An Overview of Tax Expenditures

What Are Tax Expenditures?

Tax expenditures, widely known as "tax breaks," are special provisions that reduce the taxes owed by certain individuals and businesses. These preferences come in many forms:

- A deduction, exclusion, or exemption reduces an individual's tax liability by decreasing their taxable income. For example, interest payments on mortgages can be deducted from individuals' total income when calculating taxes owed.
- A deferral shifts tax liability to the future. A worker with a traditional 401(k) retirement account, for example, does not have to pay income tax on their contributions or investment earnings until they start to make withdrawals.
- A preferential rate simply reduces the marginal tax rate on some type of income. Capital gains, for example, are taxed at lower marginal rates than ordinary income—this preferential rate is one of the most expensive tax expenditures.
- Tax credits directly reduce an individual's tax liability by a certain amount. Some credits are refundable—the Earned Income Tax Credit, for example, often decreases the tax burden of low-income workers below zero, meaning they receive a refund from the government.

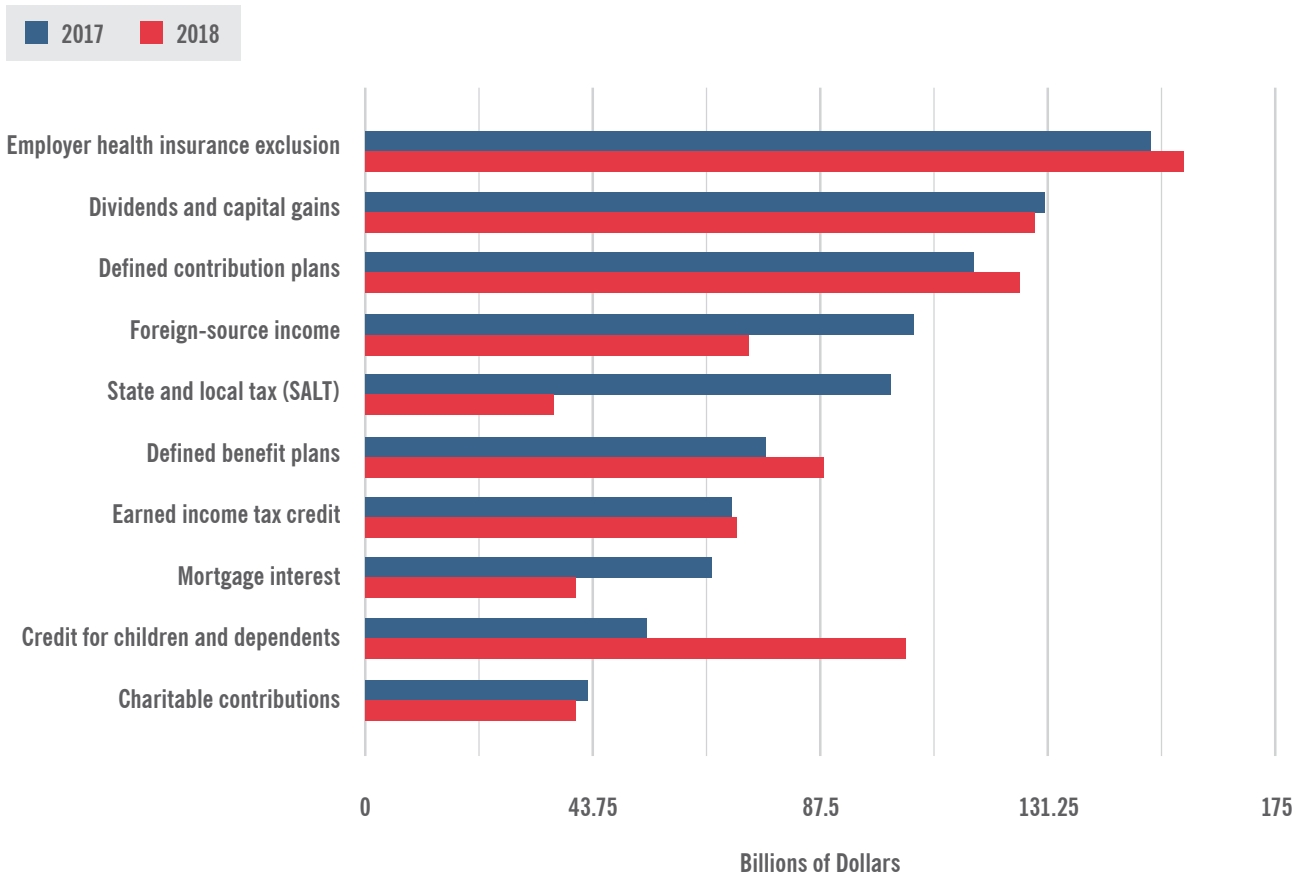
Why Are Tax Expenditures Important?

Tax expenditures affect almost every segment of the economy by changing the financial incentives for individuals, families, and businesses. For example, employer paid health insurance premiums and other medical expenses can be excluded from a business's taxable income, which incentivizes businesses to provide health insurance to their employees. Other tax expenditures make it less costly to support charity, reduce an individual's tax burden if they save for retirement, and provide financial incentives to invest in economically distressed communities, among many other examples.

How Do Tax Expenditures Impact Federal Finances?

More than 150 tax expenditures appear in the U.S. tax code. The Joint Committee on Taxation (JCT) recently released its latest estimates of tax expenditure costs. Those costs reached a total of $1.5 trillion in Fiscal Year 2017, and exceeded total federal discretionary spending of $1.2 trillion. The chart below shows cost projections of the 10 largest tax expenditures for Fiscal Years 2017 and 2018 after the passage of the Tax Cuts and Jobs Act.

Figure 1: 10 Largest Tax Expenditures



Source: BPC analysis of Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2017-2021* (JCX-34-18), May 25, 2018.

How Has the Recent Tax Bill Affected Expenditures?

Although simplifying the tax code by reducing tax expenditures has often been a goal of tax reform, JCT projects that the Tax Cuts and Jobs Act of 2017 will only briefly restrain tax expenditure growth.

That new tax law has several provisions to limit the growth of tax expenditures—repealing and capping certain deductions such as the SALT and mortgage interest deductions (see chart above), increasing the standard deduction, and cutting some income tax rates. It also has provisions that expand or create new tax expenditures, such as business expensing of equipment. JCT projects that total tax expenditures will drop slightly between Fiscal Years 2018 and 2019, before increasing once again in 2020.

Building Evidence on the Effectiveness of Tax Expenditures

Tax expenditures are written into law to achieve a policy goal, such as increasing savings for retirement or improving access to higher education, so their progress in achieving those goals should be systematically evaluated. Developing more evidence would help to determine whether federal policies are achieving the goals the public expects.

How Are Tax Expenditures Reviewed and Evaluated?

Tax expenditures benefit from a variety of formal review processes in Congress and the executive branch, but are only sometimes formally evaluated to determine whether the tax expenditure meets its intended goal.

In the executive branch, tax expenditures are administered by the Internal Revenue Service (IRS), which devotes its efforts mostly to tax compliance, rather than evaluating expenditures for effectiveness related to their policy goals. However, existing research on tax expenditures is reviewed annually by the White House Office of Management and Budget and the White House National Economic Council to identify possible reforms to the tax code as part of the budget. This review is used as the foundation for the president's annual tax proposals which are incorporated into the president's budget, known informally as the "Greenbook." This process does not directly lead to production of new evidence on tax expenditures, as the process relies on existing evidence.

In practice, the U.S. Treasury Department's Office of Tax Policy, other agencies, and non-governmental researchers do sometimes carry out evaluations of specific expenditures. For example, a large body of research has been compiled on the Earned Income Tax Credit. The majority of tax expenditures, however, are not regularly evaluated, nor even subject to basic performance monitoring. A Government Accountability Office (GAO) review found that, of more than 150 tax expenditures examined, agencies identified only 11 as contributing to their missions and have specified performance measures for only three. Because tax expenditures operate passively through the tax code, rather than being administered by the relevant agency, there is little incentive for those agencies to spend time and resources examining them.

In the legislative branch, the Congressional Research Service conducts a regular review of individual tax expenditures every two years, which includes a basic description of each expenditure as well as a brief overview of existing research on its impacts and arguments in support and opposition. In addition, GAO sometimes conducts reviews of tax expenditures at the request of Congress.

When expenditures are evaluated, government does not currently have formal processes to make the results of those evaluations readily available. While both the Treasury Department and JCT release annual reports on the revenue impacts of tax expenditures, neither report includes summaries of completed evaluations of whether they are achieving their policy goals.

What Barriers Exist to Evaluating Tax Expenditures?

Agencies have limited ability to systematically evaluate tax expenditures, in part due to an inability to access relevant data.

Agencies that do not collect their own data on tax expenditure use might be hard-pressed to evaluate them. Access to federal tax information is tightly controlled by the IRS, including data on individual tax expenditure use. IRS is permitted by law to grant access to data for tax administration purposes, though in practice approved uses have been restricted for federal agencies and non-governmental researchers alike.

Beyond challenges accessing existing data for evaluating expenditures, sometimes the data that would be needed for evaluation are not even collected by the IRS. The GAO found that, in tax year 2011, two-thirds of tax expenditures did not appear on a tax form or did not have their own line. For example, the exclusion of interest on life insurance savings is not reported on any tax form, and the credit for holding clean renewable energy bonds is aggregated with several other credits on a single line item; these expenditures cannot be specifically identified in IRS data. These unidentifiable expenditures are not insignificant—the GAO estimated that they accounted for $492 billion out of $993 billion of total tax expenditure spending in Fiscal Year 2011. Data gaps can be addressed through surveys or estimated from other administrative records, though doing so can introduce reliability and validity concerns.

How Can the Evidence on Tax Expenditures Be Increased?

Numerous proposals exist for improving the transparency and oversight of tax expenditures. GAO laid out several possibilities for increasing oversight of tax expenditures in the budget process.

Increasing government-generated evidence would increase the accountability and transparency for all government activities, including tax expenditures. The U.S. Commission on Evidence-Based Policymaking's final report included recommendations that would enhance the ability of both agencies and non-governmental researchers to build evidence about government activities. These reforms to better promote evidence building would help ensure the information is available to improve accountability and transparency of tax expenditures.