



Tax Policy Center
Urban Institute and Brookings Institution

THE TAX POLICY

BRIEFING BOOK

*A Citizens' Guide for the
2008 Election and Beyond*

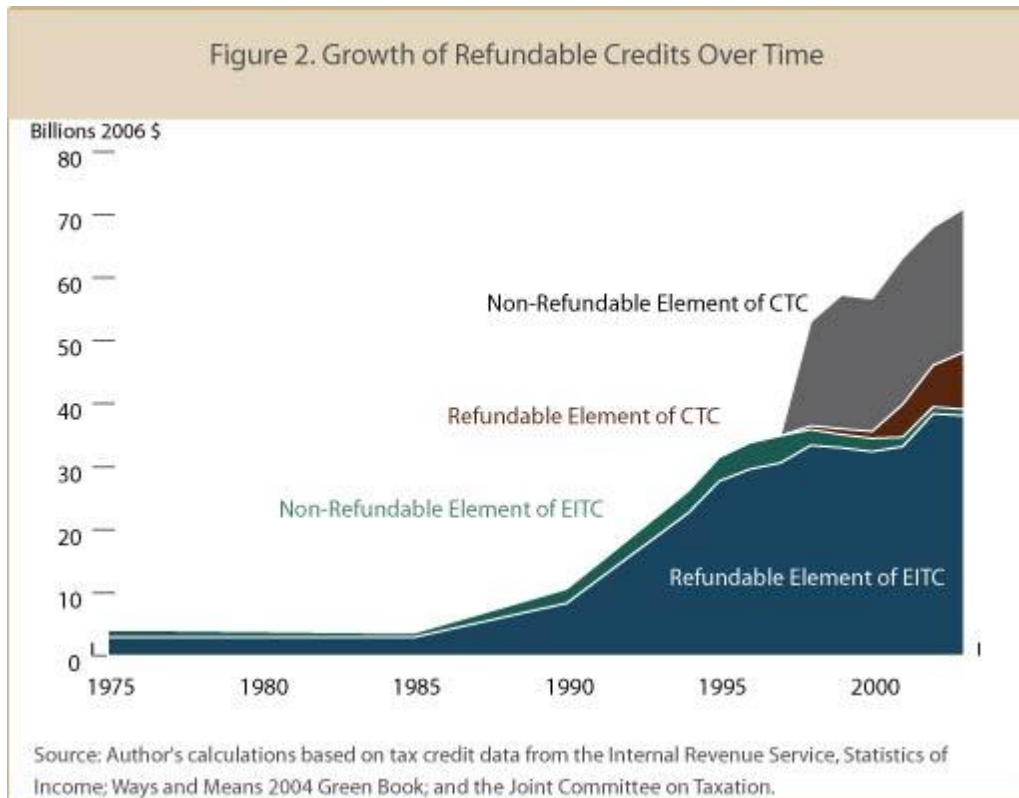
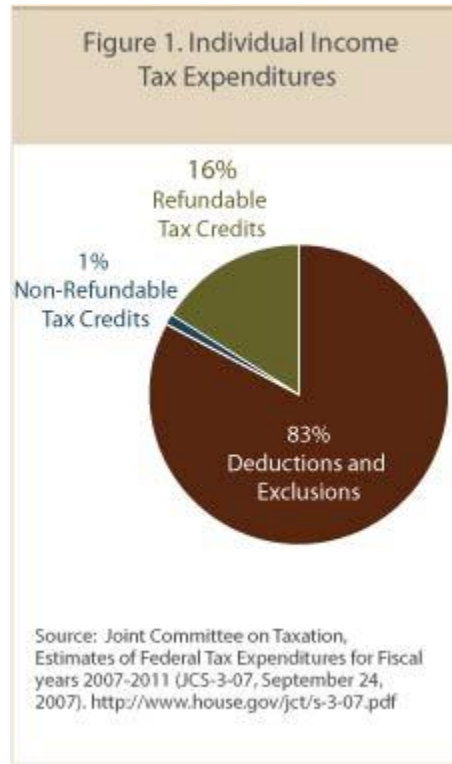
TAX EXPENDITURES

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Tax Expenditures: What are they and how are they structured?

Tax expenditures are revenue losses attributable to tax provisions that often result from the use of the tax system to promote social goals without incurring direct expenditures. How tax expenditures are structured affects both who will benefit from them and how much they will reduce federal revenues.

- Income tax provisions generally seek to promote one or more of three broad objectives: measuring income accurately, distributing fiscal benefits and burdens based on a household's ability to pay, and promoting activities or behavior that are considered socially desirable. Tax expenditures are tax provisions that are not structural features of the income tax or necessary to measure income accurately.
 - There is some debate about whether distributionally-oriented tax provisions should be considered tax expenditures and, if so, which ones should be. Similarly, commentators debate which provisions should be considered structural features of the income tax.
 - Each year the Office of Tax Analysis at the Treasury Department and the Joint Committee on Taxation publish separate lists of income tax expenditures and their estimated cost on foregone revenue. Some commentators have suggested that this Tax Expenditure Budget should be broadened to include tax expenditures within the payroll, wealth transfer, and excise taxes.
- Tax expenditures can take many forms. Some result from tax provisions that reduce the present value of taxable income through deferral allowances, or special exclusions, exemptions, or deductions from gross income. Others affect a household's after-tax income more directly through tax credits or preferential rates for specific activities.
 - Individual income tax expenditures are typically structured either as deductions or exclusions, non-refundable tax credits, or refundable tax credits. With non-refundable credits, taxpayers may only use the credit to reduce or eliminate positive income tax liability. In contrast, refundable credits do not have that restriction: if the credit exceeds pre-credit tax liability, the tax filer still receives the excess as a payment.
 - Deductions and exclusions accounted for more than 80 percent of the major individual income tax expenditures in 2008 (see figure 1). However, the use of refundable tax credits has increased over time, primarily because of the growth of the earned income tax credit (EITC) (see figure 2).

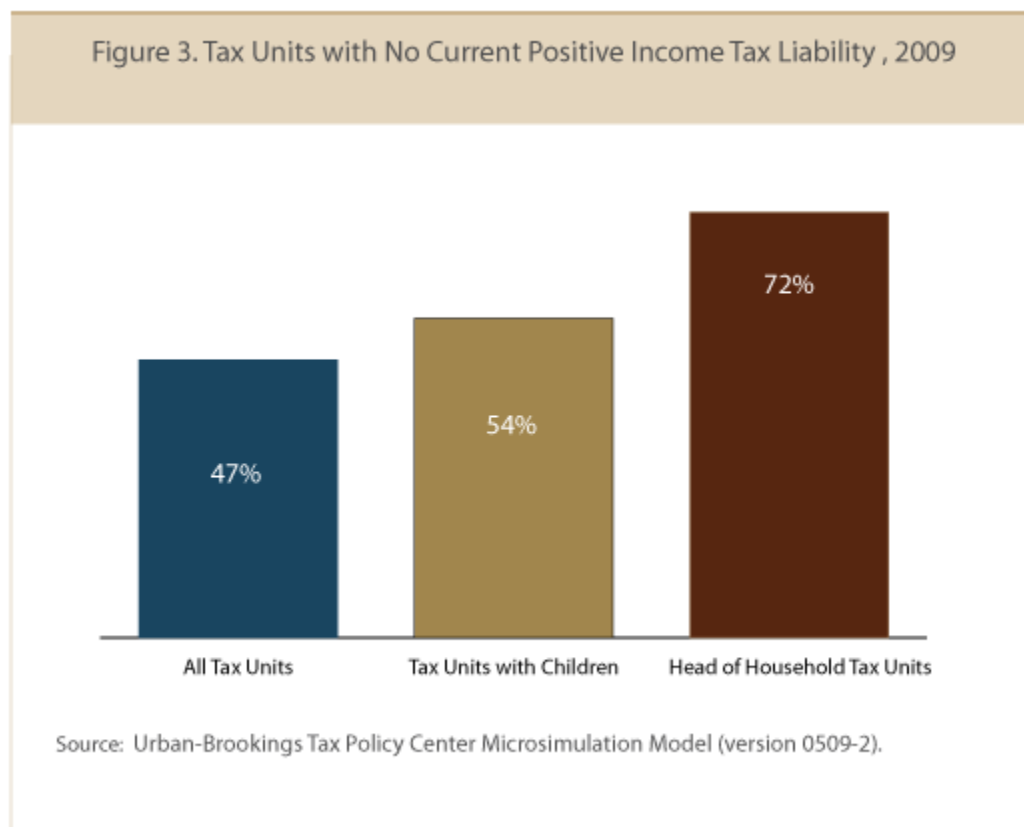


- The structure of a tax expenditure is important because it determines its value for different families.
 - Generally, deductions and exclusions are most valuable for high-income households because their value is the amount deducted or excluded times the taxpayer's marginal tax rate. Thus, a \$100

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deduction or exclusion typically saves \$35 for someone in the 35 percent top income tax bracket, but only \$10 for someone in the 10 percent bracket.

- Most deductions are itemized deductions as opposed to “above-the-line” deductions. Itemized deductions have value only when listed and claimed; they thus are worth nothing for the roughly two-thirds of households that claim the standard deduction.
- Non-refundable credits generally have the same value for all tax units whose income tax liability exceeds the credit. However, their value is limited to the taxpayer’s positive tax liability so they have no value for households that owe no tax.
- By contrast, refundable tax credits are the only form of tax expenditure that can provide the same subsidy for all households.
- All three types of tax expenditures may contain income limits or phase in or out in order to further target their distributional effects.
- Only three tax credits—the earned income tax credit (EITC), the child tax credit (CTC), and the small Health Coverage Tax Credit (HCTC)—are refundable so households in the bottom half of the income distribution reap relatively little benefit from tax expenditures.



- More than two-fifths of all households—and over half of those with children—have no federal income tax liability (see figure 3) and thus cannot benefit from deductions, exclusions and non-refundable tax credits.
- Many such households do, however, pay substantial payroll taxes and would benefit if income tax credits could be used against those levies, or against income taxes paid in the past or future. For

example, over a 25 year period, more than 80 percent of tax units with no income tax liability in the current year end up paying a positive amount of income taxes, and more than 99 percent end up paying a positive amount of income and payroll taxes, on net.

- The best way to structure a tax expenditure depends on its purpose.
 - Tax provisions intended to measure taxable income accurately should be exclusions or non-itemized deductions. Such provisions are not generally considered tax expenditures.
 - Tax expenditures designed to redistribute income must take into account which households they aim to benefit. In particular, only refundable tax credits can assist tax units at the bottom of the income distribution.
 - Tax expenditures intended to spur socially-desirable behavior or activities should focus on the relative responsiveness of targeted groups. Unless there is good reason to exclude low-income households, such tax expenditures may be most effective if they are refundable credits.

See Also

Income Tax Issues: How do the standard and itemized deductions compare?
Income Tax Issues: What is the difference between tax deductions and tax credits?
Income Tax Issues: How do phase-outs of tax provisions affect taxpayers?
Tax Expenditures: What is the tax expenditure budget?
Tax Expenditures: Why are they controversial?
Tax Expenditures: How have they changed over time?
Tax Expenditures: What are the largest tax expenditures?
Taxes and the Poor: How do refundable and nonrefundable credits differ?

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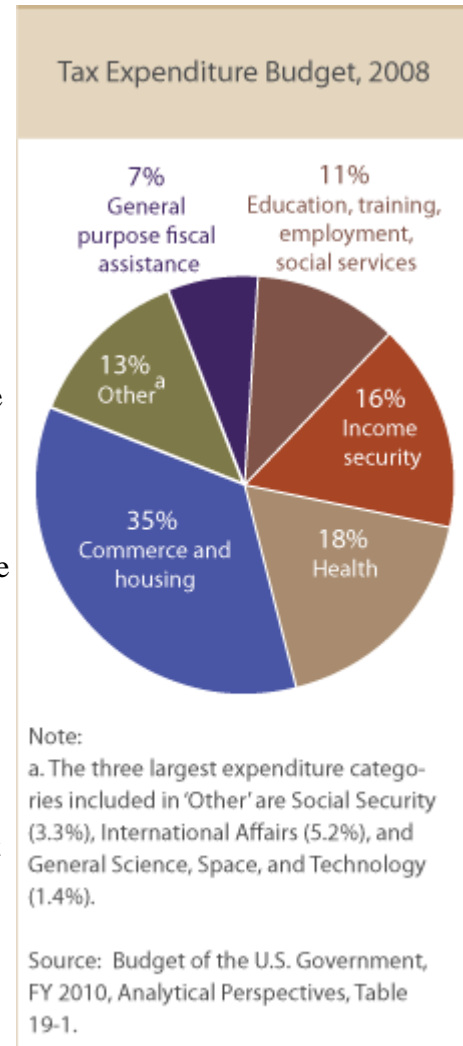
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Tax Expenditures: What is the tax expenditure budget?

The tax expenditure budget comprises the estimated revenue losses attributable to various exclusions, exemptions, deductions, nonrefundable credits, deferrals, and preferential rates in the tax code. These provisions reduce the income tax liabilities of individuals or businesses that undertake certain types of activities. For instance, people who donate to charities often deduct their donations on their tax returns and thus reduce their income tax. The tax expenditure budget estimates the aggregate cost of this and other provisions. The Congressional Budget Act of 1974 requires that the budget include estimates for tax expenditures, but only for those provisions that affect the federal income taxes of individuals and corporations. The government could, but does not, formulate tax expenditure budgets for Social Security and other taxes.

- Both the Office of Tax Analysis in the Treasury Department and the congressional Joint Committee on Taxation (JCT) estimate tax expenditures; the items that each includes and the estimated values are generally similar but do not always match. The Office of Management and Budget (OMB) publishes the Treasury's estimates in its Analytical Perspectives volume that accompanies each year's publication of the Budget of the U.S. Government. Each year JCT issues estimates covering the current and four subsequent fiscal years.
- OMB's tax expenditure budget for fiscal 2008 totaled \$878 billion, but the estimates for individual provisions are not strictly additive. Various provisions interact in ways that can make their combined tax expenditure differ from the sum of their individual revenue costs.
- Tax expenditures operate essentially like direct expenditures, even though they appear as tax breaks. They benefit hundreds of different types of activities and individuals and currently account for one-fourth to one-third of all benefits and subsidies granted to the public.
- Like mandatory programs (or entitlements) on the spending side of the budget, most tax expenditures do not go through a direct appropriations process each year. They continue and often expand with no congressional vote; for example, the value of charitable deductions rises with an expanding economy.



See also

Tax Expenditures: [What are tax expenditures and how are they structured?](#)

Tax Expenditures: [Why are they controversial?](#)

Tax Expenditures: [How have they changed over time?](#)

Tax Expenditures: [What are the largest tax expenditures?](#)

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Author: C. Eugene Steuerle and Gillian Reynolds

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Tax Expenditures: Why are they controversial?

To some, tax expenditures are spending items which do not belong in the tax code. To others, they are merely a way of reducing taxes, and repealing them would amount to a tax increase. In fact, as budget items, tax expenditures perform very much like spending programs, which means they may be bad or good, depending on whether they serve a legitimate public purpose in the best manner possible. Controversy also surrounds the identification and measurement of tax expenditures.

- Both political parties like to provide subsidies and expenditures in the form of tax breaks, because they cause the measure of net tax revenue to fall without increasing the measure of spending. Thus, they give the appearance of reducing government's size. For this reason, tax subsidies have strong political appeal. In fact, however, tax expenditures can actually expand government's interference in the economy, partly because they induce changes in taxpayers' behavior. Also, like direct spending, tax expenditures must also be paid for through higher taxes elsewhere.
- Imagine, for instance, a government that did only two things: it provided tax expenditures for energy equal to 20 percent of national income, and it collected an income tax on workers. Then it would have to assess tax rates high enough to collect 20 percent of national income from workers before it granted back the tax breaks for energy.
- Tax expenditures are based on deviations from a given tax system. Traditionally, they represent reductions in the revenue that would be collected under a comprehensive income tax. If the current income tax were replaced wholly or in part by a consumption tax, some provisions now classified as tax expenditures would no longer be regarded as such. For example, under a comprehensive consumption tax system, the tax-preferred treatment of capital gains and retirement savings would not be considered tax expenditures. In-kind benefits such as food stamps and public housing, however, would be regarded as tax expenditures under either type of system.
- In some cases it is less clear whether a given provision is a tax expenditure so their identification becomes a matter of judgment. For instance, what is the right measure of "normal depreciation" in an inflationary economy? The congressional Joint Committee on Taxation uses a different definition of what would be included in a normal or comprehensive income tax, and therefore it classifies some different items as tax expenditures than does the Treasury Department
- The value of any single tax expenditure can be measured as the revenue loss due to that tax expenditure alone (or, equivalently, as the amount by which total revenue would rise if that tax expenditure only were repealed). However, tax expenditures may interact with each other, so that the actual effect on revenue of changing several tax expenditures simultaneously could differ from the sum of their individual effects. For example, if several tax expenditures were repealed simultaneously, some individuals might be pushed into higher tax brackets, thereby changing the value of each subsidy and possibly their resulting behavior.
- Tax expenditures can also be reported as outlays equivalents rather than as revenue losses. They then reflect the amount of taxable direct spending that would be required to match the benefit of the tax provision. The difference between outlay equivalent losses and revenue losses usually arise when a tax subsidy itself is nontaxable. For instance, it would take a taxable outlay equivalent of \$1,000 (or \$1,000 in taxable wages) to give a person in a 50

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percent tax bracket the same level of benefit as \$500 in tax credits. While the fact that tax benefits are not themselves taxed often adds to their value, the Treasury Department in 2006 stopped reporting outlay equivalents that took this extra value into account. Its main justification was that the criteria "...were often judgmental and hard to apply with consistency." Of course, this leads itself to inconsistency, as when the tax expenditure budget counts the benefit of not taxing a direct outlay but ignores the parallel benefit for an equivalent tax provision.

See Also

Tax Expenditures: What are tax expenditures and how are they structured?

Tax Expenditures: What is the tax expenditure budget?

Tax Expenditures: What are the largest tax expenditures?

Tax Expenditures: How have tax expenditures changed over time?

Data Sources

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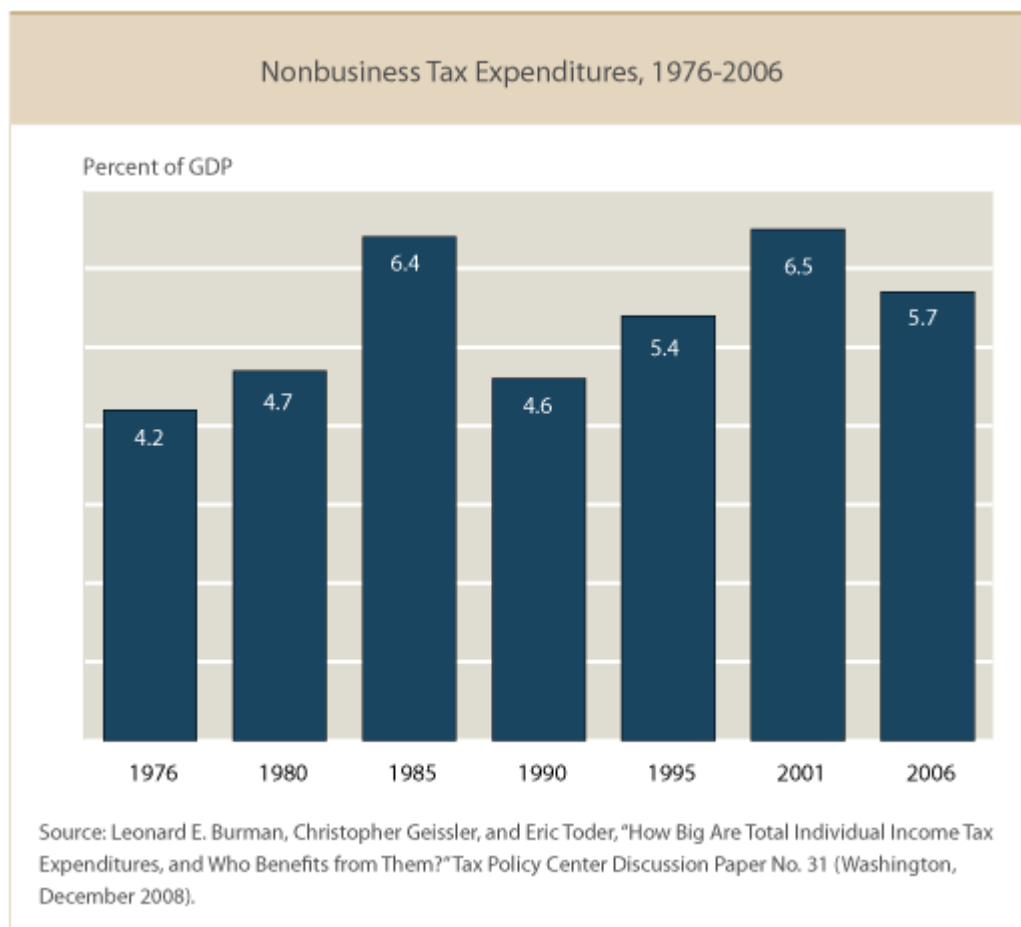
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Tax Expenditures: How have they changed over time?

Tax expenditures have shifted dramatically over time. With the important exception of the Tax Reform Act of 1986, recent decades have seen an increase in the number, and sometimes the value, of tax expenditures. At the same time there has been a rise in social tax expenditures and a decline in business tax expenditures, again due mainly to the 1986 act. Tax expenditures also vary in value with tax rates: when rates rise, so do the tax savings associated with many of the deductions and exclusions that make up a large part of the tax expenditure budget.

- Aggregate tax expenditures reported by the Treasury increased between 1976 and 1985 from 5.2 percent to 8.3 percent of GDP. (Because of their interactions, individual tax expenditures do not, strictly speaking, sum to their total cost, but the summation of Treasury numbers still provides a reasonable approximation of their aggregate effect.) They dropped sharply after the tax reform of 1986, falling to near 1976 levels, and rose gradually thereafter, peaking in 2001 at 7.4 percent. (The Treasury first began estimating tax expenditures in 1974; estimates from that year included tax expenditures for 1974-76.) They have stayed within a percentage point of 7 percent of GDP since 1999.
- In the 1970s many tax subsidies were provided as business tax breaks and deductions, which higher-income taxpayers found more valuable. The 1986 tax reform significantly cut back on business preferences, particularly through removal of the investment credit. Only a few social tax expenditures have been removed over time, although their value often fluctuated as tax rates rose or fell.
- Nonbusiness tax expenditures-those reported on individual income tax returns that do not also benefit businesses-are higher in 2006 than in 1976 (see figure).



Underlying Data: [Download](#)

- Exclusions that exempt specific kinds of income from tax constitute a substantial share of tax expenditures. Many exclusions benefit a large percentage of the population, including much of the middle class. Between 1948 and 1982 exclusions doubled, from 12 percent of personal income to 24 percent, before falling off to 19 percent in 2004. Employer contributions to health plans, Social Security benefits, and tax breaks associated with homeownership are the largest exclusions from income taxation.
- Tax credits have grown significantly since 1986. The expanded use of the earned income tax credit, child tax credits, and other tax benefits targeted toward lower-income families, especially those with children, drove much of this rise. The earned income tax credit and the child credit are refundable and thus provide benefits for many families who owe no income tax.
- The tax expenditure budget ignores the costs of complexity—the time and money costs of claiming credits and deductions on tax returns and the cost of finding and implementing strategies to minimize taxes. But taxpayers today can use software to prepare their returns, which makes it politically more feasible for Congress to add layers of tax complexity without incurring as much taxpayer wrath.

See Also

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Tax Expenditures: What is the tax expenditure budget?

Tax Expenditures: Why are they controversial?

Tax Expenditures: What are the largest tax expenditures?

Data Sources

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Tax Expenditures: 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.

The Largest Tax Expenditures, 2008		
Rank	Tax expenditure	Billions (\$)
1	Exclusion of employer contributions for medical insurance premiums and medical care	131.0
2	Net exclusion of pension contributions and earnings (all)	117.7
3	Deductibility of mortgage interest on owner-occupied homes	88.5
4	Accelerated depreciation of machinery and equipment (normal tax method)	55.9
5	Deductibility of nonbusiness state and local taxes other than owner-occupied homes	49.1
6	Deductibility of charitable contributions (all)	46.8
7	Deferral of income from controlled foreign corporations (normal tax method)	31.5
8	Capital gains exclusion on home sales	30.0
9	Deductibility of State and local property tax on owner-occupied homes	29.1
10	Child credit ^a	28.4
11	Capital gains (except agriculture, timber, and coal)	24.2
12	Step-up basis of capital gains at death	21.5

Notes:
(a) Nonrefundable portion only.
Source: Budget of the U.S. Government, FY 2010, Analytical Perspectives, Table 19.1.

- The largest tax expenditure is the exclusion of employers' contributions for their employees' medical insurance premiums and medical care. Under this provision, contributions are excluded from the employee's gross income, while the employer may deduct the cost as a business expense.
- The next-largest tax expenditure is the combined net exclusion of contributions to and earnings of employer-provided and individual pension plans. These include 401(k) plans, Individual Retirement Accounts (IRAs), the savers' credit, and Keogh plans. Most of these plans allow taxpayers to exclude employer or individual retirement contributions from their gross income, and to defer taxes on the investment income earned on these savings until the money is withdrawn.
- The deductibility of mortgage interest on owner-occupied homes is one of the three homeownership subsidies that top the list of tax expenditures. Under this provision the mortgage interest paid by owner-occupants of homes may be taken as a nonbusiness deduction, up to a limit.
- One of the largest tax expenditures for businesses is the provision that allows for accelerated depreciation of certain types of machinery and equipment.
- The deductibility of nonbusiness state and local taxes other than on owner-occupied homes is another large tax expenditure. These taxes are deductible even though they may pay for services received from the state or local government.

- Deductions of charitable contributions to nonprofit educational institutions, nonprofit health institutions, and organizations other than those for education and health are listed as three separate tax expenditures, but deductions for charitable contributions combined would rank as the sixth-largest tax expenditure.
- Another large tax expenditure for businesses is the deferral of income from controlled foreign corporations. Income earned by a U.S. firm through a foreign subsidiary is exempt from taxation by the U.S. until it is returned to the U.S. parent company as dividends or other income.
- Homeowners may exclude up to \$250,000 (\$500,000 for a couple filing jointly) of capital gains on the sale of their principal residence. This is the second-largest homeownership tax subsidy.
- The third large tax subsidy for homeownership is the deductibility of state and local property tax on owner-occupied homes. Homeowners who itemize may deduct the amount of property taxes they paid, while nonitemizers may take a deduction in addition to the standard deduction of \$250 for single filers and \$500 for joint filers.
- Taxpayers with one or more children under age 17 qualify for a partially refundable child credit of \$1,000 per child. Only the nonrefundable portion of the credit is counted as a tax expenditure; any refundable portion is considered an outlay.
- The reduced tax rate on capital gains is the another large tax expenditure. These gains are taxed at a lower rate than ordinary income, provided they are held for more than one year.
- The step-up in basis of capital gains precludes assets from being taxed on any gains accrued, but not realized, at the death of the owner. If the estate tax remains repealed in 2010, some heirs will no longer benefit from this provision.

See Also

Tax Expenditures: What is the tax expenditure budget?

Tax Expenditures: Why are they controversial?

Tax Expenditures: How have tax expenditures changed over time?

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