are an immigrant group much like the Italians of around 1910. For those Italian peasants, school was not a high priority; they expected their children to take a job and contribute to the family earnings at an early age. But over the generations, academic success rose in importance; time had a salutary effect. Hispanics are also making real gains over generations—gains obscured by a continuing influx of large numbers of uneducated and unskilled immigrants.

Thus, while 44 percent of foreign-born Hispanic youth fail to complete high school, only 15 percent of those born in this country are dropouts. The longer Latinos live in the United States, the longer they stay in school, the better their jobs, and the higher their average incomes. In part, the poor academic performance of the newcomers simply reflects the slow pace at which they learn English. They appear to be much more ambivalent than European or Asian immigrants about making a permanent commitment to living in the United States, which shows up in language acquisition. In a 1995 survey, a third of all second-generation Mexican-American students said they could not use English very well, in contrast to only 7 percent of Asian students. But cultural barriers to academic achievement do not let schools off the hook; they can do better. Some cultures are academically advantageous, but neither poverty nor culture is educational destiny.

In any case, again, it is African Americans who are of greatest concern. The first signs of underachievement appear very early in the life of black children. Although scholars have not been able to pinpoint the precise reasons, they can identify some of the risk factors that seem to be limiting their intellectual growth. Among them: low-birth weight, single-parent

households, and birth to very young mothers. African American children not only arrive in school less academically prepared; they also tend to be less ready to conform to behavioral demands. They watch an extraordinary amount of television—essential to belonging to the peer culture, they say.

The “cultural inheritance” of African Americans today is the product of a very long history of racial oppression—centuries of slavery, followed by disfranchisement, legally mandated segregation, and subordination in the Jim Crow South and intense racial prejudice in the North. Slaves were, of course, denied the opportunity to learn to read and write, since even a little learning might have sharpened their discontent. After emancipation, southern states only grudgingly created separate and grossly inferior schools for black children. It was hard for

“Of course, parental education, income, and place of residence all make a difference in school achievement. But they account for only about a third of the gap. Group cultural differences seem to explain the remaining two-thirds—in part, at least.”

African Americans to get much of an education, and when they entered the world of work, determination in school paid off very little. Most jobs that required academic skills were closed to blacks.

We live in a radically different world today. But the cultures of groups are shaped by historical memories and are slow to adjust to new realities. In the best of educational settings, the process of connecting the typical black child to the world of academic achievement isn't easy and it's particularly difficult when the students are from inner-city neighborhoods. Good schools show that it can be done, however. Terrific schools—the KIPP Academies in the South Bronx, N.Y., Houston, and elsewhere, among others—provide a road map to academic success. They prepare students to do well in a brutally competitive world.

Thus, the best inner-city schools have greatly extended instructional time with more hours in the day, longer weeks and longer years. They have terrific principals who have the authority and autonomy to manage their budgets, set salaries, staff the school with fabulous teachers and get rid of those who don't work out. These schools focus relentlessly on the core academic subjects, insisting that their students learn the times tables, basic historical facts, spelling, punctuation, the rules of grammar, and the meaning of often unfamiliar words. They provide safe, orderly environments in which to teach and learn. But

Education

they also aim to transform the culture of their students, *as that culture affects academic achievement*.

These schools combat what Harvard sociologist Orlando Patterson has called “the greatest problem now facing African Americans”—“their isolation from the tacit norms of the dominant culture.” His statement is really the academic version of Bill Cosby’s recent remarks in which he talked about black parents who are not parenting and about kids who can’t speak standard English, an indispensable skill for those who hope to land well-paying jobs.

What does combating “isolation from the tacit norms of the dominant culture” mean in concrete terms?

It means:

- Students must show up on time—every morning, including (in some schools) Saturdays and part of summer.
- They must come with their homework done, ready to work, ready to waste not a minute of day. They must walk into classrooms quietly and sit down quickly, getting to work. They must never lose their notebooks and must keep them well-organized.
- They are expected to be properly dressed—no shirts out, pants with a belt that start at the waist and end at the top of shoes, no hats, everything clean and neat.
- When teachers or classmates talk, they must look at them and listen politely, silently. Students are always polite.
- When teachers give directions, those directions must be followed precisely.
- When sitting at their desks, they must sit straight up, no heads on desks, no slouching.
- When they get up from their desks, they must push their chairs in. Their desks are always neat, as are their notebooks.
- When a student speaks, his or her voice should be clear and loud, so everyone can hear and understand.
- When visitors come, they are expected to shake hands and find a chair for them. When they talk to visitors—or any-

one else—they should look them in the eyes.

- When they leave the classroom and walk down the hall to another class, it should be quickly and silently. Order in the halls, as in the classroom.

No Child Left Behind At a Glance

All states that accept Title I assistance are required to have “Highly Qualified” teachers in the subjects they teach within 5 years:

2005

By 2005—All states are required to test children annually in Reading and Math in grades 3-8 and once in high school.

2007-08

By 2007-2008—All states are required to test children annually in Science in grades 3-8 and once in high school.

2013-14

By 2013-2014—Test results are expected to show “Adequate Yearly Progress” towards “proficiency” by every subgroup.

Results will be made public through report cards.

These are not add on messages delivered on occasion by the principal or a teacher; they are part of an entire school culture, and the expectations above permeate every minute of the day. This particular list is based on notes taken while I was observing one superb school, but all excellent schools teaching highly disadvantaged kids look very much alike, in our experience. The formula is nothing but common sense.

“Are we conservative here?” Gregory Hodge, the head of the Frederick Douglass Academy in New York’s Harlem, once asked us rhetorically. “Of course we are,” he answered. “We teach middle class values like responsibility.” David Levin, one of the original founders of the KIPP Academies, has echoed Hodge. “We are fighting a battle involving skills and values. We are not afraid to set social norms,” he has said. The best schools work hard to instill the “desire, discipline, and dedication” (KIPP watchwords) that will enable disadvantaged youth to climb the American ladder of opportunity. As important as basic math are what journalist David Shipler has called “the ‘soft skills’ of punctuality, diligence, and a can-do attitude.”

No Child Left Behind and Educational Reform

Figuring out what great schools look like is not difficult. But how to get there on a massive scale? That is the question to which no one has a reassuring answer—given the structure of public education, with its built-in obstacles to the sort of fundamental reform that will be needed.

Those obstacles include the collective bargaining agreements that most often prevent principals from: hiring a staff that works

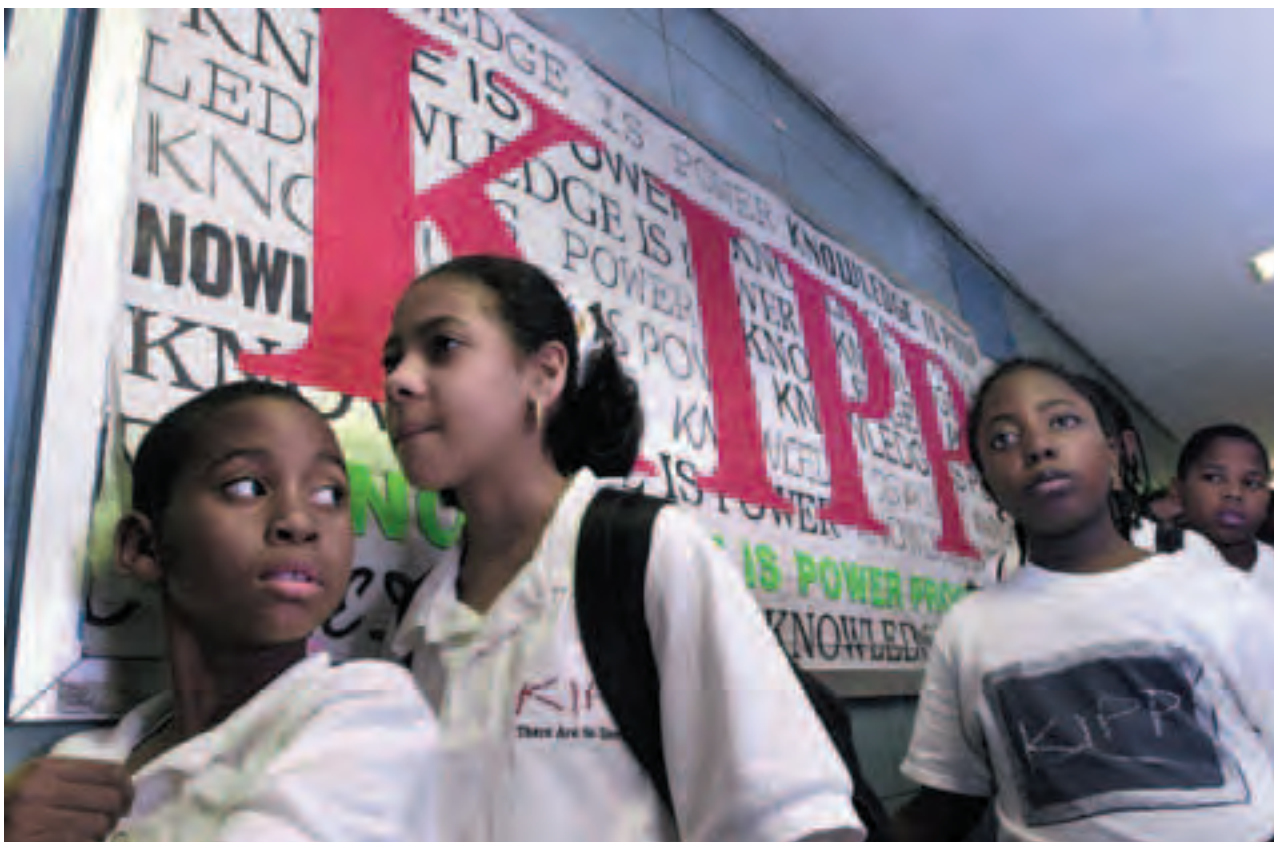
“It’s important to note that the schools we came to admire deeply could not have been created within the normal structure of public education. They were all charter schools.”

for them; getting rid of teachers who are not part of the team; determining pay by the market principles that govern other professions; deciding on the length of the school day; calling meetings at times not previously agreed upon; and so forth. Disadvantaged students desperately need good teachers. The problem of too few excellent teachers will not be solved unless the profession becomes more attractive to those smart, articulate, hardworking people who won't go to the typical education school, which Harvard professor of education Richard Elmore has described as actively promoting "mediocrity and incompetence." Schools need to have a safe and orderly environment with a culture of educational commitment. Potential teachers do not need an Ivy League degree, but they do need academic skills, a talent for communicating ideas, some sense of calling, and an ability to manage a classroom. Imaginative, competitive, innovative, ambitious young people today will gravitate towards careers that reward a strong performance with rapid promotion and higher pay, and that offer both the freedom to experiment and a safe and orderly environment. They are thus unlikely to choose teaching.

Nevertheless, all is not hopeless. Unionized teachers are a

powerful political force (hard to oppose by Democrat lawmakers), but reform is on the march. Chicago is an obvious example. In June 2004, Mayor Richard M. Daley announced a sweeping new plan under which the city will replace 60 failing schools with 100 new ones by 2010. A third of the newcomers will be managed by private companies outside of union jurisdiction—a first on this scale. Another third will be charters independent of the district, and almost all will have less than 500 students, which is small by public school standards. In Philadelphia Paul Vallas, as CEO of the district, has instituted a policy of zero tolerance for disruptive students, an extended day program, summer school, and a standard curriculum across the district (so that transient students are not lost when they join a new class). The most recent collective bargaining agreement gives principals some limited, but much-needed control over hiring.

The Chicago reforms were a pre-emptive move in anticipation of federal action against failing schools under No Child Left Behind. The 2001 federal legislation is far from perfect, but it represents the first stumbling, inadequate steps in the direction of the sort of tough-minded education reform that will be needed to close the racial gap in learning.



Chris Hondros/Newsmakers

Students at "Knowledge is Power Program" (KIPP) Academy wait in the hallway before they are let into class in The Bronx, New York. The Knowledge Is Power Program educates 200 middle-school students, mostly poor black and Latino neighborhood children, housed in a hallway on the fourth floor of a regular Bronx public school. Because of strict discipline where each student gets two hours of homework a night and a regular school day runs nine-and-a-half-hours, including Saturdays and throughout the summer, test scores are the highest in the Bronx.

Earlier efforts at federal intervention had yielded no significant results. Head Start, as implemented, has been a bust, with no lasting impact on the black children it has served. (There seems to have been some modest educational benefits for white children, and perhaps some for Hispanics as well.) Title I did little more than augment school budgets by dispersing additional federal funds to combat the disadvantage of poverty, and by 2001, Secretary of Education Rod Paige could legitimately say: “After spending \$125 billion of Title I money over 25 years, we have virtually nothing to show for it.” In 2001, however, No Child Left Behind fundamentally altered Title I, with a new emphasis on actual results, especially for disadvantaged children.

The statute is a massive tome—more than 1100 pages long. But the core elements can be quickly summarized. States have always been free to reject federal largesse, to decide to forego Title I help, but those who accept the funds must have teachers “highly qualified” in the subjects they teach within five years. By 2005, all states are required to test children annually in reading and math in grades 3-8 and once in high school. (Science will be added in 2007-2008.) Those test results are expected to show adequate yearly progress (AYP) towards “proficiency” in 2013-2014 by every subgroup; schools cannot hide their inade-

quate black performance with high test score averages that reflect the academic strength of Asians. Moreover, the results must be transparent—available to the public in the form of report cards.

Schools that fail to demonstrate AYP are subject to a series of sanctions that increase in gravity over time. With the failure to make AYP for two consecutive years, students are entitled to transfer to a better-performing school. Three years, and supplemental services (mainly tutoring) must be provided to them. After four bad years, a school is on the road to restructuring with staff replacements, a new curriculum, reconstitution as a charter

Failure Has Consequences

Failure to meet required standards will trigger a series of sanctions against deficient schools that increase in severity over time:

2 Years

Students are entitled to transfer to a better-performing school



3 Years

Students are entitled to supplemental services (mainly tutoring)



4 Years

Schools are subject to staff replacements, a new curriculum, reconstitution as a charter school, and eventually possible state or private management takeovers



school, and eventually possible state or private management takeovers. None of these sanctions is entirely new; each can be found in one state reform or another. But NCLB gathered them up, created a timetable, and made them mandatory statewide for those schools that accept Title I funds.

From the outset, it should have been clear that, in important respects, the legislation was a radical break with the past and, as such, likely to generate much opposition. In exchange for federal Title I money, schools are expected to educate their children—all their children. No excuses. And predictably, the seriousness of the sanctions, which took a while to register with lawmakers and educators, have not sat well with administrators, teachers and their union spokespersons. Thus, the statute has spawned an army of critics, mostly (but not entirely) on the political left.

Critics on the left allege that: the law is underfunded; performance standards are unrealistic, with the consequence that the accountability provisions “penalize” schools with high concentrations of disadvantaged students; the emphasis on test scores is misguided; the three Rs are stressed at the expense of art, music, and other enriching subjects; public money is diverted into the hands of private tutoring vendors; the charter school movement gets an unearned boost; and so forth. On the political right, critics worry about the expansion of federal power; its set of uniform expectations and remedies for schools in very different environments; its invitation to gamesmanship given its silence on precisely what standards schools need to meet and when; and other design and implementation flaws. They argue, as well, that the law does not give low income families the option of sending their kids to safe and rigorous private and parochial schools. In

“...by 2001, Secretary of Education Rod Paige could legitimately say: ‘After spending \$125 billion of Title I money over 25 years, we have virtually nothing to show for it.’”

“Such schools should be the heart of a civil rights strategy that addresses the nation’s most pressing race-related problem—the racial gap in learning. It is a strategy with which Republicans should feel particularly comfortable. Most Democrats are defenders of the public school status quo. They have no problem with 300-page union contracts that micromanage every hour of the school day or with ‘egalitarian’ salaries that make no distinctions among teachers on the basis of the quality of their work.”

fact, on left and right many observers have noted that the options available to children who want to transfer to a higher-performing school are severely limited in most big-city districts; the number of good schools is exceedingly small and they have no incentive to admit weak students. The choice provision is thus pretty meaningless.

There is a great deal to criticize. But there is also reason to applaud. The law brings much needed pressure for change—even in Chicago and in Philadelphia, cities which were not waiting for the feds to come along. In fact, Philadelphia is an interesting case because the state took over the district at exactly the same time that Congress passed NCLB. The threat of serious sanctions is the lever for change that is built into the federal law. But in December 2001, Philadelphia reached the ultimate sanction: a state takeover with the abolition of the school board, the reconstitution of 17 percent of the district under nonprofit and for-profit auspices, and a significant increase in the number of charter schools as well. Vallas, as CEO, cannot say to schools, improve or the state will assume control—since the city is well past the ultimate-sanction point. Schools might legitimately think, nothing left to lose.

Nevertheless, Vallas does still have considerable leverage. Every group within every school must make AYP by the measure of standards-based tests; the schools must have “qualified teachers” (definition unsettled); and a failing grade on either score can mean the use of Title I money for tutoring, as well as, in theory, more school choice. The tutoring can be from private vendors, further expanding the privatization model. And there is always the outside possibility that federal dollars could be frozen. Moreover, if companies like Edison Schools deliver, more privatization is an obvious threat. In addition, under the state takeover law, at least on paper, the CEO does have the power to circumvent future union negotiations and give principals real authority and autonomy.

NCLB helps reformers like Vallas to push for more radical change than they might otherwise want or get. In other states and districts, not already on a reform roll, the impact of the federal legislation is more modest but nevertheless significant. As

an assistant superintendent in North Carolina has noted, “the law has made everyone more aware that we have to be mindful of all students.” “All” students. An unprecedented spotlight now shines on the students who have been historically written off.

Jack Jennings, director of the Center on Education Policy, has called NCLB “a bushel of trouble.” Nevertheless, he says “there will be greater results under this law than any previous education law, because the time lines are so short and demands so great, and the schools will respond.” Indeed, schools (and districts and states) have responded. Philadelphia has given its principals more power to staff their schools; other urban districts are contemplating similar moves. “In a world where the principal is being held more and more accountable for results, you want them to be able to pick their team,” Michael Casserly, executive director of the Council of Great City Schools, has said.

In Michigan, the principals and staff at troubled schools in Grand Rapids and elsewhere are receiving additional training in teaching methods in the core subjects. Many districts with numerous failing schools have turned to private vendors to provide tutoring services for students academically behind. In New York, Chicago, and elsewhere, summer school is an option for those who might benefit. In Indiana, many schools have instituted a shorter summer vacation for all students. Anne Arundel County, Maryland, is offering teachers bonuses for higher student achievement. Massachusetts and other states are insisting that middle school teachers, who have been licensed as “generalists,” demonstrate subject-matter competence. This list could obviously be greatly extended.

School Choice and the Last Civil Right

The pressure for change that NCLB brings is overdue. American students are not learning enough, and when those students are black and Hispanic, there is reason for heightened alarm. Will the federal legislation, revised to meet legitimate criticism, suffice to turn the lives of highly disadvantaged kids around? It’s doubtful. It is the educational culture within the school building that transforms lives, and most of what goes on within each school cannot be micromanaged from on high.

Education

Superintendents can create the opportunity for educational excellence; they cannot guarantee that the principals who actually run the schools will be making the right choices—the little decisions—that are make or break in terms of student results.

We have described the essential elements of good inner-city education, as we have come to see them. Our views were shaped by the schools that we found in crisscrossing the country for a number of years in search of superb urban education.

It's important to note that the schools we came to admire deeply could not have been created within the normal structure of public education. They were all charter schools. In fact, the seeming success of these schools suggests an argument for school choice that supplements the usual one. The competitive pressures generated by choice, its advocates say, will force the public system to try harder. A market will also produce many brands of education, giving parents the chance to select a school that appeals to them. We believe in markets and the pressures they generate, but we are less interested in an array of philosophically different schools than in the emergence and success of one *particular* type for inner-city kids—that which provides an education in math, yes, but also one in which the students internalize a range of personal skills and habits essential to success. Such schools will not flower without a system of school choice.

Such schools should be the heart of a civil rights strategy that addresses the nation's most pressing race-related problem—the racial gap in learning. It is a strategy with which Republicans should feel particularly comfortable. Most Democrats are defenders of the public school status quo. They have no problem with 300-page union contracts that micromanage every hour of the school day or with “egalitarian” salaries that make no distinctions among teachers on the basis of the quality of their work. Nor do they support extending school choice—a privilege every middle class family enjoys—to low-income parents. Most Republicans, on the other hand, want what the majority of black parents desire: educational options. They do not want protection from the choices that parents as consumers make. And they believe in systems that reward risk-taking entrepreneurs who embrace individual responsibility, competence, and self-discipline.

Race-related issues generally panic Republicans; they run for the hills. It's a needless self-inflicted wound on the party. In fact, the Republican values above are precisely those that are most likely to make for the sort of reform that will have real results for the black and Hispanic youngsters who are both much too isolated “from the tacit norms of the dominant culture” and lack essential academic skills and knowledge.

A Call for Reform

The mind-numbing data on the racial gap in academic achievement should make all Americans furious—and it should radicalize the debate over educational reform. Racial progress on many fronts has been enormously heartening. But in a society committed to equal opportunity, we still have a racially iden-

tifiable group of educational have-nots—young African Americans and Latinos whose opportunities in life will almost inevitably be limited by their inadequate education.

The alternative to a radical overhaul of American education is too many black and Hispanic youngsters continuing to leave high school without the skills and knowledge to do well in life. Doors closed to too many non-Asian minorities. The perpetuation of ancient inequalities. Is that acceptable? No decent American will say, yes. 🌿

The views expressed in this paper are solely those of the author and do not necessarily represent the opinion of The Ripon Society.

Homeownership

Congressional Report

Photo by David McNew/Getty Images



Congressman Spencer Bachus

One of the most accepted assumptions upon which American society rests is the notion that homeownership constitutes a significant individual and societal good. The moral, social, and economic reasons why homeownership benefits our society are not only well-documented, but intuitively understood by most Americans. In fact, residing in a single-family, owner-occupied dwelling has become such an important social measure of success and economic security that homeownership is now almost unequivocally considered an integral component of the “American Dream.”



Unfortunately, for way too long, the opportunity to own a home has been out of reach for many Americans from minority communities. For many African-Americans and Hispanic-Americans, factors such as poor credit, a lack of accumulated wealth, and even continued discrimination have prevented them from knowing the hope and promise that homeownership brings.

Nevertheless, progress has been made. The national homeownership rate rose to 69.2 percent in 2004—a historic level. Likewise, minority communities have made great strides in homeownership in recent years. Both the African-American and Hispanic-American communities have homeownership rates swiftly approaching 50 percent.

As a Congressman from the great state of Alabama, I understand how much Alabamans, and all Americans, cherish homeownership. It is incumbent upon all of us in the public service to do our best to pursue policies that empower American families to become homeowners. I wish to applaud The Ripon Society for contributing to the debate on this public policy issue of special significance.

Minority Homeownership and the American Dream

— Steven Hornburg —

This policy brief examines options for responsibly expanding minority homeownership opportunity.¹ It recognizes that the housing and mortgage markets perform differently for minority households than for non-Hispanic white households. Various outcomes typically used by policymakers to assess market performance consistently suggest unfavorable disparities between majority and minority households.²

In fact, unequal access to opportunity based on race and ethnicity has been a persistent failing of our country that predates its founding. While this differential treatment can happen in many milieus, the housing and mortgage markets have been one of the key focal points to combat discrimination and promote wider opportunity. This focus is understandable, because where you live is the gateway to social and economic opportunity.³ Location dictates access to good education, employment opportunities, mainstream financial services, quality police and fire protection, and many other features of modern life critical to social and economic success.

Our society has deemed housing to be a merit good that, absent government intervention, may be consumed at levels considered less than socially desirable. While possessing the attributes of private enterprise, housing ranks with agriculture and defense as prime examples of industries where public and private spheres are intertwined to promote national values and imperatives. Our modern housing and mortgage markets are the creation of post-Depression era legislation, and are main-

tained by an extensive web of subsidies, tax preferences, regulation and oversight, and institutions, all promoting housing, and predominantly favoring homeownership.⁴ While some have expressed reservations over the extent of this entanglement, this framework reflects a uniquely American ethos rooted in individual ownership and a collective desire for the benefits flowing from owning a home.

Many claims have been made about the individual and community benefits of homeownership.⁵ The importance of homeownership to household wealth has been evident for some time. For most Americans, equity in their home represents the largest share of net worth, representing about one-third of the median household's net equity. (Census Bureau 2003) HUD reports that the median wealth of a low-income homeowner under age 65 is 12 times that of a similar renter (HUD 2002b). Among households in the lowest income quintile, homeowners had a median net wealth 81 times greater than renters. (Belsky and Prakken 2004) HUD reports that the median wealth of a low-income homeowner under age 65 is 12 times that of a similar renter (HUD 2002b). Gains from price appreciation on equity invested in a home can be competitive with other common investment vehicles and market indexes.⁶ Furthermore, owning a home leverages invested equity, particularly with low downpayment mortgages. With major growth in home equity lending, this wealth is more liquid and accessible to homeowners.⁷

Homeownership

Research has long suggested that homeowners vote more, participate in civic affairs, and better maintain their properties. (Rohe *et al* 2002) Community and economic development policy has often been premised on the belief that increasing homeownership helps revitalize neighborhoods through lower turnover among residents, reduced crime and blight, and increased house price appreciation. (Haurin *et al* 2003; Rohe *et al* 1996) Finally, emerging research documents positive outcomes for children of homeowners versus similarly situated children of renters, including higher graduation rates, lower rates of teenage pregnancy, higher likelihood of future homeownership, higher math and reading scores, fewer behavioral problems, and less alcohol and substance abuse. (Retsinas and Belsky 2002)

Minority Homeownership: Shameful History but Recent Progress ⁸

Decades of activism, along with litigation, legislation, and executive orders, were required to slowly peel back explicit discrimination in government housing policy. Discrimination against potential minority homebuyers was official government housing policy until 1950, enforced through underwriting criteria explicitly requiring and later favoring segregation. The final vestiges of discriminatory FHA policies were finally removed in response to passage of the Fair Housing Act of 1968. (Bradford and Shlay 1996)

Interestingly, Bradford and Shlay (1996) traced how reversing previously discriminatory FHA policy produced a perverse consequence. The compensation structure of FHA lending led to high volumes of new loans to previously excluded minority communities, typically in older, inner city neighborhoods, not well-served by mainstream depository institutions. Easy FHA credit terms combined with older homes, often in need of substantial repair, to produce massive foreclosures in many predominantly minority communities. Furthermore, fraudulent schemes taking advantage of unso-

phisticated borrowers proliferated. And many unscrupulous market players took advantage of racial divisions to threaten existing residents with rapid influxes of minority homebuyers, leading to white flight and, perversely, opportunities for increased FHA lending to minority homebuyers.

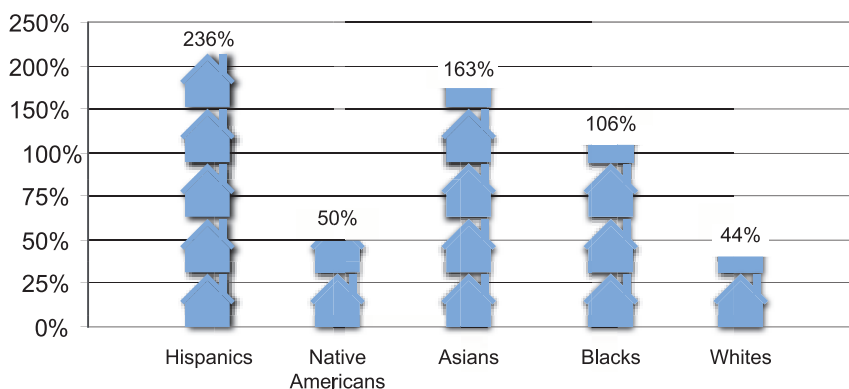
More recently, efforts to expand homeownership opportunity for minorities have centered on combating continuing discrimination in the provision of services and products for consumers shopping for homes and mortgages. This focus is supported by a substantial body of evidence demonstrating discriminatory treatment of minorities in private housing and mortgage markets.⁹ In addition, many studies have documented the lack of mortgage capital and financial services in communities with high concentrations of minority and low-income households.¹⁰ This evidence helped lead to the enactment of the Home Mortgage Disclosure Act of 1975 and the Community Reinvestment Act of 1977, as well as the creation of housing goals in 1992 for Fannie Mae and Freddie Mac, including a geographically targeted goal for “underserved areas,” a term encompassing areas with high concentrations of minorities.¹¹

With government policies focused on gently nudging the market (particularly the mortgage industry) to better serve minority homebuyers, measurable progress has recently occurred. In the 1990s, the national homeownership rate increased by 2 percentage points, a gain of 11 million homeowners. (Simmons 2001a) These gains were particularly impressive for minority groups. The number of minority homeowners rose by 4.4 million, compared to an increase of only 1.9 million in the 1980s, accounting for 40 percent of the net increase in homeowners over the decade. (Simmons 2001b) Among an age group typically associated with first-time homebuyers, homeownership rates for both African Americans and Latinos aged 25-34 increased by 4 percentage points, far outpacing the 0.3 percentage point increase for all households of this age. (Myers and Painter 2003) The number

of foreign-born households owning homes increased by 2.2 million, and accounted for 20 percent of the overall increase in homeownership rates. (Pitkin 2002)

These gains were also reflected in the mortgage markets. From 1993 to 2003, percentage increases for annual home purchase loans were more—in some cases significantly—for minority subgroups than for whites. From 1993 to 2003, the annual number of home purchase loans to Hispanics increased by 236 percent; to Asians by 163 percent; to blacks by 106 percent; and to Native Americans by 50 percent. (FFIEC

Percentage Increases for Annual Home Purchase Loans, 1993-2003



“The worst outcome of aggressive expansion of minority homeownership would be massive waves of defaults similar to the historical experience with FHA discussed earlier. Rising default rates in excess of even subprime loans should give pause to relying on highly leveraged loans through FHA.”

2004) Over the same period, lending to whites increased by 44 percent.¹²

The narrative typically used to describe this progress includes excellent economic performance and changing demographics; innovation in mortgage market technology, products, and pricing; structural transformations in the primary and secondary mortgage markets, expanded and more culturally appropriate outreach and marketing; regulatory “pushes”—notably from CRA and the GSE housing goals; and finally, a major ramping up of prepurchase homeowner education and counseling.

An early study analyzing the supply-side influences on the increases in minority homeownership, found that “(t)he data show that these (subprime) lenders, although small in number, contributed significantly to the recent growth in conventional home-purchase lending to lower-income and minority households and neighborhoods...”¹³ (Canner *et al* 1999) Other research points to the role played by increased demand, arguing a good economy (increasing incomes and favorable interest rates) and demographic changes (more households reaching prime homebuying ages and immigration) bolstered demand for increased minority homeownership.¹⁴ Finally, other research points to increased “consumer confidence” and shows comparable levels of optimism about becoming a homeowner among minority and majority renters. (Rosenthal 2000) Assuming that the potential for discriminatory treatment might reduce optimism among potential minority homebuyers, this surprising outcome could reflect the convergence of favorable economic conditions with the product innovation and increased marketing of the 1990s.

Persistent Challenges

Despite this past decade of improvement, troubling disparities remain. While the 2004 second quarter recorded an overall homeownership rate of 69.2 percent and a non-Hispanic white rate of 76.2 percent, black and Hispanic rates (49.7 and 47.4 percent, respectively) lagged considerably.

(Census Bureau 2004a) This difference is often referred to as the “homeownership gap.” This lack of parity between minority and majority households is also reflected in the continuing gap in loan denial rates.

Loan denial rates for conventional rates for home purchase loans continue to vary by race or ethnicity, and by income. In 2003, 24 percent of black applicants, 24 percent of Native American applicants, 18 percent of Hispanic applicants, 12 percent of white applicants, and 11 percent of Asian applicants were denied conventional home purchase loans. (FFIEC 2004)

Finally, various studies suggest patterns of concentration of subprime loans in minority and low-income communities. (Calem *et al* 2004) This finding does not directly prove discriminatory lending patterns, but is suggestive, given extensive anecdotal evidence of patterns of abusive marketing and lending practice.

That these differences persist should concern all Americans who believe in a level playing field. But not all of these differences in analyses of large data sets such as HMDA are *prima facie* evidence of discrimination. Some analyses use only very rudimentary controls, highlight differences by race and ethnicity of outcome measures, and conclude that these differences reflect unfair, illegal, and/or discriminatory practices. More sophisticated analyses try to control for a richer set of factors assumed to contribute to differences with more data and advanced research techniques. However, these exercises seem to always end up with residual racial gaps that cannot be explained, engendering a long-standing and vociferous debate over the role of discrimination in explaining these differences.¹⁵

One has to be careful, however, in interpreting unexplained differences in analyses of larger data sets. They may very well reflect important influences not captured in the available data. Most of the sophisticated research uses the assumptions and techniques of the economics discipline. However, this approach may not capture important preferences and psychological factors that drive consumer shopping behavior. Researchers only recently have started to incorporate consumer preferences, knowledge, attitudes, behavior and their influence on market outcomes. Discrimination clearly continues in the housing and mortgage markets, but demand-side influences have received insufficient attention in the literature.

Framing the Issue

A useful starting point to assess the sources of this gap is a framework used by HUD to categorize barriers to minority

Homeownership

homeownership. (HUD 2002a) This policy brief builds upon, and hopefully improves that framework. In some cases, categories used by HUD are modified to characterize the root cause of the barrier, rather than its expression in the housing transaction. For instance, while HUD used “lack of capital for downpayment and closing costs,” this brief uses “wealth” to trace difficulties with downpayments and closing costs back to their principal source.

Another notable modification is substituting “affordability” for HUD’s category entitled “regulatory burdens,” and including additional discussion under “continuing discrimination.” HUD’s “regulatory burden” examines how various regulations increase house prices, an entirely appropriate concern in an era of constrained public resources for housing assistance.

This approach, however, ignores the fact that a barrier is in the eye of the beholder. Some regulations are clearly exclusionary in their intent or are simply outdated and/or inefficient. But other regulations defined as “barriers” through the lens of housing costs actually reflect a complex balancing and reconciliation of competing public policy goals. Second, focusing on the supply side of the housing market (and only a part of the supply side cost equation) ignores demand-side influences on homeownership opportunity. This policy brief therefore discusses regulatory barriers in the broader context of “affordability,” focusing on this issue as one of a number of supply and demand side influences affecting minority homeownership.

HUD’s discussion of regulatory barriers also includes community opposition to affordable housing—often termed the “Not in My Back Yard,” or NIMBY syndrome. Opponents certainly have legitimate concerns over design, density, and traffic in their communities, as well as propositions perceived to reduce home values.¹⁶ However, opposition to affordable housing can be code for concerns over the racial and ethnic composition of neighborhoods and communities. Therefore, this aspect of regulatory barriers is discussed under the category of “continuing discrimination.”

HUD also addresses “lack of understanding and information about the homebuying process,” focusing on the need for homeowner education and counseling. Emerging research on consumer attitudes, preferences, and shopping behavior extends well beyond knowledge of the homebuying process, and suggests how these additional consumer attributes may influence market outcomes. Therefore, HUD’s category is expanded to include these issues and recast as “shopping orientation and behavior.”

Sources of the Gap: A Framework

Credit

Automated underwriting (AU) systems now drive the vast majority of the loan origination market. Credit scores and histories are at the core of predictive AU models assessing the

risk that the consumer will not pay back the lender on time and in full, driving decisions on whether an applicant qualifies for a mortgage, and at what price.¹⁷ A recent study (Bostic *et al* 2004) examined the distribution of credit quality across various subpopulations, including racial and ethnic minorities, as well as changes in credit quality from 1989 to 2001. The analysis found that blacks and Latinos have lower credit quality than whites.¹⁸ In addition, while median credit quality for whites increased over the 1990s, the credit quality of blacks and Latinos deteriorated in the same period. This simple descriptive information reflects the outcome of a complex set of historical and current influences, and should not be interpreted simply as poor or undisciplined credit behavior. A history of housing discrimination and disparities in access to mainstream financial institutions and services are essential to a full understanding of these differences.¹⁹ Bostic *et al* finds that, of the three commonly understood factors influencing becoming a homeowner—wealth, income, and credit—credit has emerged as the most significant barrier.

Continued Discrimination

Minorities continue to receive disparate treatment in both the housing and the mortgage markets. The latest HUD-sponsored housing discrimination study (Turner *et al* 2002b) found evidence of discrimination against minority homebuyers in their search for a home, including geographic steering, less information on available homes, and misinformation on whether a particular home was available for purchase. Additional HUD-sponsored research analyzing evidence from paired testing studies at the mortgage preapplication stage suggests unequal treatment of minorities, including receiving less time and information from loan officers and higher interest rate quotes than non-Hispanic whites. (Turner *et al* 1998; Turner *et al* 2002a)

Opposition to affordable housing also affects minority homeownership. For many, affordable housing is simply a code word for housing for people who are different. All opposition should not be tarred with this characterization.²⁰ Legitimate concerns, however, also may mask racial and ethnic fears. The nexus between opposition to affordable housing and its impact on minority homeownership opportunity have received insufficient attention in the literature on regulatory barriers.²¹

Wealth

To buy a home and qualify for a mortgage, consumers must have sufficient wealth to afford any downpayment and closing costs. Despite credit quality’s rising importance to qualifying for a mortgage, most analysts still identify equity as the most important determinant of default risk, *ceteris paribus*. Prudent underwriting therefore typically requires that borrowers put equity at risk to qualify for a mortgage, typically from savings. Here again, the relative starting position

of minorities can hinder their prospects for homeownership. In 2000, the median net worth for all households was \$59,000. However, while non-Hispanic households' median net worth was \$79,400, black and Hispanic households had far less, with median household net worth of \$7,500 and \$9,750, respectively. (Census Bureau 2003)

Affordability

The interaction of demand and supply side characteristics are revealed in various measures of affordability. Typically, these standards use a measure of housing costs as a percentage of income, and compare it against a benchmark ratio considered to be affordable. Rooted in underwriting criteria and housing policy, these measures impart a sense of how housing markets are operating and offer targets for interventions to improve access to housing.

Excessive rent burdens can delay the wealth accumulation necessary to cover mortgage downpayment and closing costs. HUD's Worst Case Housing Needs essentially measures excessive rent burden.²² In a report to Congress (HUD 2000), HUD proclaimed that worst case housing needs among minority households increased dramatically from 1991 to 1997, increasing 45 percent among Hispanic households and 13 percent among African-American households. Worst case needs of non-Hispanic whites were stable over the same period.

Other affordability measures compare the income required to support a mortgage on a typically priced home with a typical income to present the balance of supply and

“Everyone who is opposed to affordable homes is not a racist, but our understanding of the possible discriminatory intent and impact of regulatory barriers is sorely lacking. Quite frankly, the threat of fair but vigorous law enforcement may be one of the cheaper ways of increasing minority homeownership rates.”

demand in a market. Two well-known affordability indexes report these conditions over time, but do not project trends or break down measure by race or ethnicity.²³ A recent national analysis, however, indicated that given current projections and trends, “median-income, first-time home buyers with a 10 percent down payment will no longer qualify for a mortgage on a median-priced home beginning this year. By 2007, even a repeat buyer with a 20 percent down payment will not qualify for a mortgage on a median-priced home.” (Tong 2004)

On the demand side, the income of most minority subgroups lag behind non-Hispanic whites in median income, and black and Hispanic poverty rates are almost triple that of non-Hispanic whites. (Census Bureau 2004b) Lower incomes translate into less buying power, as well as more problems qualifying for a mortgage.

Supply side issues also constrain minority homeownership. Identifying regulations and policies that are “barriers” is often an exercise in subjective judgment; not all regulations and policies that increase housing costs are per se wrong. Some could be found to have a disproportionate impact on minority home seekers. And reforming processes and policies that are simply inefficient, outdated, or unnecessary clearly will help minority homebuyers, as well as the rest of the public. Outdated and costly codes governing rehabilitation and brownfields redevelopment, for instance, may have a disproportionate impact on minority households. Given their concentration in urban areas, reclaiming land and upgrading housing stock are often paths to homeownership for aspiring minority homebuyers.²⁴

Shopping Knowledge, Orientation, and Behavior

As with any purchase, understanding how to shop for a home and a mortgage is critical to getting the right product at a fair price. Buying a home and securing a mortgage are the most complex purchases most people will ever undertake. Not knowing how to shop for a home and mortgage leaves one vulnerable to problems ranging from simply paying too much to outright predatory abuse. For instance, research has suggested that subprime borrowers know less about the mortgage process, are less likely to shop, and are less likely to be offered a full set of alternatives when they shop. (Courchane *et al* 2004; Getter 2002) Furthermore, for many immigrants, simple communication, cultural practices, and attitudes become barriers to buying a home in the American market.

Also important is evidence that minorities may shop differently due to experience with and/or expectations of discriminatory treatment; differing attitudes, behaviors, and preferences, and learned understandings about credit. For instance, research on minority home seeking behavior found that blacks were significantly less likely than whites to consult brokers, probably based on expectations that they would receive discriminatory treatment. (Farley 1996)

More recent consumer segmentation research (Fannie Mae 2003) into what motivates consumers in the housing and finance arena has identified certain orientations—termed “consumer currencies”—about what a borrower wants to get out of the mortgage process. Some findings from this research

“...proposals for zero-downpayment loan programs, no matter how they are couched with the protections of counseling or enhanced underwriting, should be viewed with extreme caution.”

may have powerful implications for understanding the unexplained homeownership and loan denial gaps. For instance, a group termed “Friends and Family,” named to describe their consumer orientation and frequently African-American or Hispanic, valued “getting to yes” and saving time. Another study, finding that even higher income blacks and Hispanics exhibit worse credit quality than non-Hispanic whites, speculated that “...cultural and perhaps other factors play a role in how minorities interact with credit markets.” (Bostic *et al* 2004, p. 9)

These findings should not surprise anyone familiar with our country’s history and the enduring legacy of discrimination. While much has been done to remove overt and subtle bias in mortgage underwriting, claims can still be made about the impact that past systemic discrimination had on credit culture and expectations about how one will be treated in the market.²⁵ A high degree of sensitivity is required to understand knowledge, attitudes, and behavior among minorities towards credit, given how historical discrimination and cultural background can shape these attributes. (See, for instance, Ards and Myers 2001)

Towards Expanding Minority Homeownership Opportunity

Approach

Recent household projections show non-Hispanic white owner households, as a percentage of total owner households, dropping from 83 percent in 2000 to 76 percent in 2020, while the minority share increases from a 17 to 24 percent share. Put another way, non-Hispanic whites’ relative share among owners will drop by 8 percent over the next twenty years, while minority homeowners’ share will increase by 41 percent.²⁶

Against this demographic tidal wave, the Bush Administration’s *Blueprint for the American Dream*, seeking an increase of 5.5 million new minority homeowners by the end of the decade, is right in scope and orientation. Increasing opportunities for minority homeownership requires a wide range of actions, reflecting the breadth and complexity of the challenge. Furthermore, to truly expand opportunity in a sustainable manner, the private sector must be fully engaged in

developing this previously underdeveloped market opportunity. While a decade of progress is a start, the work is not complete.

Before turning to a specific set of recommendations, five assumptions are presented that should guide any effort to boost minority homeownership opportunity:

- The goal should not simply be to pump up the numbers of minority homeowners, but to do it in a way that is sustainable for the homebuyer, the community, and the businesses that make homeownership possible.
- The approach should first focus on the existing housing and mortgage markets, making them work better if inefficient or discriminatory, and challenging them to be innovative in putting in place new products and practices that help reach potential minority homebuyers.²⁷
- Consumer protection and antidiscrimination laws should be vigorously enforced and constantly scrutinized for performance.
- The challenge of the minority homeownership gap should be attacked as predominantly a low-income issue, although many problems are not exclusively low-income in character.
- Important differences exist among minority subpopulations, including immigrants; however, a broad and common foundation can be established against which finer policy calibrations can be made to recognize these differences.

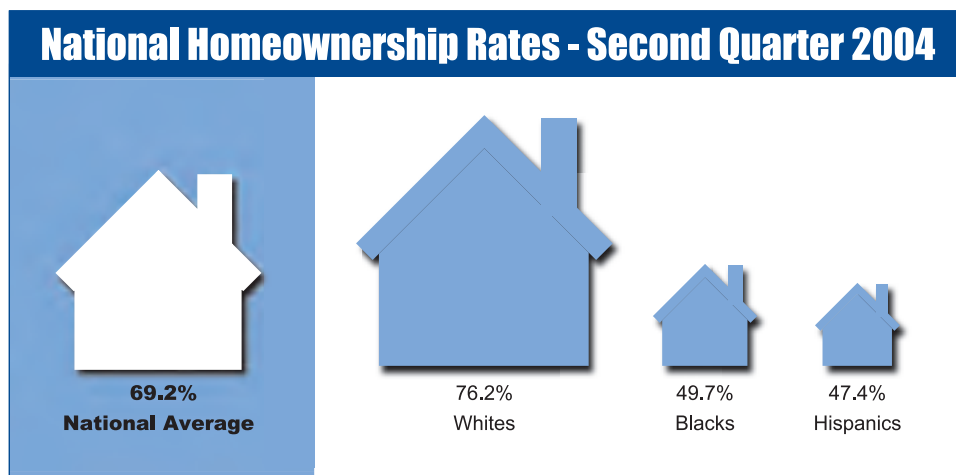
These recommendations are not presented in order of priority, but rather chronologically from preparing for through sustaining homeownership, and are based on the evidence presented above. They do not all require enacting legislation or even attention from policymakers. In fact, in some cases, policy action may make matters worse. Some recommendations challenge the market to bring about change. In sum, these thoughts represent the collective set of developments that are necessary to grow minority homeownership opportunity.

Recommendation One: Build The Pipeline

- **Treat housing assistance programs as a major source of future minority homeownership.** If programs such as public housing, housing vouchers, and low-income housing tax credit programs are not funded commensurate with need and managed with a conscious recognition of continuing discrimination, low-income minority renters will not have a chance to accumulate the necessary resources for homeownership.
- **Support financial literacy training as core curriculum in the schools.** A core set of financial skills and knowledge are necessary to participate in today’s economy and become a homeowner. Schools are a logical and appropriate setting to provide this training early and often.

Recommendation Two: Make The Market Work

- **Make a serious commitment to root out discrimination in the housing and mortgage markets.** We have made progress in opening doors previously shut, but no one can deny continued discriminatory treatment. If we are going to rely on markets to meet the challenge, then government has to ensure that they work. There has to be consumer confidence in their color-blind performance, confidence that many minorities legitimately lack at this stage. Furthermore, many of our nation's communities have been carrying on a conversation about race through the proxy topic of affordable homes. Everyone who is opposed to affordable homes is not a racist, but our understanding of the possible discriminatory intent and impact of regulatory barriers is sorely lacking. Quite frankly, the threat of fair but vigorous law enforcement may be one of the cheaper ways of increasing minority homeownership rates.



- **Clean up predatory abuse.** Continued and clear-cut cases of abuse overwhelm and undermine claims that subprime lending expands homeownership opportunity. While a bit of a paradox to some, encouraging the continued evolution of the subprime market is the long-term answer to rooting out predatory abuse. Mature markets bring more transparency and competition, which should squeeze many abusive practices.

Be wary of proposals that attempt to surgically stamp out abuse while preserving the “good” subprime lending, as the abusers will move on to new schemes, and legitimate lending may be constricted. Promising, though, is the hint of an emerging “best practices” movement in the industry based on the framework of the recent *Household Finance* settlement (see Household 2002). Rather than laying down an increasingly prescriptive set of requirements to plug all the loopholes, consider some means of mandating broader and more rigorous licensing of mortgage brokers. This delivery system has imparted a nim-

ble efficiency and responsiveness, indispensable to our current mortgage market. Easy or nonexistent oversight and regulation, however, combined with high turnover of firms and employees, invites abusive lending practices and makes this channel like internet access with no firewall or antivirus protection.

- **Monitor and publicly vet innovations in pricing, technology, and credit systems.** On balance, these innovations have made the mortgage market better for most consumers, and hold promise for future improvements. Many of these systems are by definition proprietary, and competitive businesses are unlikely to risk economic damage through disclosure. The “black box” character of these innovations, however, can undermine consumer confidence through fear and suspicion.

Furthermore, many innovations are designed for the mainstream market, which already functions well for most Americans. But some are concerned that these

innovations may widen the gap for many communities and minorities. (JCHS 2004) Therefore, innovation in tools such as credit and mortgage scoring may also require a gentle “push” to reach beyond mainstream indicators and incorporate additional means of establishing creditworthiness from other indicators such as rent and utility payments.²⁸ Strong oversight and pressure to go beyond easier, mainstream market cus-

tomers can force creative responses and improved market operation benefiting minority homebuyers.

Recommendation Three: Increase and Improve Access to Supply

- **Encourage responsible experimentation, assistance, and mortgage product development.** With a decade of innovation and comprehensive modernization of underwriting criteria, mortgage product design has squeezed almost all it can get from highly leveraged loans. In fact, one study suggests that even if we could completely eliminate any remaining barriers—essentially making loans cost-free with no equity required—we could only increase national homeownership rates by four percent (Rosenthal 2002).²⁹ And this would involve making very high risk loans that when, not if, a large number of them default, the borrower and their community would pay the cost. Therefore, proposals for zero-downpayment loan programs, no matter how they are couched with the pro-

Homeownership

tections of counseling or enhanced underwriting, should be viewed with extreme caution. More promising are proposals that provide downpayment assistance in the form of grants or extremely favorable “loans” (such as the Bush Administration’s American Dream Downpayment Initiative). Even though there have been some scams using this approach, such gifts and “loans” can impart ownership of equity, a key to establishing a borrower’s stake in not defaulting. Programs that convert existing rental assistance to cash for homebuyers’ downpayments also make sense.³⁰

Finally, the mortgage market is starting to embrace emerging information about how consumers shop and what they look for in the process. This information is particularly important to overcome attitudes and perceptions that, however legitimately grounded in unfair practice and treatment, may lead to self-defeating shopping behavior. For instance, Freddie Mac has created a

“Dispel the Myths” outreach campaign based on solid consumer research that uncovered misconceptions among Hispanics and African-Americans about attaining homeownership. (Nickerson 2004) Fannie Mae is using findings from the previously cited consumer segmentation research to develop products addressing consumer concerns about current product design. (Koch 2002)

- **Reduce the cost of a home.** Tax preferences for the housing industry, such as the Bush Administration’s proposal for a single family affordable housing tax credit, can reduce the cost of a home by simply subsidizing the cost. While the issue of regulatory barriers is a rallying cry for many, it is difficult to find traction and the tools to attack this issue at the national level. As noted above, many “barriers” are in the eye of the beholder. Just because a policy or regulation may increase the cost of a home does not mean it is ill-designed or wrong-headed. That said, there are clearly regulatory regimes that



“Against this demographic tidal wave, the Bush Administration’s Blueprint for the American Dream, seeking an increase of 5.5 million new minority homeowners by the end of the decade, is right in scope and orientation.”

Photo by Tim Boyle/Getty Images

require rethinking and modernization. Local governments also should be sensitized to the housing cost impacts of their decisions to increase informed policy-making.

But if combating regulatory barriers is to be sold as increasing minority homeownership opportunity, a much more targeted and clearly defined storyline needs to be developed to link the two issues. A starting point may be concentrating on urban areas, where minority populations are concentrated and could benefit from certain types of regulatory relief.³¹ And again, examining and highlighting any disparate impact of exclusionary zoning and planning requirements on potential minority homebuyers could produce some action.

- **Increase capital flows.** Though some vigorously dispute the cost-benefit of opportunity produced through CRA and the GSE housing goals, these goals do tap powerful engines of global finance to guide mortgage finance into publicly desired uses. The genesis and evolution of the concept of “underserved areas” demonstrated a lack of comfort with explicit goals based on race and/or ethnicity. Despite the powerful potential boost that explicit minority goals might have, the political environment may not warm such an approach.

Recommendation Four: Bolster Demand

- **Build human capital.** Recent research suggests that credit has eclipsed wealth as the biggest barrier to homeownership, and that minority households face a larger challenge with this barrier. While relatively small compared to mortgage capital flows and the federal budget, an increased investment has been made over the past decade to build a counseling industry anchored by non-profit service providers. Federal support leverages substantial industry investment, and this capacity can be further developed and rationalized by a greater understanding of what works.

Research demonstrates that homeownership counseling can reduce default rates, although exactly what works is not clear. Research has also shown that credit counseling can bring about positive changes in credit management and elevate credit scores.³² More effort is required to understand exactly what elements of counseling work so that practice can be more efficiently and effectively targeted. Initiatives such as the recently announced NeighborWorks[®] Center for Homeownership Education and Counseling, formed by the Neighborhood Reinvestment Corporation, should be supported in their mission of improving the practice of counseling.³³ Additional support for HUD’s Housing Counseling program is warranted.

- **Build financial capital.** Previous discussion has documented the disadvantaged starting position of minority households for income and wealth. To make sustainable progress, and not just bet money through highly leveraged loans, homeownership strategies must help minority homebuyers increase wealth and stretch income. A strategy combining both changing financial behavior and creating wealth for purchasing a home can be realized in individual development accounts, where personal savings are matched by additional funds. Such incentivized savings schemes combine a number of highly desirable features, including creation of real wealth and learned savings behavior. Demand side tax credits such as the Mortgage Credit Certificate program and the District of Columbia’s first time homebuyer tax credit program use the tax code to put money in the pockets of homebuyers, and are reasonably efficient.

The most powerful boost for homeownership opportunity and sustainability, however, would come from making homeownership tax preferences—mainly the mortgage interest and property tax deduction—available for households that use the standard deduction. Many minority homeowners have incomes too low to itemize their deductions, depriving them of a benefit that stretches the income of higher-income borrowers. The cost of this approach would not be insignificant, but possible consideration of tax reform and simplification might offer an opportunity to extend this important benefit to a disenfranchised class of homeowners.³⁴

Recommendation Five: Sustain Homeownership Gains

- **Build a safety net for new homeowners.** The worst outcome of aggressive expansion of minority homeownership would be massive waves of defaults similar to the historical experience with FHA discussed earlier. Rising default rates in excess of even subprime loans should give pause to relying on highly leveraged loans through FHA.³⁵ In addition to prudence on the front end, an infrastructure of post-purchase help needs to be encouraged.

Currently, post-purchase counseling has been extensively discussed but hardly pursued in the nonprofit world. Funding and attracting participants have proven to be problematic. Recent developments in private sector servicing have targeted efforts to those most likely to go deeper into default, and offered more tailored workout options sooner that keep people in their homes. (Cutts and Green 2004) These industry developments are promising and should be monitored for their effectiveness. In addition, post-purchase approaches are evolving that work out loans made with abusive and possibly illegal terms.

Homeownership

Conclusion

President Bush's advocacy of an "ownership society" has deep and long-standing bipartisan support in the homeownership arena. The Administration's goal of creating 7 million new minority homeowners by the end of the decade is ambitious. Demographic projections cited previously suggest that population growth will produce 5 million new minority homeowners by 2010, meaning that market forces and government policies will need to produce the additional 2 million new homeowners.

To attain this goal, America must continue to confront and address the historical legacy and current incidence of discrimination in housing and mortgage markets. Making markets work for all should be a guiding principle, and there is no substitute for vigorous enforcement of fair housing and consumer protections. That said, policymakers must carefully distinguish between real discrimination and imperfections due to evolving markets. Regulatory prodding and public scrutiny of housing and mortgage markets can create incentives for further innovation to overcome some barriers. Caution must be exercised, however, to not over leverage families with insufficient resources and income to absorb the ongoing costs and unexpected expenses of being a homeowner.

Supply side efforts on regulatory barriers can also make a contribution, but the specific nexus between these barriers and minority homeownership has not been well-developed. While demand-side issues have often been boiled down to homebuyer education, wealth and affordability constraints also require a focus on rental assistance and asset building strategies. And new knowledge on consumer attributes must be absorbed and understood for its implications for outreach, product design, and impact on market outcomes. Ultimately, the post-purchase safety net for new minority homeowners must be better developed to sustain progress in expanding opportunity. ☞

The views expressed in this paper are solely those of the author and do not necessarily represent the opinion of The Ripon Society.

¹ When discussing research findings, this policy brief refers to racial and ethnic subgroups as they are named in the particular study being discussed. For instance, some studies refer to "white," others use "non-Hispanic white, and some use the most precise category of "non-Hispanic white alone," reflecting multiple race identification now permitted starting with the 2000 Census. In various studies, minority populations are referred to as "Hispanic" or "Latino" and "African-American" or "black".

² Typically, these include homeownership rates, the geographic distribution of subprime loans and financial services, and loan denials, usually broken out at least by race, ethnicity, and income and often with more sophisticated statistical controls to ensure more appropriate comparisons. Unfortunately, some variables critical to current mortgage underwriting practice, namely credit scores and histories, often are not included due to a lack of access to proprietary data and privacy protections.

³ For a deeper understanding of the importance of location to the current well-being and future opportunities of households, particularly low-income minority families, see Orr *et al* (2003).

⁴ However, it is important to recognize that the creation of many of these interventions considered to promote housing were often justified on grounds other than housing such as macroeconomic stimulus. See Carliner (1998).

⁵ While homeownership confers benefits and is highly valued by our socie-

ty, this author recognizes that (1) the costs of homeownership can outweigh the benefits—see, for instance, McCarthy *et al* 2001; (2) many people prefer renting; and (3) affordable rental housing is critical to the housing ladder. The author also recognizes that ownership can be achieved through various forms, although single family homeownership dominates the American landscape. Finally, the benefits of expanding homeownership opportunities extend beyond individuals and communities to the economy and jobs. This evidence is not reviewed here—see Belsky and Prakken (2004) and HUD (2002b) for treatment of these additional benefits.

⁶ While house price appreciation was documented for the general housing market, new research suggests robust performance for low and moderate-income families buying with affordable loan products. See, for instance, Stegman *et al* (2004).

⁷ The ability to more easily access home equity is pro-consumer and gives families more financial flexibility; whether consumers responsibly use this resource and are afforded fairly-priced options with accurate and full information about the costs and possible consequences are separate questions.

⁸ This policy brief is focused on expanding minority homeownership opportunity. The topic and length constraints do not permit full treatment of historical efforts to combat discrimination and promote fair housing. For an overview of judicial, legislative, and executive milestones in the development of fair housing law from the early 1900's, see von Hoffman (1998). For an in-depth review of research on discrimination, federal policy and market practice from the 1960's through the 1990's, see Goering and Wienk (1996). Finally, to gain insight on how the broader societal milieu of segregation and racism has affected minorities, including their participation in housing and mortgage markets, see Massey and Denton (1998).

⁹ A series of three major studies sponsored by HUD—the 1977 Housing Market Practices Study (HMPS), the 1989 Housing Discrimination Study (HDS I), and the 2000 Housing Discrimination Study (HDS II) consistently found evidence of racial and ethnic discrimination in both rental and sales markets of urban areas nationwide. These studies are available online at www.huduser.org.

¹⁰ For discussions of geographic disparities in mortgage lending and financial services, see JCHS (2002a) and Stuart (2003).

¹¹ The term "underserved areas" originated with enactment of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, and reflected, in part, a desire to expand housing opportunity for minorities.

¹² While impressive, these increases reflect the smaller base against which minority growth occurred.

¹³ This study examined the 1993-1998 time period. In 1998, the industry shifted from a base of thinly capitalized firms to players with more capital, more volume and capacity, and access to cheaper capital—suggesting the potential for staying power and more competition in the market. (Duncan 2004)

¹⁴ For a discussion of aggregate trends that helped improve minority homeownership rates over the last two decades, see, for instance, Gabriel and Rosenthal (2003).

¹⁵ Debate over these residual differences has a long history in the literature, more recently anchored by the seminal 1992 Boston Fed Study examining the reasons for higher loan denial rates among minorities. (Munnell *et al* 1996)

¹⁶ For a review of sources of community opposition to affordable housing, see Koebel *et al* 2004.

¹⁷ While the use of risk-based pricing in subprime lending is widely understood, pricing also varies on prime loans based on risk.

¹⁸ This study used data from the 1989 and 2001 Survey of Consumer Finance (SCF) to assess credit quality. The SCF contains sufficient information for the authors to assign a measure of credit quality comparable to credits scores used in the mortgage industry.

¹⁹ See further discussion in "Shopping Orientation and Behavior" below.

²⁰ See Hornburg 2004b for a discussion of the importance of understanding opposition to affordable housing.

²¹ Interesting to note, however, is the surprisingly high level of support among respondents to a national opinion poll for affordable housing near one's home. (NAR 2004c) The level of support, even "next door," was sufficiently surprising to earn the lead story in the paper with the largest circulation in the United States (USA Today 2004). In interpreting the survey, the author and Robert Lang felt that these findings reflect reluctance among some respondents to express opposition to affordable housing as opposed to true support. However, a belief that opposition to affordable housing is socially unacceptable may, in fact, reflect progress. (Note: The author managed the design and conduct of this survey.)

²² While this measure also includes low-income renters who live in severely substandard housing, well over 90 percent of the households with worst case needs pay excessive rent, defined as paying over 50 percent of their income towards rent and utilities.

²³ The National Association of REALTORS® Housing Affordability Index and First-Time Buyer Index both look at such comparisons, with the First-time Buyer index focusing on households with lower incomes and starter homes. (See NAR 2004a; NAR 2004b) The National Association of Home Builders (NAHB), at first alone and then in partnership with Wells Fargo, used to publish a Housing Opportunity Index (HOI) that tracked homeownership affordability. Based on accessing the NAHB web site location for the HOI (http://www.nahb.org/fileUpload_details.aspx?contentID=534), the index appears to have been discontinued after the first quarter of 2002.

²⁴ While 74 percent of the non-Hispanic, white alone population lives in urban areas, the balance of the population (i.e., minorities) live in urban areas. (Simmons 2004)

²⁵ See, for instance, Gates *et al* 2003.

²⁶ Author's calculations from "Table A-6 - Household Projections by Race/Ethnicity, Tenure, and Family Type: 2000-2020" in the 2002 State of the Nation's Housing report. (JCHS 2002b)

²⁷ With non-Hispanic white homeownership rates probably reaching saturation and massive project growth in minority homeowners, one would expect that the housing and lending industries will continue to see these markets as their future.

²⁸ See, for instance, the Pay Rent, Build Credit data network (<http://www.payrentbuildcredit.com>) that functions as a consumer reporting agency making rental payment data available.

²⁹ This four percentage point increase may overstate net new homeowners. Analysis of the findings suggest that only 2.6 percentage points of the increase is attributable to truly new homeowners entering the market due to reduced barriers, while the balance probably represents buyers who expedite their planned purchase in response to reduced barriers.

³⁰ Rental assistance programs such as the Family Self Sufficiency program that help assisted families build savings towards downpayment and closing costs are ideal. Approaches that use rental assistance funding to help a family pay a mortgage are more problematic as funding is not guaranteed for the term of the mortgage, potentially depriving a homeowner of the needed resources to pay their mortgage obligation. This approach also skews limited assistance towards higher income families, running counter to the goal of targeting limited rental assistance to those most in need.

³¹ 74 percent of the non-Hispanic white alone population lives in urban areas, compared to 91 percent of the minority population. (Simmons 2004)

³² For a discussion of these two studies, as well as a variety of relevant literature on homeownership education and counseling, see Hornburg (2004a).

³³ For more information, see <http://www.nw.org/network/training/homeownership/default.asp>.

³⁴ One study, for instance, examined making mortgage interest payments an adjustment to income instead of an itemized adjustment, costing \$8 billion in net lost revenues. (Follain, Ling, and McGill 1993) The costs of such a proposal can be tailored to suit fiscal targets, and various mechanisms could be used to achieve parity among homeowners.

³⁵ According to MBA's National Delinquency Survey, FHA delinquency rates were around 13 percent in the first quarter of 2004, exceeding all other market segments including subprime loans.

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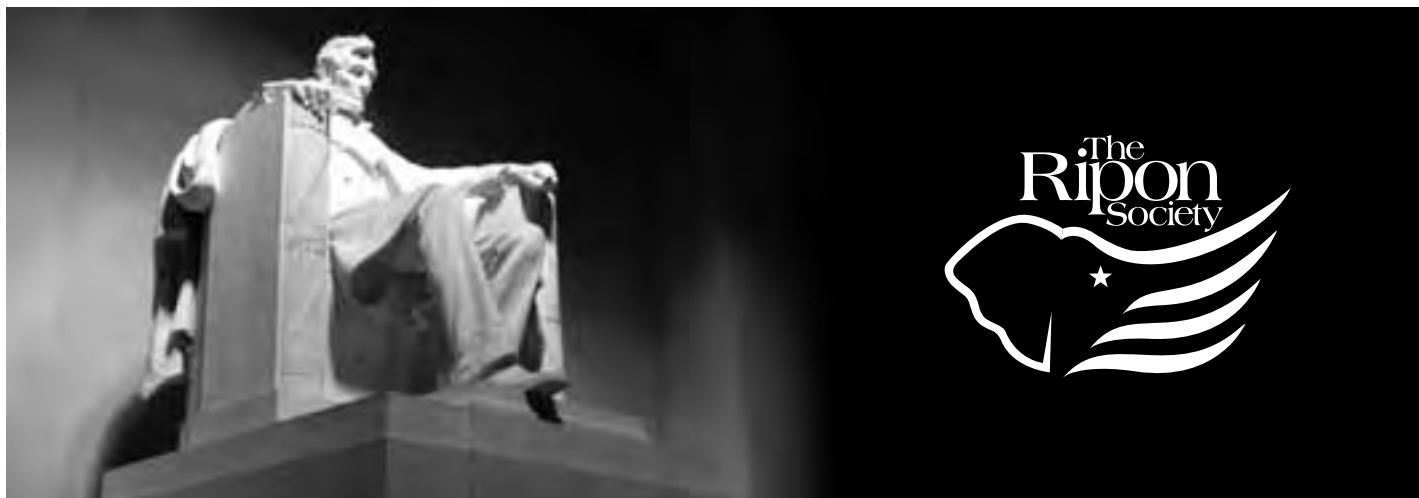
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