Background

What are the largest tax expenditures?

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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

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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.

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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 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

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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

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Further Reading

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