

## **Is the Tax Expenditure Concept Still Relevant?**

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## **Abstract**

The term “tax expenditure” refers to departures from the normal tax structure designed to favor a particular industry, activity, or class of persons. Most budget experts view the tax expenditure budget as a useful tool in managing the size and scope of the federal government, but a growing contingent of conservative critics has raised questions about the concept. The paper examines tax expenditure measurement issues, the debate about their relevance and new measures tentatively explored by the Bush Administration’s Budget, the way tax expenditure estimates are used in the U.S., and how they might be made more useful.

## Introduction

The term “tax expenditure” is attributed to Stanley S. Surrey who, as Assistant Secretary of the US Treasury for Tax Policy, instructed his staff to compile a list of preferences and concessions in the income tax that had the nature of expenditure programs. His goal was straightforward: to draw attention to these items in hopes of building momentum for tax reform, which would redirect the tax system toward its core function of raising revenues.

Stanley Surrey and coauthor, Paul R. McDaniel, defined the concept thus in their 1985 treatise on the subject:

The tax expenditure concept posits that an income tax is composed of two distinct elements. The first element consists of structural provisions necessary to implement a normal income tax, such as the definition of net income, the specification of accounting rules, the determination of the entities subject to tax, the determination of the rate schedule and exemption levels, and the application of the tax to international transactions. The second element consists of the special preferences found in every income tax. These provisions, often called tax incentives or tax subsidies, are departures from the normal tax structure and are designed to favor a particular industry, activity, or class or persons. They take many forms, such as permanent exclusions from income, deductions, deferrals of tax liabilities, credits against tax, or special rates. Whatever their form, these departures from the normative tax structure represent government spending for favored activities or groups, effected through the tax system rather than through direct grants, loans, or other forms of government assistance. (p. 3)

Seven years after Treasury first published a list of tax expenditures in 1967, the Congressional Budget Act of 1974 required the Administration to publish a list of tax expenditures as part of its annual budget submission. The concept also gained widespread acceptance outside of the United States. Both Canada and the United Kingdom started publishing lists of tax expenditures in the late 1970s, and many other OECD countries had either adopted formal tax expenditure budgets or conducted preliminary studies by 1985. (Surrey and McDaniel, 1985)

The Budget includes tax expenditures, defined as deviations from the “normal” individual and corporate income tax bases, along with its estimates of direct expenditures. Until 2002, it also included a list of tax expenditures against a transfer tax (estate and gift taxes) baseline, but those items were excluded from the FY 2003 budget because “...there is no generally accepted normal baseline for transfer taxes and ... [the tax was]... repealed under the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA).”<sup>1</sup> (US Office of Management and Budget, 2002, p. 95) In principal, tax expenditures could also be defined with respect to other taxes, such as excise taxes, but it has not been done on a systematic basis. (Davies, 1994)

Most budget experts view the tax expenditure budget as a useful tool in managing the size and scope of the federal budget, but a growing contingent of conservative critics has raised questions about the concept. That critique was elevated to new heights in 2002 when President Bush’s budget introduced the tax expenditure section with a warning that “...the Administration believes the meaningfulness of tax expenditure estimates is uncertain...” and promised a new more meaningful presentation in future years. (US Office of Management and Budget, 2002, p. 95)

The paper discusses the measurement of tax expenditures as implemented in the United States, the debate about the relevance of the tax expenditure concept as highlighted by the Bush Administration, and the way tax expenditure estimates are used in the United States.

## **Measuring Tax Expenditures**

Every year, the Treasury Department compiles a list of income tax expenditures, which is included in the Administration's Budget released in early February. The Joint Committee on Taxation prepares a similar list for Congress. The purpose of the tax expenditure estimates is to subject spending programs administered through the tax code to the same Congressional scrutiny and control as direct expenditures.

It is not clear whether this process has been effective, because it is hard to tell what the level of tax expenditures would have been absent annual revelation. Surrey and McDaniel (1985) calculated that tax expenditures grew relative to GDP and much faster than direct outlays in the first fifteen years that tax expenditure estimates were produced, between 1967 and 1982. Toder (1998) reported that tax expenditures grew only slightly faster than GDP from 1980 to 1999.

As the authors of those studies acknowledge, their measures are rough barometers at best of the cost of tax expenditures. A tax expenditure estimate reflects the amount by which tax liability is reduced due to a particular tax provision, but it does not measure the revenue that would be gained by eliminating that provision for two reasons. First, the estimate does not include any behavioral response, which would be incorporated in a revenue estimate. Thus, for example, if the Hope scholarship tax credit—a tax credit for the first two years of post-secondary education—were eliminated, many taxpayers who would have used that credit would instead opt for the slightly less generous lifetime learning tax credit or other tax subsidies aimed at higher education. In consequence, the revenue savings to the Treasury would be only a fraction of the amount of Hope tax credits allowed.<sup>2</sup>

In addition, government estimates of tax expenditures do not account for losses in tax revenues from other revenue sources, most notably payroll taxes, which are used to finance retiree health care and annuities in the US. For example, Sheils and Hogan (1999) estimate that the loss in payroll tax revenues from the tax exclusion for employer contributions to health insurance—the largest tax expenditure in 2004—is more than half of the income tax revenue loss alone.<sup>3</sup> Thus, the total income plus payroll tax expenditure could be at least \$150 billion compared with the estimate for the income tax expenditure alone of \$100 billion. (See Table 1.)

Another problem in attempting to gauge the importance of tax expenditures over time is that they may not simply be summed to come up with a tally of the cost of the web of tax expenditures as a whole because there are potentially significant interactions among the different tax provisions. For example, the cost of the deduction for home mortgage interest—the second largest tax expenditure on Table 1—and the deduction for state and local taxes—the sixth largest—is less than the sum of the two estimates. If either tax preference were eliminated, many fewer taxpayers would itemize deductions, making the value of the second tax preference significantly smaller.<sup>4</sup>

The bottom line is that the sum of tax expenditures provides very little information about the cost of tax expenditures as a whole to the federal government. However, comparing that sum over time may provide some information about trends in tax expenditures, especially if the composition of tax expenditures does not change markedly. Since 1980, however, there have been eight major tax changes, so there is likely to be considerable noise in the trend estimates.<sup>5</sup> In consequence, we know very little about how tax expenditures have changed over time as a share of the federal budget or in their relative importance compared with direct spending programs.

The Century Foundation Working Group on Tax Expenditures, a bipartisan group convened to evaluate current tax expenditures and make recommendations about how to improve monitoring and reporting, recommended a number of changes in the way tax expenditure information is reported. (Toder, Wasow, and Ettliger, 2002) These include: annual estimates of the cost of all tax expenditures together and grouped by budget category; historical estimates of total tax expenditures based on a consistent methodology; and detailed information about the distribution of tax benefits as well as an assessment of how well the tax expenditures work.

### **Is Tax Expenditure a “Meaningful Concept?”**

Measuring tax expenditures raises a number of thorny issues, some of which underlie the current Administration’s concerns about the tax expenditure budget. The most serious issue is how to define the “normal income tax.” Surrey and McDaniel (1985) argue that it should be a comprehensive Haig-Simons measure of income with adjustments to reflect problems of administration. As vague as that guideline is, the actual choice is even more nebulous. Surrey and McDaniel are agnostic about fundamental issues, such as whether the normal income tax should be indexed for inflation. The basic view is that a fixed relatively comprehensive baseline should be chosen and it will serve to be a useful measuring rod against which to gauge progress or lack thereof in improving the tax system.

There are some peculiar consequences of this approach. Expensing and accelerated depreciation of investments are treated as tax expenditures, whereas the taxation of capital gains on a realization basis, rather than as they accrue, is treated as part of the normal tax.<sup>6</sup> All of those examples convey tax benefits through a similar mechanism—taking advantage of the time value of money. Accelerating deductions and deferring income are two sides of the same tax minimization strategy, but only the deduction is accounted as a tax expenditure. An even more stark contrast is with the treatment of savings bonds, on which the interest income is deferred until the bond is cashed in, *which is basically identical to the treatment of capital gains*. But the former is considered a tax expenditure, because accrual taxation of bond interest is straightforward (and the norm for most bonds), whereas accrual taxation of gains is not.

The normal income tax contains a classical corporate income tax with no offset for double taxation. This is a source of consternation among Administration economists. They recently proposed legislation that would eliminate the double taxation of corporate income. Against the normal income tax baseline, that proposal would be considered a tax expenditure, although it is likely that the normal tax would be modified to incorporate the new norm if it were enacted.

In any event, the FY 2003 Budget promised to consider measuring tax expenditures against a more comprehensive measure of income and to consider reporting negative tax expenditures for the first time. Against such a baseline, the taxation of dividends (as well as part of the tax on capital gains) may be represented as a negative tax expenditure, and repeal of double taxation would result in neutral taxation with no tax expenditure.

This year's Budget delivered on the promises. Negative tax expenditures were reported for some items, such as the excess of economic over tax depreciation for non-residential structures. An appendix to the tax expenditure chapter in the FY 2004 Budget also examined two alternative baselines—a comprehensive income tax and a consumption tax. That analysis included an estimate of the tax expenditure against the comprehensive income tax baseline from double-taxing corporations: -\$25.4 billion in 2004.

But, interestingly, the list of items that are tax expenditures under current law, but would not be under a comprehensive income tax baseline is very short. Several of the items, such as deductibility for mortgage interest and property taxes, may be viewed as proxies for tax expenditures under the comprehensive baseline (such as the nontaxation of imputed rent).<sup>7</sup> This suggests that, despite its lack of theoretical rigor, the current tax expenditure list provides a useful perspective on the extent of distortions and deviations of our income tax from the economic ideal.

The most contentious issue is whether to define the normal tax as an income tax or a consumption tax, and this seems to be the Administration's main concern. If the income tax is considered the norm, then savings tax incentives—such as tax-exemption for individual retirement accounts and pensions, and preferential tax rates for capital gains—are considered tax expenditures. The FY2003 Budget argued that the growing prevalence of tax-free savings vehicles might suggest a change in norm. "...[T]he growing presence of tax-deferred savings vehicles in the tax code suggests that these may today be part of the 'normal' income tax circa 2002." (US Office of Management and Budget, 2002, p. 96)

If a consumption tax is taken as the norm, then the taxation of interest and dividends are negative tax expenditures—that is, taxation in excess of the norm—and tax-exempt pensions and individual retirement account are part of the normal tax and thus not worthy of note. Against this baseline, preferential tax rates on capital gains constitute a negative tax expenditure because they exceed the benchmark rate of zero. In contrast, against the income tax baseline, the failure to tax realized capital gains at full rates is the third largest tax expenditure. (See Table 1.)

The FY 2004 Budget categorizes the 30 largest tax expenditure items in terms of whether they would appear in a consumption tax expenditure list. (See Table 2.) Just over half of the items would “probably” be tax expenditures against both baselines. The 13 items that are considered not tax expenditures include savings tax preferences, accelerated depreciation, tax deferral on foreign income, and limitations on deductibility of losses.

As noted in the Administration's Budget, the choice of consumption as a base leaves many issues unresolved, because different variants of consumption tax would include very different items as tax expenditures. For example, Senate Finance Committee Chairman William Grassley recently

proposed to repeal the exclusion for a limited amount of earned income of Americans living abroad (Section 911 of the Code). That exclusion is clearly a tax expenditure measured against an income tax and would also be a tax expenditure measured against a consumed income tax, but would probably not be treated as a tax expenditure against a value added tax. The first variant of consumption tax would tax earnings (from which the 911 exclusion would be an exception) but exempt the normal return to capital, whereas the latter variant would tax only domestic consumption (and income from any source would only be taxed to the extent that it is spent in the U.S.).

There is clearly an ideological element to the debate about tax bases. People who favor an income tax also tend to favor the current method of measuring and displaying tax expenditures. Those who would prefer heavier reliance on consumption taxes would favor defining the normal tax as a broad-based consumption tax.<sup>8</sup> Given that the actual income tax is a hybrid system containing many elements of income and consumption taxation, there is no objective way to resolve this dispute. Displaying tax expenditures against multiple baselines may be helpful, but it may also contribute to overall confusion.

One aspect that will be helpful is in demonstrating the extent of overlap between the two lists. Many tax expenditures would exist against any baseline (e.g., charitable deduction, child tax credit), but it is interesting to note that social tax expenditures are the common ground, whereas business tax expenditures and savings tax breaks do not appear as tax expenditures against consumption tax base. Those are also the tax expenditures that are worth most to higher income taxpayers.

But even those who favor a consumption tax could find useful information in the current tax expenditure budget. A hybrid income-consumption tax, as we have in the United States, may actually do more to impair national savings than a pure income tax, because of the nonneutralities among different kinds of saving and investment. The tax expenditure list provides at least a crude measure of these nonneutralities, insofar as it shows that particular industries benefit far more than others.

Indeed, the Budget presentation acknowledges this point:

The hybrid character of the existing tax system leads to many provisions that might make good sense in the context of a consumption tax, but that generate inefficiencies because of the problem of the “uneven playing field” when evaluated within the context of the existing tax rules. It is not clear how these should be classified. For example, many saving incentives are targeted to specific tax-favored sources of capital income, and so potentially distort economic choices in ways that would not occur under a broad-based consumption tax. (U.S. Office of Management and Budget, 2003, p. 135)

The tax expenditure list, however, does not present this information in the most useful form. A better measure would be estimates of the effective tax rate by industry and type of investment. This information would be useful as a complement to the tax expenditure budget. Against any baseline, a tax system that produces the same revenue with relatively comparable effective tax rates (or user costs) will be more efficient than one that produces widely varying effective tax rates. (Gravelle 1994)

The most peculiar argument against the tax expenditure concept is the notion that it assumes that all income belongs to the government unless government deigns to refund it in the form of tax breaks. Interestingly, neither this argument nor the concept of tax expenditure is a new one. Brooks (1986) reports that in 1863, William Gladstone, then a Tory member of the British parliament, railed against the exemption from income tax of charitable contributions. He complained that the charitable deduction would make no sense as a direct expenditure, conflicting as it would with efforts to bring "...the whole expenditure of the State...within the control, and under the eye, of the House of Commons. If this money is to be laid out upon what are called charities, why is that portion of the State expenditure to be altogether withdrawn from view... and to be so contrived that we shall know nothing of it, and have no control over it...?"<sup>9</sup>

The rebuttal from Sir Strafford Northcote could be lifted from the modern ultraconservative's critique of tax expenditures: "The right hon. Gentleman, if he took £5 out of the pocket of a man with £100, put the case as if he gave the man £95..." (Brooks, 1986, p. 684) More than a century later, the Republican Vice Chairman of Congress's Joint Economic Committee, Jim Saxton, complained that "[t]he tax expenditure concept relies heavily on a normative notion that shielding certain taxpayer income from taxation deprives government of its rightful revenues." (Saxton 1999)

The irony of this aspect of the debate is that conservatives in other contexts object to runaway growth of government spending. Presumably it is relevant in evaluating spending on housing programs, for example, to note that the largest new construction program is implemented not as a direct expenditure managed by the Department of Housing and Urban Development, but the low-income housing credit. The largest cash assistance program for low-income families is the earned income tax credit. And so on. All of these programs could be implemented as virtually identical direct expenditure programs, and presumably conservatives in Congress would want to monitor their cost and effectiveness if they were thus transformed.

More generally, periodically evaluating the size and effectiveness of tax expenditures is a necessary (although not sufficient) requirement for good government. Even those who believe that lower taxes and smaller government are always a good thing should care about tax expenditures, because the revenues lost to such programs could be used for other purposes—such as lowering tax rates. Indeed, the Tax Reform Act of 1986, enacted two decades after the implementation of tax expenditure estimates, illustrates this trade-off. Top marginal tax rates for individuals were cut from 50 percent to 28 percent, and from 46 percent to 34 percent for corporations in a package that was designed to be revenue neutral. (Birnbaum and Murray, 1987) The dramatic rate reductions were financed entirely by eliminating or curtailing tax expenditures.<sup>10</sup> Millions of taxpayers were also removed from the tax rolls.

While some might argue that certain tax expenditures that were eliminated would have been worth slightly higher tax rates, that is exactly the kind of debate policymakers should have. It cannot happen without a full assessment of the tax expenditures in the code.



## Use of Tax Expenditures in the United States

Both the Executive and Legislative branches of the US government and occasionally private researchers measure and evaluate tax expenditures. The US Budget groups tax expenditures together by budget category, which allows analysts to examine immediately how much support is provided to various government activities.

To illustrate the analysis that might be applied to tax expenditures, take the first item in the budget tables. It might surprise some to learn that a small share of military compensation is provided in the form of an exclusion from tax of certain benefits and housing allowances for military personnel. This allowance is worth \$11.4 billion over five years—a tiny fraction of direct spending on defense—but not an insignificant sum. Presenting the estimate in the budget highlights the existence of the subsidy (a narrative section describes each provision) and allows policymakers and others to examine whether it is an effective way to spend governmental resources.

Although few in the US question the need for a strong national defense, some might wonder if the \$11 billion might be better spent directly on military compensation or perks. The exclusion is worth most to highly compensated military officers and those with substantial other sources of income, either because their spouses work or they have unearned income. At a time when press reports indicate that some military families are living in poverty, it is unlikely that a direct boost to compensation would be targeted at the best off members of the military. On the other hand, some would argue that on-base military housing is difficult to value. Adopting the most administrable solution of making housing allowances tax-free on a military base, but taxable off the base (where value of the subsidy is easy to determine), would be inequitable. The other military exclusions are related to particular circumstances where filing tax returns might be a particular hardship.

This is not the place to resolve these issues. Suffice it to say that the existence of the tax expenditure list and budget estimates invites this kind of scrutiny. If the government did not measure exclusions such as the one for military pay and perks, it is unlikely that legislators or analysts would ever submit any but the largest tax subsidies to scrutiny.

Other elements of the tax-expenditure budget routinely invite public debate. The mortgage interest deduction is the largest housing subsidy by far and dwarfs the size of not only other tax expenditures but also other direct expenditures for housing in the federal budget. The subsidy has been criticized as an upside down subsidy that provides the greatest benefit to upper middle class and upper class homeowners, while the greatest needs are among lower-income families struggling to pay rent or afford a home. (Howard 1997) In 2001, \$65 billion of tax revenues were diverted to subsidize owner-occupied housing, compared with \$14 billion on rental vouchers, \$6 billion for public housing, and \$3 billion for the low-income housing tax credit—the largest programs aimed at helping low-income renters. (Another \$22 billion in assistance for homeowners was conveyed via the deduction for property taxes.)

One issue in evaluating tax expenditures is that they are difficult to directly compare with outlay programs because the tax expenditure is net of any offsetting tax receipts that they may generate

(because the income received is taxable). In contrast, outlay estimates for spending programs simply reflect the amount of money that the agency will spend without an explicit adjustment for offsetting tax receipts. For this reason, the Treasury also produces a set of tables showing tax expenditures in “outlay equivalent” terms—in other words, the amount that would have to be budgeted for an equivalent direct spending program.<sup>11</sup>

For example, if the excluded compensation and benefits provided to military personnel were instead provided in the form of a wage supplement, the outlay equivalent would increase from the \$11.4 billion tax expenditures to a \$13.3 billion outlay. The increase is the difference between after-tax and pre-tax income. The mortgage interest deduction would increase from \$6.0 billion over five years to \$8.7 billion if implemented as a direct mortgage subsidy, and the low-income housing credit would increase from a \$3.3 billion per year (after-tax) credit to a \$4.5 billion per year (pre-tax) cash outlay. The difference arises because, if the money were paid directly to investors as cash, the income would be taxed at an average rate of 26 percent.

The Administration’s Budget presentation shows the data in several different ways. Table 1 shows the 57 largest income tax expenditures (those costing more than \$1 million—about 0.01 percent of GDP) in the United States in Fiscal Year 2004.<sup>12</sup> The table shows that the largest tax expenditures are quite large. Nontaxable fringe benefits are among the largest tax expenditures. The exclusion of employer-provided health insurance from income is expected to cost \$120 billion in lost tax revenues in 2004, nearly 15 percent of income tax revenues. The exclusion of defined contribution 401(k) plans and defined benefit employer pension plans each costs over \$55 billion, or 6 percent of income tax revenues. Clearly marginal income tax rates could be substantially reduced if these major sources of compensation were included in taxable income.

For some tax preferences that involve deferral of income tax liability, the Budget includes estimates of the present value (PV) of tax benefits with respect to activity undertaken in 2002. (See Table 1.) These estimates provide an indication of the cost of an investment tax subsidy over the life of the investment. They are also useful in showing the tax expenditure solely with respect to activity undertaken over a fixed time period—in this case, 2001. A significant portion of saving or investment tax subsidies such as the exclusion of pension contributions and earnings reflects revenue lost on saving made in prior years. For example, the tax expenditure for individual retirement accounts—number 11 on Table 1—largely reflects forgone tax revenues on amounts deposited in IRAs one or more years ago. As a result, the PV of annual contributions (10.6 billion) is less than half of the total annual cost of the IRA exclusion (\$23.1 billion).

The Joint Committee on Taxation (JCT) presents a similar tabulation of tax expenditures annually. There is not 100 percent overlap between the items on the two lists, largely because the JCT opts for a broader measure of normal income. There are also differences in the way different provisions are combined together. Nonetheless, the estimates are largely consistent, and the JCT document explains the significant differences that exist.

The JCT makes an important contribution by tabulating the distribution of benefits from selected tax expenditures by income class. A subset of JCT’s 2002 analysis is shown in Table 3. The tax expenditures at the top of the table—all deductions from income—primarily benefit upper-middle and upper-income households. Only about 30 percent of tax filers itemize deductions,

and most of those have higher incomes. In consequence, two of these tax expenditures (deduction for charitable contributions and for state and local taxes) provide just under half of their benefits to families with incomes over \$200,000. All of them provide over half of benefits to the approximately 5 percent of tax filers with incomes over \$100,000.

In contrast the child tax credit is distinctly a middle income tax subsidy (see bottom panel of Table 3). Indeed, it is not available to families with very high incomes (it starts to phase out at \$110,000 of income). In consequence, almost half of its benefits accrue to families with incomes under \$50,000. The earned income tax credit is explicitly targeted at low-income families. Almost two-thirds of its benefits accrue to families earning under \$20,000 per year. The child and dependent care tax credit is primarily a middle-class tax benefit. Lower-income families often cannot afford to pay for care, even with a tax credit, and very low-income families cannot benefit from the credit because it is not refundable.

The most systematic and comprehensive evaluation of tax expenditures is done by the Congressional Research Service of the Library of Congress every two years for the Senate Budget Committee. In 2002, the report evaluated 128 tax expenditures. (Congressional Research Service 2002) The evaluation includes a description of the provision, its cost, impact (including distribution of tax benefits by income when available), and rationale. It concludes with a summary assessment of the arguments for and against the provision. There are also references to other relevant research on the specific tax expenditure.

Beyond the summary descriptions and estimates, there is no regular and systematic evaluation of tax expenditures conducted by the executive branch of the federal government. The Government Performance Results Act of 1993 (GPRA), which was intended to “provide for the establishment of strategic planning and performance measurement in the Federal Government,” requires annual evaluations of tax expenditures by the Office of Management and Budget in consultation with the Department of the Treasury.”<sup>13</sup> Clinton’s Treasury Department, of which I was a part from 1998 to 2000, was unenthusiastic about performing these evaluations, reasoning that a comprehensive evaluation of tax expenditures would necessarily raise serious objections to measures enthusiastically advanced by the Administration. The result would either be a waste of staff time, as a credible analysis would never be published, or a whitewash that would damage the credibility of the Treasury staff. Although the menu of favorite tax expenditures changed when President Bush took office, the Office of Management and Budget has not published any new tax expenditure analyses as part of GPRA, suggesting that the same concerns still hold sway.

Other government agencies analyze tax expenditures on an ad hoc basis. The General Accounting Office has evaluated numerous tax subsidies at the request of Congress. A 1994 study concluded that tax expenditures had been growing faster than direct expenditures and recommended that tax-writing committees of Congress look for ways to draw more attention to tax expenditures as part of the budget process, although it is unclear what result that recommendation had, if any. (General Accounting Office, 1994) The Congressional Budget Office (CBO) analyzes a set of tax and budget options, including repealing or modifying a number of tax expenditures, in its annual *Budget Options* volume. (Congressional Budget Office 2003) The CBO also occasionally writes reports about particular tax expenditures (see, e.g.,

Burman, 1992). The Congressional Research Service of the Library of Congress produces similar reports at the request of Congress. In addition, all of these agencies and the JCT and Treasury are sometimes requested to analyze existing and proposed tax expenditures at Congressional hearings.

The public estimates and analysis require a good deal of staff resources, data, and computer services. Treasury's Office of Tax Analysis has a staff of about 50, many of whom work on aspects of the tax expenditure budget. Congress's Joint Committee on Taxation has a smaller staff, but many of them are also devoted to revenue estimating and tax expenditure estimates. Estimates are based on a large (>100,000) micro data file for individuals and a corporate data file that contains tax returns for all of the largest corporations. Data are brought to bear from other sources, such as the Survey of Consumer Finances, a comprehensive survey of individual wealth holding produced by the Federal Reserve Board.

Outsiders often use these data to evaluate tax expenditures. The Century Foundation recently used tax expenditure data to conduct a thorough review of tax expenditures in the US, as discussed earlier. (Toder, Wasow, and Ettliger, 2002) Eric Toder has published a number of studies of the changing nature of tax expenditures. He documented a marked shift away from business tax expenditures—savings incentives, investment tax credits, accelerated depreciation, special provisions for favored industries, etc.—in favor of social tax expenditures—programs that look like federal assistance programs for individuals. For example, the value of the earned income tax credit—an income support program for working poor families—has increased dramatically over the past two decades. Numerous tax credits have been implemented to subsidize low-income housing construction, higher education, child care, and child rearing. His chart documenting this shift, extended by Elaine Maag through 2000, is shown in Figure 1. Although the problems of aggregating tax expenditures makes the point estimates unreliable, there is little doubt that a sea change in the nature of tax expenditures has taken place. Toder (1998) discusses the factors that have contributed to this shift and its consequences.

Howard (1997) has documented the same phenomenon, writing from a political scientist's rather than an economist's perspective. He calls this shift in reliance on tax expenditures "the hidden welfare state."

## **Conclusions**

Early in the Bush Administration, conservative ideologues questioned the usefulness of the tax expenditure concept and many feared that this very useful tool might be banished from government budget presentations. Instead, the Administration has so far continued to produce its comprehensive summary and estimates of income tax expenditures with only minor political filtering (the deletion of estate tax expenditures most notably). In addition, this year's Budget includes a discussion of the issues that would be raised by measuring tax expenditures against alternate baselines—a comprehensive income tax and a comprehensive consumption tax. That analysis sheds light on the robustness of tax expenditure estimates.

Under any baseline, the tax expenditure concept is a useful way of showing how government affects the allocation of resources both directly—by financing public activities via tax

concession—and indirectly, by altering after-tax prices and thus distorting the allocation of resources. One suspects, though, that the Administration’s preference to shift the focus of analysis from an income tax baseline to a consumption tax baseline is part of a larger strategy to sneak a consumption tax in through the back door. As the 2004 Budget points out, however, savings subsidies in the context of a hybrid income-consumption tax system can create substantial resource misallocations.

It would thus be much better to have the debate about income tax versus consumption tax in the open and, once settled, attempt to make the tax system as neutral as possible. Measures and analysis of tax expenditures against the appropriate baseline will continue to be helpful in advancing that goal.

**Table 1. Income Tax Expenditures Ranked by Size in 2004**

**(In millions of dollars)**

<b>Rank</b>	<b>Provision</b>	<b>2004</b>	<b>2004-2008</b>	<b>PV(2002)</b>
1	Exclusion of employer contributions for medical insurance premiums and medical care	120,160	724,520	
2	Deductibility of mortgage interest on owner-occupied homes	68,440	375,910	
3	Net exclusion of pension contributions and earnings: Employer plans	67,870	340,550	90,570
4	Net exclusion of pension contributions and earnings: 401(k) plans	55,290	307,700	81,000
5	Capital gains (except agriculture, timber, iron ore, and coal) (normal tax method)	53,930	259,560	
6	Deductibility of nonbusiness state and local taxes other than on owner-occupied homes	50,910	212,430	
7	Deductibility of charitable contributions, other than education and health	33,990	187,000	
8	Accelerated depreciation of machinery and equipment (normal tax method)	31,110	-31,570	
9	Step-up basis of capital gains at death	28,500	152,380	
10	Exclusion of interest on public purpose State and local bonds	27,310	138,730	
11	Net exclusion of pension contributions and earnings: Individual Retirement Accounts	23,130	108,250	10,650
12	Deductibility of State and local property tax on owner-occupied homes	22,160	86,310	
13	Child credit	21,310	115,670	
14	Capital gains exclusion on home sales	20,860	110,770	
15	Exclusion of interest on life insurance savings	20,740	122,260	
16	Social Security benefits for retired workers	18,930	100,790	
17	Deferral of income from controlled foreign corporations (normal tax method)	7,900	44,990	7,180
18	Net exclusion of pension contributions and earnings: Keough Plans	7,616	41,284	9,290
19	Exclusion of workers' compensation benefits	6,460	36,480	
20	Deductibility of medical expenses	6,340	33,800	
21	Workers' compensation insurance premiums	6,190	35,330	
22	Graduated corporation income tax rate (normal tax method)	5,700	30,670	
23	Extraterritorial income exclusion	5,510	31,620	
24	Earned income tax credit	5,090	27,150	
25	Credit for increasing research activities	4,990	9,830	
26	Exception from passive loss rules for \$25,000 of rental loss	4,920	21,620	
27	Deductibility of charitable contributions (health)	4,580	25,260	
28	Deductibility of charitable contributions (education)	4,350	24,010	
29	Social Security benefits for dependents and survivors	4,140	22,830	
30	Self-employed medical insurance premiums	3,690	21,350	

**Table 1. Income Tax Expenditures Ranked by Size in 2004****(In millions of dollars)**

<b>Rank</b>	<b>Provision</b>	<b>2004</b>	<b>2004-2008</b>	<b>PV(2002)</b>
31	Credit for low-income housing investments	3,640	19,970	3,580
32	Social Security benefits for disabled	3,570	21,140	
33	Exclusion of veterans death benefits and disability compensation	3,400	18,940	
34	Credit for child and dependent care expenses	3,230	12,710	
35	Parental personal exemption for students age 19 or over	3,230	11,080	
36	Lifetime Learning tax credit	2,980	14,110	
37	HOPE tax credit	2,880	14,230	
38	Deduction for higher education expenses	2,880	9,440	
39	Expensing of research and experimentation expenditures (normal tax method)	2,760	18,790	1,800
40	Exclusion of income earned abroad by U.S. citizens	2,680	14,280	
41	Exclusion of reimbursed employee parking expenses	2,290	12,730	
42	Exclusion of benefits and allowances to armed forces personnel	2,240	11,430	
43	Tax credit for corporations receiving income from doing business in U.S. possessions	2,240	5,740	
44	Deferred taxes for financial firms on certain income earned overseas	2,130	7,540	1,740
45	Additional deduction for the elderly	2,050	10,490	
46	Low and moderate income savers credit	1,860	5,890	
47	Premiums on group term life insurance	1,830	9,450	
48	Special ESOP rules	1,790	9,960	
49	Inventory property sales source rules exception	1,620	8,970	
50	Exclusion of interest on hospital construction bonds	1,440	8,250	
51	Exclusion of scholarship and fellowship income (normal tax method)	1,260	6,830	
52	Empowerment zones, Enterprise communities, and Renewal communities	1,170	7,190	
53	Exemption of credit union income	1,160	6,640	
54	Capital gains treatment of certain income	1,120	6,240	
55	Deferral of income from post 1987 installment sales	1,100	5,710	
56	Accelerated depreciation on rental housing (normal tax method)	1,080	-4,570	
57	Exclusion of interest on owner-occupied mortgage subsidy bonds	1,050	6,030	

Source: U.S. Office of Management and Budget (2003), Tables 6-3 and 6-4.

**Table 2. Categorization of Current Tax Expenditures  
Under a Comprehensive Consumption Tax Baseline<sup>1</sup>**

Description	Revenue Effect (2004)
<i>A. Tax Expenditure Under a Consumption Base</i>	
Exclusion of Social Security benefits for retired workers	18,930
Exclusion of workers' compensation benefits	6,460
Credit for increasing research activities	4,990
Exclusion of Social Security benefits of dependents and survivors	4,140
<i>B. Probably a Tax Expenditure Under a Consumption Base</i>	
Exclusion of employer contributions for medical insurance premiums and medical care	120,160
Deductibility of mortgage interest on owner-occupied homes	68,440
Deductibility of nonbusiness state and local taxes other than on owner-occupied homes	50,910
Deductibility of charitable contributions, other than education and health	33,990
Deductibility of State and local property tax on owner-occupied homes	22,160
Child credit	21,310
Deductibility of medical expenses	6,340
Extraterritorial income exclusion	5,510
Earned income tax credit	5,090
Deductibility of charitable contributions (health)	4,580
Deductibility of charitable contributions (education)	4,350
Deductibility of self-employed medical insurance premiums	3,690
<i>C. Probably Not a Tax Expenditure Under a Consumption Base</i>	
Workers' compensation insurance premiums	6,190
<i>D. Not a Tax Expenditure Under a Consumption Base</i>	
Net exclusion of pension contributions and earnings: Employer plans	67,870
Net exclusion of pension contributions and earnings: 401(k) plans	55,290
Capital gains (except agriculture, timber, iron ore, and coal) (normal tax method)	53,930
Step-up basis of capital gains at death	28,500
Exclusion of interest on public purpose State and local bonds	27,310
Net exclusion of pension contributions and earnings: Individual Retirement Accounts	23,130
Capital gains exclusion on home sales	20,860
Exclusion of interest on life insurance savings	20,740
Accelerated depreciation of machinery and equipment (normal tax method)	16,663
Deferral of income from controlled foreign corporations (normal tax method)	7,900
Net exclusion of pension contributions and earnings: Keogh plans	7,616
Graduated corporation income tax rate (normal tax method)	5,700
Exception from passive loss rules for \$25,000 of rental loss	4,920

<sup>1</sup> The measurement of certain tax expenditures under a consumption tax baseline may differ from the official budget estimate even when the provision would be a tax expenditure under both baselines.

Source: U.S. Office of Management and Budget (2003), Appendix Table 2.



Table 3. Distribution by Income Class of Selected Individual Tax Expenditure Items, 2001

(Money amounts in millions of dollars, returns in thousands)

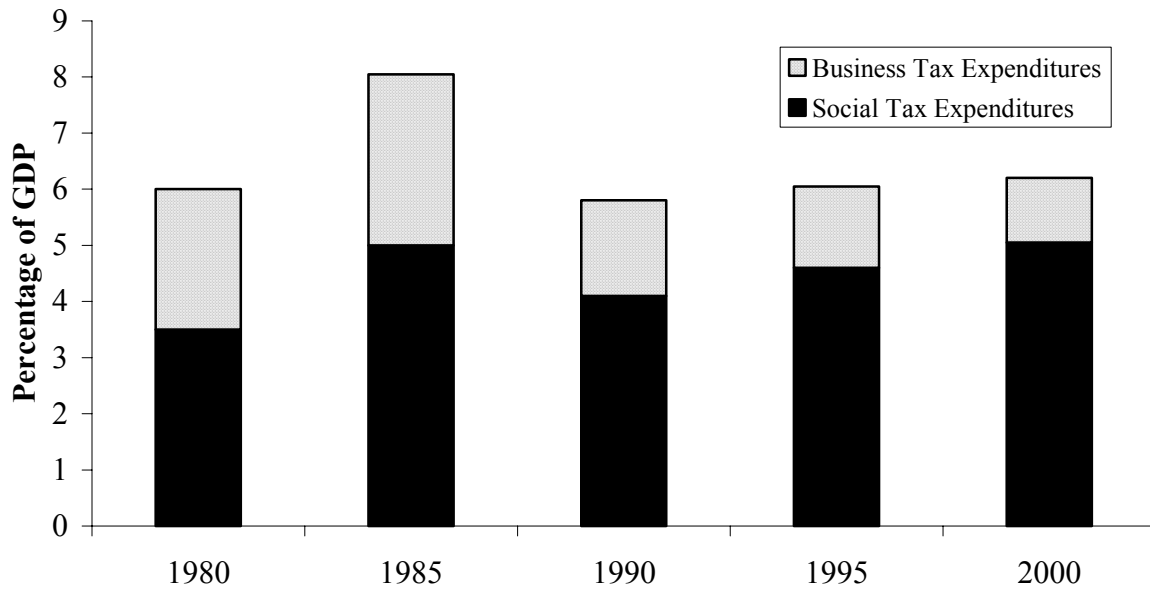
Income Class (\$thousands)	Mortgage Interest Deduction		State and Local Tax Deduction		Real Estate Tax Deduction		Charitable Contribution Deduction	
	Returns	Amount	Returns	Amount	Returns	Amount	Returns	Amount
Below \$10	67	\$13	50	2	51	\$2	59	\$2
\$10 to \$20	1,076	239	1,183	\$66	1,166	\$117	1,257	122
\$20 to \$30	1,938	817	2,435	241	2,165	\$341	2,498	365
\$30 to \$40	2,759	1,646	3,197	584	2,900	\$597	3,171	695
\$40 to \$50	3,233	2,930	3,712	1,176	3,377	\$947	3,645	1,066
\$50 to \$75	8,879	10,704	9,723	4,871	9,252	\$3,519	9,705	4,058
\$75 to \$100	6,666	14,070	7,007	6,744	6,983	\$4,275	7,219	5,251
\$100 to \$200	6,976	21,945	7,378	12,369	7,255	\$6,654	7,890	8,913
\$200 and over	2,110	14,570	2,247	22,841	2,068	\$4,786	2,592	19,959
Total	33,704	\$66,934	36,933	\$48,894	35,217	\$21,238	38,035	\$40,428

Income Class	Child Tax Credit		Earned Income Tax Credit		Child Care Credit	
	Returns	Amount	Returns	Amount	Returns	Amount
Below \$10	52	\$22	5,370	\$6,760	1	(\$4)
\$10 to \$20	3,256	1,203	5,868	15,053	68	20
\$20 to \$30	4,158	3,147	4,434	9,254	429	222
\$30 to \$40	3,671	3,399	2,520	2,703	583	348
\$40 to \$50	3,247	3,153	352	212	638	364
\$50 to \$75	7,149	7,216	16	21	1,508	745
\$75 to \$100	4,973	5,178	0	0	1,163	604
\$100 to \$200	4,204	3,857	0	0	1,500	806
\$200 and over	1	(1)	0	0	227	128
Total	30,709	\$27,176	18,560	\$34,002	6,117	\$3,236

Notes: Estimates for child tax credit and earned income tax credit include refundable portion

Source: Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2003-2007* (JCS-5-02). (Washington, DC: Government Printing Office) 2002.

Figure 1. Trends in Tax Expenditures 1980-2000 (as percent of GDP)



Sources: U.S. Office of Management and Budget (2000), Toder (1999).

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## NOTES

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<sup>1</sup> Note that repeal is not effective until 2010, and only for one year. Also, the Administration produces tax expenditure estimates for other expiring provisions, such as work opportunity tax credits, so the repeal argument for excluding the estate tax is a bit disingenuous. The more likely reason is that the Administration does not believe that the estate tax should exist. The Joint Committee on Taxation has never published estate tax expenditures.

<sup>2</sup> The same problem could occur in the measurement of the effect of spending programs, but is limited by the fact that almost all outlay programs in the US are subject to binding spending limits. In contrast, most tax expenditures are unlimited—available to all eligible individuals. Indeed, the more likely avenue for shifting costs from eliminating direct spending programs is that tax expenditures might increase. For example, if the government were to eliminate the guaranteed student loan program, which implicitly subsidizes interest rates for higher education loans, tax deductions for student loan interest would increase.

<sup>3</sup> Pensions would be the largest tax expenditure in 2004 if the tax exclusion on employer and employee contributions to pension plans were grouped together as they are in the Joint Committee on Taxation's analysis. The Budget presentation separates these two items.

<sup>4</sup> Taxpayers can take advantage of itemized deductions only to the extent that the total of all those deductions exceeds a standard deduction, which varies by filing status. About two thirds of tax filers in 2001 could not benefit from the deduction for charity, for example, because their deductible expenses were less than the standard deduction. (Balkovic 2002-2003).

<sup>5</sup> Significant changes to US tax laws were enacted in 1981, 1982, 1984, 1986, 1990, 1993, 1997, and 2001. Most analysts expect a sizable tax cut to be enacted this year, so the trend of frequent major changes is unlikely to abate any time soon.

<sup>6</sup> Haig-Simons income would include accrued capital gains, but the normal tax measures capital gains on a realization basis. Three factors drove this decision: historical precedent (gains have always been taxed for most individuals on a realization basis); the widely held belief that accrued but unrealized gains are not income; and the administrative difficulty of taxing gains when the sale price is not observable. Surrey and McDaniel (1985) seem ambivalent on this choice, deeming it as appropriate as of 1985, but one that should be reexamined over time.

<sup>7</sup> The Budget analysis also lists a number of items that might not be tax expenditures under the comprehensive income tax baseline, because those items tend to be justifiable as an approximation to a tax expenditure against the theoretical benchmark.

<sup>8</sup> Indeed, conservative economist, Bruce Bartlett (2001) argues that the current methodology creates a "...bias in favor of liberal tax policy."

<sup>9</sup> Cited in Brooks (1986, pp. 683-684).

<sup>10</sup> There was also a shift of tax liability from individuals to corporations that some viewed as anti-growth, but the point is that eliminating tax expenditures made possible substantial tax rate cuts which most economists would view as efficiency-enhancing.

<sup>11</sup> See US Office of Management and Budget (2003, pp. 112-115).

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<sup>12</sup> The budget ranks all tax expenditures. The smaller ones are excluded from Table 1, but not from the Budget.

<sup>13</sup> According to the Committee Report that accompanied the legislation, “[t]he Committee expects that annual performance reports would ... be used to report on ... tax expenditure assessments. These assessments should consider the relationship and interactions between spending programs and related tax expenditures. The Committee hopes that such reports will foster a greater sense of responsibility for tax expenditures with a direct bearing on substantial missions and goals.” (Senate Committee on Government Affairs, 1993, Section 4.)