

Example 14.1

Tax Expenditures

Chapter 14 noted that Congress has chosen to pursue some of its goals by granting individuals and businesses tax breaks relative to the ideal Haig-Simons standard. The federal government refers to these tax breaks as *tax expenditures*, because the tax revenues lost are an alternative to direct expenditures for supporting the tax-favored activities. Specifically, tax expenditures are defined as ‘the 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’.¹

The Congressional Budget Act of 1974 requires the administration to list the tax expenditures under both the individual and corporation income taxes and include an estimate of the tax revenue lost from each one. The lost revenues are estimated by the Office of Tax Analysis in the Treasury Department and published in the annual *Budget of the United States* prepared by the Office of Management and Budget (OMB). The Congressional Research Service (CRS) provides separate annual estimates of the tax expenditures for the Joint Committee on Taxation.

Tax expenditures have become a very important policy tool of the federal government, much more so than in 1974 when Congress first decided to monitor them. The number of tax expenditures increased from 67 in 1974 to 158 by 2006 and the lost tax revenue more than tripled in real terms during that same period.² The CRS estimated the total value of tax expenditures to be \$945 billion in FY2006, equal to 69% of the

¹ T. L. Hungerford, “Tax Expenditures: Trends and Critiques,” *CRS Report for Congress*, September 13, 2006, Congressional Research Service, Library of Congress, p.1.

² “Government Performance and Accountability: Tax Expenditures Represent a Substantial Federal Commitment and Need to Be Reexamined,” *Report to Agency Officials* (Washington, D.C.: United States Government Accountability Office (GAO)), September 2005, p.4; and “Tax Expenditures,” *Budget of the United States Government, Fiscal Year 2008* (Washington, D.C.: Government Printing Office, 2007), Table 19.1.

\$1,398 billion of tax revenues raised by the individual (\$1,044 billion) and corporation (\$354 billion) income taxes that year.³

The table below records the 16 largest tax expenditures in FY 2006 as estimated by the CRS. It highlights two points about the tax expenditures.

Table E14.1: Sixteen Largest Tax Expenditures for Individuals (FY 2006)⁴

Tax Expenditure	Dollars of Revenue Loss (\$billions)
Net exclusion of pension contributions and earnings [*]	124.7
Reduced tax rates on dividends and capital gains	92.2
Exclusion of employer contributions for health care	90.6
Deduction for mortgage interest	69.4
Exclusion of capital gains at death	50.9
Tax credit for children under age 17	46.0
Earned income tax credit (EITC)	42.7
Charitable contributions	41.3
Deduction of state and local taxes (except property taxes)	36.8
Exclusion of Medicare benefits	35.1
Exclusion of investment income in life insurance, annuity contracts	28.0
Exclusion of benefits provided under cafeteria plans	27.9
Exclusion of interest on public purpose state and local government Bonds	26.0
Exclusion of capital gains on sales of principal residences	24.1
Exclusion of untaxed social security benefits	23.1
Property tax deduction on owner-occupied residences	19.9
Total: Largest 16 tax expenditures	778.7
Percentage of total tax expenditures (\$945.0 billion)	82.4%
Total individual and corporation income tax revenues	1,398.0

** Includes employer plans, 401Ks plans, Keogh plans, and individual retirement accounts (IRAs)*

First, tax expenditures are highly concentrated in terms of their dollar amounts. Although there were 146 separate tax expenditures in 2006, the sixteen largest tax expenditures in the table account for 82.4% of the total value of the tax expenditures. Because the tax expenditures are so concentrated, they tend to be extremely important in certain policy areas. The OMB lists tax expenditures by their various functional categories in the annual

³ Hungerford, *op. cit.*, p. 1, and “Budget of the United States, Fiscal Year 2008, *op. cit.*, Table 2.1.

⁴ Hungerford, *op. cit.*, p. 3 and Table 1, p. 4; *Budget of the United States Government, Fiscal Year 2008, op. cit.*, Table 2.1

Budget document. Tax expenditures represent about 98% of total federal tax and direct expenditures in the Commerce and Housing category, primarily because of the three large tax expenditures for owner-occupied houses: the mortgage interest exclusion, the exclusion of capital gains on principal residences, and the deduction for local property taxes. Similarly, tax expenditures account for 49% of tax and direct expenditures in the Education, Training, Employment, and Social Services category (primarily because of the EITC), and 27% of the total federal tax and direct expenditures within the Health category (which includes Medicaid but not Medicare), primarily because of the exclusion of employer contributions for health care.⁵

Second, all of the more important tax expenditures come from tax breaks under the individual income tax rather than the corporation income tax.⁶ As such, the tax expenditures are tilted towards promoting social goals in the sense of supporting individuals and families, a tilt that has become more pronounced since 1974. The principal social goals pursued through tax expenditures are the desire to increase saving for retirement, charitable contributions, and home ownership.

Given the importance of tax expenditures, the General Accountability Office (GAO) has been pushing for the development of a common framework for evaluating the effectiveness of tax expenditures, direct expenditures, and regulatory policy, in order to determine which is the most effective policy approach within each functional area. In addition, the General Performance and Results Act of 1993 requires the administration to conduct detailed annual evaluations of tax expenditures to see if they are achieving their goals. In fact, almost no evaluation takes place. The GAO reports that neither the Clinton and the George W. Bush administrations nor Congress has shown much interest in conducting the evaluations. The result is that many of the tax expenditures have the aura of entitlement programs. They are not part of the annual review undertaken in developing the Budget, and as a result they are effectively given higher priority than any of the discretionary direct spending programs, which are reviewed each year. Nor are they subject to any other effective oversight by the administration. One problem is that the oversight function for tax expenditures is not clearly the responsibility of the OMB, or the Treasury, or the individual departments of the Executive Branch.⁷

The reluctance of the administration and Congress to closely examine the tax expenditures is understandable in one sense: any evaluation would almost certainly be highly problematic. Ideally, one would like to know what the federal government refers to as the input, the output, and the outcome for each tax expenditure. The input is the lost tax revenue, the output is the change in the activity being favored, and the outcome is the effect of the change in the activity on society's social welfare function. The last two are

⁵ GAO. September 2005, *op. cit.*, pp. 40–42.

⁶ The only important tax break under the corporation income tax in dollar amount is the ability of businesses to accelerate the depreciation of their capital relative to its true economic depreciation, which reduces their taxable profits in the earlier years that the capital is in place. The lost revenue each year is about \$12 to \$15 billion.

⁷ *Ibid.*, pp. 65–71.

especially difficult to pin down with much confidence. Establishing the output requires econometric analyses of the responses to each tax break. Economists have in fact undertaken such analyses of a number of the tax expenditures. For example, they have tried to determine how much the deduction for charitable contributions has increased charitable giving and how much the exclusions for retirement assets have stimulated total saving. Unfortunately, the results are highly mixed in each instance. Finally, determining the outcome is even more challenging and uncertain, as different people are likely to reach different conclusions regarding the effect of any given supported activity on social well-being.

This leaves only the input, the revenue loss, which both the administration and Congress do try to estimate. It is surely the easiest of the three components to estimate, but even here the estimates may not be very reliable. There are many difficulties in estimating the lost revenue from a particular tax break. The first problem is simply agreeing on a baseline against which to determine whether something qualifies as a tax expenditure. The natural annual baseline is the Haig-Simons standard of including all sources of increased purchasing power during the year, corrected for inflation, and taxing them all with the same set of tax rates. As it happens, neither the CRS nor the Office of Tax Analysis chooses the Haig-Simons standard. The CRS comes closest with its definition of a so-called normal tax baseline, which is why the CRS estimates were presented in the table above. But the normal tax baseline does not consider the personal exemptions nor the standard deduction as tax breaks, and it makes no adjustment for inflation. Until 1982, the OTA also used the normal tax baseline, but then it switched to a so-called reference tax baseline from 1983 on. The reference tax baseline is meant to provide a better reflection of the actual tax laws and their intent than the normal tax baseline, with the result that it generates fewer tax expenditures than the normal tax baseline. In FY 2006, the CRS reported 28 more tax expenditures than the OTA, with an estimated aggregate revenue loss of \$100 to \$150 billion.⁸ An important example is that the OTA does not count the reduced 15% tax rate on dividends and capital gains, the second largest tax expenditure in the CRS list above, on the grounds that both are already taxed under the corporation income tax and therefore should be subject to a reduced tax rate under the individual income tax.

There are still other problems in estimating the revenue losses. The CRS and OTA revenue loss estimates are first-pass estimates in the sense that they do not take into account any behavioral responses to the tax breaks. The estimated revenue loss is the amount of the tax-favored item reported on a tax return times the marginal tax rate of the taxpayer. This surely overstates the lost revenue because there would be less of the favored activity without the tax break and therefore less revenue collected. For example, charitable contributions would undoubtedly be lower without the tax deduction and thus eliminating the deduction would not add as much to the tax base. In addition, the lost-revenue estimates are partial equilibrium, other-things-equal estimates; they do not take

⁸ Hungerford, *op. cit.*, p. 2., and GAO, September 2005, *op. cit.*, pp. 26 and 27.

into account possible interdependencies among the tax breaks. In effect, the estimates assume that each tax expenditure would be the only one changed if it were removed, and also that removing it would have no effect on the revenue losses from any other tax expenditure. Yet some tax expenditures are clearly interdependent. For example, when the federal government removed the interest deduction on loans for consumer goods in the 1986 tax reform, consumers responded by using home equity loans to finance many of their consumption expenditures because mortgage interest continued to be deductible. As a result, the tax revenue gained was much less than the previous estimate of the revenue lost by the interest deduction on consumption loans. A related point is that removing many tax expenditures at once is likely to have two offsetting effects on the tax revenue to be gained. One is that many taxpayers who previously itemized deductions would take the standard deduction⁹, reducing the resulting tax revenue. The other is that many taxpayers would be in higher tax brackets, increasing the tax revenue. For all these reasons, it is difficult to predict with any accuracy how much tax revenue will rise or fall with the removal of one or more tax expenditures, or even in some cases whether it will rise or fall. The uncertainties are such that the OTA does not report an estimate of the aggregate revenue lost from all the tax expenditures, on the grounds that it would not be a reliable estimate. These measurement difficulties notwithstanding, there is no question that tax expenditures are an important policy tool of the federal government and have become more so over the past 30 years.

Sources

- T. L. Hungerford, "Tax Expenditures: Trends and Critiques," *CRS Report for Congress*, September 13, 2006, Congressional Research Service, Library of Congress
- "Tax Expenditures," *Budget of the United States Government, Fiscal Year 2007 and 2008* (Washington, D.C.: Government Printing Office, 2006, 2007)
- "Government Performance and Accountability: Tax Expenditures Represent a Substantial Federal Commitment and Need to Be Reexamined," *Report to Agency Officials* (Washington, D.C.: United States Government Accountability Office (GAO)), September 2005

⁹ An outline of the distinction between itemized and standard deductions is given on page 268 of *Public Sector Economics*.