

**The Growth, Distribution, and Opportunity Cost
Of Individual Income Tax Expenditures**

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I. Introduction

The term “tax expenditure” was coined by Stanley S. Surrey who, as Assistant Secretary of the US Treasury for Tax Policy in the 1960s, instructed his staff to compile a list of preferences and concessions in the income tax and estimate their revenue costs. His goals were to focus attention on those tax provisions that were effectively expenditures in disguise and to build momentum for a tax reform based on a model of a broad-based income tax. (Toder, 2005; Shaviro, 2007)

Both the Office of Management and Budget (OMB) in its budget presentation and the Joint Committee on Taxation (JCT) compile annual lists of tax expenditures, defined as deviations from the “normal” individual and corporate income tax bases.¹ Until 2002, the budget also included a list of tax expenditures against a transfer tax (estate and gift taxes) baseline, but those items were excluded from the FY 2003 budget because “...there is no generally accepted normal baseline for transfer taxes and ... [the tax was]... repealed under the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA).” (US Office of Management and Budget, 2002, p. 95) In principle, tax expenditures could also be defined with respect to other taxes, such as excise taxes, but it has not been done on a systematic basis. (Davie, 1994)

There are a number of issues in measuring tax expenditures. One is the appropriate baseline against which to measure deviations. Surrey’s “normal tax” is a comprehensive Haig-Simons type income tax adjusted to account for administrative realities. On administrative grounds, for example, the baseline taxation of capital gains is on a realization rather than an accrual basis. Income and expenses are not indexed for inflation. More fundamentally, some argue that the baseline might more appropriately eliminate the double taxation of corporate income or even be based on a comprehensive consumption tax, rather than an income tax.²

There are issues of timing. Some tax breaks, such as the tax exemption for IRA and 401(k) contributions, play out over many years. The annual change in tax revenues can be a very misleading measure of the amount of subsidy provided. For example, traditional and Roth IRAs are (under certain assumptions) economically equivalent, but the time pattern of revenue losses is much different. Traditional IRAs allow a deduction for contributions and earnings with qualifying withdrawals fully taxable. Roth IRAs allow no up-front deduction, but earnings and withdrawals are tax-free. A switch from traditional to Roth IRAs, therefore, will reduce reported annual tax expenditures during the budget period, although in fact it simply shifts revenue losses to a later period. To address this problem, OMB also reports the present value of certain tax expenditures.

Finally, tax expenditure estimates are “static,” meaning that they assume no change in economic behavior if they were eliminated. This means that tax expenditure

¹ The Office of Tax Analysis of the U.S. Treasury Department prepares the tax expenditures estimates for OMB.

² See Burman (2003) for a discussion. OMB currently reports alternative presentations based on deviations from a comprehensive income tax and a comprehensive consumption tax.

estimates may be much larger than revenue estimates for eliminating a particular provision. They also could provide a misleading estimate of the cost of a direct spending program alternative because they do not account for the fact that an equivalent spending program would frequently produce income that would itself be subject to tax. To address this problem, Treasury also presents tax expenditure estimates in terms of “outlay equivalents”—the outlay on a spending program that would produce an equivalent effect on federal finances.

Despite its limitations, most public finance economists believe that measuring tax expenditures is an important part of good budget management. As Surrey and McDaniel (1985) noted, tax expenditures “...represent government spending for favored activities or groups, effected through the tax system rather than through direct grants, loans, or other forms of government assistance.” (p. 3) They have the same effect on government finances as a direct spending program, entailing an opportunity cost either in terms of higher taxes, reduced federal spending, or both. Although it surely makes sense to run certain programs through the tax system, we should assess their effects on the federal budget and on achieving program objectives the same way we assess direct spending programs.

In some respects, however, OMB and JCT estimates of tax expenditures contain major gaps. They present estimates of the effects of specific tax expenditures on federal revenues, but no tally of the combined effect of groups of tax expenditures. In fact, as shown below, the interactions among tax expenditures can be quite significant and, in some cases, counterintuitive, especially when considered in conjunction with the AMT. Moreover, while the JCT reports the distributional effects of a small group of tax expenditures, no effort has been made before now to look at distributional effects on a comprehensive basis. As we report, overall, tax expenditures for individual taxpayers (excluding those that affect measurement of business income) are heavily skewed towards those with higher incomes.³

This paper uses the Tax Policy Center microsimulation tax model to develop new estimates of the interaction effects among tax expenditures and the distributional effects of individual tax expenditures and groups of expenditures. The analysis is not comprehensive, being limited by the information that is available on tax returns or that we can impute based on data from other sources.

However, it does illustrate some of the subtle and not so subtle ways that interactions can affect conclusions about the level and distribution of tax expenditures. We find that adding separate tax expenditures to compute total costs produces significant errors for some subgroups of provisions, but in the aggregate (and for many sub-categories) comes close to the correct sum. For all individual income tax expenditures together, failing to account for interaction effects reduces the estimated total cost of tax

³ We have not estimated tax expenditures (such as accelerated depreciation) that affect the measurement of business income or provide tax credits for businesses, but had we included them and allocated the benefits of corporate preferences to individuals, we expect the distributional effects would be even more tilted towards high-income taxpayers.

expenditures by about 7 percent under 2007 tax law (before enactment of the AMT patch) and by about 4 percent under 2007 tax law with no AMT. But those totals obscure larger changes for categories of tax expenditures. Adding up itemized deductions, for example, overstates the total costs of all itemized deduction by about 15 percent with the AMT and by about 23 percent without the AMT (which disallows or limits several itemized deductions). For every other category of tax expenditure, adding individual provisions understates the combined tax expenditure (since increasing income raises average marginal tax rates).

The next section reviews the growth of individual income tax expenditures over the past 30 years. Section III examines the interactions among tax expenditures, both with and without the AMT. Section IV looks at the distribution of tax expenditures both individually and collectively. Section V briefly considers the opportunity cost of tax expenditures in terms of forgone spending or higher tax rates. Section VI concludes.

II. Growth in Tax Expenditures

Although the list of tax expenditures items and the revenue estimates reported by OMB and JCT differ somewhat, they are pretty similar and most estimates are fairly close. In addition, some provisions are combined by one agency, but estimated separately by the other one. For example, the OMB list provides separate estimates of the revenue loss attributable to the exclusion from income tax of contributions and earnings (net of taxation of benefits) from defined benefit plans and employer-sponsored defined contribution retirement plans, while JCT provides a single combined estimate for all employer-sponsored retirement plans.

Both agencies report the revenue losses of each tax expenditure as if all the other tax expenditures were in place. They do not display the combined revenue loss of all tax expenditures or other tax expenditures under any single budget category. The combined cost of all the tax expenditures does not necessarily equal the sum of the costs of the separate provisions because the presence of one provision may affect the costs of another. For example, if the state and local tax deduction were eliminated, more taxpayers would be using the standard deduction and this would reduce the cost of other itemized deductions.

Notwithstanding the absence of estimates that account for interactions among provisions, some analysts and commentators have sought to add up tax expenditures to make general statements about their magnitude and impact on the budget, and to compare them to costs of direct spending programs. For example, Toder (1998), while acknowledging the possible errors from ignoring interactions, provides evidence on trends in tax expenditures as a share of GDP between 1980 and 1999 and their division between two categories labeled “social” and “business” tax expenditures.⁴ Toder finds

⁴ Social tax expenditures encompass those provisions that support social policy goals, such as promoting retirement saving, health insurance coverage, education, and home ownership, supporting activities of charities and local government, and providing income support for low-income families. Examples of social tax expenditures are the mortgage interest deduction, tuition credit for higher education, the exclusion of

that in the aggregate, tax expenditures increased between 1980 and 1985, dropped sharply after the tax reform of 1986, and then rose gradually in the 1990s. Over the period of two decades there was a large shift from business to social tax expenditures. This occurred because most of the largest social tax expenditures were left intact or modified only slightly by the Tax Reform Act of 1986 (though reduced in cost due to lower marginal tax rates), while social expenditures increased during the 1990s due to new provisions (tuition tax credits and the child credits) and big expansion of some existing provisions (the earned income tax credit). In a recent book on the history of U.S. tax policy over the last two decades, Steuerle (2004) updates Toder's calculations through 2003 and reports social tax expenditures continuing to grow as a share of GDP.

Chart 1 displays the growth of “non-business” tax expenditures between 1976 and 2006, as reported by OMB. (“Non-business” tax expenditures in the chart include all tax expenditures reported on individual income tax returns, with the exception of those that affect taxes paid by business, such as depreciation allowances and business tax credits.)⁵ Non-business tax expenditures rose sharply between 1976 and 1985 from 4.16 percent to 6.39 percent of GDP. They dropped between 1985 and 1990 as a result of base-broadening provisions and lower marginal income tax rates in the Tax Reform Act of 1986, but increased again throughout the 1990s, reaching 6.46 percent of GDP in 2001. Between 2001 and 2006, tax expenditures as a share of GDP declined slightly, largely due to lower marginal tax rates and some changes in the composition of economic activity (there was no significant base-broadening in the period), but they remain at relatively high levels compared with most of the past three decades.

To put this in perspective, if these provisions were classified as federal spending instead of tax benefits, federal expenditures in fiscal 2006 would have been about 30 percent higher in 2006 (slightly over 26 percent of GDP instead of 20.3 percent of GDP) than reported by OMB. Similarly, taxes (before subtracting tax expenditures) would be commensurately higher. But this calculation assumes that individual tax expenditure items can be added up and that interaction effects net to zero. The next section provides estimates of the size of interaction effects.

III. Interaction effects

Although it has long been understood that the combined cost of many tax expenditures could be far different from the sum of the individual tax expenditures, no

employer contributions for health insurance, and the earned income tax credit. Business tax expenditures were those generally aimed at promoting saving, investment, and economic growth, and included provisions such as accelerated depreciation for capital investment, the research and experiment tax credit, and preferential taxation of capital gains.

⁵ Chart 1 differs from the measure of “social” tax expenditures in Toder (1998) and Steuerle (2004) because it includes tax expenditures reported on individual tax returns, including for example tax preferences for capital gains that Toder labels “business” tax expenditures. The selection of tax expenditures for inclusion in the chart includes the categories of tax expenditures we review in this paper, but the chart includes revenue losses from these provisions attributable to both individuals and corporations. (For example, because some tax-exempt bonds are held by corporations, OMB characterizes the revenue loss on those bonds as “corporate” tax expenditures.)

one to our knowledge has systematically examined the interaction among tax expenditures. We examined the effect of eliminating groups of individual income tax expenditures for tax year 2007, assuming the law in effect before retroactive relief from the AMT was enacted at the end of 2007. We also calculated tax expenditures under an alternative baseline that assumed no AMT was in effect. We did the calculations both ways because many tax expenditures are curtailed or eliminated under the AMT and because eliminating tax expenditures can cause taxpayers to move on or off of the AMT, complicating comparisons.⁶

We grouped tax expenditures by where they appear on the individual income tax form, rather than by budget category, which is the way OMB and JCT present them. The six types of expenditures that we modeled were exclusions from income, above-the-line deductions, lower tax rates on long-term capital gains and dividends, itemized deductions, nonrefundable tax credits, and refundable tax credits. We provide estimates for provisions that account for roughly 90 percent of the revenue loss from non-business individual income tax expenditures.⁷ For the most part, our estimates are very close to official estimates, but there are a few notable exceptions. We view these differences as unimportant because our purpose is to show the effects of interactions rather than to provide precise (or improved) estimates of individual tax expenditures.⁸

Some of the largest tax expenditures are implemented as exclusions from income. Overall, we estimate that tax exclusions reduce income tax liability by \$332 billion in 2007. (See Table 1.) This is about 6 percent higher than the sum of the separate tax expenditures, which total \$313 billion. The combined tax expenditure is higher because the increase in taxable income from eliminating multiple exclusions would push taxpayers into higher income tax brackets (making the cost of each additional exclusion higher than would be the case if only that one exclusion were eliminated). Also, the higher taxable income would push more than 6 million additional taxpayers onto the AMT, and most taxpayers face higher effective marginal tax rates under the AMT than under the regular income tax. (Leiserson and Rohaly, 2006)

The results are very similar, but smaller in magnitude, if we assume no AMT. Overall, we estimate that exclusions from income would reduce tax revenues by \$314 billion were there no AMT in 2007, compared with a total of \$296 billion for the separate tax expenditures. The tax expenditures are smaller because, as noted, marginal tax rates are lower for most taxpayers under the regular income tax than under the AMT.

The three above-the-line deductions we estimate are much smaller than the tax exclusions, totaling only \$6.4 billion. The estimate would be slightly larger without the

⁶ Leiserson and Rohaly (2006) show that the likelihood of owing AMT increases with income up until about \$500,000, but those with very high incomes are much less likely to be affected by the AMT.

⁷ Significant omissions include: the capital gains exclusion on home sales (\$37.0 billion); step-up in basis of capital gains at death (\$32.6 billion); exclusion of employee parking expenses (\$2.9 billion), transit passes (\$0.6 billion), and employer-provided child care (\$0.9 billion); and the deduction for higher education expenses (\$1.5 billion). Numbers in parentheses are the OMB estimates for FY 2007.

⁸ A technical appendix in Burman, Geissler, and Toder (forthcoming) will discuss our methodology and differences between our estimates and the official estimates.

AMT because the additional deduction for the blind and elderly is an AMT preference item, not allowed for AMT taxpayers. Because these tax expenditures are collectively so small, the interaction effects are negligible.

Long-term capital gains and dividends on corporate stock are subject to lower tax rates than under the regular income tax or the AMT. Taxpayers in the two lowest brackets are taxed at a 5-percent rate on their gains and dividends, and higher-income taxpayers are taxed at a 15-percent rate. The tax expenditure is the difference between the tax paid under the alternative rate schedule and the regular income tax or tentative AMT that would otherwise be owed. Together, these two provisions reduce income tax revenues by \$96 billion. This is slightly higher than the \$94.8 billion sum for the individual income tax expenditures because a small share of gains and dividends are earned by taxpayers in the lower brackets. Were the lower rate eliminated on capital gains, for example, some taxpayers would face a higher rate on all or part of their dividends.

The tax expenditure for capital gains and dividends is slightly smaller with the AMT in place than without it because most capital gains are earned by very high-income taxpayers who, unlike most taxpayers affected by the AMT, face a higher marginal effective tax rate under the regular income tax than under the AMT.⁹ As a result, the tax expenditure on capital gains would increase by almost \$3 billion were the AMT eliminated. In contrast, the tax expenditure for dividends would decrease slightly, because dividends on average are received by people with somewhat lower incomes than capital gains recipients.

The interaction effects are largest for itemized deductions and reduce instead of increase the combined effect of the separate provisions. This negative interaction effect occurs because, when any itemized deduction is eliminated, taxpayers are more likely to take the standard deduction. For example, if the mortgage interest deduction were eliminated, millions fewer taxpayers would itemize deductions and thus would get no benefit from deducting charitable contributions or state and local taxes. Even for those taxpayers who continue to itemize, some would find that their remaining itemized deductions were not much greater than the standard deduction, and thus the gain from eliminating the remaining deductions would be reduced. In total, itemized deductions reduce income tax revenues by \$159 billion in 2007, more than 15 percent less than the sum of the individual income tax expenditures (\$188 billion).

The AMT substantially complicates matters for several reasons. First, one of the largest itemized deductions, the deduction for state and local taxes, is not allowed under the AMT. Thus, the tax expenditure for that provision is much smaller with the AMT than without it (\$46 billion versus \$83 billion).¹⁰ Second, the standard deduction is not

⁹ For the distribution of capital gains and dividends by income, see Table T05-0074, available at www.taxpolicycenter.org/T05-0074.

¹⁰ Several other, much smaller, itemized deductions, such as the deduction for medical expenses and interest on home equity lines of credit are curtailed by the AMT. We have insufficient information to

allowed under the AMT. For that reason, with the AMT in place, more taxpayers will continue to itemize when some itemized deductions are eliminated than if there were no AMT. This raises the cost of itemized deductions (other than those directly reduced or eliminated) under the AMT and reduces interactions that lower the combined cost of deductions. Third, the phase-out of itemized deductions for high-income taxpayers (sometimes called Pease) does not apply to the AMT, making the combined value of all itemized deductions larger than it would otherwise be. Finally, as with the tax exclusions, the effective tax rate applying to itemized deductions is higher under the AMT than under the regular income tax for most taxpayers. Tax expenditures that are allowed against the AMT are larger than they would be were the AMT eliminated.

The combination of all of these effects is fascinating. As expected, every individual itemized deduction other than the state and local tax deduction is worth more with an AMT than without. However, as noted, the state and local tax deduction costs much more without than with an AMT. On balance, the sum of the individual tax expenditures is larger without the AMT than with it (\$207 billion versus \$188 billion). But accounting for all of the complex interactions, the overall tax expenditure for itemized deductions, including interactions, is virtually identical--\$159.4 billion with the AMT and \$159.8 billion without it, an insignificant difference. Interestingly, if all of the itemized deduction tax expenditures were eliminated, the number of taxpayers affected by the AMT would actually increase by over 5 million. Most surprisingly, while the AMT is thought to curtail deductions, in aggregate, the value of itemized deductions is unchanged by the AMT.

There are also interesting interaction effects with respect to tax credits. Nonrefundable tax credits are limited by a taxpayer's income tax liability before credits. The AMT disallowed these tax credits under the tax law we modeled. (The late session "patch" included a provision allowing the use of personal nonrefundable tax credits against the AMT.) As a result, the more tax credits that exist, the smaller the marginal value of each one (because taxpayers have less remaining tax liability), so that when one credit is removed the revenue pickup from eliminating the remaining ones rises. In total, nonrefundable personal credits reduced income tax liability by \$8.2 billion under 2007 law as we modeled it, compared with an \$8.0 billion sum for the individual provisions. Eliminating the AMT significantly increases the value of credits (compared with the law prior to late session "patch"), but counting the interaction effects continues to raise the combined cost (from \$11.1 to \$11.3 billion).

Finally, there are the refundable earned income tax credit and the partially refundable child tax credit. (The refundable portion of the child tax credit is limited to 15 percent of earnings in excess of \$11,750.) These credits are allowed against the AMT as well as the regular tax so there is no interesting distinction there. There are, however, interaction effects, which I assume relate to stacking order, but I can't figure them out.

measure the effect of the limit on home equity lines of credit. [We might have modeled the medical spending provision incorrectly, but will check and fix it if necessary in the next version of the paper.]

Taken as a whole, the individual income tax expenditures that we modeled reduce income tax revenues by \$750 billion, or almost 75 percent of income tax receipts actually collected (or about 43 percent of revenues grossed up to include the tax expenditures). This is 7 percent more than the sum of the separate provisions, which total \$699 billion. Without the AMT, the total would be slightly smaller—\$736 billion—and the interaction effects would be significantly smaller. In other words, the AMT, ironically, appears to increase marginally the total value of individual income tax expenditures.

IV. Distribution of Individual Income Tax Expenditures

Tax expenditures in the individual income tax, taken as a group, benefit taxpayers in all income groups. They benefit high-income taxpayers more than low-income taxpayers in absolute terms and relative to their income, but less relative to the taxes they pay. The distributional effect of eliminating tax expenditures depends on how the budgetary savings are distributed. We present some calculations in this section.

With the AMT treated as under current law as of December 20, 2007 (before Congress extended the AMT patch), eliminating all individual tax expenditures would lower after-tax incomes by a larger percentage in the top income groups than in other groups – 11.1 percent for the top quintile, compared with 6.6 percent for the bottom quintile and 9.6 percent for all taxpayers. After-tax income would drop by 12.7 percent for taxpayers in the top 1 percent of the income distribution (Table 2). Tax expenditures do, however, provide larger percentage tax cuts for taxpayers in lower income groups than for taxpayers in higher income groups. Thus, if all the individual income tax expenditures we estimate in this paper (which account for the bulk of revenue lost from tax expenditures) were eliminated and marginal tax rates were cut across the board by 42.4 percent (from today's rates, which range from 10 percent to 35 percent, to new rates ranging from 5.8 percent to 20.2 percent) to keep individual income tax revenues constant, after-tax incomes would increase by 1.9 percent in the top quintile and 4.5 percent in the top 1 percent of the income distribution, but fall by amounts ranging from less than 1 percent in the fourth quintile to about 6 percent in the bottom two quintiles.

The distributional effects of eliminating tax expenditures would be similar if there were no AMT. (Table 3) With no AMT, eliminating tax expenditures would reduce after-tax income by 10.9 percent in the top quintile, 6.6 percent in the bottom quintile, and 9.4 percent on average for all income groups. Again, the drop in after-tax income would be proportionately biggest for the highest income taxpayers – 13.2 percent for returns in the top 1 percent of the income distribution. With no AMT, eliminating tax expenditures would permit a 43.6 percent reduction in all marginal tax rates, so that the new rates that would raise the same revenue would range from 5.64 percent to 19.7 percent. Again, the revenue neutral change would on balance help the highest income taxpayers the most because they would experience the smallest percentage tax increases (though the biggest gains in after-tax income) from removing tax expenditures. With tax expenditures eliminated and marginal tax rates cut proportionately to keep revenue constant, after tax income would increase by 1.7 percent in the top quintile and by 4.2 percent for the top 1 percent of taxpayers, but decline for everyone else.

The comparison between eliminating tax expenditures in tax systems with and without AMT is interesting. Although the naïve intuition might be that the tax increase from removing tax expenditures would be bigger with no AMT than with an AMT (because AMT reduces some preferences), in fact the reverse is true. The reason is that marginal tax rates are actually on average higher for taxpayers on the AMT than for taxpayers not on the AMT. For those taxpayers most likely to be on the AMT – those in the top three income quintiles – eliminating tax expenditures reduces after-tax income more in the presence of AMT than without AMT (for example 11.1 percent with AMT and 10.9 percent without AMT for taxpayers in the top quintile). For the very highest income (top 1 percent) taxpayers, however, eliminating tax expenditures reduces after-tax income more without the AMT (13.2 percent) than with the AMT (12.7 percent). These taxpayers do not experience higher marginal tax rates under the AMT because their income levels place them above the AMT phase out range and, for those who are on the AMT, eliminating tax expenditures hurts them relatively less because the AMT has already removed their state and local tax deductions.

The distributional effects are very different for different groups of taxpayers. In the presence of AMT, exclusions from income raise after-tax income relatively more for higher income than for lower income taxpayers, but by less than average for taxpayers in the top 1 percent. The major exclusions are those for contributions to and earnings from employer-sponsored pension plans (net of taxes on pension benefits) and for employer contributions for medical insurance. Above the line-deductions (student loans, higher education expenses, self-employed medical insurance premiums) provide the biggest income gain to middle-income taxpayers and almost no gain to taxpayers in the bottom quintile. Lower tax rates on capital gains and dividends disproportionately benefit the top 1 percent of taxpayers and provide little income gain for anyone else. Itemized deductions provide much larger income gains for high income than for low-income taxpayers (most of whom use the standard deduction), but the percentage income gain for the top 1 percent is less than the average gain for the top quintile. Non-refundable credits (child care credits, tuition credits for higher education, and the savers' credit) provide the biggest percentage gains for middle income taxpayers and almost no benefits to the top quintile (because most phase out at higher incomes) and bottom quintile (because they are not refundable). Refundable credits provide the biggest income gains for taxpayers in the bottom two quintiles of the income distribution.

To sum up, tax expenditures in the aggregate are a larger share of income, but a smaller share of taxes paid, for high income taxpayers than for low income taxpayers. The distributional effect of substituting rate cuts for all expenditures depends on how rates are cut. With all tax rates reduced by the same percentage, the substitution of rate cuts for tax expenditures would on average help high income taxpayers and hurt lower income taxpayers. With all tax rates reduced by the same *percentage points* (or same percent of income), the substitution of rate cuts for tax expenditures would on average help low income taxpayers and hurt high income taxpayers. Of course, there would also be large redistributions *within* income groups, with relatively larger users of

preferences experiencing net income losses from the changes and relatively smaller users experiencing net income gains.

V. Opportunity Cost of Tax Expenditures

Like direct spending programs, tax expenditures crowd out other spending and require tax rates to be higher than they would otherwise be. As shown in Table 1, non-business individual income tax expenditures reduced federal income tax revenues by as much as \$750 billion in 2007. That amount is more than total spending on national defense (\$599 billion) or non-defense discretionary spending (\$521 billion) in fiscal year 2008. (Congressional Budget Office, 2007) It dwarfs the cost of eliminating the alternative minimum tax, which would have cost \$70 billion in 2007 (the patch cost about \$50 billion). Clearly, there is a significant opportunity cost to tax expenditures.

Often, although not always, direct spending programs might be more cost-effective or better meet policy goals. For example, the lion's share of the tax exclusion for employer-sponsored health insurance goes to high-income people who would likely be insured even without a subsidy and next to nothing for lower-income people who most need help. (Burman, Furman, Leiserson, and Williams, 2007) The tax exclusion also subsidizes overly generous health insurance that may encourage over-spending on health care. Redesigning the subsidy as a refundable tax credit would be an improvement, but a better option might be to cap or eliminate the tax exclusion and use the income and payroll tax revenues saved to pay for expanded access to publicly funded health insurance.¹¹

Some conservatives object to the notion of tax expenditures because, they argue, “[t]he tax expenditure concept relies heavily on a normative notion that shielding certain taxpayer income from taxation deprives government of its rightful revenues.” (Saxton 1999) In fact, tax expenditures, like direct expenditures, require tax rates to be much higher than they otherwise would be. As an illustration, we estimate that eliminating all tax expenditures could finance an across the board reduction of income and AMT tax rates of 42 percent (and 44 percent with no AMT). That means that the top tax rate could be cut from 35 percent to about 20 percent on a revenue-neutral basis.

Of course, eliminating all tax expenditures is neither politically feasible nor desirable. Some advance important public policy goals in a comparatively effective manner and some (not necessarily the same ones) enjoy overwhelming bipartisan support. Eliminating all tax expenditures would be regressive if the increased revenues were used to reduce all income tax rates proportionately, raising taxes on the two lowest income quintiles by an average of 6 percent of income, while cutting taxes on the highest-income one percent by almost 5 percent of income. (See Table 2.) However, alternative tax rate structures (including a refundable tax credit) could be designed to be as progressive or more progressive than the current system. And replacing some tax expenditures with

¹¹ Gruber and Feldstein (1995) concluded that such a trade-off could fund universal access to health insurance and reduce overall medical spending.

spending programs that aid those with low and moderate incomes could also offset the regressivity of rate cuts alone.

But the key point is that tax expenditures are a very large part of government spending and the budgetary saving from reducing those of lesser merit could be used to advance policy goals of liberals and conservatives alike.

VI. Conclusions

Tax expenditures add up to a strikingly large share of individual income tax revenues raised and have increased as a share of GDP over the last three decades. OMB and JCT annually display lists of tax expenditures and their revenue costs, but official presentations do not display total costs of tax expenditures because eliminating some could raise or lower the gains from eliminating others. Using the TPC tax simulation model, this paper has shown that eliminating a large share of non-business individual income tax expenditures would raise about 7 percent more revenue than would be computed by adding the separate estimates for each provision. The interactions among tax expenditures provisions raise revenues mainly because eliminating some tax expenditures pushes taxpayers into higher marginal rate brackets, raising the revenue gain from eliminating additional ones. Interactions are negative for some groups of tax expenditures. In particular, the gain from eliminating all itemized deductions is less than the gain from the sum of separate provisions because, as itemized deductions are removed, more taxpayers switch to the standard deduction, reducing the incremental gain from eliminating additional deductions.

The individual alternative minimum tax (AMT) affects the overall cost of tax expenditures, but not in the direction one might initially expect. Although some tax expenditures (the largest being the state and local tax deductions) are disallowed under the AMT and others reduced, the AMT *raises* the overall cost of tax expenditures because it raises instead of lowers marginal tax rates of most individuals subject to AMT. In addition, because there is no standard deduction in the AMT, the negative interaction effects from removing additional itemized deductions under the regular tax are not present for taxpayers subject to AMT.

Different tax expenditures have differing distributional effects – special rates for capital gains and dividends disproportionately favor the highest income taxpayers, while refundable credits go almost entirely to taxpayers in the bottom two income quintiles. Overall, individual tax expenditures raise after-tax incomes more for high income than for lower income taxpayers, so their net effect can be viewed as regressive. The distributional effect of tax expenditures, however, depends on what the tax rate structure would be like in their absence. If, for example, the alternative to tax expenditures were a proportional across the board cut in marginal income tax rates, higher income groups would see their after-tax incomes increase on average and lower income groups would lose out.

Tax expenditures have a huge opportunity cost – over \$700 billion in tax year 2007 alone. These revenues could be used to lower marginal tax rates, fund more social programs, improve infrastructure, eliminate budget deficits, or promote a variety of other purposes. If used to lower rates across the board, for example, the top marginal income tax rate could fall to 20 percent. While many tax expenditures further important social goals that are worth public fiscal support, either through continued tax subsidies or direct spending programs, others are of more dubious merit. The savings from paring back provisions with lesser economic justification could be used to advance the policy goals of liberals and conservatives alike.

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**Chart 1. Non-Business Tax Expenditures
as Percentage of GDP, 1976-2006**

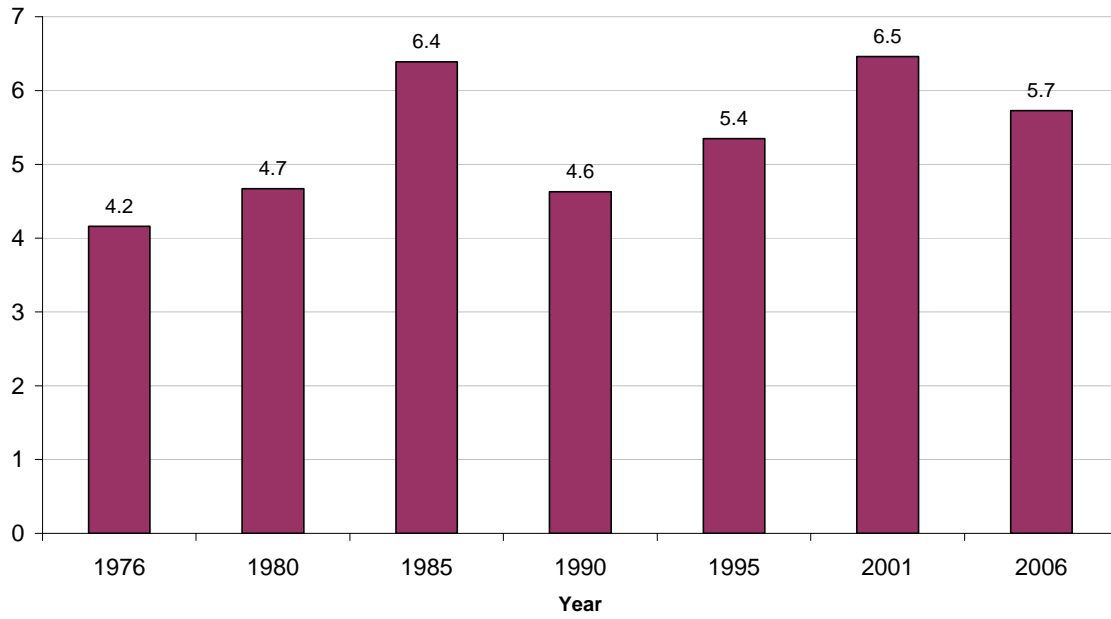


Table 1. Selected Individual Income Tax Expenditures, Individually and in Groups, Tax Year 2007

	TPC Estimates		OMB	JCT	AMT
	w/ AMT	no AMT	(FY07)	(FY07)	Taxpayers
	(billions of dollars)				(millions)
Exclusion of interest on life insurance savings	18.3	17.5	18.3	26.1	24.0
Net exclusion of contributions and earnings for retirement plans ¹	116.1	109.9			24.2
Employer contributions			49.2	108.6	
Employee contributions to DC plans			42.4		
IRAs			5.7	15.5	
Keogh plans			10.9	8.8	
Exclusion of interest on tax-exempt bonds	12.2	11.6	26.2	25.4	23.6
Exclusion of employer contributions for medical insurance	137.7	129.5	141.3	105.7	28.4
Exclusion of Social Security and railroad retirement benefits	23.0	22.6	26.9	22.4	23.9
Exclusion of veterans benefits	5.2	5.0	4.2	3.5	23.6
Subtotal: Exclusions from Income, without interactions	312.6	296.0	325.1	316.0	
Subtotal: Exclusions from Income, with interactions	331.9	314.3			29.6
percentage change	6.2%	6.2%			
Deductibility of Student Loan Interest	1.1	1.0	0.8	0.9	23.5
Self-employed medical insurance premiums	3.8	3.7	4.4	3.8	23.5
Additional deduction for the blind and elderly	1.5	1.9	2.2	1.7	23.3
Subtotal: above the line deductions, without interactions	6.4	6.6	7.4	6.4	
Subtotal: above the line deductions, with interactions	6.4	6.6			23.4
percentage change	0.0%	0.1%			
Lower tax rates on long-term capital gains	83.7	86.4	53.1		23.8
Lower tax rates on qualifying dividends	11.1	10.9	0.0	127.1	23.7
Subtotal: special tax rates, without interactions²	94.8	97.3	53.1	127.1	
Subtotal: special tax rates, with interactions	96.0	99.0			23.9
percentage change	1.2%	1.8%			
Deductibility of Mortgage interest on owner-occupied homes	92.4	79.9	79.9	73.7	28.8
Deductibility of State and Local Taxes	45.9	82.9			19.4
Property taxes on residences			15.5	16.8	
Income and other taxes			33.7	33.9	
Deductibility of Charitable Contributions	43.3	38.5	47.4	41.9	24.9
Deductibility of Casualty Losses	0.4	0.3	0.3	0.8	23.5
Deductibility of Medical Expenses	6.3	5.4	4.2	8.4	23.8
Subtotal: itemized deductions, without interactions	188.2	207.0	181.0	175.5	
Subtotal: itemized deductions, with interactions	159.4	159.8			29.2
percentage change	-15.3%	-22.8%			
HOPE tax credit	2.6	3.7	3.3	3.1	23.1
Lifetime learning tax credit?	1.6	2.2	2.2		23.2
Credit for child and dependent care expenses ³	1.9	3.4	2.8	3.0	23.1
Low and moderate income savers credit	1.9	1.9	0.7	0.9	23.5
Subtotal: non-refundable credits, without interactions	8.0	11.1	9.0	7.0	
Subtotal: non-refundable credits, with interactions	8.2	11.3			22.5
percentage change	2.8%	1.6%			
Child credit ⁴	44.9	44.9	47.5	45.0	23.6
Earned income tax credit ⁴	43.7	43.7	41.8	44.7	23.5
Subtotal: refundable credits, without interactions	88.6	88.5	89.3	89.7	
Subtotal: refundable credits, with interactions	89.2	89.1			23.6
percentage change	0.6%	0.6%			
Total: all provisions without interactions	698.6	706.6			
Total: all provisions with interactions	749.7	736.1			35.1
percentage change	7.3%	4.2%			
Total: all provisions with interactions and revenue neutral tax cut	0.3	(0.3)			35.3
Addendum: Baseline individual income tax revenues, AMT taxpayers	1,020.7	950.9			23.5

Notes

1. Tax expenditure is revenue loss attributable to deduction/exclusion for contributions and earnings net of any tax on withdrawals
2. OMB does not consider the lower tax rates on capital gains and dividends on corporate stock to be a tax expenditure
3. JCT includes the value of the exclusion of employer provided child care
4. Includes both refundable and nonrefundable portion

Table 2. Distributional Effects of Tax Expenditures with AMT Included, Tax Year 2007

	Percent Change in After Tax Income (by quintile)						
	<u>Bottom</u>	<u>2nd</u>	<u>Middle</u>	<u>4th</u>	<u>Top</u>	<u>Top 1%</u>	<u>All</u>
Exclusion of interest on life insurance savings	-0.02	-0.09	-0.16	-0.30	-0.26	-0.14	-0.24
Net exclusion of employer contributions and earnings, employer plans ²	-0.16	-0.57	-0.90	-0.61	-2.11	-1.53	-1.50
Exclusion of interest on tax-exempt bonds	0.00	0.00	-0.01	-0.04	-0.26	-0.51	-0.16
Exclusion of employer contributions for medical insurance	0.07	-1.40	-2.06	-2.38	-1.62	-0.26	-1.77
Exclusion of Social Security and railroad retirement benefits	-0.13	-0.60	-0.71	-0.50	-0.10	-0.03	-0.30
Exclusion of veterans benefits	<u>0.00</u>	<u>-0.02</u>	<u>-0.06</u>	<u>-0.10</u>	<u>-0.07</u>	<u>-0.01</u>	<u>-0.07</u>
Subtotal: Exclusions from Income, without interactions	-0.24	-2.68	-3.90	-3.93	-4.42	-2.48	-4.04
Subtotal: Exclusions from Income, with interactions	-0.64	-3.19	-4.03	-4.11	-4.65	-2.52	-4.27
Deductibility of Student Loan Interest	0.00	-0.01	-0.02	-0.02	-0.01	0.00	-0.01
Self-employed medical insurance premiums	0.00	-0.01	-0.03	-0.04	-0.07	-0.05	-0.05
Additional deduction for the blind and elderly	<u>0.00</u>	<u>-0.04</u>	<u>-0.03</u>	<u>-0.05</u>	<u>0.00</u>	<u>0.00</u>	<u>-0.02</u>
Subtotal: above the line deductions, without interactions	0.00	-0.06	-0.08	-0.11	-0.08	-0.05	-0.08
Subtotal: above the line deductions, with interactions	-0.01	-0.06	-0.08	-0.11	-0.08	-0.05	-0.08
Lower tax rates on capital gains (including ag., timber, coal)	0.00	-0.01	-0.02	-0.07	-1.82	-5.15	-1.07
Lower tax rates on dividends	<u>0.00</u>	<u>-0.01</u>	<u>-0.01</u>	<u>-0.05</u>	<u>-0.22</u>	<u>-0.43</u>	<u>-0.14</u>
Subtotal: special tax rates, without interactions	0.00	-0.02	-0.03	-0.12	-2.04	-5.58	-1.21
Subtotal: special tax rates, with interactions	0.00	-0.01	-0.04	-0.13	-2.07	-5.65	-1.23
Deductibility of Mortgage interest on owner-occupied homes	-0.01	-0.06	-0.28	-0.88	-1.70	-0.70	-1.20
Deductibility of State and local taxes ³	0.00	-0.03	-0.13	-0.48	-0.84	-1.50	-0.60
Deductibility of Charitable Contributions	0.00	-0.02	-0.09	-0.30	-0.84	-1.05	-0.56
Deductibility of Casualty Losses	0.00	0.00	0.00	0.00	-0.01	-0.01	0.00
Deductibility of Medical Expenses	<u>0.00</u>	<u>-0.04</u>	<u>-0.07</u>	<u>-0.12</u>	<u>-0.08</u>	<u>-0.02</u>	<u>-0.08</u>
Subtotal: itemized deductions, without interactions	-0.01	-0.15	-0.57	-1.78	-3.47	-3.28	-2.44
Subtotal: itemized deductions, with interactions	-0.02	-0.11	-0.41	-1.30	-3.02	-2.93	-2.07
HOPE tax credit	-0.01	-0.09	-0.10	-0.06	0.00	0.00	-0.03
Lifetime learning tax credit	-0.01	-0.05	-0.06	-0.04	0.00	0.00	-0.02
Credit for child and dependent care expenses	0.00	-0.03	-0.08	-0.05	0.00	0.00	-0.02
Low and moderate income savers credit	<u>-0.03</u>	<u>-0.11</u>	<u>-0.07</u>	<u>-0.03</u>	<u>0.00</u>	<u>0.00</u>	<u>-0.02</u>
Subtotal: non-refundable credits, without interactions	-0.05	-0.28	-0.31	-0.18	0.00	0.00	-0.09
Subtotal: non-refundable credits, with interactions	-0.05	-0.28	-0.32	-0.18	-0.01	0.00	-0.11
Child credit ⁴	-0.05	-0.96	-1.31	-0.98	-0.26	0.00	-0.58
Earned income tax credit ⁴	<u>-5.35</u>	<u>-3.99</u>	<u>-0.88</u>	<u>-0.02</u>	<u>0.00</u>	<u>0.00</u>	<u>-0.56</u>
Subtotal: refundable credits, without interactions	-5.40	-4.95	-2.19	-1.00	-0.26	0.00	-1.14
Subtotal: refundable credits, with interactions	-5.49	-5.00	-2.20	-1.00	-0.26	0.00	-1.15
Total: all provisions without interactions	-5.79	-8.19	-7.09	-7.12	-10.27	-11.39	-9.01
Total: all provisions with interactions	-6.56	-8.30	-6.99	-7.56	-11.13	-12.65	-9.62
Total: all provisions with interactions and revenue neutral tax cut	-5.99	-6.05	-2.67	-0.83	1.88	4.53	-0.03

Notes

1. Assumes AMT provisions in effect on December 18, 2007, before Congress enacted AMT "patch" for tax year 2007
2. Tax expenditure is revenue loss attributable to deduction/exclusion for contributions and earnings net of any tax on withdrawals
3. Includes both deductibility of state and local tax on owner-occupied homes and deductibility of other nonbusiness state and local taxes
4. Includes both refundable and nonrefundable portions

Table 3. Distributional Effects of Tax Expenditures with AMT Eliminated, Tax Year 2007

	Percent Change in After Tax Income (by quintile)						
	Bottom	2nd	Middle	4th	Top	Top 1%	All
Exclusion of interest on life insurance savings	-0.02	-0.08	-0.16	-0.29	-0.24	-0.14	-0.22
Net exclusion of employer contributions and earnings, employer plans ¹	-0.16	-0.57	-0.89	-0.52	-1.97	-1.56	-1.41
Exclusion of interest on tax-exempt bonds	0.00	0.00	-0.01	-0.04	-0.24	-0.50	-0.15
Exclusion of employer contributions for medical insurance	0.07	-1.40	-2.03	-2.16	-1.51	-0.27	-1.65
Exclusion of Social Security and railroad retirement benefits	-0.13	-0.60	-0.71	-0.49	-0.09	-0.03	-0.29
Exclusion of veterans benefits	<u>0.00</u>	<u>-0.02</u>	<u>-0.06</u>	<u>-0.09</u>	<u>-0.06</u>	<u>-0.01</u>	<u>-0.06</u>
Subtotal: Exclusions from Income, without interactions	-0.24	-2.67	-3.86	-3.59	-4.11	-2.51	-3.78
Subtotal: Exclusions from Income, with interactions	-0.64	-3.18	-3.97	-3.75	-4.32	-2.54	-4.00
Deductibility of Student Loan Interest	0.00	-0.01	-0.02	-0.02	-0.01	0.00	-0.01
Self-employed medical insurance premiums	0.00	-0.01	-0.03	-0.04	-0.06	-0.06	-0.05
Additional deduction for the blind and elderly	<u>0.00</u>	<u>-0.04</u>	<u>-0.03</u>	<u>-0.05</u>	<u>-0.01</u>	<u>0.00</u>	<u>-0.02</u>
Subtotal: above the line deductions, without interactions	0.00	-0.06	-0.08	-0.11	-0.08	-0.06	-0.08
Subtotal: above the line deductions, with interactions	-0.01	-0.06	-0.09	-0.11	-0.08	-0.06	-0.08
Lower tax rates on capital gains (including ag., timber, coal)	0.00	-0.01	-0.02	-0.07	-1.85	-5.33	-1.10
Lower tax rates on dividends	<u>0.00</u>	<u>-0.01</u>	<u>-0.01</u>	<u>-0.05</u>	<u>-0.22</u>	<u>-0.44</u>	<u>-0.14</u>
Subtotal: special tax rates, without interactions	0.00	-0.02	-0.03	-0.12	-2.07	-5.77	-1.24
Subtotal: special tax rates, with interactions	0.00	-0.01	-0.04	-0.12	-2.11	-5.87	-1.26
Deductibility of Mortgage interest on owner-occupied homes	-0.01	-0.06	-0.27	-0.78	-1.44	-0.72	-1.03
Deductibility of State and local taxes ²	0.00	-0.03	-0.13	-0.49	-1.63	-2.08	-1.06
Deductibility of Charitable Contributions	0.00	-0.02	-0.09	-0.26	-0.74	-1.04	-0.49
Deductibility of Casualty Losses	0.00	0.00	0.00	0.00	-0.01	-0.01	0.00
Deductibility of Medical Expenses	<u>0.00</u>	<u>-0.04</u>	<u>-0.07</u>	<u>-0.11</u>	<u>-0.06</u>	<u>-0.02</u>	<u>-0.07</u>
Subtotal: itemized deductions, without interactions	-0.01	-0.15	-0.56	-1.64	-3.88	-3.87	-2.65
Subtotal: itemized deductions, with interactions	-0.02	-0.11	-0.40	-1.14	-3.04	-3.41	-2.05
HOPE tax credit	-0.01	-0.09	-0.10	-0.08	-0.02	0.00	-0.05
Lifetime learning tax credit	-0.01	-0.05	-0.06	-0.04	0.00	0.00	-0.02
Credit for child and dependent care expenses	0.00	-0.03	-0.08	-0.06	-0.03	0.00	-0.04
Low and moderate income savers credit	<u>-0.03</u>	<u>-0.11</u>	<u>-0.07</u>	<u>-0.03</u>	<u>0.00</u>	<u>0.00</u>	<u>-0.02</u>
Subtotal: non-refundable credits, without interactions	-0.05	-0.28	-0.31	-0.21	-0.05	0.00	-0.13
Subtotal: non-refundable credits, with interactions	-0.05	-0.28	-0.33	-0.23	-0.06	0.00	-0.14
Child credit ³	-0.05	-0.96	-1.31	-0.98	-0.25	0.00	-0.57
Earned income tax credit ³	<u>-5.35</u>	<u>-3.99</u>	<u>-0.88</u>	<u>-0.02</u>	<u>0.00</u>	<u>0.00</u>	<u>-0.56</u>
Subtotal: refundable credits, without interactions	-5.40	-4.95	-2.19	-1.00	-0.25	0.00	-1.13
Subtotal: refundable credits, with interactions	-5.49	-5.00	-2.20	-0.99	-0.25	0.00	-1.14
Total: all provisions without interactions	-5.70	-8.13	-7.03	-6.67	-10.44	-12.21	-9.01
Total: all provisions with interactions	-6.56	-8.30	-6.93	-6.87	-10.91	-13.23	-9.36
Total: all provisions with interactions and revenue neutral tax cut	-5.97	-5.97	-2.52	-0.34	1.66	4.21	-0.02

Notes

1. Tax expenditure is revenue loss attributable to deduction/exclusion for contributions and earnings net of any tax on withdrawals
2. Includes both deductibility of state and local tax on owner-occupied homes and deductibility of other nonbusiness state and local taxes
3. Includes both refundable and nonrefundable portions