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NEW ANALYSIS SHOWS “TAX EXPENDITURES” OVERALL ARE COSTLY AND REGRESSIVE

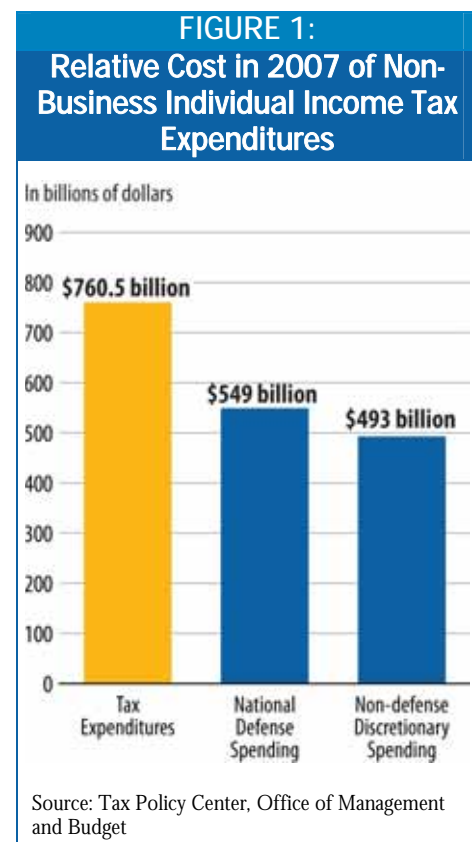
Findings Highlight Need to Restrain Tax Subsidies
As Part of Solution to Long-Term Budget Problems

by Chye-Ching Huang and Hannah Shaw

“Tax expenditures” for individuals totaled about \$760.5 billion in 2007, topping what the federal government spent on either national defense or all non-defense discretionary programs, a new analysis by the Urban Institute-Brookings Institution Tax Policy Center (TPC) shows.¹

In most cases, these tax expenditures are also regressive — that is, they benefit high-income taxpayers the most. In light of their high cost and regressive nature, they should be “on the table” when efforts to address the nation’s long-term budget problems are mounted.

The tax code is packed with scores of tax breaks that favor particular activities, such as tax-free employer contributions for health insurance, mortgage interest deductions for owner-occupied homes, and lower tax rates for capital gains and dividends. The Office of Management and Budget (OMB) and the congressional Joint Committee on Taxation (JCT) refer to these tax breaks or subsidies as “tax expenditures” because they essentially represent spending accomplished through the tax code. Former Federal Reserve Chair Alan Greenspan has termed these measures “tax entitlements.”



¹ TPC’s \$760.5 billion figure excludes benefits for business income claimed by individuals. This figure also assumes that the 2007 alternative minimum tax was in affect, but did not reflect the AMT “patch” that was enacted in 2007. TPC estimated the total cost of tax expenditures both with and without the AMT because the AMT limits and disallows some tax expenditures, which can complicate comparisons of costs of tax expenditures. See Leonard Burman, Eric Toder, and Christopher Geissler, “How Big Are Total Income Tax Expenditures, and Who Benefits from Them?” Tax Policy Center, December 2008, http://www.taxpolicycenter.org/UploadedPDF/1001234_tax_expenditures.pdf.

\$760.5 Billion Estimate Does Not Include Tax Expenditures for Businesses

At \$760.5 billion, TPC's estimate of the cost of individual income tax expenditures in 2007 makes them more expensive than the \$549.2 billion the federal government spent in fiscal year 2007 on national defense and the \$493 billion it spent on non-defense discretionary programs.

TPC also notes that if individual tax expenditures were counted as federal spending, total spending in the budget would be about 30 percent higher than what OMB reports.²

TPC's estimate of individual income tax expenditures, however, is less than the *total* budgetary impact of tax expenditures because TPC's estimate does not include tax expenditures for businesses.³ The JCT estimates that business tax expenditures will equal at least \$105 billion in 2008.⁴

Biggest Benefits Go to Upper-Income Taxpayers

Percent Change in After-Tax Income due to Tax Expenditures, 2007 (with no AMT)*							
	Tax Exclusions	Lower capital gains and dividends rates	Itemized deductions	Above-the-line deductions	Non-refundable credits	Refundable credits	All provisions
Bottom 20 percent	0.54%	0.00%	0.02%	0.01%	0.05%	5.81%	6.97%
Second 20 percent	3.08%	0.01%	0.11%	0.06%	0.28%	5.26%	8.89%
Middle 20 percent	3.94%	0.04%	0.38%	0.09%	0.33%	2.25%	7.25%
Fourth 20 percent	3.82%	0.12%	1.10%	0.11%	0.23%	1.00%	7.28%
Top 20 percent	4.98%	2.16%	3.00%	0.08%	0.06%	0.25%	12.82%
Total Cost (no AMT)	\$326 billion	\$99 billion	\$153 billion	\$6.6 billion	\$11.3 billion	\$89 billion	\$746.7 billion
Total Cost (with AMT)	\$344 billion	\$96 billion	\$154 billion	\$6.4 billion	\$8.2 billion	\$89 billion	\$760.5 billion

Source: Center on Budget and Policy Priorities calculations based on TPC calculations of effect of eliminating tax expenditures.

*Note: These figures take into account the interaction among individual tax expenditure provisions. They are based on the distribution of tax expenditures under the assumption that the alternative minimum tax is not in place, an assumption TPC made in order to facilitate the comparison among categories of tax expenditures.

² Burman *et al.*, page 4.

³ TPC was not able to model all individual income tax expenditures, and the tax expenditures left out of the analysis — such as capital gains exclusions on house sales — likely account for about 10 percent of total individual income tax expenditures. TPC's estimate includes interaction efforts among different tax expenditure measures. Due to those interactions, the \$760.5 billion *total* cost of individual tax expenditures exceeds by about 8 percent the sum of each of these tax expenditures on its own.

The TPC estimates cited in this paper are for 2007, but assume that no AMT "patch" was enacted for 2007 (although such a patch was eventually enacted).

⁴ "Estimates of Federal Tax Expenditures for Fiscal Years 2008-2012," Joint Committee on Taxation, October 31, 2008. This figure was calculated by summing expenditures categorized by JCT as "Business Synthetic Spending" that were not included in the TPC analysis. This total does not include the cost of business tax expenditures of less than \$500 million, because those costs are not reported by JCT. This estimate does not consider interaction effects among various business tax expenditures or interactions between business and individual tax expenditures.

Overall, tax expenditures are regressive, the TPC analysis shows. Moreover, almost all of the increases in after-tax income that the bottom 20 percent of taxpayers do receive from tax expenditures come from a single category of tax expenditures: refundable tax credits like the Earned Income Credit.

The TPC report examines the cost of tax expenditures in each of six categories, as well as which taxpayers (by income group) receive the benefits of the tax breaks in each category:

- *Exclusions from income*, such as for earnings from retirement plans. This is by far the most expensive tax expenditure category, accounting for \$325.5 billion of the \$746.7 billion total (without the AMT). Taxpayers in the top 20 percent of the income distribution gain more from this category of tax expenditures as a percentage of their income than does any group of taxpayers in the income distribution.
- *Lower tax rates on capital gains and dividends* than on ordinary income. People at the top of the income scale receive significantly larger gains as a share of income from this group of tax expenditures than other taxpayers. “Lower tax rates on capital gains and dividends disproportionately benefit the top 1 percent of taxpayers and provide little income gains for anyone else,” TPC notes. This group of tax expenditures cost \$99 billion, with no AMT.
- *Itemized deductions*, such as for home mortgage interest. This category of tax expenditures is the second most expensive — it cost \$153.2 billion in 2007 without the AMT— and is highly regressive. The top 20 percent of taxpayers again see their after-tax income rise by a much larger percentage than any other group.
- *Above-the-line deductions*, such as for interest on student loans. These are deductions available to filers even if they do not itemize deductions. Above-the-line deductions provide a much larger boost in after-tax income to the top 20 percent of taxpayers than to the bottom 20 percent of taxpayers, but this category is small (\$6.6 billion with no AMT).
- *Non-refundable tax credits*, such as the credit for child and dependent care expenses. The modest increases in after-tax income from these tax

TPC Tax Expenditure Categories
<p>Exclusions</p> <ul style="list-style-type: none"> Interest on life insurance savings Contributions and earnings for retirement plans Interest on tax-exempt bonds Employer contribution for medical insurance Social Security and railroad retirement benefits Veterans' benefits
<p>Above-the-line Deductions</p> <ul style="list-style-type: none"> Deductibility of student loan interest Self-employed medical insurance premiums Additional deduction for the blind and elderly
<p>Lower Capital Gains and Dividends Rates</p> <ul style="list-style-type: none"> On long-term capital gains On qualifying dividends
<p>Itemized Deductions</p> <ul style="list-style-type: none"> Mortgage interest on owner-occupied homes State and local taxes Charitable contributions Casualty losses Medical expenses
<p>Non-refundable Credits</p> <ul style="list-style-type: none"> HOPE tax credit Lifetime learning tax credit Credit for child and dependent care expenses Low- and moderate-income saver's credit
<p>Refundable Credits</p> <ul style="list-style-type: none"> Child Tax Credit Earned Income Tax Credit
<p>Tax Benefits Not Included in the TPC Analysis</p> <ul style="list-style-type: none"> Capital gains exclusion on home sales Step-up in basis of capital gains at death Exclusion of employee parking expenses Transit passes Employer-provided child care Deductions for higher education expenses

expenditures (\$11.3 billion in 2007 with no AMT) are highest for the middle 60 percent of taxpayers.

- *Refundable tax credits.* In 2007 there were two such credits: the Earned Income Tax Credit and the (partially refundable) Child Tax Credit. This is the only category of individual tax expenditures that is aimed primarily at low- and moderate-income taxpayers. The bottom 40 percent of taxpayers receive much larger gains as a share of income than other taxpayers. The benefits of refundable credits totaled \$89 billion in 2007 without the AMT.⁵

Tax Expenditures Should Be Part of Long-Term Budget Solution

The United States faces serious long-term fiscal problems. If we maintain current tax and spending policies, expenditures are projected to rise significantly as a share of GDP over the next several decades while revenues will fall, driving federal deficits and debt to unprecedented levels that will threaten serious harm to the economy. Under current policies, the federal debt will skyrocket from about 46 percent of the Gross Domestic Product at the end of fiscal 2009 to about 280 percent of GDP in 2050, according to an analysis that the Center on Budget and Policy Priorities issued in December 2008. That would be more than two and a half times the existing record, set when the debt reached 110 percent of GDP at the end of World War II.⁶

Policymakers will need to make tough choices to avert those large deficits. Given the magnitude of the problem, sacrifices will be needed on both the tax and spending sides of the budget. Closing the long-term budget gap entirely through program reductions, for example, would require the equivalent of an immediate and permanent 20 percent reduction in spending for all federal programs, including Social Security, veterans' benefits, environmental protection, education, health care programs, defense, anti-terrorism efforts, and assistance for the poor.

Some have suggested unbalanced proposals that would impose what could be austere limits on programs such as Social Security and Medicare without restraining the growth of tax expenditures. Such an approach would be unwise. Giving a free pass to the hundreds of billions of dollars in what is essentially entitlement spending delivered through the tax code would significantly weaken efforts to curb deficits.⁷

Exempting tax expenditures from fiscal discipline also would be inequitable. As the TPC analysis shows, tax expenditures deliver their largest benefits to upper-income families. In contrast, Social Security and Medicare benefits are spread far more evenly across the population. Protecting tax expenditures while imposing significant cuts on other parts of the budget would likely favor the well-off at the expense of the broad majority of Americans. It also would necessitate even deeper reductions in other parts of the budget than would otherwise be needed to restore fiscal stability.

⁵ The Tax Policy Center estimates that the tax provisions in the recently enacted American Recovery and Reinvestment Act are more progressive than the tax expenditures addressed in this paper, but the Recovery Act provisions are temporary.

⁶ Richard Kogan, Kris Cox, and James Horney, "The Long-Term Fiscal Outlook Is Bleak," Center on Budget and Policy Priorities, December 16, 2008, <http://www.cbpp.org/12-16-08bud.htm>.

⁷ See "A Balanced Approach to Restoring Fiscal Responsibility," July 2008, <http://www.cbpp.org/7-9-08bud.pdf>.