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Tax Expenditures: Overview and Analysis

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Summary

Tax expenditures—revenue losses associated with targeted provisions that move the income tax away from a "theoretical normal" tax system—are a long-standing feature of the U.S. tax code. In some ways, tax expenditures resemble direct spending programs. They both have similar budgetary effects and provide incentives that alter the allocation of resources. Hence, tax expenditures, like direct spending, are one of the ways that the federal government plays a role in shaping the economy.

Tax expenditures, however, do not regularly receive the same level of scrutiny as direct spending programs. Also, unlike direct spending programs, the revenue loss associated with most tax expenditures is only limited by eligibility—much like mandatory spending programs. A consequence of the limited oversight placed on tax expenditures is that activities may be supported by tax expenditures that have insufficient political support for funding through a direct spending program.

During the last 40 years, the level of tax expenditures has varied both as a function of taxes collected and as a share of the economy. One possible explanation for this variability is that tax reform historically reduces the scope of tax expenditures, which otherwise grow. Growth in tax expenditures has exceeded that of discretionary spending, but not mandatory spending, over the same time period.

The revenue loss from tax expenditures is concentrated among a limited number of provisions, with 66% of the revenue loss attributed to the top 10 tax expenditures against the individual income tax. In addition, the benefits of tax expenditures against the individual income tax are concentrated among upper-income taxpayers. A recent Congressional Budget Office (CBO) analysis of selected tax expenditures found that 51% of the benefits went to the top 20% of taxpayers.

Tax expenditures are a common target when base-broadening tax reform is pursued—like with the Tax Reform Act of 1986 (P.L. 99-514). This may be the result of tax expenditures being defined as being outside the normal tax code—making them a clear source for base-broadening. However, there are impediments to base broadening by eliminating or reducing tax expenditures, as some may serve important purposes, others are important for distributional reasons, and many are technically difficult to change or are broadly used by the public and quite popular.

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What Are Tax Expenditures?

Section 3(3) of the Congressional Budget and Impoundment Control Act of 1974 (Budget Act) defines tax expenditures as

> … those 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 can be categorized into the same set of budget functions as discretionary and mandatory spending and may be used to achieve similar policy outcomes. Common goals of tax expenditures include promoting the accurate measurement of income, altering the distribution of fiscal benefits and burdens to address differences in ability-to-pay, and promoting socially desirable activities. How tax expenditures are constructed and the structure of the income tax system affect both who will benefit from tax expenditures and how much they will reduce federal revenues.

Exclusions, Exemptions, and Deductions

Exclusions, exemptions, and deductions indirectly reduce taxes owed by reducing taxable income.[1] With a graduated rate structure, the value of an exclusion, exemption, or deduction increases as the taxpayer's income increases. For example, current individual income tax rates

[1] While exclusions, exemptions, and deductions have the same effect on taxable income they are distinctly different. An exclusions is a form of income that is specifically not included in taxable income. In many cases, such as employer provided health care, exclusions are provided in-kind making accurate valuation difficult. Exemptions, such as for military income earned in combat zones, occur when specific forms of income are exempted from taxation. Deductions reduce taxable income based upon expenses incurred, such as the deduction for state and local taxes.

range from 10% to 39.6%, making the value of a $100 exclusion, exemption, or deduction range from $10 to almost $40.

Tax Credits

Tax credits directly reduce taxes owed. Some tax credits are refundable—meaning taxpayers who have no tax liability can receive the balance of the credit as a cash refund. Nonrefundable tax credits cannot in aggregate exceed the taxpayer's income tax liabilities and may be worth less to low-income taxpayers, who generally have little to no income tax liability.

Preferential Tax Rates

Preferential tax rates indirectly reduce taxes by taxing a portion or particular type of income at a lower rate. With a graduated rate structure, the value of a preferential tax rate may increase as the taxpayer's income increases.

Deferral

Deferral does not reduce taxes owed. Instead, deferral alters the timing of tax payments by delaying recognition of income or speeding up the recognition of costs that would otherwise occur in future years.

What Is the "Normal" Tax System?

The Budget Act indicates that tax expenditures are to be measured relative to the "normal" personal and corporate income tax system. The baseline "normal" tax system applies the current rate structure to a broader definition of income than is used by taxpayers to calculate their income tax. Specifically, the Joint Committee on Taxation (JCT) uses a modified Haig-Simons comprehensive income tax as its baseline.[2] Under this baseline, income is roughly defined as consumption plus changes in net wealth in a given time period. As a result, tax expenditures are generally tax provisions that are not structural features of the income tax or necessary to measure income accurately.[3]

As defined in the Congressional Budget Act, the concept of tax expenditure refers to the corporate and individual income taxes. Other parts of the Internal Revenue Code—excise taxes,[4] employment taxes, estate and gift taxes—may also have exceptions, exclusions, refunds, and credits (such as a gasoline tax exemption for non-highway uses) which are not included here because they are not part of the income tax.

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[2] See Robert Haig, *The Concept of Income–Economic and Legal Aspects, in The Federal Income Tax* (Columbia University Press, 1921) and Henry Simons, *Personal Income Taxation: the Definition of Income as a Problem of Fiscal Policy* (University of Chicago Press, 1938) for a full description of Haig-Simons income.

[3] U.S. Congress, Joint Committee on Taxation, *Background Information On Tax Expenditure Analysis And Historical Survey Of Tax Expenditure Estimates*, committee print, 112th Cong., March 9, 2011, JCX-15-11.

[4] Bruce F. Davie, "Tax Expenditures in the Federal Excise Tax System," *National Tax Journal*, vol. 47, no. 1 (March 1994).

The Purpose of Tax Expenditure Estimates

Tax expenditure budgets which list the estimated annual revenue losses associated with each tax expenditure were first required to be published in 1975 as part of the Administration's budget for FY1976, and have been required to be published by the Budget Committees since 1976. The tax expenditure concept is still being refined, and therefore the classification of certain provisions as tax expenditures continues to be discussed.[5]

It is important to note that listing a provision as a tax expenditure in no way implies any judgment about its desirability or effectiveness, whether by itself or relative to non-tax provisions that could address the same policy concern. Instead, listing tax expenditures increases the transparency of the tax system and allows Congress to examine all federal programs relating to the same policy goals. This full consideration of tax and non-tax programs allows federal budget decisions to be made with the richest set of information available.

Tax expenditures reduce the tax liability of any qualified taxpayer. As a result, they function more similarly to entitlement programs than to discretionary spending. If enacted on a permanent basis they may benefit from periodic consideration of whether they are efficiently meeting the national needs and goals for which they were established. Some, including the Government Accountability Office, have recommended that the executive branch develop and implement a framework for evaluating tax expenditures.[6]

The Largest Tax Expenditures

Table 1 lists the 10 largest tax expenditures for both corporations and individuals. There are two main take-aways from **Table 1**. One, the distribution of tax expenditures is skewed slightly away from corporations. That is, corporate tax expenditures are roughly 15% of individual tax expenditures, while corporate tax revenue is 23% of individual tax revenue.[7] Second, most of the revenue lost comes from relatively few tax expenditures, with the top 10 individual tax expenditures accounting for roughly 66% of the forgone revenue from individual tax expenditures.

Each tax expenditure is calculated separately, under the assumption that all other tax expenditures remain in the Code. If two or more tax expenditures were estimated simultaneously, the total

[5] For a discussion of the conceptual problems involved in defining tax expenditures and some of the differences between the Administration's and Joint Committee on Taxation's approaches, see *The Budget of the United States Government, Fiscal Year 2009, Analytical Perspectives*, "Tax Expenditures," pp. 285-325. See also Linda Sugin, "What Is Happening to the Tax Expenditure Budget?" *Tax Notes*, August 16, 2004, pp. 763-766; and Thomas L. Hungerford, "Tax Expenditures: Good, Bad, or Ugly?" *Tax Notes*, October 23, 2006, pp. 325-334.

[6] U.S. Government Accountability Office, *Government Performance and Accountability: Tax Expenditures Represent a Substantial Federal Commitment and Need to Be Reexamined*, GAO-05-690, September 23, 2005.

[7] Strictly speaking adding up tax expenditures does not necessarily result in an accurate total. Each tax expenditure is calculated separately, under the assumption that all other tax expenditures remain. If two or more tax expenditures were estimated simultaneously, the total change in tax liability could be smaller or larger than the sum of the amounts shown for each item separately, as a result of interactions among the tax expenditure provisions. See Leonard E. Burman, Christopher Geissler, and Eric J. Toder, "How Big Are Total Individual Income Tax Expenditures, and Who Benefits from Them?," *American Economic Review*, vol. 98 (May 2008).

change in tax liability could be smaller or larger than the sum of the amounts shown for each item separately, as a result of interactions among the tax expenditure provisions.

Table 1. The 10 Largest Individual and Corporate Tax Expenditures

Individual	Estimated Revenue Loss in 2014 ($ billions)	Corporate	Estimated Revenue Loss in 2014 ($ billions)
Exclusion of employer contributions for health care	143.0	Deferral for active income of controlled-foreign corporations	83.4
Reduced tax rates on dividends and long-term capital gains	96.5	Depreciation of equipment in excess of the alternative depreciation system, excluding bonus depreciation	24.0
Exclusion of contributions to and earnings from retirement plans	88.8	Deduction of income attributable to domestic production activities	12.2
Earned income tax credit	69.2	Deferral of gains on like-kind exchanges	11.7
Deduction for mortgage interest	67.8	Exclusion of interest on public purpose state and local government bonds	9.3
Child tax credit	57.3	Deferral of gain on non-dealer installment sales	6.9
Deduction of state and local taxes	56.5	Credit for low-income housing	6.8
Exclusion of untaxed Social Security and railroad retirement benefits	37.4	Credit for increasing research activities	4.6
Deduction for charitable contributions	34.8	Reduced rates on first $10 million of corporate taxable income	3.8
Exclusion of benefits provided under cafeteria plans	34.5	Inventory property sales source rule exception	3.0
Total[a]	1,036.2	Total[a]	154.0

Source: U.S. Congress, Joint Committee on Taxation, *Estimates Of Federal Tax Expenditures For Fiscal Years 2014-2018*, committee print, 113th Cong., August 8, 2014, JCX-97-14. These estimates reflect the current law as of June 30, 2014 and do not reflect subsequent tax law changes.

a. The total listed is the total value of all tax expenditures, not just those listed in Table 1.

Who Benefits from Tax Expenditures?

A related question that may be asked is "Who benefits from tax expenditures?" This is a potentially complex question that can be answered from varying perspectives. The Congressional Budget Office (CBO)[8] chose to answer this question most recently by examining selected major

[8] Congressional Budget Office, *The Distribution of Major Tax Expenditures in the Individual Income Tax System*, May (continued...)

individual tax expenditures according to quintiles of the income distribution.[9] The CBO analysis presented in **Figure 1** details the distribution of these tax expenditures by tax expenditure type and income group. Overall, taxpayers in the top quintile claim 51% of the benefits of the tax expenditures included in the CBO analysis, with the remaining 49% going to taxpayers in the bottom four quintiles.

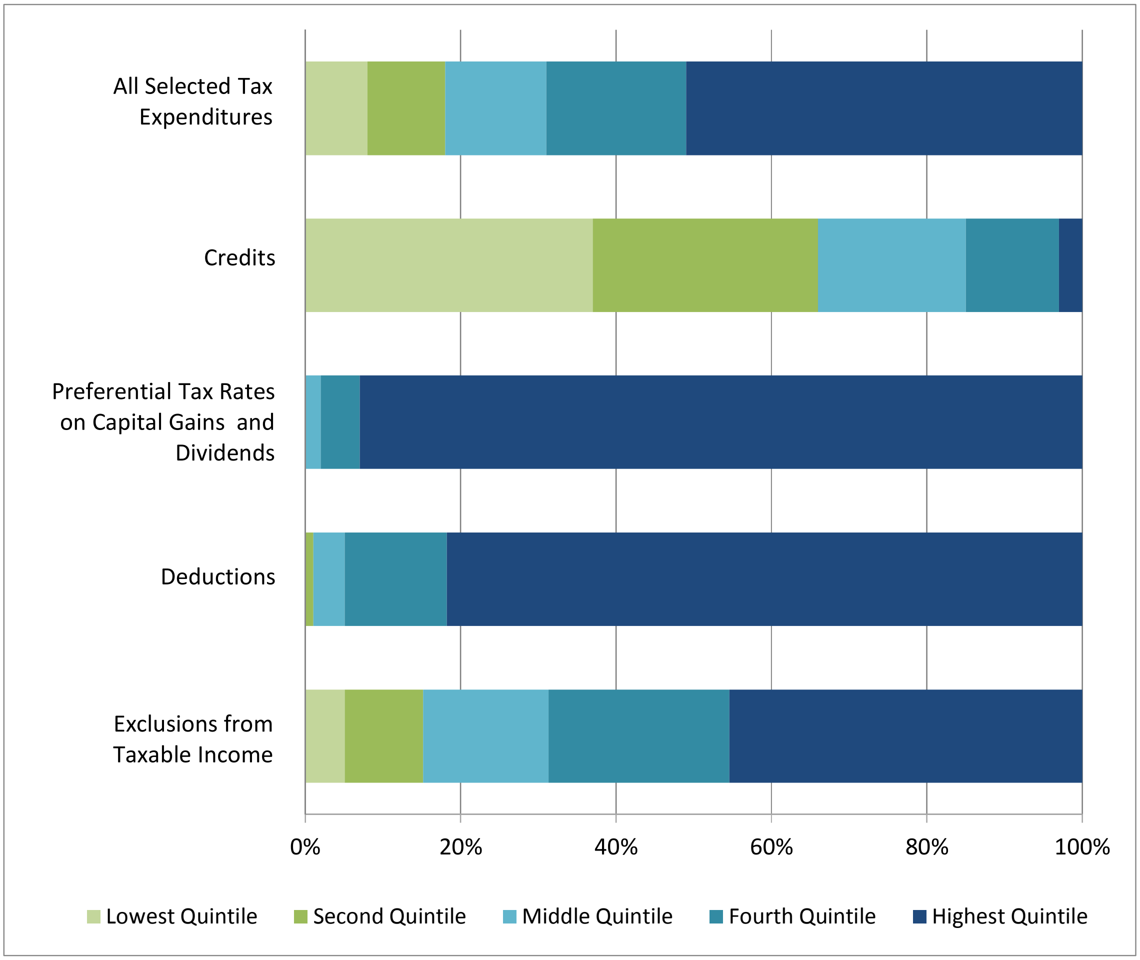
The CBO analysis also allows for this information to be disaggregated by tax expenditure category. For all categories, except credits, the top quintile claims the plurality of the benefits. This skewness is most prominent for the preferential tax rates on capital gains and dividends (where the top quintile receives 93% of the benefits) and itemized deductions (where the top quintile receives 81% of the benefits). In contrast, the top quintile receives just 3% of tax credits—with the bottom two quintiles receiving 66% of the benefits.

(...continued)

29, 2013, http://www.cbo.gov/publication/43768.

[9] The CBO report disaggregates tax expenditures using the same categories described above. Deferral is excluded from the CBO analysis as none of the major provisions CBO identified resulted in deferred tax liability. The specific exclusions examined are for employer-sponsored health insurance, net pension contributions and earnings, capital gains on assets transferred at death, and a portion of Social Security and Railroad Retirement benefits. The specific itemized deductions examined are for certain taxes paid to state and local governments, mortgage interest payments, and charitable contributions. The specific tax credits examined are the earned income tax credit and the child tax credit.

Figure 1. Distribution of Selected Major Tax Expenditures, by Income Group, 2013



Source: Congressional Budget Office, *The Distribution of Major Tax Expenditures in the Individual Tax System*, May 29, 2013.

Notes: Quintiles, or fifths, are created by ranking households by their before-tax income. Quintiles contain equal numbers of people.

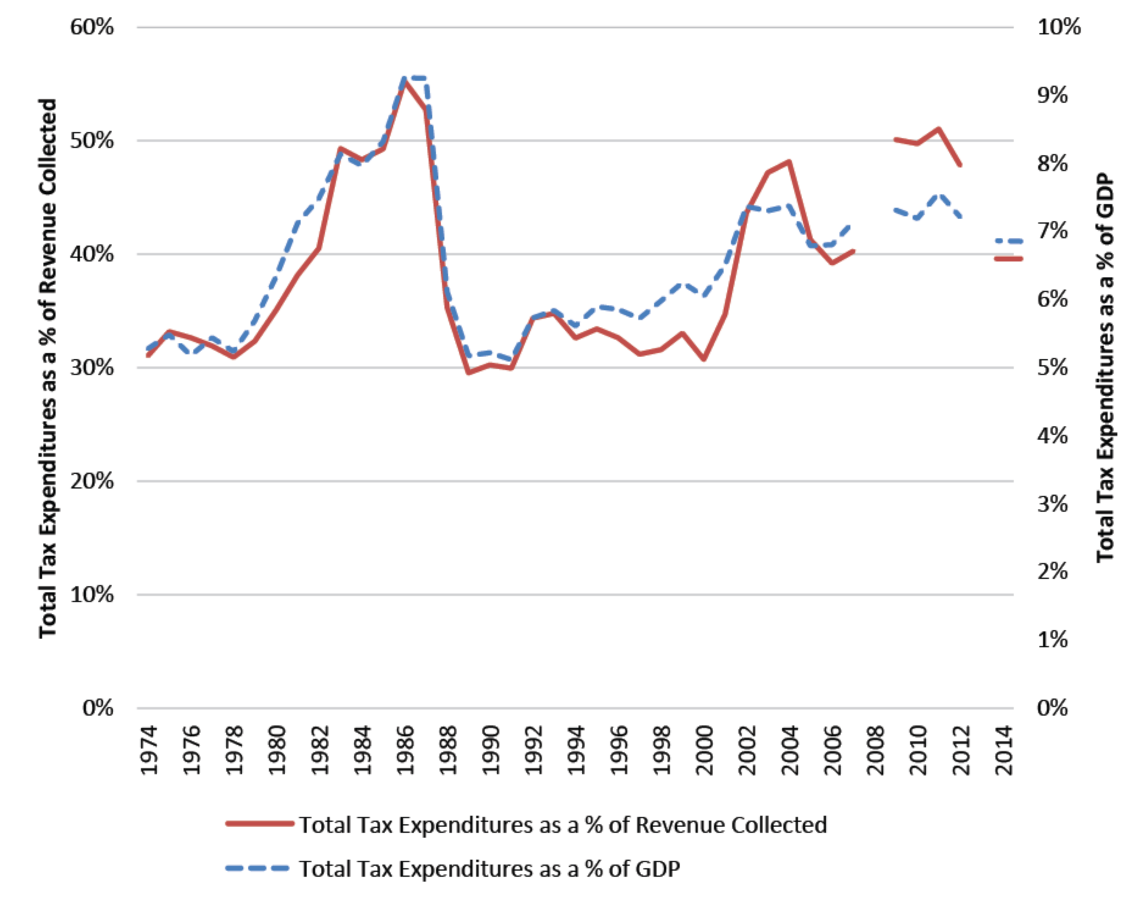
The selected major tax expenditures in the CBO analysis are the exclusion of employers' contributions for health care, health insurance premiums, and long-term-care insurance premiums; the exclusion of net pension contributions and earnings; the exclusion of capital gains on assets transferred at death; the exclusion of a portion of Social Security and Railroad Retirement benefits; the deduction for mortgage interest on owner-occupied residences; the deduction of nonbusiness state and local government income, sales, real estate, and personal property taxes; the deduction for charitable contributions; reduced rates on dividends and long-term capital gains; the earned income tax credit; and the child tax credit.

Long-Term Trends in Tax Expenditures

An alternative way to examine tax expenditures is to look for trends over an extended time period. **Figure 2** shows the sum of revenue forgone from all tax expenditures scaled against total federal revenue and gross domestic product (GDP). Scaling against total federal revenue allows for both the effects of the economy and changes in tax law to be observed, while scaling against GDP omits the effects brought on by changes in the tax code. In both cases, the relative amount of tax expenditures grew rapidly from 1974 through the mid-1980s, before reverting to just less than the 1974 levels as a result of the Tax Reform Act of 1986 (TRA86, P.L. 99-514). After TRA86, the amount of tax expenditures grew modestly scaled against GDP and was relatively flat against total revenue[10] until the enactment of the 2001/2003 tax cuts. The period after the enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA, P.L. 107-16) and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA, P.L. 108-27) is characterized by higher levels of tax expenditures, versus both GDP and total revenue. The recent divergence of the two measures is likely a result of tax stimulus measures reducing revenue collections (leading to a higher scaled percentage).[11]

Figure 2. Total Tax Expenditures as a Percentage of Federal Revenue and Gross Domestic Product (GDP)

1974-2014



Source: CRS analysis of Joint Committee on Taxation (JCT) documents.

Notes: The JCT did not produce tax expenditure estimates for 2007 and 2013.

Tax expenditures are sometimes described as "spending through the tax code." Thus, the long-term trends in tax expenditures can also be viewed against the levels of federal spending. **Figure**

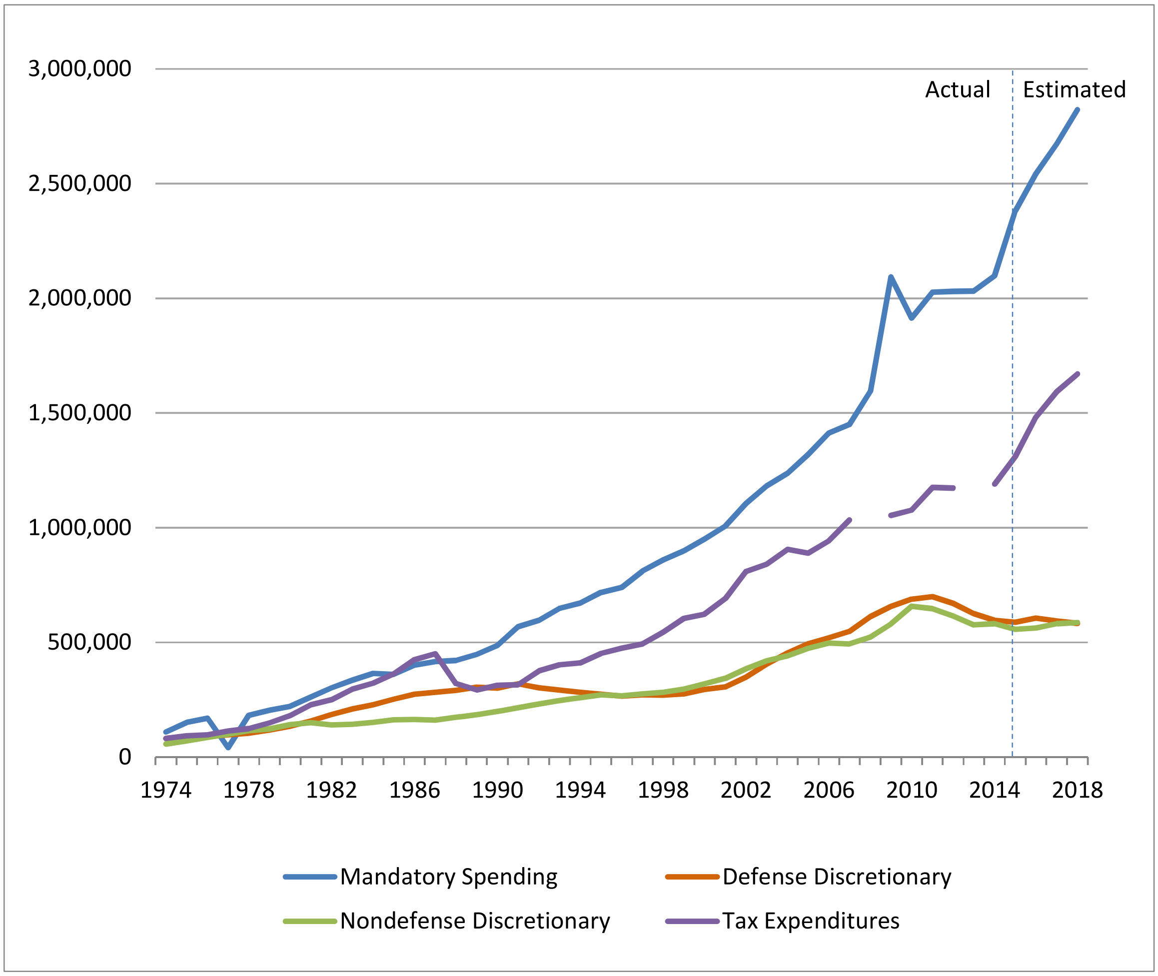
10 The Budget Acts of 1990 and 1993 both raised taxes (and thus the value of certain tax expenditures) on those with high income.

11 To the extent that the stimulus measures increased GDP, tax expenditures as a percentage of GDP would lowered.

3 compares the total value of tax expenditures to the levels of mandatory spending, defense discretionary spending, and non-defense discretionary spending since 1974. Unlike **Figure 2**, **Figure 3** is reported using current dollars (not adjusted for inflation). As a result, comparisons using **Figure 3** should be made based upon the relative distance between the levels of tax expenditures and spending over the time period. For example, in 1974 the levels of tax expenditures and discretionary defense spending were roughly comparable. In contrast, the same comparison in 2014 reveals the size of tax expenditures being roughly double the size of discretionary defense spending.

Figure 3. Tax Expenditures and Federal Spending

1974-2018 (in $ thousands)



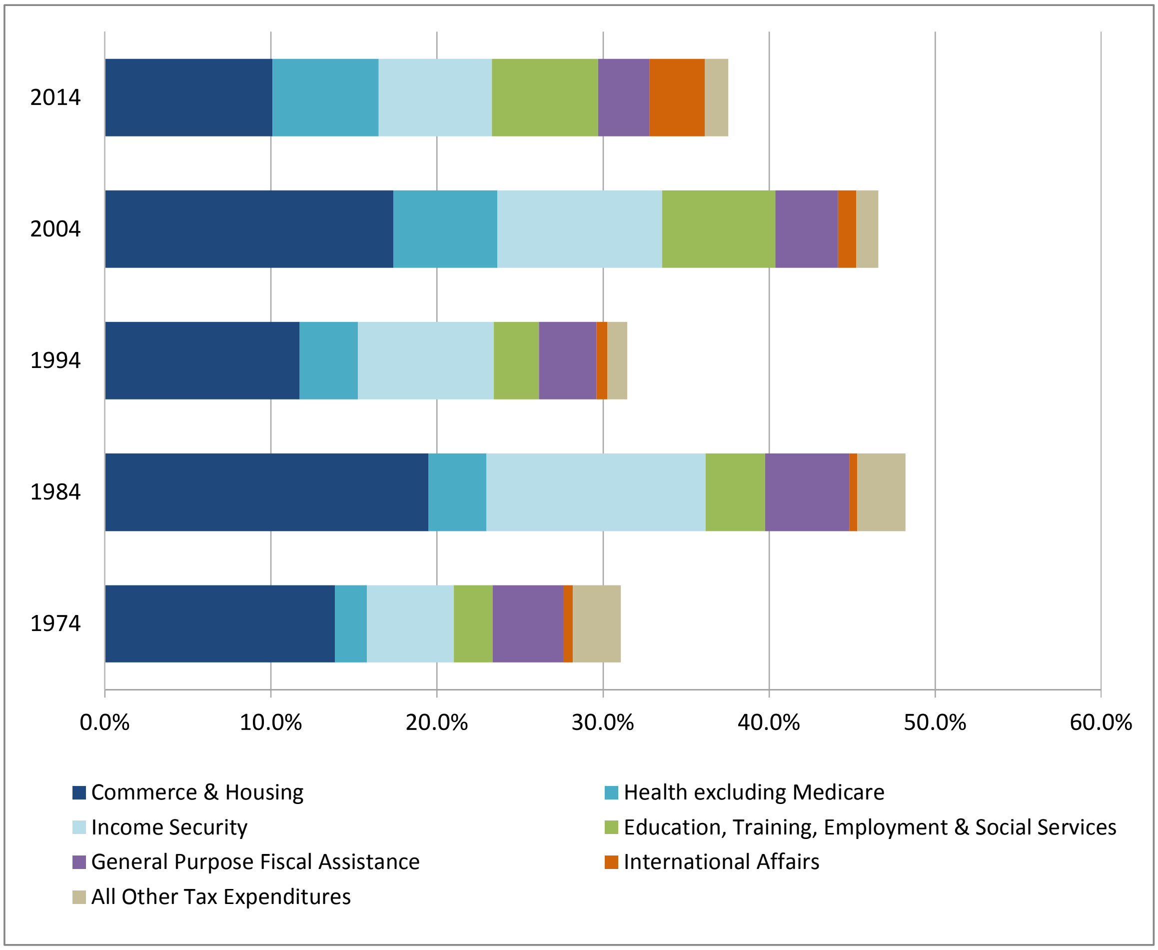
Source: CRS analysis of Office of Management and Budget (OMB) and Joint Committee on Taxation (JCT) documents.

Note: All tax expenditure figures are estimates.

A further way to examine trends in tax expenditures is to decompose them by budget function for selected years. In this manner, any changes in how tax expenditures have been dispersed can be observed. In **Figure 4** and **Figure 5** tax expenditures are presented as a percentage of federal revenue and GDP, respectively, by selected budget categories for the years 1974, 1984, 1994, 2004, and 2014. Over this time period, tax expenditures for health, international affairs, and education appear to have grown significantly. These changes are driven by the growth in the exclusion of employer contributions for health care (health), growth in deferred taxes on active income of controlled-foreign corporations (international affairs), and the enactment of the child tax credit (education).

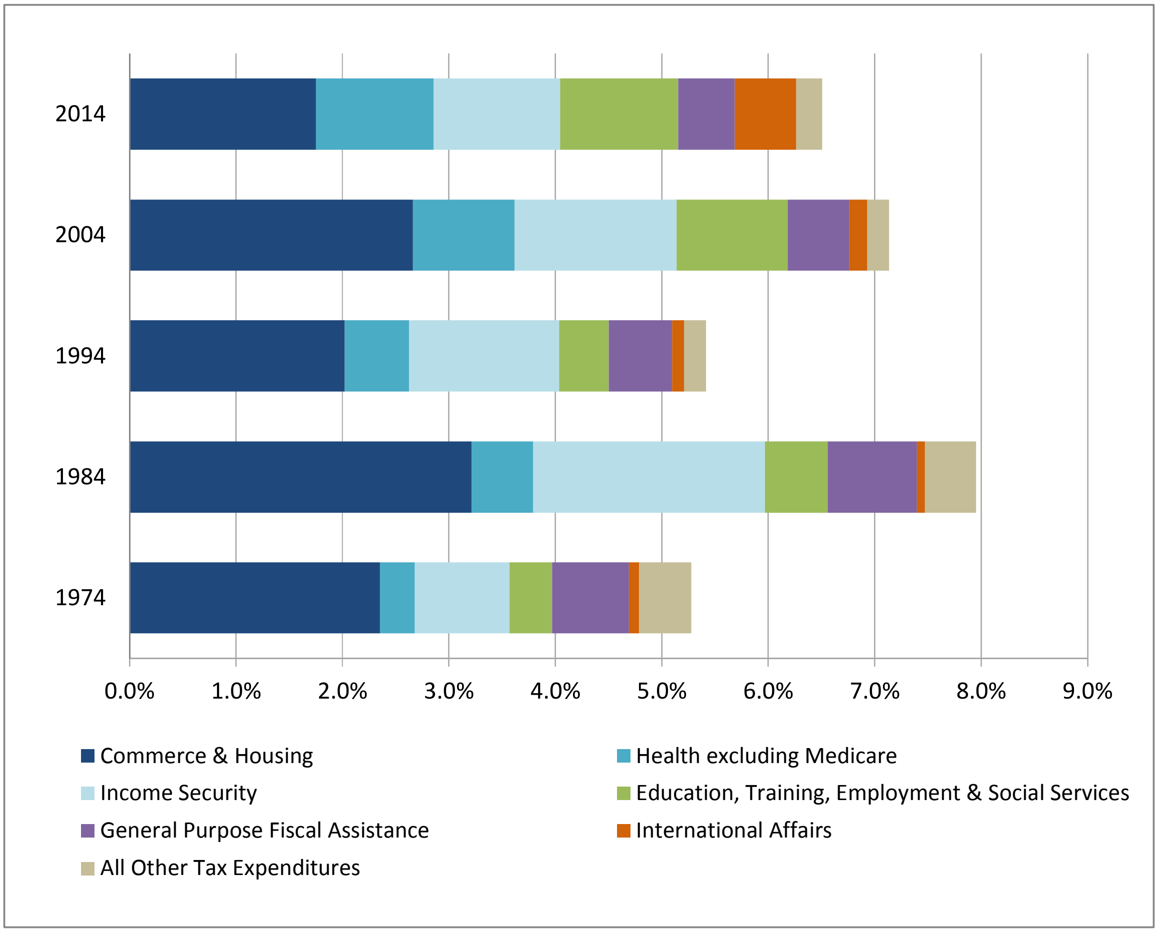
Figure 4.Tax Expenditures as a Percentage of Federal Revenue

by Selected Budget Functions



Source: CRS analysis of Joint Committee on Taxation (JCT) documents.

Figure 5. Tax Expenditures as a Percentage of GDP
by Selected Budget Functions



Source: CRS analysis of Joint Committee on Taxation (JCT) documents.

Challenges to Reforming Tax Expenditures[12]

Broad support appears to exist for base-broadening tax reform, similar to TRA86. However, some obstacles exist that may complicate matters significantly.

Broad Based Solutions May Not Be Feasible or Practical

Some policy analysts have suggested that reforming tax expenditures and broadening the tax base may be accomplished using a selection of across-the-board options.[13] One option that has been

[12] This section is drawn largely from CRS Report R42435, *The Challenge of Individual Income Tax Reform: An Economic Analysis of Tax Base Broadening*, by Jane G. Gravelle and Thomas L. Hungerford.

[13] Daniel Baneman et al., *Curbing Tax Expenditures*, Tax Policy Center, January 2012, http://www.taxpolicycenter.org/publications/url.cfm?ID=412493 and Diane M. Lim, *Limiting Individual Income Tax Expenditures*, Brookings Institution, February 2013, http://www.brookings.edu/~/media/research/files/papers/2013/02/thp%20budget%20papers/thp_15waysfedbudget_prop7.pdf.

mentioned is to convert all tax expenditures into tax credits. Making the credits refundable or converting the provisions using a credit rate less than the top tax rate may be suggested, if the progressivity of the tax system is a concern. While this option may be straightforward to apply to deductions, applying it to exclusions and preferential rates is not so easily accomplished.

A second option discussed is to cap the value of tax expenditures in dollar terms or as a percentage of income. Again, the difficulty in applying this type of limitation occurs with exclusions and preferential rates. Tax expenditures come in multiple forms and apply to numerous activities. According to GAO, as a result "there is not a 'one size fits all' framework for evaluating tax expenditures."[14] Similarly, there appears to be no "one size fits all" reform option.

Some Benefits More Easily Administered as Tax Expenditures than as Spending Programs

One possible criterion for limiting tax expenditures could be to remove social policy from the tax code. In doing so, the tax code would be able to focus on its primary goal—to collect the revenue needed to fund government spending (including for social policy). In some cases, converting tax expenditures into spending programs could be a straightforward process. For example, the deduction for classroom expenses—which allows teachers an above-the-line deduction of up to $250—could be administered as a direct payment made through the Department of Education.

In other cases, however, the process is less straightforward. This is especially true for tax expenditures, such as the Earned Income Tax Credit (EITC) or the deduction for student loan interest, that rely upon information already being collected for tax purposes. Collecting this information independent of the tax code is possible, but such an effort would be duplicative. Further, long-standing concerns about the confidentiality of tax records and information would likely exist even if the information were collected by an agency other than the Internal Revenue Service.[15]

Some Tax Expenditures Promote Desired Activities or Facilitate Compliance

Tax expenditures are sometimes viewed critically because they may change behaviors, resulting in economic inefficiency. However, if the tax expenditure addresses a market failure or achieves a policy goal then a basis for retaining the tax expenditure exists. For example, tax expenditures for retirement savings could be justified on the grounds that they (collectively) increase retirement savings toward the socially optimal level.

In other cases tax expenditures may correct for a market failure by reducing the burden of complying with the tax system. The exclusion of capital gains on owner-occupied housing is an example that could be justified using this approach, as the exclusion eliminates the need for homeowners to maintain detailed records of all home improvements necessary to establish the basis for the home at time of sale.

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[14] U.S. Government Accountability Office, *Tax Expenditures: Background and Evaluation Criteria and Questions*, GAO-13-167SP, November 29, 2012.

[15] Note that §6103 of the Internal Revenue Code expressly states that tax returns and information on them shall be considered confidential information. As a result, requirements to share this data with other government agencies would require modifications and could increase the possibility of taxpayer information being disclosed to the public.

Some Tax Expenditures Aim to Achieve Distributional Outcomes

Tax expenditures have been enacted to achieve a multitude of policy objectives. Those that aim to achieve distributional outcomes are primarily used by low- and middle-income taxpayers. The EITC, child tax credit, and the exclusions of Social Security and Medicare benefits are examples of tax expenditures that target benefits to lower-income individuals and change the distribution of after-tax income.

Some Tax Expenditures Are Difficult to Measure or Administer

Some tax expenditures are difficult to quantify, while others represent income that the taxpayer will not receive during a given tax year. A prime example of these concerns appears with the tax expenditures for pensions. For these provisions, providing a current value may not be possible, as the future value of a pension is based on events that have yet to occur. Other provisions that would face this concern include the exclusion of employer health insurance and the exclusion of Medicare benefits. Together the revenue loss from these three provisions accounts for over 20% of the revenue loss from all tax expenditures.

Some Tax Expenditures Have Broad Based Support

Tax expenditures reduce the taxes owed by a large number of taxpayers each year. For example, nearly a third of taxpayers (31.8%) in 2012 filed a Schedule A to claim itemized deductions, including the mortgage interest deduction and the deduction for state and local taxes.[16] Further, a large number of taxpayers claimed the earned income credit (17.1%), untaxed Social Security and railroad retirement benefits (20.7%), and the child tax credit (22.0%).[17]

In addition to being utilized by significant numbers of taxpayers, many tax expenditures also appear to have broad public support. For example, less than a third of survey respondents support reducing tax rates through an elimination of the deduction for state and local taxes (30%) or charitable deductions (26%).[18]

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[16] Internal Revenue Service, *Individual Income Tax Return Line Item Estimates, 2012*, Publication 4801, October 2014, http://www.irs.gov/pub/irs-soi/12inlinecount.pdf.

[17] U.S. Congress, Joint Committee on Taxation, *Estimates Of Federal Tax Expenditures For Fiscal Years 2014-2018*, committee print, 113th Cong., August 5, 2014, JCX-97-14.

[18] Gallup Poll, April 2011, http://www.gallup.com/poll/147125/Americans-Oppose-Eliminating-Income-Tax-Deductions.aspx.