



## TAX EXPENDITURE BASICS

Frank Sammartino and Eric Toder  
January 22, 2020

Tax expenditures are the revenue losses attributable to special provisions in tax laws that reduce taxes for certain sources or uses of income or for certain groups of taxpayers. They are called tax expenditures because many of them effectively serve the same function as direct spending programs despite operating as tax reductions. In this report, we briefly discuss some basic tax expenditure concepts: what they are, the different forms they take, why we should be concerned about them, and some criteria for evaluating them.

## WHAT ARE TAX EXPENDITURES?

The Congressional Budget Act of 1974 defined 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.” Tax expenditures serve many purposes. Some promote broad social goals such as health insurance coverage or saving for retirement. Others supplement the federal social safety net by providing tax relief for certain groups of people, such as low-income working families, families with children, and seniors. Still others are incentives for activities that Congress has deemed worthy of support, including regional economic development, renewable energy use, provision of low-income housing, and investment in research and development.

Both the Office of Tax Analysis (OTA) in the US Department of the Treasury and the congressional Joint Committee on Taxation (JCT) publish annual lists of tax expenditures that estimate revenue losses attributable to tax code preferences that the agencies describe as exceptions to “normal” or “reference” provisions of income tax law. Both agencies define the normal or reference tax system as one with a comprehensive income tax base and the same rates applied to all forms of income, but with some exceptions based on administrative and practical considerations. The annual lists of tax expenditures published by the OTA and the JCT include a similar set of items and usually have somewhat similar estimated values, but they do not always match. Although the agencies typically provide estimates only for tax expenditures in federal individual and corporate income taxes, tax expenditures apply to other taxes as well.

The exceptions to a comprehensive income tax system with uniform rates are called tax expenditures because many of them effectively function like direct expenditures despite operating as tax reductions. For example, tax credits for renewable energy investments could also be structured as grants from the US Department of Energy, or tax credits for students who attend higher education institutions could be replaced by expanding the Pell grant program.

Some tax preferences in the OTA and the JCT lists of tax expenditures have no direct spending analogue, however. They reflect policy decisions either to tax certain types of income at different rates (for example, lower tax rates for long-term capital gains and qualified dividends), or basic choices on how to design an income tax system (for example, the partial exemption of foreign-source income of US corporations, which departs from a comprehensive income tax, but makes US rules for taxing resident multinational companies closer to those of our major trading partners).

State tax systems also have tax expenditures. Many of the most-costly state tax expenditures result from conforming with federal rules that govern the definition of the tax base for individual and corporate income taxes. States can limit those tax expenditures by including in their tax bases income that has been excluded from the federal base and excluding deductions allowed under federal rules. However, doing so increases the cost of tax administration and compliance for state governments and their taxpayers. Many states also supplement federal tax expenditures, (such as with state earned income tax credits) or create state-specific tax expenditures (such as targeted income tax benefits for businesses and people, general sales tax exclusions and exemptions, and property tax abatements and credits).

Tax expenditures are often labeled as loopholes, but few tax expenditures fit the Wikipedia definition of a loophole as “an ambiguity or inadequacy in a system, such as a law or security, which can be used to circumvent or otherwise avoid the purpose, implied or explicitly stated, of the system.” Most of the revenue cost of tax expenditures comes from explicit provisions of tax law that are popular and widely used and have some justification in promoting worthwhile policy objectives. Nonetheless, in an era of increasing federal budget deficits and tight state budgets, tax expenditures should be subject to cost/benefit tests just like direct spending programs.

## WHAT ARE DIFFERENT FORMS OF TAX EXPENDITURES?

Tax expenditures can take the form of special exclusions, exemptions, deductions, and credits; preferential tax rates; or deferral of tax liability.

**Exclusions, exemptions, and deductions** all reduce the amount of income subject to tax. Income that is excluded, such as employer contributions to employee pensions and for health insurance premiums, or exempted, such as interest on municipal bonds, is not counted in the tax base. Deductions allow taxpayers to subtract certain uses of income—for example, contributions to individual retirement accounts—from the tax base. In a progressive income tax system (with marginal tax rates that increase with income), exclusions, exemptions, and deductions reduce tax liability more per dollar for higher-income taxpayers than for lower-income taxpayers because each dollar excluded or deducted at a higher tax rate reduces taxes by more than a dollar excluded or deducted at a lower rate. In addition, excluded forms of income and deductible expenses are often a much larger share of the total income of higher-income taxpayers than of lower-income taxpayers.

**Itemized deductions** are a special category of deductions, valuable only to taxpayers whose total itemized deductions are larger than the standard deduction available to all tax filers. The largest itemized deductions are those for home mortgage interest and charitable contributions. Before enactment of the Tax Cuts and Jobs Act (TCJA) in 2017, deductions for state and local taxes were also among the biggest itemized deductions. About 46 million taxpayers claimed itemized deductions in 2017, prior to the TCJA. Because the TCJA increased the standard deduction, imposed new limits on the deductibility of state and local taxes, and eliminated some other itemized deductions, the number of taxpayers itemizing their deductions is expected to fall to about 19 million. Taxpayers who stop itemizing deductions because of the higher standard deduction are better off because taking the larger standard deduction lowers their tax liability. But those taxpayers no longer have tax incentive to spend more on deductible expenses such as giving to charities.

**Credits** reduce tax liability by the dollar amount of the credit, and their value does not vary with the marginal tax rate of the taxpayer. For example, the \$2,000 child tax credit reduces tax liability by \$2,000 per child for all taxpayers eligible to use it fully. **Refundable credits** are a special category of credits that allows taxpayers to receive credits that exceed their income tax liability. 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 tax credit, which is partially refundable for those with earnings above a threshold amount. In federal budgetary accounts, the portion of refundable credits that exceeds income tax liability is scored as spending (or outlays).

**Preferential tax rates** benefit taxpayers who receive certain types of income. Tax rates on ordinary income range from 10 to 37 percent, while long-term capital gains and qualified dividends, for example, face a schedule of rates that range from 0 to 20 percent (plus an additional 3.8 percent surtax for high-income taxpayers).

**Deferral of tax liability** allows taxpayers to delay tax payments. Delaying payment reduces the present value of taxes because no interest is charged; additionally, delaying payment may mean that a taxpayer is in a lower rate bracket at the time of payment. An example of this is the deferral of tax on contributions to and income accrued within qualified retirement plans. Another example is immediate expensing or accelerated depreciation of certain capital investments, which shifts reported taxable income to later years by allowing taxpayers to claim deductions for the costs of those investments before they would otherwise be able to under normal income accounting rules.

## WHY SHOULD WE BE CONCERNED ABOUT TAX EXPENDITURES?

Tax expenditures reduce government revenues. The revenue loss is not capped as most are not subject to annual legislative authorization and the factors determining their cost are largely not under government control. Tax expenditures also may lead to a misallocation of economic resources, and can undermine confidence in the tax system.

By narrowing the tax base, tax expenditures decrease the amount of revenue that federal and state governments can collect without resorting to higher tax rates. Because their budgetary costs are counted as reduced tax revenues instead of increased spending, they appear to reduce the size of government. For this reason, tax subsidies have strong political appeal. But in fact, tax expenditures are an alternative way for government to intervene in the economy, and as with direct spending, they must be financed eventually through higher taxes or reduced spending elsewhere.

Like most mandatory programs (often called entitlements) on the spending side of the budget, most tax expenditures do not go through a direct appropriation process each year. Thus, unlike appropriations for most discretionary spending programs and like spending for federal programs such as Social Security and Medicare, the cost of most tax expenditures is not capped. Tax preferences are generally available to all eligible taxpayers, and in most cases, there is no limit specified for the government's fiscal exposure. A few tax expenditures (for example, tax credits for hybrid cars) are subject to dollar limits, but these may introduce new inequities among taxpayers (by basing eligibility on when preferred goods are purchased or registered). Moreover, the costs of many tax expenditures change with the economy, as the quantities and prices of subsidized activities rise and fall, and—for some provisions—with changes in other features of the tax system. For example, the cost of the mortgage interest deduction varies based on the volume of home mortgage debt outstanding and the level of interest rates, but also varies based on other tax provisions including the size of the standard deduction and itemized deductions, and the marginal tax rates applied to the taxable income of borrowers.

Tax expenditures can encourage taxpayers to spend more on certain goods and services than they would in the absence of these tax subsidies. For example, the tax exclusion for employer-provided health insurance premiums may cause consumers to be less cost-conscious when spending on health care, while tax preferences for owner-occupied housing may cause homeowners to invest too much in housing and too little elsewhere. Tax expenditures can also lead to an undesirable allocation of public funds. For example, the revenue lost from state tax incentives for specific businesses might more effectively promote economic development if spent on education and infrastructure or used to relieve tax burdens more broadly.

Tax expenditures increase the complexity of the tax code, making it opaque and increasing the cost of compliance. Taxpayers often perceive tax expenditures as tax breaks only available to special interests, with the cost coming at the expense of the general public. These perceived inequities come about because taxpayers with similar incomes end up paying different amounts of taxes, or because taxpayers believe, rightly or wrongly, that the benefits from these special provisions are only available to well-to-do taxpayers. These perceptions can undermine trust in the fairness of the tax system.

## WHAT ARE SOME CRITERIA FOR EVALUATING TAX EXPENDITURES?

In evaluating tax expenditures, policymakers should ask the following questions:

- What public policy goal does the tax expenditure provision seek to achieve? Is there a need for government intervention at all?
- If the tax expenditure is meant to promote more of some activity, does the activity generate any societal benefit beyond the gain to direct consumers of the good or service? If so, are the benefits sufficient to justify the cost? Is it well targeted at the activity that it intends to promote and is it structured as effectively as it could be? If not, how could it be modified to make it more effective in achieving its objectives.
- If the tax expenditure is meant to provide income support to selected beneficiaries, is there a justification for providing special assistance to the category of people receiving the tax break? Does it provide equal assistance to taxpayers in similar economic circumstances who meet the criteria? Is it effectively targeted to assist only the intended beneficiaries?
- Does the tax expenditure duplicate or conflict with other tax provisions? Is it coordinated with spending programs with similar objectives? What changes can be made to avoid either wasteful duplication or incomplete coverage?
- Are the provision's objectives best achieving by a tax expenditure or would it be more effective and transparent to have a direct spending program instead? Is the IRS the best agency to administer the provision?

If the conclusion is that a tax expenditure is unjustified or poorly targeted, then one must consider the economic disruption or losses to selected families or businesses if the tax expenditure were eliminated or restructured. How then can the tax expenditure be phased out to minimize economic harm to current beneficiaries?

## ACKNOWLEDGMENTS

This brief was funded by Arnold Ventures. We are grateful to the foundation and to all our funders, who make it possible for the Urban-Brookings Tax Policy Center to advance its mission.

The authors thank Aravind Boddupalli for valuable research assistance and Mark Mazur for helpful comments.

The views expressed are those of the authors and should not be attributed to the Urban-Brookings Tax Policy Center, the Urban Institute, the Brookings Institution, their trustees, or their funders.

The Tax Policy Center is a joint venture of the Urban Institute and Brookings Institution. For more information, visit [taxpolicycenter.org](http://taxpolicycenter.org) or email [info@taxpolicycenter.org](mailto:info@taxpolicycenter.org).

Copyright © 2020. Tax Policy Center. All rights reserved. Permission is granted for reproduction of this file, with attribution to the Urban-Brookings Tax Policy Center.