What are the largest tax expenditures?

Tax expenditures make up a substantial part of the federal budget. Some of them are larger than the entire budgets of the programs or departments that spend money for the same or related purposes. For example, the value of the tax breaks for homeownership exceeds total spending by the Department of Housing and Urban Development.

Table 1 ranks the top 13 US tax expenditures. The largest (an estimated $216 billion in 2016) is the exclusion of employers' contributions for employees' medical insurance premiums and medical care. Under this provision of the tax code, contributions are excluded from an employee's gross income, while an employer may deduct the cost as a business expense.

The next largest tax expenditure ($93 billion in 2016) is the preferential rate structure for individuals' capital gains income, which is taxed at rates ranging from 0 to 20 percent compared to individual income tax rates that range from 10 to 39.6 percent. Capital gains also benefit from the step up in basis at death ($67 billion in 2016), which permanently exempts all unrealized capital gains accrued during an individual's lifetime on assets that are passed on at death.

Retirement saving also benefits from very large tax expenditures. Investment income earned within tax-qualified saving accounts is tax free. In addition, with most tax-qualified retirement saving accounts, the tax on contributions is deferred until withdrawal at retirement, when a taxpayer is usually in a lower tax bracket. The revenue losses from this preference in 2016 are estimated to total $74 billion for "defined-contribution" plans such as individual retirement accounts and 401(k) plans, and $46 billion for traditional defined-benefit plans sponsored by employers.

Housing benefits from a number of tax preferences. The largest ($82 billion in 2016) is the exclusion of net imputed rental income, which is the return on housing equity in the form of rent-free housing. Housing also benefits from the home-mortgage interest deduction ($75 billion), the deduction for nonbusiness property taxes, and the exemption of the first $500,000 of capital gains for couples ($250,000 for singles) on the sale of principal residences.

Three of the largest tax expenditures mainly benefit low- and middle-income families: the earned income credit ($64 billion in 2016), the child credit ($46 billion in 2016), and the refundable premium assistance tax credit enacted under the Affordable Care Act ($43 billion in 2016). Most budgetary costs from these provisions come in the form of credits that exceed income tax liability and are counted as spending in federal budget totals.

The Office of Management and Budget (OMB) divides deductions of charitable contributions into three buckets: donations to nonprofit educational institutions, to nonprofit health institutions, and to all other organizations. The third, catch-all category benefits from a $47 billion tax expenditure. Combining the deductions for all three categories would raise its ranking in table 1.

In general, tax expenditures for individuals are larger than tax expenditures for businesses. Only one business tax expenditure makes the 2016 top-13 list—the deferral of income from controlled foreign corporations ($67.6 billion in 2016). Among other business tax expenditures, the largest in 2016 are the deduction for US production activities ($15.2 billion), the credit for low-income housing expenditures ($7.9 billion), and the expensing of research and experimentation outlays ($7.2 billion).

Over the 10-year budget horizon, one of the larger tax expenditures is the provision that allows for accelerated depreciation of certain machinery and equipment. This provision allows companies to defer the payment of tax by deducting the cost of equipment over a shorter time period than the property's likely economic life.

The tax expenditure for this provision was less than $5 billion in 2016 and was actually negative in 2015, reflecting that even more generous rules were in effect through the end of 2014. Until then, companies were allowed to deduct either all or 50 percent of the cost of equipment placed in service in selected years. These prior-year deductions have reduced the amount of depreciation firms can claim in the next few years on assets placed in service before January 1, 2015. Nonetheless, over a 10-year horizon, the provision will cost more than $300 billion.

The figures on accelerated depreciation illustrate how computations of annual revenue losses do not accurately measure the amount of subsidy a tax expenditure actually provides when the provision operates mostly by changing the timing of tax liability. For this reason, OMB also publishes a table showing the "present value" of tax benefits from a single year's use of selected provisions.

The table in the 2016 OMB report shows, for example, that the present value of tax saving to businesses from accelerated depreciation of the investments in machinery and equipment was $12 billion in 2014. By contrast, the conventional (revenue loss) measure of the same tax expenditure in 2014 was negative (-$9.4 billion), reflecting higher taxes paid on income from prior-year investments from the acceleration of deductions in earlier years.

TABLE 1

Largest Tax Expenditures

Billions of dollars, 2016

Rank	Tax expenditure	Billions ($)
1	Exclusion of employer contributions for medical insurance premiums and medical care	216.1
2	Capital gains (except agriculture, timber, iron ore, and coal)	93.0
3	Exclusion of net imputed rental income	82.4
4	Mortgage interest expense on owner-occupied residences	75.3
5	Defined contribution employer plans	73.9
6	Deferral of income from controlled foreign corporations (normal tax method)	67.8
7	Step-up basis of capital gains at death	66.7
8	Earned income tax credit[a]	63.8
9	Deductibility of nonbusiness state and local taxes other than on owner-occupied homes	51.2
10	Deductibility of charitable contributions, other than education and health	47.4
11	Defined benefit employer plans	46.3
12	Child credit[b]	46.3
13	Refundable premium assistance tax credit[c]	42.7

Sources: Budget of the United States Government, 2016, Analytical Perspectives, Table 14.3; and author's addition of outlays for refundable credits.
(a) Includes outlays of $58.7 billion.
(b) Includes outlays of $22.2 billion.
(c) Includes outlays of $45.8 billion.

Data Sources

Office of Management and Budget. *Budget of the U.S. Government, FY 2010, Analytical Perspectives*. Table 19.1.

Further Reading

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