



## 1: Tax Benefits Basics

### Government Spending Through the Tax Laws

Governments at all levels—national, state, and city—spend money to carry out the policies and projects that their legislatures enact. They do this in one of two main ways:

- 1 The government can spend it *directly* by handing out money. This is called direct spending, or a **direct expenditure**.

For example, the government could give you \$1,000 to help you buy a house.

When the government spends money directly, it ultimately gets this money from taxes you pay (it may first borrow money but in the end, it repays with taxes it collects from you).

Or

- 2 The government can spend it *indirectly* through the tax system by giving taxpayers a break on their taxes. This is called a **tax expenditure** (or **tax preference**).

For example, instead of giving homebuyers \$1,000 directly in cash, the government could decrease taxpayers' taxes by \$1000. If Hannah Homeowner would have owed \$8,000 in taxes without the tax expenditure, the indirect spending through the tax laws when Hannah buys her new house will reduce the amount of taxes she owes from \$8,000 to \$7,000.

Let's look at **direct spending** first because this is how people usually think of government spending.

## Direct Spending (Direct Expenditures).

The process may look something like what happened in the small town of Townsville. Townsville's legislature debated whether to build a new infrastructure project such as a park, bridge, or new road. It voted yes on constructing a bypass road around the town square because it decided the project would benefit the town as a whole by helping the economy because it will encourage people and businesses to move into town. The legislature also determined that the project would bring quality-of-life benefits such as decreasing congestion, commuting time, and pollution—all of which will increase tranquility and happiness among Townsville residents. Of course, some residents will benefit more than other—such as those people and businesses near town and people who use the bridge.

Townsville funded the project by spending some of the money it raises from its income tax. Townsville is a very unique town. It has only 2,000 taxpayers who all have exactly the same amount of taxable income. Consequently, each taxpayer pays the same amount of income tax—let's say \$10,000 each. So Townsville has \$20,000,000 (\$20 million or \$20M) of revenue a year, of which \$1,000,000 (\$1M) will be used for the bypass project.

Taxpayers do not get to choose which government projects to fund because their taxes go into a general fund. This fund is used to pay for all government spending. In Townsville's case, 1/20 or 5% of the money each taxpayer paid in taxes goes to build the project. In other words, \$100 (0.5 x \$2000) of Townsville taxpayer is spent on the project. Even though some people will get more benefit than others, everyone pays equally because the people (through their town representatives) agree that the project's benefits for the town as a whole are worth the cost.

## Indirect Spending (Tax Expenditures)

Governments can also spend money **indirectly** through the tax system by giving taxpayers a break on their taxes. (often called **tax benefits**, **tax expenditures** or **tax preferences**.)

Consider Townsville again. The Townsville council also decides that it would be good for the town to encourage homeownership. (Can you think of a few reasons why?) It therefore votes to give every person who buys a house \$1,000. It can do this in one of two ways. First it can spend tax money directly—just like it did with the road bypass project—by giving \$1,000 of its tax money

to each homebuyer. Or second, it could also spend the money indirectly by reducing the taxes of new homebuyers by \$1,000.

## **The Effects of the Policy to Give Each Homebuyer \$1,000.**

### **Direct Spending**

If Hannah Homestead is the only person who bought a house, the cost of the Townsville project is only \$1,000. In effect, it costs each taxpayer \$0.50, including Hannah. Unlike the other taxpayers, however, Hannah received a \$1,000 check from the government. Therefore, the homebuyer policy improves her fiscal situation by \$999.50 (the amount funded by the other 1,999 taxpayers in town).

### **Indirect spending**

Again, let's say that only Hannah buys a house but this time the government reduces her taxes by \$1,000. She would only owe \$9,000 of taxes, not the \$10,000 her non-home buying fellow taxpayers owe (and she would have owed if she hadn't bought a house).

*So whose money is being spent?*

Some people say indirect spending is not really government spending because Hannah is just getting back her *own* money—so that she ends up paying only \$9,000 instead of \$10,000 in taxes. This is not what is happening economically.

In reality, the only tax money that was Hannah's to begin with was the \$0.50 of taxes that is coming back to her. The rest of the \$1,000 (or \$999.50) comes from the other 1,999 taxpayers. They are paying taxes to fund the \$1,000 for Hannah just like they paid taxes when Townsville gave the money directly to Hannah or when they helped fund the infrastructure project. They are willing to do so because they (or their elected representatives) have decided that home ownership is something their town should support, just like the infrastructure project. The tax effects on Hannah and the other taxpayers is the same whether Hannah gets a check for \$1,000 for buying a house directly from the government or indirectly gets the money through the tax system when it reduces the amount of taxes she will have to pay by \$1,000.

If the government gives Hannah \$1,000—directly or indirectly—its revenues are reduced. If it still needs \$10,000 to fund its other programs and policies, then it will have to raise another \$1,000 in taxes.

This material focuses on government spending through the tax laws or tax expenditures because many people are completely unaware that these expenditures even exist. Even if they are aware of them, people often don't understand how they work.

Ignorance about government spending through the tax laws (tax expenditures) is dangerous for a democracy because much of what the government does is accomplished through the tax laws. The total cost of all federal income tax expenditures exceeds \$1 trillion a year—most goes to individuals but billions of it also go to corporations. This cost is more than the cost of military defense spending or the cost of social security.

Repealing a \$100 tax expenditure would not bring in exactly \$100 of revenue for a variety of reasons. (For example, changes in tax laws affect people's actual behavior). Even so, the amount of government spending through the tax laws is so enormous that it's impossible to rationally think about government policies and government spending without thinking about tax expenditures.

Because most people are unaware of tax expenditures tax expenditures may distribute money to people in ways that voters would disapprove of if the expenditures were not so hidden from them. For example, some tax expenditures benefit taxpayers who engage in certain behaviors or buy certain goods that voters would not vote for directly, if they knew about them. Some voters, for example, do not want the government to subsidize (spend money) to drill for oil. If they are unaware that the government gives money to oil companies indirectly through tax expenditures, they cannot object to such a policy.

### **Enacting Public Policy: Choosing Between Direct and Indirect Spending.**

Before a legislature enacts any policy, it must first decide whether the positives of the policy outweigh any negatives. If the legislature then determines it should enact a policy, only then should it consider **how** it should implement it. When examining methods of implementing policies or

projects, a legislature needs to look at a variety of issues including ease of administration, cost of administration, economic efficiency, simplicity, transparency, and of course, fairness. Implementation through direct spending may have very different effects in these areas than indirect (tax) spending.

These are all complicated issues, as a brief look at health care tax expenditures show. Current tax laws allow employers to provide health insurance to their employees without the employees including the value of that insurance premium in their taxable income. This is the largest tax expenditure and totals more than \$200 billion dollars. That's a lot of money! In 2018 employers spent almost \$6,000 per employee for those employees who chose just individual coverage for themselves and almost \$20,000 per employee who chose a family plan. Employees usually pay deductibles and co-pays out of their own pockets—and that can be a lot. However, they are getting tax-free the equivalent of thousands of dollars for insurance that people who don't have employer-provided health care aren't getting.

Compare Anita to Ben. Both are welders in the 20% marginal tax bracket. Anita works for We Weld, Inc. which pays her \$45,000 per year and also provides her with (tax-free) health insurance that would cost \$6,000 to buy herself. Ben works for WorldWide Welders and earns \$51,000 per year but WorldWide does not provide any health insurance. So Ben has to spend the \$6,000 himself to independently buy for himself a policy identical to that which Anita gets tax-free from her employer.

### **Who is better off?**

Anita is monetarily better off by \$1,500. Ben not only had to pay \$6,000 to buy the insurance but he also had to pay with *after-tax* dollars. That means \$7,500, of his salary is allocated to the insurance because he first must pay 20% tax on it (\$1,500). That leaves him with \$6,000 left over to buy the insurance.

But is Anita really better off? What if she really only wanted a \$4,000 health insurance policy and would have preferred a higher salary so she could have taken a course at the local university? But since she has the more expensive employer-provided insurance policy, she gets some medical

exams that she doesn't really want or need. Is this policy economically efficient since she is getting more health care than she needs or wants?

And what about Carlos who works for himself and doesn't have enough money to buy any health insurance for himself or his family? Is this policy the best way to promote health care?

### **Defining Tax Expenditures: Which provisions are tax benefits?**

The primary goal of the income tax is to raise revenue (money) to fund government spending. The tax laws do this by using a broad or “comprehensive” definition of income that is similar to—but not as large as—an economic definition of income. Tax laws, however, also have provisions whose purposes are not to raise money but are to promote social or economic policies. These provisions carry out public policies just as direct spending does.

**These provisions are called tax expenditures (or benefits or preferences) because they are just an alternative way of enacting public policies and spending money to implement—or carry them out.** Spending for some government functions and programs occurs both by direct spending and indirect spending through tax expenditures.

Tax expenditures reduce or eliminate taxes for certain taxpayers or on certain activities. Because these provisions create exceptions to the definition of income for tax purposes, a simple definition of tax expenditures is:

any income tax provision that deviates from that baseline and treats a receipt more favorably than income should be treated under the tax definition of income by either excluding the amount from income or taxing it more lightly.

For example, a deduction for interest on home mortgages is a tax expenditure because this deduction deviates from the baseline and it is not necessary to determine what income is.

Tax expenditures are created by means of exclusions, deductions, credits from the base, but not all exclusions or deductions are tax expenditures. For example, deductions for business expenses are not tax expenditures because these deductions are necessary for determining both economic and

baseline tax income. Gifts—which are economic income but not income for tax purposes—also are not tax expenditures because the baseline definition of income does not include them.

Some tax provisions exist because of administrative difficulties or because our income tax is a progressive one based on the ability-to-pay theory. For example, the standard deduction generally is not considered a tax preference because it both avoids administrative complications as well as exempts from income tax an amount that people need for living.

The definition of a tax expenditure is not always clear-cut because people sometimes disagree on the definition of income and what the baseline should be. For this reason, some politicians and tax scholars argue that the whole concept should be abandoned. But this is like throwing the baby out with the bathwater. Most people do agree on which provisions are tax expenditures and identifying them—and their costs—provides valuable information. Tax expenditure “budgets” both illuminate the degree to which they decrease revenues and give a more accurate picture of how much a government is spending to implement social and economic policies instead of merely looking at direct spending through government programs. Consequently, the federal government—and some states—are required by law to publish tax expenditures as part of their budget process.

Tax Expenditures are not an insignificant part of the budget. On the revenue side, for example, non-business tax expenditures alone cost billions. The largest, employer-provided health insurance, by itself costs about \$200 billion. You can find lots of information about tax expenditures generally and their amounts at <https://home.treasury.gov/policy-issues/tax-policy/tax-expenditures>

Some tax expenditures are more effective at carrying out governmental policies than others. The federal Earned Income Tax Credit (ETIC), for example, is the largest and most effective US income-support program for low and middle-income families. It raises millions of people out of poverty

## **Tax expenditures/preferences: How do tax benefits work?**

In general, tax preferences reduce a taxpayers' tax liability—or at least let them defer it to a later year. There are four types of tax preferences: a deduction, a credit, an exclusion, and a reduced (lower) tax rate. Each acts in a different way.

**Deductions** reduce the amount of tax liability by allowing taxpayers to subtract the amount of certain expenses from their income. Assume, for example, that you paid \$6,000 in mortgage interest payments to your bank on your home mortgage. The tax law allows you to deduct this \$6,000, and it is a tax expenditure because the deduction carries out a public policy and is not necessary to normally compute your taxable income. The deduction reduces your taxable income by \$6,000—say from \$56,000 to \$50,000. If your tax rate is a flat 10%, instead of paying \$5,600 in taxes, you pay only \$5,000. In other words, the deduction saves you \$600 in taxes.

**Reduced (lower) tax rates** let taxpayers pay tax on certain kinds of income at a lower rate than the normal (regular) rate that applies to most income. For example, income from the sale of certain types of property (like stock) is called capital gains. If a taxpayer owned the property for more than a year, this long-term capital gain is taxed at a lower rate than the tax rate on income from wages. The capital gains rate can go all the way down to zero—as happens for some taxpayers. Then that type of income is effectively excluded from being tax. The capital gains rate is never higher than 20%, even if the rate on ordinary income like wages is higher.

**Exclusions** let taxpayers not count certain amounts as income at all. Amounts taxpayers receive as gifts, for example, are excluded from income entirely. Generally, the tax effect of this is the same as with a deduction (but there are some differences sometimes. Consider the example of the \$6,000 home mortgage interest you paid. As with a deduction, the exclusion reduces your taxable income to \$50,000 instead of \$56,000—just like the deduction example.

**Credits** reduce tax liability by allowing taxpayers to decrease what would be their tax liability by certain amounts if they meet the requirements. If paying \$6,000 of home mortgage interest gave you a \$600 credit, your taxable income would still be \$56,000 and you would normally owe \$5,600 of tax on that income. The \$600 credit, however, would reduce your tax liability by \$600 and your



final tax liability would end up being \$5,000. for the \$6,000 home mortgage interest you paid would save you \$600 dollars of tax

Normally, taxpayers get the benefit of tax preferences only if they have some income tax liability. In other words, a \$100 credit, for example, won't help a taxpayer who doesn't have \$100 of tax liability. Very occasionally, however, taxpayers can get the benefit of a credit even if they don't owe the \$100. Some taxpayers, for example, can get part of the child tax credit even if they don't owe income tax. In that case, the government would send the taxpayer \$100.

### **Example: Helping with College Expenses: \$1,000 College Tax Benefit**

Assume society decides to encourage individual opportunity and economic growth by helping people obtain college degrees It can do this directly by giving a certain amount of money to any individual who goes to college (or giving the money to the college so it can charge lower tuition). It can also give individuals and educational institutions money through the tax laws.

The tax laws do this in one of three ways: an **exclusion** from income; a **deduction** from income, or a **credit** against your income tax liability. Either way, the government does not collect the usual amount of income tax from you, and you get to use some of the money you would normally pay for taxes for education. In this way, the government is investing in education right along with you. How much you pay and how much the government pays depends on the type of tax benefit the legislature enacts.

**Let's say you have taxable income of \$50,000 and pay income taxes at the rate of 15%. In other words, you would pay \$7,500 in income taxes. (15% of \$50,000).**

Now Congress decides to help pay for your college by giving you a \$1,000 education tax benefit. The benefit can be in the form of an **exclusion**, **deduction**, or **credit**. Each of these forms works slightly differently and each can reduce your taxes by a different amount. In fact, the same form may help one taxpayer more than another taxpayer. So, a \$1000 exclusion, for example, may help a taxpayer with more income—and a higher tax rate—than it helps you.

**1 Exclusions:** An exclusion means that an amount that normally would be income to you is omitted (excluded) from your income for tax purposes.

Let's say that Congress passes a tax law that says that you can exclude from your income \$1,000 if you spend at least \$1,000 on college tuition.

If you spend \$1000 on college tuition, now your taxable income is only \$49,000 instead of \$50,000. That means your federal income tax will now be only \$7,350 (15% of \$49,000) instead of \$7,500 ((15% of \$50,000). You have saved \$150 dollars of tax by spending \$1000 on college tuition (15% of \$1,000). In other words, it has only cost you \$850 for that \$1000 of college tuition because you would have not had that money anyway—it would have gone to taxes. It is like paying the taxes you normally owe and having the government give you \$150 to use for college.

**Effect of exclusion varies with different taxpayers.**

Notice that a person with higher income get a greater benefit from exclusions than a person with lower income. For example, Abel, a taxpayer in the 30% bracket, would save \$300 with a \$1,000 education exclusion. In contrast, Brendan who is in the 15% bracket would only save \$150.

*From a fairness standpoint, do these effects make sense to you? Why or why not?*

Some exclusions are not available to people who have income above a certain amount—say \$200,000. *Why do you think this is? Is it fair?*

Some categories of people may take more advantage of an exclusion than other types of people. For example, people with higher incomes may go to college more often than people with lower incomes. This means higher income taxpayers get more of the benefits of the exclusion than lower income taxpayers.

**2 Deductions:** If people can deduct—or subtract—the amount of an expenditure from their income, they will pay less tax than they would otherwise. Generally, people can deduct amounts they pay for business reasons but not for personal reasons. Taxpayer Sam, for example, can deduct the amount paid to rent a business office but not the rent paid to live in a house.

The tax laws also allow deductions for some personal expenses to further certain policies. Education is one such policy. A \$1,000 deduction for expenses paid for college tuition basically works the same way as a \$1,000 exclusion. [There can be some differences, but we don't need to talk about them here]. So you can just look back to exclusions to see what happens. Or if you'd rather see it again, here it is:

When you have a deductible education expense of \$1,000, your taxable income of \$50,000 is reduced to \$49,000 and at a 15% tax rate, your income tax is reduced from \$7,500 to \$7,350. Again, you have saved \$150 in taxes. It is as if you paid only \$850 for the school expenses and the government paid \$150.

People with higher income get a greater benefit from deductions than lower income people. For example, a taxpayer in the 30% bracket would save \$300 with a \$1,000 education deduction whereas the taxpayer in the 15% bracket only saved \$150. However, some deductions are not available to higher income taxpayers. Similarly, people with higher incomes also take advantage of tax deductions more than lower income taxpayers do.

**3 Credits:** A tax credit saves you even more money than an exclusion or deduction because it reduces your tax liability by the full amount of the credit. In other words, a \$100 tax deduction may save \$15 or \$30 depending on whether you are in the 15% or 30% bracket, but it will never save you \$100 of taxes because the income tax rate is never 100%. But a \$100 tax credit will lower your tax liability by all \$100. Like other tax benefits, some credits are available only to taxpayers whose income does not exceed a certain amount.

For every dollar of a credit, you save a full dollar of tax (and the government contributes to your college tuition, for example). Unlike deductions or exclusions, credits save all taxpayers the same amount of money—so long as their amount of tax they would owe is the same or more as the amount of the credit.

That means a \$1,000 education credit reduces your tax liability from \$7,500 to \$6,500. It saves you \$1,000 in taxes which goes to your college tuition. A \$1,000 exclusion or deduction only saves you the percentage of tax you would have paid on that amount of income—for example, 15% of \$1,000 (or \$150) if your tax rate was 15%, or \$200 if your tax rate was 20%.

Most credits are non-refundable. That means they reduce a person's tax liability dollar for dollar only to the extent the person has at least that amount of taxes. In other words, most \$100 credits reduce the tax liability of both a 10% taxpayer and a 30% taxpayer the same \$100 in taxes IF they owe at least \$100 in taxes.

Example: Ted is eligible for a \$100 credit, but he only owes \$60 of taxes.

Ted gets a \$60 credit. This means he owes no taxes.

The other \$40 of credit that he was eligible does not get used.

A very few credits—such as the Earned Income Tax Credit (the EITC) and the Child Tax Credit—are **refundable credits**. That is a taxpayer gets the full amount of the credit regardless of the amount of tax they owe. Refundable tax credits, therefore, save every taxpayer who qualifies the same amount of money.

**But** to get the money, taxpayers have to file a tax return—even if they would not otherwise have to.

Example: Vanessa is entitled to a \$100 refundable tax credit but only owes \$60 of taxes.

Sixty dollars of the credit reduces Vanessa's tax liability to zero.

In addition, the government gives Vanessa \$40.

## Summary: Major Points to Remember

1 Governments implement policy both through direct spending and indirectly through the tax laws.

2 The tax provisions that implement government policies are called tax expenditures, or tax preference. Sometimes they are referred to as tax benefits.

3 Tax expenditures are designed to carry-out social and economic policies—not raise money (revenue). that provide preferences or benefits for taxpayers who meet the requirements of the provisions.

3 Tax preferences come in many forms: exclusions, deductions, credits, lower rates. The technicalities are different for each type, but all of them reduce the income tax liability of the taxpayer who uses them. Can you explain how each works?

4 Tax expenditures reduce individual taxpayers' tax liabilities and also reduce the total amount of revenue that the government collects.

5 Indirect spending is huge part of government expenditures. Repealing a \$100 tax expenditure would not bring in exactly \$100 of revenue for a variety of reasons. For example, changes in tax laws affect people's actual behavior. Even so, the amount of government spending through the tax laws is so enormous that it's impossible to rationally think about government spending without thinking about tax expenditures or benefits.