Tax Expenditures: What They are and Who Benefits

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When Americans think of taxes, most picture filling out a form and sending a check by April 15. But U.S. tax policy involves more than the Treasury collecting from citizens. "Tax expenditures" are part of the picture, too – special breaks and refunds that enable individuals and companies to pay less in taxes than they otherwise would. Tax expenditures are justified as ways to get businesses and citizens to do desired things, such as provide health insurance or buy houses. But they are not cheap. Taken together, U.S. tax expenditures add up to more than a trillion dollars of revenue deliberately foregone every year.

For decades, tax expenditures have escaped close scrutiny. Politicians like them because they promote a desired outcome and hand out a tax break at the same time. Citizens and businesses like them, too. But now that the U.S. government is raising much less revenue than it spends, we hear more about "closing loopholes" and reducing tax breaks. With income inequality growing, many people are also noticing that tax expenditures often favor more affluent citizens.

How Tax Expenditures Work

Also known as tax loopholes or tax breaks, tax expenditures include credits, deductions, preferential tax rates, and deferrals of tax liability. The U.S. government uses all of these measures to play favorites – for example, charging companies that offer benefits to their workers less in taxes, giving a deduction to people who own homes, and taxing "capital gains" income from investments at a lower rate than income earned as wages and salaries.

If we imagine that a "pure" tax code would treat everyone earning a certain amount of income the same way, then tax expenditures can be considered a kind of government spending. Imagine two families who both earn $75,000, but one pays rent for an apartment and the other pays the same amount each month on a home mortgage. The second family will owe less in taxes because of the home mortgage interest deduction. The federal government is essentially collecting the same taxes from both families and then sending the home-owner a check.

Who Benefits?

The U.S. tax code includes a number of deductions that are supposed to promote energy, agriculture, and other favored industries. The biggest tax expenditures, however, have social welfare objectives. Most other developed countries fund programs for housing, health care, and retirement security through direct government spending, but the United States uses tax expenditures as well as direct spending for these purposes. According to the latest estimates by Congress's Joint Committee on Taxation, tax expenditures for homeowners cost at least $120 billion in foregone revenues in 2011. That sum was far more than the government spent on all rental housing programs for the poor. Tax expenditures for employer-provided health insurance and pensions cost over $200 billion – making these the largest social expenditures in the budget apart from Social Security, Medicare, and Medicaid.

One kind of tax expenditure, the Earned Income Tax Credit, provides vital support for lower income people who work; they get an extra refund at tax time to boost their wages. But this amounts to only five percent of all money devoted to tax expenditures. Ironically, most U.S tax expenditures favor high earners, for a number of reasons:

- Affluent workers are more likely to work for companies that offer pension and health benefits subsidized by taxpayers, while many low-wage workers work at small businesses that do not offer benefits and hence do not enjoy this tax break.

- Buying a house is expensive – and tax breaks for housing favor not only homeowners versus renters, but also those who can afford a mansion or a second home.

- Well-to-do Americans are usually the ones who own substantial portfolios of investments that generate large capital gains. Currently, the U.S. Treasury subsidizes portfolio owners at an annual cost of more than $100 billion.

- People who earn more are in higher tax brackets, so tax breaks are worth more to them than to average earners. Imagine two families that each have $10,000 in deductible home mortgage interest. One is in the 33% income tax bracket, while the other has earnings in the 15% bracket (perhaps the family's total income went down because one partner lost his or her job). The higher-earning family saves $3,333 in taxes, while the struggling one saves only $1,500.

Should America Reform Tax Expenditures?

The fact that government rewards some behaviors and not others is not necessarily bad. But tax expenditures fly under the radar and do not get enough critical scrutiny. Unlike appropriations, tax expenditures do not require annual Congressional approval. Tax expenditures are devised by the House and Senate tax-writing committees, whose staffs have little expertise in social policy and do not compare tax breaks to alternatives. Once passed, tax expenditures remain in place indefinitely, unless Congress deliberately votes to overturn them – which rarely happens.

Economists often question tax expenditures. Tax breaks can channel money into dying rather than emerging industries; and they may lead people to buy more of something than they really need, which raises the price for everyone. Tax breaks often reward people for doing what they would do anyway – a millionaire is going to buy a house regardless. Finally, they make the tax code confusing and complex, adding to the cost of keep records and preparing taxes.

Lack of democratic accountability may help explain why costly and inefficient tax breaks have not been reduced – even in a time of federal budget austerity, as regular spending is cut again and again. When tens of millions of citizens are struggling with debt, foreclosures, unemployment, and poverty, perhaps some of the trillion dollars our nation spends each year on hidden tax expenditures could be better used to help average Americans.

Read more in Christopher Howard, *The Hidden Welfare State: Tax Expenditures and Social Policy in the United States* (Princeton University Press, 1997) and *The Welfare State Nobody Knows* (Princeton University Press, 2007).

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