What Are Tax Expenditures?

Congress uses the tax code to promote a broad range of policy objectives. Rather than directly spend government revenue on policy programs—or implement new regulation—Congress has enacted a series of tax provisions that effectively subsidize certain politically and socially desirable activities.

These “tax expenditures” take the form of deductions, exemptions, or credits to taxpayers who engage in the targeted activity. From a budgeting perspective, they are treated as foregone government revenue, rather than increased government expenditure.

How Big Is the System?

In a word: big. Recent decades have seen an increase in both the overall number of expenditures and, in some cases, the size of existing expenditures, according to the Urban-Brookings Tax Policy Center.¹ The cumulative value of tax expenditures has risen from 4.2 percent of GDP in 1972 to 5.7 percent of GDP in 2006. For fiscal year 2011, the federal budget includes $1.06 trillion in tax expenditures.²

Figure 1
Non-business Tax Expenditures as a Percentage of GDP, 1976-2006

Source: Burman, Toder, and Geissler, 2008


What Do Tax Expenditures Target?

Tax expenditures target a wide variety of policy issues, including housing, health care, national defense, retirement security, education, community development, and the environment. Three of the largest and most well-known tax expenditures are the employer-sponsored insurance exclusion, the home mortgage interest deduction, and the 401(k) plan deferral.

The goals of these “big three” are clear: incentivize employer-provide healthcare coverage, increase homeownership, and encourage saving for retirement (respectively). But the costs are significant: as Figure 2 shows, these three expenditures alone will cost the federal government nearly $4 trillion in foregone revenue over the next five years. The tax expenditures that specifically benefit low-income families and communities are, by comparison, miniscule (see Figure 3).

Figure 2
The Ten Largest Tax Expenditures, 2010 – 2015

<table>
<thead>
<tr>
<th>Tax Expenditure</th>
<th>Projected Foregone Revenue, 2011 – 15 ($ billions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Exclusion of employer contributions for medical insurance premiums and medical care</td>
<td>$ 1,053.79</td>
</tr>
<tr>
<td>Deduction of mortgage interest on owner-occupied homes</td>
<td>$ 637.56</td>
</tr>
<tr>
<td>401(k) plan contributions</td>
<td>$ 360.84</td>
</tr>
<tr>
<td>Deductibility of non-business state and local taxes other than owner-occupied homes</td>
<td>$ 300.06</td>
</tr>
<tr>
<td>Step-up basis of capital gains at death</td>
<td>$ 282.79</td>
</tr>
<tr>
<td>Capital gains (except agriculture, timber, iron ore, and coal)</td>
<td>$ 270.91</td>
</tr>
<tr>
<td>Deductibility of charitable contributions, other than education and health</td>
<td>$ 257.14</td>
</tr>
<tr>
<td>Employer pension contributions</td>
<td>$ 247.48</td>
</tr>
<tr>
<td>Exclusion of net imputed rental income</td>
<td>$ 223.89</td>
</tr>
<tr>
<td>Capital gains exclusion on home sales</td>
<td>$ 215.88</td>
</tr>
</tbody>
</table>

Figure 3
Select Tax Expenditures Benefitting Low-Income Families and Communities

<table>
<thead>
<tr>
<th>Tax Expenditure</th>
<th>Projected Foregone Revenue, 2010 – 14 ($ billions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Earned income tax credit</td>
<td>$ 41.00</td>
</tr>
<tr>
<td>Low-income housing tax credit</td>
<td>$ 36.31</td>
</tr>
<tr>
<td>Exclusion of scholarship and fellowship income</td>
<td>$ 12.22</td>
</tr>
<tr>
<td>Low- and moderate-income savers credit</td>
<td>$ 5.32</td>
</tr>
<tr>
<td>New markets tax credit</td>
<td>$ 3.79</td>
</tr>
<tr>
<td>Work opportunity tax credit</td>
<td>$ 1.82</td>
</tr>
<tr>
<td>Investment credit for rehabilitation of structures (other than historic)</td>
<td>$ 0.15</td>
</tr>
<tr>
<td>Welfare-to-work tax credit</td>
<td>$ 0.02</td>
</tr>
</tbody>
</table>

Source: Analytical Perspectives, 2011.

Who Benefits From Tax Expenditures?

Most tax expenditures—and the largest ones in particular—benefit high-income taxpayers. Burman, Toder, and Geissler (2008) found that eliminating all tax expenditures would reduce the income of the top 1 percent of earners by 13.5 percent, while the income of the bottom 20 percent of earners would decline by just 6.5 percent (see Figure 4).

Figure 4
Distributional Effects of Eliminating All Tax Expenditures, Percent Change in After-tax Income

According to the Center on Budget and Policy Priorities, a public policy organization that studies programs affecting low- and moderate-income Americans, the bottom 20 percent of taxpayers benefit almost exclusively from refundable tax credits (totaling $89 billion in 2007) such as the Earned Income Tax Credit. By contrast, a plurality of the gains from much larger categories, such as exclusions from income ($326 billion in 2007) and itemized deductions ($153 billion in 2007), accrue to the top income quintile.

“The benefits of tax expenditures accrue disproportionately to more affluent citizens and powerful corporations.”

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What’s Wrong With the Current System?

Critics contend that tax expenditures are:

- **Expensive**, depriving the federal government of significant revenue;
- **Regressive**, disproportionately benefitting the wealthy;
- **Distortionary**, altering consumer behavior in inefficient ways;
- **Ineffective**, failing to achieve their stated goals; and,
- **Non-transparent**, immune from the annual budgeting process.

In 2005, President George W. Bush’s Advisory Panel on Federal Tax Reform recommended eliminating many targeted tax breaks, while preserving and simplifying the benefits for home ownership, charitable giving, and health care.

> “Many of these provisions shrink the size of the tax base...require higher tax rates generally to raise the same amount of revenue, and require a more graduated tax rate schedule to achieve a given distribution of the tax burden.”


The “Big Three” Tax Expenditures

Figure 5 illustrates the size of the “big three” tax expenditures: The employer-sponsored health insurance exclusion, the home mortgage interest deduction, and the 401(k) plan deferral. More detail on each of these tax expenditures is provided in the sections below.

**Figure 5**

**How Big are the “Big Three”?**

![Bar chart showing the size of the “big three” tax expenditures](image)

*Source: Analytical Perspectives, 2011*
The Employer-Sponsored Health Insurance Exclusion

Employers pay zero federal income or payroll taxes on payments toward employee health insurance and medical care. This exclusion is one major reason why most Americans—61.8 percent in 2008, according to Congress’ Joint Committee on Taxation (JCT)—are insured through their employer. Moreover, employer insurance contributions are excluded from employees’ taxable wages, even though they technically qualify as compensation.

The insurance premium exclusion is the leading component of a broad system of tax subsidies for healthcare, and the largest single tax expenditure overall. Unlike most other tax expenditures, there is no upper limit on the dollar value of health benefits an employer can provide tax-free. Altogether, healthcare tax expenditures totaled approximately $302 billion in fiscal year 2007 (JCT). However, there is little or no subsidy for insurance purchased outside the employer market, which raises equity issues. The healthcare tax expenditures also distort consumer behavior, potentially leading employers to purchase more insurance than their employees actually need. Moreover, the largest tax savings accrue to employees earning more than $100,000 a year.

Figure 6
Employer Insurance Premium Exclusion: Tax Savings by Income Level, 2007

![Bar chart showing tax savings by income level in millions of dollars.]

Source: Staff of the Joint Committee on Taxation, 2008.

The Home Mortgage Interest Deduction

For taxpayers who own their home and elect to itemize deductions—33.7 percent of homeowners in 2003—the home mortgage interest deduction reduces annual taxable income by the amount of interest paid on a home loan in the given year. Before the Tax Reform Act of 1986, the interest on all personal loans was tax deductible. That legislation narrowed the scope of tax benefits to include only home loans,

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with the policy goal of increasing homeownership. Although homeownership rates did increase from 63.8 percent in 1986 to 69.0 percent in 2004, the increase could be attributable to a number of factors, and the 2003 data show that high-income households benefit disproportionately from the home mortgage interest deduction. Households earning more than $100,000 make up only 8.7 percent of all taxpayers, yet claim 35.5 percent of the tax savings.

Figure 7
The Home Mortgage Interest Deduction: Benefits by Income Level, 2003

<table>
<thead>
<tr>
<th>Adjusted Gross Income</th>
<th>Percent of Home Mortgage Interest Deduction Claimed</th>
<th>Percent of All Tax Returns in Income Group</th>
<th>Average Mortgage Interest Deduction Per Return</th>
<th>Percentage of Returns Claiming Mortgage Interest Deduction</th>
</tr>
</thead>
<tbody>
<tr>
<td>Under $20,000</td>
<td>4.2%</td>
<td>37.8%</td>
<td>$278</td>
<td>4.0%</td>
</tr>
<tr>
<td>$20,000 - $29,999</td>
<td>5.1%</td>
<td>14.1%</td>
<td>$910</td>
<td>13.1%</td>
</tr>
<tr>
<td>$30,000 - $39,999</td>
<td>7.2%</td>
<td>10.7%</td>
<td>$1,674</td>
<td>24.2%</td>
</tr>
<tr>
<td>$40,000 - $49,999</td>
<td>7.9%</td>
<td>8.0%</td>
<td>$2,462</td>
<td>35.2%</td>
</tr>
<tr>
<td>$50,000 - $74,999</td>
<td>21.7%</td>
<td>13.3%</td>
<td>$4,068</td>
<td>50.9%</td>
</tr>
<tr>
<td>$75,000 - $99,999</td>
<td>18.2%</td>
<td>7.3%</td>
<td>$6,210</td>
<td>69.0%</td>
</tr>
<tr>
<td>$100,000 - $199,999</td>
<td>24.4%</td>
<td>6.8%</td>
<td>$8,928</td>
<td>78.9%</td>
</tr>
<tr>
<td>$200,000 and over</td>
<td>11.2%</td>
<td>1.9%</td>
<td>$14,374</td>
<td>75.7%</td>
</tr>
</tbody>
</table>

Source: Prante, 2006

The 401(k) Plan Deferral

Congress also uses tax expenditures to encourage workers to save for their retirement—in particular, by allowing individuals and firms to defer taxation on their contributions to employer-sponsored 401(k) plans. (Participants in 401(k) plans do pay income tax, often at a lower marginal rate, when their retirement savings are withdrawn). In recent years, defined-contribution plans like the 401(k) have replaced traditional defined-benefit pensions as the most common retirement savings mechanism.

According to the Tax Policy Center, the deductibility of employee inputs to retirement savings plans disproportionately benefits higher-income workers, because these workers contribute more and because they deduct their contributions at higher marginal tax rates. By contrast, the tax code provides few incentives for lower-income workers to save—although the Saver’s Credit explicitly targets households with incomes under $50,000, providing about $1 billion in annual tax benefits.

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Figure 8
Defined- Contribution Retirement Plans: Average Cash Savings, 2004

![Graph showing average cash savings by income quintile for defined-contribution retirement plans, 2004.]

Source: Burman, Gale, Hall, and Orszag, 2004.

Why Is Reform so Difficult?

Most budget experts—and many social policy advocates—readily admit the shortcomings of tax expenditures as a policy instrument. Not only have they contributed to America’s sprawling tax code, but the evidence also suggests that tax expenditures disproportionately benefit the wealthy, distort market incentives, cloud important policy debates, and supplant more efficient uses of government revenue.

Nevertheless, reforming tax expenditures has proved formidable for a generation of presidents and policymakers. Reform of any longstanding government program is difficult, but there are several reasons why tax expenditures have been particularly intractable:

- Because tax expenditures are tools for achieving policy goals, rather than goals themselves, debates about their merits are muddled.
- Tax expenditures are popular with both political parties, as they can be marketed as either tax cuts (appealing to many Republicans) or social programs (appealing to many Democrats).
- Many of the policy objectives behind tax expenditures are generally worthwhile and enjoy bipartisan support, even if tax expenditures are not the most effective means of fulfilling those objectives.
- Powerful interests have invested significant resources in maintaining the status quo.

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Because most tax expenditures are available to the middle class, even if they disproportionately benefit the wealthy, they enjoy broad popularity with the public.

What Might Reform Look Like?

Short of eliminating many tax expenditures outright, advocates have proposed reforms including the following:

- Replace deductions and exclusions with tax credits, to increase the benefits for lower-income workers.
- Lower the absolute dollar limit of certain deductions and exclusions, and/or the rate at which they are assessed.
- Increase the scrutiny and transparency of existing tax expenditures.
- Treat tax expenditures more like spending programs in government accounting and the public discourse.

Tax expenditures play a vital role in social policy at the federal level, yet often go unnoticed in public discourse. As policymakers seek novel solutions to pressing social problems amid tighter fiscal times, this trillion-dollar system warrants closer examination.

Daniel Mandel was formerly a Program Associate with the Economic Growth Program and Next Social Contract Initiative at the New America Foundation in Washington, DC. He is currently a student at the UC-Berkeley School of Law.