What are tax expenditures and how are they structured?

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 income 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

What are tax expenditures and how are they structured?

deductions are those for home mortgage interest and charitable contributions. In tax year 2017, about 27 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 from the 2017 Tax Cuts and Jobs Act, only about 11 percent of tax units will claim itemized deductions in tax year 2020. 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 child tax credit 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 or to defer recognition of current income until a future year. Examples include provisions that allow immediate expensing or accelerated depreciation of certain capital investments and others that allow taxpayers to defer 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 63 percent of individual income tax expenditures in fiscal year 2021, refundable credits for 18 percent, special rates for 11 percent, itemized deductions for 7 percent, and nonrefundable credits for 1 percent. (figure 1).

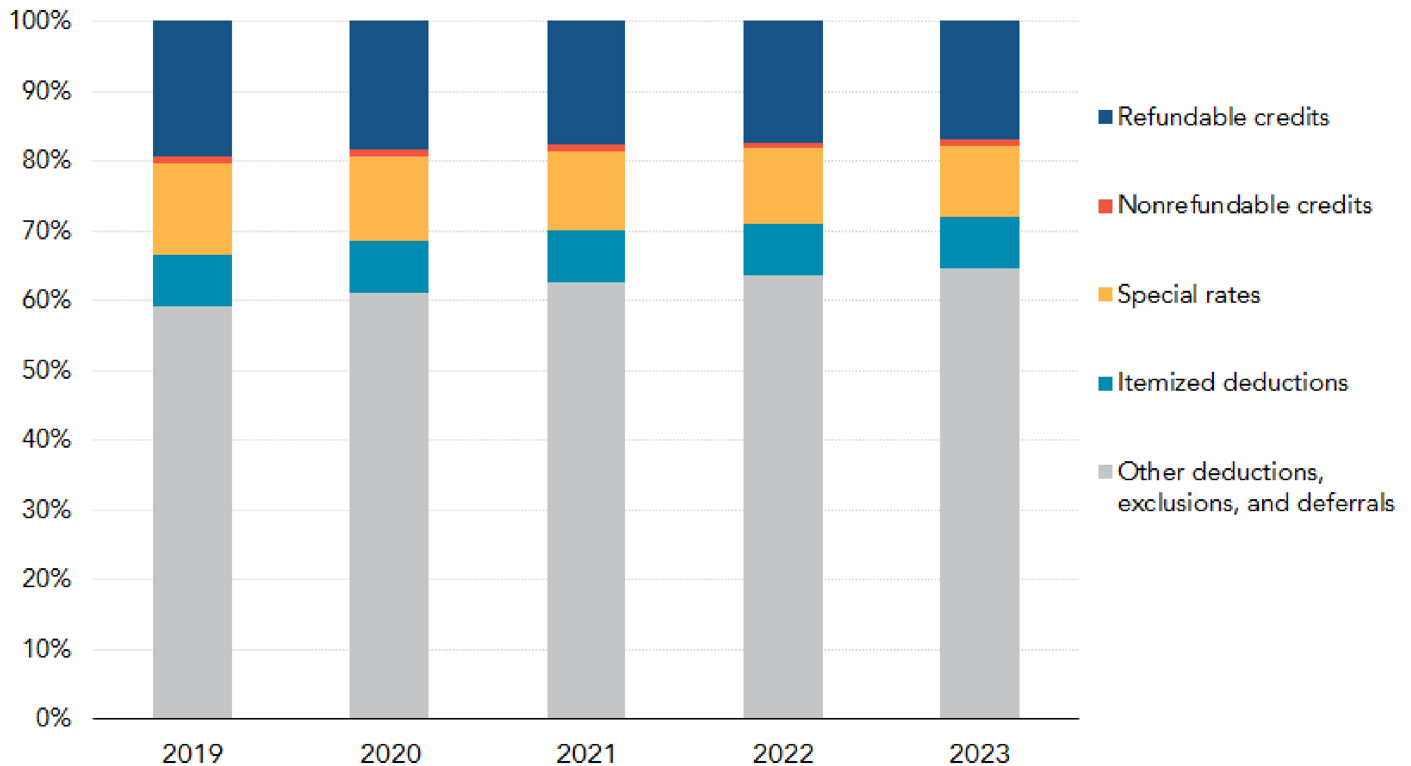
Some Background

What are tax expenditures and how are they structured?

FIGURE 1

Types of Individual Income Tax Expenditures

Fiscal years 2019 – 2023



Source: Joint Committee on Taxation. "Estimates of Federal Tax Expenditures for Fiscal Years 2019-2023," December 2019.

Updated May 2020

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What is the tax expenditure budget?

Q. What is the tax expenditure budget?

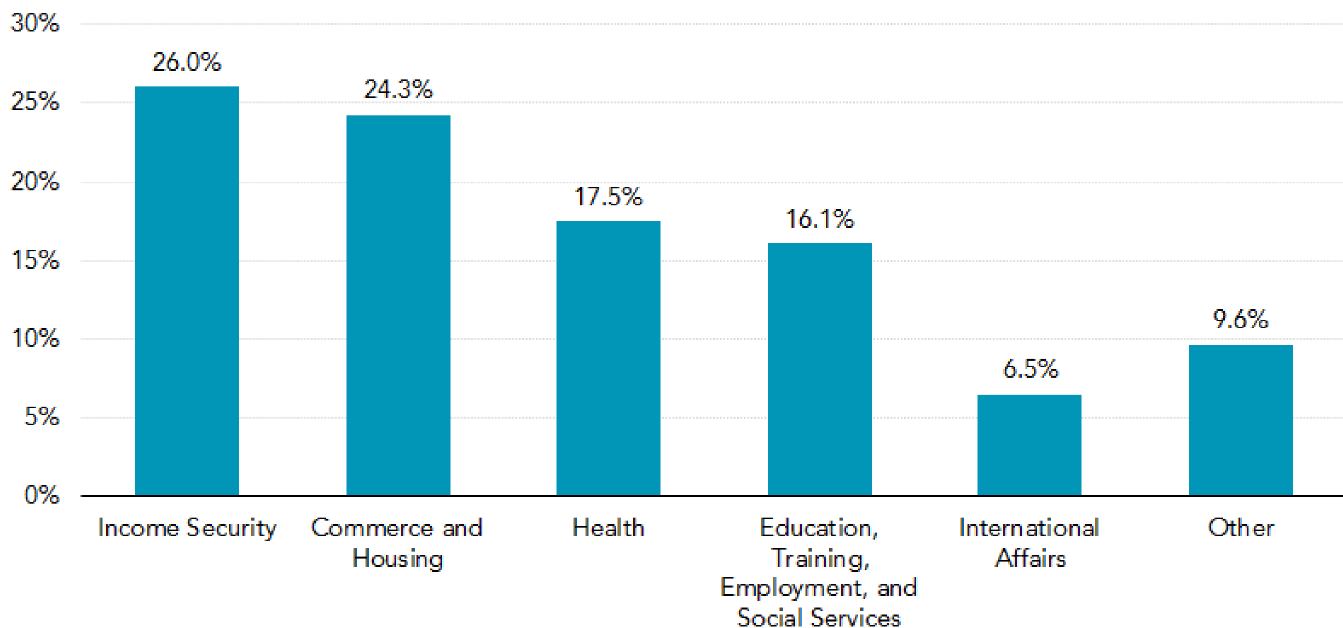
A. The tax expenditure budget displays the estimated revenue losses from special exclusions, exemptions, deductions, credits, deferrals, and preferential tax rates in federal income tax law.

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).

FIGURE 1

Components of Tax Expenditure Budget

Fiscal year 2021



Source: Joint Committee on Taxation. "Estimates of Federal Tax Expenditures for Fiscal Years 2019-2023," December 2019.
Notes: Estimates include both personal income and corporate income tax expenditure amounts. The "Other" category includes tax expenditures categorized under the following functions, ordered by size: general government, social security and railroad retirement, general science, space, and technology, energy, veterans' benefits and services, national defense, transportation, community and regional development, interest, agriculture, natural resources and environment.

Some Background

What is the tax expenditure budget?

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 2021 (including outlay effects) added up to $1.6 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 taxpayers into higher-rate brackets, thereby increasing the revenue loss from remaining exemptions. Toder and Berger (2019) estimated that the actual combined revenue loss from all individual tax expenditures in 2019 was about 5 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 then 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. For example, because the earned income credit is a direct cash transfer that is based largely on wage reporting, the IRS might serve appropriately as the administrative agency. For other tax expenditures that promote specific activities, administration by an agency with the required programmatic expertise may be preferable.

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

What is the tax expenditure budget?

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 and other tax law provisions. For example, the cost of the mortgage interest deduction varies with the volume of home mortgage debt outstanding, the level of interest rates, marginal tax rates applied to the taxable income of borrowers, the size of the standard deduction, and limitations on other itemized deductions.

Updated May 2020

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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 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 of income earned within those accounts would not be considered tax expenditures. Most other tax

Why are tax expenditures controversial?

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.

Updated May 2020

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Some Background

What are the largest tax expenditures?

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 2017 tax act, still exceeds total spending by the US Department of Housing and Urban Development.

Table 1 ranks the top 13 US tax expenditures in fiscal year 2021, based on the 2019 estimates by the Joint Committee on Taxation (JCT). The table also shows estimates for the same tax expenditures prepared by the US Department of the Treasury and reported by the Office of Management and Budget (2020).

Some Background

What are the largest tax expenditures?

TABLE 1

Largest Tax Expenditures

Billions of dollars, fiscal year 2021

Rank	Tax expenditure	JCT	OMB
1	Tax exclusion for employer-sponsored health insurance	$190.3	$227.9
2	Reduced rates of tax on dividends and long-term capital gains	$167.5	$136.2
3	Tax benefits for employer defined contribution plans	$157.8	$90.7
4	Credit for children and other dependents	$118.8	$121.7
5	Tax benefits for defined benefit plans	$109.4	$75.8
6	Reduced tax rate on active income of controlled foreign corporations	$82.1	$43.0
7	Earned income credit	$73.1	$69.6
8	Depreciation of equipment in excess of alternative depreciation system	$56.6	$40.6
9	Subsidies for insurance purchased through health benefit exchanges	$52.8	$46.5
10	Deduction for charitable contributions	$49.6	$56.2
11	20-percent deduction for qualified business income	$47.4	$54.7
12	Exclusion of capital gains at death	$43.8	$53.6
13	Exclusion of untaxed Social Security and railroad retirement benefits	$41.5	$32.5

Source: Joint Committee on Taxation (JCT). "Estimates of Federal Tax Expenditures for Fiscal Years 2019-2023," December 2019; US Department of the Treasury. "Tax Expenditures: FY 2021," February 2020.

Notes: Estimates include both personal income and corporate income tax expenditure amounts. JCT regards the exclusion of net imputed rental income as an administrative necessity, and does not classify it as a tax expenditure. However, the Treasury does include it in its tax expenditure estimates ($130.4 billion for FY2021).

Some Background

What are the largest tax expenditures?

The largest tax expenditure (an estimated $190.3 billion in fiscal year 2021 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. OMB estimates this provision will cost $227.9 billion in 2021.

The next-largest tax expenditure on the JCT list is the preferential rate structure for capital gains and dividends ($167.5 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. OMB estimates this provision will cost $136.2 billion in 2021.

The third- 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 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 by JCT to total $157.8 billion for employer-sponsored "defined-contribution" plans such 401(k) plans and $109.4 billion for defined-benefit plans. (Comparable OMB estimates are $90.7 billion for defined contribution plans and $75.8 billion for defined benefit plans). JCT reports additional losses from deductible individual retirement accounts ($19.9 billion), back-loaded individual retirement (Roth) accounts ($8.7 billion), and plans for the self-employed ($17.3 billion), and a savers' credit ($1.2 billion).

The fourth-largest tax expenditure is the credit for children and other dependents ($118.8 billion in 2021,). The 2017 Tax Cuts and Jobs Act (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. OMB estimates these credits (including the refundable portion) will cost $121.7 billion in 2021. The TJCA increases in the child credit will expire after 2025.

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 and accelerated depreciation of equipment in excess of the alternative depreciation system. The sixth largest, the reduced tax rate on the active income of controlled foreign corporations, will cost $82.1 billion in fiscal year 2021, according to JCT. OMB scores this proposal as costing a smaller amount ($43.0 billion) because OMB counts as an offset the gain in revenue from a transition tax on profits accrued prior to enactment of the TCJA. The eighth largest, the tax subsidy for investment in equipment, allows firms to deduct purchases of qualifying equipment immediately (bonus depreciation) through 2022. In fiscal year 2021, it will cost $56.6 billion according to JCT and $40.6 billion according to OMB. Beginning in 2023, however, bonus depreciation is scheduled to phase out at a rate of 20 percent per year, reaching zero in 2027.

The seventh-largest tax expenditure, the earned income credit ($73.1 billion in 2021), 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. Including the outlay costs, OMB estimates the EITC increases the budget deficit by $69.6 billion in 2021.

The ninth-largest tax expenditure is the subsidy for health insurance purchased through health benefit

Some Background

What are the largest tax expenditures?

exchanges under the Affordable Care Act ($52.8 billion). A TCJA provision reduced this subsidy by eliminating a penalty tax on individuals who lack insurance coverage, effectively reducing the number of people who purchase subsidized insurance coverage. OMB estimates this subsidy will cost $46.5 billion in 2021.

The tenth largest subsidy is the deduction for charitable contributions, which the agencies report at three separate items – charitable contributions for education, charitable contributions for health, and charitable contributions for all other purposes. Adding up the estimates for these three items, JCT estimates the charitable deduction will cost $49.6 billion in 2021, while OMB estimates it will cost $56.2 billion.

The eleventh-largest subsidy is the 20 percent deduction for qualified business income of individual taxpayers ($47.4 billion in 2021). This deduction, introduced 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. OMB estimates it will cost $54.7 billion in 2021. The deduction will expire after 2025.

The twelfth largest subsidy is the exclusion of capital gains on assets transferred at death or by gift. Assuming that the alternative treatment is taxing unrealized capital gains on the decedent's final income tax returns, JCT estimates this proposal will cost $43.8 billion in fiscal year 2021, while OMB estimates it will cost $53.6 billion.

The thirteenth-largest tax expenditure is the exclusion of untaxed Social Security and railroad benefits ($41.5 billion). These benefits are partially or fully excluded from adjusted gross income for taxpayers whose incomes fall below threshold amounts. OMB estimates the cost at $32.5 billion in 2021.

Updated May 2020

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What are the largest tax expenditures?

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Q. How did the Tax Cuts and Jobs Act 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 first post-TCJA 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 the TCJA reduced the most in fiscal years 2018–20 were 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 the TCJA increased the most were the credit for children and other dependents and depreciation of equipment in excess of the alternative depreciation system. The largest new tax expenditure enacted in the TCJA was a 20 percent deduction for qualified business income (table 1).

How did the Tax Cuts and Jobs Act affect tax expenditures?

TABLE 1

Largest Changes in Tax Expenditures

Fiscal years 2018 – 2020

Tax Expenditure Reductions	Change in Amount (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	**Change in Amount (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; "Estimates of Federal Tax Expenditures for Fiscal Years 2016-20. JCX-3-17."

Note: Estimates include both personal income and corporate income tax expenditure amounts.

DIRECT CHANGES IN TAX EXPENDITURES

Most of the tax expenditures that the TCJA eliminated were small. The principal exception was the deduction attributable to domestic production activities ($58 billion in 2018–20), which was 9 percent of taxable business income. (For large corporations, the deduction 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 from the TCJA, Congress believed this deduction was no longer needed to reduce the tax burden on domestic manufacturing.

Some Background

How did the Tax Cuts and Jobs Act affect tax expenditures?

The 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 $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 reduced estimated 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) was $218 billion. More than 100 percent of the reduction is this tax expenditures was, however, attributable to reduction in the corporate rate from 35 to 21 percent instead of the reform of international provisions.

The largest expansions were for the child credit and depreciation of equipment by businesses. The child tax credit was doubled from $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 estimated 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 $176 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 two of the three largest corporate tax expenditures before the TCJA (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 (expensing of investment in equipment, and elimination of the domestic manufacturing deduction), while more than 100 percent of the reduction in tax expenditures for foreign-source income was a result of the lower corporate tax rate.

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

Some Background

How did the Tax Cuts and Jobs Act affect tax expenditures?

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.

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 estimated saving was 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 reduced the estimated 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 estimated that the elimination of the penalty tax on individuals without health insurance coverage would reduce the take-up rate for health insurance plans under the Affordable Care Act exchanges. The resulting reduction in coverage would then reduce tax subsidies paid out by the exchanges by about $80 billion between 2018 and 2020. On the business side, the estimated tax expenditure for small business expensing under section 179 declined from about $100 billion to about $40 billion between 2018 and 2020, even though the amount of deductions taken was made more generous. The estimated tax expenditure declined 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.

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