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A Brief History of Tax Expenditures

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Introduction

The concept of "tax expenditures" began in the 1960s when Assistant Secretary of the Treasury Stanley Surrey noted that many tax preferences resemble spending. Congress mandated in 1974 that these tax expenditures be recorded annually as part of the federal budget.[2] Since the birth of the concept, tax expenditures have been defined as the deductions, credits, exclusions, exemptions, and other tax preferences that represent departures from a "normal" tax code. As we will see, "normal" is in the eye of the beholder, and the two government agencies responsible for tracking tax expenditures, Treasury and the Joint Committee on Taxation (JCT), often provide different answers when asked what is "normal." However, the two agencies' methods are largely consistent with each other from year to year. Thus, the annual tax expenditure reports produced during the budgeting process reveal something about how the tax code has changed over the years and provide some guidance for tax reform.[3]

Attempts to reduce tax expenditures have not been met with great success. The Tax Reform Act of 1986 did not significantly reduce the number of tax expenditures, though it did reduce their real dollar value by about one-third. However, beginning in the mid- to late 1990s, numerous tax expenditures were added, expanded, or otherwise allowed to grow. Today, the tax expenditure budget is $1.2 trillion, which represents real dollar growth of 44 percent since 1986 and 96 percent growth since 1991 when tax expenditures were at their lowest. All of the growth has been in the individual tax code, with about two-thirds of real dollar growth coming from just three provisions: the earned income tax credit, the child credit, and the exclusion for employer-provided healthcare. Corporate tax expenditures have actually declined since 1986 in real dollar terms such that their share of the tax expenditure budget is now about 9 percent, half of what it was in 1986.

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[1] The author would like to thank Zachary Bartsch and Lyman Stone for their research assistance.

[2] Stanley Surrey, *Federal Income Tax Reform*, 84 HARVARD LAW REVIEW 352 (1970).

[3] For more on the economics of the major tax expenditures, *see* Michael Schuyler & Stephen Entin, *The Economics of the Blank Slate: Estimating the Effects of Eliminating Major Tax Expenditures and Cutting Tax Rates*, TAX FOUNDATION FISCAL FACT NO. 378 (July 26, 2013), http://taxfoundation.org/article/economics-blank-slate-estimating-effects-eliminating-major-tax-expenditures-and-cutting-tax-rates.

What are Tax Expenditures and Where Did They Come From?

Tax expenditures are the deductions, credits, exclusions, exemptions, and other tax preferences that represent departures from a "normal" tax code. Of course, therein lies the rub, since people disagree on what is normal. According to Treasury and JCT, who are tasked with tracking tax expenditures each year, "normal" means the Haig-Simons comprehensive income tax, which taxes consumption plus changes in net wealth in a given time period (e.g., per year).[4] This is not as simple as it sounds. Whereas taxing consumption per year, for example with a sales tax, is relatively straightforward, taxing changes in net wealth per year is complicated and in many cases impractical. Capital gains, for example, have always been taxed only upon realization. Recognizing this convention, Treasury and JCT do not count the deferral of tax on unrealized capital gains as a tax expenditure.

There are other assumptions as well, and they differ slightly between Treasury and JCT, resulting in slightly different estimates. As Treasury notes, the corporate income tax is a departure from the comprehensive income tax, since it is a double tax on shareholder earnings.[5] By that standard, it should be scored as the opposite of a tax expenditure (a negative tax expenditure) since it is a tax increase over the comprehensive income tax. At about $300 billion, it dwarfs all corporate tax expenditures. Yet by convention Treasury and JCT both include the corporate income tax in the "normal" tax code.[6]

Other inconsistencies include the fact that Treasury and JCT count the graduated rates in the corporate income tax as a tax expenditure but not the graduated rates in the personal income tax. Nor do they count the standard deduction or personal exemptions in the personal income tax.

In effect, the "normal" tax code is largely the tax code that existed in 1974, when the tax expenditure estimates were first mandated by Congress, but with an inconsistently broader tax base. While this is hardly a principled basis, these tax expenditure estimates have become the most widely accepted catalogue of "loopholes," mainly because the methodology has remained roughly the same since 1974 and it does capture many questionable items.

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[4] Robert Haig, *The Concept of Income–Economic and Legal Aspects*, *in* THE FEDERAL INCOME TAX 1-28 (Columbia University Press, 1921). *See also* Henry Simons, PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY 49 (University of Chicago Press, 1938).

[5] Office of Management and Budget, *Analytical Perspectives: Budget of the U.S. Government, Fiscal Year 2014* (Mar. 2013), at 242, http://www.whitehouse.gov/omb/budget/Analytical_Perspectives.

[6] For more detail on this issue, *see* Office of Management and Budget, *Analytical Perspectives: Budget of the U.S. Government, Fiscal Year 2005* (Feb. 2004). In this report, it is estimated that the corporate tax would be worth -$35 billion as a tax expenditure under the comprehensive income tax. Under a comprehensive consumption tax it would be much larger, roughly the size of corporate tax revenue but negative, making it the largest tax expenditure in absolute terms. Treasury's corporate tax estimate never made it into the official 2004 tax expenditure list or any subsequent year's list. Also in this report, Treasury estimated the value of net imputed rent of owner-occupied housing, which did make it into the following year's official list of tax expenditures and it has remained there ever since. *Id.* at 325.

According to Treasury, there are currently 169 tax expenditures, while JCT finds more than 200. Treasury's dollar value estimate of the tax expenditure budget for 2013 is about $1.2 trillion, including refundable outlays, while JCT's estimate is closer to $1.3 trillion. Using Treasury's estimates, about $1.1 trillion, or 91 percent of the total, accrues to individuals rather than corporations.

Aside from corporate and individual, tax expenditures can be grouped into three major functional categories. First, there are social welfare programs run through the IRS. These tax provisions include the earned income tax credit, the child credit, and the exclusion for employer-provided healthcare, which alone amount to over $300 billion or about 25 percent of the tax expenditure budget. Various other items, such as the American Opportunity Tax Credit and other education benefits, push the total dollar value in this category to about $445 billion in 2013, or 37 percent of the tax expenditure budget (see Figure 1).[7]

Second, there are what might be considered "corporate welfare" programs meant to spur certain industries or activities, such as the various credits and deductions related to renewable energy and energy-efficient products like hybrid vehicles, appliances, and windows. There are also preferences for manufacturers, the housing industry, credit unions, and Blue Cross/Blue Shield. These provisions, though numerous, are small in dollar value and represent about $38 billion in total, or 3 percent of the tax expenditure budget. However, there is some overlap between the first and second categories, since things that serve some social purpose often also benefit a narrow business interest, such as the many health preferences that benefit the healthcare industry.

The third category contains those provisions that mitigate the double taxation of saving and investment that is inherent in the comprehensive personal income tax and only made worse by the corporate income tax. These include preferential rates on capital gains and dividends as well as the exclusions for retirement contributions and earnings. While these are often cast as loopholes for the wealthy, they in fact move the tax system towards a saving-consumption neutral tax base rather than the comprehensive income tax that favors consumption over saving.[8]

Also included in this third category are depreciation rules that allow businesses to write off expenses faster than under "economic depreciation," a complicated regime which overstates income. Full expensing in the year of purchase for all industries would simplify matters greatly and reduce industry lobbying but would be scored as a tax expenditure.[9] Finally, the third category includes provisions such as deferral, which mitigates the double taxation of foreign earnings (once by the host country and again by the U.S.). Deferral is often

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[7] For more information about education tax credits, *see* Kyle Pomerleau, *The Higher Education and Skills Obtainment Act: A Proposal to Reform Higher Education Tax Credits*, TAX FOUNDATION FISCAL FACT NO. 377 (July 24, 2013), http://taxfoundation.org/article/higher-education-and-skills-obtainment-act-proposal-reform-higher-education-tax-credits.

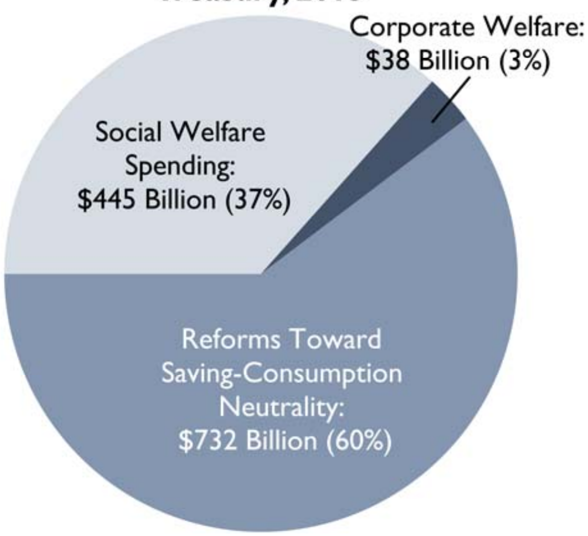
[8] For a discussion of tax expenditures under a consumption tax base, *see* Robert Carroll, David Joulfaian, & James Mackie, *Income Versus Consumption Tax Baselines for Tax Expenditures*, 64 NATIONAL TAX JOURNAL 491 (2011).

[9] Stephen Entin, *The Tax Treatment of Capital Assets and Its Effects on Growth: Expensing, Depreciation, and the Concept of Cost Recovery in the Tax System*, TAX FOUNDATION BACKGROUND PAPER NO. 67 (Apr. 24, 2013), http://taxfoundation.org/article-ns/tax-treatment-capital-assets-and-its-effect-growth-expensing-depreciation-and-concept-cost-recovery.

cast as a corporate giveaway, but in fact most countries outside the U.S. go one step further by largely exempting foreign earnings from domestic taxation.[10]

Both by count and in dollar terms, the third category is the largest. These provisions total about $732 billion in 2013, roughly 60 percent of the tax expenditure budget. While many of these provisions could be improved and simplified through fundamental tax reform, their essential function should be preserved in order to mitigate the double taxation of saving and investment. Figure 1 shows the tax expenditure budget broken down into these three categories.[11]

Figure 1. Tax Expenditure Budget reported by Treasury, 2013



Growth of Tax Expenditures Since 1986

According to both Treasury and JCT, the number of tax expenditures remained steady following the Tax Reform Act of 1986, then began increasing in the mid- to late 1990s. Treasury reports indicate there were 119 tax expenditures in 1986, 131 in 1999, and 169 in 2013. JCT reports indicate a similar trajectory, though with more tax expenditures in any one year (see Figure 2 below, reproduced from JCT).[12] According to JCT, 1996 was a banner year in which nineteen tax expenditures were added, including the child credit, various education credits, and the D.C. first-time homebuyer tax credit. Many more followed, under President George W. Bush and now under President Barack Obama, resulting in more than 200 tax expenditures today.

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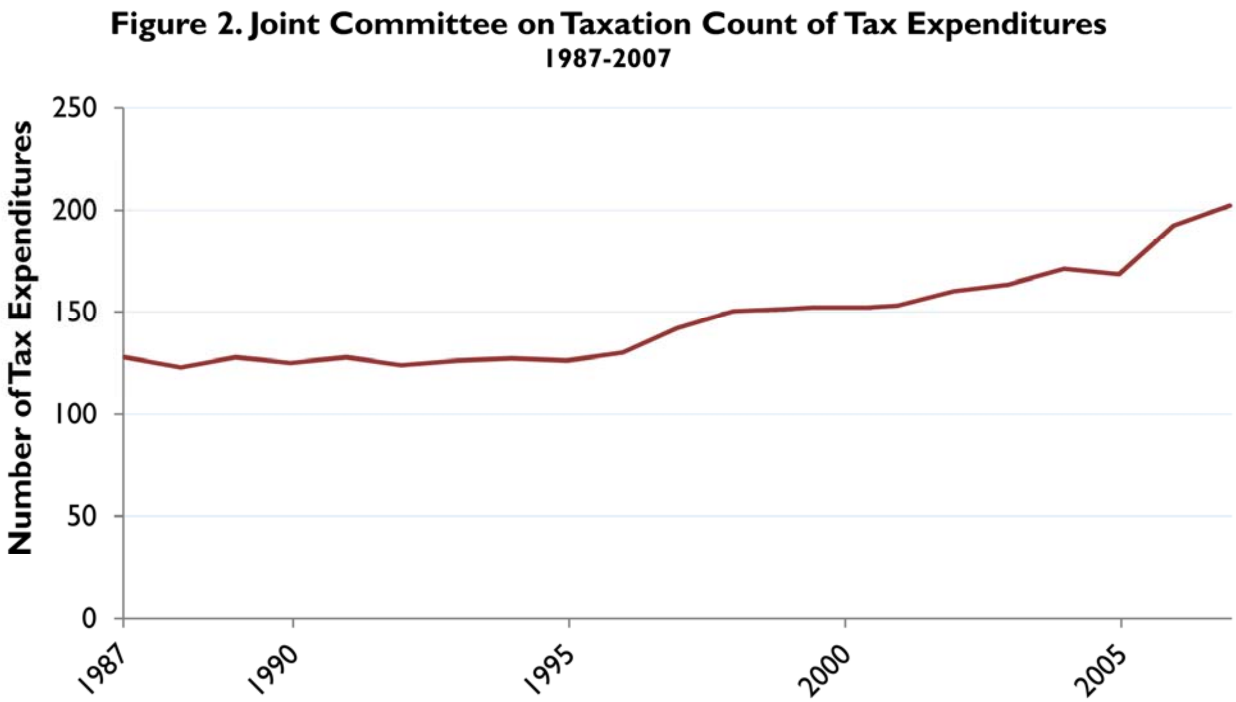
[10] William McBride, *New Zealand's Experience with Territorial Taxation*, TAX FOUNDATION FISCAL FACT NO. 375 (June 19, 2013), http://taxfoundation.org/article/new-zealands-experience-territorial-taxation.

[11] This should be considered a rough break down, since such an analysis inherently involves some grey areas depending on the type of consumption tax considered and its relation to the official tax expenditure baseline. For example, this analysis assumes that the exclusion of social security benefits is social welfare spending under the rationale that the payroll taxes used to pay for them are partially deductible (by the employer). However, since half of payroll taxes are not deductible (the employee share), half of the benefits should also be excluded. Treasury's estimate is relative to a 15 percent exclusion, so the dollar value would be smaller relative to a consumption tax base with a 50 percent exclusion. This means a portion belongs in the saving-consumption neutral category, though it is unclear what portion. For a more in depth discussion of these issues, *see*, *e.g.*, Office of Management and Budget, *Analytical Perspectives: Budget of the U.S. Government, Fiscal Year 2005* (Feb. 2004), at 314-325.

[12] Joint Committee on Taxation, *Background Information on Tax Expenditure Analysis and Historical Survey of Tax Expenditure Estimates* (Feb. 28, 2011).



In real dollar terms, the growth of tax expenditures has been entirely on the individual side of the tax system, at least since 1986. Figure 3 shows Treasury estimates of tax expenditures from 1986 to the present, adjusted for inflation to 2013 dollars. The tax expenditure budget grew from $844 billion in 1986 to $1.2 trillion in 2013, an increase of 44 percent. Over the same period, individual tax expenditures grew from $685 billion to $1.1 trillion, while corporate tax expenditures shrunk from $159 billion in 1986 to $108 billion in 2013. Corporate tax expenditures are now less than 9 percent of the tax expenditure budget, which is lower than at any time since 1986.

Figure 3 also shows that the tax expenditure budget as a whole was reduced by about one-third following the Tax Reform Act of 1986, and it reached its minimum in 1991. This was mainly due to the phase-out of the investment tax credit on the corporate side of the tax system and the elimination of preferential rates on capital gains on the individual side. The investment tax credit never returned, but preferential rates on capital gains came back when ordinary tax rates were increased in 1990. However, the return of preferential rates on capital gains explains only 10 percent of the growth in real dollar terms since 1991 and none of the growth since 1986.

Instead, the major sources of growth have been in the social welfare spending category, particularly the earned income tax credit, the child credit, and the exclusion for employer-provided healthcare. These three tax expenditures together explain two-thirds of the growth in real dollar terms since 1986 and 38 percent of the growth since 1991. The employer-provided healthcare exclusion alone explains 41 percent of the growth since 1986 and 24 percent of the growth since 1991. It is now the largest tax expenditure, costing $203 billion in 2013.[13] Its growth is not due to direct legislative changes but rather to steady growth in health insurance as a form of compensation, owing in part to its tax-free treatment. This tax bias contributes to overspending on health insurance and healthcare, ultimately raising prices rather the quality of healthcare.[14]

The earned income tax credit accounts for 15 percent of the growth since 1986 and 8 percent of the growth since 1991. The child credit accounts for 11 percent of the growth since 1986 and 7 percent since 1991. Most of the growth of these credits is due to successive legislative expansions, mainly on the refundable portion (the portion paid out in excess of the recipient's income tax liability). The American Opportunity Tax Credit for education expenses is another refundable tax credit which was created in 2009 and now accounts for 6 percent of the growth in tax expenditures since 1986.

One big problem with refundable tax credits is that they are a once-a-year windfall for recipients, which makes them less helpful for income security or work incentive purposes and more of a target for fraud and abuse.[15] Another problem is that they are phased out over some income range such that they discourage work and saving at the margin for millions of workers.[16] Finally, refundable credits contribute to the current precarious fiscal arrangement in which about half the population pays no federal income tax and a shrinking minority shoulders the lion's share of the federal tax burden.[17]

Figure 4 shows the growth of refundable tax credits and the exclusion for employer-provided healthcare in inflation adjusted 2013 dollars. The employer-provided healthcare exclusion grew from the fourth-largest tax expenditure in 1986, at $52 billion, to the largest today, at $203 billion. Of the refundable tax credits, only the earned income credit existed in 1986, at the relatively modest level of $4 billion. Today it is worth $58 billion. The child credit grew from $5 billion in 1998 to $41 billion today.[18] The American Opportunity Tax Credit grew from $2.6 billion in 2010 to $21 billion today. These four tax expenditures account for 72 percent of the growth in the tax expenditure budget since 1986 and 42 percent of the growth since 1991.

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[13] This does not count the additional loss of payroll tax revenue, which Treasury estimates at $108 billion in 2013.

[14] The U.S. spends almost one-fifth of GDP on healthcare, almost twice what any other developed country spends, yet remains average to below average in terms of measured health outcomes.

[15] *See*, *e.g.*, Government Accountability Office, Beryl H. Davis, *Improper Payments: Remaining Challenges and Strategies for Governmentwide Reduction Efforts*, GAO-12-573T, Mar. 28, 2012, http://www.gao.gov/assets/590/589681.pdf.

[16] Michael Schuyler & Stephen Entin, *The Economics of the Blank Slate: Estimating the Effects of Eliminating Major Tax Expenditures and Cutting Tax Rates*, TAX FOUNDATION FISCAL FACT NO. 378 (July 26, 2013), http://taxfoundation.org/article/economics-blank-slate-estimating-effects-eliminating-major-tax-expenditures-and-cutting-tax-rates.

[17] Will Freeland & Scott A. Hodge, *Tax Equity and the Growth of Nonpayers*, TAX FOUNDATION SPECIAL REPORT NO. 200 (July 20, 2012), http://taxfoundation.org/article/tax-equity-and-growth-nonpayers. *See also* Will Freeland, William McBride, & Ed Gerrish, *The Fiscal Cost of Nonpayers*, TAX FOUNDATION SPECIAL REPORT NO. 203 (Sept. 19, 2012), http://taxfoundation.org/article/fiscal-costs-nonpayers; Congressional Budget Office, *The Distribution of Household Income and Federal Taxes, 2008 and 2009* (July 10, 2012), http://www.cbo.gov/publication/43373.

[18] JCT's estimate of the child credit is considerably higher, at $57.3 billion in 2013.

The remainder of the growth in tax expenditures arose mainly from the increase in individual tax rates in the 1990s, which increased the value of individual tax breaks, and the booming stock market, which increased the value of tax breaks on capital gains and retirement accounts. The bulge from 2009 to 2011 in Figure 4 is from various temporary stimulus measures, namely the Making Work Pay Credit, the first-time homebuyer credit, and bonus depreciation.

Figure 3. Tax Expenditures Reported by Treasury
1986 to 2013

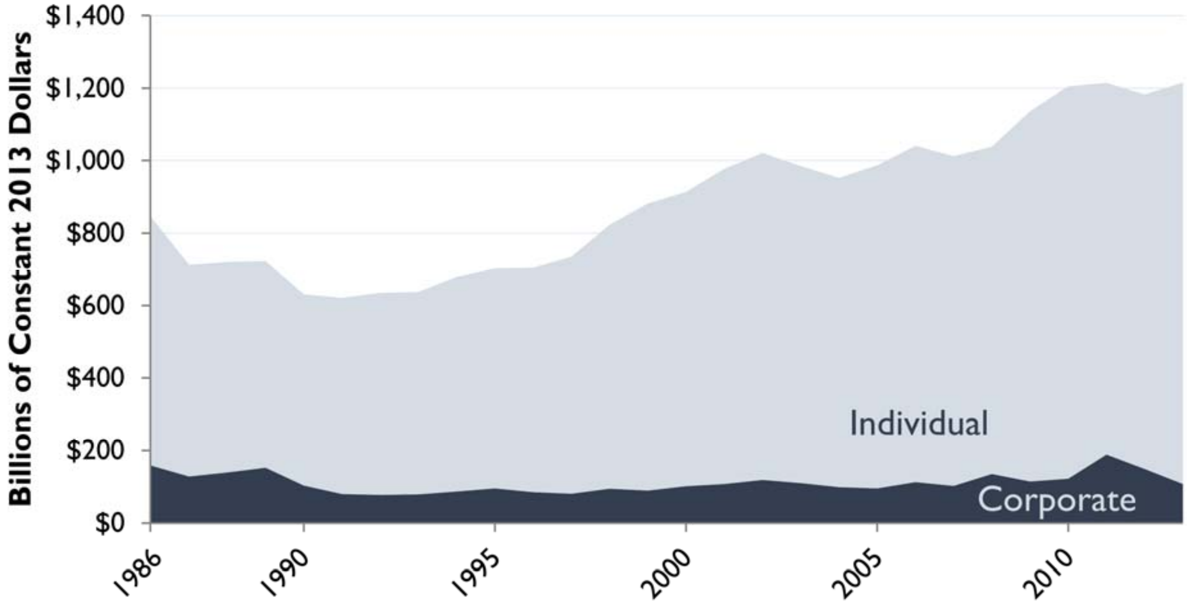
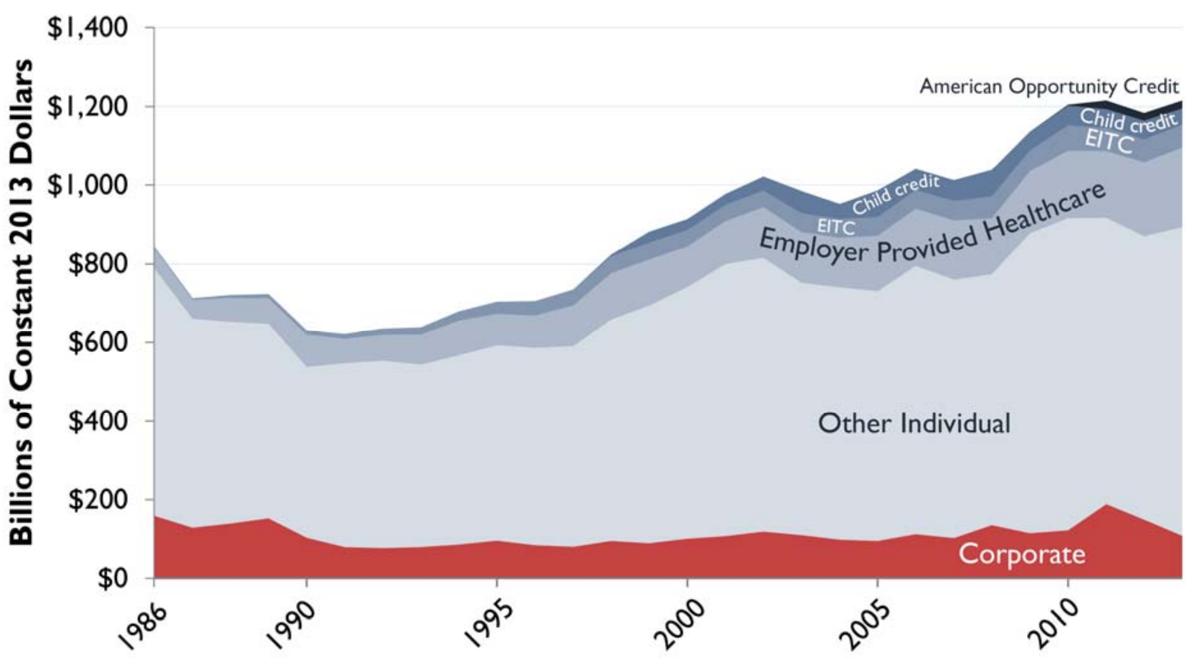


Figure 4. Fastest Growing Tax Expenditures Reported by Treasury
1986 to 2013



Conclusion

Proponents of tax reform today, as in 1986, look to the government's tax expenditure lists as a way to pay for lower tax rates. This is dangerous since the methodology used to define tax expenditures, and estimate their value, is not entirely consistent. The main problem is that it treats the comprehensive personal income tax plus corporate income tax as "normal," even though it involves double, triple, or quadruple taxation of saving and investment. Despite these inconsistencies, the tax expenditure lists do include some wasteful items and point to some areas for reform. Further, because the methodology has not changed significantly over the years, they provide some measure of how the tax code has changed over the years and where the growth has been.

The tax expenditure budget has grown about 44 percent in real dollar terms since the last major tax reform in 1986 and 96 percent since 1991, when tax expenditures were at their lowest. All of the growth has been on the individual side, with about two-thirds coming from just three provisions: the earned income tax credit, the child credit, and the exclusion for employer-provided healthcare. Corporate tax expenditures have actually declined since 1986 in real dollar terms, and their share of the tax expenditure budget is now about 9 percent, lower than at any time since 1986.

The three fast-growing tax expenditures, relating to health and income security, are part of a larger group of tax expenditures that, true to Stanley Surrey's original concept, look a lot like spending. Some other examples include the American Opportunity Tax Credit as well as a dozen other education benefits. Together, they make up about 37 percent of the tax expenditure budget and a fair amount of the complexity. They are also among the least economically valuable tax expenditures in terms of GDP growth per dollar of lost tax revenue.[19] While they may achieve some other social purpose, such as more redistribution, more healthcare, or more education, they come with many downsides relating to their implementation in the tax code, namely ineffectiveness, fraud, abuse, and overspending. One avenue for tax reform would be to move these provisions to the spending side of the ledger, overseen by a spending agency subject to the annual appropriations process rather than the IRS.

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[19] Michael Schuyler & Stephen Entin, *The Economics of the Blank Slate: Estimating the Effects of Eliminating Major Tax Expenditures and Cutting Tax Rates*, TAX FOUNDATION FISCAL FACT NO. 378 (July 26, 2013), http://taxfoundation.org/article/economics-blank-slate-estimating-effects-eliminating-major-tax-expenditures-and-cutting-tax-rates.