Six Principles for Tax Expenditure Reform

Common-Sense Guidelines for Policymakers as They Tackle Badly Needed Reform of Hidden Tax Code Spending

By Seth Hanlon

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The federal government spends more than $1 trillion every year through special provisions of the Internal Revenue Code. Called tax expenditures, these provisions have generally received far less scrutiny than other forms of government spending, partly because they are hidden in the tax code. At long last, policymakers focused on deficit reduction are discovering that tax expenditures can no longer be ignored if the United States is to achieve fiscal sustainability over the long term.

“Tax expenditure” is the technical term for special tax breaks that come in the form of exclusions, deductions, credits, preferential rates, or deferrals of tax liability. They are called expenditures because they are functionally the same thing as direct government spending, as economists have long recognized. If the government subsidizes an activity by spending money on it directly, or by carving out a special tax break for it, the effect is the same.

Individual and corporate income tax expenditures, measured by the size of the revenue loss to the federal government, add up to about $1.1 trillion. That’s about three-quarters of the amount the federal government will actually collect in income taxes this year. And it’s about twice the budget for all federal “domestic discretionary” spending, which funds critical public investments and services including transportation and infrastructure, public health and medical research, education, housing, environmental protection, food and drug safety, law enforcement, and veterans services.

![Figure 1: Major categories of federal spending, fiscal year 2010](source: Budget of the United States Government, Fiscal Year 2012, Tables S-4 and 17-1.)
Domestic discretionary spending has been hit hard by recent budget cuts. Congress in April chopped the budget authority for this category by $39 billion in fiscal year 2011, a 7 percent cut from last year’s levels. And in the recent agreement that ended this summer’s debt limit crisis, President Barack Obama and Congress cut nearly an additional $1 trillion from discretionary spending over the next 10 years, with the heaviest cuts in the nondefense category.

Under the so-called super committee’s mandate, the next round of deficit reduction can come from any source. And so it is appropriate that tax expenditures be on the table in the super committee’s deliberations and in future budget debates. It’s just as important that policymakers get it right when it comes to achieving deficit reduction through tax expenditure reform. This issue brief offers six principles intended to guide them:

• Tax expenditures are spending.

• Like all forms of spending, tax expenditures should be assessed for cost effectiveness.

• “Upside-down” subsidies should be made more fair and better targeted.

• Eliminating tax expenditures benefiting seniors living on Social Security, working families, and people with very low incomes would be misguided.

• The tax code should be scrubbed of ineffective business subsidies.

• Common-sense, fiscally responsible reforms to tax expenditures do not have to wait for comprehensive tax reform.

Tax expenditures are spending

Proposals to curtail tax expenditures, including President Obama’s, are often widely reported as “tax increases.” But economists across the ideological spectrum have long recognized that tax expenditures are really just government spending that happens to be delivered through the tax code.

If the mortgage interest deduction, for example, were administered by the Department of Housing and Urban Development, and it operated by sending homeowners checks that match a portion of their interest payments, it would be considered a spending program. But because the mortgage interest deduction is actually administered by the IRS and subsidizes homeownership through targeted tax benefits, it is accounted for in the federal budget as a tax reduction.

The distinction is mainly one of form, not substance, and it shouldn’t guide policymaking.
This point was underscored by a panel of prominent economists and tax experts testifying before the Senate Finance Committee on September 13. As former Federal Reserve Board Chairman Alan Greenspan told the senators:

>Cuts in tax expenditures can be alternatively structured, and viewed, as cuts in outlays rather than a reduction in revenues. The deduction for interest on home mortgages, for example, could just as easily have been reconstituted as a subsidy payment to homeowners. Similarly, oil and gas depletion allowances could be restructured as subsidies to producers.

President Ronald Reagan’s chief economic advisor, Martin Feldstein, likewise testified that when tax expenditures are reduced, “the economic effect is the same as any other reduction in government outlays.” And Edward Kleinbard, former director of Congress’s Joint Committee on Taxation, explained that “deliberate Congressional subsidy programs baked into the tax code … are a form of government spending, not tax reductions.”

Once you recognize that tax expenditures are simply a hidden form of spending, it makes no sense to slash federal programs and entitlements while leaving tax expenditures off the table.

This is especially true because the Budget Control Act, enacted in August, subjects other crucially important federal programs to significant cuts in the coming years. Caps imposed by the Budget Control Act will cut discretionary spending by nearly $1 trillion over the next 10 years. The result is that discretionary spending would decline from 9 percent of gross domestic product, or GDP, to about 6.2 percent by 2021, which, as Congressional Budget Office Director Douglas Elmendorf notes, is “well below the 8.7 percent average over the past 40 years.” With discretionary spending already subject to these caps, future deficit reduction must be balanced across the federal budget, including on the revenue side of the ledger. To be sure, the best and most straightforward way to raise significant revenue might simply be to allow the Bush tax rate cuts for top income earners expire on schedule at the end of 2012. But even those who are adamant about keeping all tax rates where they are now should be open to reducing hidden tax code spending.

That doesn’t mean tax expenditure reforms need to happen now. The top priority today should be job creation, not deficit reduction. And overly severe cuts to tax expenditures, like all fiscal contraction, should be avoided in the near term while the economy struggles to recover. But lawmakers should pursue an approach that gradually reforms or phases out ineffective tax expenditures.
Like all forms of spending, tax expenditures should be assessed for cost effectiveness

When the government delivers tax preferences to certain taxpayers, it increases the burden on all other taxpayers (or, given today’s deficits, on future taxpayers). Congress must therefore exercise just as much diligence with tax expenditures as it does with federal programs that spend money directly.

That means that each tax expenditure should be evaluated for cost effectiveness. As with direct government spending programs, some tax expenditures are more effective than others. Some are vitally important and some are wasteful or poorly designed. Some help low-income families work their way out of poverty, while others pad the profits of the largest companies in the world. We must distinguish meritorious tax expenditures from wasteful ones.

And yet the $1 trillion in annual tax expenditure spending is rarely reviewed for effectiveness. Most tax expenditures are permanent fixtures of the tax code, and some have long outlasted their original purpose. Even tax expenditures that have expiration dates are typically renewed every year by Congress in the so-called “extenders” package with much less scrutiny than is given to direct spending in the appropriations process.

In CAP’s 2010 report “Government Spending Undercover,” Lily Batchelder and Eric Toder detailed a framework for evaluating tax expenditures. They suggested four fundamental questions that policymakers should consider in deciding which “IRS-administered spending programs” to keep and which ones to cut:

- What goals does the program potentially seek to achieve, if any?
- Do these goals remain worthy of taxpayer support and if so, how much?
- Within this budget constraint is the program structured as effectively as it could be in order to achieve its objectives?
- If not, how could it be restructured to maximize its effectiveness?

If Congress regularly sought answers to these questions, the tax expenditure budget could be made much more efficient, reducing the deficit by billions.

“Upside-down” subsidies should be made more fair and better targeted

Though each tax expenditure should be evaluated on its own merits, a large number of tax expenditures share a common design flaw that reduces their cost effectiveness. Tax expenditures that aim to provide incentives through tax exclusions or deductions are often poorly targeted because of the so-called “upside-down” effect. That is, they tend to provide the largest government subsidies to those who need them the least while providing little or no benefit to those who could use them the most. This happens because deductions and exclusions are more valuable to those in higher tax brackets.
A prototypical example is the mortgage interest deduction. This $100 billion tax expenditure, whose purpose is promoting homeownership, is undermined by its unfair and inefficient design.

Consider: If a family in the 15 percent tax bracket (with taxable income between $17,000 and $69,000) claims the deduction, the government essentially matches 15 cents for every dollar in mortgage interest paid. Thus, a family with $65,000 in income and $10,000 in mortgage interest would derive $1,500 in savings from the mortgage interest deduction.

But for a family in the highest 35 percent tax bracket (with taxable income of $379,150 or above), the government matches 35 cents for every dollar in mortgage interest. So a family with $500,000 in income and $40,000 in mortgage interest derives $14,000 in tax savings—nearly 10 times as much in dollar terms, and more than twice as much as a percentage of each household’s mortgage interest expense. (see table above)

This is a simplified example, but it illustrates the “upside-down” dynamic that contributes to the mortgage interest deduction being 10 times more valuable in dollar terms for the average high-income family than the average middle-income family. A similar effect happens with other tax expenditures, including retirement and education savings incentives and the charitable deduction. (see figure 2 at right)

Besides being unfair, upside-down tax expenditures are also inefficient. They give the biggest subsidies to the people who would most likely take the desired action—buy a house, save disposable income—even without the incentive.

There are two ways of addressing the upside-down effect, one incremental and one more comprehensive. Let’s take them in turn.

The incremental approach is to cap deductions at a certain amount, for example at 28 percent, as President Obama has proposed in his annual budgets and the American Jobs Act as proposed in September. The 28 percent proposal reduces the upside-down effect of the mortgage interest deduction and other tax code subsidies by limiting the value of the benefit to what taxpayers in the 28 percent tax bracket receive. It wouldn’t affect the middle-income family in the example above—in fact, the proposal expressly exempts all households with adjusted gross income under $200,000 ($250,000 for couples), very

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**Figure 2**

**The upside-down effect of itemized deductions**

<table>
<thead>
<tr>
<th>Percent increase in after-tax income from itemized deductions</th>
<th>Bottom 20%</th>
<th>Second 20%</th>
<th>Middle 20%</th>
<th>Fourth 20%</th>
<th>Top 20%</th>
<th>Top 1%</th>
</tr>
</thead>
<tbody>
<tr>
<td>In percent</td>
<td>0.5</td>
<td>1.0</td>
<td>1.5</td>
<td>2.0</td>
<td>2.5</td>
<td>3.0</td>
</tr>
</tbody>
</table>

Source: [http://www.urban.org/UploadedPDF/1001234_tax_expenditures.pdf](http://www.urban.org/UploadedPDF/1001234_tax_expenditures.pdf) (table 2, with interactive effects)
few of whom are in tax brackets higher than 28 percent in any event. The wealthier family in our example above would still be entitled to a large mortgage interest deduction, but the value of that deduction would be limited to 28 percent of the $40,000 it pays in mortgage interest, or $11,200.7 That’s still a much bigger housing subsidy than the middle-income family receives, even measured per dollar of mortgage interest. Yet the 28 percent proposal would be much fairer than existing law and raise significant revenue.8

Of course, 28 is not a magic number. Congress could raise revenue even by simply keeping the maximum value of itemized deductions at the current 35 percent while allowing the top tax rate to revert to the Clinton-era 39.6 percent, as it is scheduled to do in 2013. That option would keep the marginal incentive provided by itemized deductions for top-bracket taxpayers (including for mortgage interest and charitable giving) exactly where they are now.

The more comprehensive way to improve the fairness and cost efficiency of tax expenditures is to transform them into flat credits. Credits are better targeted because they give the same benefit, per dollar of expense, to taxpayers in all brackets. The Center for American Progress, in its recent long-term balanced budget plan, “Budgeting for Growth and Prosperity,” proposed to transform deductions for mortgage interest, charitable deductions, and retirement savings into flat credits over time.

The report of the co-chairs of the president’s deficit commission (known as “Bowles-Simpson”) likewise proposed to turn itemized deductions into 12 percent tax credits, matching the bottom-bracket tax rate under the co-chairs’ “illustrative” plan.9 That is, if you pay $1,000 in mortgage interest, you could reduce your tax bill by $120, regardless of your tax bracket. This would give the same tax benefit to families in the lowest tax bracket as to all other families. The Bipartisan Policy Center’s Debt Reduction Task Force would similarly replace itemized deductions with 15 percent refundable tax credits. (A “refundable” credit means it can also benefit people with no federal income tax liability.)

• Eliminating tax expenditures benefiting seniors living on Social Security, working families, and people with very low incomes would be misguided.

Stirred up by the pernicious myth that many Americans have no “skin in the game” because they don’t pay taxes, some have suggested that a central goal of tax code reform should be increasing the number of households that have federal income tax liability in any given year. (see box on page 8)

Presidential candidate Jon Huntsman, for example, recently proposed to sweep away all tax expenditures on the theory that “the tax burden is carried by too few.” This confuses the desirable goal of broadening the income tax base with the misguided notion that everyone, every year, should owe federal income taxes in addition to the taxes they already pay.
In fact, the kinds of people who have federal income tax liability in any particular year tend to be seniors living on Social Security, working families with children, and people with very low incomes (including the unemployed, disabled, and full-time students).

These people are among the least able to afford to pay more in taxes. But if you start with the misdiagnosis that they don’t pay enough in taxes, then your misguided remedy would be to target tax expenditures that benefit them. These include, most prominently:

- **Tax exclusion of Social Security benefits.** Most Social Security benefits are excluded from federal income taxes, and this treatment is considered a tax expenditure. For example, a retired couple receiving the average annual Social Security benefit of $22,884 would currently owe no federal income taxes unless they had a substantial amount of other income (which most seniors do not).\(^{10}\) A full 93 percent of the benefit of the nontaxation of Social Security benefits accrues to households with incomes under $75,000. The largest benefit, as a share of income, goes to households earning between $20,000 and $50,000 in income.\(^{11}\) These households would be hit hardest if this tax expenditure were eliminated.

- **Earned income tax credit.** The EITC is a refundable tax credit for low-income working individuals and families. It is designed to encourage work while offsetting the impact of income, payroll, and other taxes as well as the cost of child care. It is one of the federal government’s most successful initiatives to enable low-income workers to join the workforce and reduce welfare reliance, which is why it has historically enjoyed very broad bipartisan support. President Reagan called it the “best anti-poverty, the best pro-family, the best job creation measure to come out of Congress.” The EITC lifted 5.4 million people out of poverty in 2010, including 3 million children.

- **Child tax credit.** Enacted under President Clinton and expanded under Presidents George W. Bush and Obama, the child tax credit lowers the tax burden for families raising children. It provides a partially refundable tax credit for low- and middle-income families of up to $1,000 per child. In recognizing that families with more mouths to feed have greater financial burdens, the child tax credit furthers the ideal of a tax system that is based on ability to pay. The refundable aspect of the child tax credit enables low-income families to benefit while also encouraging work; because its benefits are phased in with earned income, you have to work to claim it.

Slashing these tax expenditures would create enormous hardship for seniors and working families. While they have the effect of pushing some people off the federal income tax rolls (people who would owe only a little income tax anyway), it’s critical to remember that on the whole, tax expenditures provide much bigger benefits to high-income households, both in absolute dollar terms and relative to their incomes, largely because of the upside-down problem discussed above.\(^{12}\) Reducing or eliminating broad-based tax expenditures benefitting low- and moderate-income families would make the tax code less fair, not more.
Debunking the myth of the “nontaxpayer”

**Fact No. 1: All Americans pay taxes**

The federal income tax is only one part of an overall tax system supporting government services at federal, state, and local levels. The federal income tax raises only about 30 percent of all tax revenue, and only 45 percent of federal tax revenue. The idea that some households pay “no taxes” is simply false because it ignores all other taxes, including payroll, sales, corporate income, property, and excise taxes.

Taking these taxes into account, all households pay taxes. Everyone has “skin in the game.” Even the poorest one-fifth of Americans, with incomes averaging $12,500 per year, paid about one-sixth of their extremely modest incomes in taxes in 2010, on average. The next-poorest group, with incomes averaging $25,300, paid more than one-fifth of their income in taxes. And no one is getting skinned. The most fortunate 1 percent, with average incomes of $1.25 million, pay 30 percent of their income in taxes—not much more than the 25.1 percent paid by those in the middle.¹³

**Fact No. 2: The federal income tax was never supposed to be paid by every American every year**

Though all households pay a significant amount in taxes every year, not every household pays every kind of tax every year. The federal income tax is not intended to be a per-person “head tax.” It raises revenue based on ability to pay. By the very nature of an income tax, people tend to pay it during their prime income-earning years—not in years when they are in school, out of work, or retired. And because people with low levels of income have the least ability to pay federal income taxes, they generally aren’t required to do so. This is by design, and it is not an “injustice.” In fact, while many conservatives today seem to want to shift more of the tax burden down the income ladder, both President Ronald Reagan and President George W. Bush trumpeted the importance of removing the working poor from the income tax rolls.¹⁴

In a typical year, about 35 percent to 40 percent of households will not owe federal income tax.¹⁵ That figure is higher at times of high unemployment, which is why it has risen to an estimated 46 percent this year.¹⁶ Further, two-thirds of the households who do not owe federal income taxes will pay federal payroll taxes. Only 18 percent of households, the majority of them occupied by the elderly, will owe neither federal income nor payroll taxes.¹⁷

**Fact No. 3: People who don’t pay federal income tax in a typical year tend to be seniors living on Social Security, people with very low levels of income including the unemployed, and working families with children**

A recent analysis by the nonpartisan Tax Policy Center provides a clear picture of why some households will not have federal income tax liability this year. All policymakers who have expressed concern that too few people owe federal income taxes should read it.

Of the taxpayers who do not owe federal income taxes because of tax expenditures, the largest group (44 percent) are seniors. Most elderly tax filers do not owe federal income tax, primarily because most Social Security benefits are exempt from taxation.¹⁸ The next-largest group is low-income working families with children. That’s because the United States supports working families through the earned income tax credit and child tax credit. These credits are vitally important to millions of families and have traditionally enjoyed broad bipartisan support.

The Tax Policy Center’s report found that the biggest reason some households do not owe federal income taxes in any given year is that they have very little income (including laid-off workers, students, the disabled, and retirees). A third of those with no federal income tax liability have less than $10,000 in cash income and 62 percent have less than $20,000 (including Social Security and other government benefits).¹⁹ The basic structure of the income tax “exempts subsistence levels of income,” as the Tax Policy Center’s Roberton Williams explains.²⁰
And because the earned income tax credit and child tax credit are broad-based provisions that enable and encourage work, reducing or eliminating them would be economically inefficient. In this respect, it is important that they be distinguished from the narrow and inefficient tax expenditures like the myriad subsidies for specific industries.

The tax code should be scrubbed of ineffective business subsidies

The tax code is stuffed with about $130 billion in annual tax expenditures benefiting businesses or industries. The approximately $100 billion in annual corporate tax expenditures represents a significant share (one-quarter to one-half) of all corporate tax revenues. Indeed, tax expenditures help explain why the United States collects relatively little revenue from corporate income taxes by international standards, even though our statutory corporate tax rate is relatively high.

Some business tax subsidies are particularly indefensible. The oil industry is the beneficiary of more than $4 billion in annual tax code spending. Two of the major subsidies in the tax code—expensing of intangible drilling costs and “percentage depletion”—were enacted in 1916 and 1926, respectively, at a time when oil exploration was a fledgling industry. Today, the oil and gas industry is a mature, extremely profitable industry enjoying record profits from high gas prices. It does not need taxpayer incentives to do what it already does.

Another egregious example is the “carried interest” loophole. By exploiting that loophole, hedge fund and private equity fund managers—some of the richest people on the planet—can cut the tax rate on much of their compensation from the top ordinary tax rate of 35 percent to the preferential capital gains rate of 15 percent. There’s no reason to subsidize financial professions that are already among the most lucrative.

The tax code includes innumerable smaller subsidies that distort the choices made by businesses. A now-infamous example is the tax treatment of corporate jets. Companies can write off the costs of these purchases over five years, even though passenger jets must be depreciated over seven years—and the planes actually last for decades. Corporate jet write-offs are not the largest tax subsidy. They are estimated to cost the government “only” $4.7 billion over 10 years. But they have become symbolic of the way the tax code plays favorites. Similarly subsidized other industries include horse breeding, film and television production, and racetrack construction.

The critical question is not whether the sectors that receive special tax breaks support jobs or economic activity—of course they do—but whether there is a strong enough public policy reason to give them taxpayer subsidies not available to other businesses. A useful framework for evaluating special tax provisions is whether, if they were structured as direct spending programs, they would make economic sense or represent the best
use of taxpayer dollars. For example, if it does not make sense for the government to pay companies directly to drill or explore for oil, then the government shouldn’t be doing the economic equivalent through the tax code.

Common-sense, fiscally responsible reforms to tax expenditures do not have to wait for comprehensive tax reform

Defenders of wasteful or inefficient tax expenditures often assert that any changes should only be considered in the context of overall tax reform. Invoking the prospect of a future tax code overhaul lets everyone benefit from the status quo while appearing pro-reform. Beneficiaries suggest a willingness to give up their tax breaks if everyone else does, and politicians can pose as tax reformers without having to identify whose tax breaks they’d close. The result is that tough choices on tax expenditures are avoided, while direct government spending programs face the budget ax.

Comprehensive tax reform is a desirable goal. The tax code is badly in need of an overhaul to broaden the tax base. But sweeping tax reform may not happen for many years. The last comprehensive tax code overhaul was a quarter-century ago, in the Tax Reform Act of 1986. That legislation was enacted only after several years of twists and turns and is now viewed as a singularly rare accomplishment.

Policymakers today universally agree on the need for “tax reform,” but there is enormous disagreement over such fundamental questions as whether tax reform should raise, hold constant, or lower revenues (to say nothing of which revenue benchmarks to use) and whether the overall tax burden should be made more or less progressive than it is now.

Given these realities, there is no good reason to exempt tax expenditures from ongoing efforts to reduce long-term deficits. Just because a wasteful subsidy is technically a tax break does not mean that it can only be dealt with through overarching tax reform. There are many ways to reform tax expenditures to reduce their budget cost or eliminate the least justifiable ones. None of these options would preclude a later, more fundamental tax reform. And eliminating the most wasteful tax expenditures could make fundamental tax reform more likely by reducing the number of industries with vested interests to protect.

Many policymakers have over the last year come to recognize that any credible and balanced approach to addressing the United States’ long-term fiscal challenges must include significant tax expenditure reforms. By adhering to the principles outlined in this issue brief, policymakers can increase the fairness and cost efficiency of tax expenditures while balancing our short-term economic challenges and long-term fiscal challenges.

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Endnotes


3 These figures do not take into account the “Pease” limitation on itemized deductions, which is currently repealed but is scheduled to go back into effect in 2013 under current law, or the separate calculation required under the Alternative Minimum Tax. It also assumes that both households itemize their deductions.

4 The skewed distribution of the mortgage interest deduction also results from the fact that upper-income households tend to have larger mortgage payments, and interest is effectively deductible on up to $1.1 million in mortgage debt. Households with incomes between $200,000 and $500,000 derive an average benefit of $63,772, while households with incomes between $56,000 and $75,000 derive an average benefit of $36,4, according to estimates in: “Tax Benefits of the Mortgage Interest Deduction, Baseline: Current Law; Distribution of Federal Tax Change by Cash Income Level, 2011,” available at http://www.taxpolicycenter.org/numbers/displayatab.cfm?Docid=3146.&DocTypeID=1. These are roughly consistent with other estimates. See: Seth Hanlon, “Tax Expenditure of the Week: The Mortgage Interest Deduction,” Center for American Progress, January 26, 2011.


6 The proposal applies to itemized deductions as well as certain other tax expenditures that take the form of “above-the-line” deductions and exclusions, including exclusions for employer-sponsored health insurance, municipal bond interest, and foreign-earned income and certain other business, health care, and education-related deductions.

7 Or 39.6 percent, as would be the case in 2013 under current law, under which the high-income Bush tax cuts are scheduled to expire.

8 If applied only to itemized deductions, it is estimated to raise $321 billion; applied to a broader set of deductions and exclusions (as President Obama has proposed in the American Jobs Act), it would raise $465 billion.


22 The carried interest loophole is a component of the larger tax expenditure that provides preferential tax rates on capital gains.


