What are they and how are they structured?

Tax expenditures are special provisions of the tax code such as exclusions, deductions, deferrals, credits, and tax rates that benefit specific activities or groups of taxpayers.

The Congressional Budget Act of 1974 defines tax expenditures as "revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability." These provisions are meant to support favored activities or assist favored groups of taxpayers. Thus, tax expenditures are alternatives to direct spending programs or regulations to accomplish the same goals. The Office of Management and Budget (OMB) and the Congressional Joint Committee on Taxation (JCT) each year publish lists of tax expenditures and estimates of their associated revenue losses. The Treasury Department prepares the estimates for OMB.

The key word in the definition of tax expenditures is "special." OMB and JCT do not count all exemptions and deductions as tax expenditures. For example, the agencies do not count as tax expenditures deductions the tax law permits to measure income accurately, such as employers' deductions for employee compensation or interest expenses. Similarly, OMB and JCT do not count personal and dependent exemptions as tax expenditures on the theory that adjusting for family size is appropriate in measuring a taxpayer's ability to pay.

More generally, both the decision to count a provision as a tax expenditure and the measurement of its size require that OMB and JCT define a normative or baseline system against which some provisions are exceptions. Both agencies include in the baseline system provisions that allow tax rates to vary by income, that adjust for family size and composition in determining taxable income, and that allow for a separate tax on corporate income. The baselines of the two agencies do differ in some details, however, which contribute to differences in their lists of provisions and their estimates of revenue losses.

TAX EXPENDITURES TAKE DIFFERENT FORMS

Deductions and exclusions reduce the amount of income subject to tax. Examples are the deduction for mortgage income on personal residences and the exclusion of interest on state and local bonds. Deductions and exclusions reduce tax liability more

for higher-income taxpayers facing higher marginal income tax rates than for lower-income taxpayers in lower rate brackets.

A special category of deductions, called *itemized deductions*, is valuable only to taxpayers whose sum of itemized deductions exceeds the standard deduction amounts available to all tax filers. The largest itemized deductions are those for home mortgage interest, state and local nonbusiness taxes, and charitable contributions. In 2013, only 30 percent of tax returns claimed itemized deductions.

Credits reduce tax liability dollar for dollar for the amount of credit. For example, the child tax credit reduces liability by $1,000 per child for taxpayers eligible to use it fully. A special category of credits, called *refundable credits*, allows taxpayers to claim credits that exceed their positive income tax liability, thereby receiving a net refund from the IRS. The major refundable credits are the earned income tax credit and the health insurance premium assistance tax credit, which are fully refundable, and the child credit, which is refundable for those with earnings above a threshold amount.

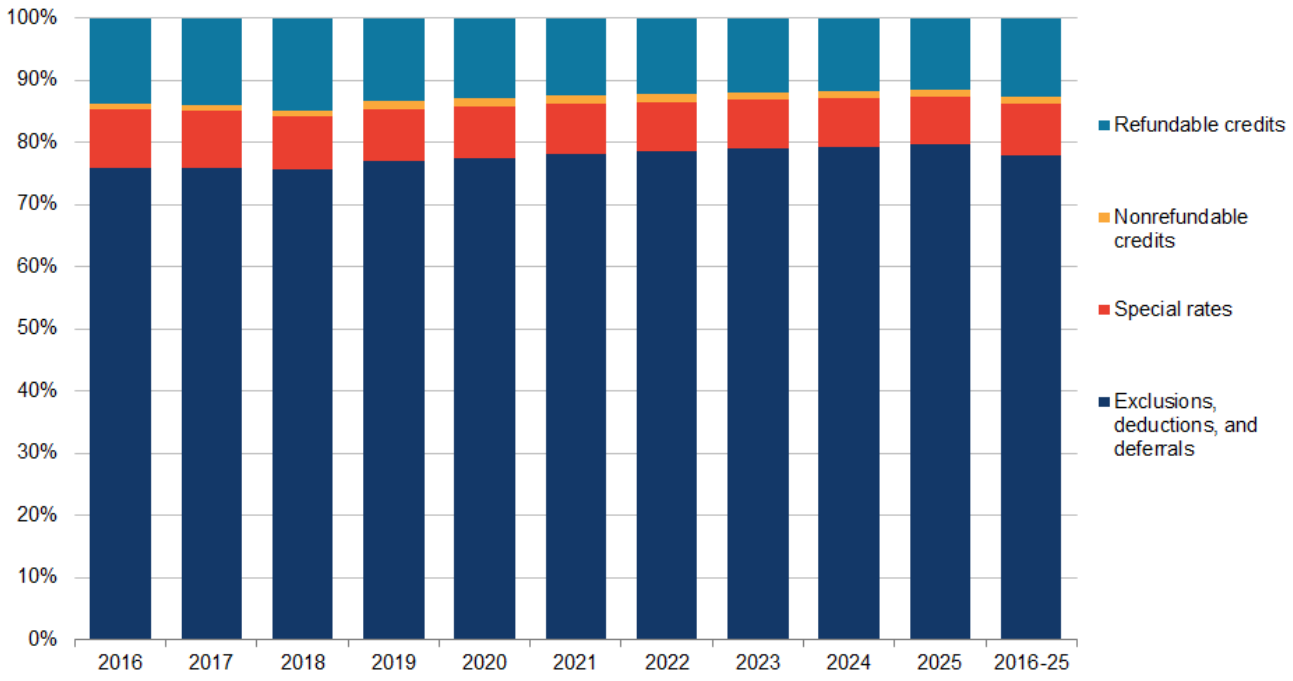
Some forms of income benefit from *preferential rates*. For example, long-term capital gains and qualified dividends face a schedule of rates ranging from 0 to 20 percent, compared with rates on ordinary income, which range from 10 to 39.6 percent.

Finally, some provisions allow taxpayers to *defer tax liability*, thereby reducing the present value of taxes they pay, either because the taxes are paid later with no interest charge or because they are paid when the taxpayer is in a lower rate bracket. These provisions allow taxpayers to claim deductions for costs of earning income before the costs are incurred. Examples include provisions that allow immediate expensing or accelerated depreciation of certain capital investments, and others that allow taxpayers to defer their tax liability, such as the deferral of recognition of income on contributions to and income accrued within qualified retirement plans.

Exclusions, deductions, and deferrals of income recognition will account for 76 percent of individual income tax expenditures in fiscal year 2017, special rates for 9 percent, nonrefundable credits for 1 percent, and refundable credits for 14 percent (figure 1).

FIGURE 1

Shares of Individual Income Tax Expenditures, 2016-25



Source: US Department of the Treasury. Tax Expenditures 2017. Table 1.

Data Source

US Department of the Treasury. *Tax Expenditures 2017*. Table 1. "Estimates of Total Individual Income Tax Expenditures for Fiscal Years 2015–2025."