Center for American Progress

Tax Expenditures 101

What They Are and How They Slip Under the Radar

What are tax expenditures?

Tax expenditures are, quite simply, spending programs implemented through the tax code. These programs give people and businesses special tax credits, deductions, exclusions, exemptions, deferrals, and preferential rates in support of various government policies. Some of these programs help people save for retirement, buy a home, or pay for college; others encourage companies to invest in green energy technologies or build nuclear power plants; they even subsidize corporations that drill for oil or purchase real estate; and much more.

The government uses both tax expenditures and direct spending to support its policies. Direct spending is when the government takes taxpayer dollars and gives them to others to spend for a specific purpose. The government uses tax expenditures to accomplish the same goals as direct spending, but it transfers money by lowering taxes for an individual or company instead of giving them the money.

Consider this example to see the similarities between direct spending and tax expenditures: The government wants to create a program that provides $10,000 to every individual who weatherizes his or her home. The government can deliver the subsidy in one of three ways: (1) cut a check for $10,000, (2) create a tax expenditure like a refundable credit worth $10,000, or (3) use a combination of direct spending and tax expenditures. In all three cases the individual who weatherizes his or her home receives $10,000 from the government.

What makes tax expenditures different from other forms of government spending?

The government uses tax expenditures and direct spending for the same purposes, but tax expenditures receive different treatment in two key ways. Most tax expenditures are not subject to the same annual appropriations process as other forms of spending. This means they are less likely to be scrutinized.

Second, tax expenditures appear to be tax cuts instead of spending because they transfer funds to businesses and individuals through tax subsidies. It is therefore generally easier to win votes for tax expenditures than direct spending. And members of Congress often pursue their priorities through tax expenditures as a result, even if direct spending would be more effective and cost less.

What are the consequences of this differential treatment?

The cost of tax expenditures has skyrocketed over the last 20 years partly because they are excluded from the budget process and because they masquerade as tax cuts. Tax expenditures doubled in number between fiscal years 1974 and 2004, and the estimated revenue losses associated with them tripled. The government now spends $1.2 trillion on tax expenditures—more than half as much as it raises ($2.2 trillion) through the tax code. Tax expenditures will make up nearly 25 percent of total government spending this year and more than double the size of the government's nonsecurity discretionary spending.

The exponential growth of these programs is particularly evident in the energy sector where more than half of all energy programs are now funded through tax expenditures. The number of energy tax expenditure line items grew from 12 to 37 between 2000 and 2007, and spending in these areas increased from $3 billion to more than $10 billion.

What can be done to rein them in?

Three recently released reports from the Center for American Progress's Doing What Works project focus on the importance of treating tax expenditures like direct spending. One of these reports stresses the need to evaluate tax expenditures and subject them to the annual budget process. Another offers four questions policymakers should consider in deciding which tax expenditures to keep and which ones to cut. And the third applies these concepts to energy tax expenditures, with suggestions for how government can get energy tax expenditures under control.

But the gist of the reports is that spending programs delivered through tax expenditures should be subject to the same level of scrutiny as direct spending programs. We should make sure tax expenditures are efficiently delivering desired results. Tax expenditures that don't work or are misguided should be scrapped—just the same as ineffective spending programs.