



October 18, 2013

Memorandum

To: Members of the Board *Wendy M. Payne*  
From: Wendy M. Payne, Executive Director  
Subj: Tax Expenditures<sup>1</sup> – **Tab A**

### MEETING OBJECTIVE

- Educational session so that members are better prepared to assess a draft tax expenditures project plan in February 2014

The Board identified tax expenditures as a high priority project earlier this year. While we are not able to staff the project yet, we can begin developing an understanding of the information used by policy makers and others. Donald Marron will be joining us to provide an introduction to tax expenditures and answer members' questions.

Dr. Marron is the Director of Economic Policy Initiatives, Institute Fellow, Urban Institute; Director Emeritus of the Tax Policy Center. He previously served as a member of the President's Council of Economic Advisers, as acting director of the Congressional Budget Office (CBO), and as executive director of Congress's Joint Economic Committee. Before his government service, he taught economics and finance at the University of Chicago Graduate School of Business and served as chief financial officer of a health care software start-up. Dr. Marron was also a visiting professor at the Georgetown Public Policy Institute. Also, during his tenure at CBO, he was a member of FASAB.

### BRIEFING MATERIALS

This memo provides a brief overview of the topic. Attachments provide additional information that would be useful as you consider questions you may wish to ask. The Appendix provides you with the most recent report on tax expenditures from the President's Budget. In addition to explanatory material, it presents estimates and descriptions of tax expenditures.

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<sup>1</sup> The staff prepares Board meeting materials to facilitate discussion of issues at the Board meeting. This material is presented for discussion purposes only; it is not intended to reflect authoritative views of the FASAB or its staff. Official positions of the FASAB are determined only after extensive due process and deliberations.

Attachments:

1. Marron, Donald. **Spending in Disguise**, *National Affairs* - <http://www.taxpolicycenter.org/UploadedPDF/1001542-Spending-In-Disguise-Marron.pdf>
2. Marron, Donald and Toller, Eric. **Tax Policy and the Size of Government**, Urban Institute and Urban-Brookings Tax Policy Center, *National Tax Association Proceedings*, 104<sup>th</sup> Annual Conference on Taxation. <http://www.taxpolicycenter.org/UploadedPDF/412850-tax-policy-size-of-government.pdf>
3. Marron, Donald. **How Large are Tax Expenditures: A 2012 Update**, *Tax Facts from the Tax Policy Center* - <http://taxpolicycenter.org/UploadedPDF/1001602-TN-How-Large-Are-Tax-Expenditures-2012-Update.pdf>

Appendix: *Analytical Perspectives*: Federal Receipts – Tax Expenditures – pages 241-277 -

<http://www.whitehouse.gov/sites/default/files/omb/budget/fy2014/assets/receipts.pdf>

## Background<sup>2</sup>

The Congressional Budget Act of 1974 defines tax expenditures 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 liability.”

Tax expenditures may take the form of credits, deductions, special exceptions and allowances, and reduce tax liability below the level implied by the baseline tax system. The normal tax baseline is patterned on a practical variant of a comprehensive income tax, which defines income as the sum of consumption and the change in net wealth in a given period of time. The normal tax baseline allows personal exemptions, a standard deduction, and deduction of expenses incurred in earning income. It is not limited to a particular structure of tax rates, or by a specific definition of the taxpaying unit. The normal tax baseline allows several major departures from a pure comprehensive income tax. For example:

- Income is taxable only when it is realized in exchange. Thus, the deferral of tax on unrealized capital gains is not regarded as a tax expenditure. Accrued income would be taxed under a comprehensive income tax.
- There is a separate corporate income tax.

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<sup>2</sup> The following is largely a summary of the appendix - *Analytical Perspectives*, Federal Receipts, Tax Expenditures (pages 241-277).

Considerations and explanatory comments include:

1. Deciding whether a provision of tax law is an exception to the normal tax baseline is a matter of judgment.
2. A grand total for the estimated tax expenditures is not provided in Analytical Perspectives because each tax expenditure is estimated assuming other parts of the Tax Code remain unchanged. The estimates would be different if tax expenditures were changed simultaneously because of potential interactions among provisions.
3. Estimates should be regarded as approximations. The individual estimates do not necessarily equal the increase in Federal revenues (or the change in the budget balance) that would result from repealing these special provisions because:
  - a. eliminating a tax expenditure may have incentive effects that alter economic behavior, and
  - b. tax expenditures are interdependent even without incentive effects.
4. Estimates are provided for the cash (current revenue) effect and the present value effect for the period 2012 through 2018. The present value effects are important because deferrals will reverse in later years. (Note that new deferral provisions may result in expenditures for which later reversals are wholly outside the time period of the estimate.)
5. Estimates are based on tax law in effect at December 31, 2012 and assume that any provisions scheduled to expire will expire (for example, alternative minimum tax relief).
6. Estimates are grouped by functional categories including:<sup>3</sup>
  - a. National defense (exclusion of benefits and allowances to armed forces personnel)
  - b. International affairs (exclusion of income earned abroad by U.S. citizens)
  - c. General science, space, and technology (credit for increasing research activities)
  - d. Energy (energy investment credit)
  - e. Natural resources and environment (Income averaging for farmers)
  - f. Agriculture (Income averaging for farmers)
  - g. Commerce and housing (carryover basis of capital gains on gifts)
  - h. Transportation (exclusion for employer-provided transit passes)
  - i. Community and regional development (investment credit for rehabilitation of structures)
  - j. Education, training, employment, and social services (HOPE tax credit)
  - k. Health (exclusion of employer contribution for premiums)
  - l. Income security (exclusion of workers comp benefits)
  - m. Social security (exclusion of social security benefits)
  - n. Veterans benefits and services (exclusion of veterans pensions)
  - o. General purpose fiscal assistance (exclusion of interest on state and local bonds)
  - p. Interest (deferred interest on savings bonds)
  - q. An addendum for aid to state and local governments (deductibility of property taxes on owner-occupied homes)
7. Tables present total revenue effects that arise under individual and corporate income taxes separately. The reader is cautioned that labeling does not imply that individuals and corporations “benefit from the special tax provisions in proportion to the respective tax expenditure amounts shown. Rather, these breakdowns show the form of tax liability that the various provisions affect. The ultimate beneficiaries of corporate tax expenditures could be shareholders, employees, customers, or other providers of capital, depending on economic forces.”

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<sup>3</sup> One example tax expenditure item is included parenthetically for each functional category. See the appendix for a complete list. Note that no functional totals are provided.

8. Tax expenditures can arise in other than income taxes (for example, excise taxes) but these generally are not included in reports on tax expenditures.

Analytical Perspectives (see Appendix) describes 169 tax expenditures. The top ten, based on total FY2014-2018 revenue effect (Table 16-3), are:

<b>Appendix Ref #</b>	<b>Provision</b>	<b>2014 (in millions)</b>	<b>2014-2018 (in millions)</b>
128	Exclusion of employer contributions for medical insurance premiums and medical care	\$ 212,820	\$ 1,206,260
59	Deductibility of mortgage interest on owner-occupied homes	101,470	640,180
146	Defined contribution employer plans	79,720	477,870
63	Exclusion of net imputed rental income	75,520	436,680
71	Capital gains (except agriculture, timber, iron ore, and coal)	46,690	331,020
145	Defined benefit employer plans	53,060	308,390
168	Deductibility of nonbusiness State and local taxes other than on owner-occupied homes	51,560	292,140
77	Accelerated depreciation of machinery and equipment (normal tax method)	17,850	273,730
62	Capital gains exclusion on home sales	45,870	263,200
124	Deductibility of charitable contributions, other than education and health	44,060	259,910

### Performance Measures

Consideration of tax expenditures is now included in performance management efforts.

Congress updated the statutory framework for performance management in the federal government, the Government Performance and Results Act of 1993 (GPRA), with the GPRA Modernization Act of 2010 (GPRAMA). Both acts require agencies to set goals and measure and report the performance of their programs. GPRAMA introduced a more integrated and crosscutting approach to performance measurement that cuts across organizational boundaries. The act requires that OMB, in coordination with agencies, develop long-term crosscutting priority goals to improve performance and management of the government. OMB is to coordinate annually with agencies to develop a federal government performance plan which establishes performance indicators for achieving these goals. Moreover, GPRAMA requires that this plan identify the tax expenditures that contribute to each crosscutting priority goal. As we noted in a recent report,

sporadic progress has been made along these lines. **OMB Circular A-11 guidance directs agencies to list tax expenditures among the various programs and activities that contribute to the subset of performance goals that are designated as agency priority goals.** [footnotes omitted]<sup>4</sup>

## Considerations for the Board

When the project plan is developed, we will want to consider questions such as:

1. Should issues be considered from a “blank slate” or should we work with the framework for existing reports such as Analytical Perspectives? This will impact:
  - a. Definitions
  - b. Measurement and presentation guidance
    - i. Normal tax
    - ii. Consideration of tax provisions that expire but are routinely extended
    - iii. Projected and/or historical amounts
    - iv. Present value over a period of time (to address reversing provisions)
2. Which of the various means of categorization (functional, tax expenditure type, related agency (goal or program)) are needed? (Is it necessary and/or appropriate to provide sub-totals?)
3. What explanatory information is needed to help users understand the estimates?
  - a. Nature of these estimates
  - b. To the extent that tax expenditures substitute for spending, what – if any - options exist to relate the tax expenditure information to net cost information and to performance measures?
  - c. Changes in law and prior projections
4. What placement in the financial reports (MD&A, financial statements, notes or required supplementary information) is needed to meet reporting objectives within the overall constraint of cost-beneficial requirements? (Note: presentation in a variety of places is possible.)
5. Is reporting only at the government-wide level or also at agency level?

At the meeting, Dr. Marron will address questions you may have regarding tax expenditures.

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<sup>4</sup> GAO-13-479 Data for Tax Expenditures

## Spending in Disguise

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*Donald B. Marron*

WITH THE UNITED STATES on track for a third year of trillion-dollar deficits, public debate is now focused on getting America's fiscal house in order. The challenge is straightforward: The federal government spends much more than it collects in tax revenue each year and will continue to do so even after the economy recovers.

The argument over how to close that gap is often dominated—sometimes debilitated—by sharp disagreements about how much should come from spending cuts and how much from tax increases. But that division can be misleading. A great deal of government spending is hidden in the federal tax code in the form of deductions, credits, and other preferences—preferences that seem like they let taxpayers keep their own money, but are actually spending in disguise. Those preferences complicate the code and often needlessly distort the decisions of businesses and families. The magnitude of these preferences raises the possibility of a dramatic reform of the tax code—making it simpler, fairer, and more pro-growth—that would amount to simultaneously cutting spending and increasing government revenue, without raising tax rates.

Such a reform would not eliminate the need for serious spending cuts, of course, nor would it take tax increases off the table. But it could dramatically improve the government's fiscal outlook and make the task of budget negotiators far easier. It will only be possible, however, if we clearly understand how spending is hidden in the tax code and what reformers might do about it—if we see that tax policy and spending policy are not always as distinct as we might think.

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To illustrate, consider a dilemma that President Obama faced in constructing his 2012 budget. Because of inflation's ups and downs, Social Security beneficiaries did not receive a cost-of-living increase in 2011, just as they did not receive one in 2010. Nor did many benefit from the payroll-tax holiday enacted as a form of stimulus at the end of last year (since few retirees are still working and paying payroll taxes). For these reasons, President Obama wanted to make a special, one-time payment of \$250 to each American receiving Social Security.

But that idea raised a question of basic fairness. Some retired government workers do not participate in Social Security. But they are just as retired—and arguably just as deserving of an additional benefit—as Social Security recipients. So the president wanted to give them \$250, too. But how could he get the money to the retired government workers? The government doesn't have a master list of retirees outside of Social Security. Even if it did, it would make no sense to have Social Security send checks to retirees who had never participated in the program to begin with. Another agency had to deliver the benefit—one that was already in contact with most retirees, could enforce eligibility requirements, and, most important, could deliver the money. Only one agency fit the bill: the Internal Revenue Service. The president thus structured his special, one-time payment as a \$250 refundable tax credit for any retiree who did not qualify for Social Security. In Beltway parlance, he offered these men and women a tax cut.

But was it really a tax cut? The president's \$250 credit would have the same budgetary, economic, and distributional effects as his \$250 boost in Social Security benefits. Both would deliver extra money to retirees, and both would finance those payments by adding to America's growing debt. One benefit would arrive as a Social Security check, the other as a reduced tax payment or a refund. These superficial differences aside, however, the proposed tax credit would be, in effect, a spending increase.

This is just a small example of a widespread practice that involves hundreds of billions of dollars each year. Because tax cuts often sound more appealing to policymakers and voters than spending increases—especially in today's political climate—the temptation to spend through the tax code is enormous. And the confusion surrounding such spending allows politicians to claim they are saving taxpayers' money when, in fact, they are really spending it.

With America deep in the red, this point is particularly important to keep in mind when considering proposals to reduce the federal deficit. It

is neither feasible nor desirable to reduce deficits with tax increases alone. But revenues must be part of the conversation — even among lawmakers who loathe the very idea of “tax hikes.” With our aging population and rising health-care costs, America will not be able to restrain spending enough to avoid increasing federal revenue above historical levels.

But these combined pressures do not mean that income tax *rates* have to go up. By properly taking account of spending disguised as tax breaks, policymakers can raise new revenue — and potentially even pay for some tax-rate *reductions* — by cutting back on the many spending-like provisions in our tax code. After all, that hidden spending should get the same scrutiny — and inspire the same enthusiasm for cuts — as the spending on entitlements, domestic programs, and defense that is targeted by today’s fiscal hawks.

#### A SEA OF TAX PREFERENCES

Identifying all of the spending programs hidden in the tax code is no easy matter. The code is notoriously complex, and distinguishing between tax provisions and spending-like provisions can involve as much art and philosophy as it does science and accounting.

The best place to begin is the list of tax preferences that the Treasury Department compiles each year for the president’s budget. This year, that list identifies more than 170 distinct preferences in the individual and corporate income taxes. These preferences fall into five categories.

First, *credits* reduce a taxpayer’s liability dollar for dollar. If a taxpayer’s total liability is low enough, and a credit is refundable, it can even result in a direct payment from the government to the taxpayer. The two largest credits are the Earned Income Tax Credit for low-income, working Americans (which provided its recipients with about \$60 billion in 2010) and the child tax credit (which gave \$48 billion to low- and moderate-income families). The most significant business credits include those for research and experimentation and for developing low-income housing, each of which amounted to almost \$6 billion last year.

Second, *deductions* reduce the amount of income subject to tax. In the personal income tax, the most important deductions include those for mortgage interest (\$79 billion in tax savings in 2010), charitable giving (\$42 billion), and state and local income taxes (\$27 billion). On the business side, the largest deductions are for accelerated depreciation (the ability to write off investment costs faster than capital actually

depreciates), which amounted to a savings of \$40 billion, and the deduction for manufacturing activities that take place in the United States (\$13 billion).

Third, *deferrals* allow taxpayers to postpone the date at which income gets taxed. Individual taxpayers get deferrals through various tax-advantaged saving programs; 401(k)s, for example, allowed taxpayers to keep about \$52 billion they otherwise would have paid to the IRS in 2010. Corporate taxpayers can defer taxes on most income earned by their foreign affiliates until the income is formally paid to the U.S. parent company, a delay that saved them about \$38 billion last year.

Fourth, *exclusions and exemptions* allow certain types of income to avoid taxation entirely. The three largest are the exclusion for employer-provided health insurance (\$260 billion in 2010), the exclusion for the imputed rental value of owner-occupied homes (\$41 billion), and the exemption for interest earned by holders of state and local bonds (\$30 billion).

Finally, *preferential rates* tax certain types of income at lower levels. The most important are the lower personal rates on long-term capital gains (\$36 billion in 2010) and qualified dividends (\$31 billion).

The estimated revenue losses from these five kinds of preferences total more than \$1 trillion annually, almost as much as we collect from individual and corporate income taxes combined, and almost as much as we spend on discretionary programs. In 2010, for example, individual income-tax preferences totaled more than \$900 billion in foregone revenue and corporate income-tax preferences more than \$100 billion. When one factors in the money disbursed to individuals and corporations through refundable credits, these provisions boost spending by another \$100 billion.

That's big money, but these figures come with two important caveats. First, eliminating all these tax preferences would not boost revenues as much as the numbers suggest. For instance, these calculations do not reflect how taxpayers might change their behavior if these preferences were eliminated. Treasury's estimates thus overstate how much money we could raise by eliminating preferences in the tax code. Still, even allowing for these adjustments, the sum of money at stake amounts to many hundreds of billions of dollars each year — and comes to trillions over the next decade.

The second caveat relates to how exactly the Treasury decides which provisions count as tax preferences. Identifying preferences inevitably

invites controversy, because it requires a benchmark notion of an idealized tax system against which any deviations are deemed preferences. Perhaps not surprisingly, tax experts differ on what kind of system represents the ideal benchmark. The Treasury, for instance, uses a comprehensive, progressive income tax as its benchmark, with a few adjustments to reflect the practical realities of administering the tax system. Other analysts believe a broad-based consumption tax would be a better benchmark. In that case, several important preferences — including accelerated depreciation, lower rates on capital gains and dividends, and some retirement provisions — would be much smaller, or would not be identified as tax preferences at all. Meanwhile, other provisions, most notably companies' ability to deduct interest expenses, *would* be identified as preferences.

Although this disagreement reflects a fundamental debate about tax policy, it does not undermine the basic fact that tax preferences are enormous. Indeed, most provisions that are preferences relative to an income-tax-based system are also preferences relative to a system built around a consumption tax. My colleague Eric Toder and I have estimated, for example, that about two-thirds of the dollar value of tax preferences identified by Treasury for 2007 would also be foregone revenue under a consumption tax.

With budget pressures continuing to build, it is no surprise that this large pot of potential revenue has caught the eyes of policymakers. Some tax reformers, like senators Ron Wyden of Oregon and Dan Coats of Indiana, have recommended substantial cuts in tax preferences in order to finance broader reform of the tax code, including reductions in tax rates. President Obama's fiscal commission — as well as the debt-reduction task force chaired by former New Mexico senator Pete Domenici and former White House budget director Alice Rivlin (a committee on which I served) — proposed even deeper cuts, with the aim of financing significant deficit reduction and across-the-board reductions in individual and corporate tax rates.

This focus on tax preferences is a healthy development. Unfortunately, it has been accompanied by rhetorical flourishes that sometimes obfuscate America's real policy challenges. Tax reformers and deficit hawks often refer to tax preferences as loopholes or special-interest provisions. The president's fiscal commission even called them "tax earmarks." Those epithets make for good, quotable copy, and occasionally they

even ring true. There is one tax provision, for example, that has as its sole purpose lowering taxes on NASCAR venues. That’s certainly heading into earmark territory.

But the real money is not in earmarks, loopholes, or special-interest provisions. It’s in the tax preferences that benefit large numbers of Americans throughout the income distribution and that play an important role in the lives of many voters. The exclusion for employer-provided health insurance and the deduction for mortgage interest, for instance, benefit tens of millions of households each year. The Earned Income Tax Credit and the various child-related credits are the two largest federal programs providing financial support to low-income families. Preferential rates on long-term capital gains and dividends reduce the tax burden on millions of individual investors. Tax preferences for research and experimentation reward firms for innovation.

It is therefore important for policymakers to recognize that tax preferences are not merely “loopholes” exploited by narrow interest groups or “earmarks” that favor some congressmen’s pet constituencies. Tax preferences are social safety-net programs. They are middle- and upper-income entitlements. They are preferences for capital income. And they are incentives for activities — such as owning a home, saving for college, or investing in new research — that many believe enhance our society. Given these realities, we should not be lulled into believing that cutting tax preferences will be as painless as closing a few loopholes. Such cuts will be as politically painful as cutting popular spending programs.

#### ARE PREFERENCES REALLY SPENDING?

How did our tax code become so stubbornly riddled with preferences? Though tax preferences are widespread and have grown rapidly in recent years, they are not a new phenomenon. Indeed, Treasury officials began tracking them in the late 1960s. But rather than brand them as “tax preferences” or “tax breaks,” they called them “tax expenditures” — a label intended to emphasize the similarity to spending programs. Congress then wrote that term into law in the landmark Congressional Budget Act of 1974 — legislation that established the rules still governing the federal budget process today.

The rationale for viewing the preferences as expenditures, rather than mere tax breaks, was (and is) that their budgetary, economic, and distributional effects are often indistinguishable from those of spending

programs. Consider, for example, the tax-exempt bonds issued by state and local governments. Typically, these bonds pay much lower interest rates than taxable bonds of comparable risk. Because investors focus on after-tax returns, they are willing to accept the lower interest payments in return for the exemption from federal taxes. In the end, many investors come out ahead.

At first glance, this system might appear to offer a major tax break to investors. In reality, however, most of the benefit flows to state and local governments, which pay less in interest on their debts than they would otherwise have to in order to compete with higher-yield taxable bonds. Investors in municipal bonds pay an implicit tax by accepting lower returns, and the state and local governments receive an implicit subsidy. The fiscal effects would be the same if the tax exemption were eliminated, investors paid taxes on their interest, and the revenues were then disbursed to fund state and local projects. But because the money would pass through federal hands, we would call that taxing and spending, not a tax break.

The same is true of the exclusion for employer-provided health insurance, the deduction for charitable contributions, the corporate credit for U.S. manufacturing activities, and many other preferences. In each case, the government could accomplish the same goal—perhaps more cheaply—through an explicit cash subsidy, but has chosen instead to structure the spending as a tax break.

Princeton economist David Bradford once offered a simple thought experiment to illustrate how far such games could go. Suppose that policymakers wanted to slash defense procurement and reduce taxes, but did not want to undermine America’s national security. They could square that circle by offering defense firms a refundable “weapons-supply tax credit” for producing desired weapons systems. The military would still get the weapons deemed essential to national security, defense contractors would get a tax cut, and politicians would get to boast about cutting both taxes and spending. But nothing would have changed meaningfully.

The government’s ability to use such maneuvers has convinced many observers that tax preferences can be the equivalent of spending. But others continue to argue that the only tax preferences that should count as spending are the refundable credits that result in direct cash payments by the government. All other preferences are tax cuts, they insist.

The conflict between these two perspectives grabbed headlines this spring when Senator Tom Coburn, a Republican of Oklahoma, proposed ending the ethanol tax credit. The credit provides 45 cents to blenders of gasoline for each gallon of ethanol used in blending fuel. The Department of Energy could pay a direct 45-cent subsidy to blenders for each gallon of ethanol they use, but policymakers have instead chosen to run the incentive through the tax code. Senator Coburn introduced an amendment to eliminate the tax credit, arguing that doing so would cut corporate welfare and, in effect, cut spending. In his words, “[e]thanol subsidies are a spending program wrongly placed in the tax code that increases the burden of government [and] keeps tax rates artificially high.”

Coburn’s amendment was opposed by Americans for Tax Reform — an influential conservative group devoted to keeping taxes low. Since 1986, ATR has asked political candidates and officeholders to sign a pledge committing, among other things, to “oppose any net reduction or elimination of deductions and credits, unless matched dollar for dollar by further reducing tax rates.” In the 112<sup>th</sup> Congress, 235 House members and 41 senators — mostly Republicans, but including a few Democrats — are pledge-signers; one is Coburn.

ATR contended that Coburn’s amendment, which the Senate passed in June, would violate his pledge not to raise taxes. It also objected to Coburn’s contention that the credit amounted to government spending. “Spending programs and tax relief are not the same thing,” said ATR’s tax-policy director, Ryan Ellis. He added: “If the government lets Tom Coburn keep a dollar of his own money, that is not the same thing as the government stealing a dollar from Ryan Ellis and giving it to Tom Coburn. The differences between tax relief and spending are unambiguous.”

In April, similar views emerged from an unexpected source: the United States Supreme Court. In *Arizona Christian School Tuition Organization v. Winn*, several Arizona residents filed suit to overturn a state tax credit for charitable donations used to pay private-school tuition. Their concern was that Arizona’s credit subsidized parochial schools, and thus violated the First Amendment’s prohibition against any law respecting the establishment of religion. In a 5-4 decision, the Court ruled that the plaintiffs did not have standing to seek relief against the tax credit. The majority argued that, although taxpayers have

long been understood to have standing to raise establishment-clause concerns about government spending, they do not have the same standing when it comes to tax incentives. Writing for the majority, Justice Anthony Kennedy concluded that the tax credit in question could not injure the plaintiff taxpayers because it did “not extract and spend [their] funds in service of an establishment.” To argue otherwise, he went on, would be to assume “that income should be treated as if it were government’s property even if it has not come into the tax collector’s hands.”

The key weakness in the arguments put forward by ATR and Justice Kennedy is that they emphasize the technicalities of budget accounting but overlook the practical effects of the tax preferences in question. As Justice Elena Kagan wrote in a dissent in the Arizona case, “Cash grants and targeted tax breaks are a means of accomplishing the same government objective—to provide financial support to select individuals or organizations”; they should therefore be judged by the same standards. Tax breaks can be viewed as a form of government spending, Kagan explained, “even assuming the diverted tax funds do not pass through the public treasury. . . . Both deplete funds in the government’s coffers by transferring money to select recipients.”

Americans for Tax Reform and Justice Kennedy also misunderstand how money actually flows between taxpayers and the government. The ethanol credit, for example, may appear to allow blenders to “keep their own money,” but that appearance is misleading. By levying an excise tax on the fuel that blenders produce, the government has already asserted a legal claim to a sum of money. In Ellis’s language, the government has already asserted its authority to “steal” the money, but has not yet collected it. Before taking collection, the government offers to pay blenders to do something that the government wants them to do: use ethanol. If the blenders go along, they can subtract that payment when they send in their taxes. That payment does not let blenders keep their own money; rather, it is a reward for doing the government’s bidding. If it were the blenders’ own money, it would not come with strings.

Still, not *all* tax preferences are functionally equivalent to spending. One example is the lower tax rate on qualified dividends. Today, the top marginal tax rate on ordinary income is 35%, but the top rate on dividend income is only 15%. The Treasury identifies the lower dividend rate as a “tax expenditure,” but it would be a mistake to confuse it with other tax expenditures that function as spending. The true purpose of

the lower rate is to correct a design flaw in our current income tax, not to covertly distribute government spending.

The flaw in this instance is double taxation. If an investor buys stock in a corporation, he faces two layers of tax. The company (of which he is part owner) pays corporate income taxes on its profits, and then the investor pays personal income taxes on any of the remaining profits he receives as dividends. The two layers of tax can boost the effective tax rate on corporate income well above the rate for other sources of income. If both corporate profits and dividends were taxed at 35%, for example, the combined tax rate could reach 58%. Applying a lower personal rate to dividends is one way to soften that double taxation. With dividends taxed at 15%, the combined tax rate on corporate income paid out as dividends would be no more than 45%, much closer to the rate applied to other forms of income.

Accelerated depreciation is another example. The Treasury identifies accelerated depreciation as a tax expenditure because it allows businesses to write off their equipment investments faster than would be appropriate under a pure income tax. Under a consumption tax, however, businesses would be allowed to write off their investments immediately. Accelerated depreciation is thus a compromise between two visions of taxation, not spending hidden in the tax code.

Analysts and policymakers should thus take care to distinguish among the various preferences. Many tax expenditures are indeed spending in disguise, but not all.

#### BIGGER GOVERNMENT

Spending-like tax preferences not only complicate our understanding of fiscal policy, but also pose a challenge to the way we think about the size of government. This is because, in examining the scope of government, analysts usually focus on official budget measures. For example, we often hear that federal outlays averaged about 20.7% of gross domestic product over the past four decades, while revenues averaged about 18.1%. But those official budget measures do not fully account for tax breaks that effectively function as spending programs.

To get a sense of how large the federal government really is, Eric Toder and I recently added up all the spending-like tax preferences in effect in 2007, the last year before the Great Recession. Using the Treasury Department's estimates, we found that those preferences amounted to

\$600 billion (this is about two-thirds of the total tax expenditures that Treasury identified; the other third were preferences that are not spending in disguise). Spending-like tax preferences thus amounted to 4.1% of GDP. This means that government spending in 2007 was 23.7% of GDP when the spending-like tax preferences are included, but only 19.6% using the official budget measure. Our more inclusive measure of government spending was thus more than one-fifth larger than the usual measure.

A similar pattern holds with revenues. The official statistics indicate that federal revenues amounted to 18.5% of GDP in 2007, near their 40-year average. When we add back the 4.1% of GDP in potential revenues that were used to finance spending-like tax preferences, however, our broad measure of federal revenues increases to 22.6% of GDP.

The federal government is therefore bigger than we typically think it is. Conventional budget measures miss hundreds of billions of dollars that are implicitly collected and spent each year through spending-like tax preferences. That measurement error affects spending and revenues equally, so our measures of deficits and debts remain accurate. But the conventional measures do understate the extent to which fiscal policy redistributes income and influences economic activity.

For the same reason, conventional budget measures can misrepresent how changes in tax policy affect the real size of government. When we understand the size of government based on its spending alone, we assume that increases or reductions in revenue have no direct effect on the real size of government—all that matters is government outlays. And when we consider how much of our economy the government takes up based on the taxes it collects, we tend to assume that tax cuts make the government smaller and that tax increases make it larger.

But both approaches to assessing the size of government run into trouble when they encounter spending-like tax preferences. For example, using official budget measures, President Obama's proposed retiree tax credit (discussed earlier) would reduce tax revenues. So if we were to assess the size of government based on how much it spends, the president's proposal would have no effect on government's size; if we measured it based on how much it taxes, the proposal would actually shrink the government. But if we (correctly) recognized the retiree tax credit as a spending increase, we would conclude that the credit would actually *increase* government spending (making the government larger), while leaving the real scope of its tax collection unchanged.

The logic also works in reverse. Suppose policymakers decided that employer-provided health insurance should be subject to the same income and payroll taxes that apply to wages and salaries. Such a measure would increase government revenues by several trillion dollars over the next decade. But it would do so by eliminating the largest example of spending through the tax code. Under conventional measures, federal revenues would increase, but government’s role in private insurance markets would actually narrow.

Advocates of smaller government are often skeptical of proposals that would increase federal revenues. But when it comes to paring back spending-like tax preferences, an increase in revenues would mean that government’s role would get smaller. This, in essence, is the point Senator Coburn was trying to make with the ethanol tax credit. And it is a point that even the most ardent anti-tax, limited-government purists should keep in mind.

#### GIVING CREDIT

The fact that some tax preferences are actually hidden spending programs does not necessarily make them bad policy. Some tax preferences support important policy goals, just as many spending programs do. And sometimes the tax system is the most efficient way to administer specific policies. The personal income tax, for example, provides a natural mechanism for providing benefits that should vary with income, like the Earned Income Tax Credit. The corporate income tax provides a convenient administrative structure for incentives like the tax credit for research and experimentation.

The importance of labeling many tax preferences as spending is not to disparage them, but to account for them honestly. The goal is to highlight the resources that the government directs through these provisions and to encourage analysts, commentators, and policymakers to subject them to the same scrutiny they give traditional spending programs. Some tax preferences provide substantial benefits and can withstand that scrutiny even in times of fiscal tightening. Others should be left on the cutting-room floor.

In addition, many of the tax preferences that *do* stand up to scrutiny—or persist because of their political popularity—would benefit from serious restructuring. Today’s preferences for low-income workers and families with children, for example, are painfully complex.

Their byzantine rules impose unnecessary costs on beneficiaries and open the door to errors and fraud. Much better would be a system that consolidated these provisions into simple, streamlined preferences for holding a job and having children. The Domenici-Rivlin task force offered one such approach, in which all existing preferences for low-income families and children would be replaced with an earnings credit and a child credit available to all households, regardless of income.

Other major preferences could accomplish their intended goals at lower cost and with less economic distortion if they were redesigned as credits. The exclusion for employer-provided health insurance, for example, is an exceedingly inefficient way to encourage people to maintain health-care coverage. One flaw is that it offers bigger subsidies to high-income households. Because the exclusion matches the tax rate for each income bracket, the government picks up 35% of the insurance tab for an attorney earning \$500,000, but only 15% of the cost for a truck driver earning \$50,000. Not only is that “upside down” structure unfair, it also reduces the exclusion’s efficiency in promoting health coverage—since high-income families are more likely to get health insurance without a subsidy than are lower-income families. If policymakers want to get as much health-insurance “bang” as possible for the many bucks devoted to health-insurance subsidies, it makes no sense to offer additional government assistance to people who are likely to carry insurance anyway.

Another flaw is that the tax exclusion raises the cost of health insurance for everyone. Because the exclusion is essentially open-ended (i.e., whatever amount an employer spends on a worker’s health insurance is excluded from that worker’s taxable income), workers have an incentive to choose expensive, high-end insurance plans that cover as much health care as possible. Such plans will usually minimize cost-sharing provisions like co-payments (which consumers usually pay for with *after*-tax dollars) while offsetting the costs through high premiums (which are paid for with *pre*-tax dollars). This system, in turn, drives up health-care costs overall—since the generous employer-provided coverage removes individual consumers’ financial incentives to limit their use of health services. Absent this tax distortion, insurers would offer less expensive plans that relied more heavily on co-pays, co-insurance, and deductibles in order to both manage demand for health services and keep insurance costs low.

If policymakers wanted to retain a tax incentive for health insurance, they could correct both of these flaws by converting the current exclusion

into a fixed, refundable credit. Individuals and families would qualify for the credit if they purchased health insurance that met some basic standard of coverage. Every taxpayer would have the same financial incentive, and would receive the same financial assistance, regardless of income. Every taxpayer would also be free to get more expensive insurance that exceeded the minimum standard, but the additional cost would not be offset by any extra tax subsidy. The credit would thus encourage the acquisition of basic health insurance across the income distribution, without undermining plans' ability to use co-insurance and other tools to influence the use of health services.

The same is true of the mortgage-interest deduction, another “upside down” preference that is more valuable for people in higher tax brackets. Researchers find that the mortgage deduction does little to encourage home ownership. Instead, it encourages middle- and upper-income taxpayers to buy bigger homes and take on more mortgage debt—neither of which is an important social goal. There is a good case, therefore, for simply eliminating the deduction. If policymakers want tax incentives for home ownership, they would be better off redesigning the deduction as a credit—one that would be both fairer and more effective. One option would be a fixed credit linked to home ownership, rather than to carrying a mortgage. For example, taxpayers might receive a fixed credit for each year they own a qualifying residence. Every taxpayer would face the same incentive and would receive the same assistance for purchasing a home. But no one would be encouraged to buy a larger house or to take on extra debt.

If policymakers want to use the tax code to encourage certain types of behavior, credits can often achieve the same results as exclusions and deductions, but more efficiently and at lower cost. Some observers may worry that greater reliance on credits would increase the amount of redistribution in the tax code, but changing the structure of tax rates could offset that effect in a broader tax reform. As both the president's fiscal commission and the Domenici-Rivlin task force demonstrated, eliminating spending-like preferences can allow for significant rate cuts even with significant deficit reduction.

#### AN ESSENTIAL REFORM

Washington's love affair with tax preferences has spawned a system that is needlessly complex, economically harmful, and often unfair. Tax

breaks reach into many aspects of daily life and influence many personal choices — on matters including health care, education, charitable donations, investment, saving for retirement, owning a home, and even raising children. They represent a major exercise of government power, but face less oversight than many activities on the spending side of the budget. They conceal the true size of government, and they confer enormous power upon the tax-writing committees in Congress — which have the ability to simultaneously raise revenue and spend it inside the tax code.

The time has come for serious reform. America needs to fix its broken tax system *and* find additional revenue to help reduce our persistent budget deficits. The best way to achieve both aims is to take a hatchet to the thicket of spending-like tax preferences. Many preferences should simply be eliminated; those deemed to serve important policy goals should be restructured to be simpler, fairer, and more effective. Lawmakers can then use the resulting revenue to cut tax rates across the board and reduce the deficit.

Such reform is long overdue. It won't be easy, but the enormity of our budget problems may finally be enough to get liberals, moderates, and conservatives to join together to get it done.

## TAX POLICY AND THE SIZE OF GOVERNMENT

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### INTRODUCTION

**H**OW BIG A ROLE THE GOVERNMENT SHOULD play in the economy is always a central issue in political debates. But measuring the size of government is not simple. People often use shorthand measures, such as the ratio of spending to gross domestic product (GDP) or of tax revenues to GDP. But those measures leave out important aspects of government action. For example, they do not capture the ways governments use deductions, credits, and other tax preferences to make transfers and influence resource use.

We argue that many tax preferences are effectively spending through the tax system. As a result, traditional measures of government size understate both spending and revenues. We then present data on trends in U.S. federal spending and revenues, using both traditional budget measures and measures that reclassify “spending-like tax preferences” as spending rather than reduced revenue. We find that the Tax Reform Act of 1986 reduced the government’s size significantly, but only temporarily. Spending-like tax preferences subsequently expanded and are now larger, relative to the economy, than they were before tax reform.

We conclude by examining how various tax and spending changes would affect different measures of government size. Reductions in spending-like tax preferences are tax increases in traditional budget accounting but are spending reductions in our expanded measure. Increasing marginal tax rates, in contrast, raises both taxes and spending in our expanded measure. Some tax increases thus reduce the size of government, while others increase it.

### MEASURING GOVERNMENT SIZE

Any effort to measure the size of government must address three issues. The first is deciding which government activities to include. The federal government collects tax revenues, provides goods and services not produced by the private sector, engages in commercial-type activities, makes cash

and in-kind transfers to families and businesses, and pays interest on its debts. It provides explicit and implicit financial guarantees against various risks, including natural disasters, terrorist attacks, and financial meltdowns. It regulates economic activity. And it implements monetary policy through the Federal Reserve. A comprehensive measure of government size would account for all these activities. But that is beyond our current effort. Instead, our goal is to develop measures that accurately reflect the scope of the government’s fiscal policies. That focus is incomplete; but, given the importance of fiscal policy, we believe it valuable for policy makers and analysts to have more accurate measures of the government’s explicit fiscal size.

The second issue is deciding whether to measure government spending or revenue. These differ, sometimes substantially, because of government borrowing. In rough terms, a focus on spending emphasizes the economic resources whose use the government directs through fiscal policy. A focus on revenue, in contrast, emphasizes the resources that the government currently collects from taxpayers. People use both measures, so our framework considers both approaches. We believe, however, that spending is the better measure of government size. Barring default, taxpayers must eventually pay for all spending; debt financing today merely shifts that burden into the future.

The third issue is deciding what accounting concept to use when measuring government activities. The federal government currently publishes three sets of accounts that could provide such a foundation: the official Budget of the United States Government (Office of Management and Budget (OMB), 2011), the government’s financial statements, which adjust budget figures to more closely resemble the accrual accounting concepts used in the private sector (Department of Treasury, 2010), and the national income and product accounts (NIPA) used to track macroeconomic aggregates, such as gross domestic product and personal income (Bureau of Economic Analysis, 2010-11).

These accounting systems differ in significant ways. The budget primarily tracks the government's cash flows — the outlays on spending programs and the receipts from taxes — with a few accrual-type adjustments for activities for which cash accounting would be particularly misleading (e.g., loans and loan guarantees). The financial statements make much greater use of accrual accounting. For example, they measure annual capital expenses based on estimates of how much structures, equipment, and software depreciate each year, while the budget records outlays on any new investments. The NIPAs, finally, treat the government as a producer and consumer of goods and services. They rely more on accrual accounting than does the budget, and they count as receipts some payments, e.g., regulatory fees that are treated as negative spending in the budget.<sup>1</sup>

One can make good arguments for greater use of accrual concepts in federal decision-making. For example, an emphasis on cash accounting understates the cost of federal employees who are accruing future retirement benefits and emphasizes the upfront cost of new capital investments while ignoring depreciation of existing capital. However, official budget measures dominate fiscal policy discussions in the media, in academia, and inside the Beltway. For that reason, we focus on ways to improve the traditional budgetary measures of government size.

#### **BUDGET MEASURES UNDERSTATE GOVERNMENT SIZE**

Policy makers have long recognized that many social and economic goals can be pursued using tax preferences, not just government spending programs. Such preferences are recorded as revenue reductions, making the government appear smaller, but often have the same effects on income distribution and resource allocation as equivalent spending programs (Bradford, 2003; Burman and Phaup, 2011; Marron, 2011). A complete measure of government size should treat these preferences as spending, not revenue reductions. Doing so raises measures of both spending and revenues, without affecting the deficit, and gives a different picture of the economic resources that the government directs.

Making these adjustments requires caution, however. It is tempting, for example, to simply add together all the provisions that the federal government identifies as “tax expenditures” and

treat those as effectively spending. But that goes too far. Not all tax expenditures are the functional equivalent of spending.

The Congressional Budget Act of 1974 defines tax expenditures 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 liability.” The key word in this definition is *special*. Identifying tax expenditures requires defining a theoretical baseline tax system, including all general tax provisions, and then identifying any deductions, credits, and other provisions that are exceptions to the general rules. The original definition of a “normal” tax baseline was meant to include provisions needed to implement a practical and broad-based income tax.<sup>2</sup> The system allows for the deduction of ordinary and necessary business expenses, for example, as well as graduated rates for individual taxpayers, alternative ways of defining the tax-paying unit (separate or joint filing for married couples), and personal exemptions to adjust for the effect of family size on ability to pay.

However, the normal tax baseline also allows some departures from a comprehensive income base. For example, it excludes accrued but unrealized capital gains from the tax base,<sup>3</sup> includes inflationary gains, and allows a separate corporate income tax in addition to individual taxes on income from corporations.

A number of authors have suggested distinguishing between tax expenditures that represent disguised spending and those that represent structural departures from a comprehensive income base, but do not replace any clearly identifiable direct spending program (Fiekowsky, 1980; Kleinbard, 2010; Shaviro, 2004; Toder, 2005; Marron, 2011). Although these authors use different formulations and labels, they all focus on a subset of tax expenditures that replace subsidies or transfer payments that could otherwise be delivered as outlays. In this view, which we share, it is only those “spending-like tax preferences” that should be included in a “spending” total designed to measure the size of government.

Unfortunately, it is not always straightforward to decide which provisions should be classified as spending substitutes and which are fundamental tax policy choices. We provide a few clear examples, while noting that it is sometimes hard to distinguish the two categories.

### Clear Spending Substitutes

Clear spending substitutes are those tax expenditures that encourage selected activities or aid specific groups of taxpayers and could be replaced by similar programs delivered as direct outlays. Examples are renewable energy credits, the home mortgage interest deduction, the exclusion from tax of employer-provided health insurance and health benefits, and tuition tax credits. All these provisions subsidize identifiable activities (renewable energy, housing investment, health insurance, and college tuition), try to promote definable social goals (reduced greenhouse gas emissions, increased home ownership, broader health insurance coverage, and increased college attendance), and could be designed as outlays administered by program agencies (e.g., the Departments of Energy, Housing and Urban Development, Health and Human Services, and Education).

### Broad Choices of Tax Structure

Other provisions represent broad choices in tax policy design, but are not associated with any clear spending objective. For example, many economists favor consumption instead of income as a tax base, and our current income tax can be thought of as a hybrid between consumption and income taxation. The treatment of saving in qualified retirement saving plans, which allows most workers to defer tax on contributions until the proceeds of their contributions and investment earnings are withdrawn from the account, is an example of a provision that taxes the return to saving based on consumption instead of income tax principles.<sup>4</sup>

Other large tax expenditures represent basic choices in how to design an income tax, not hidden spending in the tax code. For example, the deferral of taxation of foreign source income until repatriation is identified as a tax expenditure provision, because the normal income tax would include in the base all worldwide income of corporations as accrued. But, with the single exception of Brazil, no country in the world taxes the income of the controlled foreign corporations of its resident multinational corporations on a current basis. Elimination of deferral may be better policy, but the failure to enact an idealized international tax rule that virtually no one else uses can hardly be characterized as a disguised spending program.

Similarly, the preferences for realized capital gains and dividends represent a compromise

between taxing all sources of realized cash income at the same rate and the fact that accrued, but unrealized, capital gains escape tax entirely (so that taxing realizations creates a “lock-in” effect) and that dividends and a portion of capital gains have already borne some income tax at the corporate level. Again, these provisions represent possibly flawed choices of income tax design but are not substitutes for an identifiable direct spending program.

The ten largest tax expenditures in terms of 2012-16 budgetary costs (revenue losses plus outlays for refundable credits) identified by OMB (2011) will cost \$4 trillion between 2012 and 2016 – about 65 percent of the cost of all tax expenditures over that period (table 1).<sup>5</sup> We classify six of them as spending substitutes: the exclusion of employer contributions for medical insurance and medical care, deductibility of mortgage interest on owner-occupied homes, exclusion of net imputed rental income on owner-occupied homes, deductibility of nonbusiness state and local taxes other than on owner-occupied homes, the earned income tax credit, and deductibility of charitable contributions, other than education and health. Five of these provisions are clear spending substitutes. The exclusion of employer contributions for medical insurance and medical care substitute for direct outlays to subsidize the purchase of health insurance. The deductibility of mortgage interest and exclusion of net imputed rental income on owner-occupied homes substitute for direct outlays to subsidize capital costs of home ownership.<sup>6</sup> The deductibility of charitable contributions substitutes for direct outlays that provide matching grants for contributions to eligible charitable organizations. The deductibility of nonbusiness state and local taxes substitutes for direct federal grants to state and local governments.

The earned income tax credit is a closer call. Arguably, it could be viewed as a component of the federal tax schedule that provides negative tax rates within certain income ranges, with the rate varying by number of children. While it subsidizes work effort, it does not subsidize any particular industry or sector. We choose instead to view it as a substitute for a transfer program that provides assistance to families that increase with the number of children, but limits that assistance to families with earnings and claws back the payments as income rises above threshold amounts.

*Table 1*  
**Ten Largest Tax Expenditures, 2012-16**

<i>Provision</i>	<i>Budgetary Cost, 2012-16*</i> <i>(\$ Billion)</i>	<i>Classification</i>
Exclusion of employer contributions for medical insurance and medical care	\$1,071	Spending substitute
Deductibility of mortgage interest on owner-occupied homes	\$609	Spending substitute
Step-up in basis of capital gains at death	\$357	Tax policy choice
401(k) plans	\$356	Tax policy choice
Exclusion of net imputed rental income**	\$303	Spending substitute
Deductibility of nonbusiness state and local taxes other than on owner-occupied homes	\$292	Spending substitute
Accelerated depreciation of machinery and equipment	\$270	Tax policy choice
Earned income tax credit	\$266	Spending substitute
Capital gains (except agriculture, timber, iron ore, and coal)	\$256	Tax policy choice
Deductibility of charitable contributions, other than education and health	\$249	Spending substitute

\*Equals the sum of revenue losses and outlays from refundable credits.

\*\*We did not include imputed rental income on owner-occupied homes in our summary measures of tax expenditures. OMB has only reported this value in recent years, and the Joint Committee on Taxation (JCT) does not count imputed rent as a tax expenditure provision.

Source: Office of Management and Budget, *Budget of the United States Government, Analytical Perspectives, Fiscal Year 2012*, and authors' categorizations.

We classify the other four largest provisions – step-up in basis for capital gains at death, 401(k) plans, accelerated depreciation of machinery and equipment, and the special rate on capital gains (excluding other provisions that tax income in selected industries as capital gains) – as general tax policy choices instead of spending substitutes. Capital gains preferences do favor certain sectors (those with accruing asset values, such as new firms in the high-tech sector) over others, but we cannot think of a general rule for taxing capital gains that would be neutral across all possible margins. And we cannot think of a defined spending program that the capital gains preferences might replace. 401(k) plans do represent an exception to the rule that income is taxed as accrued under an income

tax, but the provisions for retirement saving are so large and pervasive that we consider the ability in our system for workers to accrue tax free savings for retirement (as they would under a consumption tax) to be a general characteristic of the U.S. income tax. Accelerated depreciation of machinery and equipment is a closer call; it obviously favors investment in machinery over investment in structures and inventory. But it is a broad-based rule that applies across many firms and industries and, like the tax treatment of retirement accounts, it can be viewed as a compromise between income taxation (which would use economic depreciation) and consumption taxation (which would allow immediate expensing). In addition, it is not obvious what the alternative correct depreciation rule should be

under a normal income tax or what a substitute spending program designed to encourage investment in machinery would look like.<sup>7</sup>

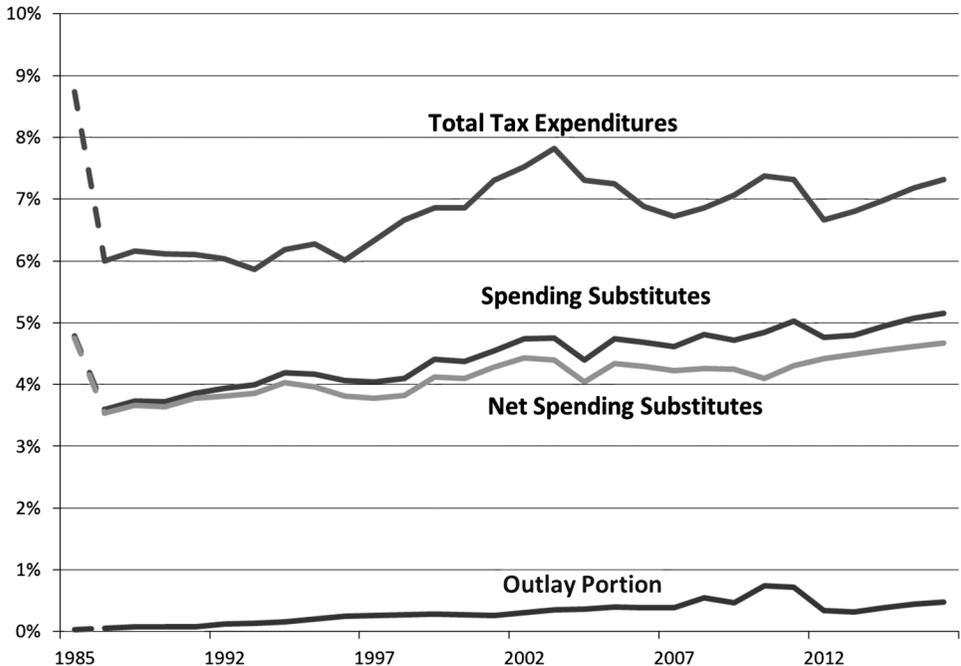
**TAX EXPENDITURES SINCE 1985**

Figure 1 tracks the size of tax expenditures, relative to GDP, from 1985 through 2016. These figures come from Rogers and Toder (2011), who created a tax expenditure database based on figures from OMB and consultations with Treasury staff. The most notable feature is the sharp drop in tax expenditures after the passage of the Tax Reform Act of 1986 (TRA86). Between 1985 and 1988, tax expenditures dropped from 8.7 percent of GDP to 6.0 percent. Many large tax expenditures were eliminated, including the investment tax credit, accelerated depreciation on rental housing, and preferential rates for capital gains, while others were substantially scaled back. In addition, lower marginal tax rates reduced the value of remaining individual and corporate income tax expenditures structured as exclusions, exemptions, deductions, and deferrals. Since then, however, tax

expenditures have grown as policy makers enacted new provisions, as marginal tax rates increased, and as certain sectors (e.g., health insurance) grew faster than the economy.

Figure 1 also tracks our estimates of the tax expenditures that we identify as spending substitutes. In making this distinction, we exclude any provisions that we classify as general structural tax policy choices (table 2). TRA86 reduced both types of tax expenditures, but the decline among general structural policies was larger. As result, spending-like provisions increased from 55 percent to 60 percent of total tax expenditures between 1985 and 1988. Since then, “spending substitutes” have become a larger share of overall tax expenditures. Indeed, by 2008, spending substitutes were a larger share of GDP than they had been in 1985. This reflects a change in the composition of tax expenditures, with much of the new growth coming from new and expanded social programs in the tax code (the child credit, an expanded earned income tax credit, tuition credits, and others) and growth in the cost of some older tax spending programs

Figure 1: Tax Expenditures as a Percent of GDP, 1985-2016



Source: Authors’ calculations based on the database created by Rogers and Toder (2011).

*Table 2*  
**Tax Expenditures Classified as Structural Tax Provisions**

<i>Provision</i>	<i>Revenue Loss, 2010 (\$ billions)</i>
Deferral of Income from Controlled Foreign Corporations	38.1
Deferred Taxes for Certain Financial Firms on Certain Income Earned Overseas	2.3
Excess bad debt reserves of financial institutions	repealed
Treatment of qualified dividends	31.1
Capital gains (except agriculture, timber, iron ore, and coal)	36.3
Step-up basis of capital gains at death	18.5
Carryover basis of capital gains on gifts	1.4
Accelerated depreciation of buildings other than rental housing	-11.1
Accelerated depreciation of machinery and equipment	40.0
Making work pay credit	60.3
Distributions from retirement plans for premiums for health and long-term care insurance	0.3
Net exclusion of pension contribution and earnings	
Employer plans	39.6
401(k) plans	52.2
Individual retirement accounts	12.4
Keogh plans	13.8
Social Security benefits	
Retired workers	21.4
Disabled workers	7.0
Spouses, dependents, survivors	3.9

Source: Authors' calculations, based on data reported in Office of Management and Budget, *Budget of the United States Government*, Fiscal Years 1987-2012.

(e.g., the exclusion of employer-provided health insurance).

Finally, figure 1 also tracks the budgetary effect of the refundable portion of tax credits. Those costs are already reported as spending, rather than revenue reductions, in official budget accounts. When we create our broader measure of government size — adding spending-like tax preferences to traditional spending — we need to ensure that the refundable portion of tax credits are not double counted. The outlay portion of refundable credits, while relatively small, has increased steadily. TRA86 expanded the earned income tax credit, and there were further expansions in 1990, 1993, 2001, and 2009. The child credit was initially enacted in 1997 and included only a small refundable portion for families with three or more children. But the

credit was doubled in 2001 and was made generally refundable for families with earnings above a threshold amount. The scheduled expiration of the 2001, 2009, and 2011 increases in credits at the end of 2012 will reduce outlays associated with the child credit and the earned income credit beginning in 2013; however, much of this reduction will be offset by a new premium support health insurance credit that was enacted in the Patient Protection and Affordable Care Act (PPACA) in 2010 and is scheduled to go into effect in 2013.

#### **TRENDS IN OUR BROADER MEASURE OF GOVERNMENT SIZE**

We use these estimates of spending-like tax preferences to construct a revised series of total fed-

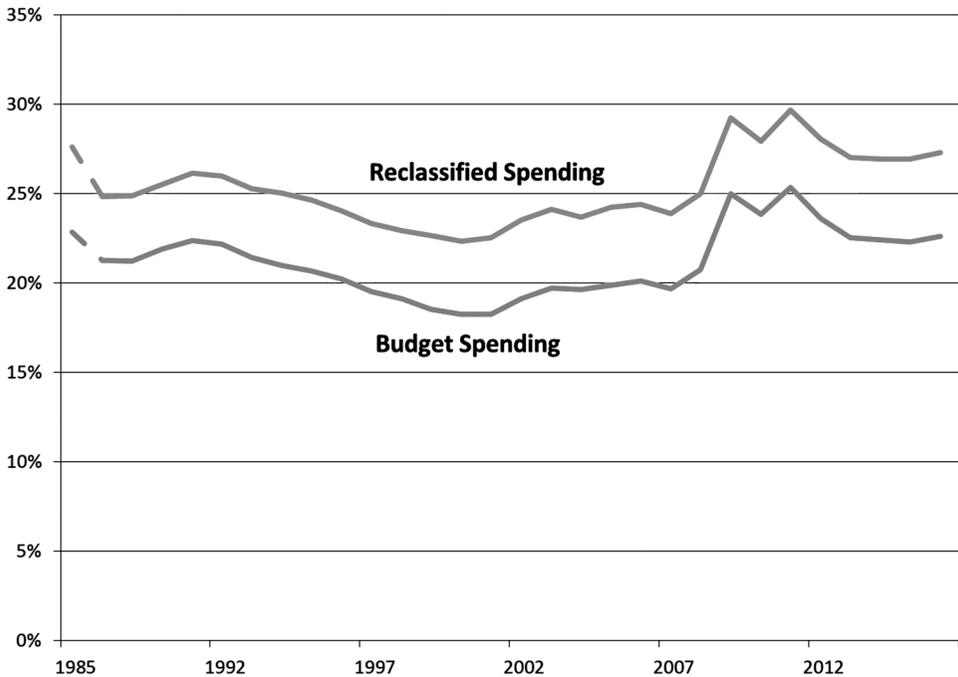
eral spending and revenue in 1985 and from 1988 through 2016. To do this, we define gross spending as outlays as measured in the budget plus spending-like tax preferences minus the refundable portion of those tax expenditures (since they are scored already as outlays). Gross revenues are similarly calculated as revenues in the budget plus spending-like tax expenditures minus the refundable portion of those tax expenditures. This accounting approach does not change the deficit — gross spending and revenues increase by the same amount. It does recognize, however, that the government raises significant revenues and then spends them without the money ever reaching the U.S. Treasury. Accounting for those resources, the federal government has been around 4 percent of GDP larger in recent years than budget figures indicate.

This reclassification does not change the basic story of how receipts and outlays have changed over the past quarter century, but there are differences (figures 2 and 3). For one thing, adding spending-like tax preferences to both outlays and

receipts makes the burden of government look bigger, whether measured by spending or revenues. Budget spending ranged from 18.2 percent of GDP in 2000 to 25.0 percent in 2009, while gross spending ranged from 22.3 percent in 2000 to 29.6 percent in 2011. Receipts ranged from 14.4 percent in 2011 to 20.6 percent in 2000, while gross receipts range from 24.7 percent in 2011 to 18.7 percent in 2000.

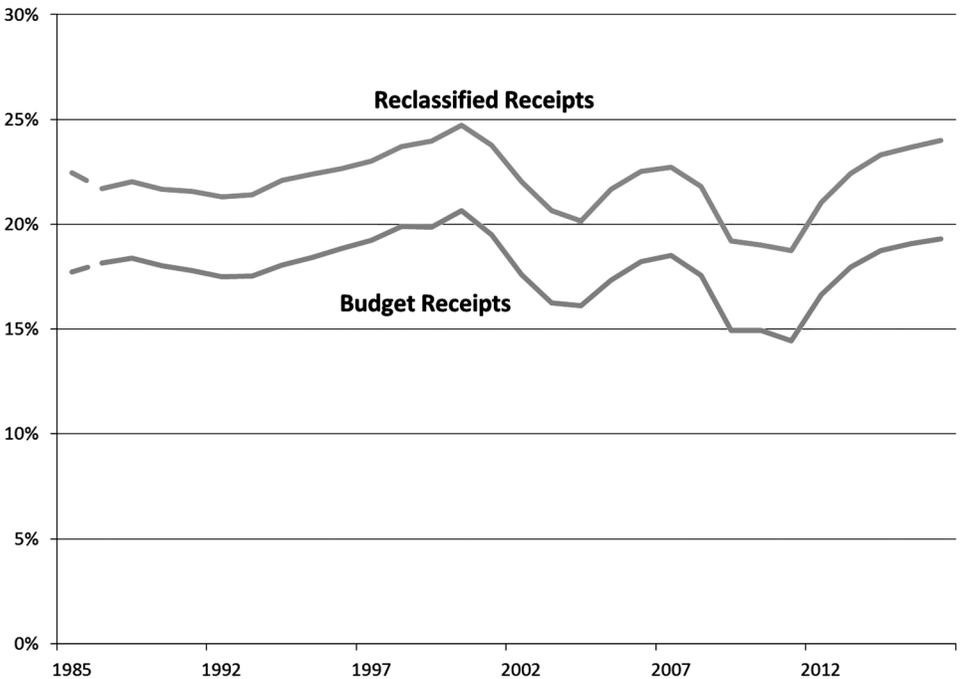
The trends in gross spending and receipts are roughly similar to trends in budget spending and receipts. The only clear qualitative difference occurred right after TRA86. Spending fell between 1985 and 1988 due to a decline in defense and non-defense discretionary spending under the Gramm-Rudman spending restrictions, but gross spending declined even more due to the cut in tax expenditures in TRA86. Revenues increased between 1985 and 1988 as the economy boomed, but nonetheless gross revenues declined slightly because of the cut in tax expenditures. By this measure, then, TRA86 significantly reduced the size of government.

Figure 2: **Spending Measures as a Percent of GDP, 1985-2016**



Source: Office of Management and Budget (2011) and authors' calculations.

Figure 3: Revenue Measures as a Percent of GDP, 1985-2016



Source: Office of Management and Budget (2011) and authors’ calculations.

During the Clinton years (1993-2000), spending-like tax preferences, net of refundable credits, increased from 3.8 percent of GDP to 4.1 percent, but this did not qualitatively alter the general story of declining spending and rising receipts during that period. They increased again (to 4.3 percent of GDP) between 2000 and 2008, but that did not change the basic Bush years’ story of rising spending and falling receipts. Looking forward from 2008 to 2016, OMB projections show a further increase in reclassified receipts to 4.7 percent of GDP. But, while this accentuates the trend a bit, it does not alter the long-term story of increases in both outlays and receipts as a percentage of GDP over that period.

**HOW TAX POLICY CHANGES AFFECT GOVERNMENT SIZE**

When we take spending-like tax preferences into account, the federal government appears much larger than standard measures suggest. Traditional budget measures understate both the amount that

the government effectively collects in revenue and the amount that it effectively spends in pursuit of social and economic goals.

That insight has some surprising implications when we consider how various tax policy options might affect the size of government. To illustrate, we consider how the size of government would be affected by three deficit reduction options: introducing a broad-based carbon tax, eliminating the mortgage interest deduction, and increasing individual income tax rates.

Under traditional budget accounting, these proposals would all increase federal revenues and have no effect on federal spending. People who emphasize revenues as a measure of government size would view all three of these policies as expanding the size of government; people who emphasize spending would view them all as reducing the deficit, but having no effect on government size.

The three policies appear quite different, however, under our broader measure of government size (table 3). A new carbon tax would still be

Table 3  
How Tax Policy Changes Affect Government Size

	<i>Official Budget</i>	<i>Broader Measure that Reclassifies Spending-like Tax Preferences</i>
Introduce a broad-based carbon tax	Tax Increase	Tax Increase
Eliminate the mortgage interest deduction	Tax Increase	Spending Cut
Increase marginal individual income tax rates	Tax Increase	Tax Increase & Spending Increase

viewed as a pure tax increase, with no effect on spending (as long as no special carve-outs created new spending through the tax system). Eliminating the mortgage interest deduction, however, would be a spending cut, not a tax increase. Under existing law, the federal government has asserted a claim to taxpayer resources, but has chosen not to collect them. Instead, it allows qualifying taxpayers to keep those monies as long as they do what the government wants — pay mortgage interest. Eliminating the mortgage interest deduction would reduce those payments (thus lowering the broader measure of spending), while having no effect on the amount of resources that the government has asserted a claim to (thus leaving the broader measure of revenues unchanged). Eliminating the mortgage interest deduction would thus reduce the size of government under the broader spending measure, even though the policy would be officially scored as a tax increase.

Increasing marginal tax rates is more complex still. Raising tax rates would boost taxes under both traditional budget accounting<sup>8</sup> and our broader measure including spending-like tax preferences. But that is not the only effect. Our current tax system has numerous exclusions, exemptions, and deductions whose value depends on marginal tax rates. If those rates go up, the value of those tax preferences goes up as well, thus boosting revenue (further) and spending. Raising marginal tax rates thus increases spending through the tax code and boosts the size of government under our broader spending measure.

The reverse also holds true. Cutting marginal tax rates reduces the size of government under our broader spending measure. Indeed, this is what happened following the Tax Reform Act of 1986. That act reduced spending through the tax code not only by cutting back on preferences, but also by lowering marginal tax rates. The idea of “starving the beast” through tax cuts has not fared

well over the past decade; lower tax revenues do not appear to have driven official spending down. If one adopts our broader spending measures, however, “starving the beast” does have some effect if done through marginal rate cuts. All else equal, lower tax rates reduce spending through the tax code, albeit not enough to offset the reduction in government receipts.

#### CONCLUSION

This paper illustrates how our understanding of government size changes when tax expenditures that represent spending substitutes are recognized as hidden spending (and revenues), rather than as tax cuts. When we include spending-like tax provisions as outlays (and revenues), the federal government in recent years appears about 4 percent of GDP larger than traditional budget figures indicate. Trends in “reclassified” spending and receipts mostly mirror trends in “budget” spending and receipts. The only qualitative difference in trends came between 1985 and 1988 when, following the Tax Reform Act of 1986, conventionally measured receipts as a percentage of GDP increased, but reclassified receipts declined due to the large drop in spending substitute tax expenditures.

Our broader measure of government size provides a different perspective on how policy changes the size of government. Eliminating spending-like tax preferences such as the mortgage interest deduction would raise conventional measures of federal revenue and leave outlays unchanged. Under our broader measure, in contrast, eliminating the deduction would reduce outlays and leave revenue unchanged. More broadly, budget reform proposals that reduce marginal tax rates and eliminate tax expenditures would be shown under this alternative measure to accomplish a much larger share of deficit reduction through spending cuts

instead of tax increases than they would under conventional measures.

### Notes

- <sup>1</sup> For a detailed discussion of the differences between the three accounting conventions, see Congressional Budget Office (2006, 2009).
- <sup>2</sup> OMB, although not the Joint Committee on Taxation (JCT), later added a concept called the “reference” tax baseline in which some provisions that departed from accurate income measurement, but were judged to be general provisions of the existing system, were included in the baseline. As a result, some provisions that Treasury calls tax expenditures relative to the “normal” tax baseline are not tax expenditures relative to the “reference” tax baseline.
- <sup>3</sup> JCT, but not OMB, also allows exclusion from the normal tax base of net imputed rental income from owner-occupied homes.
- <sup>4</sup> Nonetheless, we view provisions that allow consumption tax treatment to a narrow class of investments, such as expensing of qualified equipment for small businesses under section 179 of the Internal Revenue Code, as spending substitutes.
- <sup>5</sup> Here and elsewhere, we add up individual tax expenditure estimates to derive a total cost. Strictly speaking, the sum of the costs of separate tax expenditures need not equal the cost of all tax expenditures; Treasury and JCT estimate the cost of each provision as if all other components of the tax law were in place. If some tax expenditures were eliminated, the cost of others would change. Toder and Baneman (2011) estimate that, taking account of interactions among provisions, the cost of all tax expenditures is roughly 10 percent higher than the cost that would be computed by adding up all the separate line items. Therefore, these figures understate, to some degree, the cost of tax expenditures. It should be noted, however, that there are negative as well as positive interactions; itemized deductions cost less than three-fourths of the cost calculated as the sum of all the separate deductions.
- <sup>6</sup> If the gross rental value of owner-occupied housing were taxed, the mortgage interest deduction would not be a tax expenditure line item. To capture the full cost of not taxing gross imputed rent, it is necessary to add together Treasury’s estimates for the exclusion of net imputed rent (the net return on housing equity) and the mortgage interest deduction.
- <sup>7</sup> The tax treatment of capital investment illustrates some challenges of drawing a sharp line between spending-like provisions and tax provisions. First, there is the issue of how to handle exceptions from general rules. Even if accelerated depreciation generally is not a spending-like provision, reduced class lives for some

assets, such as corporate jets, should be viewed as the equivalent of spending programs that favor a narrowly defined activity. Lacking information about such narrow provisions, we exclude them from our calculations. Second is the issue of how depreciation rules interact with the deductibility of interest. By itself, accelerated depreciation can be viewed as a compromise between income and consumption taxation. If investment is debt-financed, however, the combination of consumption tax treatment for investment and income tax treatment for borrowing can produce a significant subsidy for some types of capital investment. That happens because interest should be deductible under an income tax but should not be deductible under a consumption tax. Lacking data on the value of interest deductions, we exclude them from our measure.

- <sup>8</sup> As long as we are on the left side of the Laffer curve.

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## How Large Are Tax Expenditures? A 2012 Update

By Donald B. Marron

Treasury estimates tax expenditures each year for the *Analytical Perspectives* volume of the president's budget. The published tables report static estimates of how much each tax expenditure reduces individual and corporate income tax receipts. Treasury does not estimate the aggregate revenue loss from these provisions, so outside analysts often sum up the individual estimates. That approach is imprecise because it does not reflect how the provisions interact with each other.<sup>1</sup> Observers often overlook that concern, however, because it is useful to have aggregate measures of tax expenditures, even if they are only approximate.

For fiscal 2012, for example, individual income tax expenditures total \$942 billion and corporate ones \$151 billion. On a static basis, those provisions thus

reduce income tax receipts by almost \$1.1 trillion. In addition, some provisions — the refundable credits — also increase federal outlays. Those outlay effects total another \$91 billion in fiscal 2012, primarily from the earned income tax credit and the child credit. The total budget impact of income tax expenditures in 2012 is thus nearly \$1.2 trillion.

Tax expenditure analysis generally emphasizes income taxes, but some policies reduce other taxes as well. Treasury does not report all these policies, but it does identify the payroll and excise tax impacts of several provisions that also affect income taxes. In 2012, the payroll tax expenditures for employer-provided health insurance amounts to \$109 billion. Several fuel tax incentives, most notably for alcohol fuels, add another \$4 billion in excise tax expenditures. Combining those amounts with the income tax expenditures yields a total budget impact of identified tax expenditures of almost \$1.3 trillion in 2012. Under current law, that figure is projected to rise to \$1.8 trillion in 2017.

One warning for tax reformers: Marginal tax rates have a big impact on these estimates. All else equal, lowering ordinary income tax rates would reduce the amount of tax expenditures because the value of deductions, exclusions, and exemptions would decline.

<sup>1</sup>One study finds the revenue loss from all nonbusiness individual income tax expenditures is almost 10 percent higher than the sum of the individual revenue losses. (Eric Toder and Daniel Baneman, 2012, "Distributional Effects of Individual Income Tax Expenditures: An Update," Tax Policy Center, Feb. 2.)

**Tax Expenditures in Fiscal 2011-2017**  
(dollars in billions)

	2011	2012	2013	2014	2015	2016	2017
<b>Lower Income Tax Receipts</b>							
Individual	\$891	\$942	\$1,017	\$1,073	\$1,161	\$1,251	\$1,337
Corporate	\$181	\$151	\$121	\$135	\$159	\$178	\$193
Subtotal	\$1,072	\$1,092	\$1,138	\$1,208	\$1,320	\$1,429	\$1,529
<b>Higher Outlays</b>							
Individual and corporate	\$113	\$91	\$91	\$78	\$98	\$110	\$117
Subtotal	\$1,186	\$1,183	\$1,229	\$1,286	\$1,418	\$1,539	\$1,646
<b>Lower Other Receipts</b>							
Payroll <sup>a</sup>	\$105	\$109	\$114	\$117	\$122	\$129	\$137
Excise <sup>a</sup>	\$7	\$4	\$0	\$0	\$0	\$0	\$0
Total	\$1,298	\$1,296	\$1,343	\$1,403	\$1,540	\$1,668	\$1,783

<sup>a</sup>Incomplete. Treasury provides estimates for only some payroll and excise tax expenditures.

Source: Tax expenditures calculated by summing the distinct provisions listed in Office of Management and Budget, "Fiscal Year 2013 Analytical Perspectives, Budget of the U.S. Government," tables 17-1 and 17-2 (Feb. 2012).



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## 16. TAX EXPENDITURES

The Congressional Budget Act of 1974 (Public Law 93–344) requires that a list of “tax expenditures” be included in the budget. Tax expenditures are defined in the law 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.” These exceptions may be viewed as alternatives to other policy instruments, such as spending or regulatory programs.

Identification and measurement of tax expenditures depends crucially on the baseline tax system against which the actual tax system is compared. The tax expenditure estimates presented in this chapter are patterned on a comprehensive income tax, which defines income as the sum of consumption and the change in net wealth in a given period of time.

An important assumption underlying each tax expenditure estimate reported below is that other parts of the

Tax Code remain unchanged. The estimates would be different if tax expenditures were changed simultaneously because of potential interactions among provisions. For that reason, this chapter does not present a grand total for the estimated tax expenditures.

Tax expenditures relating to the individual and corporate income taxes are estimated for fiscal years 2012–2018 using two methods of accounting: current revenue effects and present value effects. The present value approach provides estimates of the revenue effects for tax expenditures that generally involve deferrals of tax payments into the future.

A discussion of performance measures and economic effects related to the assessment of the effect of tax expenditures on the achievement of program performance goals is presented in Appendix A. This section is a complement to the Government-wide performance plan required by the Government Performance and Results Act of 1993.

### TAX EXPENDITURES IN THE INCOME TAX

#### Tax Expenditure Estimates

All tax expenditure estimates presented here are based upon current tax law enacted as of December 31, 2012. Thus, the estimates assume that the Bush era tax cuts expire as scheduled under the Tax Relief, Unemployment, Insurance Reauthorization, and Job Creation Act of 2010. In most cases, expired or repealed provisions are not listed if their revenue effects result only from taxpayer activity occurring before fiscal year 2012. The estimates are based on the economic assumptions from the Mid-Session Review of the 2013 Budget. The estimates do not reflect the “American Taxpayer Relief Act of 2012” (ATRA), enacted into law on January 2, 2013, which extended many tax expenditures, changed income tax rates, and provided Alternative Minimum Tax relief. Given the late passage of the legislation, revised estimates will be included in the tax expenditure tables for the 2015 Budget. The tax-related provisions of ATRA are summarized in chapter 14 of this volume, “Governmental Receipts.” In contrast to the general rule which drops expired provisions, and for the sake of continuity, the tables below show provisions that expired at the end of 2011 but were extended by ATRA.

The total revenue effects for tax expenditures for fiscal years 2012–2018 are displayed according to the Budget’s functional categories in Table 16–1. Descriptions of the specific tax expenditure provisions follow the tables of estimates and the discussion of general features of the tax expenditure concept.

Two baseline concepts—the normal tax baseline and the reference tax law baseline—are used to identify and estimate tax expenditures.<sup>1</sup> For the most part, the two concepts coincide. However, items treated as tax expenditures under the normal tax baseline, but not the reference tax law baseline, are indicated by the designation “normal tax method” in the tables. The revenue effects for these items are zero using the reference tax rules. The alternative baseline concepts are discussed in detail following the tables.

Table 16–2 reports separately the respective portions of the total revenue effects that arise under the individual and corporate income taxes separately. The location of the estimates under the individual and corporate headings does not imply that these categories of filers benefit from the special tax provisions in proportion to the respective tax expenditure amounts shown. Rather, these breakdowns show the form of tax liability that the various provisions affect. The ultimate beneficiaries of corporate tax expenditures could be shareholders, employees, customers, or other providers of capital, depending on economic forces.

Table 16–3 ranks the major tax expenditures by the size of their 2014–2018 revenue effect. The first column provides the number of the provision in order to cross reference this table to Tables 16–1 through 16–3, as well as to the descriptions below.

<sup>1</sup> These baseline concepts are thoroughly discussed in Special Analysis G of the 1985 Budget, where the former is referred to as the pre-1983 method and the latter the post-1982 method.

## Interpreting Tax Expenditure Estimates

The estimates shown for individual tax expenditures in Tables 16–1, 16–2, and 16–3 do not necessarily equal the increase in Federal revenues (or the change in the budget balance) that would result from repealing these special provisions, for the following reasons.

First, eliminating a tax expenditure may have incentive effects that alter economic behavior. These incentives can affect the resulting magnitudes of the activity or of other tax provisions or Government programs. For example, if capital gains were taxed at ordinary rates, capital gain realizations would be expected to decline, resulting in lower tax receipts. Such behavioral effects are not reflected in the estimates.

Second, tax expenditures are interdependent even without incentive effects. Repeal of a tax expenditure provision can increase or decrease the tax revenues associated with other provisions. For example, even if behavior does not change, repeal of an itemized deduction could increase the revenue costs from other deductions because some taxpayers would be moved into higher tax brackets. Alternatively, repeal of an itemized deduction could lower the revenue cost from other deductions if taxpayers are led to claim the standard deduction instead of itemizing. Similarly, if two provisions were repealed simultaneously, the increase in tax liability could be greater or less than the sum of the two separate tax expenditures, because each is estimated assuming that the other remains in force. In addition, the estimates reported in Table 16–1 are the totals of individual and corporate income tax revenue effects reported in Table 16–2 and do not reflect any possible interactions between individual and corporate income tax receipts. For this reason, the estimates in Table 16–1 should be regarded as approximations.

### Present-Value Estimates

The annual value of tax expenditures for tax deferrals is reported on a cash basis in all tables except Table 16–4. Cash-based estimates reflect the difference between taxes deferred in the current year and incoming revenues that are received due to deferrals of taxes from prior years. Although such estimates are useful as a measure of cash flows into the Government, they do not accurately reflect the true economic cost of these provisions. For example, for a provision where activity levels have changed, so that incoming tax receipts from past deferrals are greater than deferred receipts from new activity, the cash-basis tax expenditure estimate can be negative, despite the fact that in present-value terms current deferrals have a real cost to the Government. Alternatively, in the case of a newly enacted deferral provision, a cash-based estimate can overstate the real effect on receipts to the Government because the newly deferred taxes will ultimately be received.

Discounted present-value estimates of revenue effects are presented in Table 16–4 for certain provisions that involve tax deferrals or other long-term revenue effects.

These estimates complement the cash-based tax expenditure estimates presented in the other tables.

The present-value estimates represent the revenue effects, net of future tax payments, that follow from activities undertaken during calendar year 2012 which cause the deferrals or other long-term revenue effects. For instance, a pension contribution in 2012 would cause a deferral of tax payments on wages in 2012 and on pension fund earnings on this contribution (e.g., interest) in later years. In some future year, however, the 2012 pension contribution and accrued earnings will be paid out and taxes will be due; these receipts are included in the present-value estimate. In general, this conceptual approach is similar to the one used for reporting the budgetary effects of credit programs, where direct loans and guarantees in a given year affect future cash flows.

### Tax Expenditure Baselines

A tax expenditure is an exception to baseline provisions of the tax structure that usually results in a reduction in the amount of tax owed. The 1974 Congressional Budget Act, which mandated the tax expenditure budget, did not specify the baseline provisions of the tax law. As noted previously, deciding whether provisions are exceptions, therefore, is a matter of judgment. As in prior years, most of this year's tax expenditure estimates are presented using two baselines: the normal tax baseline and the reference tax law baseline. Tax expenditures may take the form of credits, deductions, special exceptions and allowances, and reduce tax liability below the level implied by the baseline tax system.

The normal tax baseline is patterned on a practical variant of a comprehensive income tax, which defines income as the sum of consumption and the change in net wealth in a given period of time. The normal tax baseline allows personal exemptions, a standard deduction, and deduction of expenses incurred in earning income. It is not limited to a particular structure of tax rates, or by a specific definition of the taxpaying unit.

The reference tax law baseline is also patterned on a comprehensive income tax, but it is closer to existing law. Reference law tax expenditures are limited to special exceptions from a generally provided tax rule that serve programmatic functions in a way that is analogous to spending programs. Provisions under the reference law baseline are generally tax expenditures under the normal tax baseline, but the reverse is not always true.

Both the normal and reference tax baselines allow several major departures from a pure comprehensive income tax. For example, under the normal and reference tax baselines:

- Income is taxable only when it is realized in exchange. Thus, the deferral of tax on unrealized capital gains is not regarded as a tax expenditure. Accrued income would be taxed under a comprehensive income tax.
- There is a separate corporate income tax.

**Table 16–1. ESTIMATES OF TOTAL INCOME TAX EXPENDITURES FOR FISCAL YEARS 2012–2018**

(In millions of dollars)

	Total from corporations and individuals							
	2012	2013	2014	2015	2016	2017	2018	2014–18
<b>National Defense</b>								
1 Exclusion of benefits and allowances to armed forces personnel .....	14,140	14,640	15,150	14,170	14,350	14,840	15,430	73,940
<b>International affairs:</b>								
2 Exclusion of income earned abroad by U.S. citizens .....	5,400	5,800	6,140	6,430	6,730	7,050	7,380	33,730
3 Exclusion of certain allowances for Federal employees abroad .....	1,070	1,120	1,180	1,240	1,300	1,370	1,430	6,520
4 Inventory property sales source rules exception .....	3,310	3,610	3,940	4,300	4,690	5,120	5,590	23,640
5 Deferral of income from controlled foreign corporations (normal tax method) .....	42,000	41,810	41,770	43,020	44,240	45,180	46,160	220,370
6 Deferred taxes for financial firms on certain income earned overseas .....	2,510	0	0	0	0	0	0	0
<b>General science, space, and technology:</b>								
7 Expensing of research and experimentation expenditures (normal tax method) .....	3,740	4,810	5,040	5,530	6,560	7,610	8,470	33,210
8 Credit for increasing research activities .....	4,390	2,320	2,130	1,970	1,820	1,680	1,530	9,130
<b>Energy:</b>								
9 Expensing of exploration and development costs, fuels .....	470	790	880	630	390	260	180	2,340
10 Excess of percentage over cost depletion, fuels .....	890	900	940	940	950	950	950	4,730
11 Alternative fuel production credit .....	20	10	0	0	0	0	0	0
12 Exception from passive loss limitation for working interests in oil and gas properties ....	10	10	10	10	10	10	10	50
13 Capital gains treatment of royalties on coal .....	90	80	60	80	90	100	110	440
14 Exclusion of interest on energy facility bonds .....	20	30	30	30	30	40	40	170
15 Energy production credit <sup>1</sup> .....	1,500	1,730	1,770	1,730	1,640	1,440	1,100	7,680
16 Energy investment credit <sup>1</sup> .....	1,040	1,270	1,360	1,670	1,880	1,110	240	6,260
17 Alcohol fuel credits <sup>2</sup> .....	140	110	50	30	10	10	0	100
18 Bio-Diesel and small agri-biodiesel producer tax credits <sup>3</sup> .....	10	0	0	0	0	0	0	0
19 Tax credit and deduction for clean-fuel burning vehicles .....	100	180	260	400	610	670	500	2,440
20 Exclusion of utility conservation subsidies .....	270	250	250	250	250	250	240	1,240
21 Credit for holding clean renewable energy bonds <sup>4</sup> .....	70	70	70	70	70	70	70	350
22 Deferral of gain from dispositions of transmission property to implement FERC restructuring policy .....	-70	-180	-190	-180	-150	-120	-80	-720
23 Credit for investment in clean coal facilities .....	380	400	420	500	320	170	170	1,580
24 Temporary 50% expensing for equipment used in the refining of liquid fuels .....	680	610	-90	-700	-830	-880	-800	-3,300
25 Natural gas distribution pipelines treated as 15-year property .....	110	100	100	100	110	120	120	550
26 Amortize all geological and geophysical expenditures over 2 years .....	90	110	110	90	80	70	70	420
27 Allowance of deduction for certain energy efficient commercial building property .....	70	70	40	20	0	0	-20	40
28 Credit for construction of new energy efficient homes .....	70	40	20	0	0	0	0	20
29 Credit for energy efficiency improvements to existing homes .....	780	0	0	0	0	0	0	0
30 Credit for energy efficient appliances .....	210	300	130	120	100	0	0	350
31 Credit for residential energy efficient property .....	910	1,010	1,140	1,270	1,420	600	0	4,430
32 Qualified energy conservation bonds <sup>5</sup> .....	20	30	30	30	30	30	30	150
33 Advanced energy property credit .....	580	460	110	0	-30	-50	-50	-20
34 Advanced nuclear power production credit .....	0	0	0	0	0	165	440	605
<b>Natural resources and environment:</b>								
35 Expensing of exploration and development costs, nonfuel minerals .....	50	60	60	80	80	80	90	390
36 Excess of percentage over cost depletion, nonfuel minerals .....	560	580	600	600	610	620	630	3,060
37 Exclusion of interest on bonds for water, sewage, and hazardous waste facilities .....	420	470	550	600	650	680	730	3,210
38 Capital gains treatment of certain timber income .....	90	80	60	80	90	100	110	440
39 Expensing of multiperiod timber growing costs .....	270	280	300	310	320	330	350	1,610
40 Tax incentives for preservation of historic structures .....	540	550	570	580	590	600	610	2,950
41 Exclusion of gain or loss on sale or exchange of certain brownfield sites .....	40	30	10	0	0	0	0	10
42 Industrial CO2 capture and sequestration tax credit .....	60	60	70	80	110	210	160	630
43 Deduction for endangered species recovery expenditures .....	20	20	20	20	30	30	30	130
<b>Agriculture:</b>								
44 Expensing of certain capital outlays .....	70	100	110	120	130	130	130	620
45 Expensing of certain multiperiod production costs .....	130	160	160	160	160	170	160	810

Table 16-1. ESTIMATES OF TOTAL INCOME TAX EXPENDITURES FOR FISCAL YEARS 2012-2018—Continued

(In millions of dollars)

	Total from corporations and individuals							
	2012	2013	2014	2015	2016	2017	2018	2014-18
46 Treatment of loans forgiven for solvent farmers .....	40	40	40	40	40	40	40	200
47 Capital gains treatment of certain income .....	880	830	630	760	910	1,030	1,110	4,440
48 Income averaging for farmers .....	130	130	130	130	140	140	140	680
49 Deferral of gain on sale of farm refiners .....	20	20	20	20	20	20	20	100
50 Expensing of reforestation expenditures .....	60	70	80	80	80	90	100	430
<b>Commerce and housing:</b>								
Financial institutions and insurance:								
51 Exemption of credit union income .....	1,440	1,560	1,660	1,750	1,940	1,890	2,220	9,460
52 Exclusion of interest on life insurance savings .....	17,580	18,350	21,010	23,130	24,670	24,870	26,190	119,870
53 Special alternative tax on small property and casualty insurance companies .....	10	10	10	10	10	10	10	50
54 Tax exemption of certain insurance companies owned by tax-exempt organizations .....	800	830	830	830	850	850	850	4,210
55 Small life insurance company deduction .....	20	20	20	20	20	20	20	100
56 Exclusion of interest spread of financial institutions .....	150	1,400	2,330	2,660	2,910	3,170	3,400	14,470
Housing:								
57 Exclusion of interest on owner-occupied mortgage subsidy bonds .....	1,040	1,170	1,370	1,520	1,630	1,740	1,850	8,110
58 Exclusion of interest on rental housing bonds .....	880	990	1,170	1,290	1,370	1,470	1,570	6,870
59 Deductibility of mortgage interest on owner-occupied homes .....	81,890	93,090	101,470	112,730	126,950	142,040	156,990	640,180
60 Deductibility of State and local property tax on owner-occupied homes .....	15,460	20,310	25,160	26,110	27,330	28,690	29,740	137,030
61 Deferral of income from installment sales .....	900	1,080	1,160	1,350	1,560	1,730	1,850	7,650
62 Capital gains exclusion on home sales .....	30,900	38,130	45,870	48,790	52,310	56,070	60,160	263,200
63 Exclusion of net imputed rental income .....	68,230	74,080	75,520	80,880	88,260	93,330	98,690	436,680
64 Exception from passive loss rules for \$25,000 of rental loss .....	10,200	12,250	14,420	16,070	16,950	17,730	18,510	83,680
65 Credit for low-income housing investments <sup>6</sup> .....	7,670	7,410	8,310	8,280	8,330	8,730	9,080	42,730
66 Accelerated depreciation on rental housing (normal tax method) .....	1,220	1,680	2,130	2,570	3,060	3,570	4,130	15,460
67 Discharge of mortgage indebtedness .....	1,930	650	0	0	0	0	0	0
Commerce:								
68 Cancellation of indebtedness .....	150	110	90	70	50	-10	-70	130
69 Exceptions from imputed interest rules .....	50	50	50	50	50	50	50	250
70 Treatment of qualified dividends .....	29,750	20,240	0	0	0	0	0	0
71 Capital gains (except agriculture, timber, iron ore, and coal) .....	65,360	61,840	46,690	56,700	68,130	76,860	82,640	331,020
72 Capital gains exclusion of small corporation stock .....	50	130	370	720	750	500	410	2,750
73 Step-up basis of capital gains at death .....	15,490	21,170	27,100	28,460	29,870	31,370	32,970	149,770
74 Carryover basis of capital gains on gifts .....	2,830	3,550	3,540	4,230	4,980	5,620	6,100	24,470
75 Ordinary income treatment of loss from small business corporation stock sale .....	60	60	60	60	60	60	60	300
76 Accelerated depreciation of buildings other than rental housing (normal tax method) .....	-7,120	-7,540	-7,570	-7,370	-7,210	-7,130	-7,100	-36,380
77 Accelerated depreciation of machinery and equipment (normal tax method) .....	69,500	14,750	17,850	40,260	57,660	72,300	85,660	273,730
78 Expensing of certain small investments (normal tax method) .....	1,270	-530	-610	530	1,120	1,510	1,800	4,350
79 Graduated corporation income tax rate (normal tax method) .....	4,270	4,300	4,210	4,180	4,170	4,240	4,250	21,050
80 Exclusion of interest on small issue bonds .....	240	270	320	350	370	400	420	1,860
81 Deduction for US production activities .....	11,570	12,860	13,630	14,370	14,790	15,510	16,620	74,920
82 Special rules for certain film and TV production .....	130	80	50	20	10	0	0	80
<b>Transportation:</b>								
83 Tonnage tax election for certain international shipping income <sup>7</sup> .....	60	60	70	70	70	80	80	370
84 Exclusion of reimbursed employee parking expenses .....	2,640	2,880	3,010	3,140	3,290	3,450	3,610	16,500
85 Exclusion for employer-provided transit passes .....	590	660	700	760	820	870	930	4,080
86 Tax credit for certain expenditures for maintaining railroad tracks .....	130	80	50	20	10	0	0	80
87 Exclusion of interest on bonds for Highway Projects and rail-truck transfer facilities .....	240	230	220	210	200	190	170	990
<b>Community and regional development:</b>								
88 Investment credit for rehabilitation of structures (other than historic) .....	30	30	30	30	30	30	30	150
89 Exclusion of interest for airport, dock, and similar bonds .....	690	780	920	1,010	1,090	1,160	1,230	5,410
90 Exemption of certain mutuals' and cooperatives' income .....	130	130	140	140	140	150	150	720
91 Empowerment zones, the DC enterprise zone, and renewal communities .....	620	420	470	460	420	360	310	2,020

**Table 16–1. ESTIMATES OF TOTAL INCOME TAX EXPENDITURES FOR FISCAL YEARS 2012–2018—Continued**  
(In millions of dollars)

	Total from corporations and individuals							
	2012	2013	2014	2015	2016	2017	2018	2014–18
92 New markets tax credit .....	930	930	910	880	840	710	460	3,800
93 Expensing of environmental remediation costs .....	–20	–180	–180	–170	–160	–160	–160	–830
94 Credit to holders of Gulf Tax Credit Bonds .....	90	100	120	130	140	150	160	700
95 Recovery Zone Bonds <sup>8</sup> .....	10	10	20	30	30	30	30	140
96 Tribal Economic Development Bonds .....	0	30	50	50	50	50	60	260
<b>Education, training, employment, and social services:</b>								
Education:								
97 Exclusion of scholarship and fellowship income (normal tax method) .....	2,760	3,020	3,470	3,600	3,740	3,890	4,040	18,740
98 HOPE tax credit .....	0	430	4,310	4,270	4,150	4,180	4,030	20,940
99 Lifetime Learning tax credit .....	2,000	2,290	4,450	4,420	4,340	4,260	4,160	21,630
100 American Opportunity Tax Credit <sup>9</sup> .....	15,580	14,400	0	0	0	0	0	0
101 Education Individual Retirement Accounts .....	60	80	90	100	110	120	130	550
102 Deductibility of student-loan interest .....	1,450	1,460	880	880	910	940	910	4,520
103 Deduction for higher education expenses .....	720	0	0	0	0	0	0	0
104 Qualified tuition programs .....	1,980	2,020	2,270	2,520	2,690	2,870	3,060	13,410
105 Exclusion of interest on student-loan bonds .....	470	530	620	680	730	770	830	3,630
106 Exclusion of interest on bonds for private nonprofit educational facilities .....	2,150	2,440	2,870	3,160	3,400	3,610	3,870	16,910
107 Credit for holders of zone academy bonds <sup>10</sup> .....	200	200	180	160	130	120	110	700
108 Exclusion of interest on savings bonds redeemed to finance educational expenses .....	10	10	10	10	20	20	20	80
109 Parental personal exemption for students age 19 or over .....	2,800	2,700	2,810	2,550	2,300	2,080	1,870	11,610
110 Deductibility of charitable contributions (education) .....	3,960	4,590	5,080	5,450	5,920	6,430	6,940	29,820
111 Exclusion of employer-provided educational assistance .....	670	240	0	0	0	0	0	0
112 Special deduction for teacher expenses .....	170	0	0	0	0	0	0	0
113 Discharge of student loan indebtedness .....	20	20	20	20	20	20	20	100
114 Qualified school construction bonds <sup>11</sup> .....	400	580	650	650	650	650	650	3,250
Training, employment, and social services:								
115 Work opportunity tax credit .....	1,130	970	660	370	160	80	30	1,300
116 Employer provided child care exclusion .....	1,360	1,570	1,620	1,720	1,840	1,980	2,120	9,280
117 Employer-provided child care credit .....	10	10	0	0	0	0	0	0
118 Assistance for adopted foster children .....	530	530	560	590	630	670	710	3,160
119 Adoption credit and exclusion <sup>12</sup> .....	62	330	110	80	80	80	80	430
120 Exclusion of employee meals and lodging (other than military) .....	5,591	6,109	6,592	6,903	7,113	7,336	7,750	35,694
121 Child credit <sup>13</sup> .....	24,790	18,430	8,650	8,380	8,020	7,670	7,240	39,960
122 Credit for child and dependent care expenses .....	3,410	1,550	1,290	1,250	1,200	1,150	1,090	5,980
123 Credit for disabled access expenditures .....	20	20	20	20	20	20	20	100
124 Deductibility of charitable contributions, other than education and health .....	33,770	39,610	44,060	47,330	51,550	56,130	60,840	259,910
125 Exclusion of certain foster care payments .....	420	420	420	430	430	420	420	2,120
126 Exclusion of parsonage allowances .....	700	760	820	890	960	1,040	1,120	4,830
127 Employee retention credit for employers in certain federal disaster areas .....	10	0	0	0	0	0	0	0
<b>Health:</b>								
128 Exclusion of employer contributions for medical insurance premiums and medical care <sup>14</sup> .....	184,320	202,530	212,820	224,610	239,620	256,850	272,360	1,206,260
129 Self-employed medical insurance premiums .....	5,210	6,140	6,740	7,160	7,650	8,240	8,860	38,650
130 Medical Savings Accounts / Health Savings Accounts .....	1,520	1,600	1,680	1,760	1,880	2,000	2,130	9,450
131 Deductibility of medical expenses .....	7,230	8,990	10,270	10,820	11,180	11,360	12,370	56,000
132 Exclusion of interest on hospital construction bonds .....	3,040	3,430	4,040	4,440	4,760	5,070	5,430	23,740
133 Refundable Premium Assistance Tax Credit <sup>15</sup> .....	0	0	0	–2,660	–3,810	–4,670	–4,930	–16,070
134 Credit for employee health insurance expenses of small business <sup>16</sup> .....	190	250	950	1,660	1,690	1,480	1,310	7,090
135 Deductibility of charitable contributions (health) .....	3,820	4,470	4,980	5,350	5,820	6,340	6,880	29,370
136 Tax credit for orphan drug research .....	840	1,000	1,190	1,410	1,680	2,010	2,390	8,680
137 Special Blue Cross/Blue Shield deduction .....	420	500	500	510	490	510	510	2,520
138 Tax credit for health insurance purchased by certain displaced and retired individuals <sup>17</sup> .....	10	10	0	0	0	0	0	0
139 Distributions from retirement plans for premiums for health and long-term care insurance .....	330	360	400	440	490	510	530	2,370

Table 16–1. ESTIMATES OF TOTAL INCOME TAX EXPENDITURES FOR FISCAL YEARS 2012–2018—Continued

(In millions of dollars)

	Total from corporations and individuals								
	2012	2013	2014	2015	2016	2017	2018	2014–18	
<b>Income security:</b>									
140	Exclusion of railroad retirement system benefits .....	350	430	510	510	510	500	490	2,520
141	Exclusion of workers' compensation benefits .....	10,080	9,120	11,440	11,570	11,680	11,800	11,950	58,440
142	Exclusion of public assistance benefits (normal tax method) .....	720	750	780	810	840	870	910	4,210
143	Exclusion of special benefits for disabled coal miners .....	40	40	40	40	40	40	40	200
144	Exclusion of military disability pensions .....	110	150	160	160	160	160	160	800
Net exclusion of pension contributions and earnings:									
145	Defined benefit employer plans .....	38,740	47,410	53,060	57,400	61,810	66,150	69,970	308,390
146	Defined contribution employer plans .....	51,830	68,820	79,720	90,870	98,650	103,140	105,490	477,870
147	Individual Retirement Accounts .....	16,180	21,240	19,260	19,370	20,620	21,970	23,360	104,580
148	Low and moderate income savers credit .....	1,110	1,180	1,220	1,243	1,250	1,270	1,270	6,253
149	Self-Employed plans .....	15,930	19,380	23,260	25,490	28,030	30,800	33,760	141,340
Exclusion of other employee benefits:									
150	Premiums on group term life insurance .....	1,870	1,910	1,940	1,970	2,030	2,080	2,140	10,160
151	Premiums on accident and disability insurance .....	340	350	360	360	370	370	380	1,840
152	Income of trusts to finance supplementary unemployment benefits .....	20	20	30	40	50	60	70	250
153	Special ESOP rules .....	810	1,190	1,260	1,330	1,410	1,500	1,580	7,080
154	Additional deduction for the blind .....	30	40	40	50	50	50	50	240
155	Additional deduction for the elderly .....	2,080	2,870	3,260	3,330	3,400	3,490	3,540	17,020
156	Tax credit for the elderly and disabled .....	10	10	10	10	10	0	0	30
157	Deductibility of casualty losses .....	300	350	370	390	410	430	450	2,050
158	Earned income tax credit <sup>18</sup> .....	1,610	4,040	5,640	5,920	6,060	6,310	6,520	30,450
<b>Social Security:</b>									
Exclusion of social security benefits:									
159	Social Security benefits for retired workers .....	22,170	27,920	32,910	34,330	35,550	36,830	38,340	177,960
160	Social Security benefits for disabled workers .....	7,510	8,960	9,970	10,280	10,560	10,810	11,060	52,680
161	Social Security benefits for spouses, dependents and survivors .....	3,740	3,970	4,130	4,230	4,370	4,490	4,550	21,770
<b>Veterans benefits and services:</b>									
162	Exclusion of veterans death benefits and disability compensation .....	4,240	5,210	6,880	7,480	8,140	8,860	9,640	41,000
163	Exclusion of veterans pensions .....	360	430	550	570	580	600	620	2,920
164	Exclusion of GI bill benefits .....	940	1,200	1,610	1,720	1,830	1,950	2,080	9,190
165	Exclusion of interest on veterans housing bonds .....	10	10	10	20	20	30	30	110
<b>General purpose fiscal assistance:</b>									
166	Exclusion of interest on public purpose State and local bonds .....	25,950	29,270	34,420	37,920	40,680	43,330	46,340	202,690
167	Build America Bonds <sup>19</sup> .....	0	0	0	0	0	0	0	0
168	Deductibility of nonbusiness State and local taxes other than on owner-occupied homes .....	29,480	43,940	51,560	54,520	58,200	62,200	65,660	292,140
<b>Interest:</b>									
169	Deferral of interest on U.S. savings bonds .....	980	1,020	1,080	1,090	1,100	1,120	1,130	5,520
<b>Addendum: Aid to State and local governments:</b>									
Deductibility of:									
	Property taxes on owner-occupied homes .....	15,460	20,310	25,160	26,110	27,330	28,690	29,740	137,030
	Nonbusiness State and local taxes other than on owner-occupied homes .....	29,480	43,940	51,560	54,520	58,200	62,200	65,660	292,140
Exclusion of interest on State and local bonds for:									
	Public purposes .....	25,950	29,270	34,420	37,920	40,680	43,330	46,340	202,690
	Energy facilities .....	20	30	30	30	30	40	40	170
	Water, sewage, and hazardous waste disposal facilities .....	420	470	550	600	650	680	730	3,210
	Small-issues .....	240	270	320	350	370	400	420	1,860
	Owner-occupied mortgage subsidies .....	1,040	1,170	1,370	1,520	1,630	1,740	1,850	8,110
	Rental housing .....	880	990	1,170	1,290	1,370	1,470	1,570	6,870
	Airports, docks, and similar facilities .....	690	780	920	1,010	1,090	1,160	1,230	5,410

16. TAX EXPENDITURES

**Table 16–1. ESTIMATES OF TOTAL INCOME TAX EXPENDITURES FOR FISCAL YEARS 2012–2018—Continued**  
(In millions of dollars)

	Total from corporations and individuals							
	2012	2013	2014	2015	2016	2017	2018	2014–18
Student loans .....	470	530	620	680	730	770	830	3,630
Private nonprofit educational facilities .....	2,150	2,440	2,870	3,160	3,400	3,610	3,870	16,910
Hospital construction .....	3,040	3,430	4,040	4,440	4,760	5,070	5,430	23,740
Veterans' housing .....	10	10	10	20	20	30	30	110
GO Zone and GO Zone mortgage .....	90	100	120	130	140	150	160	700
Credit for holders of zone academy bonds .....	200	200	180	160	130	120	110	700

<sup>1</sup> Firms can tax an energy grant in lieu of the energy production credit or the energy investment credit for facilities placed in service in 2009 and 2010 or whose construction commenced in 2009 and 2010. The effect of the grant on outlays (in millions of dollars) is as follows: 2012 \$5,080; 2013 \$8,080; 2014 \$4,710; 2015 \$2,520; 2016 \$1,580; 2017 \$330; 2018 \$0.

<sup>2</sup> In addition, the alcohol fuel mixture credit results in a reduction in excise tax receipts (in millions of dollars) as follows: 2012 \$3,540; 2013 \$0; 2014 \$0; 2015 \$0; 2016 \$0; 2017 \$0; 2018 \$0.

The alternative fuel mixture credit results in a reduction in excise tax receipts (in millions of dollars) as follows: 2012 \$310; 2013 \$10; 2014 \$10; 2015 \$0; 2016 \$0; 2017 \$0; 2018 \$0.

<sup>3</sup> In addition, the biodiesel producer tax credit results in a reduction in excise tax receipts (in millions of dollars) as follows: 2012 \$800; 2013 \$0; 2014 \$0; 2015 \$0; 2016 \$0; 2017 \$0; 2018 \$0.

<sup>4</sup> In addition, the provision has outlay effects of (in millions of dollars): 2012 \$40; 2013 \$50; 2014 \$50; 2015 \$50; 2016 \$50; 2017 \$50; 2018 \$50.

<sup>5</sup> In addition, the provision has outlay effects of (in millions of dollars): 2012 \$50; 2013 \$60; 2014 \$60; 2015 \$60; 2016 \$60; 2017 \$60; 2018 \$60.

<sup>6</sup> In addition, the credit for low-income housing investments has outlay effects (in millions of dollars) as follows: 2012 \$180.

<sup>7</sup> These figures do not account for the tonnage tax which shipping companies may opt into in lieu of the corporate income tax. The tonnage tax reduces the cost of this tax expenditure by \$20 per year in each year of the budget.

<sup>8</sup> In addition, recovery zone bonds have outlay effects (in millions of dollars) as follows: 2012 \$160, 2013 \$160, 2014 \$160, 2015 \$160, 2016 \$160; and 2017 \$160; 2018 \$160.

<sup>9</sup> The figures in the table indicate the effect of the American opportunity tax credit on receipts. The effect of the credit on outlays (in millions of dollars) is as follows: 2012 \$5,850; 2013 \$6,450; 2014 \$970

<sup>10</sup> In addition, the credit for holders of zone academy bonds has outlay effects of (in millions of dollars): 2012 \$20; 2013 \$30; 2014 \$30; 2015 \$30; 2016 \$30; 2017 \$30; and 2018 \$30.

<sup>11</sup> In addition, the provision for school construction bonds has outlay effects of (in millions of dollars): 2012 \$780; 2013 \$940; 2014 \$940; 2015 \$940; 2016 \$940; 2017 \$940, and 2018 \$940.

<sup>12</sup> The figures in the table indicate the effect of the adoption tax credit on receipts. The effect of the credit on outlays (in millions of dollars) is as follows: 2012 \$700; and 2013 \$50.

<sup>13</sup> 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: 2012 \$22,620; 2013 \$22,510; 2014 \$1,750; 2015 \$1,720; 2016 \$1,720; 2017 \$1,690; and 2018 1,660.

<sup>14</sup> 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: 2012 \$107,760; 2013 \$111,120; 2014 \$112,620; 2015 \$116,500; 2016 \$122,730; 2017 \$130,170; 2018 \$135,170.

<sup>15</sup> In addition, the premium assistance credit provision has outlay effects (in millions of dollars) as follows: 2014 \$32,270; 2015 \$58,130; 2016 \$71,470; 2017 \$78,130; 2018 \$82,150.

<sup>16</sup> In addition, the small business credit provision has outlay effects (in millions of dollars) as follows: 2012 \$70; 2013 \$60; 2014 \$140; 2015 \$240; 2016 \$250; 2017 \$220; 2018 \$190.

<sup>17</sup> The figures in the table indicate the effect of the health coverage tax credit on receipts. The effect of the credit on outlays (in millions of dollars) is as follows: 2012 \$130; 2013 \$120; 2014 \$30.

<sup>18</sup> 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: 2012 \$54,840; 2013 \$54,360; 2014 \$47,700; 2015 \$49,000; 2016 \$49,870; 2017 \$50,740; and 2018 \$51,510.

<sup>19</sup> In addition, Build America Bonds have outlay effects of (in millions of dollars): 2012 \$3,190; 2013 \$3,190; 2014 \$3,190; 2015 \$3,190; 2016 \$3,190; 2017 \$3,190; and 2018 \$3,190.

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.

**Table 16-2. ESTIMATES OF TAX EXPENDITURES FOR THE CORPORATE AND INDIVIDUAL INCOME TAXES FOR FISCAL YEARS 2012-2018**

(In millions of dollars)

	Corporations								Individuals							
	2012	2013	2014	2015	2016	2017	2018	2014-18	2012	2013	2014	2015	2016	2017	2018	2014-18
<b>National Defense</b>																
1 Exclusion of benefits and allowances to armed forces personnel .....									14,140	14,640	15,150	14,170	14,350	14,840	15,430	73,940
<b>International affairs:</b>																
2 Exclusion of income earned abroad by U.S. citizens .....									5400	5800	6140	6430	6730	7050	7380	33,730
3 Exclusion of certain allowances for Federal employees abroad .....									1070	1120	1180	1240	1300	1370	1430	6,520
4 Inventory property sales source rules exception .....	3,310	3,610	3,940	4,300	4,690	5,120	5,590	23,640								
5 Deferral of income from controlled foreign corporations (normal tax method) .....	42,000	41,810	41,770	43,020	44,240	45,180	46,160	220,370								
6 Deferred taxes for financial firms on certain income earned overseas .....	2,510	0	0	0	0	0	0	0								
<b>General science, space, and technology:</b>																
7 Expensing of research and experimentation expenditures (normal tax method) .....	3,600	4,610	4,820	5,300	6,280	7,290	8,100	31,790	140	200	220	230	280	320	370	1,420
8 Credit for increasing research activities .....	4220	2320	2130	1970	1820	1680	1530	9,130	170							0
<b>Energy:</b>																
9 Expensing of exploration and development costs, fuels .....	410	690	770	550	340	230	160	2,050	60	100	110	80	50	30	20	290
10 Excess of percentage over cost depletion, fuels .....	750	750	770	770	780	780	780	3,880	140	150	170	170	170	170	170	850
11 Alternative fuel production credit .....	20	10	0	0	0	0	0	0	0	0	0	0	0	0	0	0
12 Exception from passive loss limitation for working interests in oil and gas properties .....									10	10	10	10	10	10	10	50
13 Capital gains treatment of royalties on coal									90	80	60	80	90	100	110	440
14 Exclusion of interest on energy facility bonds .....	10	10	10	10	10	10	10	50	10	20	20	20	20	30	30	120
15 Energy production credit <sup>1</sup> .....	1,480	1,710	1,750	1,710	1,620	1,420	1,080	7,580	20	20	20	20	20	20	20	100
16 Energy investment credit <sup>1</sup> .....	920	1150	1240	1550	1750	1030	210	5,780	120	120	120	120	130	80	30	480
17 Alcohol fuel credits <sup>2</sup> .....	110	80	40	20	10	10	0	80	30	30	10	10	0	0	0	20
18 Bio-Diesel and small agri-biodiesel producer tax credits <sup>3</sup> .....	10	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
19 Tax credit and deduction for clean-fuel burning vehicles .....	20	30	60	90	110	110	70	440	80	150	200	310	500	560	430	2,000
20 Exclusion of utility conservation subsidies ..	20	10	10	10	10	10	10	50	250	240	240	240	240	240	230	1,190
21 Credit for holding clean renewable energy bonds <sup>4</sup> .....	20	20	20	20	20	20	20	100	50	50	50	50	50	50	50	250
22 Deferral of gain from dispositions of transmission property to implement FERC restructuring policy .....	-70	-180	-190	-180	-150	-120	-80	-720								
23 Credit for investment in clean coal facilities	360	380	400	480	310	160	160	1,510	20	20	20	20	10	10	10	70
24 Temporary 50% expensing for equipment used in the refining of liquid fuels .....	680	610	-90	-700	-830	-880	-800	-3,300	0	0	0	0	0	0	0	0
25 Natural gas distribution pipelines treated as 15-year property .....	110	100	100	100	110	120	120	550	0	0	0	0	0	0	0	0
26 Amortize all geological and geophysical expenditures over 2 years .....	70	80	80	70	60	50	50	310	20	30	30	20	20	20	20	110
27 Allowance of deduction for certain energy efficient commercial building property ...	30	30	20	10	0	0	-10	20	40	40	20	10	0	0	-10	20
28 Credit for construction of new energy efficient homes .....	30	20	10	0	0	0	0	10	40	20	10	0	0	0	0	10
29 Credit for energy efficiency improvements to existing homes .....	0	0	0	0	0	0	0	0	780	0	0	0	0	0	0	0
30 Credit for energy efficient appliances .....	210	150	130	120	100	0	0	350	0	150	0	0	0	0	0	0
31 Credit for residential energy efficient property .....	0	0	0	0	0	0	0	0	910	1,010	1,140	1,270	1,420	600	0	4,430
32 Qualified energy conservation bonds <sup>5</sup> .....	10	10	10	10	10	10	10	50	10	20	20	20	20	20	20	100

**Table 16-2. ESTIMATES OF TAX EXPENDITURES FOR THE CORPORATE AND INDIVIDUAL INCOME TAXES FOR FISCAL YEARS 2012-2018—Continued**

(In millions of dollars)

	Corporations									Individuals							
	2012	2013	2014	2015	2016	2017	2018	2014-18	2012	2013	2014	2015	2016	2017	2018	2014-18	
33 Advanced Energy Property Credit .....	500	390	80	0	-20	-40	-40	-20	80	70	30	0	-10	-10	-10	0	
34 Advanced nuclear power production credit .....	0	0	0	0	0	165	440	605	0	0	0	0	0	0	0	0	
<b>Natural resources and environment:</b>																	
35 Expensing of exploration and development costs, nonfuel minerals .....	50	60	60	70	70	70	80	350	0	0	0	10	10	10	10	40	
36 Excess of percentage over cost depletion, nonfuel minerals .....	530	540	550	550	560	570	580	2,810	30	40	50	50	50	50	50	250	
37 Exclusion of interest on bonds for water, sewage, and hazardous waste facilities .....	110	110	120	140	150	150	160	720	310	360	430	460	500	530	570	2,490	
38 Capital gains treatment of certain timber income .....									90	80	60	80	90	100	110	440	
39 Expensing of multiperiod timber growing costs .....	170	170	180	180	190	200	210	960	100	110	120	130	130	130	140	650	
40 Tax incentives for preservation of historic structures .....	490	500	510	520	530	540	550	2,650	50	50	60	60	60	60	60	300	
41 Exclusion of gain or loss on sale or exchange of certain brownfield sites .....	30	20	10	0	0	0	0	10	10	10	0	0	0	0	0	0	
42 Industrial CO2 capture and sequestration tax credit .....	60	60	70	80	110	210	160	630	0	0	0	0	0	0	0	0	
43 Deduction for endangered species recovery expenditures .....	10	10	10	10	10	10	10	50	10	10	10	10	20	20	20	80	
<b>Agriculture:</b>																	
44 Expensing of certain capital outlays .....	0	10	10	10	10	10	0	40	70	90	100	110	120	120	130	580	
45 Expensing of certain multiperiod production costs .....	10	10	10	10	10	10	0	40	120	150	150	150	150	160	160	770	
46 Treatment of loans forgiven for solvent farmers .....									40	40	40	40	40	40	40	200	
47 Capital gains treatment of certain income .....									880	830	630	760	910	1,030	1,110	4,440	
48 Income averaging for farmers .....									130	130	130	130	140	140	140	680	
49 Deferral of gain on sale of farm refiners .....	20	20	20	20	20	20	20	100									
50 Expensing of reforestation expenditures .....	20	20	20	20	20	20	30	110	40	50	60	60	60	70	70	320	
<b>Commerce and housing:</b>																	
Financial institutions and insurance:																	
51 Exemption of credit union income .....	1,440	1,560	1,660	1,750	1,940	1,890	2,220	9,460									
52 Exclusion of interest on life insurance savings .....	2,500	3,310	3,710	4,000	4,270	4,680	4,970	21,630	15,080	15,040	17,300	19,130	20,400	20,190	21,220	98,240	
53 Special alternative tax on small property and casualty insurance companies .....	10	10	10	10	10	10	10	50									
54 Tax exemption of certain insurance companies owned by tax-exempt organizations .....	800	830	830	830	850	850	850	4,210									
55 Small life insurance company deduction .....	20	20	20	20	20	20	20	100									
56 Exclusion of interest spread of financial institutions .....									150	1,400	2,330	2,660	2,910	3,170	3,400	14,470	
Housing:																	
57 Exclusion of interest on owner-occupied mortgage subsidy bonds .....	270	270	300	350	370	390	410	1,820	770	900	1,070	1,170	1,260	1,350	1,440	6,290	
58 Exclusion of interest on rental housing bonds .....	230	230	260	300	310	330	350	1,550	650	760	910	990	1,060	1,140	1,220	5,320	
59 Deductibility of mortgage interest on owner-occupied homes .....									81,890	93,090	101,470	112,730	126,950	142,040	156,990	640,180	
60 Deductibility of State and local property tax on owner-occupied homes .....									15,460	20,310	25,160	26,110	27,330	28,690	29,740	137,030	
61 Deferral of income from installment sales .....									900	1,080	1,160	1,350	1,560	1,730	1,850	7,650	
62 Capital gains exclusion on home sales .....									30,900	38,130	45,870	48,790	52,310	56,070	60,160	263,200	
63 Exclusion of net imputed rental income .....									68,230	74,080	75,520	80,880	88,260	93,330	98,690	436,680	
64 Exception from passive loss rules for \$25,000 of rental loss .....									10,200	12,250	14,420	16,070	16,950	17,730	18,510	83,680	

**Table 16-2. ESTIMATES OF TAX EXPENDITURES FOR THE CORPORATE AND INDIVIDUAL INCOME TAXES FOR FISCAL YEARS 2012-2018—Continued**

(In millions of dollars)

	Corporations								Individuals								
	2012	2013	2014	2015	2016	2017	2018	2014-18	2012	2013	2014	2015	2016	2017	2018	2014-18	
65	Credit for low-income housing investments <sup>6</sup> .....	7,290	7,040	7,890	7,870	7,910	8,290	8,630	40,590	380	370	420	410	420	440	450	2,140
66	Accelerated depreciation on rental housing (normal tax method) .....	210	260	320	390	470	560	660	2,400	1,010	1,420	1,810	2,180	2,590	3,010	3,470	13,060
67	Discharge of mortgage indebtedness ...									1,930	650	0	0	0	0	0	0
<b>Commerce:</b>																	
68	Cancellation of indebtedness .....									150	110	90	70	50	-10	-70	130
69	Exceptions from imputed interest rules ...									50	50	50	50	50	50	50	250
70	Treatment of qualified dividends .....									29,750	20,240	0	0	0	0	0	0
71	Capital gains (except agriculture, timber, iron ore, and coal) .....									65,360	61,840	46,690	56,700	68,130	76,860	82,640	331,020
72	Capital gains exclusion of small corporation stock .....									50	130	370	720	750	500	410	2,750
73	Step-up basis of capital gains at death ...									15,490	21,170	27,100	28,460	29,870	31,370	32,970	149,770
74	Carryover basis of capital gains on gifts ...									2,830	3,550	3,540	4,230	4,980	5,620	6,100	24,470
75	Ordinary income treatment of loss from small business corporation stock sale ...									60	60	60	60	60	60	60	300
76	Accelerated depreciation of buildings other than rental housing (normal tax method) .....	-3,380	-3,310	-3,250	-3,200	-3,160	-3,150	-3,200	-15,960	-3,740	-4,230	-4,320	-4,170	-4,050	-3,980	-3,900	-20,420
77	Accelerated depreciation of machinery and equipment (normal tax method) .	45,950	7,940	9,330	24,160	35,810	45,840	55,410	170,550	23,550	6,810	8,520	16,100	21,850	26,460	30,250	103,180
78	Expensing of certain small investments (normal tax method) .....	60	-160	-160	10	100	160	210	320	1,210	-370	-450	520	1,020	1,350	1,590	4,030
79	Graduated corporation income tax rate (normal tax method) .....	4,270	4,300	4,210	4,180	4,170	4,240	4,250	21,050								
80	Exclusion of interest on small issue bonds .....	60	60	70	80	80	90	90	410	180	210	250	270	290	310	330	1,450
81	Deduction for US production activities ...	8750	9730	10310	10870	11190	11730	12570	56,670	2,820	3,130	3,320	3,500	3,600	3,780	4050	18,250
82	Special rules for certain film and TV production .....	100	60	40	20	10	0	0	70	30	20	10	0	0	0	0	10
<b>Transportation:</b>																	
83	Tonnage tax election for certain international shipping income <sup>7</sup> .....	60	60	70	70	70	80	80	370								
84	Exclusion of reimbursed employee parking expenses .....									2,640	2,880	3,010	3,140	3,290	3,450	3,610	16,500
85	Exclusion for employer-provided transit passes .....									590	660	700	760	820	870	930	4,080
86	Tax credit for certain expenditures for maintaining railroad tracks .....	100	60	40	20	10	0	0	70	30	20	10	0	0	0	0	10
87	Exclusion of interest on bonds for Highway Projects and rail-truck transfer facilities ...	60	60	50	50	50	50	40	240	180	170	170	160	150	140	130	750
<b>Community and regional development:</b>																	
88	Investment credit for rehabilitation of structures (other than historic) .....	10	10	10	10	10	10	10	50	20	20	20	20	20	20	20	100
89	Exclusion of interest for airport, dock, and similar bonds .....	180	180	200	230	250	260	270	1,210	510	600	720	780	840	900	960	4,200
90	Exemption of certain mutuals' and cooperatives' income .....	130	130	140	140	140	150	150	720								
91	Empowerment zones, the DC enterprise zone, and renewal communities .....	230	140	150	140	120	100	80	590	390	280	320	320	300	260	230	1,430
92	New markets tax credit .....	910	910	890	860	820	690	450	3,710	20	20	20	20	20	20	10	90
93	Expensing of environmental remediation costs .....	-20	-150	-150	-140	-130	-130	-130	-680	0	-30	-30	-30	-30	-30	-30	-150
94	Credit to holders of Gulf Tax Credit Bonds. .	20	20	30	30	30	30	40	160	70	80	90	100	110	120	120	540
95	Recovery Zone Bonds <sup>8</sup> .....	0	0	0	10	10	10	10	40	10	10	20	20	20	20	20	100
96	Tribal Economic Development Bonds .....	0	10	10	10	10	10	10	50	0	20	40	40	40	40	50	210

**Table 16-2. ESTIMATES OF TAX EXPENDITURES FOR THE CORPORATE AND INDIVIDUAL INCOME TAXES FOR FISCAL YEARS 2012-2018—Continued**

(In millions of dollars)

	Corporations								Individuals							
	2012	2013	2014	2015	2016	2017	2018	2014-18	2012	2013	2014	2015	2016	2017	2018	2014-18
<b>Education, training, employment, and social services:</b>																
Education:																
97									2,760	3,020	3,470	3,600	3,740	3,890	4,040	18,740
									0	430	4,310	4,270	4,150	4,180	4,030	20,940
98									2,000	2,290	4,450	4,420	4,340	4,260	4,160	21,630
99									15,580	14,400	0	0	0	0	0	0
100									60	80	90	100	110	120	130	550
101									1,450	1,460	880	880	910	940	910	4,520
102									720	0	0	0	0	0	0	0
103									1,980	2,020	2,270	2,520	2,690	2,870	3,060	13,410
104									120	120	140	160	170	170	180	820
105									560	560	630	720	770	800	850	3,770
106									200	200	180	160	130	120	110	700
107									10	10	10	10	20	20	20	80
108									2,800	2,700	2,810	2,550	2,300	2,080	1,870	11,610
109									690	740	790	840	890	940	980	4,440
110									670	240	0	0	0	0	0	0
111									170	0	0	0	0	0	0	0
112									20	20	20	20	20	20	20	100
113									110	150	160	160	160	160	160	800
114									290	430	490	490	490	490	490	2,450
Training, employment, and social services:																
115									870	820	600	330	150	70	30	1,180
116									1360	1570	1620	1720	1840	1980	2120	9,280
117									10	10	0	0	0	0	0	0
118									530	530	560	590	630	670	710	3,160
119									62	330	110	80	80	80	80	430
120									0	0	0	0	0	0	0	0
121									5,591	6,109	6,592	6,903	7,113	7,336	7,750	35,694
122									24,790	18,430	8,650	8,380	8,020	7,670	7,240	39,960
123									3,410	1,550	1,290	1,250	1,200	1,150	1,090	5,980
124									10	10	10	10	10	10	10	50
125									1,510	1,600	1,690	1,770	1,860	1,940	2,020	9,280
126									32,260	38,010	42,370	45,560	49,690	54,190	58,820	250,630
127									420	420	420	430	430	420	420	2,120
128									700	760	820	890	960	1,040	1,120	4,830
129									10	0	0	0	0	0	0	0
130									0	0	0	0	0	0	0	0
131									0	0	0	0	0	0	0	0
<b>Health:</b>																
128									184,320	202,530	212,820	224,610	239,620	256,850	272,360	1,206,260
129									5,210	6,140	6,740	7,160	7,650	8,240	8,860	38,650
130									1,520	1,600	1,680	1,760	1,880	2,000	2,130	9,450
131									7,230	8,990	10,270	10,820	11,180	11,360	12,370	56,000

**Table 16-2. ESTIMATES OF TAX EXPENDITURES FOR THE CORPORATE AND INDIVIDUAL INCOME TAXES FOR FISCAL YEARS 2012-2018—Continued**

(In millions of dollars)

	Corporations									Individuals							
	2012	2013	2014	2015	2016	2017	2018	2014-18	2012	2013	2014	2015	2016	2017	2018	2014-18	
132 Exclusion of interest on hospital construction bonds .....	790	790	890	1,020	1,080	1,130	1,200	5,320	2,250	2,640	3,150	3,420	3,680	3,940	4,230	18,420	
133 Refundable Premium Assistance Tax Credit <sup>15</sup> .....									0	0	0	-2,660	-3,810	-4,670	-4,930	-16,070	
134 Credit for employee health insurance expenses of small business <sup>16</sup> .....	70	90	330	580	590	520	460	2,480	120	160	620	1,080	1,100	960	850	4,610	
135 Deductibility of charitable contributions (health) .....	200	210	230	240	250	260	280	1,260	3,620	4,260	4,750	5,110	5,570	6,080	6,600	28,110	
136 Tax credit for orphan drug research .....	840	1,000	1,190	1,410	1,680	2,010	2,390	8,680									
137 Special Blue Cross/Blue Shield deduction ...	420	500	500	510	490	510	510	2,520									
138 Tax credit for health insurance purchased by certain displaced and retired individuals <sup>17</sup> .....									10	10	0	0	0	0	0	0	
139 Distributions from retirement plans for premiums for health and long-term care insurance .....									330	360	400	440	490	510	530	2,370	
<b>Income security:</b>																	
140 Exclusion of railroad retirement system benefits .....									350	430	510	510	510	500	490	2,520	
141 Exclusion of workers' compensation benefits .....									10,080	9,120	11,440	11,570	11,680	11,800	11,950	58,440	
142 Exclusion of public assistance benefits (normal tax method) .....									720	750	780	810	840	870	910	4,210	
143 Exclusion of special benefits for disabled coal miners .....									40	40	40	40	40	40	40	200	
144 Exclusion of military disability pensions ....									110	150	160	160	160	160	160	800	
Net exclusion of pension contributions and earnings:																	
145 Defined benefit employer plans .....									38,740	47,410	53,060	57,400	61,810	66,150	69,970	308,390	
146 Defined contribution employer plans ....									51,830	68,820	79,720	90,870	98,650	103,140	105,490	477,870	
147 Individual Retirement Accounts .....									16,180	21,240	19,260	19,370	20,620	21,970	23,360	104,580	
148 Low and moderate income savers credit									1,110	1,180	1,220	1,243	1,250	1,270	1,270	6,253	
149 Self-Employed plans .....									15,930	19,380	23,260	25,490	28,030	30,800	33,760	141,340	
Exclusion of other employee benefits:																	
150 Premiums on group term life insurance ...									1,870	1,910	1,940	1,970	2,030	2,080	2,140	10,160	
151 Premiums on accident and disability insurance .....									340	350	360	360	370	370	380	1,840	
152 Income of trusts to finance supplementary unemployment benefits .....									20	20	30	40	50	60	70	250	
153 Special ESOP rules .....	740	1,090	1,160	1,230	1,310	1,390	1,470	6,560	70	100	100	100	100	110	110	520	
154 Additional deduction for the blind .....									30	40	40	50	50	50	50	240	
155 Additional deduction for the elderly .....									2,080	2,870	3,260	3,330	3,400	3,490	3,540	17,020	
156 Tax credit for the elderly and disabled .....									10	10	10	10	10	0	0	30	
157 Deductibility of casualty losses .....									300	350	370	390	410	430	450	2,050	
158 Earned income tax credit <sup>18</sup> .....									1,610	4,040	5,640	5,920	6,060	6,310	6,520	30,450	
<b>Social Security:</b>																	
Exclusion of social security benefits:																	
159 Social Security benefits for retired workers .....									22,170	27,920	32,910	34,330	35,550	36,830	38,340	177,960	
160 Social Security benefits for disabled workers .....									7,510	8,960	9,970	10,280	10,560	10,810	11,060	52,680	
161 Social Security benefits for spouses, dependents and survivors .....									3,740	3,970	4,130	4,230	4,370	4,490	4,550	21,770	
<b>Veterans benefits and services:</b>																	
162 Exclusion of veterans death benefits and disability compensation .....									4,240	5,210	6,880	7,480	8,140	8,860	9,640	41,000	
163 Exclusion of veterans pensions .....									360	430	550	570	580	600	620	2,920	
164 Exclusion of GI bill benefits .....									940	1,200	1,610	1,720	1,830	1,950	2,080	9,190	
165 Exclusion of interest on veterans housing bonds .....	0	0	0	0	0	10	10	20	10	10	10	20	20	20	20	90	

**Table 16-2. ESTIMATES OF TAX EXPENDITURES FOR THE CORPORATE AND INDIVIDUAL INCOME TAXES FOR FISCAL YEARS 2012-2018—Continued**

(In millions of dollars)

	Corporations								Individuals							
	2012	2013	2014	2015	2016	2017	2018	2014-18	2012	2013	2014	2015	2016	2017	2018	2014-18
<b>General purpose fiscal assistance:</b>																
166 Exclusion of interest on public purpose State and local bonds .....	6,750	6,720	7,570	8,720	9,240	9,670	10,240	45,440	19,200	22,550	26,850	29,200	31,440	33,660	36,100	157,250
167 Build America Bonds <sup>19</sup> .....	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
168 Deductibility of nonbusiness State and local taxes other than on owner-occupied homes .....									29,480	43,940	51,560	54,520	58,200	62,200	65,660	292,140
<b>Interest:</b>																
169 Deferral of interest on U.S. savings bonds ...									980	1,020	1,080	1,090	1,100	1,120	1,130	5,520
<b>Addendum: Aid to State and local governments:</b>																
Deductibility of:																
Property taxes on owner-occupied homes .....									15,460	20,310	25,160	26,110	27,330	28,690	29,740	137,030
Nonbusiness State and local taxes other than on owner-occupied homes .....									29,480	43,940	51,560	54,520	58,200	62,200	65,660	292,140
Exclusion of interest on State and local bonds for:																
Public purposes .....	6,750	6,720	7,570	8,720	9,240	9,670	10,240	45,440	19,200	22,550	26,850	29,200	31,440	33,660	36,100	157,250
Energy facilities .....	10	10	10	10	10	10	10	50	10	20	20	20	20	30	30	120
Water, sewage, and hazardous waste disposal facilities .....	110	110	120	140	150	150	160	720	310	360	430	460	500	530	570	2,490
Small-issues .....	60	60	70	80	80	90	90	410	180	210	250	270	290	310	330	1,450
Owner-occupied mortgage subsidies ....	270	270	300	350	370	390	410	1,820	770	900	1,070	1,170	1,260	1,350	1,440	6,290
Rental housing .....	230	230	260	300	310	330	350	1,550	650	760	910	990	1,060	1,140	1,220	5,320
Airports, docks, and similar facilities .....	180	180	200	230	250	260	270	1,210	510	600	720	780	840	900	960	4,200
Student loans .....	120	120	140	160	170	170	180	820	350	410	480	520	560	600	650	2,810
Private nonprofit educational facilities ...	560	560	630	720	770	800	850	3,770	1,590	1,880	2,240	2,440	2,630	2,810	3,020	13,140
Hospital construction .....	790	790	890	1,020	1,080	1,130	1,200	5,320	2,250	2,640	3,150	3,420	3,680	3,940	4,230	18,420
Veterans' housing .....	0	0	0	0	0	10	10	20	10	10	10	20	20	20	20	90
GO Zone and GO Zone mortgage .....	20	20	30	30	30	30	40	160	70	80	90	100	110	120	120	540
Credit for holders of zone academy bonds ...	200	200	180	160	130	120	110	700								

<sup>1</sup> Firms can tax an energy grant in lieu of the energy production credit or the energy investment credit for facilities placed in service in 2009 and 2010 or whose construction commenced in 2009 and 2010. The effect of the grant on outlays (in millions of dollars) is as follows: 2012 \$5,080; 2013 \$8,080; 2014 \$4,710; 2015 \$2,520; 2016 \$1,580; 2017 \$330; 2018 \$0.

<sup>2</sup> In addition, the alcohol fuel mixture credit results in a reduction in excise tax receipts (in millions of dollars) as follows: 2012 \$3,540; 2013 \$0; 2014 \$0; 2015 \$0; 2016 \$0; 2017 \$0; 2018 \$0. The alternative fuel mixture credit results in a reduction in excise tax receipts (in millions of dollars) as follows: 2012 \$310; 2013 \$10; 2014 \$10; 2015 \$0; 2016 \$0; 2017 \$0; 2018 \$0.

<sup>3</sup> In addition, the biodiesel producer tax credit results in a reduction in excise tax receipts (in millions of dollars) as follows: 2012 \$800; 2013 \$0; 2014 \$0; 2015 \$0; 2016 \$0; 2017 \$0; 2018 \$0.

<sup>4</sup> In addition, the provision has outlay effects of (in millions of dollars): 2012 \$40; 2013 \$50; 2014 \$50; 2015 \$50; 2016 \$50; 2017 \$50; 2018 \$50.

<sup>5</sup> In addition, the provision has outlay effects of (in millions of dollars): 2012 \$50; 2013 \$60; 2014 \$60; 2015 \$60; 2016 \$60; 2017 \$60; 2018 \$60.

<sup>6</sup> In addition, the credit for low-income housing investments has outlay effects (in millions of dollars) as follows: 2012 \$180.

<sup>7</sup> These figures do not account for the tonnage tax which shipping companies may opt into in lieu of the corporate income tax. The tonnage tax reduces the cost of this tax expenditure by \$20 per year in each year of the budget.

<sup>8</sup> In addition, recovery zone bonds have outlay effects (in millions of dollars) as follows: 2012 \$160, 2013 \$160, 2014 \$160, 2015 \$160, 2016 \$160; and 2017 \$160; 2018 \$160.

<sup>9</sup> The figures in the table indicate the effect of the American opportunity tax credit on receipts. The effect of the credit on outlays (in millions of dollars) is as follows: 2012 \$5,850; 2013 \$6,450; 2014 \$970

<sup>10</sup> In addition, the credit for holders of zone academy bonds has outlay effects of (in millions of dollars): 2012 \$20; 2013 \$30; 2014 \$30; 2015 \$30; 2016 \$30; 2017 \$30; and 2018 \$30.

<sup>11</sup> In addition, the provision for school construction bonds has outlay effects of (in millions of dollars): 2012 \$780; 2013 \$940; 2014 \$940; 2015 \$940; 2016 \$940; 2017 \$940, and 2018 \$940.

<sup>12</sup> The figures in the table indicate the effect of the adoption tax credit on receipts. The effect of the credit on outlays (in millions of dollars) is as follows: 2012 \$700; and 2013 \$50.

<sup>13</sup> 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: 2012 \$22,620; 2013 \$22,510; 2014 \$1,750; 2015 \$1,720; 2016 \$1,720; 2017 \$1,690; and 2018 1,660.

<sup>14</sup> 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: 2012 \$107,760; 2013 \$111,120; 2014 \$112,620; 2015 \$116,500; 2016 \$122,730; 2017 \$130,170; 2018 \$135,170.

<sup>15</sup> In addition, the premium assistance credit provision has outlay effects (in millions of dollars) as follows: 2014 \$32,270; 2015 \$58,130; 2016 \$71,470; 2017 \$78,130; 2018 \$82,150.

<sup>16</sup> In addition, the small business credit provision has outlay effects (in millions of dollars) as follows: 2012 \$70; 2013 \$60; 2014 \$140; 2015 \$240; 2016 \$250; 2017 \$220; 2018 \$190.

<sup>17</sup> The figures in the table indicate the effect of the health coverage tax credit on receipts. The effect of the credit on outlays (in millions of dollars) is as follows: 2012 \$130; 2013 \$120; 2014 \$30.

<sup>18</sup> 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: 2012 \$54,840; 2013 \$54,360; 2014 \$47,700; 2015 \$49,000; 2016 \$49,870; 2017 \$50,740; and 2018 \$51,510.

<sup>19</sup> In addition, Build America Bonds have outlay effects of (in millions of dollars): 2012 \$3,190; 2013 \$3,190; 2014 \$3,190; 2015 \$3,190; 2016 \$3,190; 2017 \$3,190; and 2018 \$3,190.

**Table 16-3. INCOME TAX EXPENDITURES RANKED BY TOTAL FISCAL YEAR 2014-2018 PROJECTED REVENUE EFFECT**  
(In millions of dollars)

Provision	2014	2014-18
128 Exclusion of employer contributions for medical insurance premiums and medical care .....	212,820	1,206,260
59 Deductibility of mortgage interest on owner-occupied homes .....	101,470	640,180
146 Defined contribution employer plans .....	79,720	477,870
63 Exclusion of net imputed rental income .....	75,520	436,680
71 Capital gains (except agriculture, timber, iron ore, and coal) .....	46,690	331,020
145 Defined benefit employer plans .....	53,060	308,390
168 Deductibility of nonbusiness State and local taxes other than on owner-occupied homes .....	51,560	292,140
77 Accelerated depreciation of machinery and equipment (normal tax method) .....	17,850	273,730
62 Capital gains exclusion on home sales .....	45,870	263,200
124 Deductibility of charitable contributions, other than education and health .....	44,060	259,910
5 Deferral of income from controlled foreign corporations (normal tax method) .....	41,770	220,370
166 Exclusion of interest on public purpose State and local bonds .....	34,420	202,690
159 Social Security benefits for retired workers .....	32,910	177,960
73 Step-up basis of capital gains at death .....	27,100	149,770
149 Self-Employed plans .....	23,260	141,340
60 Deductibility of State and local property tax on owner-occupied homes .....	25,160	137,030
52 Exclusion of interest on life insurance savings .....	21,010	119,870
147 Individual Retirement Accounts .....	19,260	104,580
64 Exception from passive loss rules for \$25,000 of rental loss .....	14,420	83,680
81 Deduction for US production activities .....	13,630	74,920
1 Exclusion of benefits and allowances to armed forces personnel .....	15,150	73,940
141 Exclusion of workers' compensation benefits .....	11,440	58,440
131 Deductibility of medical expenses .....	10,270	56,000
160 Social Security benefits for disabled workers .....	9,970	52,680
65 Credit for low-income housing investments .....	8,310	42,730
162 Exclusion of veterans death benefits and disability compensation .....	6,880	41,000
121 Child credit .....	8,650	39,960
129 Self-employed medical insurance premiums .....	6,740	38,650
120 Exclusion of employee meals and lodging (other than military) .....	6,592	35,694
2 Exclusion of income earned abroad by U.S. citizens .....	6,140	33,730
7 Expensing of research and experimentation expenditures (normal tax method) .....	5,040	33,210
158 Earned income tax credit .....	5,640	30,450
110 Deductibility of charitable contributions (education) .....	5,080	29,820
135 Deductibility of charitable contributions (health) .....	4,980	29,370
74 Carryover basis of capital gains on gifts .....	3,540	24,470
132 Exclusion of interest on hospital construction bonds .....	4,040	23,740
4 Inventory property sales source rules exception .....	3,940	23,640
161 Social Security benefits for spouses, dependents and survivors .....	4,130	21,770
99 Lifetime Learning tax credit .....	4,450	21,630
79 Graduated corporation income tax rate (normal tax method) .....	4,210	21,050
98 HOPE tax credit .....	4,310	20,940
97 Exclusion of scholarship and fellowship income (normal tax method) .....	3,470	18,740
155 Additional deduction for the elderly .....	3,260	17,020
106 Exclusion of interest on bonds for private nonprofit educational facilities .....	2,870	16,910
84 Exclusion of reimbursed employee parking expenses .....	3,010	16,500
66 Accelerated depreciation on rental housing (normal tax method) .....	2,130	15,460
56 Exclusion of interest spread of financial institutions .....	2,330	14,470
104 Qualified Tuition Programs .....	2,270	13,410
109 Parental personal exemption for students age 19 or over .....	2,810	11,610
150 Premiums on group term life insurance .....	1,940	10,160
51 Exemption of credit union income .....	1,660	9,460
130 Medical Savings Accounts / Health Savings Accounts .....	1,680	9,450
116 Employer provided child care exclusion .....	1,620	9,280
164 Exclusion of GI bill benefits .....	1,610	9,190
8 Credit for increasing research activities .....	2,130	9,130
136 Tax credit for orphan drug research .....	1,190	8,680

**Table 16-3. INCOME TAX EXPENDITURES RANKED BY TOTAL FISCAL YEAR 2014-2018 PROJECTED REVENUE EFFECT—Continued**  
(In millions of dollars)

Provision		2014	2014-18
57	Exclusion of interest on owner-occupied mortgage subsidy bonds .....	1,370	8,110
15	New technology credit .....	1,770	7,680
61	Deferral of income from installment sales .....	1,160	7,650
134	Credit for employee health insurance expenses of small business .....	950	7,090
153	Special ESOP rules .....	1,260	7,080
58	Exclusion of interest on rental housing bonds .....	1,170	6,870
3	Exclusion of certain allowances for Federal employees abroad .....	1,180	6,520
16	Energy investment credit .....	1,360	6,260
148	Low and moderate income savers credit .....	1,220	6,253
122	Credit for child and dependent care expenses .....	1,290	5,980
169	Deferral of interest on U.S. savings bonds .....	1,080	5,520
89	Exclusion of interest for airport, dock, and similar bonds .....	920	5,410
126	Exclusion of parsonage allowances .....	820	4,830
10	Excess of percentage over cost depletion, fuels .....	940	4,730
102	Deductibility of student-loan interest .....	880	4,520
47	Capital gains treatment of certain income .....	630	4,440
31	30% credit for residential purchases/installations of solar and fuel cells .....	1,140	4,430
78	Expensing of certain small investments (normal tax method) .....	-610	4,350
54	Tax exemption of certain insurance companies owned by tax-exempt organizations .....	830	4,210
142	Exclusion of public assistance benefits (normal tax method) .....	780	4,210
85	Exclusion for employer-provided transit passes .....	700	4,080
92	New markets tax credit .....	910	3,800
105	Exclusion of interest on student-loan bonds .....	620	3,630
114	Qualified school construction bonds .....	650	3,250
37	Exclusion of interest on bonds for water, sewage, and hazardous waste facilities .....	550	3,210
118	Assistance for adopted foster children .....	560	3,160
36	Excess of percentage over cost depletion, nonfuel minerals .....	600	3,060
40	Tax incentives for preservation of historic structures .....	570	2,950
163	Exclusion of veterans pensions .....	550	2,920
72	Capital gains exclusion of small corporation stock .....	370	2,750
137	Special Blue Cross/Blue Shield deduction .....	500	2,520
140	Exclusion of railroad retirement system benefits .....	510	2,520
19	Tax credit and deduction for clean-fuel burning vehicles .....	260	2,440
139	Distributions from retirement plans for premiums for health and long-term care insurance .....	400	2,370
9	Expensing of exploration and development costs, fuels .....	880	2,340
125	Exclusion of certain foster care payments .....	420	2,120
157	Deductibility of casualty losses .....	370	2,050
91	Empowerment zones, Enterprise communities, and Renewal communities .....	470	2,020
80	Exclusion of interest on small issue bonds .....	320	1,860
151	Premiums on accident and disability insurance .....	360	1,840
39	Expensing of multiperiod timber growing costs .....	300	1,610
23	Credit for investment in clean coal facilities .....	420	1,580
115	Work opportunity tax credit .....	660	1,300
20	Exclusion of utility conservation subsidies .....	250	1,240
87	Exclusion of interest on bonds for Financing of Highway Projects and rail-truck transfer facilities .....	220	990
45	Expensing of certain multiperiod production costs .....	160	810
144	Exclusion of military disability pensions .....	160	800
90	Exemption of certain mutuals' and cooperatives' income .....	140	720
94	Credit to holders of Gulf Tax Credit Bonds .....	120	700
107	Credit for holders of zone academy bonds .....	180	700
48	Income averaging for farmers .....	130	680
42	Industrial CO2 capture and sequestration tax credit .....	70	630
44	Expensing of certain capital outlays .....	110	620
34	Advanced nuclear power production credit .....	0	605
25	Natural gas distribution pipelines treated as 15-year property .....	100	550
101	Education Individual Retirement Accounts .....	90	550

**Table 16-3. INCOME TAX EXPENDITURES RANKED BY TOTAL FISCAL YEAR 2014-2018 PROJECTED REVENUE EFFECT—Continued**  
(In millions of dollars)

Provision	2014	2014-18
13 Capital gains treatment of royalties on coal .....	60	440
38 Capital gains treatment of certain timber income .....	60	440
50 Expensing of reforestation expenditures .....	80	430
119 Adoption credit and exclusion .....	110	430
26 Amortize all geological and geophysical expenditures over 2 years .....	110	420
35 Expensing of exploration and development costs, nonfuel minerals .....	60	390
83 Deferral of tax on shipping companies .....	70	370
21 Credit for holding clean renewable energy bonds .....	70	350
30 Credit for energy efficient appliances .....	130	350
75 Ordinary income treatment of loss from small business corporation stock sale .....	60	300
96 Tribal Economic Development Bonds .....	50	260
69 Exceptions from imputed interest rules .....	50	250
152 Income of trusts to finance supplementary unemployment benefits .....	30	250
154 Additional deduction for the blind .....	40	240
46 Treatment of loans forgiven for solvent farmers .....	40	200
143 Exclusion of special benefits for disabled coal miners .....	40	200
14 Exclusion of interest on energy facility bonds .....	30	170
32 Qualified energy conservation bonds .....	30	150
88 Investment credit for rehabilitation of structures (other than historic) .....	30	150
95 Recovery Zone Bonds .....	20	140
43 Deduction for endangered species recovery expenditures .....	20	130
68 Cancellation of indebtedness .....	90	130
165 Exclusion of interest on veterans housing bonds .....	10	110
17 Alcohol fuel credits .....	50	100
49 Deferral of gain on sale of farm refiners .....	20	100
55 Small life insurance company deduction .....	20	100
113 Discharge of student loan indebtedness .....	20	100
123 Credit for disabled access expenditures .....	20	100
82 Special rules for certain film and TV production .....	50	80
86 Tax credit for certain expenditures for maintaining railroad tracks .....	50	80
108 Exclusion of interest on savings bonds redeemed to finance educational expenses .....	10	80
12 Exception from passive loss limitation for working interests in oil and gas properties .....	10	50
53 Special alternative tax on small property and casualty insurance companies .....	10	50
27 Allowance of deduction for certain energy efficient commercial building property .....	40	40
156 Tax credit for the elderly and disabled .....	10	30
28 Credit for construction of new energy efficient homes .....	20	20
41 Exclusion of gain or loss on sale or exchange of certain brownfield sites .....	10	10
6 Deferred taxes for financial firms on certain income earned overseas .....	0	0
11 Alternative fuel production credit .....	0	0
18 Bio-Diesel and small agri-biodiesel producer tax credits .....	0	0
29 Credit for energy efficiency improvements to existing homes .....	0	0
67 Discharge of mortgage indebtedness .....	0	0
70 Treatment of qualified dividends .....	0	0
100 Lifetime Learning tax credit .....	0	0
103 Deduction for higher education expenses .....	0	0
111 Exclusion of employer-provided educational assistance .....	0	0
112 Special deduction for teacher expenses .....	0	0
117 Employer-provided child care credit .....	0	0
127 Employee retention credit for employers affected by Hurricane Katrina, Rita, and Wilma .....	0	0
138 Tax credit for health insurance purchased by certain displaced and retired individuals .....	0	0
167 Build America Bonds .....	0	0
33 Advanced Energy Property Credit .....	110	-20
22 Deferral of gain from dispositions of transmission property to implement FERC restructuring policy .....	-190	-720
93 Expensing of environmental remediation costs .....	-180	-830
24 Temporary 50% expensing for equipment used in the refining of liquid fuels .....	-90	-3,300
133 Refundable Premium Assistance Tax Credit .....	0	-16,070
76 Accelerated depreciation of buildings other than rental housing (normal tax method) .....	-7,570	-36,380

16. TAX EXPENDITURES

- Noncorporate tax rates vary by level of income.
- Individual tax rates, including brackets, standard deduction, and personal exemptions, are allowed to vary with marital status.
- Values of assets and debt are not generally adjusted for inflation. A comprehensive income tax would adjust the cost basis of capital assets and debt for changes in the general price level. Thus, under a comprehensive income tax baseline, the failure to take account of inflation in measuring depreciation, capital gains, and interest income would be regarded as a negative tax expenditure (i.e., a tax penalty), and failure to take account of inflation in measuring interest costs would be regarded as a positive tax expenditure (i.e., a tax subsidy).

Although the reference law and normal tax baselines are generally similar, areas of difference include:

**Tax rates.** The separate schedules applying to the various taxpaying units are included in the reference law baseline. Thus, corporate tax rates below the maximum statutory rate do not give rise to a tax expenditure. The normal tax baseline is similar, except that, by convention, it specifies the current maximum rate as the baseline for the corporate income tax. The lower tax rates applied to the first \$10 million of corporate income are thus regarded as a tax expenditure under the normal tax. By conven-

tion, the Alternative Minimum Tax is treated as part of the baseline rate structure under both the reference and normal tax methods.

**Income subject to the tax.** Income subject to tax is defined as gross income less the costs of earning that income. Under the reference tax rules, gross income does not include gifts defined as receipts of money or property that are not consideration in an exchange nor does gross income include most transfer payments from the Government.<sup>2</sup> The normal tax baseline also excludes gifts between individuals from gross income. Under the normal tax baseline, however, all cash transfer payments from the Government to private individuals are counted in gross income, and exemptions of such transfers from tax are identified as tax expenditures. The costs of earning income are generally deductible in determining taxable income under both the reference and normal tax baselines.<sup>3</sup>

<sup>2</sup> Gross income does, however, include transfer payments associated with past employment, such as Social Security benefits.

<sup>3</sup> In the case of individuals who hold “passive” equity interests in businesses, the pro-rata shares of sales and expense deductions reportable in a year are limited. A passive business activity is defined generally to be one in which the holder of the interest, usually a partnership interest, does not actively perform managerial or other participatory functions. The taxpayer may generally report no larger deductions for a year than will reduce taxable income from such activities to zero. Deductions in excess of the limitation may be taken in subsequent years, or when the interest is liquidated. In addition, costs of earning income may be limited under the Alternative Minimum Tax.

**Table 16–4. PRESENT VALUE OF SELECTED TAX EXPENDITURES FOR ACTIVITY IN CALENDAR YEAR 2012**  
(In millions of dollars)

Provision	2012 Present Value of Revenue Loss
5 Deferral of income from controlled foreign corporations (normal tax method) .....	21,000
7 Expensing of research and experimentation expenditures (normal tax method) .....	2380
21 Credit for holding clean renewable energy bonds .....	310
9 Expensing of exploration and development costs - fuels .....	220
35 Expensing of exploration and development costs - nonfuels .....	60
39 Expensing of multiperiod timber growing costs .....	130
45 Expensing of certain multiperiod production costs - agriculture .....	-140
44 Expensing of certain capital outlays - agriculture .....	-100
50 Expensing of reforestation expenditures .....	30
52 Deferral of income on life insurance and annuity contracts .....	16,530
66 Accelerated depreciation on rental housing .....	7,270
76 Accelerated depreciation of buildings other than rental housing .....	-17,740
77 Accelerated depreciation of machinery and equipment .....	4,750
78 Expensing of certain small investments (normal tax method) .....	-220
107 Credit for holders of zone academy bonds .....	160
65 Credit for low-income housing investments .....	6,630
104 Deferral for state prepaid tuition plans .....	3,510
145 Defined benefit employer plans .....	92,570
146 Defined contribution employer plans .....	64,170
147 Exclusion of IRA contributions and earnings .....	1,030
147 Exclusion of Roth earnings and distributions .....	3,160
147 Exclusion of non-deductible IRA earnings .....	100
149 Exclusion of contributions and earnings for Self-Employed plans .....	2,540
166 Exclusion of interest on public-purpose bonds .....	15,170
Exclusion of interest on non-public purpose bonds .....	5,460
169 Deferral of interest on U.S. savings bonds .....	223

*Capital recovery.* Under the reference tax law baseline no tax expenditures arise from accelerated depreciation. Under the normal tax baseline, the depreciation allowance for property is computed using estimates of economic depreciation.

*Treatment of foreign income.* Both the normal and reference tax baselines allow a tax credit for foreign income taxes paid (up to the amount of U.S. income taxes that would otherwise be due), which prevents double taxation of income earned abroad. Under the normal tax method, however, controlled foreign corporations (CFCs) are not regarded as entities separate from their controlling U.S. shareholders. Thus, the deferral of tax on income received by CFCs is regarded as a tax expenditure under this method. In contrast, except for tax haven activities, the reference law baseline follows current law in treating CFCs as separate taxable entities whose income is not subject to U.S. tax until distributed to U.S. taxpayers. Under this baseline, deferral of tax on CFC income is not a tax expenditure because U.S. taxpayers generally are not taxed on accrued, but unrealized, income.

## Descriptions of Income Tax Provisions

Descriptions of the individual and corporate income tax expenditures reported on in this chapter follow. These descriptions relate to current law as of December 31, 2012.

### National Defense

**1. Benefits and allowances to Armed Forces personnel.**—Under the baseline tax system, all compensation, including dedicated payments and in-kind benefits, should be included in taxable income because they represent accretions to wealth that do not materially differ from cash wages. As an example, a rental voucher of \$100 is (approximately) equal in value to \$100 of cash income. In contrast to this treatment, certain housing and meals, in addition to other benefits provided military personnel, either in cash or in kind, as well as certain amounts of pay related to combat service, are excluded from income subject to tax.

**2. Income earned abroad.**—Under the baseline tax system, all compensation received by U.S. citizens is properly included in their taxable income. It makes no difference whether the compensation is a result of working abroad or whether it is labeled as a housing allowance. In contrast to this treatment, U.S. tax law allows U.S. citizens who live abroad, work in the private sector, and satisfy a foreign residency requirement to exclude up to \$80,000, plus adjustments for inflation since 2004, in foreign earned income from U.S. taxes. In addition, if these taxpayers receive a specific allowance for foreign housing from their employers, then they may also exclude such expenses to the extent that they do not exceed 30 percent of the earned income inclusion, with geographical adjustments, over 16 percent of the earned income limit. If taxpayers do not receive a specific allowance for housing expenses, they may deduct housing expenses up to the amount by which foreign earned income exceeds their foreign earned income exclusion.

**3. Exclusion of certain allowances for Federal employees abroad.**—In general, all compensation received by U.S. citizens is properly included in their taxable income. It makes no difference whether the compensation is a result of working abroad or whether it is labeled as an allowance for the high cost of living abroad. In contrast to this treatment, U.S. Federal civilian employees and Peace Corps members who work outside the continental United States are allowed to exclude from U.S. taxable income certain special allowances they receive to compensate them for the relatively high costs associated with living overseas. The allowances supplement wage income and cover expenses such as rent, education, and the cost of travel to and from the United States.

**4. Sales source rule exceptions.**—The United States generally taxes the worldwide income of U.S. persons and business entities. Under the baseline tax system, taxpayers receive a credit for foreign taxes paid which is limited to the pre-credit U.S. tax on the foreign source income. In contrast, the sales source rules for inventory property under current law allow U.S. exporters to use more foreign tax credits by allowing the exporters to attribute a larger portion of their earnings abroad than would be the case if the allocation of earnings was based on actual economic activity.

**5. Income of U.S.-controlled foreign corporations.**—Under the baseline tax system, the United States generally taxes the worldwide income of U.S. persons and business entities. In contrast, certain active income of foreign corporations controlled by U.S. shareholders is not subject to U.S. taxation when it is earned. The income becomes taxable only when the controlling U.S. shareholders receive dividends or other distributions from their foreign stockholding. The reference law tax baseline reflects this tax treatment where only realized income is taxed. Under the normal tax method, however, the currently attributable foreign source pre-tax income from such a controlling interest is considered to be subject to U.S. taxation, whether or not distributed. Thus, the normal tax method considers the amount of controlled foreign corporation income not yet distributed to a U.S. shareholder as tax-deferred income.

**6. Exceptions under subpart F for active financing income.**—The United States generally taxes the worldwide income of U.S. persons and business entities. The baseline tax system would not allow the deferral of tax or other relief targeted at particular industries or activities. In contrast, under current law, financial firms may defer taxes on income earned overseas in an active business. This provision expired at the end of 2011, but ATRA extended it through December 31, 2013 (extension not shown in the tables).

### General Science, Space, and Technology

**7. Expensing R&E expenditures.**—The baseline tax system allows a deduction for the cost of producing income. It requires taxpayers to capitalize the costs associated with investments over time to better match the streams of income and associated costs, Research and

experimentation (R&E) projects can be viewed as investments because, if successful, their benefits accrue for several years. It is often difficult, however, to identify whether a specific R&E project is successful and, if successful, what its expected life will be. Because of this ambiguity, the reference law baseline tax system would allow of expensing of R&E expenditures. In contrast, under the normal tax method, the expensing of R&E expenditures is viewed as a tax expenditure. The baseline assumed for the normal tax method is that all R&E expenditures are successful and have an expected life of five years.

**8. R&E credit.**—The baseline tax system would uniformly tax all returns to investments and not allow credits for particular activities, investments, or industries. In contrast, the Tax Code allows an R&E credit of 20 percent of qualified research expenditures in excess of a base amount.

The base amount of the credit is generally determined by multiplying a “fixed-base percentage” by the average amount of the company’s gross receipts for the prior four years. The taxpayer’s fixed base percentage generally is the ratio of its research expenses to gross receipts for 1984 through 1988. Taxpayers can elect the alternative simplified credit regime, which is equal to 14 percent (12 percent prior to 2009) of qualified research expenses that exceed 50 percent of the average qualified research expenses for the three preceding taxable years. Prior to January 1, 2009, taxpayers could also elect an alternative incremental credit regime. Under the alternative incremental credit regime the taxpayer was assigned a three-tiered fixed base percentage that is lower than the fixed-base percentage that would otherwise apply, and the credit rate was reduced. The rates for the alternative incremental credit ranged from 3 percent to 5 percent. Under current law as of December 31, the research credit expired on December 31, 2011. However, ATRA extended the provision through December 31, 2013 (extension not shown in the tables.)

## Energy

**9. Exploration and development costs.**—Under the baseline tax system, the costs of exploring and developing oil and gas wells would be capitalized and then amortized (or depreciated) over an estimate of the economic life of the well. This insures that the net income from the well is measured appropriately each year.

In contrast to this treatment, current law allows intangible drilling costs for successful investments in domestic oil and gas wells (such as wages, the cost of using machinery for grading and drilling, and the cost of unsalvageable materials used in constructing wells) to be deducted immediately, i.e., expensed. Because it allows recovery of costs sooner, expensing is more generous for the taxpayer than would be amortization. Integrated oil companies may deduct only 70 percent of such costs and must amortize the remaining 30 percent over five years. The same rule applies to the exploration and development costs of surface stripping and the construction of shafts and tunnels for other fuel minerals.

**10. Percentage depletion.**—The baseline tax system would allow recovery of the costs of developing certain oil and mineral properties using cost depletion. Cost depletion is similar in concept to depreciation, in that the costs of developing or acquiring the asset are capitalized and then gradually reduced over an estimate of the asset’s productive life, as is appropriate for measuring net income.

In contrast, the Tax Code generally allows independent fuel and mineral producers and royalty owners to take percentage depletion deductions rather than cost depletion on limited quantities of output. Under percentage depletion, taxpayers deduct a percentage of gross income from mineral production. In certain cases the deduction is limited to a fraction of the asset’s net income. Over the life of an investment, percentage depletion deductions can exceed the cost of the investment. Consequently, percentage depletion offers more generous tax treatment than would cost depletion, which would limit deductions to an investment’s cost.

**11. Alternative fuel production credit.**—The baseline tax system would not allow credits for particular activities, investments, or industries. Instead, it generally would seek to tax uniformly all returns from investment-like activities. In contrast, the Tax Code provides a credit of \$3 per oil-equivalent barrel of production (in 2004 dollars) for coke or coke gas during a four-year period for qualified facilities. Qualifying facilities producing coke and coke gas must be placed in service by December 31, 2009.

**12. Oil and gas exception to passive loss limitation.**—The baseline tax system accepts current law’s general rule limiting taxpayers’ ability to deduct losses from passive activities against nonpassive income (e.g., wages, interest, and dividends). Passive activities generally are defined as those in which the taxpayer does not materially participate, and there are numerous additional considerations brought to bear on the determination of which activities are passive for a given taxpayer. Losses are limited in an attempt to limit tax sheltering activities. Passive losses that are unused may be carried forward and applied against future passive income.

An exception from the passive loss limitation is provided for a working interest in an oil or gas property that the taxpayer holds directly or through an entity that does not limit the liability of the taxpayer with respect to the interest. Thus, taxpayers can deduct losses from such working interests against nonpassive income without regard to whether they materially participate in the activity.

**13. Capital gains treatment of royalties on coal.**—The baseline tax system generally would tax all income under the regular tax rate schedule. It would not allow preferentially low tax rates to apply to certain types or sources of income. For individuals in 2012, tax rates on regular income vary from 10 percent to 35 percent, depending on the taxpayer’s income. In contrast, current law allows capital gains realized by individuals

to be taxed at a preferentially low rate that is no higher than 15 percent. Certain sales of coal under royalty contracts qualify for taxation as capital gains rather than ordinary income, and so benefit from the preferentially low 15 percent maximum tax rate on capital gains. Beginning in 2013, the top statutory preferential tax rate on capital gains will be 20 percent.

14. **Energy facility bonds.**—The baseline tax system generally would tax all income under the regular tax rate schedule. It would not allow preferentially low (or zero) tax rates to apply to certain types or sources of income. In contrast, the Tax Code allows interest earned on State and local bonds used to finance construction of certain energy facilities to be exempt from tax. These bonds are generally subject to the State private-activity-bond annual volume cap.

15. **Energy production credit.**—The baseline tax system would not allow credits for particular activities, investments, or industries. Instead, it generally would seek to tax uniformly all returns from investment-like activities. In contrast, the Tax Code provides a credit for certain electricity produced from wind energy, biomass, geothermal energy, solar energy, small irrigation power, municipal solid waste, or qualified hydropower and sold to an unrelated party. In addition to the electricity production credit, an income tax credit is allowed for the production of refined coal and Indian coal at qualified facilities.

16. **Energy investment credit.**—The baseline tax system would not allow credits for particular activities, investments, or industries. Instead, it generally would seek to tax uniformly all returns from investment-like activities. However, the Tax Code provides credits for investments in solar and geothermal energy property, qualified fuel cell power plants, stationary microturbine power plants, geothermal heat pumps, small wind property and combined heat and power property. Owners of renewable power facilities that qualify for the energy production credit may instead elect to take an energy investment credit.

17. **Alcohol fuel credits.**—The baseline tax system would not allow credits for particular activities, investments, or industries. Instead, it generally would seek to tax uniformly all returns from investment-like activities. In contrast, the Tax Code provides an income tax credit for ethanol derived from renewable sources and used as fuel. In lieu of the alcohol mixture credit, the taxpayer may claim a refundable excise tax credit. In addition, small ethanol producers are eligible for a separate income tax credit for ethanol production and a separate income tax credit is available for qualified cellulosic biofuel production. With the exception of the cellulosic biofuel credit, these provisions expired on December 31, 2011. However, ATRA extended the provision through December 31, 2013 (extension not shown in the tables).

18. **Bio-Diesel tax credit.**—The baseline tax system would not allow credits for particular activities, investments, or industries. Instead, it generally would seek to tax uniformly all returns from investment-like activities. However, the Tax Code allows an income tax credit for bio-diesel used or sold and for bio-diesel derived from virgin

sources. In lieu of the bio-diesel credit, the taxpayer may claim a refundable excise tax credit. In addition, small agri-biodiesel producers are eligible for a separate income tax credit for ethanol production and a separate credit is available for qualified renewable diesel fuel mixtures. This provision expired on December 31, 2011. However, ATRA extended the provision through December 31, 2013 (extension not shown in the tables).

19. **Credit for alternative motor vehicles and refueling property.**—The baseline tax system would not allow credits or deductions for particular activities, investments, or industries. Instead, it generally would seek to tax uniformly all returns from investment-like activities. In contrast, the Tax Code allows a number of credits for certain types of vehicles and property. These are available for hydrogen alternative fuel vehicle refueling property, fuel cell vehicles and plug-in electric-drive motor vehicles. The credits for non-hydrogen alternative fuel vehicle refueling property, plug-in conversions, and low-speed, motorcycle, and three-wheeled plug-in electric vehicles expire on December 31, 2011. However, ATRA extended the provision through December 31, 2013 (extension not shown in the tables).

20. **Exclusion of utility conservation subsidies.**—The baseline tax system generally takes a comprehensive view of taxable income that includes a wide variety of (measurable) accretions to wealth. In certain circumstances, public utilities offer rate subsidies to non-business customers who invest in energy conservation measures. These rate subsidies are equivalent to payments from the utility to its customer, and so represent accretions to wealth, income, that would be taxable to the customer under the baseline tax system. In contrast, the Tax Code exempts these subsidies from the non-business customer's gross income.

21. **Credit to holders of clean renewable energy bonds.**—The baseline tax system would uniformly tax all returns to investments and not allow credits for particular activities, investments, or industries. In contrast, the Tax Code provides for the issuance of Clean Renewable Energy Bonds which entitles the bond holder to a Federal income tax credit in lieu of interest. The limit on the volume issued in 2009–2010 is \$2.4 billion. As of March 2010, issuers of the unused authorization of such bonds could opt to receive direct payment with the yield becoming fully taxable.

22. **Deferral of gain from dispositions of transmission property to implement FERC restructuring policy.**—The baseline tax system generally would tax gains from sale of property when realized. It would not allow an exception for particular activities or individuals. However, the Tax Code allows utilities to defer gains from the sale of their transmission assets to a FERC-approved independent transmission company. The sale of property must be made prior to January 1, 2012. However, ATRA extended the provision through December 31, 2013 (extension not shown in the tables).

23. **Credit for investment in clean coal facilities.**—The baseline tax system would uniformly tax all returns to investments and not allow credits for particu-

lar activities, investments, or industries. Instead, it generally would seek to tax uniformly all returns from investment-like activities. In contrast, the Tax Code provides investment tax credits for clean coal facilities producing electricity and for industrial gasification combined cycle projects.

**24. Temporary 50 percent expensing for equipment used in the refining of liquid fuels.**—The baseline tax system allows the taxpayer to deduct the decline in the economic value of an investment over its economic life. However, the Tax Code provides for an accelerated recovery of the cost of certain investments in refineries by allowing partial expensing of the cost, thereby giving such investments a tax advantage.

**25. Natural gas distribution pipelines treated as 15-year property.**—The baseline tax system allows taxpayers to deduct the decline in the economic value of an investment over its economic life. However, the Tax Code allows depreciation of natural gas distribution pipelines (placed in service between 2005 and 2011) over a 15 year period. These deductions are accelerated relative to deductions based on economic depreciation.

**26. Amortize all geological and geophysical expenditures over two years.**—The baseline tax system allows taxpayers to deduct the decline in the economic value of an investment over time. However, the Tax Code allows geological and geophysical expenditures incurred in connection with oil and gas exploration in the United States to be amortized over two years for non-integrated oil companies.

**27. Allowance of deduction for certain energy efficient commercial building property.**—The baseline tax system would not allow deductions in addition to normal depreciation allowances for particular investments in particular industries. Instead, it generally would seek to tax uniformly all returns from investment-like activities. In contrast, the Tax Code allows a deduction, per square foot, for certain energy efficient commercial buildings.

**28. Credit for construction of new energy efficient homes.**—The baseline tax system would not allow credits for particular activities, investments, or industries. Instead, it generally would seek to tax uniformly all returns from investment-like activities. However, the Tax Code allows contractors a tax credit of \$2,000 for the construction of a qualified new energy-efficient home that has an annual level of heating and cooling energy consumption at least 50 percent below the annual consumption of a comparable dwelling unit. The credit equals \$1,000 in the case of a new manufactured home that meets a 30 percent standard. This provision expired on December 31, 2011. However, ATRA extended the provision through December 31, 2013 (extension not shown in the tables).

**29. Credit for energy efficiency improvements to existing homes.**—The baseline tax system would not allow credits for particular activities, investments, or industries. However, the Tax Code provides an investment tax credit for expenditures made on insulation, exterior windows, and doors that improve the energy efficiency of homes and meet certain standards. The Tax Code also provides a credit for purchases of advanced main air circulat-

ing fans, natural gas, propane, or oil furnaces or hot water boilers, and other qualified energy efficient property. This provision expired on December 31, 2011. However, ATRA extended the provision through December 31, 2013 (extension not shown in tables.)

**30. Credit for energy efficient appliances.**—The baseline tax system would not allow credits for particular activities, investments, or industries. Instead, it generally would seek to tax uniformly all returns from investment-like activities. In contrast, the Tax Code provides tax credits for the manufacture of efficient dishwashers, clothes washers, and refrigerators. The size of the credit depends on the efficiency of the appliance. This provision expired on December 31, 2011. However, ATRA extended the provision through December 31, 2013 (extension not shown in the tables).

**31. Credit for residential energy efficient property.**—The baseline tax system would uniformly tax all returns to investments and not allow credits for particular activities, investments, or industries. However, the Tax Code provides a credit for the purchase of a qualified photovoltaic property and solar water heating property, as well as for fuel cell power plants, geothermal heat pumps and small wind property.

**32. Credit for qualified energy conservation bonds.**—The baseline tax system would uniformly tax all returns to investments and not allow credits for particular activities, investments, or industries. However, the Tax Code provides for the issuance of energy conservation bonds which entitle the bond holder to a Federal income tax credit in lieu of interest. The limit on the volume issued in 2009–2010 is \$3.2 billion. As of March 2010, issuers of the unused authorization of such bonds could opt to receive direct payment with the yield becoming fully taxable.

**33. Advanced energy property credit.**—The baseline tax system would not allow credits for particular activities, investments, or industries. However, the Tax Code provides a 30 percent investment credit for property used in a qualified advanced energy manufacturing project. The Treasury Department may award up to \$2.3 billion in tax credits for qualified investments.

**34. Advanced nuclear power facilities production credit.**—The baseline tax system would not allow credits or deductions for particular activities, investments, or industries. Instead, it generally would seek to tax uniformly all returns from investment-like activities. In contrast, the Tax Code allows a tax credit equal to 1.8 cents times the number of kilowatt hours of electricity produced at a qualifying advanced nuclear power facility. A taxpayer may claim no more than \$125 million per 1,000 MW of capacity. The Treasury Department may allocate up to 6,000 megawatts of credit-eligible capacity.

### Natural Resources and Environment

**35. Exploration and development costs.**—The baseline tax system allows the taxpayer to deduct the depreciation of an asset according to the decline in its economic value over time. However, certain capital outlays

associated with exploration and development of nonfuel minerals may be expensed rather than depreciated over the life of the asset.

**36. Percentage depletion.**—The baseline tax system allows the taxpayer to deduct the decline in the economic value of an investment over time. Under current law, however, most nonfuel mineral extractors may use percentage depletion (whereby the deduction is fixed as a percentage of revenue and can exceed total costs) rather than cost depletion, with percentage depletion rates ranging from 22 percent for sulfur to 5 percent for sand and gravel. Over the life of an investment, percentage depletion deductions can exceed the cost of the investment. Consequently, percentage depletion offers more generous tax treatment than would cost depletion, which would limit deductions to an investment's cost.

**37. Sewage, water, solid and hazardous waste facility bonds.**—The baseline tax system generally would tax all income under the regular tax rate schedule. It would not allow preferentially low (or zero) tax rates to apply to certain types or sources of income. In contrast, the Tax Code allows interest earned on State and local bonds used to finance construction of sewage, water, or hazardous waste facilities to be exempt from tax. These bonds are generally subject to the State private-activity-bond annual volume cap.

**38. Capital gains treatment of certain timber.**—The baseline tax system generally would tax all income under the regular tax rate schedule. It would not allow preferentially low tax rates to apply to certain types or sources of income. However, under current law certain timber sales can be treated as a capital gain rather than ordinary income and therefore subject to the lower capital-gains tax rate. For individuals in 2012, tax rates on regular income vary from 10 percent to 35 percent, depending on the taxpayer's income. In contrast, current law allows capital gains to be taxed at a preferentially low rate that is no higher than 15 percent. Beginning in 2013, the top statutory preferential tax rate on capital gains will be 20 percent.

**39. Expensing multi-period timber growing costs.**—The baseline tax system requires the taxpayer to capitalize costs associated with investment property. However, most of the production costs of growing timber may be expensed under current law rather than capitalized and deducted when the timber is sold, thereby accelerating cost recovery.

**40. Historic preservation.**—The baseline tax system would not allow credits for particular activities, investments, or industries. However, expenditures to preserve and restore certified historic structures qualify for an investment tax credit of 20 percent under current law for certified rehabilitation activities. The taxpayer's recoverable basis must be reduced by the amount of the credit. Qualified GO (Gulf Opportunity) Zone expenditures qualify for a 26 percent credit.

**41. Exclusion of gain or loss on sale or exchange of certain brownfield sites.**—In general, a tax-exempt organization must pay taxes on income from activities unrelated to its nonprofit status. The Tax Code, however,

provides a special exclusion from unrelated business taxable income of the gain or loss from the sale or exchange of certain qualifying brownfield properties.

**42. Industrial CO<sub>2</sub> capture and sequestration tax credit.**—The baseline tax system would uniformly tax all returns to investments and not allow credits for particular activities, investments, or industries. In contrast, the Tax Code allows a credit of \$20 per metric ton for qualified carbon dioxide captured at a qualified facility and disposed of in secure geological storage. In addition, the provision allows a credit of \$10 per metric ton of qualified carbon dioxide that is captured at a qualified facility and as a tertiary injectant in a qualified enhanced oil or natural gas recovery project.

**43. Deduction for endangered species recovery expenditures.**—The baseline tax system generally would tax all income under the regular tax rate schedule. It would not allow preferentially low tax rates to apply to certain types or sources of income. In contrast, under current law farmers can deduct up to 25 percent of their gross income for expenses incurred as a result of site and habitat improvement activities that will benefit endangered species on their farm land, in accordance with site specific management actions included in species recovery plans approved pursuant to the Endangered Species Act of 1973.

## Agriculture

**44. Expensing certain capital outlays.**—The baseline tax system requires the taxpayer to capitalize costs associated with investment property. However, farmers may expense certain expenditures for feed and fertilizer as well as for soil and water conservation measures as well as other capital improvements under current law.

**45. Expensing multi-period livestock and crop production costs.**—The baseline tax system requires the taxpayer to capitalize costs associated with an investment over time. However, the production of livestock and crops with a production period greater than two years (e.g., establishing orchards or constructing barns) is exempt from the uniform cost capitalization rules, thereby accelerating cost recovery.

**46. Loans forgiven solvent farmers.**—The baseline tax system requires debtors to include the amount of loan forgiveness as income or else reduce their recoverable basis in the property related to the loan. If the amount of forgiveness exceeds the basis, the excess forgiveness is taxable. However, for bankrupt debtors, the amount of loan forgiveness reduces carryover losses, unused credits, and then basis, with the remainder of the forgiven debt excluded from taxation.

**47. Capital gains treatment of certain income.**—For individuals in 2012, tax rates on regular income vary from 10 percent to 35 percent, depending on the taxpayer's income. The baseline tax system generally would tax all income under the regular tax rate schedule. It would not allow preferentially low tax rates to apply to certain types or sources of income. In contrast, current law as of December 31, 2012 allowed capital gains to be taxed at a

preferentially low rate that was no higher than 15 percent. Certain agricultural income, such as unharvested crops, qualify for taxation as capital gains rather than ordinary income, and so benefit from the preferentially low 15 percent maximum tax rate on capital gains. Under ATRA, beginning in 2013, the top statutory preferential tax rate on capital gains will be 20 percent. However, the tables do not show the changes under ATRA.

48. **Income averaging for farmers.**—The baseline tax system generally taxes all earned income each year at the rate determined by the income tax. However, taxpayers may average their taxable income from farming and fishing over the previous three years.

49. **Deferral of gain on sales of farm refiners.**—The baseline tax system generally subjects capital gains to taxes the year that they are realized. However, the Tax Code allows a taxpayer who sells stock in a farm refiner to a farmers' cooperative to defer recognition of the gain if the proceeds are re-invested in a qualified replacement property.

50. **Expensing of reforestation expenditures.**—The baseline tax system requires the taxpayer to capitalize costs associated with an investment over time. In contrast, the Tax Code provides for the expensing of the first \$10,000 in reforestation expenditures with 7-year amortization of the remaining expenses.

### Commerce and Housing

This category includes a number of tax expenditure provisions that also affect economic activity in other functional categories. For example, provisions related to investment, such as accelerated depreciation, could be classified under the energy, natural resources and environment, agriculture, or transportation categories.

51. **Credit union income exemption.**—Under the baseline tax system, corporations pay taxes on their profits under the regular tax rate schedule. It would not allow preferentially low (or zero) tax rates to apply to certain types or sources of income. However, in the Tax Code the earnings of credit unions not distributed to members as interest or dividends are exempt from the income tax.

52. **Deferral of income on life insurance and annuity contracts.**—Under the baseline tax system, individuals and corporations pay taxes on their income when it is (actually or constructively) received or accrued, depending on their method of accounting. Nevertheless, the Tax Code provides favorable tax treatment for investment income earned within qualified life insurance and annuity contracts. In general, investment income earned on qualified life insurance contracts held until death is permanently exempt from income tax. Investment income distributed prior to the death of the insured is tax-exempt to the extent that investment in the contract is overstated (because premiums paid for the cost of life insurance protection are credited to investment in the contract), while the remaining distributed amounts are tax-deferred because income is not taxed on a current basis, but is recognized only when distributed from the contract.

Investment income earned on annuities benefits from tax deferral.

53. **Small property and casualty insurance companies.**—Under the baseline tax system, corporations pay taxes on their profits under the regular tax rate schedule. It would not allow preferentially low (or zero) tax rates to apply to certain types or sources of income. Under current law, however, stock non-life insurance companies are generally exempt from tax if their gross receipts for the taxable year do not exceed \$600,000 and more than 50 percent of such gross receipts consist of premiums. Mutual non-life insurance companies are generally tax-exempt if their annual gross receipts do not exceed \$150,000 and more than 35 percent of gross receipts consist of premiums. Also, non-life insurance companies with no more than \$1.2 million of annual net premiums may elect to pay tax only on their taxable investment income.

54. **Insurance companies owned by exempt organizations.**—Under the baseline tax system, corporations pay taxes on their profits under the regular tax rate schedule. It would not allow preferentially low (or zero) tax rates to apply to certain types or sources of income. Generally the income generated by life and property and casualty insurance companies is subject to tax, albeit by special rules. Insurance operations conducted by such exempt organizations as fraternal societies, voluntary employee benefit associations, and others, however, are exempt from tax.

55. **Small life insurance company deduction.**—Under the baseline tax system, corporations pay taxes on their profits under the regular tax rate schedule. It would not allow preferentially low (or zero) tax rates to apply to certain types or sources of income. However, under current law small life insurance companies (with gross assets of less than \$500 million) can deduct 60 percent of the first \$3 million of otherwise taxable income. The deduction phases out for otherwise taxable income between \$3 million and \$15 million.

56. **Exclusion of interest spread of financial institutions.**—The baseline tax system generally would tax all income under the regular tax rate schedule. It would not allow preferentially low (or zero) tax rates to apply to certain types or sources of income. Consumers and non-profit organizations pay for some deposit-linked services, such as check cashing, by accepting a below-market interest rate on their demand deposits. If they received a market rate of interest on those deposits and paid explicit fees for the associated services, they would pay taxes on the full market rate and (unlike businesses) could not deduct the fees. The Government thus foregoes tax on the difference between the risk-free market interest rate and below-market interest rates on demand deposits, which under competitive conditions should equal the value added of deposit services.

57. **Mortgage housing bonds.**—The baseline tax system generally would tax all income under the regular tax rate schedule. It would not allow preferentially low (or zero) tax rates to apply to certain types or sources of income. In contrast, the Tax Code allows interest earned on State and local bonds used to finance homes

purchased by first-time, low-to-moderate-income buyers to be exempt. These bonds are generally subject to the State private-activity-bond annual volume cap.

**58. Rental housing bonds.**—The baseline tax system generally would tax all income under the regular tax rate schedule. It would not allow preferentially low (or zero) tax rates to apply to certain types or sources of income. In contrast, the Tax Code allows interest earned on State and local government bonds used to finance multi-family rental housing projects to be tax-exempt.

**59. Interest on owner-occupied homes.**—Under the baseline tax system, expenses incurred in earning income would be deductible. However, such expenses would not be deductible when the income or the return on an investment is not taxed. In contrast, the Tax Code allows an exclusion from a taxpayer's taxable income for the value of owner-occupied housing services and also allows the owner-occupant to deduct mortgage interest paid on his or her primary and secondary residences as an itemized non-business deduction. In general, the mortgage interest deduction is limited to interest on debt no greater than the owner's basis in the residence, and is also limited to interest on debt of no more than \$1 million. Interest on up to \$100,000 of other debt secured by a lien on a principal or second residence is also deductible, irrespective of the purpose of borrowing, provided the total debt does not exceed the fair market value of the residence. As an alternative to the deduction, holders of qualified Mortgage Credit Certificates issued by State or local governmental units or agencies may claim a tax credit equal to a proportion of their interest expense.

**60. Taxes on owner-occupied homes.**—Under the baseline tax system, expenses incurred in earning income would be deductible. However, such expenses would not be deductible when the income or the return on an investment is not taxed. In contrast, the Tax Code allows an exclusion from a taxpayer's taxable income for the value of owner-occupied housing services and also allows the owner-occupant to deduct property taxes paid on his or her primary and secondary residences.

**61. Installment sales.**—The baseline tax system generally would tax all income under the regular tax rate schedule. It would not allow preferentially low (or zero) tax rates, or deferral of tax, to apply to certain types or sources of income. Dealers in real and personal property (i.e., sellers who regularly hold property for sale or resale) cannot defer taxable income from installment sales until the receipt of the loan repayment. Nondealers (i.e., sellers of real property used in their business) are required to pay interest on deferred taxes attributable to their total installment obligations in excess of \$5 million. Only properties with sales prices exceeding \$150,000 are includable in the total. The payment of a market rate of interest eliminates the benefit of the tax deferral. The tax exemption for nondealers with total installment obligations of less than \$5 million is, therefore, a tax expenditure.

**62. Capital gains exclusion on home sales.**—The baseline tax system would not allow deductions and exemptions for certain types of income. In contrast, the Tax Code allows homeowners to exclude from gross income up

to \$250,000 (\$500,000 in the case of a married couple filing a joint return) of the capital gains from the sale of a principal residence. To qualify, the taxpayer must have owned and used the property as the taxpayer's principal residence for a total of at least two of the five years preceding the date of sale. In addition, the exclusion may not be used more than once every two years.

**63. Imputed net rental income on owner-occupied housing.**—Under the baseline tax system, the taxable income of a taxpayer who is an owner-occupant would include the implicit value of gross rental income on housing services earned on the investment in owner-occupied housing and would allow a deduction for expenses, such as interest, depreciation, property taxes, and other costs, associated with earning such rental income. In contrast, the Tax Code allows an exclusion from taxable income for the implicit gross rental income on housing services, while in certain circumstances allows a deduction for some costs associated with such income, such as for mortgage interest and property taxes.

**64. Passive loss real estate exemption.**—The baseline tax system accepts current law's general rule limiting taxpayers' ability to deduct losses from passive activities against nonpassive income (e.g., wages, interest, and dividends). Passive activities generally are defined as those in which the taxpayer does not materially participate and there are numerous additional considerations brought to bear on the determination of which activities are passive for a given taxpayer. Losses are limited in an attempt to limit tax sheltering activities. Passive losses that are unused may be carried forward and applied against future passive income.

In contrast to the general restrictions on passive losses, the Tax Code exempts owners of rental real estate activities from "passive income" limitations. The exemption is limited to \$25,000 in losses and phases out for taxpayers with income between \$100,000 and \$150,000.

**65. Low-income housing credit.**—The baseline tax system would uniformly tax all returns to investments and not allow credits for particular activities, investments, or industries. However, under current law taxpayers who invest in certain low-income housing are eligible for a tax credit. The credit rate is set so that the present value of the credit is equal to 70 percent for new construction and 30 percent for (1) housing receiving other Federal benefits (such as tax-exempt bond financing), or (2) substantially rehabilitated existing housing. The credit can exceed these levels in certain statutorily defined and State designated areas where project development costs are higher. The credit is allowed in equal amounts over 10 years and is generally subject to a volume cap.

**66. Accelerated depreciation of residential rental property.**—Under an economic income tax, the costs of acquiring a building are capitalized and depreciated over time in accordance with the decline in the property's economic value due to wear and tear or obsolescence. This insures that the net income from the rental property is measured appropriately each year. However, the depreciation provisions of the Tax Code are part of the reference

law rules, and thus do not give rise to tax expenditures under reference law. Under normal law, however, depreciation allowances reflect estimates of economic depreciation.

**67. Discharge of mortgage indebtedness.**—Under the baseline tax system, all income would generally be taxed under the regular tax rate schedule. The baseline tax system would not allow preferentially low (or zero) tax rates to apply to certain types or sources of income. In contrast, the Tax Code allows an exclusion from a taxpayer's taxable income for any discharge of indebtedness of up to \$2 million (\$1 million in the case of a married individual filing a separate return) from a qualified principal residence. The provision applies to debt discharged after January 1, 2007, and before January 1, 2013. However, ATRA extended the provision through December 31, 2013 (extension not shown in the tables.)

**68. Cancellation of indebtedness.**—The baseline tax system generally would tax all income under the regular tax rate schedule. It would not allow preferentially low (or zero) tax rates to apply to certain types or sources of income. In contrast, under current law individuals are not required to report the cancellation of certain indebtedness as current income. If the canceled debt is not reported as current income, however, the basis of the underlying property must be reduced by the amount canceled.

**69. Imputed interest rules.**—Under the baseline tax system, holders (issuers) of debt instruments are generally required to report interest earned (paid) in the period it accrues, not when paid. In addition, the amount of interest accrued is determined by the actual price paid, not by the stated principal and interest stipulated in the instrument. But under current law, and in general, any debt associated with the sale of property worth less than \$250,000 is excepted from the general interest accounting rules. This general \$250,000 exception is not a tax expenditure under reference law but is under normal law. Exceptions above \$250,000 are a tax expenditure under reference law; these exceptions include the following: (1) sales of personal residences worth more than \$250,000, and (2) sales of farms and small businesses worth between \$250,000 and \$1 million.

**70. Treatment of qualified dividends.**—The baseline tax system generally would tax all income under the regular tax rate schedule. It would not allow preferentially low tax rates to apply to certain types or sources of income. For individuals in 2012, tax rates on regular income vary from 10 percent to 35 percent, depending on the taxpayer's income. In contrast, qualified dividends were taxed at a preferentially low rate that is no higher than 15 percent. Beginning in 2013, dividends would have been once again taxed as ordinary income. However, ATRA set a permanent statutory maximum tax rate of 20 percent (change not shown in the tables.)

**71. Capital gains (other than agriculture, timber, and coal).**—The baseline tax system generally would tax all income under the regular tax rate schedule. It would not allow preferentially low tax rates to apply to certain types or sources of income. For individuals

in 2012, tax rates on regular income vary from 10 percent to 35 percent, depending on the taxpayer's income. In contrast, capital gains on assets held for more than one year were taxed at a preferentially low rate that is no higher than 15 percent. Beginning in 2013, the top statutory preferential tax rate on capital gains will be 20 percent.

**72. Capital gains exclusion for small business stock.**—The baseline tax system would not allow deductions and exemptions, or provide preferential treatment of certain sources of income or types of activities. In contrast, the Tax Code provides an exclusion of 50 percent (from a 28 percent tax rate) for capital gains from qualified small business stock held by individuals for more than 5 years; 75 percent for stock issued after February 17, 2009 and before September 28, 2010; and 100 percent for stock issued after September 27, 2010 and before January 1, 2012. A qualified small business is a corporation whose gross assets do not exceed \$50 million as of the date of issuance of the stock. ATRA extended the provision through December 31, 2013 (extension not shown in the tables).

**73. Step-up in basis of capital gains at death.**—Under the baseline tax system, unrealized capital gains would be taxed when assets are transferred at death or by gift. It would not allow for exempting gains upon transfer of the underlying assets to the heirs. In contrast, capital gains on assets held at the owner's death are not subject to capital gains tax under current law. The cost basis of the appreciated assets is adjusted to the market value at the owner's date of death which becomes the basis for the heirs.

**74. Carryover basis of capital gains on gifts.**—Under the baseline tax system, unrealized capital gains would be taxed when assets are transferred at death or by gift. In contrast, when a gift of appreciated asset is made under current law, the donor's basis in the transferred property (the cost that was incurred when the transferred property was first acquired) carries over to the donee. The carryover of the donor's basis allows a continued deferral of unrealized capital gains.

**75. Ordinary income treatment of losses from sale of small business corporate stock shares.**—The baseline tax system limits to \$3,000 the write-off of losses from capital assets, with carryover of the excess to future years. In contrast, the Tax Code allows up to \$100,000 in losses from the sale of small business corporate stock (capitalization less than \$1 million) to be treated as ordinary losses and fully deducted.

**76. Depreciation of non-rental-housing buildings.**—Under an economic income tax, the costs of acquiring a building are capitalized and depreciated over time in accordance with the decline in the property's economic value due to wear and tear or obsolescence. This insures that the net income from the property is measured appropriately each year. However, the depreciation provisions of the Tax Code are part of the reference law rules, and thus do not give rise to tax expenditures under reference law. Under normal law, however, depreciation allowances reflect estimates of economic depreciation.

**77. Accelerated depreciation of machinery and equipment.**—Under an economic income tax, the costs of acquiring machinery and equipment are capitalized and depreciated over time in accordance with the decline in the property's economic value due to wear and tear or obsolescence. This insures that the net income from the property is measured appropriately each year. However, the depreciation provisions of the Tax Code are part of the reference law rules, and thus do not give rise to tax expenditures under reference law. Under normal law, however, depreciation allowances reflect estimates of economic depreciation.

**78. Expensing of certain small investments.**—Under the reference law baseline, the costs of acquiring tangible property and computer software would be depreciated using the Tax Code's depreciation provisions. Under the normal tax baseline, depreciation allowances are estimates of economic depreciation. However, the Tax Code allows qualifying investments by small businesses in tangible property and certain computer software to be expensed rather than depreciated over time.

**79. Graduated corporation income tax rate schedule.**—Because the corporate rate schedule is part of reference tax law, it is not considered a tax expenditure under the reference method. A flat corporation income tax rate is taken as the baseline under the normal tax method; therefore the lower rate is considered a tax expenditure under this concept.

**80. Small issue industrial development bonds.**—The baseline tax system generally would tax all income under the regular tax rate schedule. It would not allow preferentially low (or zero) tax rates to apply to certain types or sources of income. In contrast, the Tax Code allows interest earned on small issue industrial development bonds (IDBs) issued by State and local governments to finance manufacturing facilities to be tax exempt. Depreciable property financed with small issue IDBs must be depreciated, however, using the straight-line method. The annual volume of small issue IDBs is subject to the unified volume cap discussed in the mortgage housing bond section above.

**81. Deduction for U.S. production activities.**—The baseline tax system generally would tax all income under the regular tax rate schedule. It would not allow preferentially low (or zero) tax rates to apply to certain types or sources of income. In contrast, the Tax Code allows for a deduction equal to a portion of taxable income attributable to domestic production.

**82. Special rules for certain film and TV production.**—The baseline tax system generally would tax all income under the regular tax rate schedule. It would not allow deductions and exemptions or preferentially low (or zero) tax rates to apply to certain types or sources of income. In contrast, under current law taxpayers may deduct up to \$15 million per production (\$20 million in certain distressed areas) in non-capital expenditures incurred during the year.

## Transportation

**83. Deferral of tax on U.S. shipping companies.**—The baseline tax system generally would tax all profits and income under the regular tax rate schedule. It would not allow preferentially low (or zero) tax rates to apply to certain types or sources of income. In contrast, the Tax Code allows certain companies that operate U.S. flag vessels to defer income taxes on that portion of their income used for shipping purposes, primarily construction, modernization and major repairs to ships, and repayment of loans to finance these investments. U.S. shipping companies may choose to be subject to a tonnage tax based on gross shipping weight in lieu of an income tax, in which case profits would not be subject to tax under the regular tax rate schedule.

**84. Exclusion of employee parking expenses.**—Under the baseline tax system, all compensation, including dedicated payments and in-kind benefits, would be included in taxable income. Dedicated payments and in-kind benefits represent accretions to wealth that do not differ materially from cash wages. In contrast, the Tax Code allows an exclusion from taxable income for employee parking expenses that are paid for by the employer or that are received by the employee in lieu of wages. In 2012, the maximum amount of the parking exclusion is \$240 per month. The tax expenditure estimate does not include any subsidy provided through employer-owned parking facilities.

**85. Exclusion of employee transit pass expenses.**—Under the baseline tax system, all compensation, including dedicated payments and in-kind benefits, would be included in taxable income. Dedicated payments and in-kind benefits represent accretions to wealth that do not differ materially from cash wages. In contrast, the Tax Code allows an exclusion from a taxpayer's taxable income for passes, tokens, fare cards, and vanpool expenses that are paid for by an employer or that are received by the employee in lieu of wages to defray an employee's commuting costs. Under current law as of December 31, 2012, the maximum amount of the transit exclusion was \$125 per month. However, ATRA extended parity of employer-provided parking and transit benefits through 2013 (retroactive through 2012), meaning that the maximum amount of transit exclusion is \$240 per month in 2012 and 2013 (extension not shown in tables.)

**86. Tax credit for certain expenditures for maintaining railroad tracks.**—The baseline tax system would not allow credits for particular activities, investments, or industries. However, under current law eligible taxpayers may claim a credit equal to the lesser of 50 percent of maintenance expenditures and the product of \$3,500 and the number of miles of track owned or leased.

**87. Exclusion of interest on bonds for financing of highway projects and rail-truck transfer facilities.**—The baseline tax system generally would tax all income under the regular tax rate schedule. It would not allow preferentially low (or zero) tax rates to apply to certain types or sources of income. In contrast, the Tax Code provides for \$15 billion of tax-exempt bond author-

ity to finance qualified highway or surface freight transfer facilities. The authority to issue these bonds expires on December 31, 2015.

### Community and Regional Development

88. **Rehabilitation of structures.**—The baseline tax system would uniformly tax all returns to investments and not allow credits for particular activities, investments, or industries. However, the Tax Code allows a 10-percent investment tax credit for the rehabilitation of buildings that are used for business or productive activities and that were erected before 1936 for other than residential purposes. The taxpayer's recoverable basis must be reduced by the amount of the credit. Qualified GO Zone expenditures qualify for a 13 percent credit.

89. **Airport, dock, and similar facility bonds.**—The baseline tax system generally would tax all income under the regular tax rate schedule. It would not allow preferentially low (or zero) tax rates to apply to certain types or sources of income. In contrast, the Tax Code allows interest earned on State and local bonds issued to finance high-speed rail facilities and Government-owned airports, docks, wharves, and sport and convention facilities to be tax-exempt. These bonds are not subject to a volume cap.

90. **Exemption of income of mutuals and cooperatives.**—Under the baseline tax system, corporations pay taxes on their profits under the regular tax rate schedule. In contrast, the Tax Code provides for the incomes of mutual and cooperative telephone and electric companies to be exempt from tax if at least 85 percent of their revenues are derived from patron service charges.

91. **Empowerment zones and renewal communities.**—The baseline tax system generally would tax all income under the regular tax rate schedule. It would not allow preferentially low (or zero) tax rates to apply to certain types or sources of income, tax credits, and write-offs faster than economic depreciation. In contrast, under current law qualifying businesses in designated economically depressed areas can receive tax benefits such as an employer wage credit, increased expensing of investment in equipment, special tax-exempt financing, accelerated depreciation, and certain capital gains incentives. A taxpayer's ability to accrue new tax benefits for Empowerment Zones and the DC Enterprise Zone expired December 31, 2011. However, ATRA extended the provision through December 31, 2013 (extension not shown in the tables).

92. **New markets tax credit.**—The baseline tax system would not allow credits for particular activities, investments, or industries. However, under current law taxpayers who make qualified equity investments in a community development entity (CDE), which then makes qualified investments in low-income communities, are eligible for a tax credit received over 7 years. A CDE must first receive an allocation of tax credit from Treasury before it can sell the tax credit to the investor in exchange for the equity investment. The total equity investment available for the credit across all CDEs is \$5 billion in 2011, the last year for which allocations can be made. However,

ATRA extended the provision for two more years (extension not shown in tables.)

93. **Expensing of environmental remediation costs.**—Under the baseline tax system, the costs would be amortized (or depreciated) over an estimate of the economic life of the building. This insures that the net income from the buildings is measured appropriately each year. However, the Tax Code allows taxpayers who clean up certain hazardous substances at a qualified site to expense the clean-up costs, even though the expenses will generally increase the value of the property significantly or appreciably prolong the life of the property.

94. **Credit to holders of Gulf and Midwest Tax Credit Bonds.**—The baseline tax system would not allow credits for particular activities, investments, or industries. Instead, under current law taxpayers that own Gulf and Midwest Tax Credit bonds receive a non-refundable tax credit rather than interest. The credit is included in gross income.

95. **Recovery Zone Bonds.**—The baseline tax system would not allow credits for particular activities, investments, or industries. In addition, it would tax all income under the regular tax rate schedule. It would not allow preferentially low (or zero) tax rates to apply to certain types or sources of income. In contrast, the Tax Code allows local governments to issue up \$10 billion in taxable Recovery Zone Economic Development Bonds in 2009 and 2010 and receive a direct payment from Treasury equal to 45 percent of interest expenses. In addition, they would be allowed to allocate up to \$15 billion in tax exempt Recovery Zone Facility Bonds. These bonds finance certain kinds of business development in areas of economic distress.

96. **Tribal Economic Development Bonds.**—The baseline tax system generally would tax all income under the regular tax rate schedule. It would not allow preferentially low (or zero) tax rates to apply to certain types or sources of income. In contrast, the Tax Code was modified in 2009 to allow Indian tribal governments to issue tax exempt "tribal economic development bonds." There is a national bond limitation of \$2 billion.

### Education, Training, Employment, and Social Services

97. **Scholarship and fellowship income.**—Scholarships and fellowships are excluded from taxable income to the extent they pay for tuition and course-related expenses of the grantee. Similarly, tuition reductions for employees of educational institutions and their families are not included in taxable income. From an economic point of view, scholarships and fellowships are either gifts not conditioned on the performance of services, or they are rebates of educational costs. Thus, under the baseline tax system of the reference law method, this exclusion is not a tax expenditure because this method does not include either gifts or price reductions in a taxpayer's gross income. The exclusion, however, is considered a tax expenditure under the normal tax method, which includes gift-like transfers of Government funds in gross income

(many scholarships are derived directly or indirectly from Government funding).

**98. HOPE tax credit.**—The baseline tax system would not allow credits for particular activities, investments, or industries. Under current law, however, the non-refundable HOPE tax credit allows a credit for 100 percent of an eligible student's first \$1,200 of tuition and fees and 50 percent of the next \$1,200 of tuition and fees. The credit only covers tuition and fees paid during the first two years of a student's post-secondary education. In 2012, the credit is phased out ratably for taxpayers with modified AGI between \$104,000 and \$124,000 if married filing jointly (\$52,000 and \$62,000 for other taxpayers), indexed.

**99. Lifetime Learning tax credit.**—The baseline tax system would not allow credits for particular activities, investments, or industries. Under current law, however, the non-refundable Lifetime Learning tax credit allows a credit for 20 percent of an eligible student's tuition and fees, up to a maximum credit per return of \$2,000. In 2012, the credit is phased out ratably for taxpayers with modified AGI between \$104,000 and \$124,000 if married filing jointly (\$52,000 and \$62,000 for other taxpayers), indexed. The credit applies to both undergraduate and graduate students.

**100. American Opportunity Tax Credit.**—The baseline tax system would not allow credits for particular activities, investments, or industries. Under current law in 2012, however, the American Opportunity tax credit allows a partially refundable credit of up to \$2,500 per eligible student for qualified tuition and related expenses paid during each of the first four years of the student's post-secondary education. The credit is phased out for taxpayers with modified adjusted gross income between \$80,000 and \$90,000 (\$160,000 and \$180,000 for married taxpayers filing a joint return). The credit expired at the end of 2012, but was extended for five years under ATRA (extension not shown in tables.)

**101. Education Individual Retirement Accounts (IRA).**—The baseline tax system generally would tax all income under the regular tax rate schedule. It would not allow preferentially low (or zero) tax rates to apply to certain types or sources of income. While contributions to an education IRA are not tax-deductible under current law, investment income earned by education IRAs is not taxed when earned, and investment income from an education IRA is tax-exempt when withdrawn to pay for a student's education expenses. The maximum contribution to an education IRA in 2012 is \$2,000 per beneficiary. In 2012, the maximum contribution is phased down ratably for taxpayers with modified AGI between \$190,000 and \$220,000 if married filing jointly (\$95,000 and \$110,000 for other taxpayers).

**102. Student-loan interest.**—The baseline tax system accepts current law's general rule limiting taxpayers' ability to deduct non-business interest expenses. In contrast, taxpayers may claim an above-the-line deduction of up to \$2,500 on interest paid on an education loan. In general, interest may only be deducted for the first five years in which interest payments are required, and the

maximum deduction is phased down ratably for taxpayers with modified AGI between \$60,000 and \$75,000 if married filing jointly (\$40,000 to \$55,000 for other taxpayers), indexed from 2001. However, for tax years beginning on January 1, 2001 and before December 31, 2011, the first five year requirement is suspended, and the phase down range for the deduction is raised. In 2012, the maximum deduction is phased down ratably for taxpayers with modified AGI between \$125,000 and \$155,000 if married filing jointly (\$60,000 and \$75,000 for other taxpayers).

**103. Deduction for higher education expenses.**—The baseline tax system would not allow a deduction for personal expenditures. In contrast, the Tax Code provides a maximum annual deduction of \$4,000 in 2011 for qualified higher education expenses for taxpayers with adjusted gross income up to \$130,000 on a joint return (\$65,000 for other taxpayers). Taxpayers with adjusted gross income up to \$160,000 on a joint return (\$80,000 for other taxpayers) may deduct up to \$2,000. This provision expired on December 31, 2011. However, ATRA extended the provision through December 2013 (extension not shown in the tables.)

**104. Qualified tuition programs.**—The baseline tax system generally would tax all income under the regular tax rate schedule. It would not allow preferentially low (or zero) tax rates to apply to certain types or sources of income. Some States have adopted prepaid tuition plans prepaid room and board plans, and college savings plans, which allow persons to pay in advance or save for college expenses for designated beneficiaries. Under current law, investment income, or the return on prepayments, is not taxed when earned, and is tax-exempt when withdrawn to pay for qualified expenses.

**105. Student-loan bonds.**—The baseline tax system generally would tax all income under the regular tax rate schedule. It would not allow preferentially low (or zero) tax rates to apply to certain types or sources of income. In contrast, interest earned on State and local bonds issued to finance student loans is tax-exempt under current law. The volume of all such private activity bonds that each State may issue annually is limited.

**106. Bonds for private nonprofit educational institutions.**—The baseline tax system generally would tax all income under the regular tax rate schedule. It would not allow preferentially low (or zero) tax rates to apply to certain types or sources of income. In contrast, under current law interest earned on State and local Government bonds issued to finance the construction of facilities used by private nonprofit educational institutions is not taxed.

**107. Credit for holders of zone academy bonds.**—The baseline tax system would not allow credits for particular activities, investments, or industries. Under current law, however, financial institutions that own zone academy bonds receive a non-refundable tax credit rather than interest. The credit is included in gross income. Proceeds from zone academy bonds may only be used to renovate, but not construct, qualifying schools and for certain other school purposes. Under current law, the total amount of zone academy bonds that may be issued is limited to \$1.4 billion in 2009 and 2010. As of March 2010, issuers of the

unused authorization of such bonds could opt to receive direct payment with the yield becoming fully taxable. An additional \$0.4 billion of these bonds with a tax credit was authorized to be issued before January 1, 2011. However, ATRA extended the provision through December 31, 2013 (extension not shown in the tables).

108. **U.S. savings bonds for education.**—The baseline tax system generally would tax all income under the regular tax rate schedule. It would not allow preferentially low (or zero) tax rates to apply to certain types or sources of income. Under current law, however, interest earned on U.S. savings bonds issued after December 31, 1989 is tax-exempt if the bonds are transferred to an educational institution to pay for educational expenses. The tax exemption is phased out for taxpayers with AGI between \$109,250 and \$139,250 if married filing jointly (\$72,850 and \$87,850 for other taxpayers) in 2012.

109. **Dependent students age 19 or older.**—Under the baseline tax system, a personal exemption for the taxpayer is allowed. However, additional exemptions for targeted groups within a given filing status would not be allowed. In contrast, the Tax Code allows taxpayers to claim personal exemptions for dependent children who are over the age of 18 and under the age of 24 and who (1) reside with the taxpayer for over half the year (with exceptions for temporary absences from home, such as for school attendance), (2) are full-time students, and (3) do not claim a personal exemption on their own tax returns.

110. **Charitable contributions to educational institutions.**—The baseline tax system would not allow a deduction for personal expenditures. In contrast, the Tax Code provides taxpayers a deduction for contributions to nonprofit educational institutions. Moreover, taxpayers who donate capital assets to educational institutions can deduct the asset's current value without being taxed on any appreciation in value. An individual's total charitable contribution generally may not exceed 50 percent of adjusted gross income; a corporation's total charitable contributions generally may not exceed 10 percent of pre-tax income.

111. **Employer-provided educational assistance.**—Under the baseline tax system, all compensation, including dedicated payments and in-kind benefits, should be included in taxable income because they represent accretions to wealth that do not materially differ from cash wages. Under current law, however, employer-provided educational assistance is excluded from an employee's gross income even though the employer's costs for this assistance are a deductible business expense. The maximum exclusion is \$5,250 per taxpayer.

112. **Special deduction for teacher expenses.**—The baseline tax system would not allow a deduction for personal expenditures. In contrast, under current law educators in both public and private elementary and secondary schools, who work at least 900 hours during a school year as a teacher, instructor, counselor, principal or aide, may subtract up to \$250 of qualified expenses when figuring their adjusted gross income (AGI). This provision expired on December 31, 2011. However, ATRA extended

the provision through December 31, 2013 (extension not shown in the tables.)

113. **Discharge of student loan indebtedness.**—Under the baseline tax system, all compensation, including dedicated payments and in-kind benefits, should be included in taxable income. In contrast, the Tax Code allows certain professionals who perform in underserved areas or specific fields, and as a consequence have their student loans discharged, not to recognize such discharge as income.

114. **Qualified school construction bonds.**—The baseline tax system would not allow credits for particular activities, investments, or industries. Instead, it generally would seek to tax uniformly all returns from investment-like activities. In contrast, the Tax Code was modified in 2009 to provide a tax credit in lieu of interest to holders of qualified school construction bonds. The national volume limit is \$22.4 billion over 2009 and 2010. As of March 2010, issuers of such bonds could opt to receive direct payment with the yield becoming fully taxable.

115. **Work opportunity tax credit (WOTC).**—The baseline tax system would not allow credits for particular activities, investments, or industries. Instead, it generally would seek to tax uniformly all returns from investment-like activities. In contrast, the Tax Code provides employers with a tax credit for qualified wages paid to individuals. The credit applies to employees who begin work on or before December 31, 2011 and who are certified as members of various targeted groups. The amount of the credit that can be claimed is 25 percent of qualified wages for employment less than 400 hours and 40 percent for employment of 400 hours or more. Generally, the maximum credit per employee is \$2,400 and can only be claimed on the first year of wages an individual earns from an employer. However, the credit for long-term welfare recipients can be claimed on second year wages as well and has a \$9,000 maximum. Employees must work at least 120 hours to be eligible for the credit. Employers must reduce their deduction for wages paid by the amount of the credit claimed. The credit was extended to certain recently discharged unemployed veterans through December 31, 2012 with a maximum credit of \$9,600 for hiring eligible veterans. ATRA extended the provision through December 31, 2013 (extension not shown in the tables).

116. **Employer-provided child care exclusion.**—Under the baseline tax system, all compensation, including dedicated payments and in-kind benefits, should be included in taxable income. In contrast, under current law up to \$5,000 of employer-provided child care is excluded from an employee's gross income even though the employer's costs for the child care are a deductible business expense.

117. **Employer-provided child care credit.**—The baseline tax system would not allow credits for particular activities, investments, or industries. Instead, current law provides a credit equal to 25 percent of qualified expenses for employee child care and 10 percent of qualified expenses for child care resource and referral services. Employer deductions for such expenses are reduced by

the amount of the credit. The maximum total credit is limited to \$150,000 per taxable year.

118. **Assistance for adopted foster children.**—Under the baseline tax system, all compensation, including dedicated payments and in-kind benefits, should be included in taxable income. Taxpayers who adopt eligible children from the public foster care system can receive monthly payments for the children's significant and varied needs and a reimbursement of up to \$2,000 for non-recurring adoption expenses; special needs adoptions receive the maximum benefit even if that amount not spent. These payments are excluded from gross income under current law.

119. **Adoption credit and exclusion.**—The baseline tax system would not allow credits for particular activities. Instead, taxpayers can receive a tax credit for qualified adoption expenses under current law. The maximum credit is \$12,650 per child for 2012, and is phased-out ratably for taxpayers with modified AGI between \$189,710 and \$229,710. The credit amounts and the phase-out thresholds are indexed for inflation. Taxpayers may also exclude qualified adoption expenses provided or reimbursed by an employer from income, subject to the same maximum amounts and phase-out as the credit. The same expenses cannot qualify for tax benefits under both programs; however, a taxpayer may use the benefits of the exclusion and the tax credit for different expenses.

120. **Employer-provided meals and lodging.**—Under the baseline tax system, all compensation, including dedicated payments and in-kind benefits, should be included in taxable income. In contrast, under current law employer-provided meals and lodging are excluded from an employee's gross income even though the employer's costs for these items are a deductible business expense.

121. **Child credit.**—The baseline tax system would not allow credits for particular activities or targeted at specific groups. Under current law, however, taxpayers with children under age 17 can qualify for a \$1,000 partially refundable per child credit. Any unclaimed credit due to insufficient tax liability may be refundable – taxpayers may claim a refund for 15 percent of earnings in excess of a \$3,000 floor, up to the amount of unused credit. Alternatively, taxpayers with three or more children may claim a refund of the amount of payroll taxes paid in excess of EITC received (up to the amount of unused credit) if this results in a larger refund. The credit is phased out for taxpayers at the rate of \$50 per \$1,000 of modified AGI above \$110,000 (\$75,000 for single or head of household filers and \$55,000 for married taxpayers filing separately). The maximum credit had been scheduled to decline to \$500 in 2013 under current law as of December 31 2012, but ATRA made the \$1,000 maximum credit permanent. However, the tables do not show the changes under ATRA.

122. **Child and dependent care expenses.**—The baseline tax system would not allow credits for particular activities or targeted at specific groups. In contrast, the Tax Code provides parents who work or attend school and who have child and dependent care expenses a tax credit. In 2012, expenditures up to a maximum \$3,000 for one dependent and \$6,000 for two or more dependents are

eligible for the credit. The credit is equal to 35 percent of qualified expenditures for taxpayers with incomes of \$15,000. The credit is reduced to a minimum of 20 percent by one percentage point for each \$2,000 of income in excess of \$15,000.

123. **Disabled access expenditure credit.**—The baseline tax system would not allow credits for particular activities, investments, or industries. In contrast, the Tax Code provides small businesses (less than \$1 million in gross receipts or fewer than 31 full-time employees) a 50-percent credit for expenditures in excess of \$250 to remove access barriers for disabled persons. The credit is limited to \$5,000.

124. **Charitable contributions, other than education and health.**—The baseline tax system would not allow a deduction for personal expenditures. In contrast, the Tax Code provides taxpayers a deduction for contributions to charitable, religious, and certain other nonprofit organizations. Taxpayers who donate capital assets to charitable organizations can deduct the assets' current value without being taxed on any appreciation in value. An individual's total charitable contribution generally may not exceed 50 percent of adjusted gross income; a corporation's total charitable contributions generally may not exceed 10 percent of pre-tax income.

125. **Foster care payments.**—The baseline tax system generally would tax all income under the regular tax rate schedule. It would not allow preferentially low (or zero) tax rates to apply to certain types or sources of income. Foster parents provide a home and care for children who are wards of the State, under contract with the State. However, compensation received for this service is excluded from the gross incomes of foster parents; the expenses they incur are nondeductible.

126. **Parsonage allowances.**—Under the baseline tax system, all compensation, including dedicated payments and in-kind benefits, would be included in taxable income. Dedicated payments and in-kind benefits represent accretions to wealth that do not differ materially from cash wages. In contrast, the Tax Code allows an exclusion from a clergyman's taxable income for the value of the clergyman's housing allowance or the rental value of the clergyman's parsonage.

127. **Provide an employee retention credit to employers affected by certain natural disasters.** -- The baseline tax system would not allow credits for particular activities, investments, or industries. In contrast, the Tax Code provides tax credits against the wages paid to eligible employees in selected areas affected by natural disasters such as hurricanes Katrina, Rita, Wilma, and Ike.

## Health

128. **Employer-paid medical insurance and expenses.**—Under the baseline tax system, all compensation, including dedicated payments and in-kind benefits, should be included in taxable income. In contrast, under current law, employer-paid health insurance premiums and other medical expenses (including long-term care)

are deducted as a business expense by employers, but they are not included in employee gross income.

**129. Self-employed medical insurance premiums.**—Under the baseline tax system, all compensation and remuneration, including dedicated payments and in-kind benefits, should be included in taxable income. In contrast, under current law self-employed taxpayers may deduct their family health insurance premiums. Taxpayers without self-employment income are not eligible for this special deduction. The deduction is not available for any month in which the self-employed individual is eligible to participate in an employer-subsidized health plan and the deduction may not exceed the self-employed individual's earned income from self-employment.

**130. Medical and health savings accounts.**—Under the baseline tax system, all compensation, including dedicated payments and in-kind benefits, should be included in taxable income. Also, the baseline tax system would not allow a deduction for personal expenditures. In contrast, individual contributions to Archer Medical Savings Accounts (Archer MSAs) and Health Savings Accounts (HSAs) are allowed as a deduction in determining adjusted gross income whether or not the individual itemizes deductions. Employer contributions to Archer MSAs and HSAs are excluded from income and employment taxes. Archer MSAs and HSAs require that the individual have coverage by a qualifying high deductible health plan. Earnings from the accounts are excluded from taxable income. Distributions from the accounts used for medical expenses are not taxable. The rules for HSAs are generally more flexible than for Archer MSAs and the deductible contribution amounts are greater (in 2012, \$3,100 for taxpayers with individual coverage and \$6,250 for taxpayers with family coverage). Thus, HSAs have largely replaced MSAs.

**131. Medical care expenses.**—The baseline tax system would not allow a deduction for personal expenditures. In contrast, under current law personal expenditures for medical care (including the costs of prescription drugs) exceeding 7.5 percent of the taxpayer's adjusted gross income are deductible. For tax years beginning after 2012, only medical expenditures exceeding 10 percent of the taxpayer's adjusted gross income are deductible. However, for the years 2013, 2014, 2015 and 2016, if either the taxpayer or the taxpayer's spouse turns 65 before the end of the taxable year, the threshold remains at 7.5 percent of adjusted income.

**132. Hospital construction bonds.**—The baseline tax system generally would tax all income under the regular tax rate schedule. It would not allow preferentially low (or zero) tax rates to apply to certain types or sources of income. In contrast, under current law interest earned on State and local government debt issued to finance hospital construction is excluded from income subject to tax.

**133. Refundable Premium Assistance Tax Credit.**—The baseline tax system would not allow credits for particular activities or targeted at specific groups. In contrast, for taxable years ending after 2013, the Tax Code provides a premium assistance credit to any eligible taxpayer for any qualified health insurance purchased

through a Health Insurance Exchange. In general, an eligible taxpayer is a taxpayer with annual household income between 100% and 400% of the federal poverty level for a family of the taxpayer's size and that does not have access to affordable minimum essential health care coverage. The amount of the credit equals the lesser of (i) the actual premiums paid by the taxpayer for such coverage or (ii) the difference between the cost of a statutorily-identified benchmark plan offered on the exchange and a required payment by the taxpayer that increases with income.

**134. Credit for employee health insurance expenses of small business.**—The baseline tax system would not allow credits for particular activities or targeted at specific groups. In contrast, the Tax Code provides a tax credit to qualified small employers that make a certain level of non-elective contributions towards the purchase of certain health insurance coverage for its employees. To receive a credit, an employer must have fewer than 25 full-time-equivalent employees whose average annual full-time-equivalent wages from the employer are less than \$50,000 (indexed for taxable years after 2013). However, to receive a full credit, an employer must have no more than 10 full-time employees, and the average wage paid to these employees must be no more than \$25,000 (indexed for taxable years after 2013). A qualifying employer may claim the credit for any taxable year beginning in 2010, 2011, 2012, and 2013 and for up to two years for insurance purchased through a Health Insurance Exchange thereafter. For taxable beginning in 2010, 2011, 2012, and 2013, the maximum credit is 35 percent of premiums paid by qualified taxable employers and 25 percent of premiums paid by qualified tax-exempt organizations. For taxable years beginning in 2014 and later years, the maximum tax credit will increase to 50 percent of premiums paid by qualified taxable employers and 35 percent of premiums paid by qualified tax-exempt organizations.

**135. Charitable contributions to health institutions.**—The baseline tax system would not allow a deduction for personal expenditures. In contrast, the Tax Code provides individuals and corporations a deduction for contributions to nonprofit health institutions. Tax expenditures resulting from the deductibility of contributions to other charitable institutions are listed under the education, training, employment, and social services function.

**136. Orphan drugs.**—The baseline tax system would not allow credits for particular activities, investments, or industries. In contrast, under current law drug firms can claim a tax credit of 50 percent of the costs for clinical testing required by the Food and Drug Administration for drugs that treat rare physical conditions or rare diseases.

**137. Blue Cross and Blue Shield.**—The baseline tax system generally would tax all profits under the regular tax rate schedule. It would not allow preferentially low tax rates to apply to certain types or sources of income. In contrast, Blue Cross and Blue Shield health insurance providers in existence on August 16, 1986 and certain other nonprofit health insurers are provided exceptions from otherwise applicable insurance company income tax

accounting rules that substantially reduce their tax liabilities, provided that their percentage of total premium revenue expended on reimbursement for clinical services provided to enrollees is not less than 85 percent for the taxable year.

138. **Tax credit for health insurance purchased by certain displaced and retired individuals.**—The baseline tax system would not allow credits for particular activities, investments, or industries. In contrast, the Trade Act of 2002 provides a refundable tax credit of 65 percent for the purchase of health insurance coverage by individuals eligible for Trade Adjustment Assistance and certain Pension Benefit Guarantee Corporation pension recipients. The American Recovery and Reinvestment Act and a subsequent extension increased the credit to 80 percent in coverage months preceding March 2011. The Trade Adjustment Assistance Extension Act of 2011 extended an enhanced credit of 72.5% through December 2013, but eliminated the credit entirely beginning January 1, 2014.

139. **Distributions for premiums for health and long-term care insurance.**—Under the baseline tax system, all compensation, including dedicated and deferred payments, should be included in taxable income. In contrast, the Tax Code provides for tax-free distributions of up to \$3,000 from governmental retirement plans for premiums for health and long term care premiums of public safety officers.

### Income Security

140. **Railroad retirement benefits.**—Under the baseline tax system, all compensation, including dedicated and deferred payments, should be included in taxable income. In contrast, railroad retirement benefits are not generally subject to the income tax unless the recipient's gross income reaches a certain threshold under current law. The threshold is discussed more fully under the Social Security function.

141. **Workers' compensation benefits.**—Under the baseline tax system, all compensation, including dedicated payments and in-kind benefits, should be included in taxable income. However, workers compensation is not subject to the income tax under current law.

142. **Public assistance benefits.**—Under the reference law baseline tax system, gifts and transfers are not treated as income to the recipients. In contrast, the normal tax method considers cash transfers from the Government as part of the recipients' income, and thus, treats the exclusion for public assistance benefits under current law as a tax expenditure.

143. **Special benefits for disabled coal miners.**—Under the baseline tax system, all compensation, including dedicated payments and in-kind benefits, should be included in taxable income. However, disability payments to former coal miners out of the Black Lung Trust Fund, although income to the recipient, are not subject to the income tax.

144. **Military disability pensions.**—Under the baseline tax system, all compensation, including dedicat-

ed payments and in-kind benefits, should be included in taxable income. In contrast, most of the military pension income received by current disabled retired veterans is excluded from their income subject to tax.

145. **Defined benefit employer plans.**—Under the baseline tax system, all compensation, including deferred and dedicated payments, should be included in taxable income. In contrast, under current law certain contributions to defined benefit pension plans are excluded from an employee's gross income even though employers can deduct their contributions. In addition, the tax on the investment income earned by defined benefit pension plans is deferred until the money is withdrawn.

146. **Defined contribution employer plans.**—Under the baseline tax system, all compensation, including deferred and dedicated payments, should be included in taxable income. In contrast, under current law individual taxpayers and employers can make tax-preferred contributions to employer-provided 401(k) and similar plans (e.g. 403(b) plans and the Federal Government's Thrift Savings Plan). In 2012, an employee could exclude up to \$17,000 (indexed) of wages from AGI under a qualified arrangement with an employer's 401(k) plan. Employees age 50 or over could exclude up to \$22,500 in contributions (indexed). The defined contribution plan limit, including both employee and employer contributions, is \$50,000 in 2012 (indexed). The tax on contributions made by both employees and employers and the investment income earned by these plans is deferred until withdrawn.

147. **Individual Retirement Accounts (IRAs).**—Under the baseline tax system, all compensation, including deferred and dedicated payments, should be included in taxable income. In contrast, under current law individual taxpayers can take advantage of traditional and Roth IRAs to defer or otherwise reduce the tax on the return to their retirement savings. The IRA contribution limit is \$5,000 in 2012 (indexed); taxpayers age 50 or over are allowed to make additional "catch-up" contributions of \$1,000. Contributions to a traditional IRA are generally deductible but the deduction is phased out for workers with incomes above certain levels who, or whose spouses, are active participants in an employer-provided retirement plan. Contributions and account earnings are includible in income when withdrawn from traditional IRAs. Roth IRA contributions are not deductible, but earnings and withdrawals are exempt from taxation. Income limits also apply to Roth IRA contributions.

148. **Low and moderate-income savers' credit.**—The baseline tax system would not allow credits for particular activities or targeted at specific groups. In contrast, the Tax Code provides an additional incentive for lower-income taxpayers to save through a nonrefundable credit of up to 50 percent on IRA and other retirement contributions of up to \$2,000. This credit is in addition to any deduction or exclusion. The credit is completely phased out by \$57,500 for joint filers, \$43,125 for head of household filers, and \$28,750 for other filers in 2012.

149. **Self-Employed plans.**—Under the baseline tax system, all compensation, including deferred and dedicated payments, should be included in taxable income.

In contrast, under current law self-employed individuals can make deductible contributions to their own retirement plans equal to 25 percent of their income, up to a maximum of \$50,000 in 2012. Total plan contributions are limited to 25 percent of a firm's total wages. The tax on the investment income earned by self-employed SEP, SIMPLE, and qualified plans is deferred until withdrawn.

**150. Employer-provided life insurance benefits.**—Under the baseline tax system, all compensation, including deferred and dedicated payments, should be included in taxable income. In contrast, under current law employer-provided life insurance benefits are excluded from an employee's gross income even though the employer's costs for the insurance are a deductible business expense, but only to the extent that the employer's share of the total costs does not exceed the cost of \$50,000 of such insurance.

**151. Employer-provided accident and disability benefits.**—Under the baseline tax system, all compensation, including dedicated payments and in-kind benefits, should be included in taxable income. In contrast, and under current law, employer-provided accident and disability benefits are excluded from an employee's gross income even though the employer's costs for the benefits are a deductible business expense.

**152. Employer-provided supplementary unemployment benefits.**—Under the baseline tax system, all compensation, including dedicated payments and in-kind benefits, should be included in taxable income. Employers may establish trusts to pay supplemental unemployment benefits to employees separated from employment. Investment income earned by such trusts is exempt from taxation.

**153. Employer Stock Ownership Plan (ESOP) provisions.**—ESOPs are a special type of tax-exempt employee benefit plan. Under the baseline tax system, all compensation, including dedicated payments and in-kind benefits, should be included in taxable income. In contrast, employer-paid contributions (the value of stock issued to the ESOP) are deductible by the employer as part of employee compensation costs. They are not included in the employees' gross income for tax purposes, however, until they are paid out as benefits. In addition, the following special income tax provisions for ESOPs are intended to increase ownership of corporations by their employees: (1) annual employer contributions are subject to less restrictive limitations than other qualified retirement plans; (2) ESOPs may borrow to purchase employer stock, guaranteed by their agreement with the employer that the debt will be serviced by his payment (deductible by him) of a portion of wages (excludable by the employees) to service the loan; (3) employees who sell appreciated company stock to the ESOP may defer any taxes due until they withdraw benefits; and (4) dividends paid to ESOP-held stock are deductible by the employer.

**154. Additional deduction for the blind.**—Under the baseline tax system, the standard deduction is allowed. An additional standard deductions for targeted

groups within a given filing status would not be allowed. In contrast, the Tax Code allows taxpayers who are blind to claim an additional \$1,450 standard deduction if single, or \$1,150 if married in 2012.

**155. Additional deduction for the elderly.**—Under the baseline tax system, the standard deduction is allowed. An additional standard deductions for targeted groups within a given filing status would not be allowed. In contrast, the Tax Code allows taxpayers who are 65 years or older to claim an additional \$1,450 standard deduction if single, or \$1,150 if married in 2012.

**156. Tax credit for the elderly and disabled.**—Under the baseline tax system, a credit targeted at a specific group within a given filing status or for particular activities would not be allowed. In contrast, the Tax Code allows taxpayers who are 65 years of age or older, or who are permanently disabled, to claim a tax credit equal to 15 percent of the sum of their earned and retirement income. The amount to which the 15 percent rate is applied is limited to no more than \$5,000 for single individuals or married couples filing a joint return where only one spouse is 65 years of age or older and disabled, and up to \$7,500 for joint returns where both spouses are 65 years of age or older and disabled. These limits are reduced by one-half of the taxpayer's adjusted gross income over \$7,500 for single individuals and \$10,000 for married couples filing a joint return.

**157. Casualty losses.**—Under the baseline tax system, neither the purchase of property nor insurance premiums to protect its value are deductible as costs of earning income. Therefore, reimbursement for insured loss of such property is not included as a part of gross income, and uninsured losses are not deductible. In contrast, the Tax Code provides a deduction for uninsured casualty and theft losses of more than \$100 each, to the extent that total losses during the year exceed 10 percent of the taxpayer's adjusted gross income.

**158. Earned income tax credit (EITC).**—The baseline tax system would not allow credits for particular activities or targeted at specific groups. In contrast, the Tax Code provides an EITC to low-income workers at a maximum rate of 45 percent of income. For a family with one qualifying child, the credit is 34 percent of the first \$9,320 of earned income in 2012. The credit is 40 percent of the first \$13,090 of income for a family with two qualifying children, and it is 45 percent of the first \$13,090 of income for a family with three or more qualifying children. Low-income workers with no qualifying children are eligible for a 7.65 percent credit on the first \$6,210 of earned income. The credit is phased out at income levels and rates which depend upon how many qualifying children are eligible and marital status. Earned income tax credits in excess of tax liabilities owed through the individual income tax system are refundable to individuals. After 2012, the additional benefit for families with three or more children was to be eliminated. However, ATRA permanently extended this provision (extension not shown in the tables).

## Social Security

159. **Social Security benefits for retired workers.**—Under the baseline tax system, all compensation, including dedicated payments and in-kind benefits, would be included in taxable income because they represent accretions to wealth that do not materially differ from cash wages. Thus, the portion of Social Security benefits that is attributable to employer contributions and earnings on employer and employee contributions (and not attributable to employee contributions) would be subject to tax. In contrast, the Tax Code may not tax all of the Social Security benefits that exceed the beneficiary's contributions from previously taxed income. Actuarially, previously taxed contributions generally do not exceed 15 percent of benefits, even for retirees receiving the highest levels of benefits. Up to 85 percent of recipients' Social Security and tier 1 railroad retirement benefits are included in (phased into) the income tax base if the recipient's provisional income exceeds certain base amounts. (Provisional income is equal to other items included in adjusted gross income plus foreign or U.S. possession income, tax-exempt interest, and one half of Social Security and tier 1 railroad retirement benefits.) The untaxed portion of the benefits received by taxpayers who are below the income amounts at which 85 percent of the benefits are taxable is counted as a tax expenditure.

160. **Social Security benefits for the disabled.**—Under the baseline tax system, all compensation, including dedicated payments and in-kind benefits, should be included in taxable income because they represent accretions to wealth that do not materially differ from cash wages. Under current law, however, benefit payments from the Social Security Trust Fund for disability are fully or partially excluded from a beneficiary's gross incomes. (See provision number 161, Social Security benefits for retired workers.)

161. **Social Security benefits for dependents and survivors.**—Under the baseline tax system, all compensation, including dedicated payments and in-kind benefits, should be included in taxable income because they represent accretions to wealth that do not materially differ from cash wages. Under current law, however, benefit payments from the Social Security Trust Fund for dependents and survivors are fully or partially excluded from a beneficiary's gross income.

## Veterans Benefits and Services

162. **Veterans death benefits and disability compensation.**—Under the baseline tax system, all compensation, including dedicated payments and in-kind benefits, should be included in taxable income because they represent accretions to wealth that do not materially differ from cash wages. In contrast, all compensation due to death or disability paid by the Veterans Administration is excluded from taxable income under current law.

163. **Veterans pension payments.**—Under the baseline tax system, all compensation, including dedicated payments and in-kind benefits, should be included in taxable income because they represent accretions to wealth that

do not materially differ from cash wages. Under current law, however, pension payments made by the Veterans Administration are excluded from gross income.

164. **G.I. Bill benefits.**—Under the baseline tax system, all compensation, including dedicated payments and in-kind benefits, should be included in taxable income because they represent accretions to wealth that do not materially differ from cash wages. Under current law, however, G.I. Bill benefits paid by the Veterans Administration are excluded from gross income.

165. **Tax-exempt mortgage bonds for veterans.**—The baseline tax system generally would tax all income under the regular tax rate schedule. It would not allow preferentially low (or zero) tax rates to apply to certain types or sources of income. In contrast, under current law, interest earned on general obligation bonds issued by State and local governments to finance housing for veterans is excluded from taxable income.

## General Government

166. **Public purpose State and local bonds.**—The baseline tax system generally would tax all income under the regular tax rate schedule. It would not allow preferentially low (or zero) tax rates to apply to certain types or sources of income. In contrast, under current law interest earned on State and local government bonds issued to finance public-purpose construction (e.g., schools, roads, sewers), equipment acquisition, and other public purposes is tax-exempt. Interest on bonds issued by Indian tribal governments for essential governmental purposes is also tax-exempt.

167. **Build America Bonds.**—The baseline tax system would not allow credits for particular activities or targeted at specific group. In contrast, the Tax Code in 2009 allowed State and local governments to issue taxable bonds through 2010 and receive a direct payment from Treasury equal to 35 percent of interest expenses. Alternatively, State and local governments may issue taxable bonds and the private lenders receive the 35 percent credit which is included in taxable income.

168. **Deductibility of certain nonbusiness State and local taxes.**—Under the baseline tax system, a deduction for personal consumption expenditures would not be allowed. In contrast, the Tax Code allows taxpayers who itemize their deductions to claim a deduction for State and local income taxes (or, at the taxpayer's election, state and local sales taxes) and property taxes, even though these taxes primarily pay for services that, if purchased directly by taxpayers, would not be deductible. ATRA extended the provision through December 31, 2013 (extension not shown in the tables.)

## Interest

169. **U.S. savings bonds.**—The baseline tax system would uniformly tax all returns to investments and not allow an exemption or deferral for particular activities, investments, or industries. In contrast, taxpayers may defer paying tax on interest earned on U.S. savings bonds until the bonds are redeemed.

## APPENDIX

### Performance Measures and the Economic Effects of Tax Expenditures

The Government Performance and Results Act of 1993 (GPRA) directs Federal agencies to develop annual and strategic plans for their programs and activities. These plans set out performance objectives to be achieved over a specific time period. Most of these objectives are achieved through direct expenditure programs. Tax expenditures – spending programs implemented through the tax code by reducing tax obligations for certain activities -- contribute to achieving these goals in a manner similar to direct expenditure programs.

Tax expenditures by definition work through the tax system and, particularly, the income tax. Thus, they may be relatively advantageous policy approaches when the benefit or incentive is related to income and is intended to be widely available.<sup>4</sup> Because there is an existing public administrative and private compliance structure for the tax system, income based programs that require little oversight might be efficiently run through the tax system. In addition, some tax expenditures actually simplify the operation of the tax system (for example, the exclusion for up to \$500,000 of capital gains on home sales). Tax expenditures also implicitly subsidize certain activities in a manner similar to direct expenditures. For example, exempting employer-sponsored health insurance from income taxation is equivalent to a direct spending subsidy equal to the forgone tax obligations for this type of compensation. Spending, regulatory or tax-disincentive policies can also modify behavior, but may have different economic effects. Finally, a variety of tax expenditure tools can be used, e.g., deductions; credits; exemptions; deferrals; floors; ceilings; phase-ins; phase-outs; and these can be dependent on income, expenses, or demographic characteristics (age, number of family members, etc.). This wide range of policy instruments means that tax expenditures can be flexible and can have very different economic effects.

Tax expenditures also have limitations. In many cases they add to the complexity of the tax system, which raises both administrative and compliance costs. For example, personal exemptions, deductions, credits, and phase-outs can complicate filing and decision-making. The income tax system may have little or no contact with persons who have no or very low incomes, and does not require information on certain characteristics of individuals used in some spending programs, such as wealth or duration of employment. These features may reduce the effectiveness of tax expenditures for addressing socioeconomic disparities. Tax expenditures also generally do not enable the

same degree of agency discretion as an outlay program. For example, grant or direct Federal service delivery programs can prioritize activities to be addressed with specific resources in a way that is difficult to emulate with tax expenditures.

Outlay programs have advantages where the direct provision of government services is particularly warranted, such as equipping and maintaining the armed forces or administering the system of justice. Outlay programs may also be specifically designed to meet the needs of low-income families who would not otherwise be subject to income taxes or need to file a tax return. Outlay programs may also receive more year-to-year oversight and fine tuning through the legislative and executive budget process. In addition, many different types of spending programs include direct Government provision; credit programs; and payments to State and local governments, the private sector, or individuals in the form of grants or contracts provide flexibility for policy design. On the other hand, certain outlay programs may rely less directly on economic incentives and private-market provision than tax incentives, thereby reducing the relative efficiency of spending programs for some goals. Finally, spending programs, particularly on the discretionary side, may respond less rapidly to changing activity levels and economic conditions than tax expenditures.

Regulations may have more direct and immediate effects than outlay and tax-expenditure programs because regulations apply directly and immediately to the regulated party (i.e., the intended actor), generally in the private sector. Regulations can also be fine-tuned more quickly than tax expenditures because they can often be changed as needed by the Executive Branch without legislation. Like tax expenditures, regulations often rely largely on voluntary compliance, rather than detailed inspections and policing. As such, the public administrative costs tend to be modest relative to the private resource costs associated with modifying activities. Historically, regulations have tended to rely on proscriptive measures, as opposed to economic incentives. This reliance can diminish their economic efficiency, although this feature can also promote full compliance where (as in certain safety-related cases) policymakers believe that trade-offs with economic considerations are not of paramount importance. Also, regulations generally do not directly affect Federal outlays or receipts. Thus, like tax expenditures, they may escape the degree of scrutiny that outlay programs receive. Some policy objectives are achieved using multiple approaches. For example, minimum wage legislation, the earned income tax credit, and the food stamp program (SNAP) are regulatory, tax expenditure, and direct outlay programs, respectively, all having the objective of improving the economic welfare of low-wage workers and families.

<sup>4</sup> Although this chapter focuses upon tax expenditures under the income tax, tax expenditures also arise under the unified transfer, payroll, and excise tax systems. Such provisions can be useful when they relate to the base of those taxes, such as excise tax exemption for certain types of consumption deemed meritorious.

### A Framework for Evaluating the Effectiveness of Tax Expenditures

Across all major budgetary categories – from housing and health to space, technology, agriculture, and national defense tax expenditures make up a significant portion of Federal activity and affect every area of the economy. For these reasons, a comprehensive evaluation framework that examines incentives, direct results, and spillover effects will benefit the budgetary process by informing decisions on tax expenditure policy.

As described above, tax expenditures, like spending and regulatory programs, have a variety of objectives and economic effects. These include: encouraging certain types of activities (e.g., saving for retirement or investing in certain sectors); increasing certain types of after-tax income (e.g., favorable tax treatment of Social Security income); and reducing private compliance costs and Government administrative costs (e.g., the exclusion for up to \$500,000 of capital gains on home sales). Some of these objectives are well suited to quantitative measurement and evaluation, while others are less well suited.

Performance measurement is generally concerned with inputs, outputs, and outcomes. In the case of tax expenditures, the principal input is usually the revenue effect. Outputs are quantitative or qualitative measures of goods and services, or changes in income and investment, directly produced by these inputs. Outcomes, in turn, represent the changes in the economy, society, or environment that are the ultimate goals of programs. Evaluations assess whether programs are meeting intended goals, but may also encompass analyzing whether initiatives are superior to other policy alternatives.

The Administration is working towards examining the objectives and effects of the wide range of tax expenditures in our budget, despite challenges related to data availability, measurement, and analysis. Evaluations include an assessment of whether tax expenditures are achieving intended policy results in an efficient manner, with minimal burdens on individual taxpayers, consumers, and firms; and an examination of possible unintended effects and their consequences.

As an illustration of how evaluations can inform budgetary decisions, consider education and research and investment credits.

*Education.* There are millions of individuals taking advantage of tax credits designed to help pay for educational expenses. There are a number of different credits available as well as other important forms of Federal support for higher education such as subsidized loans and grants. An evaluation would explore the possible relationships between use of the credits and the use of loans and grants, seeking to answer, for examples, whether the use of credits reduce or increase the likelihood of the students applying for loans. Such an evaluation would allow stakeholders to determine the most effective program – whether it is a tax credit, a subsidized loan, or a grant.

*Investment.* A series of tax expenditures reduce the cost of investment, both in specific activities such as research and experimentation, extractive industries, and

certain financial activities and more generally throughout the economy, through accelerated depreciation for plant and equipment. These provisions can be evaluated along a number of dimensions. For example, it is useful to consider the strength of the incentives by measuring their effects on the cost of capital (the return which investments must yield to cover their costs) and effective tax rates. The impact of these provisions on the amounts of corresponding forms of investment (e.g., research spending, exploration activity, equipment) might also be estimated. In some cases, such as research, there is evidence that the investment can provide significant positive externalities—that is, economic benefits that are not reflected in the market transactions between private parties. It could be useful to quantify these externalities and compare them with the size of tax expenditures. Measures could also indicate the effects on production from these investments such as numbers or values of patents, energy production and reserves, and industrial production. Issues to be considered include the extent to which the preferences increase production (as opposed to benefiting existing output) and their cost-effectiveness relative to other policies. Analysis could also consider objectives that are more difficult to measure but still are ultimate goals, such as promoting the Nation's technological base, energy security, environmental quality, or economic growth. Such an assessment is likely to involve tax analysis as well as consideration of non-tax matters such as market structure, scientific, and other information (such as the effects of increased domestic fuel production on imports from various regions, or the effects of various energy sources on the environment).

The tax proposals subject to these analyses include items that indirectly affect the estimated value of tax expenditures (such as changes in income tax rates), proposals that make reforms to improve tax compliance and administration, as well as proposals which would change, add, or delete tax expenditures.

*Barriers to Evaluation.* Developing a framework that is sufficiently comprehensive, accurate, and flexible is a significant challenge. Evaluations are constrained by the availability of appropriate data and challenges in economic modeling:

1. **Data availability.** Data may not exist, or may not exist in an analytically appropriate form, to conduct rigorous evaluations of certain types of expenditures. For example, measuring the effects of tax expenditures designed to achieve tax neutrality for individuals and firms earning income abroad, and foreign firms could require data from foreign governments or firms which are not readily available.
2. **Analytical constraints.** Evaluations of tax expenditures face analytical constraints even when data are available. For example, individuals might have access to several tax expenditures and programs aimed at improving the same outcome. Isolating the effect of a single tax credit is challenging absent a well-specified research design.

3. Resources. Tax expenditure analyses are seriously constrained by staffing considerations. Evaluations typically require expert analysts who are often engaged in other more competing areas of work related to the budget.

The Executive Branch is focused on addressing these challenges in order to lay the foundation for the analysis of tax expenditures comprehensively, alongside evaluations of the effectiveness of direct spending initiatives.

### **Current Administration Proposals on Tax Expenditures**

The Administration considers performance measurement, evaluations, and the economic effects of tax expenditures each year in its deliberation for the Budget and proposals are informed by these analyses. The President's National Commission on Fiscal Responsibility and Reform submitted a report in 2010 in which they said that the income tax system is unduly complicated and that the government should "sharply reduce rates, broaden the base, simplify the tax code, and reduce the many 'tax expenditures'—another name for spending through the tax code."

The current Budget and enacted Administration policies include several proposals that would change existing tax expenditures to raise revenue, eliminate ineffective or counterproductive tax expenditures, and enhance effective tax expenditures. The tax expenditure proposals in the budget further the Administration's goals of economic recovery and growth, clean and secure energy, a world-class education for all Americans, and fairness in the tax code. Some of these proposals are highlighted below.

*Reduce the value of certain tax expenditures.* The Administration proposes to limit the tax rate at which upper-income taxpayers can use itemized deductions and other tax preferences to reduce tax liability to a maximum of 28 percent. This limitation would affect only married taxpayers filing a joint return with income adjusted for these tax preferences of over \$250,000 (at 2014 levels) and single taxpayers with income over \$200,000 (at 2014 levels). The limit would apply to all itemized deductions, tax-exempt interest, employer-sponsored health insurance, deductions and income exclusions for employee retirement contributions, and certain above-the-line deduc-

tions, effective for taxable years beginning after December 31, 2013. These are among the largest tax expenditures. This proposal would make the tax code more equitable because the value of the tax expenditure as a percentage of the deduction is proportional to one's tax bracket, so it is less valuable to those in lower brackets.

*Reduce preferences for oil, gas, and coal.* Current law provides a number of credits and deductions that are targeted towards certain oil, gas, and coal activities. These tax preferences run counter to our policies for reducing greenhouse gas emissions. In accordance with the President's agreement at the G-20 summit in 2009 to phase out subsidies for fossil fuels so that we can transition to a 21st century energy economy, the Administration proposes to repeal a number of tax preferences available for fossil fuels.

*Enhance and make permanent the Research and Experimentation (R&E) credit.* The extension of this credit every year creates uncertainty reducing firms' incentive to expand their research activities. For this reason, and more generally to achieve the President's R&D goals, the Budget proposes making the R&E credit permanent.

*Make permanent the American Opportunity Tax Credit (AOTC), the expansion of the EITC for larger families, EITC marriage penalty relief, and the refundability of the child tax credit.* These provisions were extended through 2017 in ATRA and the Budget assumes in its baseline that these provisions would be permanently extended. Although permanent extension would increase the cost of these tax expenditures, it would increase the equity of the overall tax system and provide benefits to low and middle income families.

*Allow a range of tax expenditures to expire.* The Tax Reconciliation, Unemployment Insurance Reauthorization, the Job Creation Act of 2010, and ATRA, have extended many provisions of the tax code, including many provisions identified as tax expenditures in this chapter. However, a number of provisions identified as tax expenditures have been allowed to expire. For instance, the Making Work Pay Credit, the sales tax deduction for new cars and trucks, the above-the-line deduction for property taxes up to \$500 for taxpayers who do not itemize, and the exemption from taxes for the first \$2,400 of unemployment benefits were allowed to expire.