

THE CENTURY FOUNDATION

Issue Brief

HOW TO REDUCE DEFICITS AND IMPROVE THE TAX SYSTEM WITHOUT HURTING MOST FAMILIES

BY BERNARD WASOW

INTRODUCTION

The economic crisis that began in 2007 has caused current federal deficits to soar while worsening the already poor long-term budgetary outlook. Declining incomes and corporate profits have greatly reduced tax revenues, while the federal stimulus legislation and the “automatic stabilizers” of safety net programs have increased domestic spending, leading the deficit to catapult from \$248 billion in 2006 to \$1.4 trillion in 2009.

Under the latest projections of the Congressional Budget Office (CBO), deficits are expected to decline after the economy recovers but then are expected to increase unsustainably beginning in the decade of the 2020s. Those forecasts show that, without corrective action, federal debt will exceed 113 percent of GDP in 2026—surpassing the previous record set during World War II—and then will rise ever upward in the years beyond. Virtually everyone agrees: the long-term budget outlook is serious enough that after job growth resumes, restoring fiscal health will require some combination of sizeable tax increases and spending cuts. But there is no consensus at all about the details of how to achieve that goal.

President Obama created a National Commission on Fiscal Responsibility and Reform, co-chaired by Democrat Erskine Bowles and Republican Alan Simpson, to develop recommendations for significantly reducing long-term deficits. If fourteen of the commission’s eighteen members can agree upon a plan, which is due by December 1, 2010, it will be presented to Congress.

Although the co-chairmen of the commission have insisted that “everything is on the table,” many of the Republican members in the past have adamantly opposed tax increases. So it is highly uncertain whether the commission will be able to reach a consensus, and if it does, whether Congress will approve its recommendations.

As these deliberations unfold, one common refrain will be that there is no painless way to reduce deficits. Many will argue that cuts to important and popular social insurance programs such as Social Security, Medicare, and Medicaid are the only path to fiscal responsibility. But the debate over the past year that recently concluded with enactment of health care reform is instructive. Rapidly rising medical costs are far and away the single biggest factor underlying the projected long-term increase in federal deficits.

Many provisions in the health care bill, particularly those affecting Medicare and Medicaid, are intended to help make the nation’s highly inefficient health care system less wasteful. Because we do not know yet how successful those experiments will be, government forecasts of rapidly rising costs have not changed much

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in the wake of the legislation's passage. But many experts are optimistic that some of those reforms might help to "bend the cost curve," which would ease at least some of the long-term budgetary pressures on the federal government. If so, that would demonstrate that reforms could help to reduce deficits without inflicting pain on average Americans. In fact, if they work, they would save money while improving and expanding medical coverage.

One other possible source of savings that would not only be painless for the vast majority of Americans but also salutary is reform of the loophole-riddled federal tax code, which is filled with inefficiencies, unnecessary complexity, and inequities. The CBO tabulates 165 major deviations from a straightforward, simple income tax. In spite of the fact that these tax breaks—more formally known as "tax expenditures"—are expected to cost more than \$5 trillion in foregone revenue over the next five years, they remain deeply embedded in the system without any of the congressional oversight or review that spending programs receive as a matter of course. No process exists for evaluating the extent to which tax breaks are accomplishing their desired goals or otherwise justifying their cost. In fact, the vast majority of tax breaks have not been shown to change behavior in ways that Congress intended when first enacting them into law.

Legislators use tax breaks to encourage certain behaviors and at times simply to reward private constituents as well as businesses. In the name of promoting saving, investment, and home ownership, for example, the income tax code has been endowed with special provisions that deliver very little to low-income households, significant benefits to the middle class, and huge tax breaks to high-income households. Imagine a direct spending program that delivered benefits worth 5 percent of income to top earners, 2 percent of income to the upper-middle class, and less than 1 percent to those earning less than \$30,000 per year. Such a spending program rightly would be looked upon as unfair. But in the guise of "tax expenditures" such unfair "spending" is widespread.

Many political analysts and pundits argue that it is hopeless to try to scrub the tax code of wasteful provisions because well-financed interest groups have a huge stake in sustaining and adding to those breaks. But the experience in 1986, when President Reagan and Congress enacted a sweeping set of reforms that reduced or eliminated, at least for a while, many tax breaks, demonstrates that it is possible in the United States to gain broad political support for major tax simplification. Although the revenue gained from eliminating sundry tax breaks was offset entirely by tax rate reductions and other changes in 1986—producing a "revenue neutral" bill—one goal of new legislation would be to help reduce the long-term growth in federal debt that everyone acknowledges must be addressed. Moreover, the tax increases of 1993 under President Clinton demonstrated, contrary to the dire predictions at the time, that increasing revenues can help lead to economic prosperity and a vastly improved budget outlook.

The good news is that many of the inefficiencies in the tax code could be curtailed without imposing a significant hit on the finances of Americans who can bear it the least. Because most of the existing tax breaks benefit specific industries, and the most costly breaks disproportionately benefit upper-income households, tax reform could be implemented in ways that would raise needed revenues; make the tax system simpler, fairer, and economically efficient; and impose costs primarily on those who can most afford them. Because the economy still is struggling mightily, with unemployment over 9 percent, it would be premature and counterproductive to try to reduce tax breaks today. But since the debate over deficit reduction is sure to focus on cuts to programs that mainly help middle-class and poor Americans, it is important for the public to understand that there are other alternatives that would be less painful and more beneficial to the country as a whole.

THE SIZE OF THE DEFICIT PROBLEM

Budget deficits in and of themselves are not inherently harmful to a country, and actually are the most prudent policy during economic downturns, when government spending is essential to alleviating hardship

and revitalizing economic activity. But large and growing deficits during periods of prosperity can become a significant problem for several reasons. One is that if federal debt—deficits accumulated over the years—grows faster than revenues, the interest payments required to service that debt take over from other spending, crowding out a more productive use of funds. When the economy is near full employment, public borrowing also can drive up interest rates, crowding out private investment.

There is no level of debt to annual income (debt/GDP) at which a crisis is certain. The European Community worries about its members' high debt burdens and accordingly has set the target that every country should aim for at a debt/GDP ratio no greater than 60 percent. This is an arbitrary rule of thumb—just as the target that housing costs should not exceed one-third of income is arbitrary for a family—but it is the product of prolonged deliberation among European economic experts. Currently, federal debt held by the public amounts to about 60 percent but is expected to climb to 90 percent by 2020.

Another commonly discussed target is to limit annual deficits during periods of economic expansion to levels that would cause over debt levels to stop growing and begin to decline as a share of the economy. That works out to deficit-to-GDP levels between 2.5 percent and 3 percent, which is about half of the currently projected 6 percent.

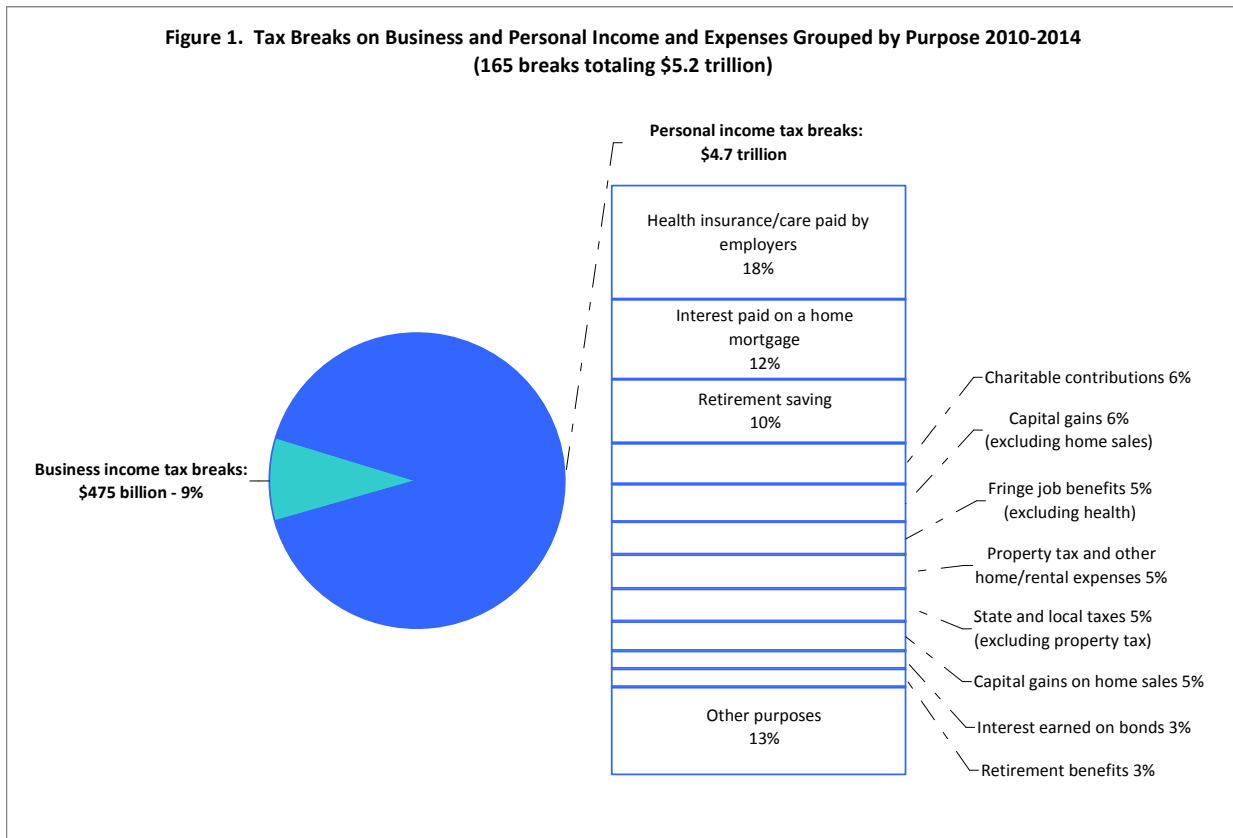
REMOVING THE TAX BREAK LOG JAM

Curtailing tax breaks could go a long way toward bridging the gap between current deficits and either the 60 percent debt/GDP target or the 3 percent deficit/GDP goal, but few policy makers are talking about it. Tax breaks today cost about 6.7 percent of GDP in foregone revenue, climbing to an expected 7.4 percent by 2014.¹ The 165 specific breaks identified by the Office of Management and Budget (OMB) together reduce revenue over the 2010 to 2014 period by about \$5.2 trillion.² A moderate reform of tax breaks could be expected to reduce the deficit as a percentage of GDP by perhaps a quarter to a half of the fiscal correction needed to meet the target at the end of the next decade.

One lesson of the 1986 tax legislation is that, in order to surmount political obstacles, reform must be generally perceived as making the system fairer for the vast majority of taxpayers. The entire set of tax breaks must be reviewed as a package, with sacrifice widely shared and a resulting revised system that is easily understood to be more fair and simple than what we have today. For that, we turn to a more detailed analysis of the tax data.

Many tax breaks apply to specific commercial interests, such as extractive industries—oil and gas, mining, and timber. Others apply to industries or activities, such as insurance or exporting. But the biggest tax breaks, in terms of foregone revenue, apply to the personal income tax. Over the next five years, the OMB projects that more than 90 percent of revenues foregone to tax breaks will arise from provisions affecting households, through exclusions and deductions that go beyond the standard deduction.³

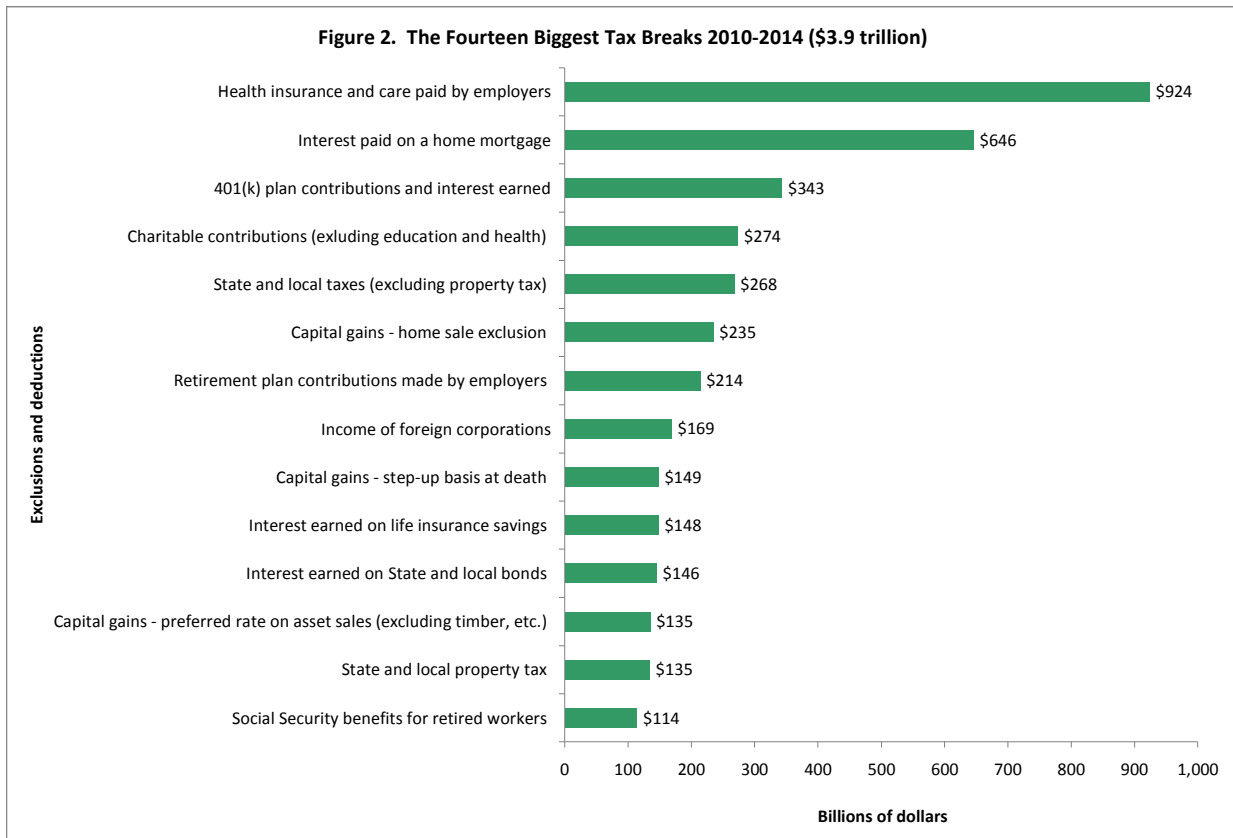
**Figure 1. Tax Breaks on Business and Personal Income and Expenses Grouped by Purpose 2010-2014
(165 breaks totaling \$5.2 trillion)**



Source: Office of Management and Budget, Budget of the United States Government Fiscal Year 2010, Analytical Perspectives, Table 19-1, <http://www.gpoaccess.gov/usbudget/fy10/pdf/spec.pdf>.

Exclusions are income tax by their purpose.⁴ (See Figure 1.) For example, tax breaks for 401(k) plans, Keogh accounts, the Savers Credit, and Individual Retirement Accounts are combined in the slice of the stacked bar labeled “retirement saving.” The multitude of slices—there are eleven, plus a catch-all “other” category—conveys the wide variety of functions that tax breaks are supposed to serve while suggesting the broad array of special interests that could be expected to resist efforts to reform the tax code.⁵

The fourteen largest single tax breaks together cost about \$3.9 trillion, three-quarters of the total cost.⁶



Source: Office of Management and Budget, Budget of the United States Government Fiscal Year 2010, Analytical Perspectives, Table 19-1, <http://www.gpoaccess.gov/usbudget/fy10/pdf/spec.pdf>.

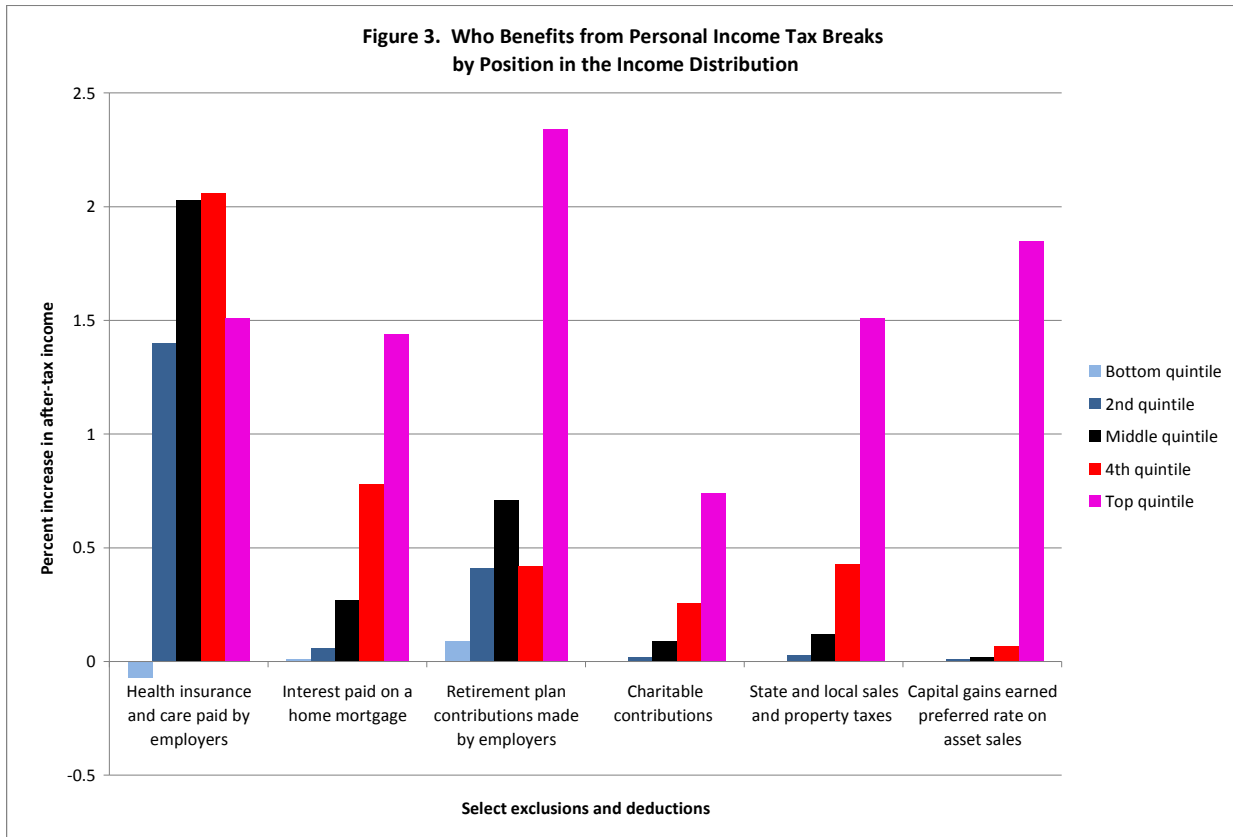
The public policy goals supported by these tax breaks focus on home ownership (2 and 6), retirement saving (3), financing state and local governments (5, 11, and 13), charitable giving (4), and employee benefits (1, 7). Only number 8—deferral of income from controlled foreign corporations—is clearly directed exclusively at business. The remaining 151 tax breaks cost under \$100 billion each and are listed in the Appendix.⁷

When some businesses and households gain after-tax income as a result of tax breaks, the rest must both bear a bigger share of the tax load and suffer from various distortions that tax breaks encourage. For example, if tax breaks stimulate investment in housing and petroleum extraction, other sectors must compete for resources on an “uneven playing field” with these favored sectors. Similarly, tax breaks for home mortgage interest make losers of households that rent.

Most tax breaks, including most big tax breaks at the top of Figure 2, favor the groups that pay the most income taxes, that is, the top 20 percent (quintile) of the income distribution. Though outside the scope of this discussion, other taxes, such as the payroll tax, state sales, and sin taxes, also result in a smaller burden for those with higher earnings because the tax amount is a smaller portion of their income. There are a few tax breaks, however, that deliver disproportionate benefits to the middle class and the poor. These include child care credits, deductions for medical expenses, and, especially, the Earned Income Tax Credit, which is targeted at working households with low income. Figures 3 and 4 illustrate the distributional impact of some important tax breaks as reported by two different sources.

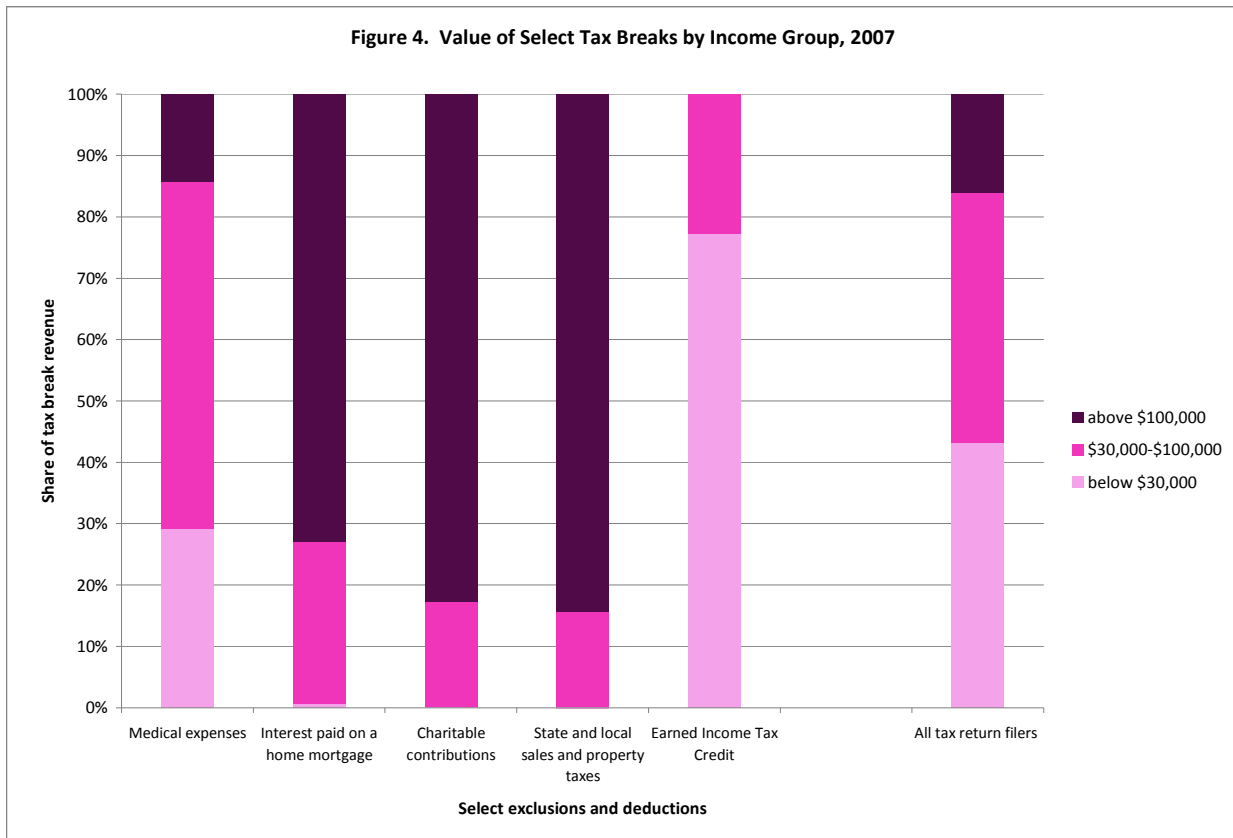
The largest tax break, employer health insurance contributions, benefits all income groups except the bottom quintile. Figure 3 illustrates that the other five of the big fourteen tax breaks shown

disproportionately benefit the top quintile. Even tax breaks that are heavily used by the middle class, such as the home mortgage interest deduction, deliver much greater benefits to the top quintile. Some important tax breaks, most notably the reduced rate on capital gains, deliver almost no benefits below the top quintile of the income distribution.



Source: Leonard E. Berman, Christopher Geissler, and Eric J. Toder, "How Big Are Total Individual Tax Expenditures and Who Benefits from Them?" *American Economic Review* 98, no. 2 (December 2008).

In dollar terms, the incomes of those who benefit from most tax breaks are overwhelmingly above \$100,000 per year (in 2007 dollars), as Figure 4 illustrates. Those with earnings below \$30,000 are hardly touched by tax breaks. Again, the popular and widely used mortgage interest deduction delivers nearly three-quarters of its benefits to households with income above \$100,000 per year. To put the matter differently, without the EITC and refundable child care credits, virtually nobody with income below \$30,000 per year would have reason to itemize deductions, though they would benefit from employer contributions to medical and retirement plans (as shown in Figure 3) without itemizing.



Source: Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2008–2012* (Washington, D.C.: Government Printing Office, 2008).

One reason why itemized deductions favor upper-income households is because tax rates are higher on additional income earned above specified thresholds. A deductible dollar reduces tax liability by ever-greater amounts as the tax rate climbs. As an example, take two homeowners in different tax brackets with the same amount of deductible mortgage interest. A homeowner facing a marginal tax rate of 15 percent would reduce her taxes by \$1,500 if she pays \$10,000 in mortgage interest. Another homeowner also with \$10,000 in mortgage interest, but who is in the 35 percent tax bracket, would save \$3,500 off of his tax bill—more than twice as much.

Since most of the benefits from today’s tax breaks accrue to a relatively small part of the population, namely those with the highest incomes, a ceiling on these tax breaks would affect only a small segment of the population. The Obama administration has proposed capping at 28 percent the amount that taxpayers in higher brackets could deduct from their income. That reform would retain some tax breaks for most households, but would prevent them from becoming excessive. If the main purpose of the home mortgage interest deduction is to encourage home ownership, for example, it does not make sense to give massive tax breaks to rich households who would buy a fine home anyway, even without such generous subsidies.⁸

TOWARD A BETTER TAX CODE AND SMALLER DEFICITS

Reforms that addressed tax breaks not only could make the tax code simpler and fairer, it could eliminate half the deficit problem with relatively little consequence for middle- and low-income families. Although tax code reform is no easy task, the basic elements of a good tax system are:

- It collects enough revenue to finance necessary public spending.
- It collects revenue efficiently; that is, in a way that minimally distorts private decisions regarding work and leisure, saving and spending, or choices among ordinary items to purchase and produce.

- It collects revenue fairly, taking into account ability to pay and who benefits from public spending, while minimizing the extent to which taxpayers in similar circumstances owe different amounts to the government.
- It is simple and inexpensive for citizens to comply with and for public servants to manage.

Reform will combine some tax breaks, eliminate others, cap benefits, and otherwise modify special favors in the code. Reform also could revisit basic income tax rates, which can be cut, even while revenues are increased, because reform of tax breaks will broaden the tax base, namely the amount of income subject to taxation. Our current tax system not only fails to collect enough revenue, it does not do well on the other three standards either. Laced as it is with special breaks and provisions to suit specific interest groups, we have a system that distorts all kinds of private decisions while undermining the fairness of the tax system by creating tax-sheltered segments of the population and the business community.

The net effect of all the special provisions of the income tax code is to make it complex and expensive to work with, both for government employees and for households and businesses. Businesses pay finance experts—and more importantly, lobbyists—enormous sum of money, first to create special tax benefits, and then to take advantage of those breaks. Hundreds of thousands of accountants and software company executives enjoy well-paid careers helping individuals and corporate taxpayers navigate the sea of exemptions, deductions, and credits. In contrast to the income tax, the payroll tax that finances Social Security and Medicare is far more transparent and efficient.

Although imperfect in that it hits low-wage workers harder than upper-income taxpayers while exempting investment income entirely, anyone can calculate their Social Security tax liability in a few minutes. Simply take your wage income under \$106,800, and calculate 12.4 percent of that to compute what you owe (split evenly between you and your employer). The myriad provisions infesting the income tax code make the system enormously difficult to implement and enforce, create countless inequities and economic inefficiencies, reinforce public hostility toward government, and perpetuate deficits by cordoning off legitimate sources of federal revenue. Simply by revising our system of tax breaks, it should be possible to collect more than a percent and a half of GDP as additional federal revenues while improving the efficiency, fairness, and user-friendliness of the tax system.

PRINCIPLES FOR REVISING TAX BREAKS

Every tax break has a history that includes some mixture of legitimate justification, less legitimate rationalization, and raw special interest. The latter two of those forces become even more powerful in sustaining tax breaks once they are in place. A successful strategy to reform tax breaks cannot be put together piecemeal. Reform must be planned comprehensively so that costs and benefits are shared; and costs must fall most heavily on those best able to bear them. The following four principles could show the way to comprehensive reform of tax breaks:

1. Move in the direction of treating income from all sources uniformly (no special rates for capital income—dividends, interest, and realized capital gains).
2. Replace deductions from taxable income with direct tax credits—reductions of taxes owed—which should have a uniform rate for households of all income levels.⁹
3. Put caps or ceilings on the tax benefit a taxpayer can obtain from a single tax break, as well as all tax breaks combined.
4. Eliminate to the maximum extent possible narrow, special interest breaks for industry.

Capped tax credits for some of the big fourteen, such as mortgage interest, saving, charitable contributions, and other activities, would make those breaks both less costly and fairer. For example, the ceiling on the tax credit to encourage saving (merging a variety of current programs) could be set at, say, \$5,000. A household that saved \$20,000 per year would receive the maximum tax credit of \$5,000; any additional income saved would be subject to normal income taxation (see Table 1).

TABLE 1. SOME EXAMPLES OF POSSIBLE REFORMS

Tax Break	2010–2014 cost (billions)	Direction of Reform
Exclusion of employer contributions for medical insurance premiums and medical care	\$924	The health reform bill instituted a ceiling on the exclusion for plans with very high premiums. The impact of that change should be studied as it is implemented before further changes are made.
Deductibility of mortgage interest on owner-occupied homes	\$646	This deduction should be converted to a credit and capped.
401(k) plans	\$343	This is one of a number of vehicles for retirement saving that should be consolidated. A cap should be set on total income from earnings, and property income (including realized capital gains) that may be added to saving tax free any year. A maximum annual tax credit should set that cap.
Deductibility of charitable contributions, other than education and health	\$274	A cap should be introduced on tax credits for charitable contributions. No such cap should exist for the estate tax.
Deductibility of non-business state and local taxes other than on owner-occupied homes	\$268	This deduction should be converted to a credit and capped. States can be aided more equitably through grants funded by progressive federal taxes.
Capital gains exclusion on home sales	\$235	Capital gains should be treated like other income, but it should be corrected for inflation if property was held for more than a year. If it is impossible to eliminate special treatment of home sales, the tax break should be capped and converted to a credit.

Many breaks on the corporate income tax aim at specific interests in extractive industries or other big firms in the districts of powerful legislators. Although the forgone revenue from each is small compared to the big fourteen, eliminating narrow provisions for special business interests could have a meaningful impact when combined and will increase real and perceived notions of a fair tax system.

Even if it proves to be politically difficult to remove popular but ill-conceived tax breaks, it may be possible to reduce their cost to the Treasury, target those tax expenditures more in the direction of lower- and middle-income households, and use the difference to reduce the deficit. Far from radically eviscerating the entire system of tax breaks, we suggest that reforms should eliminate roughly a quarter of revenues foregone today through the existing system.

CONCLUSION

The U.S. income tax code's cornucopia of tax breaks totals to more than double the additional revenues the government will need after recovery to bring the federal debt under control. At a time when legitimate

concerns about the nation's long-term budget outlook are growing, many of those tax expenditures are the lowest hanging fruit available from a public policy standpoint in narrowing fiscal gaps without imposing undue hardship.

While every tax break has its passionate partisans, all Americans would be better off from reforms building on the successful changes in 1986 under President Reagan. A combination of taxing income from all sources at the same rate, eliminating narrow and ineffective deductions, shifting the remainder to credits, and capping tax breaks would make the system far more simple and fair while significantly closing the long-term budget gap. Most households would notice little difference, and those that pay significantly more taxes would be those best able to pay. Once the economy has recovered beyond the need for fiscal stimulus, reforms such as these should be introduced. But now is the time to begin a new, long overdue debate over reforms to the federal income tax.

APPENDIX: OFFICE OF MANAGEMENT AND BUDGET ESTIMATES

ESTIMATES OF TOTAL INCOME TAX EXPENDITURES			
Total from corporations and individuals (in millions of dollars)			
		2008	2010-2014
	National defense		
1	Exclusion of benefits and allowances to armed forces personnel	11,190	54,590
	International affairs		
2	Exclusion of income earned abroad by U.S. citizens	5,070	30,880
3	Exclusion of certain allowances for Federal employees abroad	880	5,360
4	Inventory property sales source rules exception	2,200	15,600
5	Deferral of income from controlled foreign corporations (normal tax method)	31,580	169,140
6	Deferred taxes for financial firms on certain income earned overseas	5,570	29,850
	General science, space, and technology		
7	Expensing of research and experimentation expenditures (normal tax method)	5,180	27,400
8	Credit for increasing research activities	7,440	17,230
	Energy		
9	Expensing of exploration and development costs, fuels	1,650	8,020
10	Excess of percentage over cost depletion, fuels	920	6,890
11	Alternative fuel production credit	590	100
12	Exception from passive loss limitation for working interests in oil and gas properties	10	50
13	Capital gains treatment of royalties on coal	110	630
14	Exclusion of interest on energy facility bonds	10	140
15	New technology credit	920	5,770
16	Energy investment credit	50	250
17	Alcohol fuel credits [1]	50	900
18	Bio-Diesel and small agri-biodiesel producer tax credits [2]	40	20
19	Tax credit and deduction for clean-fuel burning vehicles	170	290
20	Exclusion of utility conservation subsidies	120	550
21	Credit for holding clean renewable energy bonds	40	350
22	Deferral of gain from dispositions of transmission property to implement FERC restructuring policy	-30	-1,810

23	Credit for investment in clean coal facilities	30	1,230
24	Temporary 50% expensing for equipment used in the refining of liquid fuels	350	3,920
25	Natural gas distribution pipelines treated as 15-year property	80	530
26	Amortize all geological and geophysical expenditures over 2 years	20	440
27	Allowance of deduction for certain energy efficient commercial building property	170	680
28	Credit for construction of new energy efficient homes	30	10
29	Credit for energy efficiency improvements to existing homes	230	150
30	Credit for energy efficient appliances	120	180
31	Credit for residential purchases/installations of solar and fuel cells	20	20
32	Partial expensing for advanced mine safety equipment	20	0
33	Qualified energy conservation bonds	0	160
	Natural resources and environment		
34	Expensing of exploration and development costs, nonfuel minerals	210	1,200
35	Excess of percentage over cost depletion, nonfuel minerals	720	4,080
36	Exclusion of interest on bonds for water, sewage, and hazardous waste facilities	170	2,180
37	Capital gains treatment of certain timber income	110	630
38	Expensing of multiperiod timber growing costs	290	1,620
39	Tax incentives for preservation of historic structures	480	2,900
40	Expensing of capital costs with respect to complying with EPA sulfur regulations	30	20
41	Exclusion of gain or loss on sale or exchange of certain brownfield sites	30	170
42	Industrial CO ₂ capture and sequestration tax credit	0	700
43	Deduction for endangered species recovery expenditures	0	130
	Agriculture		
44	Expensing of certain capital outlays	110	590
45	Expensing of certain multiperiod production costs	80	430
46	Treatment of loans forgiven for solvent farmers	10	90
47	Capital gains treatment of certain income	1,160	6,480
48	Income averaging for farmers	80	400
49	Deferral of gain on sale of farm refiners	20	100
	Commerce and housing		
	<i>Financial institutions and insurance:</i>		
50	Exemption of credit union income	1,140	6,650
51	Exclusion of interest on life insurance savings	21,190	148,490
52	Special alternative tax on small property and casualty insurance companies	40	240
53	Tax exemption of certain insurance companies owned by tax-exempt organizations	190	1,040
54	Small life insurance company deduction	50	250
55	Exclusion of interest spread of financial institutions	270	1,930
	<i>Housing:</i>		
56	Exclusion of interest on owner-occupied mortgage subsidy bonds	460	5,810
57	Exclusion of interest on rental housing bonds	410	5,200
58	Deductibility of mortgage interest on owner-occupied homes	88,500	646,080
59	Deductibility of State and local property tax on owner-occupied homes	29,130	134,570

60	Deferral of income from installment sales	1,230	8,280
61	Capital gains exclusion on home sales	30,090	234,700
62	Exclusion of net imputed rental income	-1,720	13,820
63	Exception from passive loss rules for \$25,000 of rental loss	8,430	49,690
64	Credit for low-income housing investments	3,210	27,640
65	Accelerated depreciation on rental housing (normal tax method)	9,690	71,860
66	Discharge of mortgage indebtedness	310	670
67	Credit for first-time homebuyer	9,530	-6,120
	<i>Commerce:</i>		
68	Cancellation of indebtedness	60	180
69	Exceptions from imputed interest rules	50	250
70	Capital gains (except agriculture, timber, iron ore, and coal) [3]	24,240	135,400
71	Capital gains exclusion of small corporation stock	60	1,320
72	Step-up basis of capital gains at death	21,590	148,510
73	Carryover basis of capital gains on gifts	670	6,950
74	Ordinary income treatment of loss from small business corporation stock sale	50	300
75	Accelerated depreciation of buildings other than rental housing (normal tax method)	-6,640	-35,990
76	Accelerated depreciation of machinery and equipment (normal tax method)	55,890	27,070
77	Expensing of certain small investments (normal tax method)	930	-5,280
78	Graduated corporation income tax rate (normal tax method)	2,460	15,700
79	Exclusion of interest on small issue bonds	140	1,850
80	Deduction for U.S. production activities	10,660	87,960
81	Special rules for certain film and TV production	70	-320
	Transportation		
82	Deferral of tax on shipping companies	20	100
83	Exclusion of reimbursed employee parking expenses	2,920	16,940
84	Exclusion for employer-provided transit passes	480	2,990
85	Tax credit for certain expenditures for maintaining railroad tracks	180	110
86	Exclusion of interest on bonds for Financing of Highway Projects and rail-truck transfer facilities	80	410
	Community and regional development		
87	Investment credit for rehabilitation of structures (other than historic)	40	220
88	Exclusion of interest for airport, dock, and similar bonds	380	4,830
89	Exemption of certain mutuals' and cooperatives' income	70	370
90	Empowerment zones and renewal communities	-1,650	-4,020
91	New markets tax credit	990	3,660
92	Expensing of environmental remediation costs	590	-530
93	Credit to holders of Gulf Tax Credit Bonds	10	330
	Education, training, employment, and social services		
	<i>Education:</i>		
94	Exclusion of scholarship and fellowship income (normal tax method)	2,000	11,730
95	HOPE tax credit	3,770	24,560
96	Lifetime Learning tax credit	2,470	15,730
97	Education Individual Retirement Accounts	30	380
98	Deductibility of student-loan interest	1,250	5,430
99	Deduction for higher education expenses	1,550	1,430

100	State prepaid tuition plans	1,030	9,250
101	Exclusion of interest on student-loan bonds	210	2,770
102	Exclusion of interest on bonds for private nonprofit educational facilities	860	11,040
103	Credit for holders of zone academy bonds	160	770
104	Exclusion of interest on savings bonds redeemed to finance educational expenses	20	100
105	Parental personal exemption for students age 19 or over	4,690	12,900
106	Deductibility of charitable contributions (education)	4,330	30,660
107	Exclusion of employer-provided educational assistance	650	750
108	Special deduction for teacher expenses	180	160
109	Discharge of student loan indebtedness	20	100
	<i>Training, employment, and social services:</i>		
110	Work opportunity tax credit	490	2,380
111	Welfare-to-work tax credit	80	40
112	Employer-provided child care exclusion	940	7,840
113	Employer-provided child care credit	20	40
114	Assistance for adopted foster children	430	2,740
115	Adoption credit and exclusion	470	1,260
116	Exclusion of employee meals and lodging (other than military)	970	5,870
117	Child credit [4]	28,420	76,054
118	Credit for child and dependent care expenses	3,020	8,820
119	Credit for disabled access expenditures	30	150
120	Deductibility of charitable contributions, other than education and health	38,200	273,990
121	Exclusion of certain foster care payments	480	2,400
122	Exclusion of parsonage allowances	550	3,510
123	Employee retention credit for employers in certain Federal disaster areas	30	40
124	Exclusion for benefits provided to volunteer EMS and firefighters	20	140
125	Temporary income exclusion for employer provided lodging in Midwestern disaster area		
	Health		
126	Exclusion of employer contributions for medical insurance premiums and medical care [5]	131,080	923,740
127	Self-employed medical insurance premiums	5,080	37,540
128	Medical Savings Accounts/Health Savings Accounts	1,830	11,220
129	Deductibility of medical expenses	9,320	74,160
130	Exclusion of interest on hospital construction bonds	1,350	17,300
131	Deductibility of charitable contributions (health)	4,310	30,900
132	Tax credit for orphan drug research	290	2,310
133	Special Blue Cross/Blue Shield deduction	620	3,350
134	Tax credit for health insurance purchased by certain displaced and retired individuals [6]	0	50
135	Distributions from retirement plans for premiums for health and long-term care insurance	240	1,910
	Income security		
136	Exclusion of railroad retirement system benefits	390	1,820
137	Exclusion of workers' compensation benefits	5,830	31,020
138	Exclusion of public assistance benefits (normal tax method)	560	3,480
139	Exclusion of special benefits for disabled coal miners	40	200
140	Exclusion of military disability pensions	110	1,130
	<i>Net exclusion of pension contributions and earnings:</i>		

141	Employer plans	46,120	214,240
142	401(k) plans	47,000	343,000
143	Individual Retirement Accounts	11,700	79,000
144	Low and moderate income savers credit	890	4,970
145	Keogh plans	12,000	87,000
	<i>Exclusion of other employee benefits:</i>		
146	Premiums on group term life insurance	2,230	12,260
147	Premiums on accident and disability insurance	310	1,740
148	Income of trusts to finance supplementary unemployment benefits	30	230
149	Special ESOP rules	1,600	10,600
150	Additional deduction for the blind	40	220
151	Additional deduction for the elderly	2,250	15,000
152	Tax credit for the elderly and disabled	10	50
153	Deductibility of casualty losses	540	3,640
154	Earned income tax credit [7]	5,380	38,980
155	Additional exemption for housing Hurricane Katrina displaced individuals	20	0
	Social Security		
	<i>Exclusion of social security benefits:</i>		
156	Social Security benefits for retired workers	19,700	113,980
157	Social Security benefits for disabled	5,420	33,050
158	Social Security benefits for dependents and survivors	3,570	17,980
	Veterans benefits and services		
159	Exclusion of veterans death benefits and disability compensation	3,870	24,420
160	Exclusion of veterans pensions	180	1,030
161	Exclusion of GI bill benefits	280	1,590
162	Exclusion of interest on veterans housing bonds	10	150
	General purpose fiscal assistance		
163	Exclusion of interest on public purpose State and local bonds	11,110	145,680
164	Deductibility of nonbusiness State and local taxes other than on owner-occupied homes	49,140	268,110
	Interest		
165	Deferral of interest on US savings bonds	1,310	7,170

[1] In addition, the alcohol fuel credit results in a reduction in excise tax receipts (in millions of dollars) as follows: 2008 \$4,410; 2009 \$4,730; 2010 \$5,230; 2011 \$1,630; 2012 \$0; 2013 \$0; and 2014 \$0.

[2] In addition, the bio-diesel producer tax credit results in a reduction in excise tax receipts (in millions of dollars) as follows: 2008 \$940; 2009 \$780; 2010 \$70; 2011 \$60; 2012 \$40; 2013 \$40; and 2014 \$10.

[3] An alternative calculation for this tax expenditure based on pre-2005 methodology is shown in Table 19-4.

[4] The figures in the table indicate the effect of the child tax credit on receipts. The effect of the credit on outlays (in millions of dollars) is as follows: 2008 \$34,020; 2009 \$26,940; 2010 \$17,230; 2011 \$16,740; 2012 \$1,510; 2013 \$1,490; and 2014 \$1,480.

[5] The figures in the table indicate the effect on income taxes of the employer contributions for health. In addition the effect on payroll tax receipts (in millions of dollars) is as follows: 2008 \$83,150; 2009 \$86,490; 2010 \$91,460; 2011 \$97,820; 2012 \$104,660; 2013 \$111,000; and 2014 \$117,560.

[6] The figures in the table indicate the effect of the health insurance tax credit on receipts. The effect of the credit on outlays (in millions of dollars) is as follows: 2007 \$100; 2008 \$110; 2009 \$120; 2010 \$130; 2011 \$140; 2012 \$150; and 2013 \$160.

[7] The figures in the table indicate the effect of the earned income tax credit on receipts. The effect of the credit on outlays (in millions of dollars) is as follows: 2008 \$45,282; 2009 \$42,271; 2010 \$49,733; 2011 \$50,954; 2012 \$45,837; 2013 \$46,667; and 2014 \$47,974.

Note: Provisions with estimates denoted normal tax method have no revenue loss under the reference tax law method.

All estimates have been rounded to the nearest \$10 million. Provisions with estimates that rounded to zero in each year are not included in the table.

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THE CENTURY FOUNDATION IS PUBLISHING THE ISSUE BRIEF SERIES TO HELP EXPLAIN AND CALL ATTENTION TO PUBLIC POLICY IDEAS THAT ARE WORTHY OF DISCUSSION AND DEBATE. THE VIEWS EXPRESSED IN THIS SERIES ARE SOLELY THOSE OF THE AUTHORS OF EACH ARTICLE.

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¹ These figures are first approximations because they exclude interaction among tax breaks, and, more importantly, they ignore the effects of tax breaks on behavior.

² The Office of Management and Budget, Budget of the United States Government Fiscal Year 2010, Analytical Perspectives, Table 19-1, <http://www.gpoaccess.gov/usbudget/fy10/pdf/spec.pdf>.

³ Estimates of the total value of tax breaks differ from source to source, with the OMB, the Joint Committee on Taxation, and the Brookings-Urban Institute Tax Policy Center providing the basic estimates. None of these estimates takes into account the greatest source of inaccuracy: the possibility that tax breaks that are introduced with the justification that they will change behavior actually do change behavior. It is assumed, for example, that the amount of home mortgage interest—that is, the amount and the terms of mortgage debt—would not change if the home mortgage interest deduction were eliminated. Estimates also depend on the baseline tax system against which tax expenditures are measured, for example, the inclusion or exclusion of the Alternative Minimum Tax. (We ignore estimates that include an AMT, which we doubt will be retained as it affects more and more middle income taxpayers.) The estimates of the total cost of tax breaks are rough estimates.

⁴ In many cases, the break is tied to multiple functions, but we have judged the principle function. For example, the tax break on bonds to finance housing for veterans could be classified as promoting housing, helping veterans, or as a tax break for interest income accruing to purchasers of bonds. Of course, it is all three, but we have designated it as one of nine similar measures the function of which is to reduce taxation of interest income. In Figure 1, it is in the slice “interest on bonds.”

⁵ Even the many slices in Figure 1 fail to show how many interest groups have a stake in tax breaks. For example, the nine types of bonds on which interest is tax favored, a single slice in the pie, include bonds to finance various types of infrastructure as well as hospitals, housing, and state and local borrowing, each of which has its own supporters.

⁶ This tabulation does not include the portion of the Earned Income Tax Credit that is refunded; it includes only the reduction in taxes owed.

⁷ Tax breaks work in multiple ways. Exclusions are benefits that are excluded from taxation, such as an employer’s contribution to an employee’s health insurance premiums. Deductions such as charitable contributions, retirement savings and mortgage interest payments allow individuals to deduct some of their purchases and payments from their taxable income at the end of the year. Tax credits are a third type of break and they are dollar for dollar reductions in the amount of tax owed.

⁸ One might well ask why home ownership should be such a key feature of public policy. Why not encourage a more diversified portfolio of assets and liabilities? Such questions are beyond the scope of this brief, though a review of all tax breaks surely would suggest total elimination of some.

⁹ For example, a tax credit on mortgage interest might take the following form: “25 percent of payments on mortgage interest are deductible from taxes.”