TAX FOUNDATION
SPECIAL REPORT
Apr. 2014
No. 218

Corporate vs Individual Tax Expenditures

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Key Findings

- A tax expenditure is a departure from the normal tax code that lowers a taxpayer's burden—e.g., an exemption, a deduction, or a credit.
- The list of tax expenditures in a tax system depends heavily on what one considers the normal tax code to be.
- The federal tax system is a non-neutral tax system due to its bias in favor of immediate consumption over future consumption (i.e., saving); thus, many tax expenditures are an effort to make the tax base more neutral.
- The total cost of tax expenditures in 2014 is $1.2 trillion with $148 billion in corporate expenditures and $1.036 trillion in individual expenditures.
- The largest individual tax expenditures by cost are the exclusion of employer contributions for medical insurance premiums ($196 billion), the exclusion of net imputed rental income ($76 billion), and the deductibility of mortgage interest on owner-occupied housing ($70 billion).
- The largest corporate tax expenditures by cost are deferral of foreign income ($76 billion), the deduction for domestic production activities ($10 billion), and accelerated depreciation of machinery and equipment ($8 billion).
- The existence of many piecemeal efforts to make the tax code more neutral provides more evidence that fundamental tax reform is needed.

Introduction: What is a Tax Expenditure?

A tax expenditure is a departure from the default tax code that lowers a taxpayer's burden—for example, an exemption, a deduction, or a credit. They are called tax "expenditures" because, in practice, they resemble government spending. For example, a taxpayer claiming the American Opportunity Tax Credit gets a lower tax bill because he has qualifying college expenses—but one could achieve a functionally identical result by administering the credit through a spending program instead of the IRS. The tax credit "spends" by forgoing the revenue collection in the first place.

This idea officially became part of the tax policy lexicon in 1974, when Congress mandated that these be recorded as part of the annual budget.[1] Under that act, tax expenditures were officially defined as "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."[2]

Defining the Base: What Counts as a Tax Expenditure?

Given that a tax expenditure is defined as a departure from the "normal" tax code, the nature of tax expenditures depends crucially on what the "normal" tax code is. The Treasury and Joint Committee on Taxation (JCT) have adopted similar definitions, but while these definitions have been consistent, they are not very economically coherent.

The federal tax system is built on a poor intellectual foundation; it relies heavily on a definition of income developed by economists Robert Haig and Henry Simons almost a century ago. The Haig-Simons definition of income is that income equals the sum of your consumption plus your change in net worth.[3] While this is a useful accounting identity, it is a poor tax base, because it is not neutral between immediate consumption and future consumption.

Furthermore, it is impractical to calculate, because a taxpayer's net worth may include assets with ever-changing values. For this reason, changes in asset value are usually only recorded as capital gains (or losses) upon the sale of the asset. This is certainly a departure from the platonic ideal of Haig-Simons income—and as a "deferral of tax liability," it would be considered a tax expenditure under that definition—but it is too difficult to calculate the value of the deferral of capital gains in practice, and it is not historically considered a tax expenditure.

This is one of the many compromises that Treasury and JCT make in determining tax expenditures. Some of these are very significant. For example, progressive income tax brackets are not counted as a "preferential rate of tax."

1 Stanley Surrey, *Federal Income Tax Reform*, 84 Harvard Law Review 352 (1970).
2 Congressional Budget and Impoundment Control Act of 1974, 2 U.S.C. § 622(3).
3 This can be expressed as $I = C + \Delta NW$.

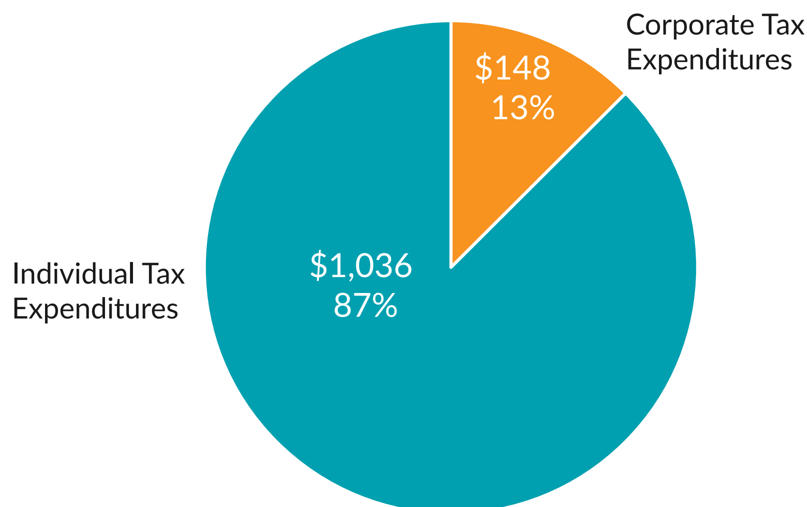
As a result, the official list of tax expenditures tends to favor wealthier taxpayers, because the progressivity of the tax system is already assumed in defining the base.[4] Additionally, the corporate income tax is considered "normal," even though it departs from the Haig-Simons ideal, since it double taxes income (once at the corporate level and again at the shareholder level).

Lastly, the personal exemption and the standard deduction are generally considered not to be tax expenditures, but rather part of a structure that defines a zero-rate bracket.[5] Given all of these metaphysical questions about what constitutes a normal tax structure, the true nature of tax expenditures will always be somewhat subjective.

Relative Size of Corporate versus Individual Tax Expenditures

The majority of the expenses incurred by tax expenditures comes from the individual side. For Fiscal Year 2014, the Office of Management and Budget projects $148 billion in corporate expenditures and $1.036 trillion in individual tax expenditures for nearly $1.2 trillion in total.[6]

Chart 1. Tax Expenditures in Billions of Dollars
Fiscal Year 2014



Source: Office of Management and Budget

4 Michael Schuyler, *Baked In the Cake: Why the Progressivity of the Income Tax Isn't Visible in the Distribution of Tax Expenditures*, Tax Foundation Special Report No. 212 (Jan. 13, 2014), http://taxfoundation.org/article/baked-cake-why-progressivity-income-tax-isn-t-visible-distribution-tax-expenditures.

5 Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2012-2017*, https://www.jct.gov/publications.html?func=startdown&id=4504.

6 Office of Management and Budget, *Analytical Perspectives: Budget of the U.S. Government, Fiscal Year 2015* (Mar. 2014) at Tables 14-1 to 14-4, http://www.whitehouse.gov/omb/budget/Analytical_Perspectives.

Largest Individual Tax Expenditures

Though some tax expenditures help move the tax code toward a neutral base, the largest tax expenditures for individuals predominantly reflect the use of credits, deductions, or exclusions to prioritize certain behaviors. This is a practice that should be reviewed with skepticism; the IRS's primary purpose is to raise revenue, not to encourage certain types of economic activity over others. Here is a summary of the five largest individual tax preferences, as defined and estimated by OMB.[7]

1. **The Exclusion of Employer Contributions for Medical Insurance Premiums ($196 billion).** Employer contributions to insurance premiums reflect a tax preference for those taxpayers with employer-provided health insurance, because they receive a form of labor compensation that goes untaxed. This is the largest tax preference at $196 billion—larger than all corporate tax expenditures combined.[8] Recent Congresses have shown some willingness to chip away at this preference; for example, the "Cadillac Tax" in the Patient Protection and Affordable Care Act levies a tax on employer contributions above a certain threshold, and the recent tax reform proposal by Ways and Means Chairman Dave Camp included employer-provided health contributions in its definition of modified adjusted gross income.[9]

2. **Exclusion of Net Imputed Rental Income ($76 billion).** This line item comes from owner-occupied housing. In our tax code, if you rent real estate to someone else, you pay taxes on that rental income. However, if you "rent" the real estate to yourself by living in your own home, there is no market income to tax. Your "income" comes from the personal benefit you get from your home. This benefit is called imputed rent. This exclusion is considered a tax expenditure due to the definition of income used in the tax code. However, this expenditure actually represents a move toward investment-consumption neutrality. Under a neutral tax base, rental income on property, whether market or imputed, would not be taxed.

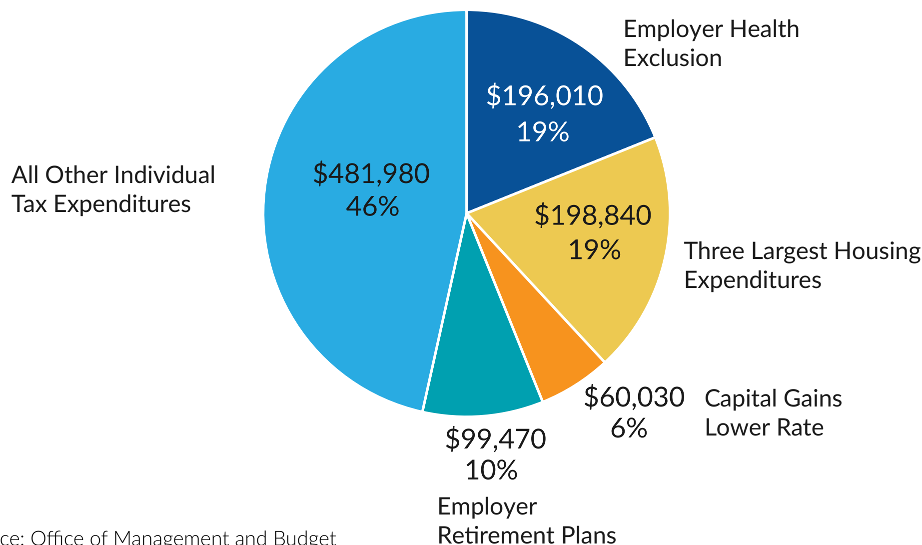
3. **Deductibility of Mortgage Interest on Owner-Occupied Housing ($70 billion).** This is the largest individual tax deduction and the third-largest individual tax expenditure. There is some investment-consumption neutrality logic here: if interest income on mortgages is taxable, then the lost income from paying that interest should be deductible—otherwise the borrower and the lender are taxed on the same income, creating a double tax. However, this would be better addressed with some type of comprehensive treatment of interest rather than a specific one for owner-occupied housing alone.[10]

7 *Id.*
8 In addition to this lost income tax revenue, Treasury estimates that in 2014 it will reduce payroll tax revenue by $123 billion for a combined total revenue loss of $319 billion. This is larger than corporate tax revenue collections in a typical year.
9 Though eliminating the tax exclusions for employer provided health insurance would move toward a neutral base, a system including a measure of modified adjusted gross income would not.
10 Alan Cole, *A Partial Defense of the Mortgage Interest Deduction*, Tax Foundation Tax Policy Blog, Aug. 20, 2013, http://taxfoundation.org/blog/partial-defense-mortgage-interest-deduction.

4. **Lower Rate for Capital Gains ($60 billion).** This represents a move toward a neutral tax base. The proper treatment of capital income is to either deduct saving and tax withdrawals from the saving account (as in a Traditional IRA) or to tax income initially but not tax the capital income from the account (as in a Roth IRA). A lower rate for capital gains moves the federal tax system closer to a Roth IRA-style consumption base and away from a Haig-Simons income base. It also reduces the additional double-taxation of corporate income, resulting from the corporate income tax combined with shareholder taxes.

5. **Defined Contribution Employer Plans ($59 billion).** 401(k) plans and similar retirement vehicles allow taxpayers to deduct retirement savings and pay income taxes only when those savings are withdrawn. Defined benefit employer plans ($40 billion) are treated similarly, but counted as a separate tax expenditure.[11]

In total, the majority of the individual tax expenditure budget is accounted for by just a handful of items. Combining some of the large individual tax expenditures with similar purposes reveals that only a few big priorities motivate most tax expenditure spending. The three largest housing expenditures, for example—including the imputed rent exclusion, the mortgage interest deduction, and the capital gains exclusion on housing sales—combine for $199 billion. The employer-provided health insurance exclusion accounts for $196 billion. Defined benefit and defined contribution plans together add another $99 billion.



11 If you were to include the both the refundable and non-refundable portion of the earned income tax credit ($62.7 billion), it would be the fourth-largest individual expenditure. The refundable portion is usually considered an outlay, not a tax expenditure, because it is spending, not lost revenue.

Many of these large tax expenditures are efforts to straddle the line between the Haig-Simons income base and a more neutral tax base. In that respect, they are actually good tax policy. However, investment in owner-occupied housing features much more neutral treatment than other sorts of investment, which is poor policy; other investment should be given more neutral treatment as well.

Smaller tax expenditures aren't always moves toward a neutral tax code. In fact, some are precisely the opposite. Some obvious non-neutral tax expenditures are the credits for Empowerment Zones, the DC Enterprise Zone, and Renewal Communities. These credits are literally designed to give tax favoritism to certain geographical areas of the country.

Largest Corporate Tax Expenditures

Corporate tax expenditures, collectively, are far smaller than the individual tax expenditures. Nonetheless, some of them are quite substantial. The corporate tax code follows a similar story to the individual tax code. Some tax expenditures are attempts to keep the tax code neutral across time horizons. Others, though, are attempts to favor certain sorts of economic activity over others. Here are the three largest corporate tax preferences:

1. **Deferral of Income from Controlled Foreign Corporations ($76 billion).** This expenditure is the result of a misguided attempt to stick to a worldwide system of corporate taxation, even though other countries are moving toward the superior territorial system that exempts most foreign earnings from domestic taxation.[12] The few remaining countries with a worldwide tax system, including the U.S., also have deferral as a way to keep their multinational companies somewhat competitive with those based in territorial countries.[13] Deferral here means that the additional domestic tax on foreign earnings (i.e., the repatriation tax), which is over and above what is paid abroad, can be deferred as long as the earnings remain invested abroad.[14] Indefinite deferral approaches a territorial tax system of full exemption of foreign earnings, although it involves excessive tax planning and administrative costs and also results in the problem of locked out profits.

2. **Deduction for U.S. Production Activities ($10 billion).** Also known as Section 199, this is a 3 percent deduction for business with qualified production activities in the United States. Although this is certainly an incentive for businesses to invest in the United States, and it is taken by most industries, it leaves certain industries—such as retail food preparation—out in the cold. Elements of the tax system that favor certain

12 Philip Dittmer, *A Global Perspective on Territorial Taxation*, Tax Foundation Special Report No. 202 (Aug. 10, 2012), http://taxfoundation.org/article/global-perspective-territorial-taxation.

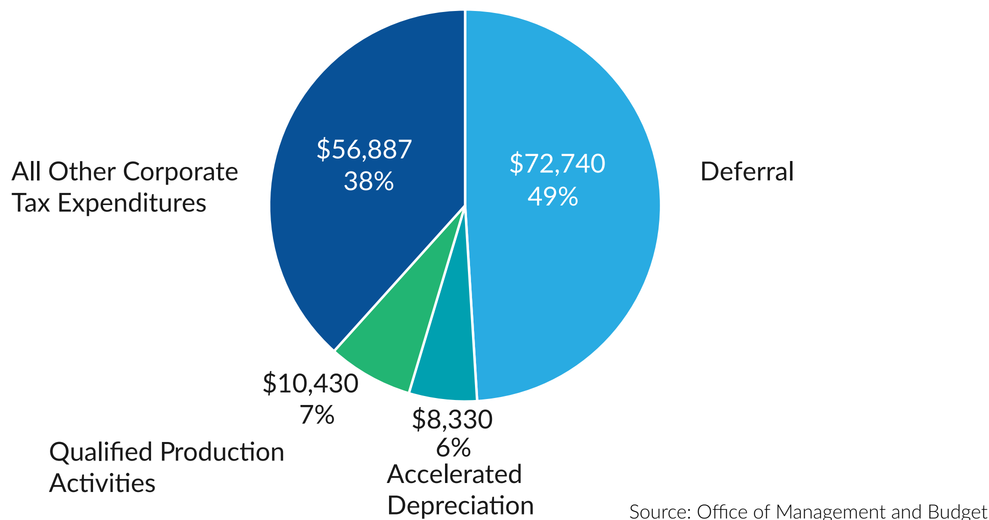
13 New Zealand is one country that tried worldwide taxation without deferral. This was so harmful to economic growth that the country eventually switched to a territorial tax system in 2009. *See* William McBride, *New Zealand's Experience with Territorial Taxation*, Tax Foundation Fiscal Fact No. 375 (June 19, 2013), http://taxfoundation.org/article/new-zealands-experience-territorial-taxation.

14 *See* Robert Carroll, *The Importance of Tax Deferral and A Lower Corporate Tax Rate*, Tax Foundation Special Report No. 174 (Feb. 2010), http://taxfoundation.org/sites/taxfoundation.org/files/docs/sr174.pdf.

industries over others should be eliminated and replaced with more neutral elements.

3. **Accelerated Depreciation of Machinery and Equipment ($8 billion).** This expenditure is also a symptom of a muddled corporate tax code. When a physical asset—like a factory—is purchased, the purchase price is written off over a depreciation schedule of years or decades and not counted as an immediate expense. While depreciation is a useful accounting concept to calculate book values of corporations, the economic costs of an asset should be reflected by expensing; the cost of the plant should be deductible in the year that the money is actually spent. This would properly reflect the time value of money.[15] The lack of full expensing is a tax bias against firms that invest heavily in physical capital, such as manufacturers. Lately, some tax law on depreciation, like bonus depreciation, has fallen in with the extenders—a grab bag of tax provisions that are handled on an ad hoc basis from year to year. Because Congress has not yet handled 2014's extenders, the value of this expenditure could increase from OMB's estimate above.[16]

Combined, these three expenditures make up the majority of the corporate tax expenditures in the budget.



15 Stephen Entin, *The Tax Treatment of Capital Assets and Its Effects on Growth: Expensing, Depreciation, and the Concept of Cost Recovery in the Tax System*, Tax Foundation Background Paper No. 67 (Apr. 24, 2013), http://taxfoundation.org/sites/taxfoundation.org/files/docs/bp67.pdf.

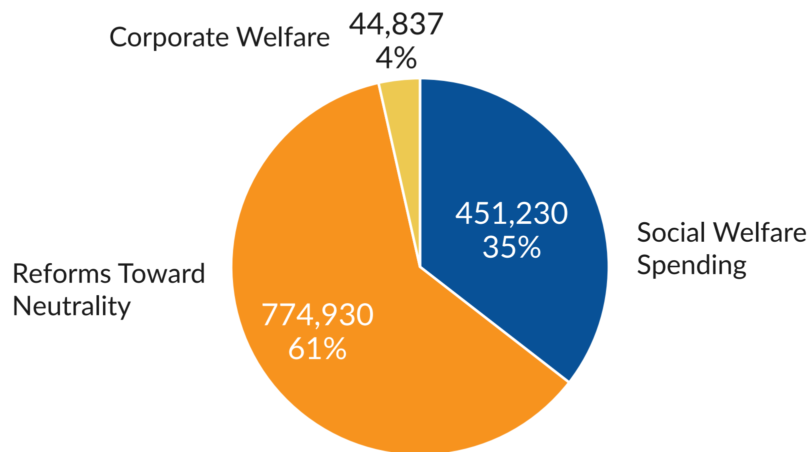
16 Andrew Lundeen & Kyle Pomerleau, *Not All Tax Extenders Are Worth Extending*, Tax Foundation Tax Policy Blog, Jan. 22, 2014, http://taxfoundation.org/blog/not-all-tax-extenders-are-worth-extending.

Most Tax Expenditures Make the Tax Code More Neutral

Tax expenditures can be roughly divided into three categories: those that help move toward neutrality, those that serve social welfare priorities, and those that benefit just one favored class of corporations (corporate welfare.)[17]

The tax expenditures that move toward a neutral tax code make up the majority of the budget. These are often decent policy, but they can also add complexity or help some kinds of investment more than others. We would be better served by simply redefining the tax base to be neutral in the first place. Those tax expenditures that serve as social welfare spending would often be better redesigned as spending programs such that their costs and benefits could be understood more easily. Finally, the corporate welfare tax expenditures would best be eliminated entirely in order to help pay for lower rates.

Chart 4. Tax Expenditure Budget Reported by OMB, 2014
Millions of Dollars



Source: Office of Management and Budget

Conclusion

The issue of what constitutes a tax expenditure is a subjective and difficult exercise. However, it has important implications for tax policy, because the elimination of tax expenditures is a popular way to pay for tax reform. It is thus important to know that some tax expenditures represent partial moves toward a neutral tax base and are not arbitrary pork-barrel spending.[18]

17 William McBride, *A Brief History of Tax Expenditures*, Tax Foundation Fiscal Fact No. 391 (Aug. 22, 2013), http://taxfoundation.org/article/brief-history-tax-expenditures.

18 Michael Schuyler & Stephen J. Entin, *The Economics of the Blank Slate: Estimating the Effects of Eliminating Major Tax Expenditures and Cutting Tax Rates*, Tax Foundation Fiscal Fact No. 378 (July 26, 2013), http://taxfoundation.org/sites/taxfoundation.org/files/docs/ff378.pdf.

Because not all tax expenditures are equally worthy of elimination, it is important to ask whether the expenditure serves a reasonable purpose and whether it accomplishes that purpose in a reasonable way. This trillion-dollar area of the tax code deserves careful examination when lawmakers craft new proposals.

SPECIAL REPORT (ISSN 1068-0306) is published at least 6 times yearly by the Tax Foundation, an independent 501(c)(3) organization chartered in the District of Columbia.

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