POLICY BRIEF

CENTER FOR THE NEW ECONOMY

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Providing Genuine Equality of Opportunity: The Case for Puerto Rican Stakeholder Accounts

PROVIDING GENUINE EQUALITY OF OPPORTUNITY: THE CASE FOR PUERTO RICAN STAKEHOLDER ACCOUNTS

Sergio Marxuach
Director of Policy Development

Introduction

Equality and liberty, These two values lie at the heart of all democratic societies. Yet, the tension between them has caused endless debate. If the case for equality is pressed too hard in the name of "maximizing overall social utility" – for example, by taxing the well-off at punishing rates – liberty will inevitably be curtailed. Furthermore, each citizen's standing in society should not depend on her contribution to the maximization of some ethereal, aggregate social utility function. We are individuals, each with rights of self-determination.

However, if the scales tip too far to the libertarian side, if we let the chips fall where they may, according to the ruthless logic of the all-powerful invisible hand, we run the risk of denying the equal right to exploit life's opportunities to thousands of our citizens. The fact remains that each person commences his life with an economic endowment he cannot be said to rightfully deserve. In our society, starting points are irrevocably shaped by parental wealth and position. It cannot be denied that the children of the wealthy commence life with many advantages – they get excellent preschool care, go to first-class schools, attend the most prestigious colleges, have access to important social networks, receive financial help from their parents and may eventually receive a good inheritance. Yet, libertarians ignore the morally arbitrary nature of this initial distribution of economic endowments and focus only on the protection of individual freedom to use these entitlements.

Traditional social welfare policy focuses on achieving a precarious balance between these two extremes by providing a minimum level, a floor if you will, of support for the very young, the old, the sick and the disabled. Since the 1930s, welfare policy has centered on the sufficiency of this floor: welfare liberals seek to increase it, while social conservatives seek to restrain the growth of social "entitlements". We at the Center for the New Economy challenge the underlying premise of this argument and propose a third way between the politics of paternalistic welfare and the politics of social abandonment: stakeholding.

By establishing Puerto Rican Stakeholder Accounts (PRSAs) at birth for every Puerto Rican and making those funds available at age 18, we would radically improve the chances of every Puerto Rican, not only the wealthy ones, to make the most of life's opportunities. Our approach is based on betting on the energy and creativity of the young, respecting individual freedom, providing equality of opportunity, and requiring that each individual be responsible for his actions. Our objective is not to penalize or reduce wealth at the top, but rather to create the opportunity for each Puerto Rican to save and accumulate the wealth necessary to attempt his or her own shot at the pursuit of happiness. In summary, we seek to provide the public foundation, through stakeholder accounts, for the genuine exercise of individual freedom.

Stakeholding – What is it?

Stakeholding is a simple idea: give each citizen a pre-determined amount of economic resources and let them use those resources in a way that makes sense to them. It is also an idea that has been around for a while. For example, Thomas Paine, in his 1797 pamphlet *Agrarian Justice*, proposed the creation of a national fund from which each citizen would be given an asset pool. Every citizen, Paine argued, had a right to a stake of fifteen pounds sterling at the age of 21 and also to the sum of ten pounds sterling per year during life after reaching fifty years of age. Paine's system of stakeholding would apply to both men and women and would be financed through a 10% tax on inheritances, so the wealth of one generation could endow the next.

There are also more recent variations on this theme. In 1992, for example, the Czech Republic, confronted with the task of selling thousands of state-owned enterprises, instituted a mechanism of "voucher privatization". Each citizen could subscribe to a book of vouchers he could use to bid for shares in state companies. The vast majority of citizens, 8.5 out of 10.5 million, participated in the program, which helped legitimize the transition to liberal democracy by giving citizens the opportunity to partake of the national patrimony.

The state of Alaska has also made stakeholding a regular part of their economy. Revenues generated from taxes related to the extraction of North Slope oil are deposited into the "Permanent Fund" and invested by professional asset managers. The Fund, which as of first week of April 2004 had a balance in excess of $28 billion, distributes yearly dividends to each resident of Alaska. For 2003 the dividend was $1,107 per person. This program, which has become widely popular, allows all Alaskans, regardless of his or her private wealth, to claim a stake in the commonwealth of the state.

In England, Prime Minister Tony Blair has announced an innovative program whereby the UK government will establish an account for each child born on or after September 1, 2002. For each new-born child, the government will make an initial endowment of at least 250 pounds sterling ($460), rising to 500 pounds sterling ($920) for the poorest children. In the words of the Prime Minister "it is a universal and progressive reform that will benefit everyone, with more to those that need the most." In addition, each child will receive additional contributions at age 7 and parents and extended family can also make annual contributions. The objectives of this so-called "baby bonds" program are to use asset-ownership to "vigorously promote equality in life's chances" and as a tool against "poverty, long-term unemployment and the inequalities passed from one generation to the next"

There are many other variations on stakeholding. For the sake of convenience, we summarize below four of the most prominent proposals: the UK program, called the Child Trust Fund (CTF); a recent proposal developed by the New America Foundation for implementation in the United States; the proposal advocated by Yale Law School professors Bruce Ackerman and Anne Alstott in their 1999 book *The Stakeholder Society*, and Senate Bill 2751, introduced in the U.S. Senate on July 22, 2004, to encourage savings and expand opportunities for young adults by establishing KIDS Accounts.

UK Child Trust Fund	New America Foundation Proposal	Ackerman and Alstott Proposal	Senate Bill 2751
• Accounts set up with initial government endowment • Endowment of 250 pounds sterling for all with an additional 250 pounds sterling for children in poverty • Additional government payment to all recipients at age 7 • Parents, families, friends and the child will be able to contribute up to 1,200 pounds a year between them • Funds not accessible until age 18 • Funds can be used without restriction for any purpose at age 18 • Accounts to be offered and managed by private financial service providers in accordance with CTF regulations • Accounts can be moved between providers at any time • All income and gains exempt from personal tax	• Initial government deposit of $2,000 • Additional government deposits linked to educational achievement and community service • Voluntary contributions capped on an annual basis • Withdrawals allowed after age 18 but only permitted for training, post-secondary education, homeownership, retirement or small business capitalization • Accounts will be created and managed by a government entity • Repayment of initial seed deposit required after self-sufficiency is achieved • Accounts will be used to facilitate financial education	• Each American citizen would be entitled to receive a one-time grant of $80,000 • Grant would be disbursed only to high school graduates • In general, the grant would be disbursed at age 21 in four annual payments of $20,000 (plus interest) • Grant would be available at 18 to finance four year college education • Stake would be financed with a 2% annual tax on the nation's total net worth • Recipients have obligation to repay grant with interest at death • Stakeholders are free to use their grant for whatever purpose they may choose	• Every child born in 2006 and beyond would automatically receive a $500 deposit into a Kids Account once a Social Security number is issued. • Children from households below the national median income would receive a supplemental deposit at birth and would be eligible to receive dollar-for-dollar matching funds up to $500 per year for voluntary contributions to the account, up to $1,000 per year. • All funds grow tax-free. • Access to the account prior to age 18 would not be permitted • At age 18 the Kids Account may be used to go to college, buying a home, or build up a nest-egg for retirement. • The accountholder must begin paying back the $500 at-birth deposit at age 30.

A Stakeholding Proposal for Puerto Rico

Based on an analysis of these proposals and the cultural characteristics and economic situation of Puerto Rico, Puerto Rico Stakeholder Accounts could have the following features:

- Participation would be universal – All children of U.S. citizens and permanent residents born in Puerto Rico would be eligible. This structure reduces administrative costs by eliminating the need to develop and enforce other eligibility criteria.

- Accounts would be set up at birth with an initial government seed deposit of $500, with an additional payment of $1,000 for children born to parents living under the Federal Poverty Line.

- Additional government deposits would be linked to educational achievement and community service – PRSAs are designed to allow children to build a modest asset pool that can help them invest in their future, but they are also intended to provide a clear sign to every child that the broader community has made a long-term investment in them. The deposit of funds directly into the account of every child would send a strong message and the timing of deposits has the potential to provide positive reinforcements. Therefore, the series of deposits would correspond to strategic points in a child's life cycle.

    (1) In addition to the seed deposit, the government would make further payments into each child's PRSA through two merit deposits linked to educational achievement:

    (a) $500 upon the completion of grade school in Puerto Rico and
    (b) $1,000 upon the completion of high school in Puerto Rico

    (2) An additional set of government contributions would be made available to reward any participant who performs at least 100 hours of community service in Puerto Rico. The PRSA proposal allows for up to two $500 community ser vice deposits. The idea is to reinforce the mutual connection between the account holder and the greater community.

- Parents, friends, family and beneficiaries would be able to contribute up to $4,000 a year between them – $4,000 is the current maximum contribution to IRAs under the Puerto Rico tax code. This limitation on voluntary contributions to PRSAs is necessary to limit inter-vivos gifts (and the corresponding deduction in their tax returns) by high net worth individuals.

- Funds would not be available to beneficiaries unless they satisfy all of these requirements:

    (1) Beneficiaries must be at least 18 years of age;
    (2) Have obtained a high school diploma or GED; <u>and</u>
    (3) Lived in Puerto Rico for at least 10 years since his/her birth

- After submitting satisfactory evidence of compliance with the requirements stated above, funds can be used by beneficiaries for vocational training, post-secondary education, homeownership, small business capitalization, or retirement (rollover into an IRA) – The fundamental idea of stakeholding is to give each person equal respect by providing an opportunity to develop their own talents as they deem appropriate.

- Accounts would be offered and managed by private financial service providers in accordance with regulations to be issued by the government.

- Beneficiaries would have the option to change providers at any time.

- All accounts providers must offer a basic stakeholder account which will be invested in equity index funds, subject to certain risk controls.

- Additional types of accounts may be offered by the market.

- Annual account management fees would be capped at a specific percentage of the account balance – In the alternative, financial service providers could be entitled to a one time tax credit for each stakeholder account they manage to help offset administrative and overhead costs. The tax credit would be equal to the present value of the estimated costs of managing one basic PRSA for 18 years. We recognize that any stakeholding program that relies on private providers of financial services needs to ensure charges and fees are set at levels that offer good value for savers while also allowing efficient providers to make adequate returns. The British government has determined that a 1.50% fee is reasonable for financial service providers in England. A similar 1.50% cap in Puerto Rico would have to be validated after consultation with local financial service providers. The tax credit proposal is an alternative to avoid charging fees to the beneficiaries that could be attractive to local account providers.

- All income and capital gains accruing to the beneficial owner of the PRSA would be exempt from individual income tax.

Cost Estimates

Based on the following assumptions, we estimate the annual costs of the prototype PRSA program to be between $60 and $70 million:

- 60,000 children born every year
- $500 seed deposit paid at birth to every child
- Additional $1000 endowment paid at birth for poor children (50% of all births)
- Grade school payment of $500 (Asuming 100% of children complete grade school)
- High school payment of $1,000 (Asuming 100% of children complete high school)
- $1,000 service contribution starting at year 16 for 50% of participants
- All contributions (initial, merit and service) indexed at 3% inflation
- 6% discount rate

Final cost estimates depend on the scale of the program and the level of benefits to be awarded to beneficiaries.

Policy Arguments in Support of Stakeholding

A broad stakeholding program like the one outlined above can be justified on several grounds. First, from a philosophical perspective, as professors Ackerman and Alstott have noted, stakeholding recognizes that "no person is inherently better than any other, and thus everyone has a right to a fair share of initial resources with which to begin and plan her adult life, regardless of whether her parents were rich or poor, frugal or improvident." After all, we would be appalled if rich people had more votes than the poor, or vice versa, based solely on socioeconomic status. In the same way that one-person one-vote is indicative of political equality, an equal stake for every citizen expresses equality of opportunity.

Second, stakeholding respects individual liberty by allowing stakeholders to use their stake as they see fit. No citizen will be obligated to justify her plan to use the money, say for a house instead of a college education, to a government bureaucrat. Stakeholders then are not only equal but free to pursue their interests in the way that makes sense the most to them. Their failures and their achievements would be their own.

Third, stakeholding, as a public policy, has had a long and successful history in the United States and around the world. Singapore, for example, has achieved one of the highest rates of savings and homeownership in the world through its Central Provident Fund. In the United States, initiatives such as the Homestead Act of 1862, the creation of the Federal Housing Administration in 1934 and the GI Bill of 1944, have enabled thousands of Americans to increase their economic stakes in United States, be it through land acquisition, homeownership, grants for higher education or loans for setting up new business. These programs helped to create wealth across social classes and produced tangible positive economic and social results over the long-term.

Fourth, stakeholding is a matter of fairness. Both the federal and Puerto Rico tax codes provide popular tax breaks for homeownership, college education, business ownership, investments and retirement that disproportionately benefit the upper socioeconomic classes. By establishing PRSAs, the poor and lower middle classes will be able to partake for the first time in the kind of social and economic returns generated by these policies. Stakeholding would level up the playing field across social classes.

Fifth, stakeholding represents a new approach to welfare policy in Puerto Rico. In general, welfare policy in Puerto Rico traditionally has focused on the issue of income distribution. If we employ the often used metaphor of a ladder, traditional welfare policy addresses the question of how far apart are the rungs in the ladder. The usual answer is to reduce the distance between the rungs by providing income supports for the poorest, while mostly ignoring the working poor. The failure of these policies has been stark. Today 44% of Puerto Rican families and 58% of their children live in poverty.

Stakeholding, on the other hand, addresses issues of opportunity, that is, it focuses on the question of who occupies which rung of the ladder and the related issues of social mobility within and between generations. Unlike traditional approaches to social welfare, it seeks to provide all citizens not with a temporary palliative but with the means to genuinely take advantage of their talents and move up the ladder for good. As Michael Sherraden, author of *Assets and the Poor*, has observed "Few people have ever spent their way out of poverty. Those who escape do so through saving and investing for long-term goals."

Sixth, the stake will serve as a powerful new engine of economic growth and employment, as generations of young Puerto Ricans claim their stake and invest it in education and start new business ventures. Of course, many will fail and still others will make foolish decisions with their stake. But many others will not. Over the long-term, this increase in entrepreneurial activity will pay off, with a net positive effect on economic and social life. In addition, as the private sector grows, there will be less pressure on government to provide employment to hundreds of thousands of Puerto Ricans.

Seventh, as the New America Foundation has observed, research shows that asset-building policies, such as the PRSAs, have positive spillover effects on children, families and neighborhoods. In general, there is growing evidence that assets are associated with household stability, educational attainment, local civic involvement and satisfaction among adults. Stakeholding would allow the underclass and the working poor to enjoy some of these non-economic benefits for the first time.

Finally, stakeholding could be a powerful tool in changing the nature of the increasingly inflexible class structure that is emerging in Puerto Rico: a lower class destined to dead-end jobs and rampant unemployment, an upper class of professionals enjoying unprecedented prosperity, and an enormous middle class trapped in the swampy quagmire of economic stagnation. Social policy thinking in Puerto Rico has not caught up with this emerging reality. On one hand, we offer generous subsidies and tax breaks to foreign capital and to those in the upper class (preferential capital gains, 10% on dividends etc.). On the other, we offer some meager help to the underclass. To the vast working middle class in between we offer nothing. Stakeholding can change this social dynamic by breaking the cycle in which inequality of outcomes in one generation becomes inequality of opportunity in the next. And it does so by respecting individual freedom in the context of equal opportunity and responsibility for all.