Washington & Lee University

Selected U.S. Tax Expenditures: Historical Trends in Regressivity

Caroline Gill, Undergraduate Class of 2014

Abstract:

U.S. tax expenditures represent $1.2 trillion dollars of lost federal tax revenues in 2013 due to exclusions, deductions, deferrals, and credits allowed by the tax code. Without tax expenditures, the US government would collect enough additional tax revenue to budget for nondefense discretionary spending twice over again. This paper asks how necessary tax expenditures are as they are written in the tax code today, what is the regressive impact of these tax expenditures, have they become more or less regressive over time, and can these tax expenditures be made more progressive while still preserving their original intent? First, this paper reviews the size, structure, value, and composition of tax expenditures as a whole. Then, this paper explains the design, purpose, legislative history, growth, and progressivity/regressivity of six selected tax expenditures (earned income tax credit, child tax credit, exclusion for pension earnings and contributions, mortgage interest deduction, exclusion for employer-provided health insurance, and the preferential rates on capital gains). After commenting on overall historical trends of regressivity, the paper discusses and recommends policies that increase the progressivity of tax expenditures while preserving their original policy intent.

Keywords: tax expenditures, regressive, progressive, earned income tax credit, child tax credit, exclusion for pension earnings and contributions, mortgage interest deduction, exclusion for employer-provided health insurance, preferential rates on capital gains

Caroline Gill

Beckley

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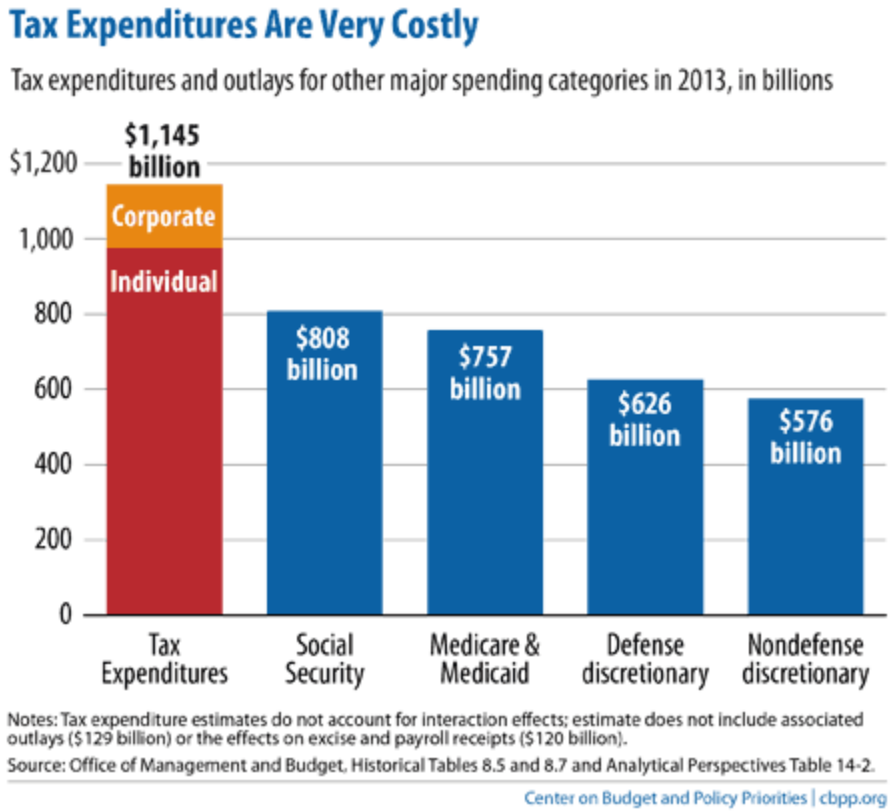
I. Introduction

In a political environment where fears and arguments about deficits, budget ceilings, and fiscal cliffs dominate the headlines, the budgetary effects of tax expenditures cannot be ignored. We are seeing an increasingly polarized democracy in which Democrats and Republicans struggle to reach compromises about tax revenues and outlays. Democrats generally want to increase spending while also raising taxes, specifically on wealthier Americans. Republicans generally want to cut spending, specifically on social programs, and simultaneously cut taxes. With differing views on poverty, Republicans advocate job creation for all Americans while Democrats believe more targeted programs that foster capability in areas such as education and health are necessary to assist the poor. Most recently, the battle has been over the farm bill. Republicans originally hoped for a $40 billion cut in federal food stamp funding as part of the bill. The version of the bill that finally passed in February 2014 only cut the program by $8 billion. In a similar negotiation process, when proposing the federal budget for the fiscal year 2014, Obama offered cuts to Social Security and Medicare in hopes to garner some Republican support. These compromises over spending cuts and tax rates largely ignore the potential revenue never collected by the federal government due to exceptions in the tax code.

This loss of federal revenue, referred to collectively as tax expenditures, is no small amount. The Treasury's estimate of 2013 tax expenditures is $1.2 trillion (Figure A). Compare that to the 2013 outlays for discretionary spending, including defense, also equaling $1.2 trillion. Without defense spending, these outlays total to approximately $576 billion. So without tax expenditures, the US government would collect enough additional tax revenue to fund the budget for government services such as the Department of Health and Human Services, Homeland Security, the Justice Department, and the Department of Education twice over again. Of course, eradicating all tax expenditures would be unwise as some tax expenditures incentivize certain socially desirable behaviors such as investing in the economy or owning a home. However, due to their enormous budgetary power, we should ask ourselves how necessary are tax expenditures as they are written into the tax code today? When social programs that target low-income Americans are facing cuts due to less than sufficient tax revenues, it is important to assess and ask questions about the tax revenues that the federal government pass up each year. What is the regressive impact of these tax expenditures and have they become more regressive over time?

Figure A[1]:



Tax expenditures are not distributed evenly among income groups[2]. This is not surprising as higher-earning income groups contribute more in federal taxes, so the effect of deductions and exclusions are higher. But also, higher-earning income groups tend to participate more in the activities that tax expenditures incentivize, such as employer-contributing retirement plans, employer-contributing health insurance, and paying a mortgage on a home. In addition, higher-earning income groups are more likely to have knowledge and understanding of the tax code, often because they can afford professional tax assistance. However, more progressive tax expenditures like the Earned Income Tax Credit (EITC) and the Child Tax Credit (CTC) target

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[1] From "Policy Basics: Federal Tax Expenditures." *Center on Budget and Policy Priorities,* 2014. <http://www.cbpp.org/cms/?fa=view&id=4055>.

[2] From "American Social Spending in Perspective: Historical Trends and International Comparisons." by Joseph Landry, *Washington and Lee University*, 2013.

low-income households. These programs have continued to expand, but have they expanded enough over time to make the tax expenditure system less regressive overall? If not, how should the tax code be changed to redistribute the benefits more equitably? These are important questions that this paper attempts to tackle.

While this paper considers tax expenditures as a whole, it focuses specifically on several of the most important. It examines closely the three current largest tax expenditures: the exclusion of employer contributions for medical insurance, the net exclusion of pension contributions and earnings, and the deductibility of mortgage interest on owner-occupied homes; the (partially) refundable social tax expenditures: the Child Tax Credit (CTC) and the Earned Income Tax Credit (EITC); and another large tax expenditure that clearly benefits wealthy Americans: the preferential rate on capital gains.

II. Tax Expenditures Defined: Structure, Value, and Composition

Tax expenditures are exclusions, deductions, deferrals and credits that reduce tax liabilities and represent revenue losses at the federal level. These expenditures can be structured in different ways. Deductions or exclusions reduce taxable income, and thus reduce tax liability by an amount dependent on the taxpayer's income bracket.[3] Non-refundable tax credits reduce tax liability by the amount of the credit up until the taxpayer's liability is equal to zero, while refundable tax credits allow taxpayers to receive a check from the government for the difference if the credit exceeds their tax liability[4]. For example, a $100 deduction saves $35 for someone in the 35 percent top income tax bracket, while only saving $10 for someone in the 10 percent

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[3] From "Tax Expenditures: What are they and how are they structured?" by Lily Batchelder, *Tax Policy Center*, 2009. <http://www.taxpolicycenter.org/briefing-book/background/shelters/expenditures.cfm>.
[4] Ibid.

bracket. A non-refundable credit of $100 is typically worth $100 for each eligible household, despite their tax bracket, unless their taxable income is less than the credit. A household with $75 in tax liability only receives a $75 credit and a household with no tax liability does not receive the credit. On the other hand, a refundable tax credit provides the same credit to all eligible households no matter the tax liability. If the tax credit exceeds the liability, the difference is given as a refund to the household. So for a $100 refundable credit, a household with $75 in tax liability would receive a $25 refund and its income tax liability would be reduced to $0. All three types of these structures can have income limits or phase in and out rates in order to distribute the benefits further.

The structure of the tax expenditure is important because it determines the value. Deductions and exclusions are the most valuable for high-income households because they have higher marginal tax rates[5]. Non-refundable tax credits have no value for those households with zero tax liability. A refundable tax credit is the most progressive structure since households with zero tax liability (low-income households) receive a benefit. However, the number of refundable credits peaked at eleven in 2010, dropped to six in 2013, and three of these six are set to expire by 2018.[6] This paper considers only EITC and CTC in depth, as these are the largest refundable tax credits and they are not set to expire. Refundable tax credits are the most impactful for poor households since 47% of all households and 54% of households with children have no positive

[5] Ibid.

[6] The Health Coverage Tax Credit expired December 31, 2013; the American Opportunity Tax Credit expires December 31, 2017; the Prior-Year Alternative Minimum Tax Credit for Corporations expired December 31, 2013. From "Refundable Tax Credits." *Congressional Budget Office*, 2013. < http://www.cbo.gov/publication/43767>.

income tax liability and thus cannot benefit from deductions, exclusions, and non-refundable credits[7].

Tax expenditures represent departures from a “normal” tax code, which is mainly the tax code as it was in 1974 when Congress began requiring expenditure estimates.[8] Both the Treasury and the Joint Committee on Taxation (JCT) are in charge of tracking these expenditures, and their assumptions and measurements of tax expenditures differ slightly, resulting in different estimates. According to the Treasury, there are currently 169 tax expenditures, while the JCT reports more than 200. The Treasury estimates the 2013 tax expenditure budget at about $1.2 trillion while JCT’s estimate is higher at $1.3 trillion.[9]

Beyond structure and the individual vs. corporate classification, tax expenditures can be grouped into three functional categories (Figure 1[10]). First, there are what the Tax Foundation terms “social welfare spending” programs such as the Earned Income Tax Credit, the Child Tax Credit, and the exclusion for employer-provided healthcare, which represent about 25% of total tax expenditures. It is interesting that the exclusion for employer-provided healthcare is included in the Tax Foundation’s social welfare category, since it is not a tax credit and is highly regressive. Most likely, this is because the Tax Foundation considers health to relate to the general welfare of society. This category also includes various other expenditures such as the Health Coverage Tax Credit, the American Opportunity Tax Credit, and other education benefits[11]. All together this category constituted about $445 billion or 37% of the 2013 tax

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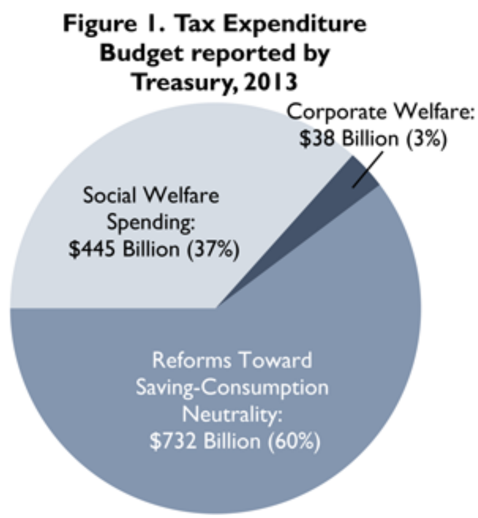
[7] From “Tax Expenditures: What are they and how are they structured?” by Lily Batchelder, Tax Policy Center, 2009. <http://www.taxpolicycenter.org/briefing-book/background/shelters/expenditures.cfm>.
[8] From “A Brief History of Tax Expenditures.” by William McBride, *Tax Foundation*, 2013. <http://www.taxfoundation.org/article/brief-history-tax-expenditures>.
[9] Ibid.
[10] Ibid.
[11] The Health Coverage Tax Credit expired in 2013 but it equal to 80% of the health insurance premiums of a Pension Benefit Guaranty Corporation or Trade Adjustment Assistance member. The American Opportunity Tax Credit is a tax credit of up to $2500 of the cost of tuition, fees and course materials paid during the taxable year.

expenditure budget. The second category incentivizes certain industries or activities. Tax preferences are given to the housing industry, credit unions, certain manufacturers, BlueCross BlueShield, and to corporations and individuals for the use of certain energy-efficient products.[12] The third category, the largest in number and dollars, constitutes about $732 billion or 60% of the 2013 tax expenditure budget. This category includes all the expenditures that address saving and investment by individuals and corporations. It includes preferential rates on capital gains, deductibility of mortgage interest, exclusion of pension contributions and earnings, charitable contributions and deferral of foreign earnings.



With the exception of the Tax Reform Act of 1986[13], which reduced the tax expenditure budget by one third, recent decades have seen an increase in the number and value of tax

40% of the credit is refundable. An example of other education benefits includes student loan interest deductions up to $2500 for taxpayers with adjusted gross income less than $75,000 (IRS).
[12]As an example, credit unions do not pay corporate income taxes.

[13] The Tax Reform Act of 1986 repealed 14 tax expenditures and scaled back the eligibility requirements of 16 others. The largest expenditures repealed were the investment tax credit, the capital gains exclusion, and the deduction for two earner married couples. The largest expenditures scaled back were the Individual Retirement Accounts, the deductibility of interest on consumer credit, and deductibility of non-business State and local taxes From "The Tax Expenditure Budget Before and After the Tax Reform Act of 1986." *US Treasury Department*, 1988.

expenditures (Figure 2[14]). It is interesting that the Tax Reform Act of 1986 was passed by Republican president Ronald Reagan as it eliminated many tax expenditures that Republican supporters would have wanted to keep, such as the preferential rate on capital gains. However, the Tax Reform Act of 1986 also reduced the top marginal individual income tax rate from 50% to 28% and the corporate income tax rate from 46% to 34%.[15] These provisions would have pleased many Republicans. Nineteen tax expenditures including the Child Tax Credit were introduced in 1996, and the presidencies of George W. Bush and Barack Obama have added even more. Most of this growth, however, has been in individual tax expenditures (Figure 3[16]). The tax expenditure budget grew from $844 billion in 1986 to $1.2 trillion in 2013, while corporate tax expenditures actually shrunk over this same time period from $159 billion in 1986 to $108 billion in 2013. This growth in the total tax expenditure budget is driven by the growth in EITC, CTC, and the exclusion of employer contributions to health insurance (Figure 4[17]). The employer-provided healthcare exclusion, now the largest tax expenditure, accounts for 41 percent of the growth since 1986, while the EITC and the CTC explain 15 and 11 percent respectively. So, 67 percent of all growth is from two progressive tax expenditures and one regressive. The growth in the exclusion for employer-sponsored healthcare is not due to policy changes but due to the growth in healthcare costs, while the growth in EITC and CTC comes from legislative expansions, as this paper will discuss in greater detail. The remainder of the growth in tax expenditures over this time period came mainly from the increase in tax rates in the 1990s and the stimulus measures from 2009-2011.

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[14] From "A Brief History of Tax Expenditures." by William McBride, *Tax Foundation*, 2013. <http://www.taxfoundation.org/article/brief-history-tax-expenditures>.

[15] From "This Day in History: President Ronald Reagan Signs the Tax Reform Act of 1986." *Americans for Tax Reform,* 2013. < http://www.atr.org/history-president-ronald-reagan-signs-tax-a7946>.

[16] From "A Brief History of Tax Expenditures." by William McBride, *Tax Foundation*, 2013. <http://www.taxfoundation.org/article/brief-history-tax-expenditures>.

[17] Ibid.

Figure 2. Joint Committee on Taxation Count of Tax Expenditures
1987-2007

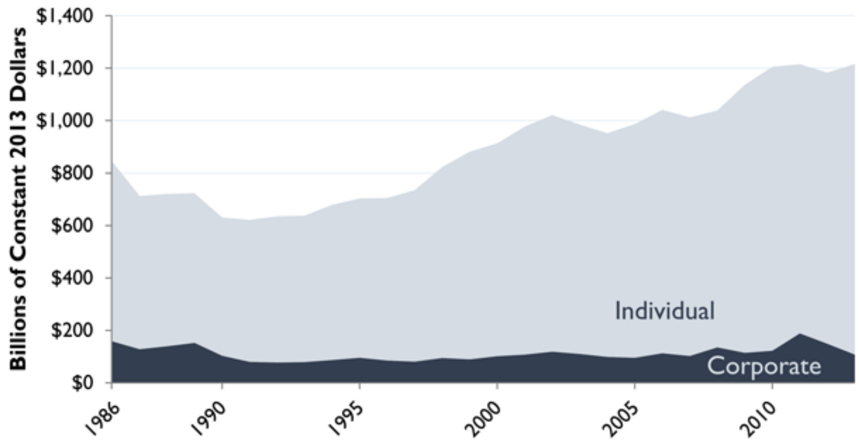

Figure 3. Tax Expenditures Reported by Treasury
1986 to 2013

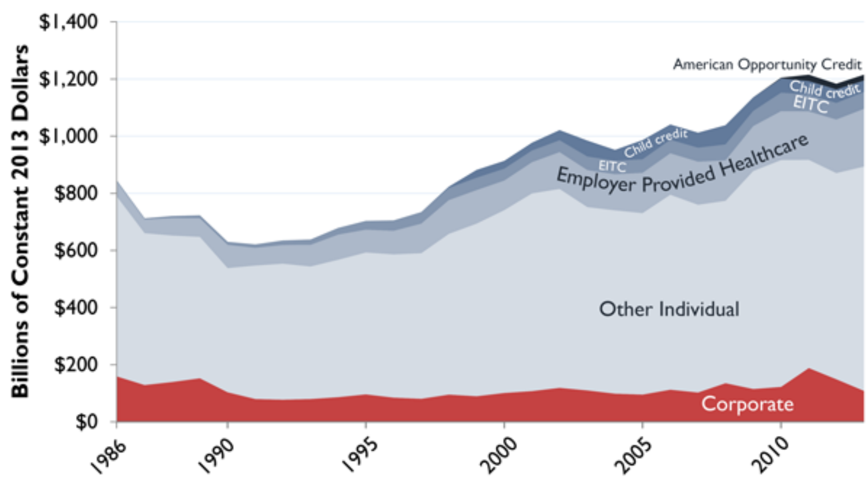

Figure 4. Fastest Growing Tax Expenditures Reported by Treasury
1986 to 2013

III. Earned Income Tax Credit

The Earned Income Tax Credit is a refundable tax credit, meaning it directly reduces the recipient's federal tax liability rather than reducing taxable income. While deductions benefit taxpayers in higher income brackets more since the deduction is multiplied by a higher marginal tax rate, the EITC is more progressive since it both targets low- to middle-income workers and directly reduces tax liability by the full dollar amount of the credit. Also, the refundable nature of the EITC is important because if the credit is greater than the recipient's total federal tax liability, the recipient receives a tax refund in the amount of the difference. EITC is directly tied to work since the amount of the credit is based on earnings. Thus, it does little for the unemployed or the unemployable. The amount of the credit increases as earnings increase, reaches a maximum credit up to the phase out point, and then falls as earnings increase. The maximum credit, credit rate, and phase-out rate differ for workers with no children, one child, two children, and three children (Figure 5[18]).

Figure 5

Earned Income Tax Credit Parameters, 1975-2014
[Dollar amounts unadjusted for inflation]

Calendar year	Credit rate (percent)	Minimum income for maximum credit	Maximum credit	Phaseout rate (percent)	Phaseout range [1] Beginning income	Ending income
2014						
No children	7.65	6,480	496	7.65	8,110	14,590
One child	34	9,720	3,305	15.98	17,830	38,511
Two children	40	13,650	5,460	21.06	17,830	43,756
Three children	45	13,650	6,143	21.06	17,830	46,997

The Tax Reduction Act of 1975 enacted the Earned Income Tax Credit (EITC) during the Ford administration as a temporary refundable credit meant to offset the burden of the Social

[18] From "Earned Income Tax Credit Parameters, 1975-2014." *Tax Policy Center,* 2014. <http://www.taxpolicycenter.org/taxfacts/Content/PDF/historical_eitc_parameters.pdf>.

Security payroll tax and rising food and energy costs on low-income workers[19]. The Revenue Act of 1978 made the EITC permanent and created a range of income for which the maximum credit is received before phase-out. President Reagan, who called it “the best anti-poverty, the best pro-family, the best job creation measure to come out of Congress,” indexed the maximum earned credit and phase-out levels to inflation with the Tax Reform Act of 1986[20]. Before 1990, the credit was only for workers with children, but there was no adjustment for family size. The Omnibus Budget Reconciliation Act (OBRA) of 1990 introduced a larger credit for families with two children and the American Recovery Act of 2009 added a new credit category for three or more children[21]. Childless workers did not receive any credit until OBRA 1993[22]. This 1993 legislation represented a large expansion of the EITC program and was engineered by David Ellwood, a key Clinton advisor. The expansion raised the credit rate for families with two children from 19.5 to 30 percent and the credit rate for families with one child from 18.5 to 26.3 percent in the next year.[23] Ellwood argued that no working family should be in poverty.[24] Obama’s proposed budget for 2015 calls for a more generous credit for childless workers, as the credit rate has remained at 7.65% of earnings since its inception in 1993.

The EITC is the most progressive of all the tax expenditures, with 51% of the expenditure accruing to the lowest quintile and 29% to the second quintile in 2013.[25] In 2012, the EITC lifted

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[19] From “Tax Expenditures: Compendium of Background Material of Individual Provisions.” *Senate Budget Committee,* 2011.
[20] From “The Earned Income Tax Credit and the Child Tax Credit: History, Purpose, Goals, and Effectiveness.” by Thomas L. Hungerford and Rebecca Thiess, *Economic Policy Institute*, 2013.
[21] From “Tax Expenditures: Compendium of Background Material of Individual Provisions.” *Senate Budget Committee,* 2011.
[22] Ibid.
[23] “Earned Income Tax Credit Parameters, 1975-2014.” *Tax Policy Center,* 2014. <http://www.taxpolicycenter.org/taxfacts/Content/PDF/historical_eitc_parameters.pdf>.
[24] From *The Poverty Welfare Reform* by Joel F. Handler. Yale University Press, 1995. Print.
[25] “The Distribution of Major Tax Expenditures in the Individual Income Tax System.” *Congressional Budget Office,* 2013.

about 6.5 million people out of poverty, including about 3.3 million children.[26] Thus, it is an anti-poverty program as Ellwood envisioned. Studies have shown that the EITC encourages many single parents to leave welfare for work, especially in a strong economy. One study found that EITC expansions during the 1990s were more responsible for increasing the employment rate than welfare reform or the economy[27]. Opponents of the EITC, such as Congresswoman Michele Bachmann, criticize the fact that it eliminates the federal income tax liability for some recipients so that they have "no skin in the game" and only receive from the government rather than contribute[28].

IV. The Child Tax Credit

The Child Tax Credit is a partially refundable tax credit that began as part of the Taxpayer Relief Act of 1997 as a $400 per qualifying child credit[29]. A child must be under 17 and claimed as a dependent to qualify. The purpose of the credit is to lower the tax burden on families raising children. Before the CTC, there was a deduction given per child, but it was not refundable and was not a tax credit. Similar to EITC, earnings requirements incentivize work but prevent the unemployed or unemployable from receiving any credit. In 1999 the credit increased to $500 and then again to $1000 with the Bush Tax Cuts of 2001[30]. The Fiscal Cliff Deal of January 2013 made the $1000 credit permanent. Initially, the credit was only refundable for families with three or more children up to the amount equal to their Social Security taxes minus

[26] From "Policy Basics: The Earned Income Tax Credit." *Center on Budget and Policy Priorities,* 2014. <http://www.cbpp.org/cms/?fa=view&id=2505>.
[27] Ibid.
[28] From "The Earned Income Tax Credit and the Child Tax Credit: History, Purpose, Goals, and Effectiveness." by Thomas L. Hungerford and Rebecca Thiess, *Economic Policy Institute*, 2013.
[29] From "Tax Expenditures: Compendium of Background Material of Individual Provisions." *Senate Budget Committee,* 2011.
[30] Ibid.

their EITC[31]. The tax legislation of 2001 extended the refundable portion of the CTC to all families with children, refundable up to 15% of earnings over an earnings threshold that is indexed to inflation[32]. The American Recovery and Reinvestment Tax Act of 2009 temporarily reduced this earnings threshold to $3000, not indexed to inflation. This provision has subsequently been extended through 2017. Suppose a family earns $16,000 per year and has two children. Let's say they have no positive income tax liability. Then, they are eligible for a credit up to 15% of $13,000 (the amount earnings exceed threshold), not exceeding $2000 since the credit is a maximum of $1000 per child. Thus, this family would receive a refund of $1950. Because the CTC amount of $1000 per child is not indexed to inflation, the value decreases every year. However, the permanent threshold (not the temporary $3000) is indexed to inflation, so by design, families must earn more and more to qualify for a credit that is worth less and less[33]. This problem only applies to lower-income families who do not have enough positive tax liability to receive the entire credit. In 2011, 28% of children with working parents were part of families who did not receive the full credit because parental income was too low. Five percent of these children were in families who received no credit at all because parental income was below the threshold[34]. These statistics were much worse before the threshold was lowered to $3000. Without this lowering, the 2013 threshold would likely be over $13,000. The credit does not begin to phase-out for married taxpayers until their adjusted gross income reaches $110,000 ($75,000 for single taxpayers).[35] Every $1000 that their income surpasses the phase out point

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[31] From "Taxation and the Family: What is the child tax credit?" by Elaine Maeg and Adam Carasso, *Tax Policy Center*, 2013. <http://www.taxpolicycenter.org/briefing-book/key-elements/family/ctc.cfm>.
[32] Ibid.
[33] Ibid.
[34] Ibid.
[35] From "Child Tax Credit" *H&R Block,* 2013. <http://www.hrblock.com/taxes/partner/article.jsp?otpPartnerId=180&articleId=35>.

decreases the credit by $50.[36] Thus a married couple with two qualifying children can receive some credit up to $150,000 in annual income.

The distribution of the Child Tax Credit is therefore more centered on the middle quintiles. In 2013, the share of the CTC was distributed in this way: 22% to the lowest quintile, 29% to the second, 26% to the third, 18% to the fourth, and 4% to the top quintile.[37] The lower temporary threshold of $3000 is crucial to the progressivity of the CTC. In 2001, before the threshold was lowered, the bottom quintile received less than 1% of the tax expenditure.[38]

IV. Exclusion of Employer Contributions for Medical Insurance Premiums and Medical Care

The exclusion of employer contributions for medical insurance premiums and medical care is currently the largest tax expenditure. There was no deduction for medical expenses until 1943 when the IRS ruled that employer provided health insurance was not taxable to the employee.[39] The deduction was introduced in order to relieve American taxpayers of higher wartime income tax rates. Families with medical expenses exceeding 5% of net income would receive a maximum deduction of $2500. This maximum was raised several times before being eliminated in 1965. At that time just 1.3 million of 130 million Americans had hospital insurance, but when FDR issued an executive order in 1942 freezing wages during the war, employers began to turn to health benefits as a way to attract workers. By 1945, 32 million people had health insurance and when the wartime tax rates continued, the expansion of health

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[36] Ibid.
[37] From “The Distribution of Major Tax Expenditures in the Individual Income Tax System.” *Congressional Budget Office*. 2013.
[38] From “Taxation and the Family: What is the child tax credit?” by Elaine Maeg and Adam Carasso, *Tax Policy Center*, 2013. <<http://www.taxpolicycenter.org/briefing-book/key-elements/family/ctc.cfm>.
[39] From “The Question of Taxing Employer-Provided Health Insurance,” by Bruce Bartlett. Economix Blog, *New York Times,* 30 July 2013. < http://economix.blogs.nytimes.com/2013/07/30/the-question-of-taxing-employer-provided-health-insurance/?_php=true&_type=blogs&_r=0>.

insurance continued throughout the 1950s. By 1960, more than two-thirds of the population was covered: 122 million of 179 million. In 1951, the 5% floor for medical expenses was eliminated for the elderly and those taking care of aged dependent parents.[40] However, in 1965, the Social Security Act required all taxpayers, even the elderly, to be subject to a 3% floor.[41] Health insurance has continued to expand since the 1960s and the passage of the Affordable Care Act now requires essentially universal coverage.[42]

Figure 6 shows historical estimates of four of the largest tax expenditures at five-year intervals beginning in the year 1975.[43] For each expenditure, the sum of the tax expenditure estimates for the five fiscal years is reported in nominal dollars. Looking at Figure 6, the exclusion of employer contributions to medical insurance premiums and medical care has been one of the fastest growing tax expenditures. This is more than likely due to the rising healthcare costs in the US over the past few decades since there have been no policy changes since 1965. Healthcare costs per capita have grown an average of 2.4 percentage points faster than GDP since 1970.[44]

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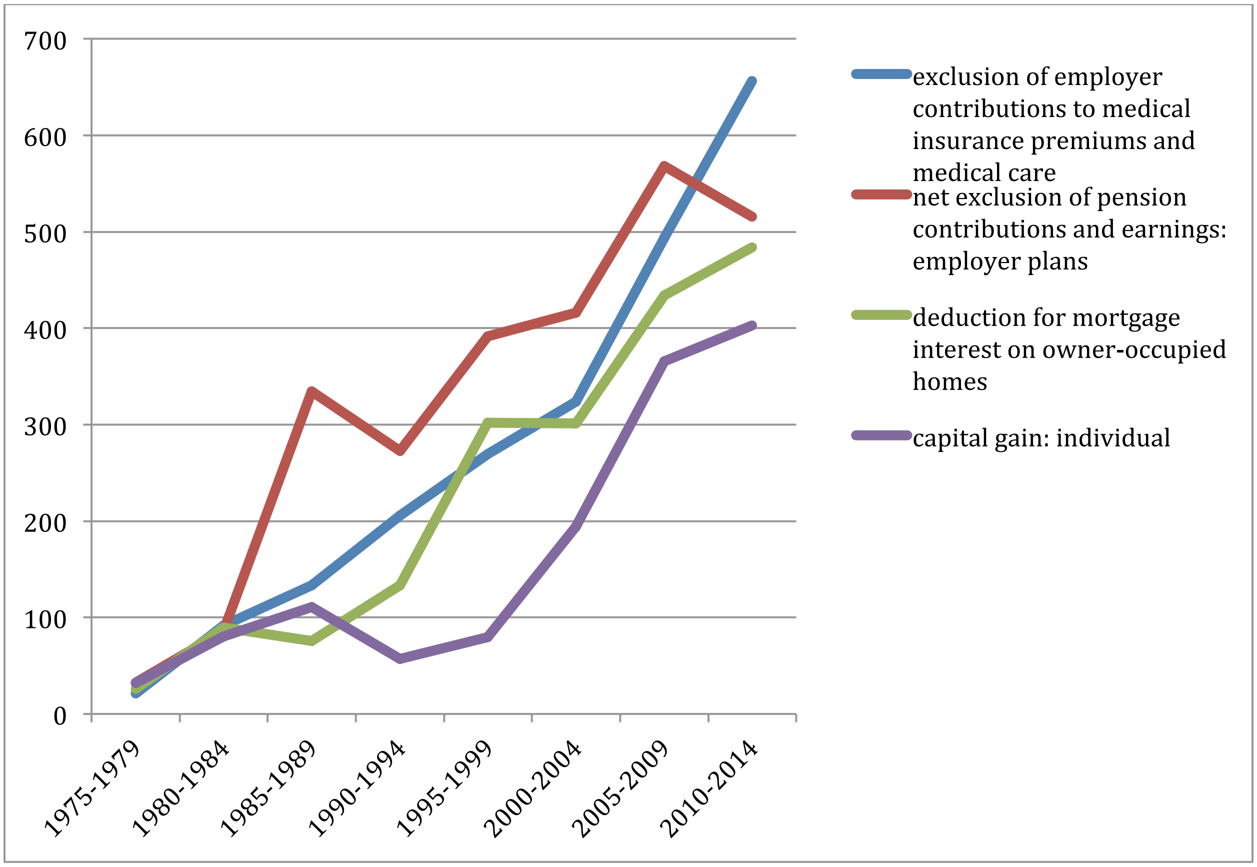
[40] From "Tax Expenditures for Health Care." by Eugene Steuerle and Ronald Hoffman. *National Tax Journal,* Vol. 32., No. 2, June 1979.
[41] Ibid.
[42] The ACA is covered by subsidies and not by tax expenditures, however.
[43] From "Background Information on Tax Expenditure Analysis and Historical Survey of Tax Expenditure Estimates" *Joint Committee on Taxation*, 2011.
[44] From "Health Care Costs: A Primer" *Henry J. Kaiser Family Foundation*, 2012.

Figure 6: Historical Estimates of Selected Tax Expenditures (Billions of Nominal Dollars)



Exclusions for employer-sponsored health insurance are distributed more fairly across income groups than some other tax expenditures. In 2013, the highest share of the expenditure went to the top quintile, but this was only 34% while the fourth quintile received 26%, the middle quintile 19%, the second 14% and the lowest 8%.[45] The likelihood of having employer-sponsored health insurance increases with income but the average cost of premiums does not increase as much as income increases, so the distribution is not as skewed towards the top quintile.[46] However, deductions are more valuable for higher income earners and low-income

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[45] From "The Distribution of Major Tax Expenditures in the Individual Income Tax System." *Congressional Budget Office*. 2013.
[46] Ibid.

earners may not enroll in employer-sponsored health plans even if they are offered to them because the subsidized premiums might still be too expensive.

V. Deduction for mortgage interest on owner occupied residences

Since the inception of the income tax in 1913, there has been a deduction for all interest paid. The tax code did not distinguish between types of interest paid, thus there is no evidence this deduction was designed to encourage home ownership.[47] Before the Tax Reform Act of 1986, there were no restrictions on the dollar amount of the mortgage interest deduction or on the number of homes that qualified for the deduction. This Act eliminated the consumer interest deduction and limited the mortgage interest deduction to first and second homes.[48] The Omnibus Budget Reconciliation Act of 1987 limited the deduction to $1 million for combined interest owed on debt incurred to build, buy, or improve first and second residences.[49] The mortgage interest deduction tax expenditure has increased significantly over the past forty years, growing from about $25.7 billion in 1975-1979 to $484 billion in 2010-2014. However, from 1980-1984 to 1985-1989, the total amount of the tax expenditure actually decreased from $89.5 billion to $75.6 billion. See Figure 6. The legislation of 1986 and 1987 limiting the deduction amount to $1 million on first and second homes seems to have resulted in a significant reduction in the tax expenditure. However, the value of the tax expenditure varies with the rate of home ownership and mortgage interest rates, so this decline might also be explained by the notable decrease in the

[47] From "Tax Expenditures: Compendium of Background Material of Individual Provisions" *Senate Budget Committee,* 2011.
[48] Ibid.
[49] Ibid.

average 30 year mortgage annual fixed rate which fell from 14.706% in 1980-1984 to 10.698% in 1985-1989.[50]

This deduction only benefits those taxpayers who own their own homes. In 2006, 38% of households in the bottom quintile and 57% of those in the second quintile owned their own homes, compared to 91% in the top quintile.[51] Thus, by design, this tax expenditure benefits higher-income households much more than other households. In 2013, the Congressional Budget Office (CBO) estimates that almost 75% of the benefit from this deduction accrued to the top quintile with 15% of the benefit going to the top 1% of income earners. The lowest quintile only received between zero and 0.5% of the deduction benefit and the second quintile received a mere 2%.[52]

VI. Preferential Rates on Capital Gains

Capital gains are not of the typical deduction, exclusion, or credit tax expenditure structure, but rather they are taxed at a preferential tax rate and thus represent revenue losses at the federal level.[53] For that reason they are considered a type of tax expenditure. Capital gains are the profit when an investment held for more than one year is sold.[54] For most of income tax history, capital gains have been taxed at a lower rate than income. However, the Tax Reform Act of 1986 eliminated the capital gains preference, but it reappeared when ordinary income rates

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[50] "30-Year Fixed-Rate Mortgages Since 1971" *Freddie Mac,* 2014. <http://www.freddiemac.com/pmms/pmms30.htm>.

[51] "Homeownership: America's Dream?" prepared from a paper by Raphael W. Bostic and Kwan Ok Lee. *National Poverty Center,* 2008. <http://npc.umich.edu/publications/policy_briefs/brief15/.>.

[52] From "The Distribution of Major Tax Expenditures in the Individual Income Tax System." *Congressional Budget Office.* 2013.

[53] There are also state capital gains tax rates, but we only consider federal rates here.

[54] From "The Distribution of Major Tax Expenditures in the Individual Income Tax System." *Congressional Budget Office.* 2013.

were raised in 1990 and 1993 without raises in capital gains rates.[55] Capital gains rates were then reduced in 1997 and 2003, although they have increased recently under the Obama administration.[56] In 2013, the capital gains rate for the top income bracket increased from 15% to 20%. Looking at Figure 6, the effect of the 1986 Tax Reform Act's elimination of the capital gains preference is visible as the total tax expenditure declines from $111 billion in 1985-1989 to only $57.4 billion in 1990-1994. Since 1994, the capital gains tax expenditure has increased in size. This growth can partially be explained by the growth in capital gains as a percentage of total income for taxpayers in the top quintile.[57] Currently, capital gains are taxed at a maximum rate of 20% for taxpayers in the top tax bracket, who pay a 39.6% income tax rate. Taxpayers in the 25-35% brackets pay a maximum of 15%, while taxpayers in the 10% and 15% brackets pay 0%.[58] A preferential rate for capital gains is not a policy unique to the United States. Most OECD countries have preferential capital gains rates and eleven of these countries do not tax them at all.[59] This type of policy is meant to encourage investment in the economy rather than make taxes more progressive. Ninety-three percent of the benefits from the capital gains preference accrue to the top quintile. Sixty-eight percent goes to the top 1% of income earners alone. The benefit to the lowest and second quintiles is negligible and the middle quintile only receives 2% of the benefit. These statistics are from 2013 and include the preferential tax rates on dividends.[60] A report by the nonpartisan Congressional Research Service's Thomas

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[55] From "The Tax Break-Down: Preferential Rates on Capital Gains" *The Committee For A Responsible Federal Budget,* 2013. < http://crfb.org/blogs/tax-break-down-preferential-rates-capital-gains>.
[56] Ibid.
[57] From "CRS: Capital Gains and Dividends Drive Income Inequality" by Walid Zafar, *Political Correction,* 2012. <http://politicalcorrection.org/blog/201201040009>.
[58] From "The Distribution of Major Tax Expenditures in the Individual Income Tax System." *Congressional Budget Office,* 2013.
[59] From "The Tax Break-Down: Preferential Rates on Capital Gains" *The Committee For A Responsible Federal Budget,* 2013. < http://crfb.org/blogs/tax-break-down-preferential-rates-capital-gains>.
[60] From "The Distribution of Major Tax Expenditures in the Individual Income Tax System." *Congressional Budget Office,* 2013.

Hungerford concludes that income earned through capital gains, dividends, and business income contributed more to the increasing income inequality than wages and salaries or changing tax rates.[61]

VII. Exclusions for Pension Contributions and Earnings

The purpose of excluding pension earnings and contributions is to encourage people to save for retirement. The tax expenditure allows taxpayers to defer taxes on their earnings and contributions until retirement when they will most likely be in a lower tax bracket. The net exclusion of pension contributions and earnings is one of the longest existing tax expenditures. First, pension contributions by employers were made deductible by a treasury decision in 1914.[62] Subsequent regulations allowed pension contributions also to be deductible for employees. The Revenue Act of 1926 exempted pension earnings from tax.[63] In 1962, the Self-employed Individuals Retirement Act allowed self-employed individuals to establish pension plans; these plans are often included in the measurement of this tax expenditure.[64] In 1986, there were significant reductions in the maximum contributions allowed under defined-contribution plans.[65] The effect of this legislation can be seen in Figure 6, as the total value of the tax expenditure decreases from $334.6 billion in 1985-1989 to $272.9 billion in 1990-1994. This decline is most likely due to the reduction of the tax expenditure for very high income recipients, as they are most likely to be meeting the maximum contribution limit. In 2006, 27% of those making more than $160,000 a year were constrained by the contribution limits, while only 10% of those

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[61] From "CRS: Capital Gains and Dividends Drive Income Inequality" by Walid Zafar, *Political Correction,* 2012. <http://politicalcorrection.org/blog/201201040009>.
[62] From "Tax Expenditures: Compendium of Background Material of Individual Provisions" *Senate Budget Committee,* 2011.
[63] Ibid.
[64] Ibid.
[65] Ibid.

making less than $160,000 were constrained.[66] 2001 tax cuts raised the contribution and benefit limits temporarily until 2010, but these increases were made permanent by the Pension Protection Act of 2006.[67] The total amount of the tax expenditure was increasing before the limits were increased, but after this legislation the rate of growth increased. From 2005-2009 to 2010-2014 the tax expenditure decreased for the first time since the mid-1980s (Figure 6). A news article published in the fall of 2012 perhaps gives some insight into the reason for this decrease. The article describes corporations across the country freezing pension benefits or cutting them altogether. For example, General Motors and Ford downsized their pension plans.[68] Anecdotally, these reductions have affected middle-class workers much more than high-income earners. Defined-benefit pensions have been decreasing in both the private and public sectors, while the decline has been more dramatic in the private sector. In 1979, 38% of Americans over age 60 received income from private defined-benefit pension plans. By 2010, this number was a mere 15%.[69] The data in Figure 6 only includes traditional defined-benefit and defined-contribution pensions; it does not include IRAs or 401(k)s. While not considered in depth in this paper, exclusions for IRAs and 401(k)s earnings and contributions are also regressive.

The distribution of this tax expenditure tilts toward the top quintile, which received about two-thirds of the benefit in 2013.[70] Part of this is due to the effect of a higher tax bracket on the amount of the deduction. Also, higher-income households are much more likely to have a retirement account. Eighty-eight percent of the top quintile had a retirement account in 2010

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[66] "Retirement Tax Incentives Are Ripe for Reform." by Chuck Marr, Nathaniel Frentz, and Chye-Ching Huang, *Center on Budget and Policy Priorities*, 2013. <http://www.cbpp.org/cms/?fa=view&id=4063>.
[67] From "Tax Expenditures: Compendium of Background Material of Individual Provisions." *Senate Budget Committee,* 2011.
[68] "Why the Decline in Pensions Will Mean An Increase In Poverty For America's Retirees." by Travis Waldron. *Think Progress,* 8 Aug 2012. <http://thinkprogress.org/economy/2012/08/08/656681/pension-decline-poverty-increase/>.
[69] Ibid.
[70] From "The Distribution of Major Tax Expenditures in the Individual Income Tax System." *Congressional Budget Office.* 2013.

compared to 11% of the bottom quintile and 31% of the second quintile.[71] Low- to moderate-income workers have less access to employer-based retirement plans because their employers do not offer them or because they work part-time and do not qualify.[72] Additionally, they are less likely to participate because they live paycheck to paycheck and do not feel they can forego consumption for savings. Nevertheless, pensions are important for keeping elderly out of poverty. A study based on Census data found poverty rates were nine times greater in 2010 in households without defined-benefit pension income. Pensions result in 4.7 million fewer poor or near poor families and 1.2 million fewer families on various forms of public assistance.[73] Pensions also help reduce relative poverty among the elderly middle class.

VIII. Overall Trends in Regressivity

All six of the tax expenditures discussed above are included in the ten largest tax expenditures for 2013. Overall, these tax expenditures disproportionately benefit the highest quintile (Figure 7).[74] The snapshot of the distribution of the major tax expenditures in 2013 shows us they are indeed regressive, but have these expenditures become more regressive over time? Ideally, we would want to look at the quintile distribution of these expenditures historically, say every five years since 1975. This data is not readily available in this form, so this is a great area for further research.

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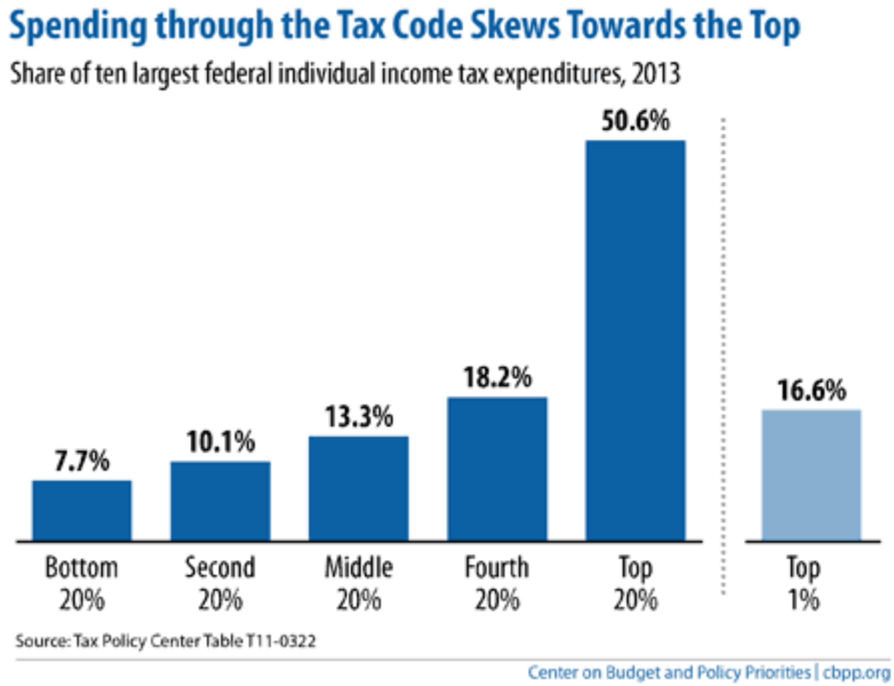
[71] "Retirement Tax Incentives Are Ripe for Reform." by Chuck Marr, Nathaniel Frentz, and Chye-Ching Huang, *Center on Budget and Policy Priorities*, 2013. <http://www.cbpp.org/cms/?fa=view&id=4063>.
[72] Ibid.
[73] "Why the Decline in Pensions Will Mean An Increase In Poverty For America's Retirees" by Travis Waldron. *Think Progress,* 8 Aug 2012. <http://thinkprogress.org/economy/2012/08/08/656681/pension-decline-poverty-increase/>.
[74] From "Policy Basics: Federal Tax Expenditures." *Center on Budget and Policy Priorities,* 2014. <http://www.cbpp.org/cms/?fa=view&id=4055>.

Despite not having this exact data, commentary on the overall trends in regressivity can still be made. The Tax Reform Act of 1986 was an important step toward progressivity. Provisions of this Act had a significant effect on capital gains, deduction for mortgage interest, and the exclusion for pension earnings and contributions. The Act eliminated the preferential rate for capital gains, limited the deduction for mortgage interest to two homes (and then to $1 million in 1987), and lowered the maximum contribution for defined-contribution pension plans. In Figure 6, each of these three regressive tax expenditures decreases in size in the late 1980s or early 1990s. However, in the 1990s and 2000s, there are countervailing forces. The CTC is introduced and subsequently expanded along with EITC. These progressive tax expenditures together make up 26 percent of the growth in total tax expenditures since 1986 (Figure 4). However, this introduction and expansion of more progressive policy is offset by the growth in the regressive employer-sponsored healthcare tax expenditure. Forty-one percent of the growth in total tax expenditures since 1986 can be attributed to the growth in employer-provided healthcare (Figure 4). Additionally, the 1990s and 2000s have seen the other four regressive tax expenditures discussed grow in size as well. These trends suggest tax expenditures may be more regressive than they were in the late 1980s.

Figure 7



IX. Policy Recommendations

There are ways, however, to reform the tax code that would decrease regressivity, still preserve the original intent of the policy, and provide additional revenue for the government to direct toward progressive transfers like Medicaid and SNAP or toward investments in education, job training, and other programs that foster capability.

First, policymakers should address the most regressive tax expenditure: preferential rates for capital gains. A tax expenditure whose benefits are almost all received by the top quintile, small policy changes could have a large impact on federal revenue. President Obama has already enacted such a change. Passed as part of the Affordable Care Act, beginning in 2013, taxpayers with income over $200,000 for single filers and over $250,000 for joint filers will have to pay a surtax of 3.8% of their investment income, including capital gains and dividends.[75] Essentially, this surtax reduces the tax break on capital gains for the wealthiest Americans. 91% of the effect of this surtax will fall on the top 1% of income earners.[76] The rest will affect the 96th through 99th percentiles. The surtax is expected to raise revenues by $17 billion in 2013.[77] This reform only affects the very top percentages of income earners, so it should not discourage investment for the large majority of taxpayers, thus preserving the purpose of the tax expenditure. There are other potential reforms that the government should consider. Raising the capital gains rate by 2 percentage points would generate $55 billion in savings for the federal government for 2014-2023. Taxing capital gains as ordinary income but lowering the top tax bracket to 28 percent would generate savings of $55 - $90 billion.[78]

The deduction for interest paid on mortgages is the second most regressive tax expenditure examined in this paper. The deduction should be eliminated for second homes. There is no good justification for why the government should subsidize the purchase of vacation second homes. The government should also consider decreasing the maximum deduction to $500,000. With the elimination of a second home, it makes sense to cut the limit in half. However, the $1 million limit is not indexed to inflation, so it's value has cut in half since 1988 and will continue to slowly decrease.[79]

The exclusions for pension contributions and earnings as well as for contributions to employer-sponsored health insurance are both tilted toward the highest income earners, but less so than capital gains and mortgage interest deduction. President Obama has proposed something

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[75] From "The Tax Break-Down: Preferential Rates on Capital Gains" *The Committee For A Responsible Federal Budget,* 2013. < http://crfb.org/blogs/tax-break-down-preferential-rates-capital-gains>.
[76] Ibid.
[77] Ibid.
[78] Ibid.
[79] "Reforming Individual Income Tax Expenditures." *Citizens for Tax Justice*, 2013. <http://www.ctj.org/pdf/pitexpenditures2013.pdf.>.

known as the "28 percent rule" that would limit tax savings from each dollar of deductions or exclusions to 28 cents.[80] Currently, those in the highest tax bracket save 40 cents to the dollar. Five of the ten largest individual tax expenditures would be subject to the 28 percent rule including the exclusion for employer-provided health insurance, the exclusion of employee (but not employer) contributions to retirement savings plans, and mortgage interest paid. This rule is projected to raise around half a trillion dollars over a decade and a Citizens for Tax Justice report finds that it would only affect 3.6 percent of Americans.[81] This rule would also apply to charitable deductions, and that fact has caused some controversy. Nevertheless, the 28 percent rule would make all the tax expenditures it applied to more progressive.

The distribution of the exclusion of contributions to employer-sponsored health insurance is relatively fair, with only 2% of the tax expenditure going to the richest 1%. Additionally, beginning in 2018, a 40% excise tax will be assessed for "Cadillac" health insurance plans.[82] These plans are those that surpass $10,200 for an individual annually and $27,500 for couple or family coverage. While not a change to the tax expenditure, this Cadillac tax will effectively reduce the deductions received by the top income earners. This threshold ($10,200 for individual policies) is extremely high and could be potentially adjusted lower for a greater progressive effect.

As for the most progressive tax credits, both the EITC and the CTC, the government should continue to expand these expenditures. Obama's proposed expansion of EITC for childless workers could potentially help fathers pay more child support. The $3000 earnings threshold for the CTC should be made permanent and the amount of the tax credit should be

80 "Reforming Individual Income Tax Expenditures." *Citizens for Tax Justice*, 2013. <http://www.ctj.org/pdf/pitexpenditures2013.pdf.>.

81 Ibid.

82 "Excise Tax on 'Cadillac' Plans" by JoAnn Volk, *Health Affairs,* 2013. <http://www.healthaffairs.org/healthpolicybriefs/brief.php?brief_id=99>.

indexed to inflation. Without this policy change, the value of the Child Tax Credit will continue to decrease as years go by while the permanent earnings threshold, which is indexed to inflation, will make it harder and harder for low-income taxpayers to qualify for the credit.

IX. Conclusion

Tax expenditures have enormous budgetary power. They are currently regressive, with most of the benefits accruing to the top income earners, and historical trends show the growth of tax expenditures in recent decades has made them even more so. However, with only small policy changes that do not call for the elimination of any of the tax expenditures, federal tax revenue could increase by around $600 billion or more in the next decade. Each of these policy changes would increase the progressivity of tax expenditures while maintaining their original policy goal. This additional revenue could not only be redirected toward transfers that target low-income Americans, but it could also be invested in health and education programs that benefit all Americans. Furthermore, this additional tax revenue could serve to decrease the federal deficit significantly. Tax expenditures are a promising area of reform both Republicans and Democrats alike should not ignore.

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