

Background

What are tax expenditures and how are they structured?

TAX EXPENDITURES
1/5

Q. What are tax expenditures and how are they structured?

A. 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 and Impoundment Control 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 often 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 US Department of the Treasury 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 standard deductions that differ by filing status as tax expenditures on the theory that exempting a basic level of income from tax and adjusting for family composition are 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 and that adjust for family size and composition in determining taxable income. OMB and JCT also allow for a separate tax on corporate income. The baselines of the two agencies do differ in some details, however, which contribute to modest 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 interest on personal residences and the exclusion of interest on state and local bonds. Deductions and exclusions typically reduce tax liability more for higher-income taxpayers facing higher marginal income tax rates than for lower-income taxpayers in lower rate brackets, since a deduction is worth more at a higher rate and higher-income taxpayers often spend more on the subsidized item.

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

Background

What are tax expenditures and how are they structured?

deductions are those for home mortgage interest and charitable contributions. In 2017, only 26 percent of tax units (tax returns plus nonfiling units) claimed itemized deductions. Following the increase in the standard deduction and new limits on deductibility of state and local taxes in the Tax Cut and Jobs Act of 2017, only about 10 percent of tax units will claim itemized deductions in 2018. However, an itemized deduction claimed mostly by higher-income taxpayers is not necessarily unfair, if the standard deduction is worth more to lower-income taxpayers than claiming the deduction. Some itemized deductions may still be objectionable because they are inefficient or inappropriate as a matter of policy.

Credits reduce tax liability dollar for dollar by amount of credit. For example, the \$1,000 child tax credit (current value) reduces liability by \$2,000 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 Internal Revenue Service. 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 37 percent.

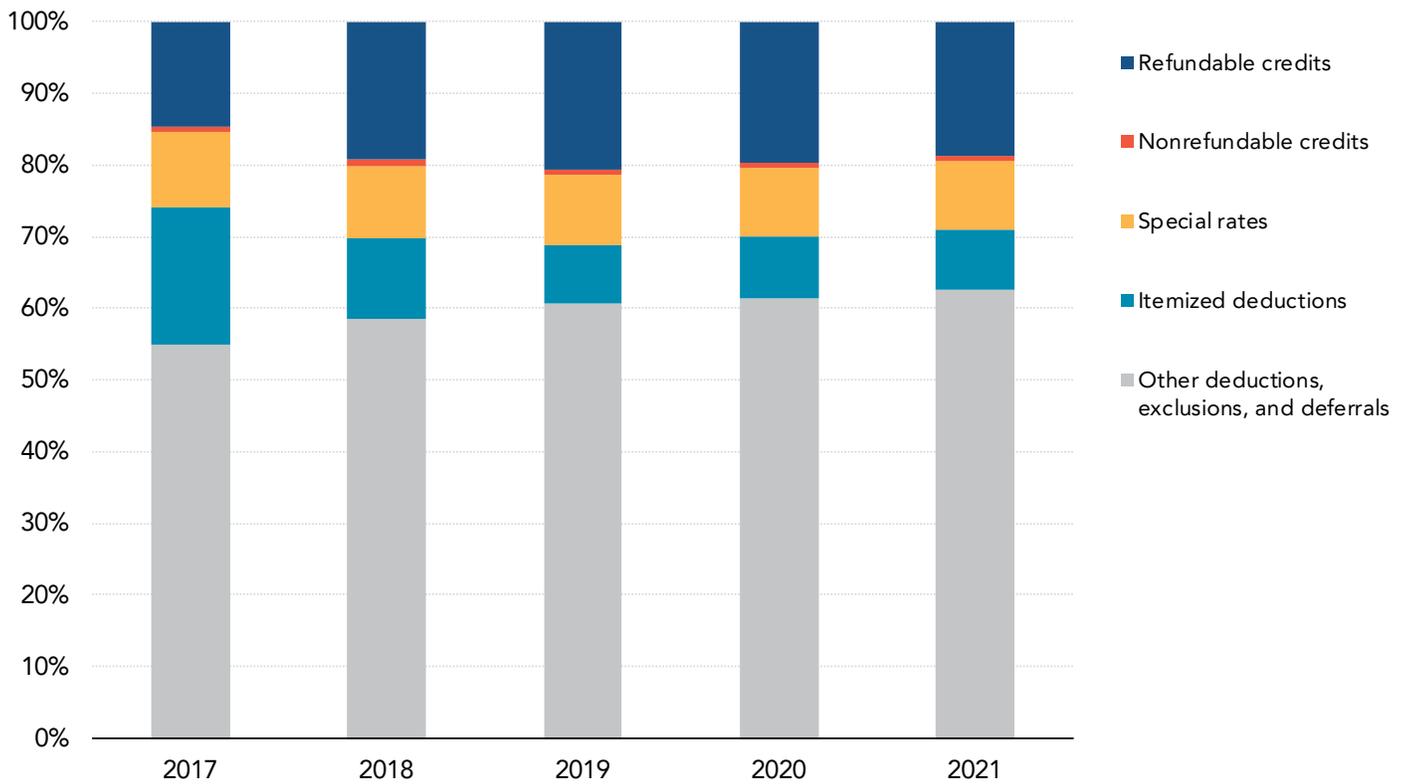
Finally, some provisions allow taxpayers to defer *tax liability*, thereby reducing the present value of taxes they pay, either because the taxes are paid later with no interest charge or because they are paid when the taxpayer is in a lower rate bracket. These provisions allow taxpayers to claim deductions 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 pensions and retirement plans.

Exclusions, deductions, and deferrals of income recognition excluding itemized deductions will account for 61 percent of individual income tax expenditures in fiscal year 2019, refundable credits for 21 percent, special rates for 10 percent, itemized deductions for 8 percent, and nonrefundable credits for 1 percent. (figure 1).

Background

What are tax expenditures and how are they structured?

FIGURE 1
Shares of Individual Income Tax Expenditures
 2017–21



Source: Joint Committee on Taxation (2018) and Tax Policy Center calculations.

Data Source

Joint Committee on Taxation. 2018. "[Estimates of Federal Tax Expenditures for Fiscal Years 2017–2021](#)." JCX-34-18. Washington, DC: Joint Committee on Taxation.

Background

What is the tax expenditure budget?

TAX EXPENDITURES
2/5

Q. What is the tax expenditure budget?

A. The tax expenditure budget displays the estimated revenue losses from special exclusions, exemptions, deductions, credits, deferrals, and preferential tax rates in federal income tax law.

Every year, the Office of Management and Budget (OMB) and the congressional Joint Committee on Taxation (JCT) publish lists of tax expenditures. These lists, sometimes called the Tax Expenditure Budgets, enumerate the estimated revenue losses attributable to preferences in the tax code the agencies describe as exceptions to “normal” or “reference” provisions of the income tax law (figure 1).

Tax expenditures reduce the income tax liabilities of individuals and businesses that undertake activities Congress specifically encourages. For example, the deduction for charitable contributions reduces tax liability for people who itemize on their tax returns rather than take a standard deduction and donate to qualifying charitable organizations. Tax expenditures can also reduce tax liability for individuals Congress wishes to assist. For example, a portion of Social Security benefits received by retired or disabled people is exempt from federal income tax.

The Congressional Budget and Impoundment Control Act of 1974 requires that the budget include estimates for tax expenditures, but only for provisions that affect the federal income taxes of individuals and corporations. The government could, but does not, provide lists of tax expenditures for payroll taxes, excise taxes, and other taxes, although OMB does estimate (in footnotes) the effects on payroll tax receipts of income tax expenditures. At one time, an estate tax expenditure budget was produced by the US Department of the Treasury and published by OMB.

Both the Office of Tax Analysis in the Treasury and the JCT estimate tax expenditures annually. The items included in each, along with their estimated values, are generally similar but do not always match. OMB publishes the Office of Tax Analysis’s estimates in its Analytical Perspectives volume that accompanies each year’s Budget of the US Government.

The budget generally treats tax expenditures as revenue losses instead of as spending. Accordingly, only the portion of refundable tax credits, such as the earned income tax credit, that offsets individuals’ positive income tax liabilities are shown in OMB’s tables as tax expenditures, while the portion that is refundable and exceeds tax liabilities is counted in spending. On the other hand, JCT’s tables include both the revenue loss and outlay effects of refundable credits. Both OMB and JCT display the outlay effects in footnotes.

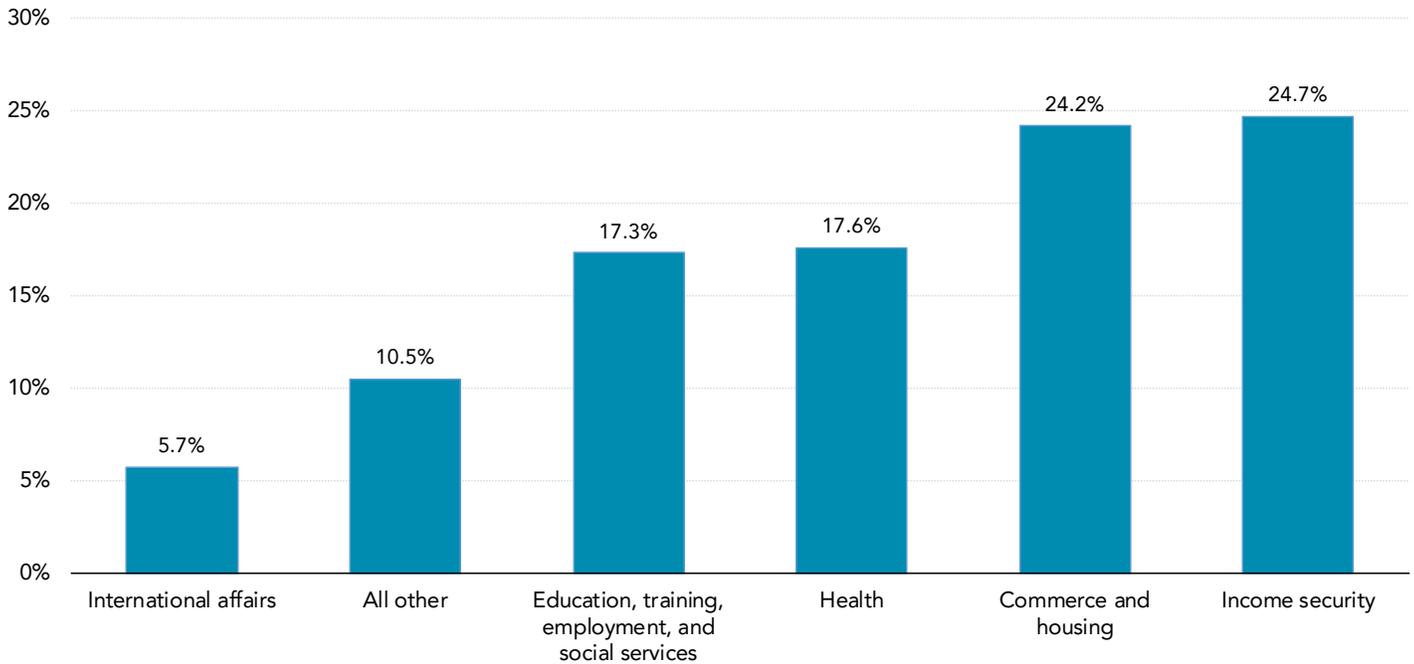
JCT’s tax expenditures for fiscal 2019 (including outlay effects) added up to just under \$1.5 trillion. The combined revenue loss for all provisions does not equal the sum of the losses for each provision because of how the provisions interact. For example, eliminating one exemption from taxable income would push

Background

What is the tax expenditure budget?

FIGURE 1

Shares of Tax Expenditure Budget Fiscal year 2019



Source: Joint Committee on Taxation (2018).

Note: The "all other" category includes the following: general purpose, fiscal assistance, social security, general science, space and technology, national defense, veterans benefits and services, energy, transportation, community and regional development, agriculture, natural resources, and interest.

taxpayers into higher-rate brackets, thereby increasing the revenue loss from remaining exemptions. Toder, Berger, and Zhang (2016) estimated that the actual combined revenue loss from all individual tax expenditures in 2015 was about 6 percent larger than the amount computed by summing individual tax expenditures—though for one subcategory, itemized deductions, the total revenue loss is less than the sum of losses from the separate deductions.

Some tax expenditures effectively function like direct expenditures even though they appear as tax breaks, because programs with similar effects could be structured as outlays (Burman and Phaup 2011). An example is the tax credit for renewable energy investment, which could be structured as grants from the Department of Energy. Other expenditures have no direct spending analogy, but can instead be viewed as departures from an income tax with a comprehensive base. Marron and Toder (2013) estimate that provisions that could be viewed as spending substitutes have recently amounted to over 4 percent of gross domestic product.

Complicating matters is that the ideal administrative agency for a tax subsidy might or might not be the Internal Revenue Service (IRS), regardless of classification. Because the earned income credit is based largely on wage reporting, the IRS might serve appropriately as the administrative agency. Yet all the

Background

What is the tax expenditure budget?

subsidy, including the portion of the credit used to reduce tax payments, could still be classified as a direct expenditure.

Like most mandatory programs (or entitlements) on the spending side of the budget, most tax expenditures do not go through a direct appropriation process each year and are available with no budget ceiling to all who qualify. Expenditure costs change with the growth of the economy, changes in the quantities and prices of subsidized activities, and—for some provisions—changes in marginal tax rates applied to individual and corporate income. For example, the cost of the mortgage interest deduction varies with the volume of home mortgage debt outstanding, the level of interest rates, and marginal tax rates applied to the taxable income of borrowers.

Data Source

Joint Committee on Taxation. 2018. "[Estimates of Federal Tax Expenditures For Fiscal Years 2017–2021](#)." JCX-34-18. Washington, DC: Joint Committee on Taxation.

Further Reading

Burman, Leonard E., and Marvin Phaup. 2011. "Tax Expenditures, the Size and Efficiency of Government, and Implications for Budget Reform." Working Paper 17268. Cambridge, MA: National Bureau of Economic Research.

Marron, Donald, and Eric Toder. 2013. "[Tax Policy and the Size of Government](#)." Washington, DC: Urban-Brookings Tax Policy Center.

Toder, Eric J., Daniel Berger, and Yifan Zhang. 2016. "[Distributional Effects of Individual Income Tax Expenditures: An Update](#)." Washington, DC: Urban-Brookings Tax Policy Center.

Background

Why are tax expenditures controversial?

TAX EXPENDITURES
3/5

Q. Why are tax expenditures controversial?

A. To some, tax expenditures are spending items that 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.

Most tax expenditures perform very much like spending programs, which means they may serve or harm the public depending on whether they serve a legitimate public purpose in the most efficient manner possible. But the identification and measurement of tax expenditures are controversial.

Subsidies and expenditures in the form of tax breaks reduce the measure of net tax revenue instead of increasing measured spending. Thus, they give the appearance of reducing government's size. For this reason, tax subsidies have strong political appeal. In fact, tax expenditures are an alternative way for government to intervene in the economy and, like direct spending, must be financed through higher taxes or reduced spending elsewhere.

Imagine, for instance, a new government program that provides tax credits for energy production at a cost of \$5 billion per year, and finances it by raising income tax rates. To pay for the energy tax credit, the government would have to raise tax rates enough to collect an additional \$5 billion—no different than what it would need to do if the subsidies for energy production were provided by a US Department of Energy grant instead of by tax credits.

Here's the conceptually tricky part: tax expenditures are defined as deviations from a baseline tax system. In the example above, it is straightforward to see the equivalence between an energy tax credit and a spending program. Often, however, the definition and estimated magnitude of tax expenditures are a matter of judgment because what belongs in the baseline tax system itself reflects the judgment of analysts.

Since the government began regular reporting of tax expenditures in the 1970s, the baseline against which tax expenditures are measured generally has been a version of a comprehensive income tax. But there have always been exceptions, often for income that is difficult to assess. For example, income often, but not always, has been counted only when realized, so that the deferral or exclusion from tax for unrealized capital gains is not counted, as a tax expenditure but some forms of deferral of receipts by business are. Also, the US Department of the Treasury, but not the congressional Joint Committee on Taxation (JCT), includes net imputed rental income from homeownership in its baseline used for estimating tax expenditures.

If the current income tax were replaced wholly or partly by a consumption tax, as some economists and political leaders favor, some provisions now classified as tax expenditures would no longer be regarded as such. For example, under a comprehensive consumption tax system, the tax base would be consumption, not income. Thus, the deferral of earnings contributed to retirement savings accounts and the exemption

Background

Why are tax expenditures controversial?

of income earned within those accounts would not be considered tax expenditures. Most other tax expenditures, however, including the deductibility of home mortgage interest, charitable contributions, and state and local taxes, as well as the exemption of employer contributions to health insurance plans, would still be so classified.

In other cases, estimating the size of a tax expenditure requires some judgment. For example, under an income tax, firms can recover the costs of capital investment over time with depreciation deductions that reflect the decline in the value of their assets. But what is the right measure of depreciation in an inflationary economy? For these and other items, the JCT and the Treasury use different definitions of what would be included in a normal or comprehensive income tax. Therefore their classification and measurement of some tax expenditures differ.

In addition, estimates by the Office of Management and Budget and the JCT can differ from each other depending upon when the two estimates were prepared. A special case occurred in 2018, when the JCT estimates (published in May 2018) included the effects of the 2017 Tax Cuts and Jobs Act, while the Office of Management and Budget estimates (published in February 2018, but based on Treasury estimates first released in October 2017) did not include changes from the act.

Data Source

Office of Management and Budget. 2018. Analytical Perspectives, Tax Expenditures. Table 13-1. "[Estimates of Total Income Tax Expenditures for Fiscal Years 2017–2027](#)."

Further Reading

Burman, Leonard E. 2003. "Is the Tax Expenditure Concept Still Relevant?" Washington, DC: Urban-Brookings Tax Policy Center.

Burman, Leonard E., and Marvin Phaup. 2011. "Tax Expenditures, the Size and Efficiency of Government, and Implications for Budget Reform." Research Report. Washington, DC: Urban-Brookings Tax Policy Center.

Joint Committee on Taxation. 2018. "Estimates of Federal Tax Expenditures for Fiscal Years 2017–2021." JCX-34-18. Washington, DC: Joint Committee on Taxation.

Marron, Donald, and Eric Toder. 2013. "Tax Policy and the Size of Government." Washington, DC: Urban-Brookings Tax Policy Center.

Toder, Eric. 2005. "Tax Expenditures and Tax Reform: Issues and Analysis." Presented at the National Tax Association meetings, Miami, FL, Nov. 19.

———. 2000. "Tax Cuts or Spending: Does It Make a Difference?" Washington, DC: Urban-Brookings Tax Policy Center.

Toder, Eric, Joseph Rosenberg, and Amanda Eng. 2014. "Evaluating Broad-Based Approaches for Limiting Tax Expenditures" Research Report. Washington, DC: Urban-Brookings Tax Policy Center.

Background

What are the largest tax expenditures?

TAX EXPENDITURES

4/5

Q. What are the largest tax expenditures?

A. 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, although reduced by the latest tax bill, still exceeds total spending by the US Department of Housing and Urban Development.

Table 1 ranks the top 13 US tax expenditures, based on the 2018 estimates by the Joint Committee on Taxation (JCT). The Office of Management and Budget also publishes lists of tax expenditures based on estimates by the US Department of the Treasury, but the 2018 estimates were prepared before passage of The Tax Cuts and Jobs Act (TCJA) late in 2017.

The largest tax expenditure (an estimated \$172.8 billion in fiscal year 2019) 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 on the JCT list is the preferential rate structure for capital gains and dividends (\$127.0 billion in 2019), which are taxed at rates ranging from 0 to 20 percent, as compared with individual income tax rates that range from 10 to 37 percent. Capital gains also benefit from the step up in basis at death (\$34.0 billion in 2019), which permanently exempts all unrealized capital gains accrued during an individual's lifetime on assets that are passed on at death.

The third-largest tax expenditure is the credit for children and other dependents (\$121.7 billion in 2019, up from \$54.1 billion in 2017). TCJA doubled the child credit to \$2,000 per qualifying child, increased the maximum refundable credit amount to \$1,400, raised the income at which the credit begins to phase out to \$400,000 for joint returns (\$200,000 for single), and introduced a new \$500 credit for nonchild dependents. At the same time, TCJA eliminated personal exemptions for taxpayers and dependents. JCT and Treasury, perhaps inconsistently, did not count the dependent exemption as a tax expenditure, so the tax expenditure budget accounts imply a greater increase in child benefits from the switchover than taxpayers realized on net.

The fourth- and fifth-largest tax expenditures are the benefits for tax-qualified retirement saving accounts. The tax on contributions, as well as the income earned within the accounts, is deferred until withdrawal begins at retirement. At that point, in addition to the benefits of the deferral, many taxpayers are in a lower bracket. Alternatively, some Roth retirement saving gets no deferral of tax on deposit, but complete

Background

What are the largest tax expenditures?

TABLE 1

Largest Tax Expenditures

Fiscal year 2019



Rank	Tax expenditure	Billions (\$)
1	Tax exclusion for employer-sponsored health insurance	172.8
2	Reduced rates of tax on dividends and long-term capital gains	127.0
3	Credit for children and other dependents ^a	121.7
4	Tax benefits for employer defined contribution plans	121.5
5	Tax benefits for defined benefit plans	90.7
6	Earned income credit ^b	72.6
7	Reduced tax rate on active income of controlled foreign corporations	68.0
8	Depreciation of equipment in excess of alternative depreciation system	63.0
9	Subsidies for insurance purchased through health benefit exchanges	51.3
10	20 percent deduction for qualified business income	50.2
11	Exclusion of untaxed Social Security and railroad retirement benefits	37.0
12	Exclusion of capital gains on sales of principal residences	36.3
13	Exclusion of benefits provided under cafeteria plans	35.0

Source: Joint Committee on Taxation. 2018. "Estimates of Federal Tax Expenditures for Fiscal Years 2017–2021." JCX-34-18. Washington, DC: Joint Committee on Taxation.

Notes: JCT regards the exclusion of net imputed rental income as an administrative necessity, and does not classify it as a tax expenditure. However, it is included by the Treasury; in October 2017, before TCJA tax changes, the Treasury estimated that total income tax expenditures from the exclusion of net imputed rental income is \$131.1 billion for FY2019 (US Department of the Treasury 2017).

(a) includes outlays of \$48.5 billion.

(b) includes outlays of \$64.9 billion.

Background

What are the largest tax expenditures?

exemption from tax of all investment returns on the saving. The revenue losses from retirement saving accounts in 2019, measured on a cash flow basis, are estimated to total \$121.5 billion for employer-sponsored “defined-contribution” plans such as 401(k) plans and \$90.7 billion for traditional defined-benefit plans. There are additional losses from deductible individual retirement accounts (\$17.7 billion), back-loaded (Roth) accounts (\$7.7 billion), and plans for the self-employed (\$14.7 billion).

The sixth-largest tax expenditure, the earned income credit (\$72.6 billion in 2019), mainly benefits low-income families with children. The credit increases with family size and is phased out as income rises above a threshold amount. Most of the credit’s budgetary cost comes from the portion that exceeds income tax liability and is therefore counted as outlays, rather than as a tax expenditure, in the Office of Management and Budget estimates.

In general, tax expenditures for individuals are larger than tax expenditures for businesses. Only two business tax expenditures made it into the list of the top 13: the reduced tax rate on active income of controlled foreign corporations (\$68.0 billion in 2019) and accelerated depreciation of equipment in excess of the alternative depreciation system (\$63.0 billion in 2019).

The seventh largest, the reduced tax rate on foreign income, replaces pre-TCJA rules that allowed companies to defer tax on most income accrued within controlled foreign corporations. The eighth largest, the tax subsidy for investment in equipment, was increased by a TCJA provision that allows firms to deduct purchases of qualifying equipment immediately (bonus depreciation) through 2022. Beginning in 2023, however, bonus depreciation is scheduled to phase out at a rate of 20 percent per year, reaching zero in 2027.

The ninth-largest tax expenditure is the subsidy for health insurance purchased through health benefit exchanges under the Affordable Care Act (\$51.3 billion). A TCJA provision reduces this subsidy by eliminating a penalty tax on individuals who lack insurance coverage, effectively reducing the number of people who purchase subsidized insurance coverage. The JCT projects that the cost of the tax subsidy will decline to \$44.3 billion by 2021.

The tenth-largest subsidy is the 20 percent deduction for qualified business income (\$50.2 billion in 2019). This deduction, made newly available by the TCJA for tax years beginning in 2018, is available to individuals with income from self-employment and ownership of shares in pass-through businesses (partnerships and subchapter S corporations) but is partially limited for high-income individuals according to complex criteria based on the types of activities from which they earn income, the wages they pay to their employees, and the amount of capital they own.

The eleventh-largest tax expenditure is the exclusion of untaxed Social Security and railroad benefits (\$37.0 billion). These benefits are partially or fully excluded from adjusted gross income for taxpayers whose incomes fall below threshold amounts.

The twelfth-largest tax expenditure is the exclusion of the first \$250,000 of gains (\$500,000 for joint filers) on sales of a principal residence (\$36.3 billion). Homeowners also benefit from the home mortgage interest deduction (\$33.9 billion in 2019). TCJA substantially reduced the benefit of the mortgage interest deduction by raising the standard deduction and setting a \$10,000 limit on state and local income and property tax

Background

What are the largest tax expenditures?

deductions, so that many fewer taxpayers claim the remaining itemized deductions and many of those who do claim them receive much smaller benefits than before.

The thirteenth-largest tax expenditure is the exclusion of benefits under cafeteria plans (\$35.0 billion in 2019). These are plans in which employers allow employees to set aside funds to purchase certain goods and services from pretax dollars. The biggest uses of cafeteria plans are for out-of-pocket health expenses (including the employee share of health insurance premiums) and dependent care expenses.

Two itemized deductions from earlier years have dropped off the top 10 list. The cost of the deduction of state and local income, sales, and property taxes will decline from \$100.9 billion in 2017 to only \$21.2 billion in 2019 because of the increase in the standard deduction and because the tax deduction is now limited to no more than \$10,000 per tax return.

The cost of the charitable deduction will also decline, but the charitable deduction, although substantially reduced after TCJA, would have just made the top 13 list if JCT considered it a single tax expenditure item. Instead, JCT reports separate estimates for the charitable deduction for education (\$7.3 billion), the charitable deduction for health (\$3.3 billion), and the charitable deduction except for education and health (31.3 billion).

Data Source

Joint Committee on Taxation. 2018. "[Estimates of Federal Tax Expenditures for Fiscal Years 2017–2021](#)." JCX-34-18. Washington, DC: Joint Committee on Taxation.

Further Reading

Marron, Donald, and Eric Toder. 2013. "Tax Policy and the Size of Government." Washington, DC: Urban-Brookings Tax Policy Center.

Rogers, Allison, and Eric Toder. 2011. "Trends in Tax Expenditures: 1985–2016." Washington, DC: Urban-Brookings Tax Policy Center.

Toder, Eric, Daniel Berger, and Yifan Powers. 2016. "Distributional Effects of Individual Income Tax Expenditures: An Update." Washington, DC: Urban-Brookings Tax Policy Center.

US Department of the Treasury. 2017.

US Senate Budget Committee. 2008. Tax Expenditures: Compendium of Background Material on Individual Provisions. Washington, DC: US Government Printing Office.

Background

How did the TCJA affect tax expenditures?

TAX EXPENDITURES

5/5

Q. How did the TCJA affect tax expenditures?

A. The TCJA reduced some tax expenditure provisions, eliminated others, and introduced and expanded still others. In addition to these direct changes in tax expenditure provisions, an increase in the standard deduction and lower individual and corporate tax rates reduced the number of taxpayers using tax expenditure provisions and the value of the tax benefits they receive.

While the Tax Cuts and Jobs Act (TCJA) reduced overall federal receipts by about \$1.5 trillion over 10 years, it did modestly reduce the net revenue cost of tax expenditures. Comparing the most recent Joint Committee on Taxation (JCT) tax expenditure estimates to its last pre-TCJA estimates, the sum of the revenue losses for all tax expenditures for fiscal years 2018–20 (the years for which both JCT studies provide estimates) declined from \$5.0 trillion to \$4.5 trillion. (The total revenue losses from tax expenditures do not exactly equal the sum of losses from each provision because of interactions among the provisions, but studies by the Urban-Brookings Tax Policy Center have shown that the simple sum of revenue losses from separate provisions is a reasonably good approximation of the revenue loss of tax expenditures including these interactions.)

The TCJA eliminated and reduced some tax expenditures while introducing some new ones and increasing some existing ones. In addition, interactions between tax expenditures and changes in the law affected the number of taxpayers who benefit from tax expenditure provisions and the value of benefits they receive. The most important of these indirect effects comes from lower individual and corporate income tax rates, which reduce the value of many tax expenditures, and the increase in the standard deduction which reduces tax benefits from itemized deductions.

The tax expenditures that decline the most in fiscal years 2018–20 are the deduction of nonbusiness state and local income and property taxes, replacement of deferral by a reduced tax rate on the active income of controlled foreign corporations, deductions for mortgage interest on owner-occupied residences, subsidies for insurance purchased through health benefit exchanges, expensing of business depreciable property for small businesses under section 179, and the deduction for income attributable to domestic production activities (table 1).

The existing tax expenditures that increase the most are the credit for children and other dependents and depreciation of equipment in excess of the alternative depreciation system. The largest new tax expenditure is a 20 percent deduction for qualified business income (table 1).

Background

How did the TCJA affect tax expenditures?

TABLE 1

Largest Changes in Tax Expenditures

Fiscal years 2018-2020



Tax Expenditure Reductions	Total Change in Billions (\$)
Deduction of nonbusiness state and local government taxes	-267.3
Reduced tax rate on active income of controlled foreign corporations (formerly deferral)	-147.2
Deduction for mortgage interest on owner-occupied residences	-123.0
Subsidies for insurance purchased through health benefit exchanges	-80.0
Expensing under section 179 of depreciable business property	-60.7
Deduction for income attributable to domestic production activities	-57.5
New and Increased Tax Expenditures	Total Change in Billions (\$)
Credit for children and other dependents	187.4
Depreciation of equipment in excess of alternative depreciation system	175.5
20 percent deduction for qualified business income	142.6

Source: Joint Committee on Taxation, "Estimates of Federal Tax Expenditures for Fiscal Years 2017-21", JCX-34-18, and "Estimates of Federal Tax Expenditures for Fiscal Years 2016-20. JCX-3-17."

DIRECT CHANGES IN TAX EXPENDITURES

Most of the tax expenditures eliminated by TCJA were small. The principal exception is the deduction attributable to domestic production activities (\$62 billion in 2018–20), which was 9 percent of taxable business income. (For large corporations, this was equivalent to a cut in the tax rate on profits from domestic production from 35 to 31.9 percent.) With the lower corporate tax rate, Congress believed this deduction was no longer needed to reduce the tax burden on domestic manufacturing.

TCJA raised much more revenue from reducing several large tax expenditures instead of eliminating them. It reduced the value of the nonbusiness state and local income, sales, and property tax deductions in fiscal years 2018–20 to less than one-quarter its former cost. This resulted from a combination of changes: a

Background

How did the TCJA affect tax expenditures?

\$10,000 cap on the amount of taxes taxpayers could claim as a deduction; an increase in the standard deduction and reductions in other itemized deductions, which reduced the number of taxpayers claiming the deduction; and modestly lower individual income tax rates, which reduced the tax saving for taxpayers who claim it.

International provisions in the TCJA also reduced tax expenditures. The replacement of deferral of the profits of controlled foreign corporations until repatriation with a reduced tax rate on intangible profits accrued in low-tax countries will reduce tax expenditures in 2018–20 by \$147 billion. JCT previously scored deferral as costing \$365 billion over the three-year period, while the estimated revenue loss from the reduced tax rate on accrued profits (10.5 percent instead of 21 percent) is \$218 billion.

The largest expansions were for the child credit and depreciation of equipment by businesses. The child tax credit was roughly doubled from a bit more than \$1,000 to \$2,000 per child. TCJA introduced a new \$500 credit for dependents and other children receiving the regular child tax credit, it increased the income levels at which the credit phases out, and it increased the amount of the credit that could be refunded. These changes raised the 2018–20 revenue loss from the child credit by \$187 billion.

The largest new tax expenditure, the 20 percent deduction for qualified business income received by owners of pass-through businesses (sole proprietorships, partnerships, limited liability companies, and subchapter S corporations), effectively reduces the top rate on qualified business income from 37 percent to 29.8 percent. On the business side, the largest change was the enactment of 100 percent bonus depreciation for five years beginning in 2018 (and then phasing out at 20 percent per year beginning in 2023). Bonus depreciation raised the cost of depreciation of equipment in excess of the alternative depreciation system (JCT's view of depreciation rules under the baseline income tax) by \$174 billion between 2018 and 2020.

INDIRECT EFFECTS ON THE COST OF TAX EXPENDITURES

Lower marginal tax rates reduce the cost of tax expenditures that take the form of exclusions and deductions, because reducing taxable income provides smaller tax benefits at lower rates. TCJA modestly reduced the value of many individual tax expenditures by reducing the individual rate schedule from rates ranging from 10 to 39.6 percent to rates ranging from 10 to 37 percent.

The decline in the top corporate tax rate from 35 to 21 percent was much larger than the cut in the marginal individual rates. Most corporate tax expenditures are small, however, so the corporate rate cut per se did not change their total cost very much. Changes in what were the three largest corporate tax expenditures before the TCJA (deferral of income accrued in controlled foreign corporations, depreciation in excess of the alternative depreciation system, and the domestic manufacturing deduction) were largely or wholly the result of other changes in the legislation (replacement of deferral with a minimum tax on intangible income in low tax-countries, expensing of investment in equipment, and elimination of the domestic manufacturing deduction).

Other provisions of the legislation also had significant indirect effects on selected tax expenditures. The increase in the standard deduction significantly reduced the value of itemized deductions, which benefit taxpayers only to the extent that their sum exceeds the standard deduction. And the cap on the state and local deduction reduced the value of other itemized deductions, by also reducing the amount by which itemized deductions exceed the standard deduction.

Background

How did the TCJA affect tax expenditures?

For example, the cost of the mortgage interest deduction declined from \$234 billion to \$112 billion. Only a small portion of this decline came from the direct provisions affecting mortgage interest—the reduced ceiling on the size of new mortgages eligible for the deduction from \$1 million to \$750,000 and elimination of the deduction for up to \$100,000 of home equity loans. Most of the saving is instead an indirect effect of the increase in the standard deduction, the \$10,000 cap on state and local tax deductions, and lower marginal tax rates. The same indirect effects will reduce the cost of charitable deductions (other than for education and health) from \$142 billion to \$110 billion.

Indirect effects also reduced other tax expenditures. The Congressional Budget Office estimates that the elimination of the penalty tax on individuals without health insurance coverage will reduce the take-up rate for health insurance plans under the Affordable Care Act exchanges. The resulting reduction in coverage will reduce tax subsidies paid out by the exchanges by about \$80 billion between 2018 and 2020. On the business side, the tax expenditure for small business expensing under section 179 will decline from about \$100 billion to about \$40 billion between 2018 and 2020, even though the amount of deductions taken was made more generous. The tax expenditure declines because with bonus depreciation in place, the additional benefit of allowing expensing under section 179 is much less than it would have been without bonus depreciation.

Data Sources

Joint Committee on Taxation. 2017. "[Estimates of Federal Tax Expenditures for Fiscal Years 2016–2020](#)." JCX-3-17. Washington, DC: Joint Committee on Taxation.

———. 2018. "[Estimates of Federal Tax Expenditures for Fiscal Years 2017–2021](#)." JCX-34-18. Washington, DC: Joint Committee on Taxation.

Further Reading

Marron, Donald, and Eric Toder. 2013. "[Tax Policy and the Size of Government](#)." Washington, DC: Urban-Brookings Tax Policy Center.

Rogers, Allison, and Eric Toder. 2011. "[Trends in Tax Expenditures: 1985–2016](#)." Washington, DC: Urban-Brookings Tax Policy Center.

Toder, Eric, Daniel Berger, and Yifan Powers. 2016. "[Distributional Effects of Individual Income Tax Expenditures: An Update](#)." Washington, DC: Urban-Brookings Tax Policy Center.