

Tax Policy Center

Urban Institute and Brookings Institution

Trends in Tax Expenditures, 1985-2016

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The landmark Tax Reform Act of 1986 greatly changed the cost of tax expenditures. The revenue lost to tax expenditures declined sharply after enactment of the 1986 Act, falling from nearly 9 percent of total GDP in fiscal year 1985 to 6 percent in 1988. Since then, tax expenditures have gradually increased as a share of GDP but have remained below the 1985 level. Furthermore, the composition of tax expenditures has changed significantly.

Methodology

We use as our data source the annual list of tax expenditures compiled by the Office of Tax Analysis of the U.S. Department of the Treasury and reported annually in the Budget of the United States Government.¹ We omitted 1986 and 1987, which were years of transition between the pre- and post-tax reform systems, but include all other years from 1985 through 2016. Each budget estimates tax expenditures for the projected five-year budget period and the two previous years. For example, the 2012 budget reports tax expenditures for fiscal years 2010 through 2016. In all cases, we used the latest estimate for a given fiscal year. Thus, the 1988 estimates come from the fiscal budget, the 1989 estimates from the fiscal year 1991 budget, and the 2010–2016 estimates from the fiscal year 2012 budget.

¹The Congressional Budget Act of 1974 requires that the Office of Management and Budget (OMB) and the Congressional Budget Office (CBO) compile and report annual lists of the costs of tax expenditures, which are defined as “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.” The report currently appears in the Analytical Perspectives section of the Federal budget, which replaced a report called Special Analysis G. The Treasury Department prepares the estimates for OMB. On the Congressional side, the Joint Committee on Taxation (JCT) prepares the annual list of tax expenditures.

To produce a more consistent time series, we adjusted some Treasury estimates to correct for anomalies and inconsistencies. Treasury included particular tax expenditure items in the budgets in some years but not in others, even though the provisions remained in effect in both sets of years. Other provisions were estimated using changing methodologies or were based on data that have been updated irregularly. Still other cases had sharp drops or spikes in estimates that could not be explained by changes in the tax law, timing effects, or economic events.

Adjustments to the data included smoothing some data series and imputing estimates for years in which the methodology had changed based on comparisons of estimates for other years that were reported by both the Office of Management and Budget (OMB) and the Joint Committee on Taxation (JCT).² We omitted one item entirely—imputed rental income—because Treasury only recently began counting that as a tax expenditure and we did not have a good method for imputing consistent values for earlier years.

Treasury and JCT estimate each tax expenditure provision under the assumption that all other provisions of the tax law remain in place. If some tax expenditures were eliminated, however, the cost of removing other tax expenditures would change. As a result, the total revenue gain from eliminating all tax expenditures could be larger or smaller than the sum of all tax expenditure revenue changes reported by JCT and Treasury.³ Burman, Toder, and Geissler estimate the simultaneous effect of eliminating a large set of individual income tax expenditures and find the revenue loss between 5 and 8 percent greater than the sum of the revenue losses for the separate items.⁴

² A forthcoming paper will describe these adjustments more completely.

³ If, for example, the exclusion for employer-provided health insurance were eliminated, reported taxable income would increase and some taxpayers would move into higher rate brackets. The resulting increase in marginal tax rates would raise the revenue loss from other exemptions and deductions and make the total revenue loss from all exemptions greater than the sum of revenue losses of the separate provisions. But the revenue effect of some groups of provisions could also be less than the sum of the separate provisions. For example, if the mortgage interest deduction were eliminated, some taxpayers would switch to the standard deduction. This would reduce the revenue loss from eliminating other itemized deductions. The net effect for all tax expenditures could go in either direction.

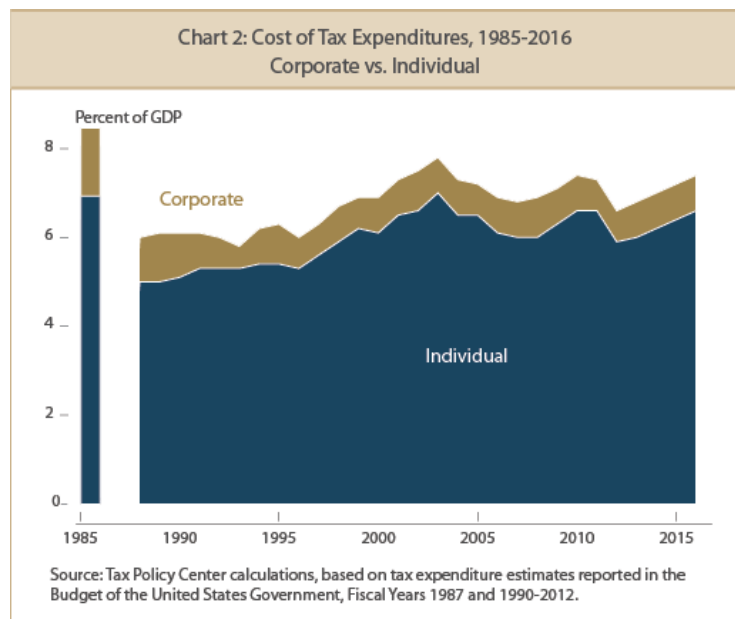
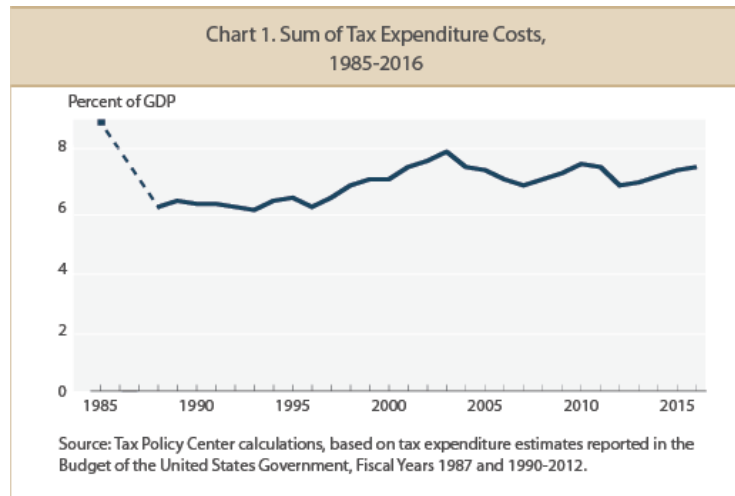
⁴ Len Burman, Christopher Geissler, and Eric Toder, *How Big Are Total Individual Income Tax Expenditures, and Who Benefits from Them?* (Washington, DC: Urban-Brookings Tax Policy Center, 2008), Retrieved from <http://www.taxpolicycenter.org/publications/url.cfm?ID=1001234>.

Findings

All tax expenditures. The sum of the revenue losses from all tax expenditures declined following the Tax Reform Act of 1986 from 8.7 percent of GDP in 1985 to 6.0 percent of GDP in 1988 (chart 1).⁵ They remained stable for a few years and were 5.9 percent of GDP in 1993. Increases in marginal tax rates in 1990 and 1993 and the introduction of new tax expenditures and expansion of existing ones during the Clinton

administration raised tax expenditures over the next decade; they reached 7.3 percent of GDP in 2001 and peaked at 7.9 percent of GDP in 2003. Tax expenditures declined slightly as a share of GDP after 2003, but remained at 7.4 percent of GDP in 2010 and are expected to be about the same in 2016 (7.3 percent of GDP).

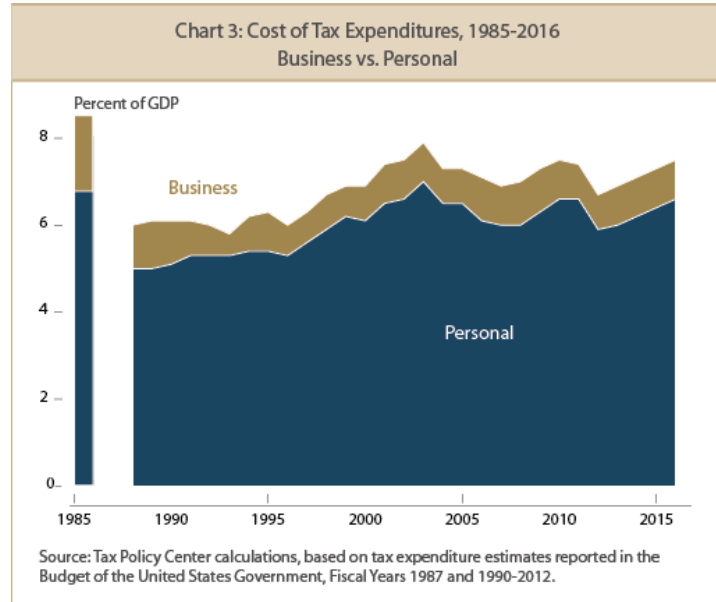
Individual and corporate tax expenditures. OMB and JCT also divide tax expenditures into those claimed on individual tax returns and those claimed on corporate returns. The share of tax expenditures claimed on individual returns increased after the 1986 tax reform and has continued to rise since then, while the corporate share has correspondingly declined (chart 2). The corporate share dropped from 20.7 percent of tax expenditures in 1985 to 16.3 percent of tax expenditures in 1988 and has continued to trend downward since, reaching 10.8 percent of tax expenditures in 2010. Growth of individual tax expenditures is projected to depress the corporate share further in coming years, dropping it to 10.1 percent of tax expenditures in 2016. As a share of GDP, corporate tax expenditures dropped from 1.8 percent in 1985 to 1.0 percent in 1988 and 0.8 percent in 2010, while individual income tax expenditures dropped from 6.9 percent of GDP in 1985 to 5.0 percent of GDP in 1988, but then increased to 6.7 percent of GDP in 2010.



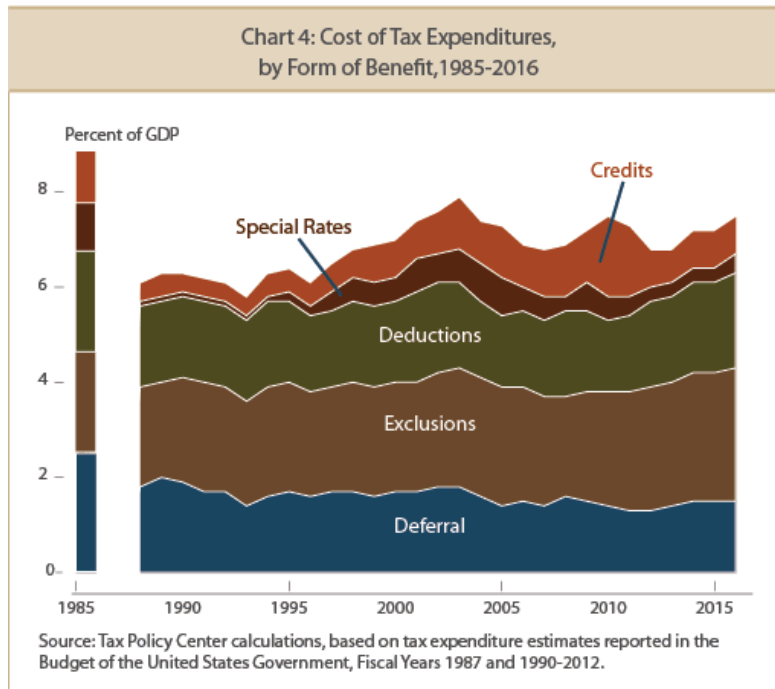
⁵ The appendix table provides data for all charts in this paper.

Personal and business tax expenditures. Part of the decline in corporate tax expenditures reflects the long-term changes in business organization—primarily the rising share of economic activity generated within partnerships and subchapter S corporations, whose income is taxed only at the individual level and not the corporate level. We therefore also divide tax expenditures into personal and business tax expenditures, where business tax expenditures include preferences that reduce taxes paid from income reported on schedules C (business income), E (partnership income), and F (farm income) on individual income tax returns.

The trends for business and personal tax expenditures are similar to those for corporate and individual tax expenditures (chart 3). Business tax expenditures dropped from 2 percent of GDP in 1985 to 1 percent of GDP in 1988 and have hovered there or just below since. Personal tax expenditures dropped from nearly 7 percent of GDP in 1985 to 5 percent of GDP in 1988, rose back to 7 percent in 2002, and have fluctuated around 6 percent since.



Tax expenditures by type of incentive. Tax expenditures come in different forms: *deferrals* of income recognition, *exclusions* from income, *deductions* from taxable income, *special rates*, and tax *credits*. Those different forms of tax expenditures have experienced notable ups and downs over the past 25 years (chart 4).



- *Deferrals* allow taxpayers to delay recognition of current income to a future year. Two examples are (1) provisions that allow small businesses to expense qualifying investments immediately instead of depreciating them and deducting their costs of overtime and (2) provisions that let individuals defer tax on the portion of income they contribute to qualified retirement savings amounts until the amounts are withdrawn.

Deferrals declined as a share of GDP following the 1986 tax reform, dropping from 2.7 percent in 1985 to 1.8 percent in 1988 and 1.4 percent in 1993. They drifted upward over the next decade to 1.9 percent in 2003 but have fallen since then to 1.3 percent of GDP in 2010.

- *Exclusions* leave income from specific sources out of the income tax base. Examples include the exclusion for employer contributions to health insurance plans and the step-up basis provision that allows unrealized capital gains on assets that are transferred at death to escape tax permanently.

The cost of exclusions rose gradually, from 2.0 percent of GDP in 1985 to 2.5 percent in 2005, dipped for a couple of years, and then resumed its upward trend toward a projected 2.8 percent of GDP in 2016. The increased cost of exclusions largely reflects the effect of rising health care costs on the revenue loss from omitting employer-sponsored health insurance premiums from taxable compensation.

Deductions allow certain outlays to be subtracted from taxable income. Examples include the deductions for home mortgage interest and charitable contributions.

Deductions as a share of GDP dropped after the Tax Reform Act of 1986, largely due to the reduction in marginal tax rates, and have remained roughly constant since then.

Deferrals, exemptions, and deductions all reduce the present value of income subject to tax, and all provide larger tax reductions to taxpayers in high marginal rate brackets than to taxpayers in low marginal rate brackets or to those who would have no income tax liability even without these provisions.

- *Special rates* reduce the tax rates that would otherwise apply to certain forms of income. An example is the special rate schedule that taxes both long-term capital gains and qualified dividends at a maximum rate of 15 percent.

The change in cost of special rates largely reflects changes in the taxation of capital gains and dividends and in market fluctuations, which affect realizations of capital gains. The 1986 Tax Reform Act eliminated the preferential rate for capital gains, causing the cost of special rates to fall from 0.8 percent of GDP in 1985 to less than one-tenth of 1 percent in 1988. The cost of the preference rose in 1990 and 1993 when individual marginal income tax rates were raised, but capital gains continued to face a maximum rate of 28 percent. The cost increased further with the cut in the capital gains rate in 1997 and the dot-com boom of the late 1990s, reaching 0.7 percent of GDP in 2001. After dipping briefly during the subsequent recession, the cost increased further with the cut in the capital gains rate to 15 percent and the enactment of a maximum special rate on dividends in 2003, reaching 0.8 percent of GDP by 2004, higher than its cost before the 1986 Tax Reform Act. The cost of the preference plummeted with the 2008 stock market crash and is projected to continue to fall in future years—to just 0.4 percent of GDP in 2016—as a result of the scheduled increase in the top tax rate on capital gains to 20 percent and the elimination of the special rates on dividends.⁶

- Tax *credits* directly lower tax liability by the stated dollar amount. Examples include the \$1,000 child credit and credits that pay for a specified percentage of energy conservation costs.

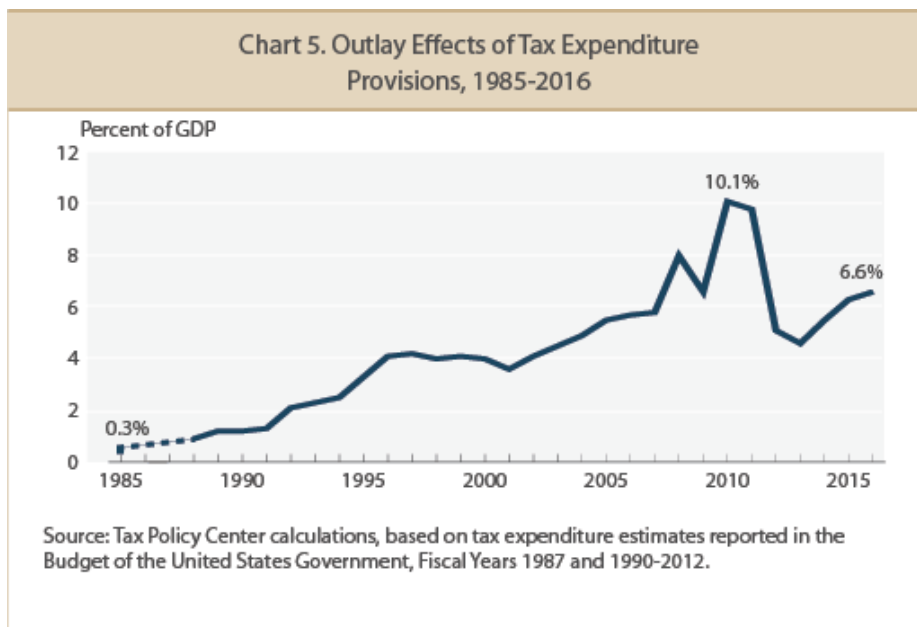
Credits dropped from 0.9 percent of GDP in 1985 to 0.3 percent of GDP in 1988, largely due to the elimination of the investment tax credit in the Tax Reform Act of 1986. They subsequently rose substantially, mostly because of the expansion of the earned income tax credit (EITC) in the 1990s and the introduction and expansion of the child credit in 1997 and 2001, respectively. Both legislation and the slowdown in the economy increased their share of GDP further in 2010, to 1.6 percent, almost five times as large as in 1988. But credits as a share of GDP are projected to drop to 0.7 percent in 2016, due to projected economic recovery, the expiration of the 2001 doubling of the child credit, and the expiration of EITC expansions enacted during the past decade.

⁶ The OMB tables in the fiscal 2012 budget were prepared before the December 2010 extension of the 2001, 2003, and 2010 tax cuts through the end of 2012. Thus, the 2011 and 2012 estimates reflect the higher rates that would have been in effect had the tax cuts expired.

Outlay effects. OMB includes only the revenue losses from these provisions in the tax expenditure tables. The portions of refundable credits that exceed income tax liability and thus result in a negative income tax payment are scored in the budget as outlays. OMB does not include outlay effects in the tables but reports them in footnotes.

The major refundable credits are the earned income tax credit, the child credit, and the American Opportunity Tax Credit (AOTC). Introduced in 1975, the earned income credit remained small until tax legislation enacted in 1986, 1990, and 1993 expanded it greatly (with the latter expansions phased in over three-year periods). It was again expanded modestly in 2001 and 2009. The child credit was initially enacted in 1997, but only a small portion of the credit was refundable.⁷ The 2001 tax act doubled the credit and expanded its refundability for many working families. The AOTC, which was enacted for two years in 2009 and subsequently extended through 2012 as a replacement for the (non-refundable) HOPE tax credit, is partially refundable.⁸

Tax credits' outlay effects have grown steadily over the past 25 years, from just 0.03 percent of GDP in 1985 to 0.8 percent of GDP in 2010. They are projected to drop in 2012 due to the expiration of recent expansions, but then will begin to grow again. Although revenue losses still account for most of the cost of tax expenditures, outlays accounted for 10 percent of the cost of tax expenditures in 2010, up from only 0.3 percent in 1985 (chart 5).



⁷ Only families with three or more children could claim a refundable credit and then only up to the amount of payroll tax they paid.

⁸ As with other expiring provisions extended at the end of 2010, the OMB estimates were done before the extension was enacted and assumed the American Opportunity Tax Credit expired at the end of 2010.

Conclusions

Tax expenditures have composed a significant component of the cost of government for decades. The 1986 Tax Reform Act cut them substantially but they subsequently rebounded, recovering more than half their decline from tax reform, measured as a share of GDP.

The composition of tax expenditures has changed over the years. Individual tax expenditures have increased relative to corporate tax expenditures and personal tax expenditures have grown relative to business tax expenditures. Credits and exclusions have increased relative to deductions and deferrals. Outlays from refundable credits remain a small share of the total cost of tax expenditures, but have experienced a huge growth over the past 25 years.

We gratefully acknowledge financial support from the John D. and Catherine T. MacArthur Foundation.

Appendix Table: Characteristics of Tax Expenditures, 1985–2016

Year	Chart 1		Chart 2				Chart 3				Chart 4					Chart 5		
	Total Tax Expenditures		Individual vs. Corporate Tax				Personal vs. Business Tax				Tax Expenditures by Form (percent of GDP)					Outlay Effects of Tax Expenditures		
	Millions of Dollars	Percent of GDP	Individual		Corporate		Personal		Business		Deferral	Exclusions	Deductions	Special Tax Credits		Millions of Dollars	Percent of GDP	Share of Total
			Percent of GDP	Share of Total	Percent of GDP	Share of Total	Percent of GDP	Share of Total	Percent of GDP	Share of Total				Special Tax Rates	Credits			
1985	362,337	8.7%	6.9%	79.3%	1.8%	20.7%	6.7%	77.0%	2.0%	23.0%	2.7%	2.0%	2.4%	0.8%	0.9%	1,100	0.0%	0.3%
1988	300,590	6.0%	5.0%	83.7%	1.0%	16.3%	5.0%	83.5%	1.0%	16.5%	1.8%	2.1%	1.7%	0.1%	0.3%	2,695	0.1%	0.9%
1989	332,785	6.2%	5.0%	81.8%	1.1%	18.2%	4.9%	80.1%	1.2%	19.9%	2.0%	2.0%	1.7%	0.1%	0.4%	4,005	0.1%	1.2%
1990	350,505	6.1%	5.1%	83.9%	1.0%	16.1%	5.1%	83.4%	1.0%	16.6%	1.9%	2.2%	1.7%	0.1%	0.3%	4,355	0.1%	1.2%
1991	362,239	6.1%	5.3%	87.1%	0.8%	12.9%	5.3%	86.5%	0.8%	13.5%	1.7%	2.3%	1.7%	0.1%	0.3%	4,885	0.1%	1.3%
1992	376,362	6.0%	5.3%	87.8%	0.7%	12.2%	5.2%	86.9%	0.8%	13.1%	1.7%	2.2%	1.7%	0.1%	0.3%	7,765	0.1%	2.1%
1993	386,311	5.9%	5.3%	90.9%	0.5%	9.1%	5.3%	90.2%	0.6%	9.8%	1.4%	2.2%	1.7%	0.1%	0.3%	8,910	0.1%	2.3%
1994	431,546	6.2%	5.4%	87.2%	0.8%	12.8%	5.4%	87.6%	0.8%	12.4%	1.6%	2.3%	1.8%	0.1%	0.4%	10,990	0.2%	2.5%
1995	460,946	6.3%	5.4%	86.3%	0.9%	13.7%	5.4%	86.3%	0.9%	13.7%	1.7%	2.3%	1.7%	0.2%	0.4%	15,245	0.2%	3.3%
1996	464,204	6.0%	5.3%	87.6%	0.7%	12.1%	5.2%	86.8%	0.8%	13.2%	1.6%	2.2%	1.6%	0.2%	0.4%	19,159	0.2%	4.1%
1997	519,575	6.3%	5.6%	89.0%	0.7%	11.2%	5.6%	88.3%	0.7%	11.7%	1.7%	2.2%	1.6%	0.4%	0.5%	21,856	0.3%	4.2%
1998	577,209	6.7%	5.9%	88.7%	0.8%	11.3%	5.8%	87.6%	0.8%	12.4%	1.7%	2.3%	1.7%	0.5%	0.5%	23,239	0.3%	4.0%
1999	631,301	6.9%	6.2%	90.0%	0.7%	10.0%	6.1%	88.7%	0.8%	11.3%	1.6%	2.3%	1.7%	0.5%	0.7%	26,077	0.3%	4.1%
2000	673,714	6.9%	6.1%	88.9%	0.8%	11.1%	6.0%	87.8%	0.8%	12.2%	1.7%	2.3%	1.7%	0.5%	0.7%	26,909	0.3%	4.0%
2001	746,549	7.3%	6.5%	88.9%	0.8%	11.1%	6.4%	87.5%	0.9%	12.5%	1.7%	2.3%	1.9%	0.7%	0.7%	27,100	0.3%	3.6%
2002	793,775	7.5%	6.6%	88.1%	0.9%	11.9%	6.6%	87.7%	0.9%	12.3%	1.8%	2.4%	1.9%	0.6%	0.8%	32,890	0.3%	4.1%
2003	858,347	7.8%	7.0%	89.4%	0.8%	10.9%	6.9%	88.6%	0.9%	11.4%	1.8%	2.5%	1.8%	0.7%	1.0%	38,396	0.3%	4.5%
2004	853,193	7.3%	6.5%	89.7%	0.8%	10.5%	6.5%	89.2%	0.8%	10.8%	1.6%	2.5%	1.6%	0.8%	0.8%	42,051	0.4%	4.9%
2005	901,563	7.2%	6.5%	90.3%	0.7%	9.8%	6.4%	88.6%	0.8%	11.4%	1.4%	2.5%	1.5%	0.8%	1.0%	49,179	0.4%	5.5%
2006	910,787	6.9%	6.1%	88.0%	0.8%	12.0%	5.9%	85.6%	1.0%	14.4%	1.5%	2.4%	1.6%	0.5%	0.8%	51,639	0.4%	5.7%
2007	934,038	6.7%	6.0%	88.6%	0.8%	11.4%	5.8%	86.5%	0.9%	13.5%	1.4%	2.3%	1.6%	0.5%	0.9%	54,529	0.4%	5.8%
2008	987,017	6.9%	6.0%	87.3%	0.9%	12.7%	5.8%	85.0%	1.0%	15.0%	1.6%	2.1%	1.8%	0.3%	1.0%	79,402	0.6%	8.0%
2009	996,618	7.1%	6.3%	89.3%	0.8%	10.4%	6.1%	86.2%	1.0%	13.8%	1.5%	2.3%	1.7%	0.6%	1.0%	65,335	0.5%	6.6%
2010	1,070,820	7.4%	6.6%	88.9%	0.8%	10.8%	6.5%	87.7%	0.9%	12.3%	1.4%	2.4%	1.5%	0.5%	1.6%	108,390	0.7%	10.1%
2011	1,102,645	7.3%	6.6%	90.2%	0.7%	9.6%	6.5%	89.4%	0.8%	10.6%	1.3%	2.5%	1.6%	0.4%	1.4%	108,270	0.7%	9.8%
2012	1,053,310	6.7%	5.9%	89.3%	0.7%	10.4%	5.9%	88.4%	0.8%	11.6%	1.3%	2.6%	1.8%	0.3%	0.7%	53,320	0.3%	5.1%
2013	1,138,690	6.8%	6.0%	88.7%	0.8%	10.9%	5.9%	87.4%	0.9%	12.6%	1.4%	2.6%	1.8%	0.3%	0.6%	52,620	0.3%	4.6%
2014	1,242,060	7.0%	6.2%	89.0%	0.8%	10.7%	6.1%	87.1%	0.9%	12.9%	1.5%	2.7%	1.9%	0.3%	0.7%	68,120	0.4%	5.5%
2015	1,349,920	7.2%	6.4%	89.3%	0.8%	10.4%	6.2%	87.0%	0.9%	13.0%	1.5%	2.7%	1.9%	0.3%	0.7%	84,570	0.4%	6.3%
2016	1,447,100	7.3%	6.6%	89.6%	0.8%	10.1%	6.4%	87.3%	0.9%	12.7%	1.5%	2.8%	2.0%	0.4%	0.7%	94,980	0.5%	6.6%

Source: Tax Policy Center calculations, based on tax expenditure estimates reported in the Budget of the United States Government, Fiscal Year 1987 and Fiscal Years 1990-2012.