



Tax Expenditures and the Federal Budget

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Summary

Americans often mention economic issues as the most important problem facing the United States. Recent economic issues mentioned include rising gasoline prices, rising unemployment, falling home prices, and rising mortgage interest rates. Relatively few, however, mention long-term federal budget concerns. But many policy makers and analysts rate long-term federal budgetary problems high on their list of economic problems facing the United States. President Obama created a bipartisan commission in February 2010 to develop solutions to the long-term federal fiscal problem.

Budget experts from think tanks and academia have developed proposals for dealing with long-term fiscal difficulties. Many argue that the federal budget deficits are unsustainable and threaten the future of the economy, but they differ on the causes of federal deficits. One group claims that Social Security, Medicare, and Medicaid are the major drivers of escalating deficits, and proposes that the budget process be reformed so these three programs are no longer on “autopilot.” Another group proposes reducing projected deficits by reducing the growth of Medicare and health care spending, increasing Medicare premiums for higher income beneficiaries, eliminating or limiting many tax expenditures, reforming farm subsidy programs, and adhering to pay-as-you-go budget rules.

Among the options likely to be considered to deal with the long-term fiscal problem is reform of the federal tax system. The growth of the alternative minimum tax (AMT) and the expiration of the 2001 and 2003 tax cuts in 2010 will likely force some action on tax policy. Past efforts to reform the federal tax system have included policies to rein in the use and expense of tax expenditures, which account for a large proportion of the resources the federal government uses to achieve various national goals. By 2007, it is estimated that tax expenditures amounted to about \$1 trillion and accounted for about a quarter of total expenditures. When combined with outlays for mandatory spending programs and net interest payments, almost three-quarters of total expenditures are for permanent programs that many claim are more or less on “autopilot.” The proportion of total expenditures subject to annual review by the Appropriations Committees in the appropriations process has been declining over the past two decades.

Estimates of the revenue losses and distributional effects of tax expenditures depend on the parameters of the tax code. Both will change not only because of direct changes to the tax expenditures themselves, but also because of changes elsewhere in the tax code. Consequently, while many tax expenditures may be considered permanent, the revenue losses can vary year to year because of changing economic conditions and changes to the tax code. For example, the revenue loss and distributional impacts of many tax expenditures will change after 2010 when the individual income tax rates are scheduled to revert back to their pre-2001 levels.

This report will be updated as legislative developments warrant.

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Americans often mention economic issues as the most important problem facing the United States. Recent economic issues mentioned include rising gasoline prices, rising unemployment, falling home prices, and rising mortgage interest rates. Relatively few, however, mention long-term federal budget concerns.¹ But many policy makers and analysts rate long-term federal budgetary problems high on their list of economic problems facing the United States. President Obama created a bipartisan commission in February 2010 to develop solutions to the long-term federal fiscal problem.

The federal budget deficit was almost 10% of gross domestic product (GDP) in FY2009. The Congressional Budget Office's (CBO's) baseline projection of the budget shows a steadily improving deficit until 2015 when it is projected to be 2.6% of GDP. After 2015 the deficit is projected to slowly rise, reaching 3.0% of GDP by 2010.² The baseline analysis, however, assumes that current law does not change over the projection period (for example, the 2001 and 2003 tax cuts will expire in 2010 as scheduled). CBO also puts out a long-term projection that captures current fiscal policy.³ In this alternative scenario, the alternative minimum tax (AMT) is indexed to inflation and none of the scheduled tax changes after 2009 take effect. The federal budget deficit under the alternative scenario reaches 14.6% of GDP in 2035 and 42.8% of GDP by 2080. CBO estimates a 75-year fiscal gap of 8.1% of GDP.⁴ In comparison, CBO's estimate of the fiscal gap under a scenario that simply extends their baseline assumptions is 3.2%.

In April 2008, a team of 16 budget experts from Washington think tanks issued proposals for dealing with long-term fiscal difficulties.⁵ These experts argue that the federal budget deficits are unsustainable and threaten the future of the economy. They claim that Social Security, Medicare, and Medicaid are the major drivers of escalating deficits. As a first step to establishing budget responsibility, they propose that the budget process be reformed so these three programs are no longer on "autopilot." Specifically they recommend that (1) explicit long-term budgets for the three programs be enacted, which "are sustainable, set limits on automatic spending growth, and reduce the relatively favorable budgetary treatment of these programs compared with other types of expenditures"; (2) the programs be regularly revised to determine whether they are within budgeted amounts; and (3) "significant long-term deviations from budgeted amounts trigger automatic adjustments in benefits, premiums, provider payments, or other revenues."⁶ These budget experts do acknowledge that there are "other mandatory or entitlement programs and tax subsidies that grow automatically without review" (p. 6), but they recommend starting with Social Security, Medicare, and Medicaid.

¹ About 60% of respondents to a recent New York Times-CBS News poll mention economic issues as the most important problem facing the country. Only 1% mention the budget deficit or federal debt. See New York Times-CBS News Poll, July 2008.

² See Congressional Budget Office (CBO), *The Budget and Economic Outlook: Fiscal Years 2010 to 2020*, January 2010.

³ See CBO, *The Long-Term Budget Outlook*, June 2009.

⁴ The fiscal gap is a measure of the nation's fiscal imbalance adjusting for the time value of money. It is expressed as a percentage of GDP. It represents the extent to which the federal government would have to immediately and permanently raise revenues or reduce spending in order to maintain fiscal balance over the 75-year period.

⁵ Joseph Antos and others, *Taking Back Our Fiscal Future*, The Brookings Institution and The Heritage Foundation, available at http://www.brookings.edu/~media/Files/rc/papers/2008/04_fiscal_future/04_fiscal_future.pdf, visited July 28, 2008.

⁶ Antos and others, p. 2.

More recently, another team of 16 budget experts from think tanks and academia criticized the Antos and others' proposal, mentioned above, as unbalanced for focusing solely on Social Security, Medicare, and Medicaid; ignoring the broader problem of rising health care costs; and advocating automatic budget cuts, which have proved ineffective in the past.⁷ This group of budget experts proposes reducing projected deficits by reducing the growth of Medicare and health care spending, increasing Medicare premiums for higher income beneficiaries, eliminating or limiting many tax expenditures, using a different version of the consumer price index (CPI) for calculating cost-of-living adjustments, reforming farm subsidy programs, and adhering to pay-as-you-go budget rules.

Among the options likely to be considered to deal with the long-term fiscal problem is reform of the federal tax system. The growth of the alternative minimum tax (AMT) and the expiration of the 2001 and 2003 tax cuts in 2010 will likely force some action on tax policy. The perception that the federal tax system is too complex and unfair could lead to public support for tax reform. Past efforts to reform the federal tax system have included policies to rein in the use and expense of tax expenditures—the special deductions, exclusions, exemptions, and credits resulting in revenue losses. This report examines tax expenditures within the context of the federal budget and discusses tax expenditure analysis.

Tax Expenditures and Federal Spending

Federal spending is split into discretionary spending and mandatory spending (often referred to as direct spending). Discretionary spending is provided in and controlled by the annual appropriations acts under the jurisdiction of the Appropriations Committees. Mandatory spending is controlled by substantive legislation under the jurisdiction of the legislative committees, primarily the House Ways and Means Committee and the Senate Finance Committee. Most, but not all mandatory spending is permanent in nature. In some instances, such as for the Medicaid program, funding is provided in the annual appropriations acts, but the Appropriations Committees do not effectively control it.⁸

Figure 1 displays the FY2009 outlays by the type and category of spending. Overall, discretionary spending accounted for 36% of total outlays split between defense (19%) and nondefense (17%) spending. Mandatory spending accounted for 59% of outlays while interest on the federal debt held by the public (net interest payments) accounted for 5% of FY2009 outlays. Social Security, Medicare, and Medicaid are the largest mandatory programs accounting for 37% of total outlays.

Outlays, however, provide an incomplete picture of federal resources used to achieve national economic and social goals. Tax expenditures—special deductions, exclusions, exemptions, and credits in the tax code—are often used instead of direct expenditures (mandatory and discretionary spending) to achieve these national goals.⁹ Tax expenditures, in many ways, are similar to entitlement spending. Eric Toder notes that tax expenditures are available to everyone

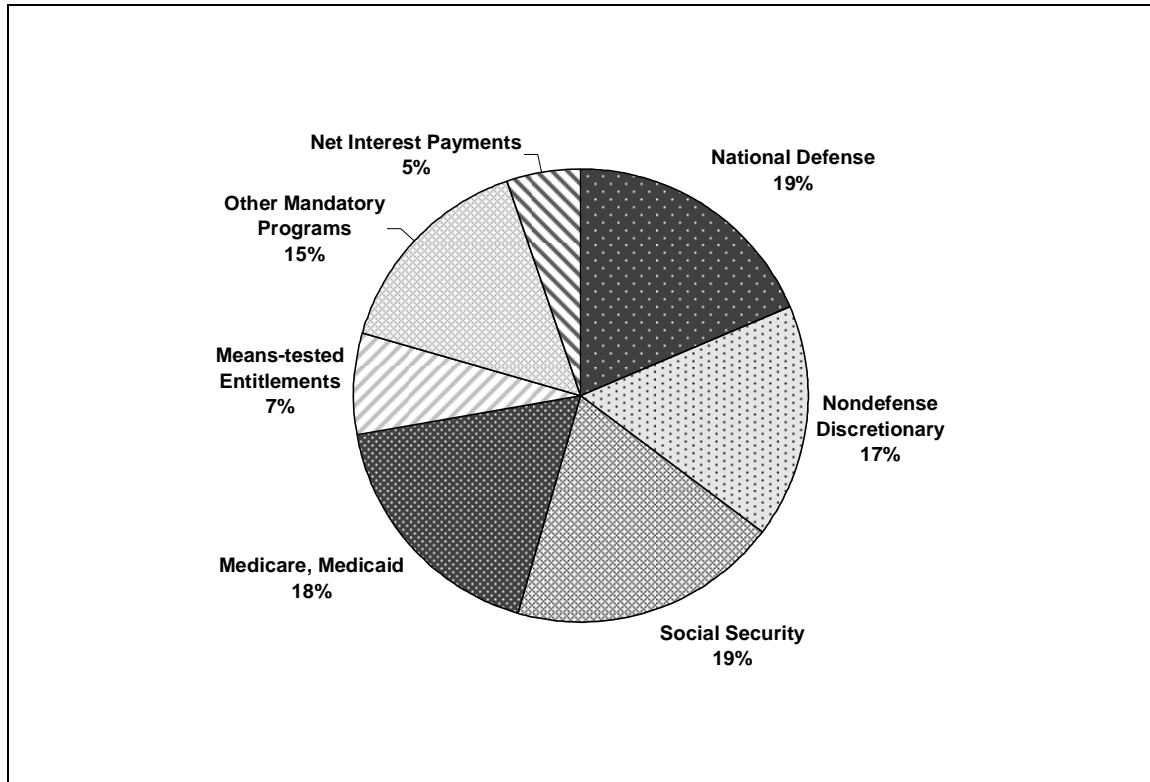
⁷ Henry Aaron and others, *A Balanced Approach to Restoring Fiscal Responsibility*, The Brookings Institution, July 2008, available at http://www.brookings.edu/~media/Files/rc/papers/2008/07_fiscal_responsibility_aaron/07_fiscal_responsibility_aaron.pdf, visited July 28, 2008.

⁸ See CRS Report 98-721, *Introduction to the Federal Budget Process*, by Robert Keith.

⁹ See CRS Report RL33641, *Tax Expenditures: Trends and Critiques*, by Thomas L. Hungerford.

who qualifies and federal budgetary costs depend on program rules (the tax code), economic conditions, and behavioral responses.¹⁰ Furthermore, they often remain in the tax code until changed or eliminated by congressional action.¹¹

Figure 1. Federal Outlays, Fiscal Year 2009



Source: Office of Management and Budget (OMB).

Figure 2 shows the trend of the three major components of outlays (mandatory spending, discretionary spending, and net interest payments) plus the aggregate revenue loss of tax expenditures as a percentage of GDP since 1974.¹² Several points are worth highlighting:

- in FY1987, mandatory spending, discretionary spending, and tax expenditures were each approximately equal at about 9.7% of GDP;

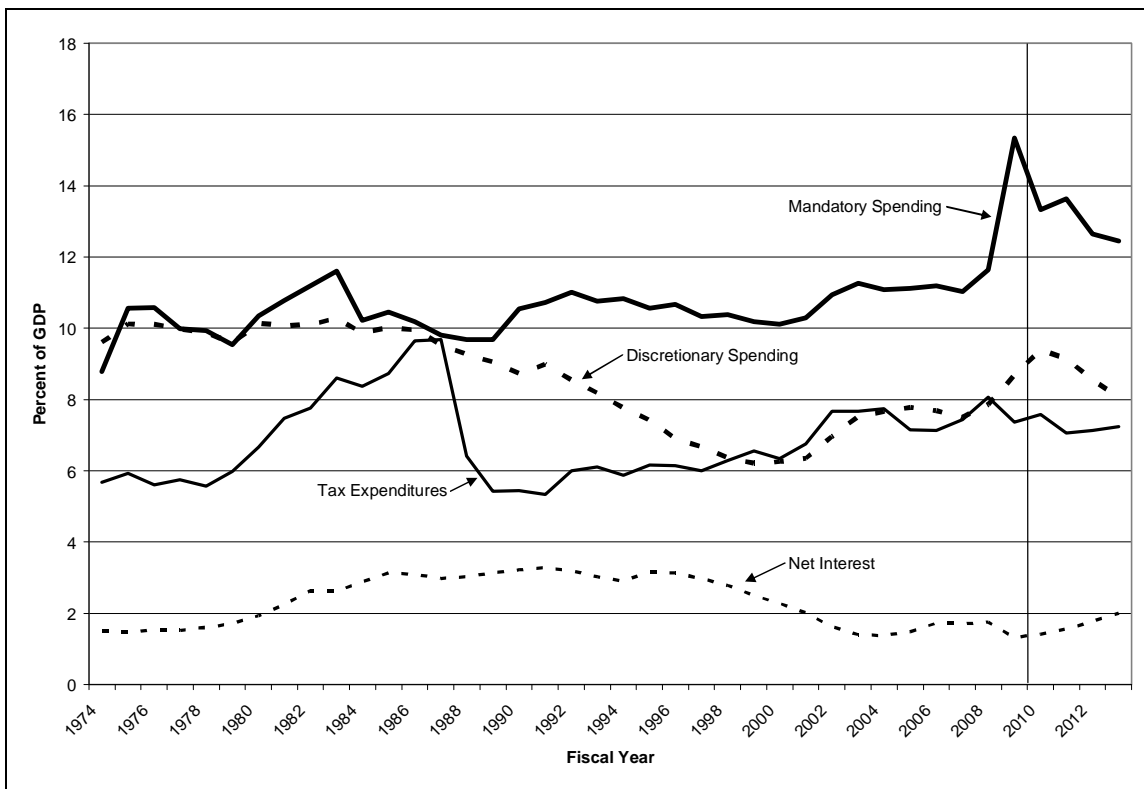
¹⁰ Eric J. Toder, "Tax Cuts or Spending—Does it Make a Difference?" *National Tax Journal*, vol. 53, no. 3, part 1 (September 2000), pp. 361-372.

¹¹ David A. Weisbach and Jacob Nussim, "The Integration of Tax and Spending Programs," *Yale Law Journal*, vol. 113, no. 5 (March 2004), pp. 955-1028.

¹² The Joint Committee on Taxation (JCT) estimates tax expenditures in terms of revenues lost to the U.S. Treasury. The revenue loss is a straightforward and easily understood concept—it is simply the taxes not paid and represents revenues forgone by the government. Simply aggregating the individual tax expenditures as estimated by the JCT ignores the interactions among tax expenditures. A recent study estimates that the sum of revenues lost under the separate tax expenditures is about 8% less than the revenue loss when the tax expenditures are taken as a group. See Leonard E. Burman, Christopher Geissler, and Eric J. Toder, "How Big Are Total Individual Income Tax Expenditures, and Who Benefits from Them?" *American Economic Review*, papers and proceedings, vol. 98, no. 2 (May 2008), pp. 79-83.

- by FY2007, discretionary spending was approximately equal to the estimated revenue loss of tax expenditures (about 7.6% of GDP);
- estimated tax expenditures experienced a large decline relative to GDP between 1987 and 1989 largely because of the effects of the Tax Reform Act of 1986, which broadened the tax base by eliminating several tax expenditures and reduced tax rates;
- discretionary spending for the most part steadily declined relative to GDP until 2001 while mandatory spending remained fairly constant;
- discretionary spending increased relative to GDP between 2002 and 2005, primarily because of increases in defense spending;
- both mandatory and discretionary spending rose after 2007 because of policy responses to the financial crisis and the recession; and
- tax expenditures decreased relative to GDP in 2009 because of reduced tax revenues due to the recession.

Figure 2. Total Expenditures, FY1974 to FY2013



Source: OMB, JCT, and CBO.

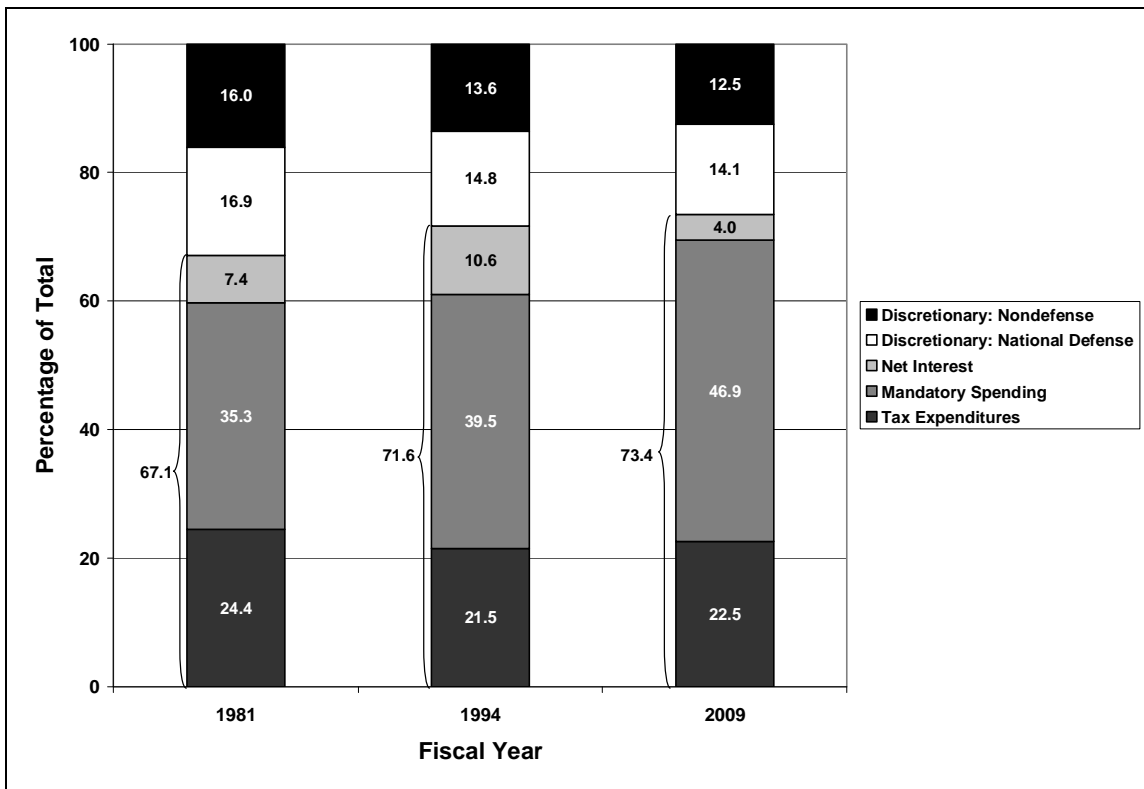
Figure 3 provides a different view of the information presented in Figure 2 for selected years. The figure breaks total expenditures down into its components (discretionary spending, mandatory spending, net interest payments, and tax expenditures).¹³ At the top of each bar are the

¹³ For the purposes of this report, total expenditures is the sum of federal outlays and the revenue loss of tax (continued...)

two discretionary spending categories (defense and nondefense), which represent the proportion of total expenditures considered annually in the appropriations bills by the two Appropriations Committees. The bottom three categories—tax expenditures, mandatory spending, and net interest payments—represent expenditures of permanent programs more or less on “autopilot.” Some of these expenditures are subject to annual appropriation, but the Appropriations Committees have little discretion on the amounts provided.

In 1981, discretionary spending accounted for 32.9% of total expenditures while the nondiscretionary categories (tax expenditures, mandatory spending, and net interest) accounted for 67.1%. In 1994, the nondiscretionary categories accounted for 71.6% of all expenditures. By 2009, the nondiscretionary categories were 73.4% of the total and only 26.6% was discretionary spending subject to annual consideration.

Figure 3. Composition of Total Expenditures, Selected Years



Source: OMB, JCT, and CBO.

In 2009, the big three mandatory programs—Social Security, Medicare, and Medicaid—accounted for 29.6% of total expenditures. Under CBO’s long-term alternative projection (the alternative scenario) and the assumption that tax expenditures remain a constant percentage of GDP (7.4% of GDP), interest payments on the national debt will account for about 42.0% of total

(...continued)
expenditures.

expenditures in 2080 while Medicare and Medicaid will account for 25.0% and Social Security for 8.6%.¹⁴

Tax Expenditure Analysis

Special deductions, exclusions, and exemptions (sometimes characterized as “loopholes”) have been in the tax code since the passage of the progressive income tax in 1913.¹⁵ Since then, over 100 special deductions, exemptions, and credits have been added to the tax code. Of course, for the first 25 years of the income tax, tax expenditures were relatively unimportant. Prior to World War II, the federal income tax was of little economic importance—individual and corporate income tax receipts amounted to less than 2% of gross domestic product (GDP). By 1945, however, income tax receipts accounted for over 15% of GDP. As the income tax became more economically important, so did the tax subsidies from the special deductions, exemptions, exclusions, and credits.

In the mid-1960s, the Department of the Treasury became interested in tracking and accounting for these tax subsidies.¹⁶ Indeed, the term “tax expenditures” was first used at this time.¹⁷ With the enactment of the Congressional Budget and Impoundment Control Act of 1974 (P.L. 93-344), tax expenditures were officially defined as “those revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability.”¹⁸ Both the Department of the Treasury and the Joint Committee on Taxation (JCT) prepare annual lists and estimates of tax expenditures.

Tax expenditures include reductions in tax liability resulting from special tax provisions. To determine if a provision is a tax expenditure, the JCT defines a baseline or reference income tax structure referred to as the “normal income tax law,” which has a broader concept of income than under U.S. tax law.¹⁹ The committee staff uses its judgement to distinguish between what are normal income tax provisions and what are special provisions.

The U.S. Department of the Treasury uses a similar procedure to identify tax expenditures, but uses two baseline income tax structures: the normal income tax baseline and the reference income tax baseline. The reference tax baseline is closer to existing tax law and, consequently, identifies

¹⁴ While the path under this scenario is obviously unsustainable, it does offer a version of the consequences of extending today’s fiscal environment 75 years into the future.

¹⁵ The United States had an income tax in the years during and immediately following the Civil War. The income tax was repealed in 1872 because the revenue was no longer needed. An income tax was re-established in 1894, but was declared unconstitutional by the Supreme Court in 1895. Ratification of the 16th Amendment on February 3, 1913 permitted the federal government to tax income. The graduated income tax was established on October 3, 1913. See Roy G. Blakey and Gladys C. Blakey, *The Federal Income Tax* (New York: Longmans, Green and Co., 1940) for a history of early years of the income tax.

¹⁶ See Jonathan Barry Forman, “Origins of the Tax Expenditure Budget,” *Tax Notes*, February 10, 1986, pp. 537-545 for a review of the beginnings of tax expenditure analysis.

¹⁷ See Stanley S. Surrey and Paul R. McDaniel, *Tax Expenditures* (Cambridge, MA: Harvard University Press, 1985). The first author was the Assistant Secretary for Tax Analysis at the Department of Treasury at the time.

¹⁸ 2 U.S.C. § 622.

¹⁹ U.S. Congress, Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2007-2011*, joint committee print, 110th Cong., 1st sess., JCS-3-07 (Washington: GPO, 2007).

fewer tax expenditures. This baseline has been used by the Treasury since 1982. Prior to 1982, there were few differences between the tax expenditures lists of the JCT and the Department of the Treasury, since both used the same baseline. After 1982, the differences between the two lists have grown. The JCT has used a consistent methodology to define and estimate tax expenditures over time, whereas the Department of the Treasury's methodology has changed from administration to administration.²⁰

Other baseline tax law structures have been proposed. One commonly proposed baseline is the consumption tax baseline, which has been used in the past as one of the baselines in the Administration's annual list of tax expenditures. This baseline has fewer built-in distortions than the income tax. For example, the choice between future consumption (that is, saving) and current consumption is not biased as it is when income is taxed. Many of the largest tax expenditures would no longer be defined as tax expenditures using this baseline concept, and an alternative set of tax expenditures would be produced. The current tax system, however, is an income tax. Furthermore, many observers believe it is unlikely that the U.S. income tax will be replaced by a consumption tax in the foreseeable future.

The choice of the baseline tax law system is probably the most controversial aspect in defining and measuring tax expenditures.²¹ Stanley Surrey had in mind a Haig-Simons definition of income as the basis for tax expenditure analysis.²² Simons defined personal income as "the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question."²³ The normal tax baseline, however, is an attempt to apply the Haig-Simons concept to the real world. It does not include some items that would be considered income (for example, imputed rent, home produced consumption goods, and accrued capital gains) and includes other items that would not be considered income (for example, inflationary gains).²⁴

Criticisms of tax expenditures appeared almost immediately after the concept was introduced. Boris Bittker points out the "many ambiguities that become apparent as soon as one attempts to apply the Haig-Simons definition to the protean stream of economic life."²⁵ He further argues that the baseline is arbitrary and, consequently, tax expenditures will be defined as disparities between the tax code and whatever the observer thinks the tax code should be. This theme was extended by Douglas Kahn and Jeffrey Lehman, who argue that tax expenditure analysis creates "an illusion of value-free scientific precision in a heavily politicized domain."²⁶ Leonard Burman,

²⁰ For example, the George W. Bush Administration, which has questioned the whole concept of tax expenditures, stated in the FY2002 budget: "Because of the breadth of this arbitrary tax base, the Administration believes that the concept 'tax expenditure' is of questionable analytic value." See "Tax Expenditures," ch. 15 in OMB, *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2002*, February 2001, p. 61.

²¹ See Douglas A. Kahn and Jeffrey S. Lehman, "Tax Expenditure Budgets: A Critical View," *Tax Notes*, March 30, 1992, pp. 1661-1665, for a critical review of various baseline tax law structures.

²² See Stanley S. Surrey, *Pathways to Tax Reform* (Cambridge, MA: Harvard University Press, 1973), p. 12; and Stanley S. Surrey and Paul R. McDaniel, *Tax Expenditures* (Cambridge, MA: Harvard University Press, 1995), p. 14.

²³ Henry C. Simons, *Personal Income Taxation* (Chicago, IL: University of Chicago Press, 1938), p. 50.

²⁴ See Eric J. Toder, "Tax Expenditures and Tax Reform," paper presented at the Ninety-eighth Annual Conference on Taxation, National Tax Association, Miami, FL, November 17-19, 2005.

²⁵ Boris R. Bittker, "Accounting for Federal 'Tax Subsidies' in the National Budget," *National Tax Journal*, vol. 22, no. 2 (June 1969), p. 260.

²⁶ Douglas A. Kahn and Jeffrey S. Lehman, "Tax Expenditure Budgets: A Critical View," *Tax Notes*, March 30, 1992, p. 1663.

however, argues that even with the lack of theoretical rigor the current list of tax expenditures is a useful list of the extent of deviations of the tax code from an economic ideal and notes that many tax expenditures would exist against any baseline.²⁷ He concludes that tax expenditure analysis shows “how government affects the allocation of resources both directly—by financing public activities via tax concessions—and indirectly, by altering after-tax prices and thus distorting the allocation of resources.”²⁸

The Joint Committee of Taxation Pamphlet on Tax Expenditure Analysis

Even with the criticisms, the need for analysis of tax expenditures has long been recognized. Walter Blum in a 1955 Joint Economic Committee report stated that tax expenditures are “hidden in technicalities of the tax law; they do not show up in the budget; their cost frequently is difficult to calculate; and their accomplishments are even more difficult to assess.”²⁹ As a result of this lack of transparency, analysts argue that tax expenditure analysis is a critical tool in achieving a more accountable process for enacting and tracking government programs.³⁰ In May 2008, the JCT released a pamphlet justifying the need to reconsider their implementation of tax expenditure analysis.³¹

The JCT acknowledges the criticisms of the use of a normal tax system and sets out to modify tax expenditure analysis so it will serve as an “effective and neutral analytical tool for policymakers.”³² Their approach is to revise the classification of tax expenditures without reference to the normal tax system. The revised classification creates two broad categories of tax expenditures: tax subsidies and tax-induced structural distortions.³³

Tax subsidies are tax provisions that are “deliberately inconsistent with an identifiable general rule of the present tax law.”³⁴ Tax subsidies are further divided into three subcategories. The first is tax transfers, which are transfers to taxpayers regardless of their tax liability and would include the refundable portions of various tax credits (for example, the earned income credit (EIC) and the child tax credit). The second subcategory is social spending, which is designed to induce behaviors unconnected to the production of business income. Examples would include the charitable giving deduction, deductions and exclusions for individual retirement accounts (IRAs), and the nonrefundable portions of the EIC and child tax credit. The final subcategory is business

²⁷ Leonard E. Burman, “Is the Tax Expenditure Concept Still Relevant?” *National Tax Journal*, vol. 56, no. 3 (September 2003), pp. 613-627.

²⁸ *Ibid.*, p. 626.

²⁹ Walter J. Blum, “The Effects of Special Provisions in the Income Tax on Taxpayer Morale,” in U.S. Congress, Joint Economic Committee, *Federal Tax Policy for Economic Growth and Stability*, report, 84th Cong., 1st sess. (Washington, DC: GPO, 1955), 251-252.

³⁰ See, for example, J. Clifton Fleming and Robert J. Peroni, “Reinvigorating Tax Expenditure Analysis and its International Dimension,” *Virginia Tax Review*, vol. 27, no. 3 (Winter 2008), pp. 437-562.

³¹ Joint Committee on Taxation, *A Reconsideration of Tax Expenditure Analysis*, May 12, 2008 (JCX-37-08), hereafter referred to as *Reconsideration*.

³² *Reconsideration*, p. 7.

³³ The JCT also proposes to have a third category that includes tax expenditures as defined under their current methodology but don’t fit into either of these two categories.

³⁴ *Reconsideration*, p. 9.

synthetic spending, which includes subsidies designed to induce behaviors directly related to the production of business income (for example, various energy tax subsidies).

Tax-induced structural distortions contain the elements of the tax code that “materially affect economic decisions in a manner that imposes substantial economic efficiency costs.”³⁵ An example of this category of tax expenditure is the differential taxation of debt and equity financing. Since interest is a deductible business expense, corporations may be encouraged to raise capital as debt rather than equity.

Issues in Measuring Tax Expenditures

There are several issues associated with measuring tax expenditures. One issue is estimating the revenue loss of tax expenditures. Another issue is estimating their distributional impact. Both the revenue loss and distributional effects depend on the parameters of the tax code—both will change when the parameters of the tax code change, such as marginal tax rates. Consequently, tax expenditure estimates can change from year to year not only because of direct changes to the tax expenditures themselves, but also because of changes elsewhere in the tax code. This is illustrated in **Table 1** for nine selected deductions and exclusions. The table reports the change in revenue loss estimates and distributional effects under two scenarios with different tax rates. The first scenario assumes that the 2000 tax rates were in effect while the second scenario assumes a flat 20% tax rate on taxable income. No behavioral changes are incorporated into the analysis, the AMT is ignored, and no other changes are made to the tax code. The analysis uses the 2004 Internal Revenue Service (IRS) Statistics of Income Public Use Data File.³⁶

Table 1. Revenue Losses and Progressivity Measures of Selected Tax Expenditures Under Alternative Scenarios

	Percentage Difference from 2004 Tax Rate Revenue Loss Estimate	
	2000 Tax Rates (1)	Flat Tax Rate (2)
Mortgage Interest Deduction	10.0%	-10.1%
State and Local Property Tax Deduction	3.0%	-9.1%
State and Local Nonbusiness Tax Deduction	10.7%	-20.4%
Charitable Contribution Deduction	10.2%	-13.9%
IRA Deduction	8.8%	6.9%
Student Loan Interest Deduction	8.2%	15.1%
Tuition and Fees Deduction	12.0%	0.7%
Exclusions of Social Security Benefits	12.2%	37.2%

³⁵ *Reconsideration*, p. 10.

³⁶ The Public Use Data File is a nationally representative sample of tax returns for the 2004 tax year. To protect the identity of individual taxpayers while preserving the character of the data, the IRS made some changes to the data, especially for high income taxpayers. The unit of analysis is the tax return for a taxpayer and IRS-provided sample weights are used throughout the analysis. Taxpayers with negative total income or who are claimed as a dependent by another taxpayer are omitted from the analysis sample.

	Percentage Difference from 2004 Tax Rate Revenue Loss Estimate	
Exclusion of State and Local Public Purpose Bond Interest	10.7%	-22.1%

Source: Author’s analysis of 2004 IRS Statistics of Income Public Use Data File.

Notes: The AMT is excluded from the analysis.

Table 1 reports the percentage difference in revenue loss estimates under the two scenarios using the 2004 tax code as the base. The 2000 tax rates are generally more progressive than the 2004 tax rates—higher for higher income taxpayers (for example, the top marginal tax rate is increased from 35% to 39.6%). But there is no 10% tax bracket for low income taxpayers. The flat tax essentially raises the tax rate for lower income taxpayers (from 10% and 15% to 20%) and lowers it for higher income taxpayers. The revenue loss estimates are all higher under the 2000 tax rates than under the 2004 tax rates (see the first column). The difference ranges from 3% for the property tax deduction to over 12% for the exclusion of Social Security benefits.

The difference in the revenue loss estimates between the flat tax rate and the 2004 tax rates vary dramatically, from -20% to +37%. Since the tax rate is higher for lower income taxpayers under the flat tax, the revenue loss estimates for tax expenditures used primarily by lower income taxpayers increase. These tax expenditures are the above-the-line deductions (deductions for IRAs, student loan interest, and tuition and fees) and the exclusion of Social Security benefits. The opposite is true for the tax expenditures utilized primarily by high income taxpayers—the itemized deductions (mortgage interest, property taxes, nonbusiness taxes, and charitable contributions) and exclusion of public purpose bond interest.

The next three tables report distributional measures of the various tax expenditures. In the tables, the average reduction in tax liability (or value) due to a particular deduction or exclusion is reported by income group. The income distribution is divided into five income categories.³⁷ Quintile 1 contains the poorest 20% of taxpayers while quintile 5 contains the richest 20%. Also shown is information for the richest 10%, 5%, and 1% of taxpayers.

Table 2 reports the averages for the four itemized deductions examined in this report. Taxpayers generally only itemize if their itemized deductions are greater than the standard deduction. These four itemized deductions display the classic “upside down” distributional pattern because of the progressive nature of the individual income tax and higher income taxpayers have greater deductions. This upside down distribution is demonstrated in column (1) of each panel in the table. The average tax savings increases as income increases. For example, the average tax savings from the mortgage interest deduction is \$4 for the poorest 20% of taxpayers (quintile 1) but is nearly \$6,000 for the richest 1% of taxpayers.

The 2000 tax rates were slightly more progressive than the 2004 tax rates (the tax rates were higher for higher income taxpayers). Consequently, the reduction in tax liability from itemized deductions is greater as income increases under the 2000 tax rates than under the 2004 tax rates (see the second column in each panel). The value of the mortgage interest deduction increases by

³⁷ Income is total income as reported on the tax return and includes tax exempt interest and untaxed Social Security benefits. Total income is divided by the square root of the number of exemptions claimed to account for differences in family size. The income categories are based on this measure of income. The income breaks between income categories are: 20th percentile = \$11,453; 40th percentile = \$21,060; 60th percentile = \$33,820; 80th percentile = \$52,053; 90th percentile = \$72,268; 95th percentile = \$100,020; and 99th percentile = \$239,421.

12% for the richest 1% of taxpayers on average, but essentially remains the same for the poorest 20% of taxpayers. Even though the income tax is more progressive under the 2000 tax rates, the benefits of itemized deductions are more regressively distributed.

Table 2. Average Tax Savings from Schedule A Itemized Deductions Under Alternative Scenarios

	Mortgage Interest			State and Local Property Taxes		
	2004 Tax Rates (1)	2000 Tax Rates (2)	Flat Tax Rate (3)	2004 Tax Rates (1)	2000 Tax Rates (2)	Flat Tax Rate (3)
Quintile 1	\$4	\$5	\$5	\$2	\$2	\$2
Quintile 2	\$48	\$63	\$83	\$16	\$21	\$28
Quintile 3	\$210	\$223	\$292	\$73	\$79	\$104
Quintile 4	\$551	\$587	\$604	\$198	\$210	\$226
Quintile 5	\$1,838	\$2,039	\$1,399	\$790	\$875	\$609
Top 10%	\$2,495	\$2,770	\$1,788	\$1,126	\$1,249	\$819
Top 5%	\$3,292	\$3,651	\$2,235	\$1,543	\$1,711	\$1,067
Top 1%	\$5,502	\$6,172	\$3,577	\$2,810	\$3,147	\$1,838

	State and Local Nonbusiness Taxes			Charitable Contributions		
	2004 Tax Rates (1)	2000 Tax Rates (2)	Flat Tax Rate (3)	2004 Tax Rates (1)	2000 Tax Rates (2)	Flat Tax Rate (3)
Quintile 1	\$2	\$2	\$2	\$2	\$2	\$2
Quintile 2	\$13	\$19	\$22	\$16	\$21	\$27
Quintile 3	\$72	\$76	\$99	\$70	\$74	\$98
Quintile 4	\$238	\$253	\$259	\$186	\$196	\$215
Quintile 5	\$1,666	\$1,856	\$1,203	\$1,046	\$1,160	\$794
Top 10%	\$2,724	\$3,038	\$1,886	\$1,648	\$1,831	\$1,192
Top 5%	\$4,387	\$4,895	\$2,936	\$2,611	\$2,901	\$1,826
Top 1%	\$12,796	\$14,398	\$8,383	\$7,762	\$8,674	\$5,317

Source: Author's analysis of 2004 IRS Statistics of Income Public Use Data File.

Notes: The AMT is excluded from the analysis.

The flat tax rate increases the value of itemized deductions for the bottom 80% of taxpayers and reduces the value for the richest 20% of taxpayers (see the third column in each panel of **Table 2**). The primary reason is the flat tax rate raises the tax rate for those in the bottom 80% of the income distribution and reduces the tax rate for the top 20%. Taxes become less progressive but the value of deductions becomes less regressive.

The distributional effects of the three above-the-line deductions are reported in **Table 3**. These deductions are generally limited to lower and middle income taxpayers and, unlike itemized deductions, are available to all who qualify rather than solely to those who itemize. The average value of these deductions generally rises with income at first and then declines with income for

those taxpayers at the top of the income distribution. The average value of these tax expenditures across the income distribution vary by the progressivity of the tax rates (see the second and third column in each panel).

Table 3. Average Tax Savings from Above-the-Line Deductions Under Alternative Scenarios

	IRA			Student Loan Interest		
	2004 Tax Rates (1)	2000 Tax Rates (2)	Flat Tax Rate (3)	2004 Tax Rates (1)	2000 Tax Rates (2)	Flat Tax Rate (3)
Quintile 1	\$0	\$0	\$0	\$0	\$0	\$0
Quintile 2	\$3	\$3	\$5	\$2	\$3	\$4
Quintile 3	\$10	\$11	\$15	\$7	\$7	\$9
Quintile 4	\$23	\$24	\$27	\$13	\$14	\$14
Quintile 5	\$39	\$43	\$33	\$18	\$9	\$7
Top 10%	\$50	\$55	\$39	\$3	\$4	\$3
Top 5%	\$57	\$63	\$42	\$0	\$0	\$0
Top 1%	\$57	\$64	\$38	\$0	\$0	\$0

	Tuition and Fees		
	2004 Tax Rates (1)	2000 Tax Rates (2)	Flat Tax Rate (3)
Quintile 1	\$1	\$2	\$3
Quintile 2	\$4	\$6	\$8
Quintile 3	\$7	\$7	\$10
Quintile 4	\$22	\$24	\$22
Quintile 5	\$39	\$44	\$32
Top 10%	\$24	\$26	\$19
Top 5%	\$6	\$7	\$5
Top 1%	\$2	\$3	\$2

Source: Author's analysis of 2004 IRS Statistics of Income Public Use Data File.

Notes: The AMT is excluded from the analysis.

The distributional results for the two income exclusions are reported in **Table 4**. These two exclusions are available to all receiving Social Security benefits or interest income from state and local public purpose bonds. But how these two exclusions are calculated is very different. On the one hand, most or all benefits from Social Security received by lower income individuals and families are not taxed, and many do not file income tax returns (these individuals and families are not included in the analysis). Part of Social Security income received by high income taxpayers, however, is included in income and taxed. On the other hand, all state and local public purpose bond interest income is excluded from income for tax purposes. These bonds, however, are owned primarily by higher income taxpayers.

Table 4. Average Tax Savings from Income Exclusions Under Alternative Scenarios

	Social Security Benefits			State and Local Public Purpose Bond Interest		
	2004 Tax Rates (1)	2000 Tax Rates (2)	Flat Tax Rate (3)	2004 Tax Rates (1)	2000 Tax Rates (2)	Flat Tax Rate (3)
Quintile 1	\$1	\$1	\$1	\$0	\$0	\$0
Quintile 2	\$34	\$47	\$63	\$1	\$1	\$1
Quintile 3	\$191	\$224	\$304	\$2	\$3	\$4
Quintile 4	\$260	\$277	\$356	\$16	\$17	\$21
Quintile 5	\$142	\$155	\$136	\$473	\$523	\$357
Top 10%	\$153	\$168	\$135	\$882	\$978	\$645
Top 5%	\$170	\$187	\$142	\$1,607	\$1,786	\$1,138
Top 1%	\$213	\$236	\$162	\$5,774	\$6,438	\$3,903

Source: Author's analysis of 2004 IRS Statistics of Income Public Use Data File.

Notes: The AMT is excluded from the analysis.

Given these differences, the distributional patterns of the value of the exclusions differ. The average value of the Social Security benefit exclusion increases with income up through quintile 4 and then falls for the richest 20% of taxpayers (see the first column). The value of the exclusion does change when the tax rates change (see the second and third column in the panel). The public purpose bond interest exclusion displays the classic upside down distributional pattern (see the first column in the panel). Again the magnitude of the tax savings varies and tax rates become more or less progressive (see the second and third columns in the panel).

The 2001 and 2003 tax cuts reduced the tax rates to their current levels.³⁸ The tax rates are scheduled to revert back to their pre-2001 levels after 2010. This reversion alone will change the revenue loss estimates and distributional impacts of tax expenditures.

Conclusions

Tax expenditures account for a large proportion of the resources the federal government uses to achieve various national goals. In 2009, it was estimated that tax expenditures amounted to about \$1 trillion and accounted for about a quarter of total expenditures. When combined with outlays for mandatory spending programs and net interest payments, almost three-quarters of total expenditures are for permanent programs that many claim are more or less on “autopilot.” The proportion of total expenditures subject to annual review by the Appropriations Committees in the appropriations process has been declining over the past two decades. Given the long-term fiscal imbalances, part of the solution will likely involve tax reform and the limitation or outright

³⁸ See CRS Report RL34498, *Statutory Individual Income Tax Rates and Other Elements of the Tax System: 1988 through 2009*, by Maxim Shvedov.

elimination of some tax expenditures. Tax expenditure analysis can be a useful tool for policymakers considering tax reform proposals.

Estimates of the revenue losses and distributional effects of tax expenditures depend on the parameters of the tax code. Both will change not only because of direct changes to the tax expenditures themselves, but also because of changes elsewhere in the tax code. Consequently, while many tax expenditures may be considered permanent, the revenue losses can vary year to year because of changing economic conditions and changes to the tax code. For example, the revenue loss and distributional impacts of many tax expenditures will change after 2010 when the individual income tax rates are scheduled to revert back to their pre-2001 levels.

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