



A TRILLION LITTLE SUBSIDIES: The Economic Impact of Tax Expenditures in the Federal Income Tax Code

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SUMMARY

The loopholes known as “tax expenditures” reduce individual and corporate tax obligations by more than \$1 trillion each year. But while these tax deductions are hugely popular and fiercely protected, are they *really* a good deal for most Americans?

A new Mercatus Center study looks at the ten largest tax expenditures for individuals and corporations and weighs the economic impact of each. The study also reviews the intended-vs-actual beneficiaries and outcomes of particular tax expenditures and considers the economic and political implications of eliminating *all* expenditures in a single swipe.

To read “A Trillion Little Subsidies: The Economic Impact of Tax Expenditures in the Federal Income Tax Code” and to learn more about its authors, please click here <http://mercatus.org/publication/trillion-little-subsidies-economic-impact-tax-expenditures-federal-income-tax-code>.

BACKGROUND

- According to the Office of Management and Budget, FY2011 federal tax expenditures were more than \$1 trillion—with 80 percent, or \$891 billion, going to individuals, and 20 percent, or \$181 billion, to corporations.
 - To put this in perspective: FY2011 tax expenditures were nearly equal to all federal income tax collected in that year, or to the entire FY2011 discretionary budget; they were also greater than the annual federal spending on Medicare or Social Security.
 - Although applied through the tax code, their effect is similar to spending provisions, hence the name tax *expenditures*: They encourage certain kinds of government-supported behavior by subsidizing it. Because they are part of the tax code, however—reducing revenue from what it otherwise would be, rather than overtly increasing spending—they mask the true size and scope of government.

KEY POINTS

- Tax expenditures hinder economic growth by distorting individuals’ and corporations’ behavior toward qualifying for tax loopholes rather than making the best economic decisions.
 - By distorting behavior, tax expenditures distort the entire economic system by altering spending on goods and services; distorting capital allocation; changing the distribution of income; and encouraging lobbying and rent-seeking to maintain and expand these provisions.

- ♦ For example, corporations must divert significant resources away from pro-growth activities to the non-productive—but critical to compete with other U.S. corporations—activity of fighting for more and bigger tax breaks.
- Of the largest tax expenditures studied, the authors found the stated legislative intent was seldom realized.
 - ♦ Intended economic benefits seldom materialized.
 - ♦ Intended beneficiaries were seldom the *greatest* beneficiaries; most tax-expenditure benefits accrue disproportionately to higher-income earners, and encourage “gaming” the system by those in a position to take advantage, often resulting in cronyism and the capture of the tax code for private gain.
 - ♦ For example, while the encouragement of home ownership has become the common justification of the home mortgage interest deduction, it does not effectively achieve this goal.
 - ◇ Of the 33 percent of taxpayers who itemize deductions, only 20 percent claim the home mortgage deduction. Of those, two thirds make more than \$100,000 a year.
 - ◇ Consequently, individuals and families on the margin who could be motivated to become homeowners by incentives—that is, lower-income individuals and families—are unlikely to use this deduction.
- With respect to tax expenditures, the authors conclude that economically optimal tax reform must include two key pieces: eliminate all tax expenditures *and* lower marginal rates across the board.
 - Eliminating expenditures without simultaneously lowering tax rates amounts to a tax increase on the economy as a whole. This would result in slower economic growth and, thus, lower future tax collections.
 - While a one-shot elimination of tax expenditures seems less unlikely, the authors find it more probable than a piecemeal elimination. This is because the former would give all taxpayers an immediately recognizable benefit (such as an increase in individuals’ paychecks or a significant reduction in lobbying and accounting expenses for businesses) to offset later loophole losses.

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