Tax Expenditures: A Brief Introduction

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Broadly speaking, government budgets involve two pots of money—revenues and outlays. Sometimes, though, one pot does double duty. Through special provisions in the tax code, government essentially spends money on millions of individuals and businesses. Well-known examples include tax deductions for charitable contributions and employer-provided health insurance. These provisions are tax expenditures, otherwise known as tax breaks or tax loopholes. Collectively, over 170 tax expenditures cost the U.S. government almost two trillion dollars in foregone revenue in 2024.

Because they can be portrayed as tax cuts or spending programs, tax expenditures can generate support even in a polarized environment. Many tax expenditures benefit specific industries or large groups of individuals, making them hard to cut back. But with budget deficits and inequality at historically high levels, tax expenditures deserve closer scrutiny.

How Tax Expenditures Work

In a “pure” tax system, everyone would be treated the same regardless of how they earned income or what they purchased. All those who made, say, $75,000 a year would pay the same income taxes. Societies would still have to decide how regressive or progressive they wanted tax rates to be (i.e., how much the rates would increase or decrease as incomes rise). Clearly, the U.S. tax system is far from pure.

Besides tax deductions, tax expenditures include tax credits, exclusions from taxation, deferrals of tax liability, and preferential tax rates. The U.S. government uses all these options to play favorites among taxpayers (state governments do the same). For example, capital gains from investments are often taxed at a lower rate than wage and salary income. The tax code has long favored homeowners over renters. The government could tax them equally, then distribute payments to homeowners. Collecting less tax from homeowners is simpler, but still a subsidy.

With so many tax expenditures, the Treasury Department has to administer a wide range of government programs, from agriculture and commerce to health, housing, and retirement income. That’s a tall order for any bureaucracy. In fact, tax expenditures make the larger mission of the Treasury—collecting revenue—harder to achieve. Without adequate funding, the Internal Revenue Service cannot determine whether taxpayers are claiming more tax breaks than they should.

Who Benefits?

Tax expenditures for business are often disparaged as corporate welfare, and a few are quite large. Most of them, however, cost less than $5 billion. The biggest tax expenditures often have social welfare objectives.

According to estimates from Congress's Joint Committee on Taxation, tax breaks for private health insurance cost more than $200 billion in 2024; tax breaks for insurance bought through Affordable Care Act exchanges were more than $100 billion. Tax expenditures for job-based retirement pensions exceeded $350 billion that year.

In that case, maybe the main beneficiaries of tax expenditures are ordinary Americans? Not exactly; the big-ticket items usually favor the upper-middle class and the rich. They get the best health insurance and pension plans from their employers. They can afford to buy expensive homes. They are also more likely to have long-term capital gains and stock dividends that are taxed at lower rates. Although everyone can make charitable contributions, two-thirds of those tax benefits currently go to millionaires.

Another reason for the upward skew in benefits is the progressive nature of our income tax. A tax break is usually worth more for people in the 35 percent tax bracket than the 12 percent bracket.

There are a few exceptions. The Earned Income Tax Credit (EITC) is deliberately aimed at low-income workers, and most of the benefits accrue to families earning less than $40,000. The EITC typically wipes out their income tax obligation and generates a refund. The Child Tax Credit (CTC) helps families across the income spectrum, but Republicans allowed changes that favored lower-income families to expire at the end of 2021. Together, the EITC and CTC cost almost $200 billion, making them vital parts of U.S. family policy.

What Comes Next?

Tax expenditures were not central to the 2024 presidential campaign, but they will affect at least two upcoming policy debates. The first is the fate of Trump's 2017 tax cuts. Many of them will expire at the end of 2025, and Trump wants to extend and expand them. This debate has implications for the Child Tax Credit, home mortgage interest deduction, charitable deductions, and a variety of corporate tax breaks. Trump's earlier tax cuts made deficits bigger, not smaller, and his current plans will have the same effect. Republicans in Congress have to decide how much they truly care about deficits.

The other debate concerns inequality, which got worse during Trump's first term as president. Trump's proposals for lower taxes on the rich and higher tariffs would lead to even more inequality. To dampen these effects, Democrats could push for improvements to tax expenditures like the Earned Income Tax Credit and Child Tax Credit. Doing that would benefit many working-class Americans who did not vote Democratic in 2024.

Ideally, officials should be evaluating tax expenditures as carefully as traditional spending programs. Studies have found that some tax expenditures lead people to buy more of something than they really need (e.g., housing), which raises the price for everyone. Other tax breaks reward behavior that would have happened anyway, such as buying and selling stocks. Tax expenditures make the tax code confusing and complex, adding to the cost of recordkeeping and tax preparation. Just as worrisome, such complexity can undermine confidence in the tax system and government more generally if people feel that only suckers pay their full tax bill.

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).