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Tax Expenditures: Revenue Loss Versus Outlay Equivalents

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Tax expenditures refer to the revenue losses attributable to provisions of the federal tax laws that deviate from a "normal" tax on income. Although there are debates over precisely what a tax expenditure is, many exclusions, deductions, credits, preferential rates, and deferrals of tax liability — other than those necessary to calculate income correctly or to provide a basic exemption from taxation — are considered tax expenditures. Common examples of tax expenditures are itemized deductions for charitable contributions and the employee exclusion from taxation for employer-provided health benefits.

The Treasury employs two main methods of evaluating the cost of these tax benefit programs. The first method is to simply estimate the revenue forgone. The second is to estimate the "outlay equivalent" — in theory, the value of the same program were it administered as a taxable federal outlay to recipients. The two approaches end up counting different items as tax expenditures in part by whether or not they could ever be a direct outlay administered by an expenditure agency. Our focus here is on another primary difference: that some of these tax deductions and credits are themselves *nontaxable.* Thus, the outlay equivalent takes into account that the subsidy itself might be nontaxable, which adds to its value. For instance, a nontaxable tax credit like the child tax credit is more valuable to a taxpayer than a taxable subsidy provided as a direct expenditure or a tax subsidy.

Consider, for example, a wage earner who is in the 25 percent income tax bracket. He would need to earn $100 to finance what could be provided with a $75 nontaxable tax credit. The $75 figure is what tends to show up as the traditional revenue estimate, where the "outlay equivalent" reflects the $100 value. However, note that the term "outlay equivalent" can be misleading as well since many outlays are themselves nontaxable. Publicly subsidized education is an example. The outlay side of the budget may report $75 of saving to the taxpayer for getting $75 of additional public education expense, but that estimate by itself also understates the $100 value to the 25-percent-bracket taxpayer.

The table below compares the revenue loss and outlay equivalent for several well-known tax subsidies or expenditures. The ratio of outlay equivalent to revenue loss rises when the tax rates of beneficiaries are higher. Thus, the ratio is lowest for programs like the earned income tax credit, much of which goes to low-income families.

Revenue vs. Outlay Equivalent Cost for Eight Tax Expenditures in 2004

Dollars in millions

Provision	Revenue Loss	Outlay Equivalent	Ratio of Outlay Equivalent to Revenue Loss
1. Net exclusion of pension contributions and earnings (All plans)	$151,906	$180,890	1.19
2. Employer exclusion for medical premiums and care	123,850	160,520	1.30
3. Charitable contribution deduction (All types)	42,120	59,790	1.42
4. Child credit	21,310	28,410	1.33
5. Medical expenses deduction	6,340	6,910	1.09
6. Workers' compensation benefits	6,190	7,710	1.25
7. Hope and lifetime learning tax credits	5,860	7,510	1.28
8. Earned income tax credit	5,090	5,660	1.11

Note: The amounts for the child credit and earned income tax credit shown here count the non-refundable portions only.
Source: Budget of the U.S. Government, 2004, Analytical Perspectives, Tables 6-3 and 6-5.