Tax Expenditures Are a Low-Hanging Fruit to Cut Government Waste

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Calvin Johnson January 21, 2025

The clearest $1 trillion a year of waste resides in the federal tax expenditure budget.

A tax expenditure is a tax benefit given to achieve a specified goal. Most tax reductions are privileged waste—that is, the taxpayer can do anything they want with what they have after tax. It's the taxpayer's money.

By contrast, when achievement of some goal is the offered justification, the waste isn't privileged. The good achieved for the tax reduction is supposed to be greater than the tax Congress has given up. Both government spending and tax expenditures need to be paid for by other taxpayers now or in the future.

Tax expenditures are currently estimated at $1.8 trillion a year, according to the Peter G. Peterson Foundation, looking at the inventories compiled by the White House and congressional staffs. A fair estimate is that half of that could be cut just by eliminating the rents and imposing sharper definitions of the good to be achieved.

People hate waste in government spending. That hate-waste attitude needs to be carried over to tax expenditures. Waste in government spending is typically reported in the millions of dollars, but tax expenditures carry $1 trillion of waste, which is a million millions.

Tax expenditures are wasteful because only a fraction of the tax benefit from a deduction or exclusion is delivered to the site of the purported good. Even once the benefit is delivered, it's hardly clear what good is sought and whether it's worth the cost.

For long-term tax-exempt municipal bonds, for example, investors in the highest tax brackets take out 64% of the value of the exemption, under current (but varying) conditions, and pass over to the supposed target—the issuers of the bonds, only 36% of the federal cost.

High-tax-bracket investors have too many opportunities to avoid tax on long-term investments. They therefore don't accept the lower pre-tax interest rate that would pass on the full cost of the tax exemption to the benefit of bond issuers.

Then, even once the residual benefit is delivered on-site, one wonders whether the good is worth the cost and why the activity is subsidized at all. Why are we subsidizing more borrowing and higher profligacy by state and local governments?

Why not subsidize the other direction—responsible reduction of their debt? Why are we subsidizing a shift in capital projects away from the presumably more effective private sector? Why not just give municipalities government checks that would be delivered 100%, and let the local governments decide how to use them?

Tax-exempt bonds are a fair sample of all tax expenditures. Only a fraction of the cost of a deduction or exclusion is delivered, and the rest are rents taken out by the middleman. Once delivered, we don't know why the activity was subsidized or whether the good is worth the cost.

Government spending is reviewed annually, in a highly competitive process, but tax expenditures are never reviewed. The good at the core of tax expenditures needs to be defined more austerely, skeptically, and cheaply. Congress hasn't exercised sufficient responsibility to cut the fat.

To quantify tax expenditures, one needs a base of the normal tax that would be collected if Congress weren't trying to pay for something. A great deal of tax law serves just to adjust accounting taxable income to fit the tax brackets with a better determination of the taxpayer's ability to pay tax.

Adjustments such as allowing deductions for catastrophic losses, catastrophic illness, or the childcare credit aren't trying to subsidize more catastrophes or children—they're just trying to refine the description of the taxpayer's ability to pay tax. There are many controversial ability-to-pay decisions set in defining taxable amounts, but they aren't tax expenditures because they do try to pay for something and don't trigger a cost-benefit analysis.

We might also look at tax expenditures that include home mortgage interest, conservation easements, opportunity zones, and qualified pension plans, and replace the waste with more narrow spending that more rigorously defines the good to be achieved.

The best baseline to trigger a congressional cost-benefit analysis is the broadest tax of economic income. Measuring the baseline by "internal rate of return" is a good one. But anything done to take out waste from the tax expenditure budget is a constructive step that's better than nothing.

Those who get rents from tax expenditures will oppose change—that's to be expected. But it isn't a reason not to go after the fat.

Cutting out waste from the tax expenditure budget far surpasses alternative ways to reduce the federal deficit and debt. Increasing tax rates incentivizes tax avoidance, and tax avoided is the source of dead-weight economic losses. Tax rates should be as low as possible. But an across-the-board cut in government spending would cut into programs that people really want.

The drawbacks of tax rate hikes and broad spending cuts show why it would be best to get the $1 trillion waste out of tax expenditures before looking to anything else.

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