

The Changing Composition of Tax Incentives

1980-99

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I. Introduction

Tax incentives represent a significant share of Federal financial support for many social policy goals. These include support for low-income families, health (for the non-elderly population), housing, savings incentives, and support for state and local governments and private charitable organizations. Recent years have seen an expansion of tax incentives for social policy, even as politicians of both parties have proclaimed an end to the "era of big government."

Tax incentives are popular because they represent a way of increasing Federal support for social policy, while seeming to be tax cuts rather than increases in spending. Compared to direct outlay programs with similar goals, they better meet the need of politicians to appear to favor spending restraint and in some circumstances can be financed at a lower political cost. ⁽¹⁾

Some analysts refer to tax incentives as "tax expenditures", in recognition of the fact that tax provisions often substitute for direct spending programs as ways of advancing Federal policy goals. ⁽²⁾ The Office of Management and Budget (OMB) defines "tax expenditures" as "revenue losses due to preferential provisions of the Federal tax laws, such as special exclusions, exemptions, deductions, credits, deferrals, or tax rates."⁽³⁾ Both the OMB and the Congressional Joint Committee on Taxation (JCT) annually publish a list of Federal tax expenditures and estimates of their revenue losses. (The U.S. Treasury Department provides the estimates for the OMB publication.) In spite of the terminology, some proposals the agencies call "tax expenditures" do not have an obvious spending program counterpart, although they do provide preferential treatment relative to a comprehensive income tax.⁽⁴⁾ But many others could equally well be designed as explicit outlays.

This paper reviews trends in tax expenditures over the past 20 years, documenting how tax expenditures have increasingly been used to promote social policy goals instead of business investment. We classify tax expenditures into two broad types—business tax expenditures and social tax expenditures. Generally speaking, business tax expenditures are those that intend to promote investment generally or to help certain industries that Congress has considered important for economic growth or national security. They include items such as the partial exclusion of capital gains from income, the investment tax credit, and incentives for energy production and conservation. Social tax expenditures include provisions that promote education, health, housing, retirement security, and income security for low-income families. Appendix 1 lists the items we classify as business tax expenditures and those we classify as social tax expenditures.

The data we use are based on Treasury tax expenditure estimates reported by OMB in the Federal budgets of 1980, 1985, 1990, 1995, and 1999. These estimates reflect both ambiguities in Treasury's measurement of specific tax expenditure items and additional errors introduced in this paper by adding up separate items without considering interactions among them. Thus, the numbers presented below need to be interpreted with caution. Nonetheless, the data do present an accurate picture of *broad trends* in the level and composition of tax expenditures. Appendix 2 discusses the methodology used by Treasury and JCT to measure tax expenditures and some of the measurement problems.

II. Overall Trends, 1980-99

Tax expenditures will add up to about 6.3 percent of GDP in Fiscal Year 1999. Of this amount, about 5 percent come from items this paper classifies as social tax expenditures and about 1.3 percent from business tax

expenditures. A substantial share of the revenue losses from tax expenditures come from a relatively small number of provisions. In 1999, the top 5 social tax expenditures accounted for about 65 percent of the revenue loss from all social tax expenditures. The top 5 social tax expenditures, and their associated 1999 revenue losses were: net exclusion of contributions to, and earnings from, retirement savings plans (\$86.9 billion); exclusion of employer contributions for medical insurance premiums and medical care (\$76.2 billion); deductibility of mortgage interest on owner-occupied homes (\$53.7 billion); deductibility of non-business state and local taxes, other than on owner-occupied homes (\$33.5 billion); and the earned income tax credit (\$29.1 billion).⁽⁵⁾ The top 5 business tax expenditures, in the same year, accounted for over 70 percent of the estimated revenue loss from all business tax expenditures. The top five business tax expenditures, and their associated 1999 revenue losses, were: accelerated depreciation of machinery and equipment (\$28.5 billion); preferable tax rates on capital gains (\$26.1 billion); exclusion of interest on life insurance savings (\$14.2 billion); step-up in basis of capital gains at death (\$9.5 billion); and graduated corporate income tax rates (\$5.1 billion). In addition to these, many tax expenditures that are small in dollar terms are nevertheless important because they provide a large subsidy relative to the dollar amount of the activity receiving assistance.

Over the past twenty years, total tax expenditures as a percentage of GDP have increased slightly (Chart 1). But the bigger story is the change in the composition of tax expenditures. Social tax expenditures as a percentage of GDP have increased by over 40 percent between 1980 and 1999, while, over the same period, revenue losses from business tax expenditures have been cut in half. Consequently, in 1999, social tax expenditures will account for 79 percent of all tax expenditures, up from 57 percent in 1980.

Tax Policy in the Past Two Decades: Three Distinct Periods

The 1980-99 trends reflect three distinct periods in the past two decades of tax policymaking—the early 1980s, the middle 1980s, and the decade of the 1990s.⁽⁶⁾

The Early 1980s: Growth in Both Business and Social Tax Expenditures. Between 1980 and 1985, both business and social tax expenditures increased. Business tax expenditures rose from 2.6 to 3.1 percent of GDP, while social tax expenditures increased from 3.5 to 5.0 percent of GDP. The increase in tax expenditures came from two main sources: new and expanded tax incentives in the Economic Recovery Tax Act of 1981 (ERTA81) and economic and behavioral changes that raised the cost of tax expenditures that were in the law prior to 1980.

The increase in business tax expenditures between 1980 and 1985 resulted mainly from provisions in ERTA81. ERTA81 introduced a variety of new investment incentives, the most important of which were greatly accelerated depreciation allowances for machinery and equipment, commercial buildings, and residential real estate. The estimated tax expenditure on accelerated depreciation on machinery and equipment by itself increased by 0.5 percent of GDP between 1980 and 1985.

In contrast, the increase in social tax expenditures was driven in large part by increased use of preferences in the tax law prior to 1981, although there were also important new tax law provisions. For example, the revenue losses from exemption of employer-paid health insurance contributions and the mortgage interest deduction together increased by 0.4 percent of GDP. These increases reflected only economic and behavioral changes—higher interest rates and housing prices, rising expenditures on medical care—not changes in the tax law. But the increase in the revenue loss from qualified retirement saving—which amounted to 0.8 percent of GDP—resulted both from behavioral changes and changes in the tax law. The build-up of tax-free savings in employer-provided pension plans increased faster than GDP throughout the period. But two new tax incentives contributed to the expansion in the revenue loss. First, ERTA 81 allowed all employees to contribute up to \$2,000 of their wages to tax-deductible individual retirement accounts (IRAs); prior to ERTA only employees without pension plans could contribute to IRAs. Second, the 1978 Act had allowed employees to deduct contributions to voluntary salary reduction plans, or 401(k) plans, established by their employees. Following the issuance of Treasury regulations in 1982, many employers established these plans and contributions to them increased exponentially throughout the 1980s.⁽⁷⁾

The Late 1980s: Effects of the Tax Reform Act of 1986 (TRA86). The goal of TRA86 was to make the tax system fairer, more conducive to economic efficiency, and simpler by lowering individual and corporate tax rates and broadening the tax base. TRA86 reduced tax expenditures in two ways. First, it directly eliminated some major tax expenditures, such as the investment tax credit, the capital gains exclusion, and consumer interest deductions and reduced others, such as accelerated depreciation for machinery and equipment. Most of the direct reduction was in business tax expenditures. The major social tax expenditures (employer-provided pensions, health insurance, mortgage interest) were left untouched or modified only slightly. (The availability of IRAs to employees with a pension plans was, however, sharply curtailed.) Second, by lowering marginal tax rates, TRA86 reduced the value of remaining tax preferences (such as the mortgage interest deduction and the exclusion of employer contributions to health insurance).⁽⁸⁾

Following enactment of TRA86, both social and business tax expenditures declined as a percentage of GDP. Between 1985 and 1990, the ratio of social tax expenditures to GDP declined by almost 20 percent (mostly due to lower tax rates), while the ratio of business tax expenditures to GDP fell almost in half. Nonetheless, social tax expenditures as a percentage of GDP remained higher than they had been at the beginning of the decade, while business tax expenditures were substantially lower.

The 1990s: Growth in Social Tax Expenditures. Social tax expenditures increased in the 1990s, due to both new tax legislation and economic and demographic changes. By 1999, social tax expenditures had increased to 5 percent of GDP—the same level as before TRA86. Business tax expenditures, as a percentage of GDP,

continued to decline.

Tax legislation in 1990 and 1993 partially reversed the effects of TRA86. Marginal tax rates for high income taxpayers were increased in 1990 and 1993, but remained below pre-TRA86 levels. This raised the cost of deductions and exemptions that remained in the law after TRA86. Some existing social expenditures were expanded and new ones were enacted. In particular, Congress in 1990 and 1993 enacted major expansions of the earned income tax credit (EITC). Most of the major base-broadening provisions for business and capital income taxation enacted in 1986, however, remained in the law.

The Taxpayer Relief Act of 1997 continued the trend towards expansion of social tax expenditures. It introduced new tax credits for expenses of post-secondary education, broadened incentives for saving for higher education, expanded eligibility for tax-advantaged individual retirement accounts (IRAs), provided a new, partially refundable, child credit and expanded incentives for business to invest in economically depressed areas and employ disadvantaged workers. Based on 1997 estimates by the JCT, these new and enhanced incentives will reduce Federal revenues by about \$27 billion in FY 1999 and \$34 billion in FY 2003.

Growth of the Largest Tax Expenditure Items.

As discussed in the Appendix, total tax expenditures are not the sum of separate tax expenditure items estimated by Treasury and JCT because there are interactions among provisions. But looking at the largest separate items shows the same general 20-year trends as the aggregated data—growth in social tax expenditures and decline in business tax expenditures.

Most of the largest social tax expenditures will be a bigger percentage of GDP in 1999 than they were in 1980. (Chart 2). The EITC has experienced the largest growth, primarily as a result of expansions enacted in 1986, 1990, and 1993. Incentives for qualified retirement savings declined after 1985, in part due to the cutback in IRAs in TRA86, but increased between 1995 and 1999. The growing cost of these incentives reflects mainly the increased use of 401(k) plans. The Taxpayer Relief Act of 1997 expanded eligibility for IRAs, but most of the revenue cost of that expansion is deferred to future years. The cost of the tax preference for employer health insurance has continued to increase, largely due to the rising cost of health care.

In contrast to social tax expenditures, most of the largest business tax expenditures have not increased as a percentage of GDP (Chart 3). Accelerated depreciation for machinery and equipment increased sharply in the early 1980s, but declined after TRA86 and has remained constant (relative to GDP) in recent years. The exclusion for capital gains was eliminated in TRA86, but has since been restored, although its projected cost in 1999 is still below the 1985 level. The combined cost of the capital gains exclusion and the step-up in basis for capital gains transferred at death is still about 25 percent below the 1985 cost. The top capital gains rate is the same now (20%) as it was in 1985, but the capital gains preference costs less, mainly because the highest ordinary income tax rates are lower now than in 1985⁽⁹⁾

III. Concluding Comments

This paper has documented the growing use of tax incentives to promote social policy goals. Over the past twenty years, the role of tax incentives has increased and shifted. Tax incentives to promote business investment have declined relative to the size of the economy, while tax incentives to promote social policy goals have expanded.

Tax incentives are here to stay. Tax reform proposals that eliminate all tax incentives in the name of a pure, fair, and simple tax system are not politically realistic and may do major harm to important social goals unless the goals are met by new direct spending or regulations. ⁽¹⁰⁾

Many important questions of program design are the same whether benefits are conveyed through government outlays or tax incentives. There are some circumstances in which either outlays or tax incentives may be relatively more cost-effective. In evaluating social programs, the details of program design are much more important than the issue of whether a program is designed as an explicit expenditure or a tax subsidy.

But the proliferation of detailed social policy proposals through the tax system has major costs. Political incentives may lead Congress to choose direct instead of tax incentives even when tax incentives are the less cost-effective way of providing benefits. Tax incentives make the income tax system more complex and make it appear less fair in its treatment of taxpayers in equal economic circumstances. They conceal the cost of program administration by adding burdens to the IRS instead of explicitly funding administration by program agencies. They allow politicians to understate the contributions of new programs to the size of government by promoting them as tax cuts instead of new spending. For these reasons, and others, the trend towards using the tax system as a vehicle for social policymaking merits more careful attention than it has received to date.

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Chart 1. Trends in Tax Expenditures, 1980-99

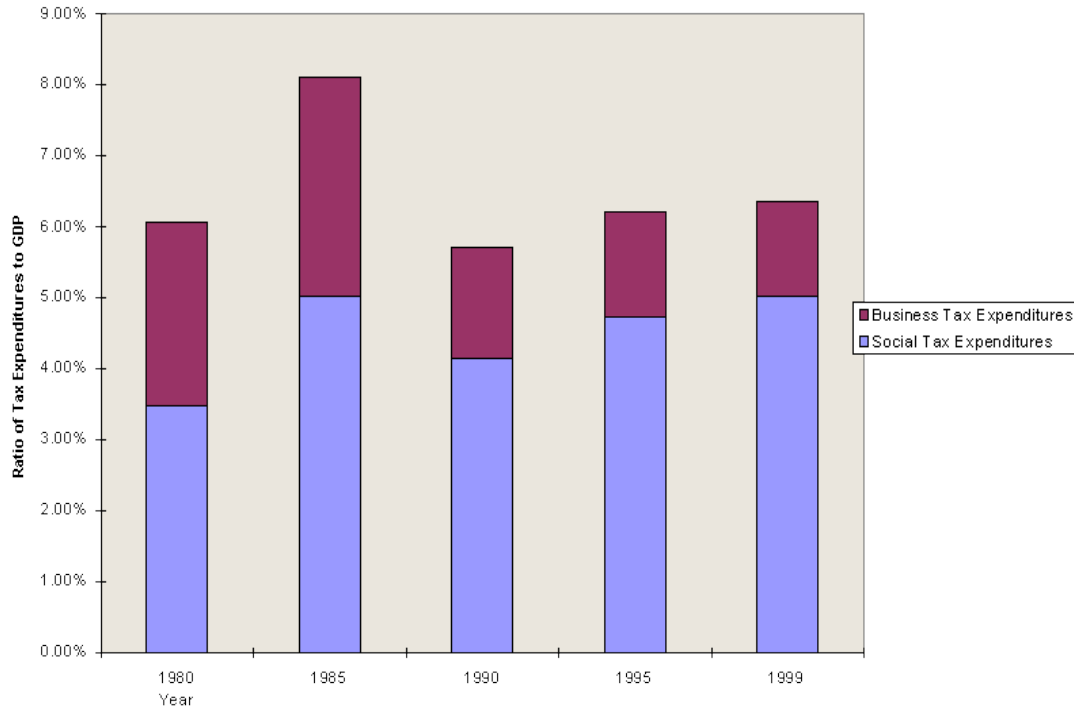


Chart 2. Top Five Social Tax Expenditures, 1999

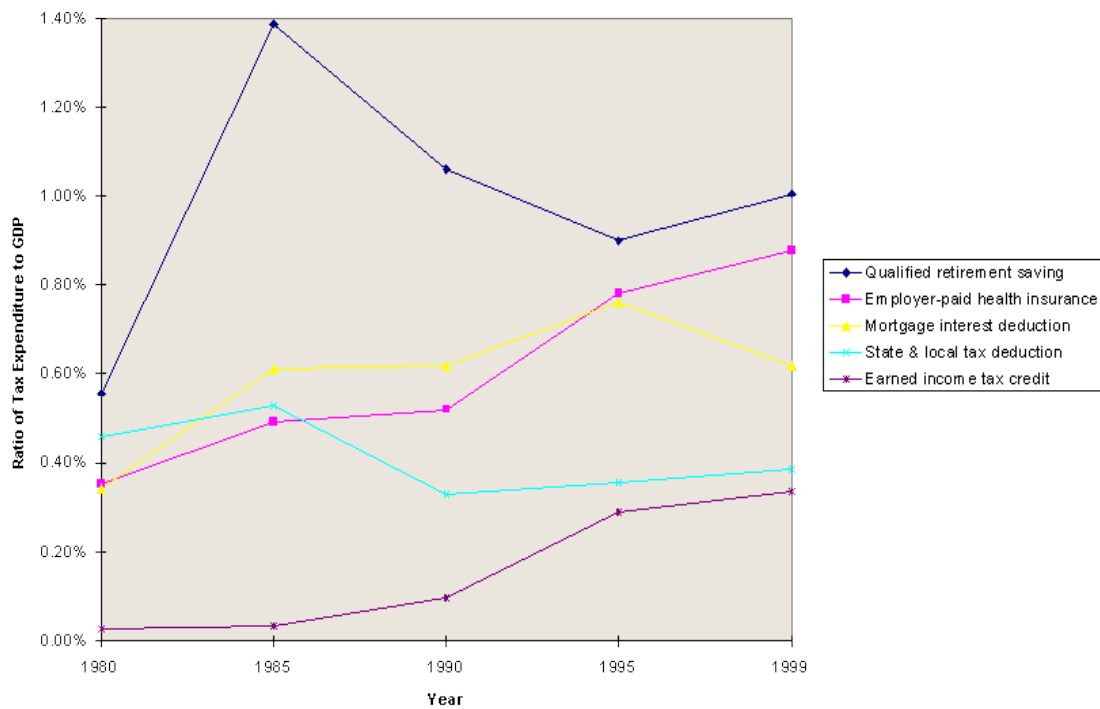
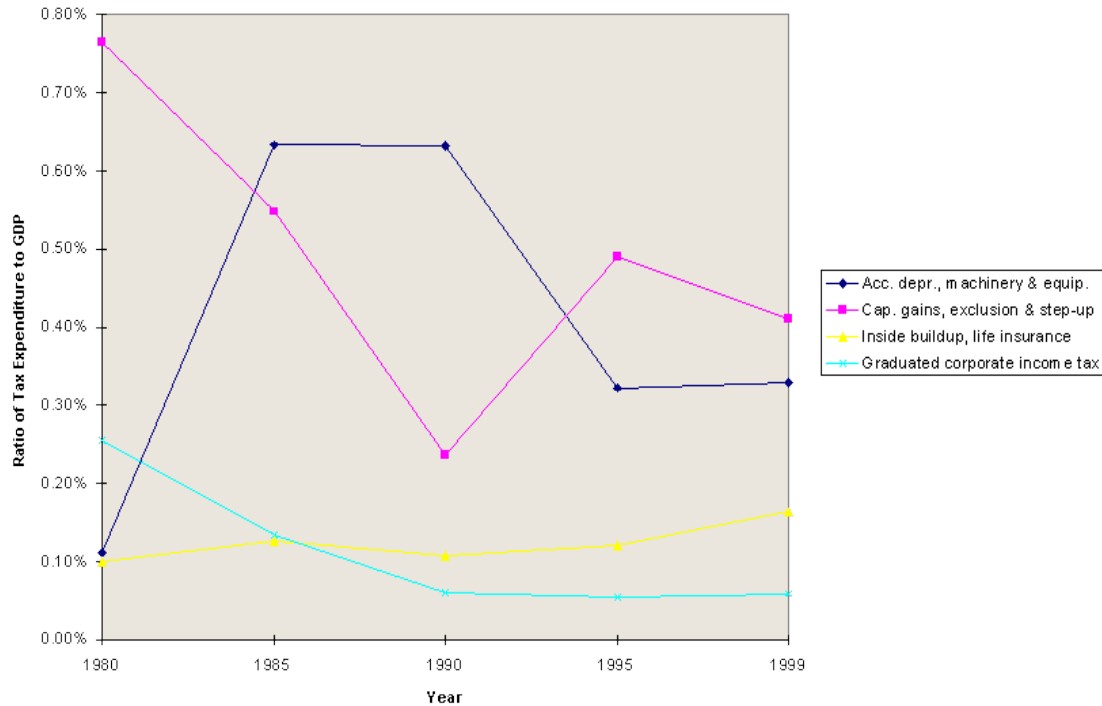


Chart 3. Top Five Business Tax Expenditures (2 Capital Gains Items Combined)



ENDNOTES

- Howard (1997) did case studies of the political forces behind the enactment and growth of four tax incentives: the home mortgage interest deduction, exemption of contributions to, and income accrued within, employer-provided pension plans, the earned income tax credit, and the targeted jobs credit (now the work opportunity credit). He found that the political forces influencing the growth of tax incentives differed greatly from forces influencing direct spending programs.
- The term "tax expenditures" and the concept of a tax expenditure budget were originally developed by Stanley Surrey, who was Assistant Secretary for Tax Policy at the U.S. Treasury Department in the 1960s. See Surrey (1973) and Surrey and McDaniel (1985).
- U.S. Office of Management and Budget (1998).
- For example, the step-up in basis for capital gains on assets transferred at death is listed as a tax expenditure. The step-up in basis exempts capital gains accrued during the lifetime of the decedent even if the asset is subsequently sold. It clearly produces preferential treatment of one form of income. But it is difficult to imagine the spending program that step-up in basis replaces.
- The figure cited for the earned income tax credit (EITC) includes both the revenue loss and outlay. The refundable portion of the EITC (the portion in excess of positive tax liability of taxpayers) is scored as an outlay.
- For a discussion of the politics and economics of tax policymaking in the 1980s, see Steuerle (1992).
- Some of the growth in 401(k) plans substituted for traditional defined-benefit plans, so that the net growth in tax-exempt saving caused by 401(k) plans was less than the growth in 401(k) plans alone. For a discussion of substitution among different forms of saving, see Engen, Gale, and Scholz (1996).
- See Congressional Budget Office (1988).
- Ranking tax expenditures by their 1999 cost creates a bias towards showing growth, relative to the alternative of ranking them by their cost in an earlier year. This bias occurs because items are more likely to be in the top 5 in 1999 than in the top 5 in 1980 if they increased in cost between 1980 and 1999. Thus, Chart 3 understates the extent to which the top business tax expenditures over the period have stagnated and/or declined. In particular, the largest business tax expenditures of the 1980s, the investment tax credit, does not appear on the chart because it has been eliminated.
- For a discussion of potential effects of radical tax reform proposals on health insurance coverage and on charitable organizations, see Gruber and Poterba (1996) and Clotfelter and Schmalbeck (1996).

Classification of Major 1999 Tax Expenditures and 1999 Costs as a Percentage of GDP*

Social Tax Expenditures	Cost/GDP
Net Exclusion of Pension Earnings and Contributions	1.01
Exclusion of Employer Contributions for Health Insurance	0.88
Deductibility of Mortgage Interest on Owner-Occupied Housing	0.62
Deductibility of Non-Business State and Local Taxes, Except Owner-Occupied Housing	0.39
Earned Income Tax Credit	0.34
Exclusion of Social Security Benefits	0.30
Child Credit	0.23
Charitable Deduction, Except Education and Health	0.23
Deduction of State and Local Property Tax on Owner-Occupied Housing	0.21
Exclusion of Interest on State and Local Public Purpose Bonds	0.17
Capital Gains Exclusion on Home Sales	0.11
Exclusion of Workmen's Compensation Benefits	0.06
Deductibility of Medical Expenses	0.06
HOPE Tax Credit (Tuition)	0.05
Business Tax Expenditures	
Accelerated Depreciation, Machinery and Equipment	0.33
Capital Gains, Partial Exclusion or Special Rate	0.30
Exclusion of Inside buildup, Life insurance Savings	0.16
Capital Gains, Step-up in Basis at Death	0.11
Graduated Corporate Income Tax Rates	0.06
*Includes only items with costs in excess of 0.05 percent of GDP	

Appendix 2

Treasury/JCT Methodology of Estimating Tax Expenditures

Treasury and JCT define and measure tax expenditures as departures from a "baseline" income tax. (The two agencies use slightly different definitions of the baseline tax.) The baseline tax system is meant to represent a practical and broad-based income tax that reflects the general and widely applicable provisions of the current Federal income tax. This baseline tax is not a conceptually pure income tax that includes all net income in the tax base once. It excludes some components of what tax scholars would define as income, on the grounds that including them in the tax base is administratively unfeasible. Examples of such exclusions from the baseline tax are accrued but unrealized capital gains and imputed rental income from owner-occupied homes. It includes as part of the baseline tax provisions that overstate income, such as the failure to index investment income for inflation and the double taxation of corporate dividends. Personal exemptions, standard deductions and graduated individual tax rates are considered part of the baseline tax, on the grounds that the baseline system can be progressive and can provide appropriate adjustments for family size. But graduated corporate tax rates are treated as a preferential item that favors small business. Revenue losses for each tax expenditure item are computed separately, assuming all provisions in current law, other than the item in question, are in effect. Thus, they do not take account of interactions among tax expenditure provisions. For example, if the mortgage interest deduction were eliminated, the revenue loss from charitable deductions might be smaller because fewer people would itemize deductions on their tax returns. But the computation of both the revenue loss from the mortgage interest deduction and the revenue loss from the charitable deduction assume the other deduction remains in place. Because interactions among provisions are not considered, Treasury and JCT do not display sums of the total revenue cost of all tax expenditures.

The revenue loss estimates do not consider hypothetical behavioral effects from eliminating tax expenditures. Instead, they measure the foregone revenue at projected levels of activity in the presence of the tax expenditure provisions. For example, the tax expenditure estimate for preferential rates for capital gains uses the projected level of capital gains realizations under current law to calculate the loss in revenue. But if Congress proposed eliminating the capital gains differential, both agencies would assume that capital gains realizations would fall in the presence of higher rates and would take account of the change in realizations in

computing the revenue effect.

Problems in Measuring/Interpreting Tax Expenditure Data. As the above discussion suggests, the definition of which provisions constitute "tax expenditures" and the measurement of their revenue cost is not without ambiguity. The agencies' definition of the baseline tax does not reflect a clear conceptual approach. For many tax expenditure items, this lack of clarity does not pose any problem. Few observers, for example, could argue seriously that tax credits for alternative fuel production or for investment in low-income housing, however meritorious their purposes, constitute a general provision of a baseline income tax instead of a conscious effort to direct society's resources towards some desired purpose. Many of the new provisions in the 1997 legislation, such as the new tuition tax credits, were clearly intended as incentives and could by no reasonable definition be considered part of the baseline tax structure.

But, in other cases, reasonable people could disagree on the appropriate baseline, and therefore on whether or not an item should be classified as a tax expenditure. Even when an item clearly represents a tax expenditure, the estimate of its cost may depend on the detailed method of constructing the baseline.

Beyond this, there are broader philosophical assumptions underlying the tax expenditure calculations that do not command universal acceptance among economists. Many economists, for example, believe that a tax based on an individual's annual consumption is fairer and more neutral than a tax based on income. (See, for example, Bradford and U.S. Treasury Tax Policy Staff, 1984). Under a consumption tax, for example, the current law provisions allowing exemption of income accrued within qualified pension plans would be part of the normal tax, not a tax expenditure. Most economists believe that a neutral income tax should tax corporate income only once. But the normal tax used for tax expenditure calculations includes the double taxation of corporate dividends. Some business tax expenditures can be viewed as just offsetting the effects of double taxation although, as selective instead of general provisions, they do channel resources towards some economic sectors at the expense of others and in that way resemble direct expenditures.

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