United States Government Accountability Office

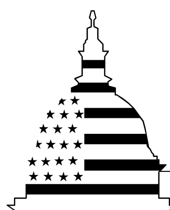
GAO

Report to Agency Officials

September 2005

GOVERNMENT PERFORMANCE AND ACCOUNTABILITY

Tax Expenditures Represent a Substantial Federal Commitment and Need to Be Reexamined



GAO

Accountability ★ Integrity ★ Reliability

GAO-05-690

Highlights of GAO-05-690, a report to agency officials

September 2005

GOVERNMENT PERFORMANCE AND ACCOUNTABILITY

Tax Expenditures Represent a Substantial Federal Commitment and Need to Be Reexamined

Why GAO Did This Study

Numerous federal programs, policies, and activities are supported through the tax code. As described in statute, tax expenditures are reductions in tax liabilities that result from preferential provisions, such as tax exclusions, credits, and deductions. They result in revenue forgone. This report, done under the Comptroller General's authority, is part of an effort to assist Congress in reexamining and transforming the government to meet the many challenges and opportunities that we face in the 21st century. This report describes (1) how tax expenditures have changed over the past three decades in number, size, and in comparison to federal revenue, spending, and the economy, and (2) the amount of progress made since our 1994 recommendations to improve scrutiny of tax expenditures.

What GAO Recommends

GAO recommends the Office of Management and Budget (OMB), consulting with the U.S. Department of the Treasury, take several steps to ensure greater transparency of and accountability for tax expenditures by reporting better information on tax expenditure performance and more fully incorporating tax expenditures into federal performance management and budget review processes. Citing methodological and conceptual issues, OMB disagreed with the recommendations. GAO still believes the recommendations are valid.

www.gao.gov/cgi-bin/getrpt?GAO-05-690.

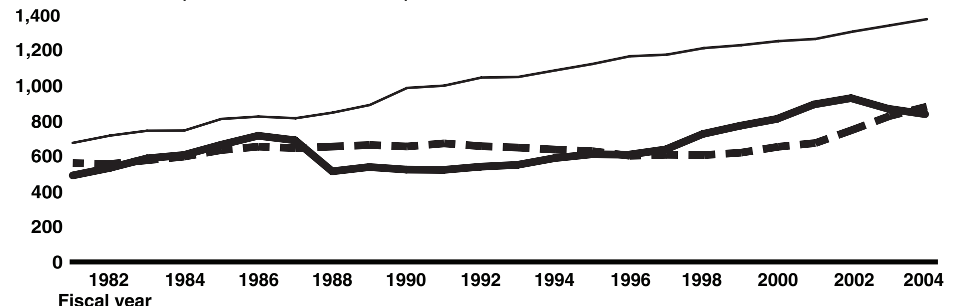
To view the full product, including the scope and methodology, click on the link above. For more information, contact Michael Brostek, (202) 512-9110, brostekm@gao.gov.

What GAO Found

Whether gauged in numbers, revenues forgone, or compared to federal spending or the size of the economy, tax expenditures have represented a substantial federal commitment over the past three decades. Since 1974, the number of tax expenditures more than doubled and the sum of tax expenditure revenue loss estimates tripled in real terms to nearly $730 billion in 2004. The 14 largest tax expenditures, headed by the individual income tax exclusion for employer-provided health care, accounted for 75 percent of the aggregate revenue loss in fiscal year 2004. On an outlay-equivalent basis, the sum of tax expenditure estimates exceeded discretionary spending for most years in the last decade. For some budget functions, the sum of tax expenditure estimates was of the same magnitude as or larger than federal spending. As a share of the economy, the sum of tax expenditure outlay-equivalent estimates has been about 7.5 percent of gross domestic product since the last major tax reform legislation in 1986.

All federal spending and tax policy tools, including tax expenditures, should be reexamined to ensure that they are achieving their intended purposes and designed in the most efficient and effective manner. The nation's current and projected fiscal imbalance serves to reinforce the importance of engaging in such a review and reassessment. Although data and methodological challenges exist, periodic reviews of tax expenditures could establish whether they are relevant to today's needs; if so, how well they have worked to achieve their objectives; and whether the benefits from specific tax expenditures are greater than their costs. Over the past decade, however, the Executive Branch made little progress in integrating tax expenditures into the budget presentation, in developing a structure for evaluating tax expenditure outcomes or in incorporating them under review processes that apply to spending programs, as we recommended in 1994. More recently, the Administration has not used its Program Assessment Rating Tool process to systematically review tax expenditures or promote joint reviews of tax and spending programs sharing common goals.

Sum of Tax Expenditure Estimates Compared with Total Federal Outlays, 1981-2004



Source: GAO analysis of OMB budget reports on tax expenditures, fiscal years 1983-2006.

Note: Summing tax expenditure estimates does not take into account interactions between individual provisions.

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United States Government Accountability Office
Washington, D.C. 20548

September 23, 2005

The Honorable Joshua Bolten
Director
Office of Management and Budget

The Honorable John W. Snow
The Secretary of the Treasury

Over the last decade, a culture of performance has taken root in the federal government. This culture has placed a greater premium on the importance of accountability for the effective use of public resources and authorities. Periodic reexamination of existing federal policies and operations offers the prospect of weeding out ineffective or outdated programs, policies, functions, or activities while strengthening and updating those that are retained. While inefficient and ineffective programs and policies are never appropriate, the nation's long-term fiscal imbalance provides an additional impetus for reexamining all major spending programs and tax provisions.[1] This includes tax incentives and subsidies intended to promote various social and economic objectives. Tax preferences—which are legally known as tax expenditures—result in forgone revenue for the federal government due to preferential provisions in the tax code, such as exemptions and exclusions from taxation, deductions, credits, deferral of tax liability, and preferential tax rates. These tax expenditures are often aimed at policy goals similar to those of federal spending programs; existing tax expenditures, for example, are intended to encourage economic development in disadvantaged areas, finance postsecondary education, and stimulate research and development. Tax expenditures have a significant effect on overall tax rates—in that, for any given level of revenue, overall tax rates must be higher to offset the revenue forgone through tax expenditures—as well as the budget and fiscal flexibility. They also contribute to the growing complexity of the federal tax system. Regardless of the level of revenue deemed appropriate, tax expenditures—like other federal programs or activities—should be reviewed to determine their effectiveness and continued relevance. Yet, tax expenditures and their relative contributions toward achieving federal missions and goals are often less visible than spending programs which are subject to more systematic review.

[1]For more information, see GAO, *21st Century Challenges: Reexamining the Base of the Federal Government*, GAO-05-325SP (Washington, D.C.: February 2005).

A little over a decade ago, GAO examined the growth in tax expenditures and opportunities to focus policymakers' attention on them.[2] Our review found that tax expenditures were not integrated into annual federal budget review processes, and most were not subject to reauthorization, even though revenues forgone through tax expenditures were substantial. In turn, policymakers had few opportunities to make explicit comparisons or trade-offs between tax expenditures and federal spending programs. Therefore, we made several recommendations to the Office of Management and Budget (OMB) intended to encourage more informed policy debate about tax expenditures and to stimulate joint reviews of related tax and spending programs. OMB agreed that our recommendations were generally reasonable and reported that the Executive Branch had initiated efforts to integrate tax expenditures in the budget review process and develop performance measures for some tax expenditures.

We have prepared this report under the Comptroller General's authority as part of a continuing effort to assist Congress in reexamining the base of federal programs, policies, and activities critical to achieving fiscal discipline in the budget as a whole. This report updates our 1994 work and specifically describes (1) how tax expenditures have changed over the past three decades in number and size and in comparison to federal revenue, spending, and the economy, and (2) the amount of progress that has been made since 1994 in how the Executive Branch scrutinizes tax expenditures.

This update draws on our previously issued work on tax expenditure trends and individual tax provisions as well as results-oriented management and performance reporting. We also reviewed relevant literature related to tax expenditure measurement and reporting, and trends in the use of tax expenditures over time. We interviewed relevant agency officials and tax policy experts to obtain a greater understanding of information gained through our literature review. To gauge trends in the numbers and size of tax expenditures for fiscal years 1974 to 2004, we relied on the Department of the Treasury's (Treasury) annual list of tax expenditures and estimates for each tax expenditure of the associated revenue loss—the amount of revenue that the government forgoes—and the outlay-equivalent value—the amount of outlays required to deliver the

[2]GAO, *Tax Policy: Tax Expenditures Deserve More Scrutiny*, GAO/GGD/AIMD-94-122 (Washington, D.C.: June 3, 1994).

same after-tax income as provided through the tax expenditure.[3] We added the tax expenditure revenue loss estimates for each fiscal year to approximate the total revenue forgone through tax expenditure provisions. While sufficiently reliable as a gauge of general magnitude, the sum of the individual revenue loss estimates has important limitations in that any interactions between tax expenditures will not be reflected in the sum. In addition, tax expenditure revenue loss estimates for specific provisions do not take into account potential behavioral responses to changes in these provisions on the part of taxpayers, and, in turn, no potential behavioral response would be reflected in the sum of the estimates. Thus, the revenue loss from all or several tax expenditures together might be greater or less than the sum of the estimated revenue losses from the individual tax expenditures, and no measure of the size or the magnitude of these potential interactions or behavioral responses to all or several tax expenditures is available. Growth in the sum of tax expenditure estimates across the three-decade period is presented in inflation-adjusted 2004 dollars and measured relative to the economy as a share of the gross domestic product (GDP). We compared the sum of tax expenditure outlay-equivalent estimates to total federal mandatory and discretionary spending and spending by budget function. Finally, we used Treasury's estimates to examine trends in the size of tax expenditures by taxpayer group and identify the largest tax expenditures in 2004.

To examine progress over the last decade in how the federal government scrutinizes tax expenditures, we examined actions taken by the Executive Branch to implement our 1994 recommendations for (1) presenting tax expenditures in the annual budget, (2) developing a structure for conducting reviews of tax expenditures' performance, (3) conducting case studies to assess performance review structure, and (4) incorporating tax expenditures into the annual budgetary review process. We reviewed efforts to include tax expenditures under the Government Performance and Results Act's (GPRA) statutory framework for strategic planning,

[3]We used revised estimates, which incorporate the most recent changes in tax policy and economic activity, developed by the U.S. Department of the Treasury and reported in each year's budget in either the *Special Analyses*, *Appendixes*, or *Analytical Perspectives*. We chose the tax expenditure estimates reported in the budget for our analysis because Treasury develops (1) revised estimates based on changes in tax policy and economic activity for the year prior to the reported fiscal budget year and (2) outlay-equivalent estimates that facilitate comparison to federal spending. Although they are the last available estimates reported, Treasury's estimates are still projected estimates and may not reflect additional policy changes.

performance measurement, and program reporting and evaluation.[4] We also considered any related activities to include tax expenditures under OMB's Program Assessment Rating Tool (PART)—its current framework for assessing the performance of federal programs. (See app. I for details on our scope and methodology.)

Our work was conducted from August 2003 through July 2005, in accordance with generally accepted government auditing standards. In July 2005, we requested comments on a draft of this report from the Director of the Office of Management and Budget, the Secretary of the Department of the Treasury, and the Commissioner of the Internal Revenue Service (IRS). We received comments from OMB's Associate Director for Economic Policy in a letter dated September 2, 2005 (see app. II). Treasury did not provide separate comments, instead deferring to OMB. IRS staff provided a technical correction that we incorporated.

Results in Brief

Whether gauged in absolute numbers and revenues forgone or in comparison to federal spending or the size of the economy, tax expenditures have represented a substantial commitment of federal support over the past three decades. Between 1974 and 2004, tax expenditures doubled in number from 67 to 146, and while some were repealed or allowed to expire, considerably more were added to Treasury's list. Based on our analysis of Treasury's estimates, the sum of revenue loss estimates associated with tax expenditures, adjusted for inflation, tripled from approximately $240 billion to nearly $730 billion over the period.[5] The 14 largest tax expenditures, headed by the largest single tax expenditure—the income tax exclusion for employer-provided health care—accounted for 75 percent of the aggregate revenue loss in fiscal year 2004. The sum of the revenue loss estimates for tax expenditures that are used by individual taxpayers increased in real terms from approximately $190 billion to nearly $650 billion. Since 1981 when outlay-equivalent estimates were first available, the sum of the outlay-equivalent estimates for tax expenditures has been similar in magnitude to discretionary spending, and this sum

[4] Pub. L. No. 103-62, Aug. 3, 1993.

[5] Aggregate tax expenditure estimates must be interpreted carefully because of inherent limitations in the meaning of the summed estimates. The sum of the individual tax expenditure estimates is useful for gauging the general magnitude of revenue forgone through provisions of the tax code but does not take into account interactions between individual provisions.

exceeded total discretionary spending for most years during the last decade. As a share of the U.S. economy, the sum of tax expenditure outlay-equivalent estimates remained relatively stable at about 7.5 percent of GDP since the last major tax reform legislation in 1986. Across budget functions, the size of tax expenditures varied, and for some budget functional areas, such as housing and education, tax expenditures were the same magnitude as, or larger than, federal spending.

Although tax expenditures are substantial in size, little progress has been made in the Executive Branch to increase the transparency of and accountability for tax expenditures. The entire set of tools the federal government can use to address national objectives—including discretionary and mandatory spending, tax provisions, and loans and loan guarantees—should be subject to periodic reviews and reexamination to ensure they are achieving their intended purposes and designed in the most efficient and effective manner. The nation's current and projected fiscal imbalance serves to reinforce the importance of engaging in such a review and reassessment. Tax expenditures may not always be efficient, effective, or equitable and, consequently, information on these attributes can help policymakers make more informed decisions as they adapt current policies in light of our fiscal challenges and other overarching trends. In addition, some tax expenditures, at least as currently designed, may serve to exacerbate other key private sector and public policy challenges, such as controlling health care costs. Although data and methodological challenges may impede studies of some tax expenditures, periodic reviews of tax expenditures could help establish whether these programs are relevant to today's needs; if so, how well tax expenditures have worked to achieve their objectives; and whether the benefits from particular tax expenditures are greater than their costs. Over the past decade, however, the Executive Branch has made little progress in integrating tax expenditures into the budget presentation, in developing a structure for evaluating the performance of tax expenditures, or in incorporating tax expenditures under review processes that apply to spending programs, as we recommended in 1994. Also, more recently, OMB has not used its PART process to systematically review tax expenditures and promote joint and integrated reviews of tax and spending programs sharing common, crosscutting goals. One of the key impediments to moving forward in evaluating tax expenditures' performance is the continuing lack of clarity about the roles of OMB, Treasury, IRS, and departments or agencies with outlay program responsibilities.

We are recommending that the Director of OMB, in consultation with the Secretary of the Treasury, take several steps to ensure greater transparency of and accountability for tax expenditures by reporting better information on tax expenditures' performance and more fully incorporating tax expenditures into federal performance management and budget review processes.

In providing comments on a draft of this report, OMB's Associate Director for Economic Policy disagreed with our recommendations, raised concerns about our use of tax expenditure estimates developed by Treasury and reported in the annual federal budget, and implied that increasing the attention paid to tax expenditures due to the severity of the nation's long-term fiscal imbalance would lead to tax increases. Pursuant to the Congressional Budget Act of 1974, the term tax expenditure, as our draft stated, has been used in the federal budget for three decades, and the tax expenditure concept—while not precisely defined—is a valid representation of one tool that the federal government uses to allocate resources. In addition, OMB's implication that focusing more attention on tax expenditures would automatically lead to increased taxes is unfounded. Our report states that the revenues forgone through tax expenditures reduce revenues available to fund other federal activities or they require higher tax rates to obtain a given amount of revenue. Thus, if the evaluations of tax expenditures we call for lead to reducing or eliminating some tax expenditures, the net change after rate adjustments could, depending on overall congressional priorities and preferences, result in tax reductions for many taxpayers. Furthermore, although specific tax expenditures, such as the earned income tax credit (EITC) and Liberty Zone tax benefits, have received varying degrees of scrutiny, efforts to date have not provided the Congress and others with an integrated perspective on the extent to which programs and tools—including tax expenditures—contribute to national goals and position the government to successfully meet 21st century demands. The lack of a requirement to disclose tax expenditures in agencies' annual performance and accountability reports may result in important performance and cost related data not being fully considered with other federal resources allocated to achieve similar objectives. Although challenges must be overcome to provide systematic reviews of tax expenditures, these challenges cannot be addressed absent effective leadership within the Executive Branch. For these reasons, we believe our recommendations, if fully implemented, will ensure that policymakers and the public have the necessary information to make informed decisions and to improve the progress toward greater scrutiny of tax expenditures.

Background

To understand the trends in the size of tax expenditures, it is helpful to understand how tax expenditures are defined and how the different types affect taxpayer liability. For this report, we also provide an overview of the broad purposes of tax expenditures—one method the federal government can use to achieve national objectives—and a discussion of how tax expenditures interact with the federal budget.

Tax Expenditures Defined

Tax expenditures are revenue losses—the amount of revenue that the government forgoes—resulting from federal tax provisions that grant special tax relief for certain kinds of behavior by taxpayers or for taxpayers in special circumstances. These provisions may, in effect, be viewed as spending programs channeled through the tax system and are classified in the U.S. budget by the same functional categories as other spending, such as energy and health. Tax expenditures are provisions that are exceptions to the "normal structure" of the individual and corporate income tax necessary to collect government revenues.[6] Deciding whether an individual provision should be characterized as a tax expenditure is a matter of judgment, and disagreements about classification stem from different views about what should be included in the income tax base.[7] As a practical matter, the term tax expenditure has been used in the federal budget for three decades, and the tax expenditure concept—while not precisely defined—is a valid representation of one tool that the federal government uses to allocate resources.

Both the congressional Joint Committee on Taxation (JCT) and Treasury's Office of Tax Analysis annually compile a list of tax expenditures and estimates of their cost.[8] (App. III provides additional information on how

[6]The concept of tax expenditures extends beyond the income tax. Tax expenditures also exist for other types of taxes such as excise and payroll taxes; however, this report considers only tax expenditures for the federal income tax system.

[7]Some object that the distinction between those tax provisions labeled tax expenditures and those that are not is arbitrary and, that the very notion of labeling these provisions expenditures implies that all income could be taxed and thus, all income inherently belongs to the government. See, for example, Joint Economic Committee, *Tax Expenditures: A Review and Analysis* (Washington, D.C.: August 1999).

[8]Office of Management and Budget, *Analytical Perspectives*, *Budget of the United States Government*, *Fiscal Year 2006* (Washington, D.C.: 2005); and Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2005-2009*, JCS-1-05, (Washington, D.C.: Jan. 12, 2005).

tax expenditures are measured and reported and perspective on differences among the lists of tax expenditures reported by JCT and Treasury.) Treasury's tax expenditure estimates are included as an informational supplement to the annual federal budget by the OMB. The revenue loss is estimated for each tax expenditure separately by comparing the revenue raised under current law with the revenue that would have been raised if the single provision did not exist, assuming all other parts of the tax code remain constant and taxpayer behavior is unchanged. Revenue loss estimates are intended to provide information about the value of tax expenditures. However, tax expenditure estimates do not incorporate any behavioral responses and thus do not necessarily represent the exact amount of revenue that would be gained if a specific tax expenditure were repealed.[9] For example, when the consumer interest deduction was phased out gradually beginning in 1987, some taxpayers shifted to interest-deductible home equity loans to finance consumption, thereby affecting the revenue gain from eliminating the consumer interest deduction.

In addition to estimating revenue loss, Treasury also measures tax expenditures on an outlay-equivalent basis. Outlay-equivalent estimates represent the amount of budget outlays that would be required if the government were to provide taxpayers with the same after-tax income they receive through the tax expenditure. Outlay-equivalent estimates are often higher than revenue loss estimates to reflect that a comparable outlay program could result in additional taxable income to recipients.[10] Outlay-equivalent estimates are useful to compare tax expenditures and other parts of the federal budget. For example, the outlay-equivalent estimate for the tax exclusion for housing and meal allowances for military personnel reflects the additional pretax income that military personnel would have to be paid to raise their income after federal taxes by the amount of the tax expenditure. The outlay-equivalent estimate can be used to compare this tax expenditure with other outlays for defense compensation on a more consistent basis.

[9]Changes in taxpayer behavior are taken into account when JCT and Treasury prepare revenue estimates for proposed legislation.

[10]Although outlay-equivalent estimates are often higher than revenue loss estimates, the net estimated revenue loss for the government is unchanged. For more information on how outlay-equivalent estimates are measured, see app. III.

Types of Tax Expenditures

The Congressional Budget and Impoundment Control Act of 1974[11] lists six types of tax expenditures: exclusions, exemptions, deductions, credits, preferential tax rates, and deferral of tax liability. Some tax expenditures apply only to individual taxpayers, such as deductions and exclusions for employer-provided contributions for medical insurance, and some only to corporate taxpayers, such as a tax credit for corporations doing business in U.S. possessions. Other tax expenditures, such as accelerated depreciation, apply both to corporations and to individual taxpayers with income from businesses such as sole proprietorships or partnerships.[12] Table 1 shows examples of each type of tax expenditure and the taxpayer group that may claim a particular type.

[11] Pub. L. No. 93-344, Sec. 3, 88 Stat. 299 (July 12, 1974) (codified at 2 U.S.C. sec. 622(3)).

[12] Tax expenditures have been described by some analysts as being directed toward social or business interests. A social tax expenditure provides transfer payments related to old age, education, occupational and health benefits. A business tax expenditure has as its central goal the provision of financial support to corporations, partnerships, or individuals in any industry. See Eric Toder, *The Changing Composition of Tax Incentives: 1980-99*, (Washington, D.C.: The Urban Institute, March 1999).

Table 1: Examples of Types of Tax Expenditures Available to Taxpayer Groups

Types of tax expenditures[a]	Taxpayer groups: Individual taxpayers[b]	Taxpayer groups: Corporate taxpayers	Taxpayer groups: Both corporate and individual taxpayers
Exclusion from taxable income	Exclusion of employer contributions to medical insurance premiums and medical care	Extraterritorial income exclusion	Exclusion of interest on public purpose state and local bond
Exemption from taxable income	Parent personal exemption for student age 19 and over	Exemption of credit union income	Special employer stock ownership plan rules
Deduction from taxable income	Deductibility of mortgage interest on owner-occupied homes	Special Blue Cross/Blue Shield deduction	Deductibility of charitable contributions
Credit subtracted from taxes ordinarily computed	Child tax credit	Employer-provided child care credit	Credit for low-income housing investments
Preferential tax rate for all or part of taxable income	Averaging previous period taxable income for farmers	Graduated corporation income tax rate	N/A
Deferral of tax liability	Carryover basis of capital gains on gifts	Deferral of income from controlled foreign corporations	Accelerated depreciation of machinery and equipment

Source: GAO.

[a]Types of tax expenditures that are identified in the U.S. Congressional Budget and Impoundment Act of 1974.

[b] Individual tax expenditures include those available to non-corporate forms of business such as sole proprietorships.

Figure 1 illustrates how tax expenditures appear on the U.S. Individual Income Tax Return (Form 1040). Exclusions are those items of income that would otherwise constitute a part of the taxpayer's gross income, but are excluded under a specific provision of the tax code. Exclusions generally do not appear on the Form 1040, and excluded income is not reflected in total reported income. For example, the income tax exclusion of employer contributions to medical insurance premiums and medical care is not reported in a taxpayer's wages or salaries. An exemption, such as the parent personal exemption for students over age 19 but under age 24, is a reduction in taxable income offered to taxpayers because of their status or circumstances. Deductions are adjustments from adjusted gross income.[13] Deductions claimed before the adjusted gross income line on the Form 1040, such as the tuition and fees deduction (this appears on line 27 in fig. 1), are sometimes called "above-the-line" deductions. Taxpayers may

[13]Adjusted gross income is equal to gross income less qualifying adjustments to income, including some deductions.

also claim “below-the-line” deductions after the adjusted gross income line; to do so, taxpayers must itemize their deductions.[14]

[14]Taxpayers list their itemized deductions on the U.S. Individual Income Tax Return Form 1040 Schedule A—Itemized Deductions. In 2001, we reported that less than one-third of individual taxpayers itemize their deductions; in lieu of itemizing their deductions, most taxpayers take the standard deduction, which is considered part of the individual income tax structure. See GAO, *Tax Deductions: Estimates of Taxpayers Who May Have Overpaid Federal Taxes by Not Itemizing*, GAO-01-529 (Washington, D.C.: Apr. 12, 2001).

Figure 1: Examples of How Each Type of Tax Expenditure Relates to the U.S. Individual Income Tax Return (Form 1040)

Form **1040** Department of the Treasury—Internal Revenue Service
U.S. Individual Income Tax Return 2004 (99) IRS Use Only—Do not write or staple in this space.

For the year Jan. 1–Dec. 31, 2004, or other tax year beginning , 2004, ending , 20 OMB No. 1545-0074

Label (See instructions on page 16.) Use the IRS label. Otherwise, please print or type.

LABEL HERE

Your first name and initial | Last name | Your social security number

If a joint return, spouse's first name and initial | Last name | Spouse's social security number

Home address (number and street). If you have a P.O. box, see page 16. | Apt. no.

City, town or post office, state, and ZIP code. If you have a foreign address, see page 16.

Important! You must enter your SSN(s) above.

Presidential Election Campaign (See page 16.)
Note. Checking "Yes" will not change your tax or reduce your refund.
Do you, or your spouse if filing a joint return, want $3 to go to this fund? You ☐Yes ☐No Spouse ☐Yes ☐No

Filing Status
Check only one box.
1 ☐ Single
2 ☐ Married filing jointly (even if only one had income)
3 ☐ Married filing separately. Enter spouse's SSN above and full name here.
4 ☐ Head of household (with qualifying person). (See page 17.) If the qualifying person is a child but not your dependent, enter this child's name here.
5 ☐ Qualifying widow(er) with dependent child (see page 17)

Exemptions
6a ☐ Yourself. If someone can claim you as a dependent, do not check box 6a
b ☐ Spouse
c Dependents: (1) First name Last name | (2) Dependent's social security number | (3) Dependent's relationship to you | (4) ✓ if qualifying child for child tax credit (see page 18)
If more than four dependents, see page 18.
d Total number of exemptions claimed
Boxes checked on 6a and 6b
No. of children on 6c who: lived with you; did not live with you due to divorce or separation (see page 18)
Dependents on 6c not entered above
Add numbers on lines above

Income
Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.
7 Wages, salaries, tips, etc. Attach Form(s) W-2 — 7
8a Taxable interest. Attach Schedule B if required — 8a
b Tax-exempt interest. Do not include on line 8a — 8b
9a Ordinary dividends. Attach Schedule B if required — 9a
b Qualified dividends (see page 20) — 9b
10 Taxable refunds, credits, or offsets of state and local income taxes (see page 20) — 10
11 Alimony received — 11
12 Business income or (loss). Attach Schedule C or C-EZ — 12
13 Capital gain or (loss). Attach Schedule D if required. If not required, check here ☐ — 13
If you did not get a W-2, see page 19.
14 Other gains or (losses). Attach Form 4797 — 14
15a IRA distributions 15a | b Taxable amount (see page 22) — 15b
16a Pensions and annuities 16a | b Taxable amount (see page 22) — 16b
Enclose, but do not attach, any payment. Also, please use Form 1040-V.
17 Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E — 17
18 Farm income or (loss). Attach Schedule F — 18
19 Unemployment compensation — 19
20a Social security benefits 20a | b Taxable amount (see page 24) — 20b
21 Other income. List type and amount (see page 24) — 21
22 Add the amounts in the far right column for lines 7 through 21. This is your total income — 22

Adjusted Gross Income
23 Educator expenses (see page 26) — 23
24 Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ — 24
25 IRA deduction (see page 26) — 25
26 Student loan interest deduction (see page 28) — 26
27 Tuition and fees deduction (see page 29) — 27
28 Health savings account deduction. Attach Form 8889 — 28
29 Moving expenses. Attach Form 3903 — 29
30 One-half of self-employment tax. Attach Schedule SE — 30
31 Self-employed health insurance deduction (see page 30) — 31
32 Self-employed SEP, SIMPLE, and qualified plans — 32
33 Penalty on early withdrawal of savings — 33
34a Alimony paid b Recipient's SSN — 34a
35 Add lines 23 through 34a — 35
36 Subtract line 35 from line 22. This is your adjusted gross income — 36

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see page 75. Cat. No. 11320B Form **1040** (2004)

Exemption
An example of an exemption is the parent personal exemption for students over age 19 but under age 24 (appears on **line 6c**).

Exclusion
Excluded income generally does not appear on the tax form, but can still cause the income line to be lower than it otherwise would be. For example, the exclusion of employer contributions to medical insurance premiums and medical care causes the reported amount of wages and salaries to be less than it would be otherwise (see **line 7**).

Deferral
An example of a deferral is the accelerated depreciation of machinery and equipment for a sole proprietorship (appears on **line 12** via Schedule C–Profit or Loss from Business and Form 4562–Depreciation and Amortization.

Preferential tax rate
An example of this tax expenditure type is the preferential tax rate on capital gains of certain income (appears on **line 13** via the Schedule D–Capital Gains and Losses form).

Deduction
An example of a deduction above the adjusted gross income line is the tuition and fees deduction (appears on **line 27**). An example of an itemized deduction below-the-line is the deduction for mortgage interest on owner-occupied homes (appears on **line 39** as an itemized deduction via the Schedule A–Itemized Deductions form).

Note: Adjusted gross income is equal to gross income less qualifying adjustments to income, including some deductions.

Credit
An example of a credit is the tax credit for the elderly or disabled (appears on **line 48**). An example of a refundable credit is the child tax credit (appears on **line 51** with the refundable portion on **line 67** via Form 8812–Additional Child Tax Credit).

Form 1040 (2004) Page **2**

Tax and Credits

37 Amount from line 36 (adjusted gross income) 37

38a Check if: { ☐ **You** were born before January 2, 1940, ☐ Blind. / ☐ **Spouse** was born before January 2, 1940, ☐ Blind. } **Total boxes checked ▶ 38a**

b If your spouse itemizes on a separate return or you were a dual-status alien, see page 31 and check here ▶ **38b** ☐

Standard Deduction for—
- People who checked any box on line 38a or 38b **or** who can be claimed as a dependent, see page 31.
- All others:

Single or Married filing separately, $4,850

Married filing jointly or Qualifying widow(er), $9,700

Head of household, $7,150

39 **Itemized deductions** (from Schedule A) **or** your **standard deduction** (see left margin) . . 39

40 Subtract line 39 from line 37 40

41 If line 37 is $107,025 or less, multiply $3,100 by the total number of exemptions claimed on line 6d. If line 37 is over $107,025, see the worksheet on page 33 41

42 **Taxable income.** Subtract line 41 from line 40. If line 41 is more than line 40, enter -0- . 42

43 **Tax** (see page 33). Check if any tax is from: **a** ☐ Form(s) 8814 **b** ☐ Form 4972 . . . 43

44 **Alternative minimum tax** (see page 35). Attach Form 6251 44

45 Add lines 43 and 44 . . . . ▶ 45

46 Foreign tax credit. Attach Form 1116 if required 46

47 Credit for child and dependent care expenses. Attach Form 2441 47

48 Credit for the elderly or the disabled. Attach Schedule R . . 48

49 Education credits. Attach Form 8863 49

50 Retirement savings contributions credit. Attach Form 8880 . . 50

51 Child tax credit (see page 37) 51

52 Adoption credit. Attach Form 8839 52

53 Credits from: **a** ☐ Form 8396 **b** ☐ Form 8859 . . . 53

54 Other credits. Check applicable box(es): **a** ☐ Form 3800 **b** ☐ Form 8801 **c** ☐ Specify ________ . . 54

55 Add lines 46 through 54. These are your **total credits** 55

56 Subtract line 55 from line 45. If line 55 is more than line 45, enter -0- . . . . ▶ 56

Other Taxes

57 Self-employment tax. Attach Schedule SE 57

58 Social security and Medicare tax on tip income not reported to employer. Attach Form 4137 . . 58

59 Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required . 59

60 Advance earned income credit payments from Form(s) W-2 60

61 Household employment taxes. Attach Schedule H 61

62 Add lines 56 through 61. This is your **total tax** . . . . ▶ 62

Payments

63 Federal income tax withheld from Forms W-2 and 1099 . . 63

64 2004 estimated tax payments and amount applied from 2003 return 64

If you have a qualifying child, attach Schedule EIC.

65a **Earned income credit (EIC)** 65a

b Nontaxable combat pay election ▶ 65b

66 Excess social security and tier 1 RRTA tax withheld (see page 54) 66

67 Additional child tax credit. Attach Form 8812 67

68 Amount paid with request for extension to file (see page 54) 68

69 Other payments from: **a** ☐ Form 2439 **b** ☐ Form 4136 **c** ☐ Form 8885 . 69

70 Add lines 63, 64, 65a, and 66 through 69. These are your **total payments** . . . ▶ 70

Refund

Direct deposit? See page 54 and fill in 72b, 72c, and 72d.

71 If line 70 is more than line 62, subtract line 62 from line 70. This is the amount you **overpaid** 71

72a Amount of line 71 you want **refunded to you** . . . . ▶ 72a

▶ b Routing number ▶ c Type: ☐ Checking ☐ Savings

▶ d Account number

73 Amount of line 71 you want **applied to your 2005 estimated tax** ▶ 73

Amount You Owe

74 **Amount you owe.** Subtract line 70 from line 62. For details on how to pay, see page 55 ▶ 74

75 Estimated tax penalty (see page 55) 75

Third Party Designee

Do you want to allow another person to discuss this return with the IRS (see page 56)? ☐ **Yes.** Complete the following. ☐ **No**

Designee's name ▶ Phone no. ▶ ( ) Personal identification number (PIN) ▶

Sign Here

Joint return? See page 17. Keep a copy for your records.

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Your signature | Date | Your occupation | Daytime phone number ( )

Spouse's signature. If a joint return, **both** must sign. | Date | Spouse's occupation

Paid Preparer's Use Only

Preparer's signature | Date | Check if self-employed ☐ | Preparer's SSN or PTIN

Firm's name (or yours if self-employed), address, and ZIP code | EIN | Phone no. ( )

Form **1040** (2004)

Source: GAO.

Each type of tax expenditure creates tax savings in different ways and, consequently, reduces federal revenues in different ways. The amount of tax relief per dollar that a taxpayer receives using an exclusion, exemption, or deduction depends on the taxpayer's marginal tax rate.[15] Generally, the higher the taxpayer's marginal tax rate, the greater the tax savings from these tax expenditure types.[16] Tax credits reduce tax liability dollar-for-dollar, so the value of a credit is the same regardless of the taxpayer's marginal tax rate. A nonrefundable tax credit can be used to reduce current year tax liability to zero, and a refundable credit in excess of tax liability results in a cash refund. For preferential tax rates which reduce the tax rate on some forms of income such as capital gains, the tax savings depend on the difference between the preferential rate and a taxpayer's marginal tax rate. By allowing taxpayers to reduce current tax liability by delaying recognition of some income or accelerating some deductions otherwise attributable to future years, a tax deferral shifts the timing of tax payments and, in effect, provides an interest-free "loan" to the taxpayer. The benefit from a deferral is even greater if the taxpayer expects to face a lower tax bracket in the future. A lower-income taxpayer—with no net annual income or with no current tax liability after claiming the standard deduction and any personal exemptions—would not directly benefit from most tax expenditures other than refundable credits.

Some techniques have been used to limit the benefits that taxpayers may receive from individual tax expenditures or groups of them. Congress has controlled the amount of revenue forgone for some tax expenditures by adopting provisions to restrict taxpayers' eligibility for benefits. For example, the mortgage interest deduction is limited to interest on debt up to $1 million to buy, build, or improve first and second homes and up to $100,000 in home equity debt. Aggregate itemized deductions are reduced by 3 percent of the amount of a taxpayer's adjusted gross income that exceeds a certain threshold, eliminating 3 cents of itemized deductions for each dollar of income above the threshold for higher-income taxpayers.[17] Some tax expenditures, such as tax-exempt private-activity bonds issued by each state, are subject to volume caps limiting the aggregate amount of

[15]A marginal tax rate is the tax rate that applies to an additional dollar of income.

[16]Marginal individual tax rates for 2004 taxes were 10 percent, 15 percent, 25 percent, 28 percent, 33 percent, and 35 percent.

[17]The reduction in itemized deductions for higher-income taxpayers may also be viewed as a hidden tax rate.

benefits available. The alternative minimum tax (AMT) also affects tax expenditures and the amount of the revenue loss for the federal government.[18] The AMT is intended to ensure that taxpayers with income over certain thresholds pay some income tax, no matter how much they claim in certain deductions and credits. Under the AMT, taxpayers may have to add back some tax expenditures that they could otherwise claim under the regular tax system, such as deductions for state and local taxes and home equity loan interest, and they may have to include as income certain tax-exempt bond interest that is excluded under the regular tax system.

Objectives of Tax Expenditures

In addition to raising revenue, the federal income tax has long been used as a tool for accomplishing social and economic objectives. The general objectives of tax expenditures are to encourage particular types of activities (such as saving for retirement, promoting home ownership, investing in certain sectors, or funding research and development) and provide economic relief to selected groups of taxpayers (such as the elderly, the blind, and those with children). Another objective of tax expenditures may also be to adjust for differences in individuals' ability to pay taxes. For example, if two taxpayers have the same income, but one has a catastrophic illness and costly medical bills (or large casualty and theft losses), the other taxpayer is judged better able to pay income taxes. Some tax expenditures may be enacted to compensate for other provisions of the tax code. For example, advocates of reduced tax rates on capital gains often explain the special treatment of capital gains income as offsetting, in part, the assessment of taxes on the nominal, rather than the real, value of capital gains. The rationale and reasons for a particular tax expenditure may change over time. For example, according to the Congressional Research Service (CRS), the income tax code instituted in 1913 contained a deduction for all interest paid. No distinction was made between business and personal interest expenses, although most interest payments at that time represented business expenses. The legislative history does not indicate that the deductibility of mortgage interest was originally intended to encourage home ownership or subsidize the housing industry. However, over time, encouraging home ownership, stimulating

[18]The AMT is a separate tax system that applies to both individual and corporate taxpayers. It parallels the regular individual income tax system but with different rules for determining taxable income, different tax rates for computing tax liability, and different rules for allowing the use of tax credits.

residential construction and maintenance, and encouraging families to save and invest in a major financial asset have all been offered as justifications for the mortgage interest deduction.[19]

The tax expenditure tool may substitute for a federal spending program in that the federal government "spends" some of its revenue on subsidies by forgoing taxation on some income.[20] Certain activities may be cheaper and simpler to subsidize through the tax code than by setting up a separate program using a different tool. For example, the incremental administrative and compliance costs to deliver the tax credit for child and dependent care expenses may be relatively low compared to the costs of setting up a separate system for processing child care applications and sending vouchers to those eligible. The administrative infrastructure already exists for the government to collect and remit money to over 131 million individual tax filers and 6 million corporations via the tax system administered by the IRS. In concept, the costs to implement an income-based benefit program through the existing tax system could be lower than to set up separate spending programs to deliver these benefits.

In some circumstances, tax expenditures may not be the best policy choice to deliver timely benefits or reach intended populations. For programs that seek to provide benefits within a given year, the annual income measure relevant for income tax purposes may not be the best way to target benefits. Relative to spending programs, tax expenditures are limited in their ability to directly provide benefits to nontaxpayers. For example, tax credits must be refundable to reach low-income individuals who do not pay taxes and otherwise would not be required to file tax returns. Tax expenditures generally do not deliver federal resources directly to state and local governments and tax-exempt nonprofit organizations. The charitable contribution deduction provides an incentive for individual and corporate taxpayers to donate to charitable, religious, educational, and

[19]For more information on the history of the mortgage interest deduction, see Pamela J. Jackson, *Fundamental Tax Reform: Options for the Mortgage Interest Deduction*, Library of Congress, Congressional Research Service Report RL33025 (Washington, D.C.: Aug. 8, 2005).

[20]For more discussion of administering programs using tax expenditures, see OMB, *Analytical Perspectives*, *Budget of the United States Government*, *Fiscal Year 2006* (Washington, D.C.: 2005); Eric J. Toder, "Tax Cuts or Spending—Does It Make a Difference?" *National Tax Journal*, Vol. LIII, No. 3, September 2000); and Joel Slemrod and Jon Bakija, *Taxing Ourselves: A Citizen's Guide to the Debate Over Taxes*, *3rd Edition* (Cambridge, Mass.: The MIT Press, 2004).

health nonprofit organizations. The deduction, in effect, is a federal grant to the donor that reduces the out-of-pocket cost of giving. The itemized deduction for state and local taxes directly increases an individual taxpayer's after-tax income and thus reduces the after-tax price of state and local taxes. State and local governments receive some of the benefit to the extent that taxpayers may be more willing to pay state and local taxes.

Tax expenditures are not necessarily an either/or alternative to federal spending and may be used in combination with federal spending and strategies to achieve national objectives. For example, the HOPE and Lifetime Learning tax credits are used with federal education assistance, such as student loans, all of which help individuals fund higher education. Many tax expenditures are comparable to entitlement programs for which spending is determined by rules for eligibility, benefit formulas, and other parameters rather than by Congress appropriating specific dollar amounts each year.[21] With some exceptions, tax expenditures typically make funds (through reduced taxes) available to all qualified claimants, regardless of how many taxpayers claim the tax expenditures, how much they claim collectively, or how much federal revenue is reduced by these claims. Some tax expenditures resemble other policy tools, such as grants or direct loans. A few tax expenditures are administered like grant programs, allowing for some administrative discretion over who receives funds. For the New Markets Tax Credit (NMTC), those seeking the credit must apply to the Community Development Financial Institutions (CDFI) Fund within Treasury and be chosen by a group of evaluators to receive the tax credit. Like a grant program, the NMTC has a maximum amount that can be allocated by CDFI.[22] Tax expenditures in the form of deferrals resemble loans, because they allow taxpayers to postpone the time when income is recognized for tax purposes or to accelerate the deduction of expenses, both of which effectively lower the amount of income currently subject to tax. Deferrals can result in higher taxes in later years when taxpayers recognize deferred income in later tax years or have fewer deductions to claim than they otherwise would have had; the amount of the deferral is, in effect, analogous to a government loan.

[21]Entitlement statutes provide the authority to make payments to any person or government if, under the provisions of the law containing that authority, the United States is obligated to make such payments to persons or governments who meet the requirements established by that law.

[22]The NMTC legislation limits the allocation of equity eligible for tax credits from 2001 through 2007 from $1 billion to $3.5 billion per year, totaling $15 billion over the 7 years.

Tax Expenditures and the Federal Budget

Tax expenditures, by definition, reduce federal revenue and thus have implications for income tax rates, federal spending, and the federal budget. To obtain a given amount of revenue, tax expenditures require overall statutory tax rates to be higher. Otherwise, revenues forgone through tax expenditures reduce the revenue base available for funding federal spending programs. From a budgetary perspective, most tax expenditures are comparable to mandatory spending for entitlement programs, in that no further action is required to provide resources for tax expenditures. Tax expenditures do not compete overtly in the annual budget process and, in effect, receive a higher funding priority than discretionary spending subject to the annual appropriations process. Revenues forgone through tax expenditures—unless offset by increased taxes or lower spending—increase the unified budget deficit and federal borrowing from the public (or reduce the unified budget surplus available to reduce debt held by the public).

As noted previously, both the executive and legislative branches—by Treasury and JCT, respectively—publish annual lists of tax expenditures and the associated revenue loss, but budgetary decisions generally are not based on these lists. Like any spending program, newly proposed tax expenditures and those subject to expiration, to some extent, are subject to scrutiny, but most tax expenditures are not subject to reauthorization. Tax expenditures may be indirectly controlled to the extent that the Congress aims to achieve any revenue target. The tax committees consider tradeoffs between tax expenditures, tax rates, and other parts of the tax code.

In concept, eliminating or limiting an existing tax expenditure—like an existing spending program—would free up resources to reduce tax rates, increase federal spending or other tax expenditures, reduce the deficit, or produce some combination thereof. Conversely, adding a new tax expenditure, expanding an existing tax expenditure, or extending an expiring tax expenditure reduces the resources available to reduce tax rates, fund federal spending and tax expenditures, or reduce the deficit. The overall effect on the unified budget position would depend on the extent to which any change in tax expenditures is offset by adjustments to the tax code or other spending programs.

Tax Expenditures Have Represented a Substantial Federal Commitment over Time

Whether gauged in absolute numbers, by revenues forgone, or in comparison to federal spending or the size of the economy, tax expenditures have been substantial over the last three decades. Between fiscal years 1974 and 2004, tax expenditures doubled in number, and the sum of estimated revenue losses associated with tax expenditures tripled, most of which was accounted for by tax expenditures that were used by individual taxpayers. Since 1981 when outlay-equivalent estimates were first available, the sum of the outlay-equivalent estimates for tax expenditures has been similar in magnitude to discretionary spending, and this sum exceeded total discretionary spending for most years during the last decade. As a share of the U.S. economy, the sum of tax expenditure outlay-equivalent estimates remained relatively stable at about 7.5 percent of GDP since the last major tax reform legislation.

Sums of Tax Expenditure Estimates Are Useful for Gauging Magnitude of Tax Spending but Need to Be Interpreted Carefully

Summing the individual tax expenditure estimates is useful for gauging the general magnitude of the federal revenue involved, but it does not take into account possible interactions between the individual tax code provisions. Because of this limitation, sums of tax expenditure estimates must be interpreted carefully. The JCT and Treasury estimate the revenue loss from each tax expenditure separately, assuming that the rest of the tax code remains unchanged. Neither JCT nor Treasury adds tax expenditure estimates, because summing them does not take into account possible interaction effects among the provisions. If two or more tax expenditures were estimated simultaneously, the total change in federal revenue could be smaller or larger than the sum of the amounts shown for each item separately as a result of interactions among the tax expenditure provisions. For example, the repeal of an itemized deduction tax expenditure might cause more taxpayers to take the standard deduction instead of itemizing. However, the revenue loss estimate for any single tax expenditure among the itemized deductions does not reflect this potentially sizeable interaction with the standard deduction. Eliminating several itemized deductions at the same time could cause significant numbers of taxpayers to take the standard deduction, and thus, the decrease in revenue could be less than the sum of the estimated revenue loss estimates for each itemized deduction. To demonstrate the magnitude of possible interactions and the potential implications for summing tax expenditures, Treasury's Office of

Tax Analysis illustrated for us the repeal of five itemized deductions.[23] Based on tax year 2002 data, the sum of the five separate tax expenditure estimates, each calculated assuming the rest of the tax code was unchanged, was over $175 billion.[24] Assuming the simultaneous repeal of all five provisions, Treasury estimated the revenue loss after interaction totaled $131 billion—about 25 percent less than the sum of the separate estimates. According to Treasury, this example cannot be generalized given that some groups of tax provisions have substantial interactions and others do not. For all tax expenditures, the magnitude of the difference between the sum of the estimates and an estimate for all tax expenditures simultaneously is not known.

Additionally, tax expenditure estimates developed by Treasury and JCT do not take into account possible behavioral responses by taxpayers if a tax expenditure were repealed. For example, if the HOPE scholarship tax credit—a tax credit for the first 2 years of post-secondary education—were eliminated, taxpayers who would have used that tax credit may instead opt for the Lifetime Learning tax credit or other tax subsidies aimed at higher education. In contrast, certain kinds of behavioral responses, such as changes in the timing of transactions, income recognition, or shifts between sectors of the economy, are taken into account when JCT and Treasury prepare revenue estimates for proposed legislation. Potential macroeconomic effects, such as changes to GDP, are not reflected in tax expenditure revenue loss estimates or in revenue estimates for proposed legislation.

To some extent, the same kinds of challenges in interpreting tax expenditure estimates also exist in projecting the costs of spending programs. Budget line items generally do not reflect the actual budget savings to be gained by abolishing specific programs or groups of programs. For instance, eliminating all veterans' benefits would reduce the federal budget by less than the amount currently spent on those programs because spending likely would increase in food stamps, Medicaid, and other entitlement programs. Although interaction effects also occur for

[23]The 2002 estimates for the five itemized deductions were: (1) charitable contributions, $33.8 billion; (2) home mortgage interest expenses, $69.2 billion; (3) state and local income taxes, $43.0 billion; (4) state and local property taxes, $24.2 billion; and (5) medical expenses, $5.5 billion.

[24]The sum of Treasury's 2004 revenue loss estimates for the five itemized deductions was about $168 billion; see app. III.

spending programs, Treasury officials responsible for developing tax expenditure estimates told us that the bias in summing tax expenditure revenue loss estimates likely is greater than the bias for outlay projections. Whereas historical data are reported for federal budget receipts and outlays, the last available values for tax expenditures remain estimates. Treasury's last reported re-estimates for past fiscal years reflect legislation enacted, prevailing economic conditions, and the latest taxpayer data available at the time of estimation.[25] Projections of the future costs of tax expenditures are more uncertain than projections for future tax receipts or outlays because it is not known with certainty, even after the fact, how much was spent for any given tax expenditure.

Despite the limitations in summing separate tax expenditure revenue loss and outlay-equivalent estimates, these are the best available data to measure the value of tax expenditures and make comparisons to other spending programs. Summing the estimates provides perspective on the use of tax expenditures as a policy tool and represents a useful gauge of the general magnitude of government subsidies carried out through the tax code. The estimates also can be used to compare tax expenditures to federal spending overall and by budget function. Other researchers also have summed tax expenditure estimates to help gain perspective on the use of this policy tool and examine trends in the aggregate growth of tax expenditure estimates over time.[26]

Tax Expenditures Have More Than Doubled in Number and Tripled in Size

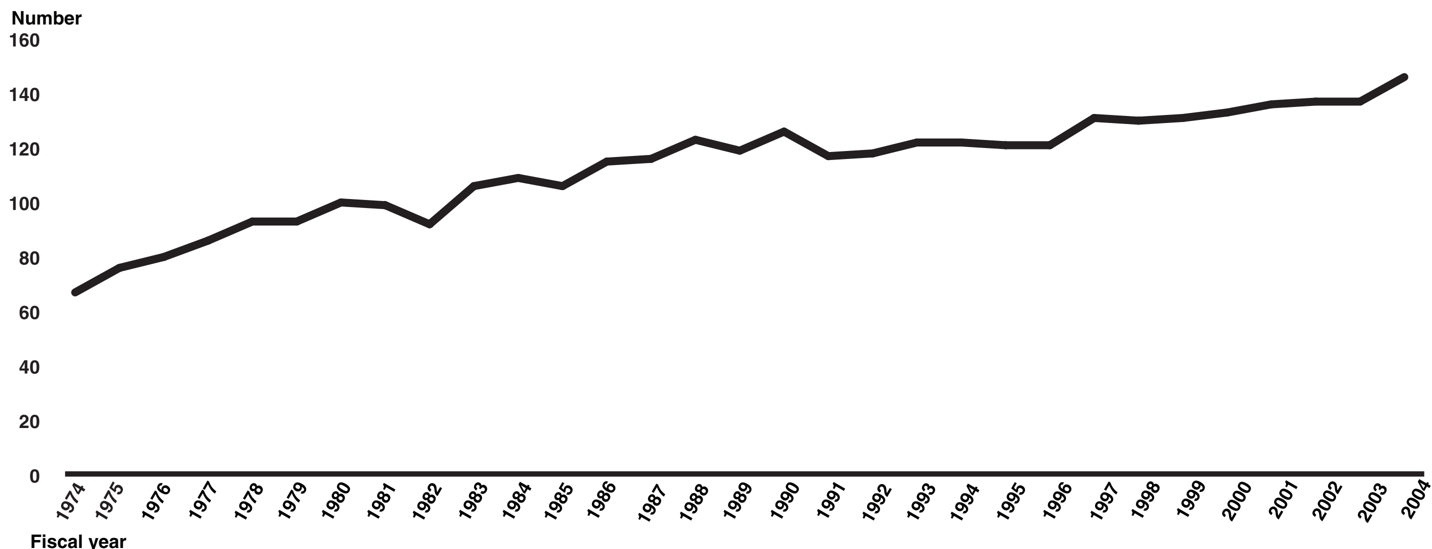
Between 1974 and 2004, tax expenditures reported by Treasury more than doubled in overall number from 67 to 146, and while some were dropped, considerably more were added. For 1974, Treasury listed 67 separate exclusions, exemptions, deductions, credits, preferential tax rates, and

[25]Treasury's fiscal year 2004 re-estimates were published in February 2005, still months before 2004 tax returns would be filed. JCT projects the revenue loss for future years and does not re-estimate tax expenditures for past fiscal years.

[26]See for example: Eric Toder, *The Changing Composition of Tax Incentives: 1980-1999*. (Washington, D.C.: The Urban Institute, 1999); Dhammika Dharmapala, *Tax Expenditures Versus Direct Subsidies: A Review of the Issues*. (Austin, Tex.: National Tax Association, 91st Annual Conference, 1998); Christopher Howard, "Tax Expenditures," *The Tools of Government: A Guide to the New Governance*, edited by Lester M. Salamon (New York, N.Y.: Oxford University Press, 2002), pp. 410-444; Congressional Research Service, *Overview of the Federal Tax System* (Washington, D.C.: 2005).

deferral of tax liability as tax expenditures.[27] In 1986, Treasury reported 115 tax expenditures, and by 2004 Treasury's list grew to 146 tax expenditures. Figure 2 shows the rise of the overall number of tax expenditures over the last three decades. (App. IV contains a compilation of all tax expenditures reported by Treasury between 1974 and 2004.)

Figure 2: Number of Tax Expenditures Reported by Treasury, 1974-2004



Source: GAO analysis of OMB budget reports on tax expenditures, Fiscal Years 1976-2006.

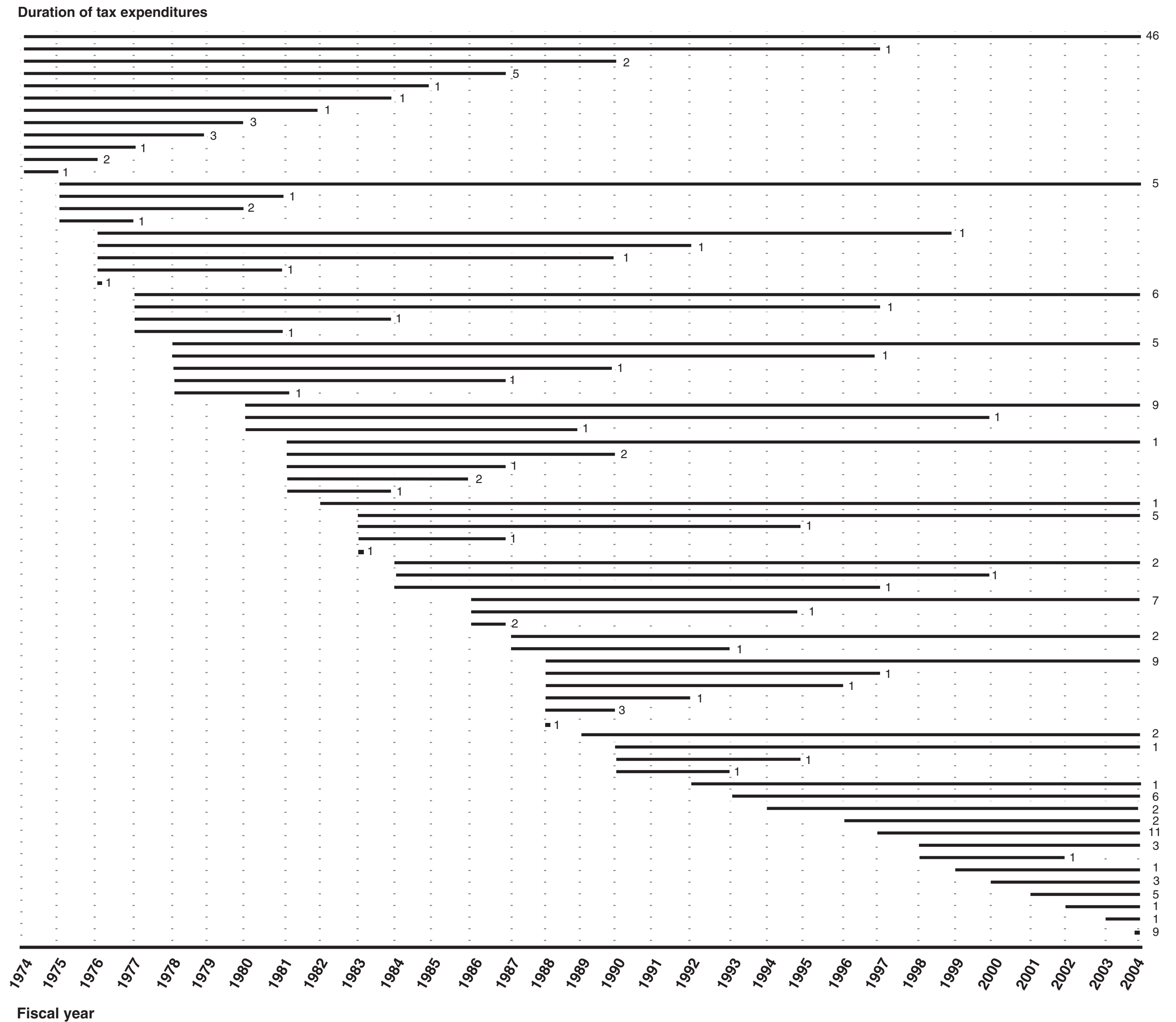
Note: The number of tax expenditures reflects all provisions reported by Treasury, including those enacted but effective for future fiscal years. For example, Treasury's last available list included eight new tax expenditures enacted in 2004 that will be effective in fiscal year 2005 and later. In addition, fluctuations in the trend lines from year-to-year may reflect changes in OMB's methodology. For example, the exclusion of scholarship and fellowship income and several other tax expenditures were excluded for fiscal year 1982, but included in prior and post years, because of changes in Treasury's income tax baseline that defines a tax expenditure.

Of the 146 tax expenditures listed by Treasury in the President's fiscal year 2006 budget, 32 percent were on the first list in 1974, 23 percent were added between 1975 and 1986, and 45 percent were added since 1986. Figure 3 shows the duration of tax expenditures listed by Treasury. Of the 67 tax expenditures listed in 1974, 21 had been dropped over the period, leaving

[27]The revenue loss estimates for fiscal year 1974 were reported in the President's Budget for fiscal year 1976, published in 1975. The list has been required by the Congressional Budget Act of 1974 in the budget thereafter.

46 remaining on the list in 2004. Since 1974, 143 tax expenditures were added to Treasury's list, although 43 of them have since dropped from the list over the period. Of the 100 added since 1974 and still reported in fiscal year 2004, 66 were first reported for 1986 or later.

Figure 3: Duration of Tax Expenditures Reported by Treasury, 1974-2004



Source: GAO.

Note: The number of tax expenditures reflects all provisions reported by Treasury, including those enacted but effective for future fiscal years. For example, Treasury's last available list included eight new tax expenditures enacted in 2004 that will be effective in fiscal year 2005 and later. Fluctuations in

the trend lines from year-to-year may reflect changes in OMB's methodology. For example, the exclusion of scholarship and fellowship income and several other tax expenditures were excluded for fiscal year 1982, but included in prior and post years, because of changes in Treasury's income tax baseline that defines a tax expenditure.

The number of tax expenditures reported by Treasury has changed over time for several reasons. Some provisions expired or were repealed; others were merged with another tax expenditure. For example, until expiration on December 31, 1984, state and local governments were allowed to issue tax-exempt obligations to finance the purchase of mass-commuting vehicles for lease to government transit agencies; the Tax Reform Act of 1986[28] repealed the investment tax credit; and the tax expenditure that provided 5-year amortization for pollution control was merged into the investment tax credit by the Tax Reform Act of 1976.[29] Legislation also added new tax expenditures over time, such as the child tax credit created by the Taxpayer Relief Act of 1997.[30] Some tax expenditures split into additional listings to reflect legislation expanding existing tax expenditures. For example, Treasury began listing the net exclusion of pension contributions and earnings with separate estimates for employer-sponsored defined-benefit and 401(k) pension plans following 2001 legislation increasing the contribution limits for 401(k) accounts. Finally, changes in the baseline used by Treasury to identify tax expenditures may have caused some tax expenditures to drop off its list, while adding new tax expenditure listings.[31] For example, Treasury briefly dropped the exclusion of scholarship and fellowship income from its fiscal year 1982 list because it was not considered a tax expenditure under the baseline that Treasury used that year.

As the overall number reported by Treasury doubled, the sum of the estimated revenue loss due to tax expenditures, adjusted for inflation, tripled from approximately $243 billion for 1974 to $728 billion for 2004.[32] Figure 4 shows the sum of Treasury's revenue loss estimates over the past

[28]Pub. L. No. 99-514, October 2, 1986.

[29]Pub. L. No. 94-455, October 4, 1976.

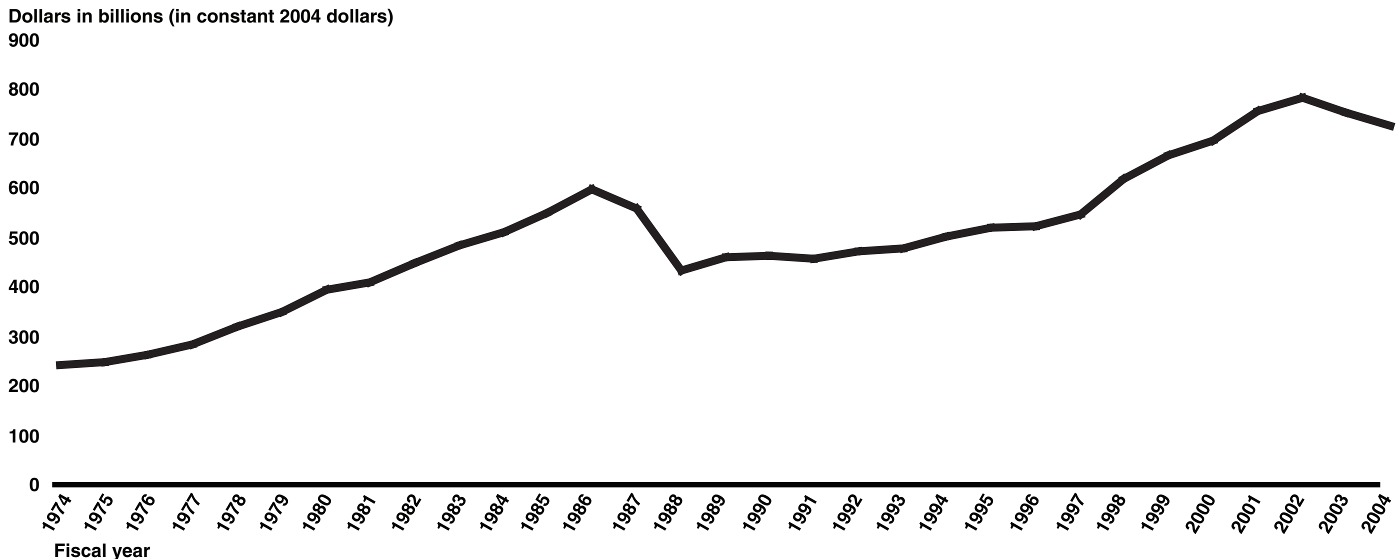
[30]Pub. L. No. 105-34, August 5, 1997.

[31]To determine the tax code provisions that satisfy the definition of a tax expenditure, the existing tax law must be compared or measured against an alternative set of tax rules that represent a baseline. App. III discusses in more detail the baselines used by Treasury as well as how Treasury measures and reports tax expenditures.

[32]The tax expenditure revenue loss estimates take into account the AMT liability.

three decades. From 1974 to 1986, revenue losses increased by nearly two and one-half times from approximately $243 billion for 1974 to $598 billion for 1986 (in 2004 dollars). Over the next 2 years, the sum of the revenue losses decreased by about 28 percent to approximately $433 billion for 1988. From 1989 through 1997, however, revenue losses increased by approximately 16 percent to approximately $547 billion. From 1998 to 2002, the sum of the estimated revenue loss increased by an average of about $41 billion per year, peaking at about $783 billion for 2002. The sum of the revenue loss estimates declined to approximately $728 billion in 2004.

Figure 4: Sum of Tax Expenditure Revenue Loss Estimates, 1974-2004

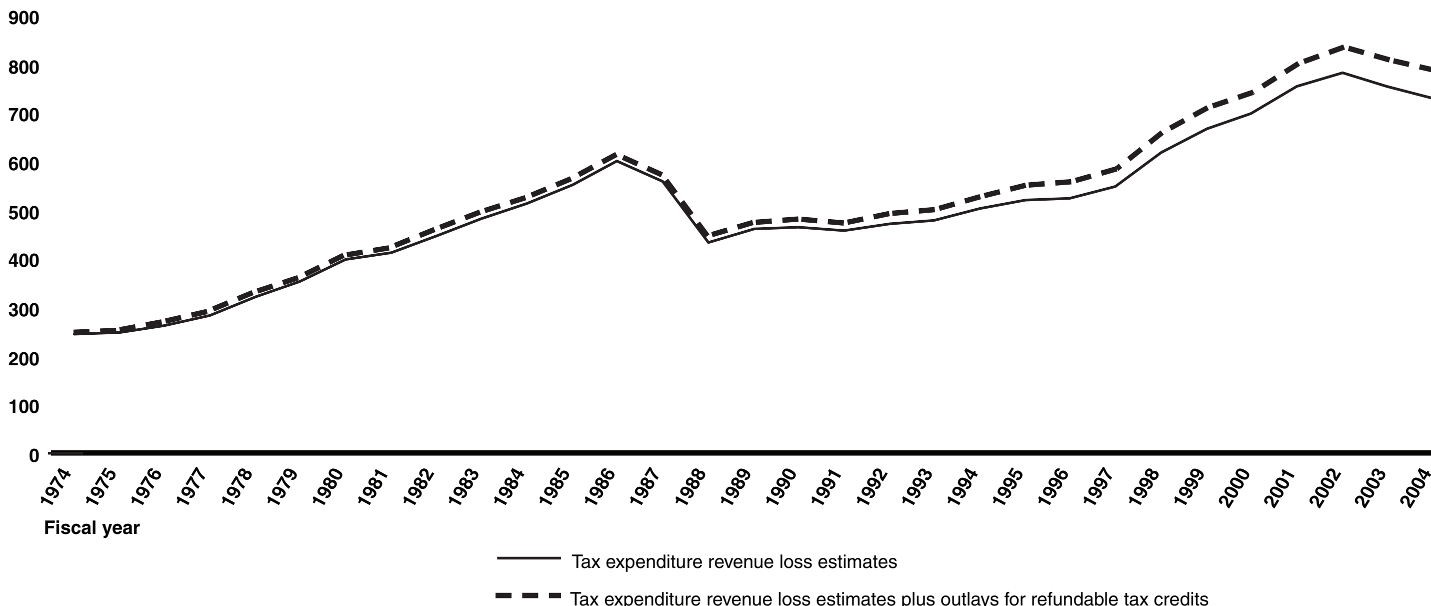


Source: GAO Analysis of OMB budget reports on tax expenditures, Fiscal Years 1976-2006.

Note: Summing the revenue loss estimates does not take into account possible interaction effects among the tax expenditures that we mentioned earlier in the report. Changes in economic conditions and estimation techniques can affect revenue loss estimates for tax expenditures, making them differ from year to year. Changes to the number of tax expenditures reported by Treasury would also affect the amount of revenue loss reported if some tax expenditures were eliminated or added. Finally, revenue loss estimates include the effect of certain tax credits on receipts only and not the effect of the credits on outlays.

The revenue loss estimates do not reflect the outlays for the refundable portion for certain tax credits.[33] Summing these outlays along with the sum of the revenue loss estimates provides a more complete picture of the aggregate cost of tax expenditures throughout the period, as shown in figure 5. The sum of the estimated revenue losses and outlays associated with tax expenditures totaled about $770 billion for fiscal year 2004.

Figure 5: Sum of Tax Expenditure Revenue Loss Estimates with Outlays for Refundable Tax Credits, 1974-2004



Source: GAO analysis of OMB budget reports on tax expenditures, fiscal years 1976-2006.

Note: Reflects refundable amounts for the EITC from 1976 to 2004, the child tax credit for 1997 to 2004, the child insurance medical premium credit for 1992 to1993, and the tax credit for health insurance purchased by certain displaced and retired individuals for 2004. Summing the revenue loss estimates does not take into account possible interaction effects among the tax expenditures that we mentioned earlier in the report. Changes in economic conditions and estimation techniques can affect revenue loss estimates for tax expenditures, making them differ from year to year. Changes to the number of tax expenditures reported by Treasury would also affect the amount of revenue loss reported if some tax expenditures were eliminated or added. Finally, revenue loss estimates include the effect of certain tax credits on receipts only and not the effect of the credits on outlays.

[33]In fiscal year 2004, the associated outlays were $33.1 billion for the EITC, $8.9 billion for the child tax credit, and $0.7 billion for the health insurance tax credit for certain displaced and retired individuals.

Trends in the sum of tax expenditures are due, at least in part, to legislation affecting the number or scope of tax expenditures or modifying tax rates or other basic structural features of the tax code. During this period, tax legislation directly influenced the sum of tax expenditure estimates by repealing or limiting some tax expenditures, enacting new ones, and extending the life of expiring tax expenditures. Even without changes to tax expenditures, legislation affecting tax rates or the tax structure affects the sum of the tax expenditure estimates. When a taxpayer uses a tax expenditure, his or her effective tax rate[34] is reduced, because some part of his or her income remains untaxed or is taxed at a lower rate. When statutory rates increase, a taxpayer's ability to avoid tax on a portion of income is worth more; consequently, tax expenditures are worth more. Likewise, when rates decrease, tax expenditures are worth relatively less.

Figure 6 highlights tax legislation enacted since 1974 that likely influenced the aggregate revenue losses due to tax expenditures. The sum of estimated revenue losses declined following the Tax Reform Act of 1986,[35] primarily because of individual and corporate marginal tax rate reductions which indirectly scaled back the value of all but a few tax credits. The 1986 act, which created the last major tax reform, also eliminated or limited the scope of various tax expenditures directly, for example, by repealing the investment tax credit, phasing out the interest deduction for consumer credit over 5 years, and limiting the expensing of the intangible drilling costs for oil and gas to successful, domestic wells. While materially reducing the number and scope of tax expenditures broadened the tax base, the act resulted in no net change in federal revenue because of the lower tax rates. In contrast, the sum of estimated revenue losses increased following the Omnibus Budget Reconciliation Act of 1993,[36] which directly increased several tax expenditures—for example, extending the EITC to single workers with no children earning $9,000 or less—and indirectly increased the value of other tax expenditures by increasing the top individual income tax rates and adding a third rate. The sum of estimated revenue losses accelerated following the Taxpayer Relief Act of 1997, which expanded several tax expenditures—for example, increasing eligibility for traditional individual retirement accounts—and created an assortment of new tax expenditures, including the child tax credit and

[34]The effective tax rate is the ratio of taxes paid to a taxpayer's total income.

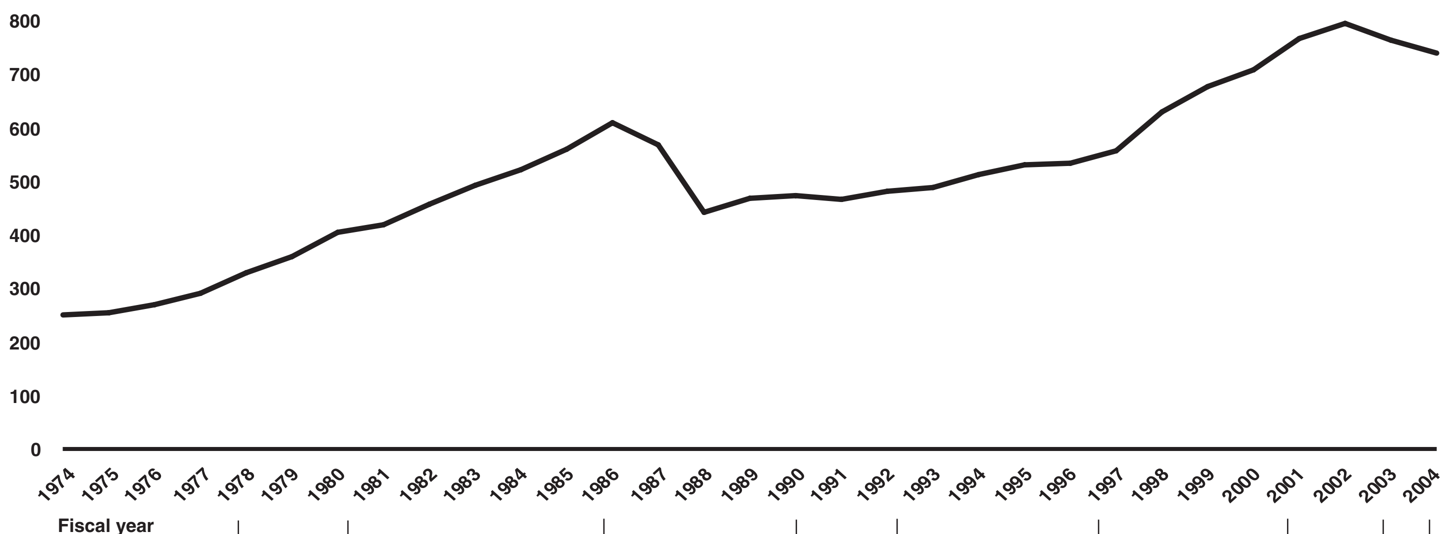
[35]Pub. L. No. 99-514, October 21, 1986.

[36]Pub. L. No. 103-66, August 10, 1993.

postsecondary education tax incentives. The Economic Growth and Tax Relief Reconciliation Act of 2001[37] reduced tax rates again and also increased the individual AMT exemption. The influence on the aggregate trend is less apparent for legislation expanding or adding tax expenditures while also reducing tax rates.

[37]Pub. L. No. 107-16, June 7, 2001.

Figure 6: Tax Legislation Enacted From 1974-2004 That May Have Influenced the Sum of Revenue Loss Estimates for Tax Expenditures



The Revenue Act of 1978: P.L. 95-600, November 6, 1978, made the EITC a permanent provision of the Internal Revenue Code and reduced individual and corporate tax rates.

The Economic Recovery Tax Act of 1981: P.L. 97-34, August 13, 1981, enacted several new tax expenditures, expanded existing tax expenditures for individuals and businesses, and phased in a 23 percent cut in individual tax rates.

The Tax Reform Act of 1986: P.L. 99-514, October 22, 1986, removed or scaled back several tax expenditures, lowered tax rates for individuals and corporations, and broadened the tax base by expanding the AMT for individuals.

The Omnibus Budget Reconciliation Act of 1990: P.L. 101-508, November 5, 1990, expanded family eligibility for the EITC and replaced the top three marginal tax rate brackets of the Tax Reform Act of 1986 with two brackets.

The Omnibus Budget Reconciliation Act of 1993: P.L. 103-66, August 10, 1993, extended several existing tax expenditures that encouraged select forms of investment and employment expenditures, and raised income tax rates at the very top of the income scale.

The Taxpayer Relief Act of 1997: P.L. 105-34, August 5, 1997, expanded several tax expenditures and created many new provisions, such as the child, HOPE, and Lifetime Learning education credits.

The Economic Growth and Tax Relief Reconciliation Act of 2001: P.L. 107-16, June 7, 2001**,** expanded several tax expenditures, lowered tax rates, and created an increase in the individual alternative minimum tax exemption amount.

The Jobs and Growth Tax Relief Reconciliation Act of 2003: P.L. 108-27, May 28, 2003, increased the child tax credit, and accelerated reductions in the regular income tax rates that were scheduled for 2004 through 2006.

American Jobs Creation Act of 2004: P.L. 108-357, October 22, 2004, extended several tax provisions that expired in 2003 or were scheduled to expire in 2004, including the research and development tax credit; simplified the rules for utilizing foreign tax credits; and reduced the corporate tax rate from 35 percent for domestic manufacturers, producers, farmers, and small corporations.

Source: GAO analysis of OMB budget reports on tax expenditures, fiscal years 1976-2005.

Note: The effects of legislative changes on tax expenditure estimates might not have occurred within the same year that the legislation was enacted. Summing the revenue loss estimates does not take into account possible interaction effects among the tax expenditures that we mentioned earlier in the report. Changes in economic conditions and estimation techniques, can affect revenue loss estimates

for tax expenditures, making them differ from year to year. Changes to the number of tax expenditures reported by Treasury would also affect the amount of revenue loss reported if some tax expenditures were eliminated or added. Finally, revenue loss estimates include the effect of certain tax credits on receipts only and not the effect of the credits on outlays.

Changes in economic conditions and in the baseline tax system can also affect revenue loss estimates for tax expenditures, making them differ from year to year. For example, rising housing prices may cause the estimated cost of the mortgage interest deduction to increase as homeowners finance larger mortgages or take out equity with home equity loans. In addition, changes in tax expenditure baselines could also cause estimates to differ from year to year. For example, for fiscal years 2003 and 2004, Treasury redefined accelerated depreciation tax expenditures so that they are calculated relative to a replacement cost basis baseline rather than the historic cost basis previously used. This redefinition had the effect of reducing the estimated size of the accelerated depreciation tax expenditures.[38]

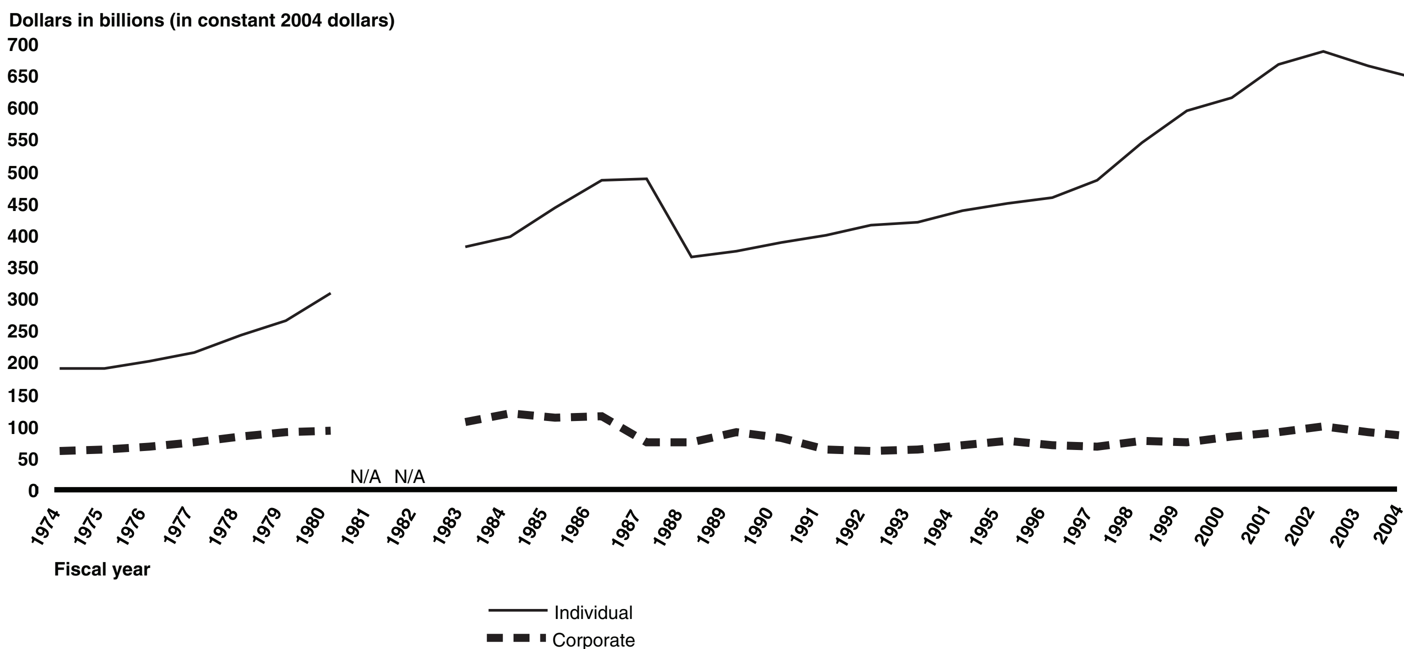
Tax Expenditures for Individual Taxpayers Accounted for Most of the Sum of Tax Expenditure Revenue Losses

The sum of estimated revenue losses due to tax expenditures for individual income taxpayers accounted for substantially more of the revenue loss between 1974 and 2004 than corporate tax expenditures, as shown in figure 7. The sum of revenue loss estimates for tax expenditures that arise under the individual income tax increased from approximately $187 billion for 1974 to $487 billion for 1987 (in 2004 dollars). After decreasing to approximately $363 billion for 1988, the sum gradually increased to a high of approximately $688 billion for 2002 and then declined in 2003 and 2004. On average over the entire period, revenue loss estimates for individual income taxpayers accounted for about 83 percent of the sum of revenue loss estimates per year. While estimated revenue losses for all tax expenditures tripled, the sum of revenue loss estimates for corporate tax expenditures increased from approximately $57 billion for fiscal year 1974 to a high of about $116 billion in 1984 (in 2004 dollars). After 1984, the sum dropped back to approximately $57 billion in 1992 and increased slightly over the rest of the period, with some fluctuation between years. In 2004, revenue loss estimates for tax expenditures that arise under the corporate income tax accounted for 11 percent of the sum of revenue losses due to all

[38]This is one of the reasons why the sum of tax expenditure revenue loss estimates by Treasury and JCT, which had been tracking each other rather closely since 1987, diverged in 2003 and 2004. While Treasury has changed its tax expenditure baselines over time, JCT's tax expenditure baseline has changed little over time. See app. III for additional information on how JCT and Treasury measure tax expenditures.

tax expenditures. At about 10 percent of total federal receipts, corporate income taxes also accounted for a smaller share than individual income taxes.

Figure 7: Sum of Revenue Loss Estimates by Taxpayer Group, 1974-2004



Source: GAO analysis of OMB budget reports on tax expenditures, fiscal years 1976-2006.

Note: Treasury did not report separate estimates for the individual and corporate income tax expenditures for fiscal years 1981 and 1982. Total revenue loss estimates for fiscal years 1981 and 1982 were approximately $410 and $448 billion (in 2004 dollars). The location of tax expenditure estimates under the individual and corporate tax expenditure headings does not imply that these categories of filers benefit from the special tax provisions in proportion to the respective tax expenditure amounts shown. For instance, the ultimate beneficiaries of corporate tax expenditures could be shareholders, employees, customers, or other providers of capital, depending on economic forces. In addition, summing the revenue loss estimates does not take into account possible interaction effects among the tax expenditures that we mentioned earlier in the report. Changes in economic conditions and estimation techniques, can affect revenue loss estimates for tax expenditures, making them differ from year to year. Changes to the number of tax expenditures reported by Treasury would also affect the amount of revenue loss reported if some tax expenditures were eliminated or added. Finally, revenue loss estimates include the effect of certain tax credits on receipts only and not the effect of the credits on outlays.

The sum of revenue loss estimates due to individual income tax expenditures is primarily attributable to a small number of large tax expenditures. The fourteen tax expenditures listed in table 2—each with an annual revenue loss estimated at $20 billion or more—accounted for

about 75 percent of the sum of revenue losses for fiscal year 2004. Ten of the 14 largest tax expenditures focused entirely on individual taxpayers, and the other 4 were available for individuals and corporations. Most of the largest tax expenditures are long-standing ones, and only 2 of the 14 were added to the tax code since 1986.[39] The child tax credit, enacted in 1997, is among the largest tax expenditures based on its estimated revenue losses alone, not counting associated outlays of $8.9 billion in fiscal year 2004. With revenue losses estimated at $4.9 billion, the EITC does not appear on this list; if $33.1 billion in associated outlays were included, this refundable credit ranks among the largest tax expenditures.

[39]The exclusion of net imputed rental income on owner-occupied homes is a long-standing feature of the income tax system. It was first listed as a tax expenditure by Treasury in the 2006 budget; JCT does not list this tax expenditure.

Table 2: Revenue Loss Estimates for the Largest Tax Expenditures Reported for Fiscal Year 2004, with Taxpayer Group and Budget Function

Tax expenditure	Revenue loss estimate (Billions $)	Revenue loss estimate as a percentage of sum	Taxpayer group	Budget function
Income tax exclusion of employer contributions to medical insurance premiums and medical care[a]	$102.3	14.0%	Individual	Health
Deductibility of mortgage interest on owner occupied homes[a]	61.5	8.4%	Individual	Commerce and housing credit
Net exclusion of pension contributions and earnings: 401(k)	47.7	6.6%	Individual	Income security
Net exclusion of pension contributions and earnings: employer plans[a]	47.0	6.5%	Individual	Income security
Deductibility of nonbusiness state and local taxes (other than on owner-occupied homes)[a]	45.3	6.2%	Individual	General purpose fiscal assistance
Accelerated depreciation of machinery and equipment	44.7	6.1%	Corporate and Individual	Commerce and housing credit
Capital gains exclusion on home sales	29.7	4.1%	Individual	Commerce and housing credit
Deductibility of charitable contributions other than education and health[a]	27.4	3.8%	Corporate and Individual	Education, training, employment, social services
Exclusion of interest on public purpose state and local bonds[a]	26.2	3.6%	Corporate and Individual	General purpose fiscal assistance
Capital gains (other than agriculture, timber, iron ore, and coal)[a]	25.2	3.5%	Individual	Commerce and housing credit
Exclusion of net imputed rental income on owner-occupied homes	24.6	3.4%	Individual	Commerce and housing credit
Step-up basis of capital gains at death	24.2	3.3%	Individual	Commerce and housing credit
Child credit (effect on receipts only)	22.4	3.1%	Individual	Education, training, employment, and social services
Exclusion of interest on life insurance savings[a]	20.1	2.98%	Corporate and Individual	Commerce and housing credit

Source: GAO analysis of OMB budget report on tax expenditures, fiscal year 2006.

[a]Denotes tax expenditures that have been reported by Treasury since 1974.

Note: Some tax expenditures split into additional listings to reflect legislation expanding existing tax expenditures. For example, Treasury began listing the net exclusion of pension contributions and earnings with separate estimates for employer-defined benefits and 401(k) pension plans following 2001 legislation increasing the contribution limits for 401(k) accounts. From year to year, revenue loss estimates may change because Treasury updates their estimates for each new budget to reflect legislation enacted, prevailing economic conditions, and the latest taxpayer data available. Although there are substantial revenues forgone for these 14 large tax expenditures, the estimated amount of

federal spending that would be required to provide equivalent assistance is frequently larger than the revenue forgone because this spending could be subject to income tax. For example, the outlay-equivalent estimate for the income tax exclusion of employer contributions for medical insurance premiums and medical care is $126.7 billion for fiscal year 2004. Outlay-equivalent estimates for tax expenditures are discussed in more detail in app. III.

Tax expenditure revenue loss estimates reflect federal income tax revenue forgone and do not account for provisions that exclude certain earnings from payroll taxes. For example, the income tax exclusion for health care not only permits the value of health insurance premiums to be excluded from the calculation of employees' taxable earnings for income taxes but also excludes the value of the premiums from the calculation of Social Security and Medicare payroll taxes for both employees and employers.[40] Some researchers have estimated that these payroll tax revenue losses amount to more than half of the income tax revenue losses.[41] If payroll tax revenue losses were 50 percent of the $102.3 billion in income tax revenue loss estimated by Treasury, the combined revenue loss associated with the exclusion of employer contributions for health insurance premiums would be $153.5 billion in 2004.

While Tax Expenditures Have Exceeded Discretionary Spending in Some Years, They Have Remained Relatively Stable as a Share of the U.S. Economy

The sum of tax expenditure outlay-equivalent estimates exceeded the amount of discretionary spending for most years during the last decade, as shown in figure 8.[42] Outlay-equivalent estimates, introduced by Treasury in 1981, allow the value of a tax expenditure to be compared with a direct federal outlay. The sum of the outlay-equivalent estimates reported by Treasury was approximately $853 billion in 2004.[43] Until 1987, the sum of outlay-equivalent estimates for tax expenditures was roughly the same magnitude as discretionary spending. From 1988 through 1995, the sum of tax expenditure outlay-equivalent estimates averaged about $104 billion (in

[40]Employers may deduct their premium payments as a business expense in calculating their net taxable income; this deduction, like those for other labor costs, is not a tax benefit for employers.

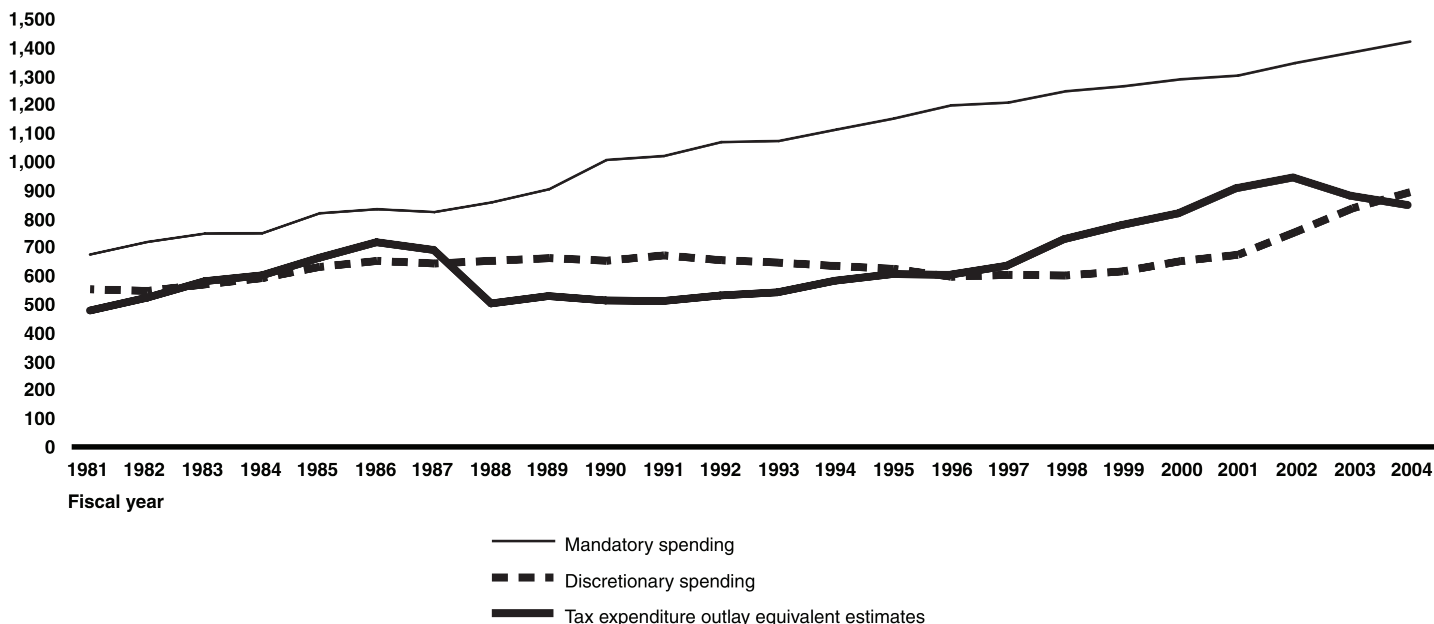
[41]John Sheils and Randall Haught, "The Cost of Tax-Exempt Health Benefits in 2004," *Health Affairs* (Feb. 25, 2004); and Leonard E. Burman and Jonathan Gruber, "Tax Credits for Health Insurance," Tax Policy Center Discussion Paper No. 19 (Washington, D.C.: The Tax Policy Center, June 2005).

[42]When measured in terms of sum of revenue loss estimates, tax expenditures also exceeded discretionary spending in some years.

[43]The sum of tax expenditure outlay-equivalent estimates plus outlays associated with refundable credits amounted to $896 billion in fiscal year 2004.

2004 dollars) less than annual discretionary spending. Beginning in 1996, the sum of tax expenditure outlay-equivalent estimates surpassed discretionary spending and averaged about $114 billion (in 2004 dollars) more than annual discretionary spending through 2003. However, in 2003, the sum of Treasury's tax expenditure estimates declined markedly, and the sum of tax expenditure outlays fell below discretionary spending in fiscal year 2004. This decline may be due, at least in part, to changes in the way Treasury defined and measured several tax expenditures in these years. Just as the sum of tax expenditure outlay-equivalent estimates increased since the late 1990s, discretionary spending also increased over this period. Between 1996 and 2002, the sum of tax expenditure estimates increased by an average of approximately $46 billion annually, while discretionary spending increased by an average of $21 billion annually (in 2004 dollars). Mandatory spending—larger than the sum of tax expenditure estimates or discretionary spending—consistently rose over the period shown by an average of $43 billion annually (in 2004 dollars).

Figure 8: Sum of Tax Expenditure Outlay-equivalent Estimates Compared with Total Mandatory and Total Discretionary Outlays, 1981-2004



Source: GAO analysis of OMB budget reports on tax expenditures, fiscal years 1983-2006

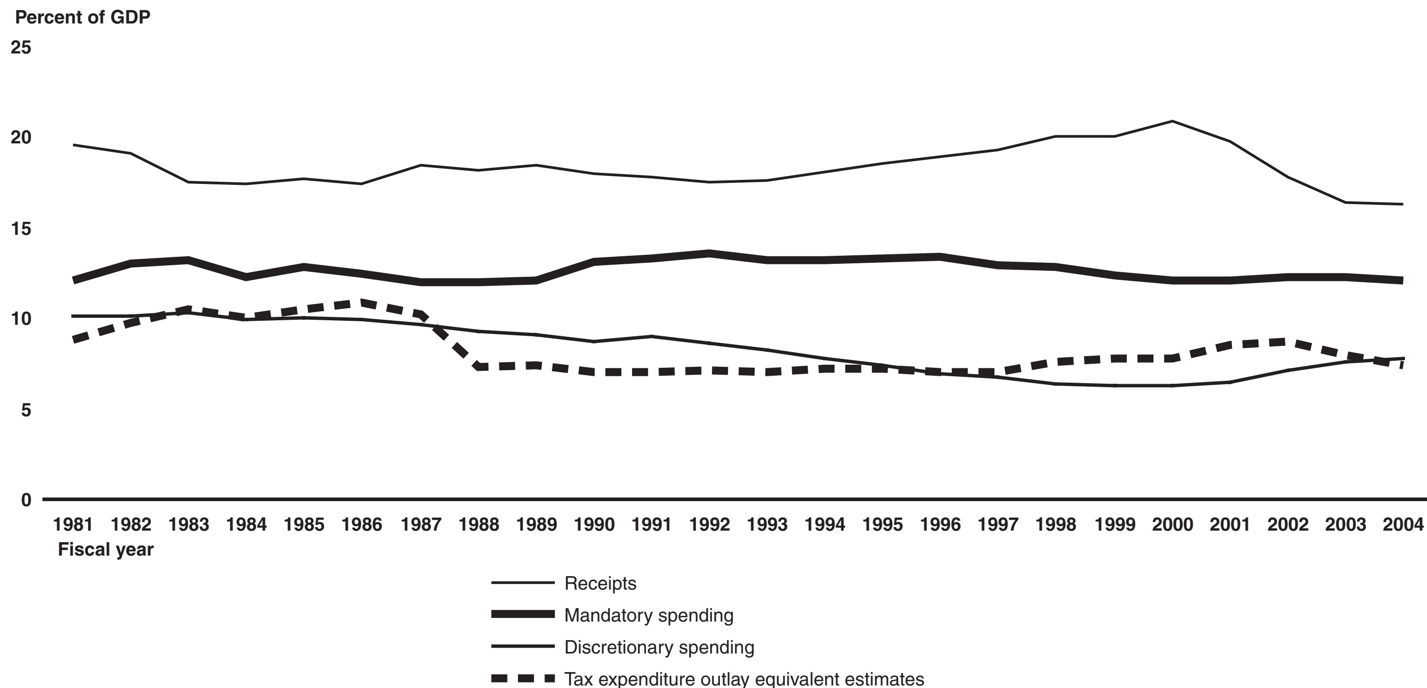
Note: Mandatory spending includes net interest. Summing the outlay-equivalent estimates does not take into account possible interaction effects among the tax expenditures. In addition, tax expenditure estimates developed in different years generally use different economic, demographic, and other assumptions. Finally, changes to the number of tax expenditures reported by Treasury would also affect the amount of outlay-equivalent estimates reported if some tax expenditures were eliminated or added.

Figure 9 compares tax expenditures and federal outlays as a share of GDP as a way to measure the amount of federal spending through the tax code and other programs relative to the economy.[44] As a share of the U.S. economy, the sum of tax expenditure outlay-equivalent estimates peaked at 10.9 percent of GDP in 1986. Since 1988, the sum of tax expenditure outlays has remained relatively stable at about 7.5 percent of GDP. Over the period shown, mandatory spending also was fairly constant as a share of the economy, at an average of 12.7 percent of GDP. As a share of the economy, discretionary spending declined from 10.1 percent of GDP in 1981 to 6.3 percent in 1999 and 2000, with some fluctuation between the years. In recent years, discretionary spending has grown faster than the economy, increasing to 7.8 percent of GDP in fiscal year 2004. Averaging about 18.0 percent of GDP in the 1980s through the early 1990s, federal receipts steadily rose to 20.9 percent of GDP in 2000 and since declined to 16.3 percent of GDP in fiscal year 2004. With total federal outlays—including mandatory and discretionary spending plus net interest—reaching 19.9 percent of GDP, the federal unified budget deficit amounted to 3.6 percent of GDP ($412 billion) in fiscal year 2004. The on-budget deficit in fiscal year 2004 amounted to 4.9 percent of GDP ($567 billion).[45]

[44]Expressing tax expenditures as a share of the nation's economy provides the context for assessing trends in federal revenue and spending. GDP is a commonly used measure of domestic national income. GDP is the value of all goods and services produced within the United States in a given year and is conceptually equivalent to incomes earned in production. It is a rough indicator of the economic earnings base from which the government draws its revenues.

[45]Whereas the unified budget is a consolidated measure of federal activity, the on-budget deficit excludes Social Security and the Postal Service which are off-budget under current law. In fiscal year 2004, the off-budget surplus included a $151 billion Social Security surplus and a $4 billion surplus for the Postal Service.

Figure 9: Sum of Tax Expenditure Outlay-Equivalent Estimates Compared to Total Mandatory and Discretionary Outlays and Receipts as a Percentage of GDP, 1981-2004



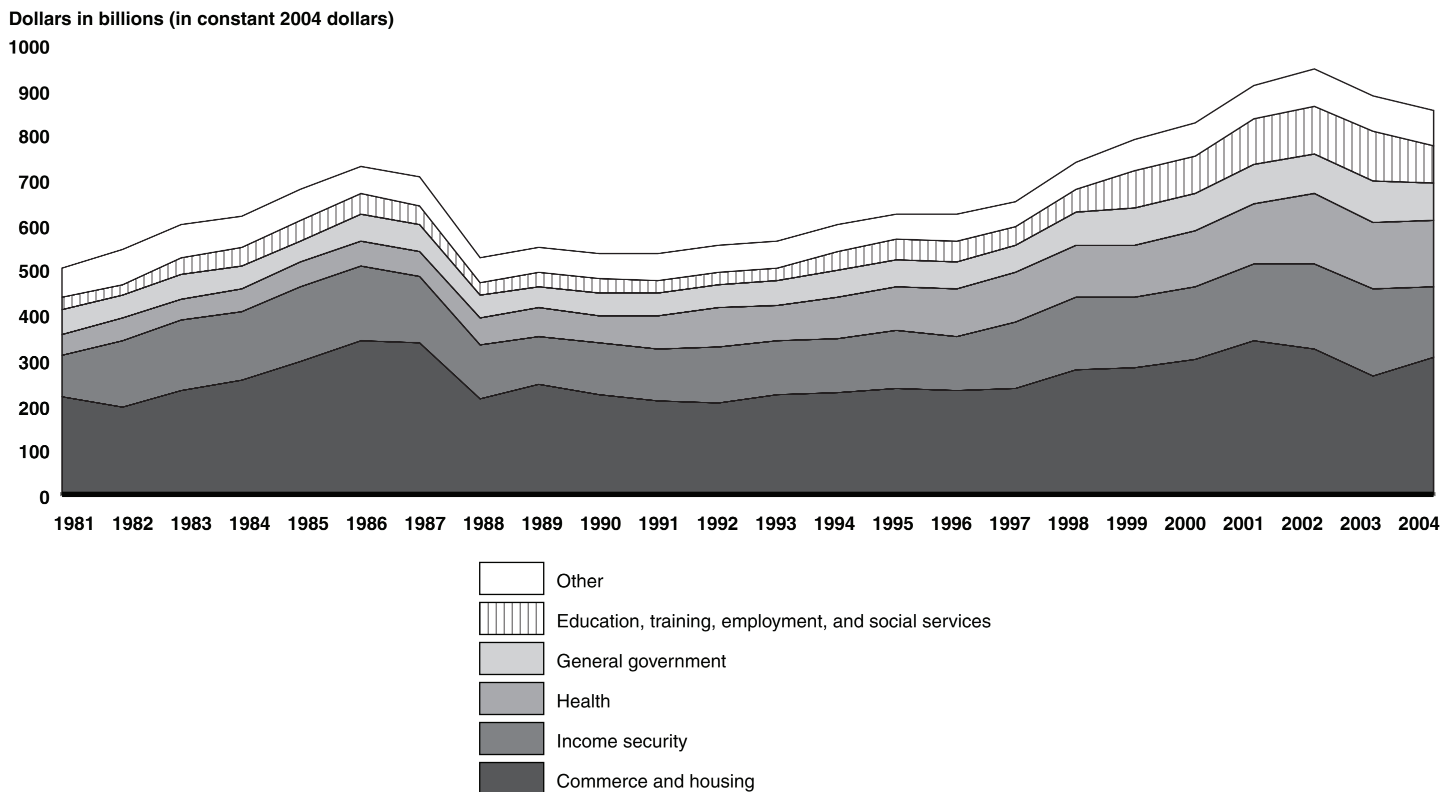
Source: GAO analysis of OMB budget reports on tax expenditures, fiscal years 1983-2006.

Note: Mandatory spending includes net interest. Whereas the mandatory and discretionary numbers represent actual money that was spent by the federal government, tax expenditure figures are estimates. In addition, summing the outlay-equivalent estimates does not take into account possible interaction effects among the tax expenditures that we mentioned earlier in the report. Tax expenditure estimates developed in different years generally use different economic, demographic, and other assumptions. Changes to the number of tax expenditures reported by Treasury would also affect the amount of outlay-equivalent estimates reported if some tax expenditures were eliminated or added.

Tax expenditures span almost all federal mission areas, but their relative size differs across budget functions. To gauge the relative role of tax expenditures, the sum of tax expenditure outlay-equivalent estimates and federal outlays can be compared to total spending by budget function. For 2004, Treasury reported tax expenditures for 16 of 20 budget functions. Five of the functions accounted for 91 percent of the sum of the tax expenditure outlay-equivalent estimated dollar amounts in 2004—commerce and housing credit; education, training, employment and social services; income security; health; and general government, as shown in figure 10. (See app. III for a list of tax expenditures reported for 2004 by budget function.) For the most part, these same five budget functions accounted for the largest percentage of total outlay-equivalent estimates

over time, although the relative size of the estimated outlay-equivalent dollar amounts for the five budget functions varied somewhat over the period shown. For example, the health and the education, training, employment and social services budget functions more than doubled between 1986 and 2002 (in 2004 dollars).

Figure 10: Size of Tax Expenditure Outlay-Equivalent Estimates by Budget Function, 1981-2004



Source: GAO Analysis of OMB Budget Reports on Tax Expenditures, Fiscal Years 1983-2006.

Note: The other budget functions that Treasury lists tax expenditures under are national defense; international affairs; general science, space, and technology; energy; natural resources and environment; agriculture; transportation; community and regional development; social security; veterans' benefits and services; and net interest. The general government budget function includes tax expenditures listed by Treasury under the general purpose fiscal assistance budget subfunction. For two budget functions—commerce and housing credit; and education, training, employment, and social services—tax expenditures are listed by subfunction. In addition, summing the outlay-equivalent estimates by budget function does not take into account possible interaction effects among the expenditures. Tax expenditure estimates developed in different years generally use different economic, demographic, and other assumptions. Changes to the number of tax expenditures reported by Treasury would also affect the amount of outlay-equivalent estimates reported if some tax expenditures were eliminated or added.

The sum of the tax expenditure outlay-equivalent estimates was greater than what the federal government spends in discretionary and mandatory spending for some budget functions. As shown in figure 11, the sum of the tax expenditure outlay-equivalent estimates exceeded federal outlays for three budget functions: energy,[46] commerce and housing credit, and general government. Outlay-equivalent estimates for tax expenditures in the commerce and housing credit budget function totaled $300 billion for 2004, while budget outlays for that function totaled $5 billion.[47] Seven of the 14 largest tax expenditures, listed in table 2 with revenue losses exceeding $20 billion in 2004, were reported under the commerce and housing credit budget function. The mortgage interest deduction—the second largest single tax expenditure in fiscal year 2004—had an outlay-equivalent estimate of $61.5 billion, compared to $45 billion in outlays for the Department of Housing and Urban Development, which is responsible for, among other things, mortgage credit and housing assistance programs.[48] Various tax expenditures for accelerated depreciation and capital gains listed under the commerce and housing credit budget function also provide incentives for a wide range of different investments that can affect other federal mission areas. The general government budget function included two of the largest tax expenditures—the deduction of state and local income and sales tax, and the exclusion of interest on public purpose state and local bonds—which together accounted for about $71.5 billion in tax expenditures outlays.[49]

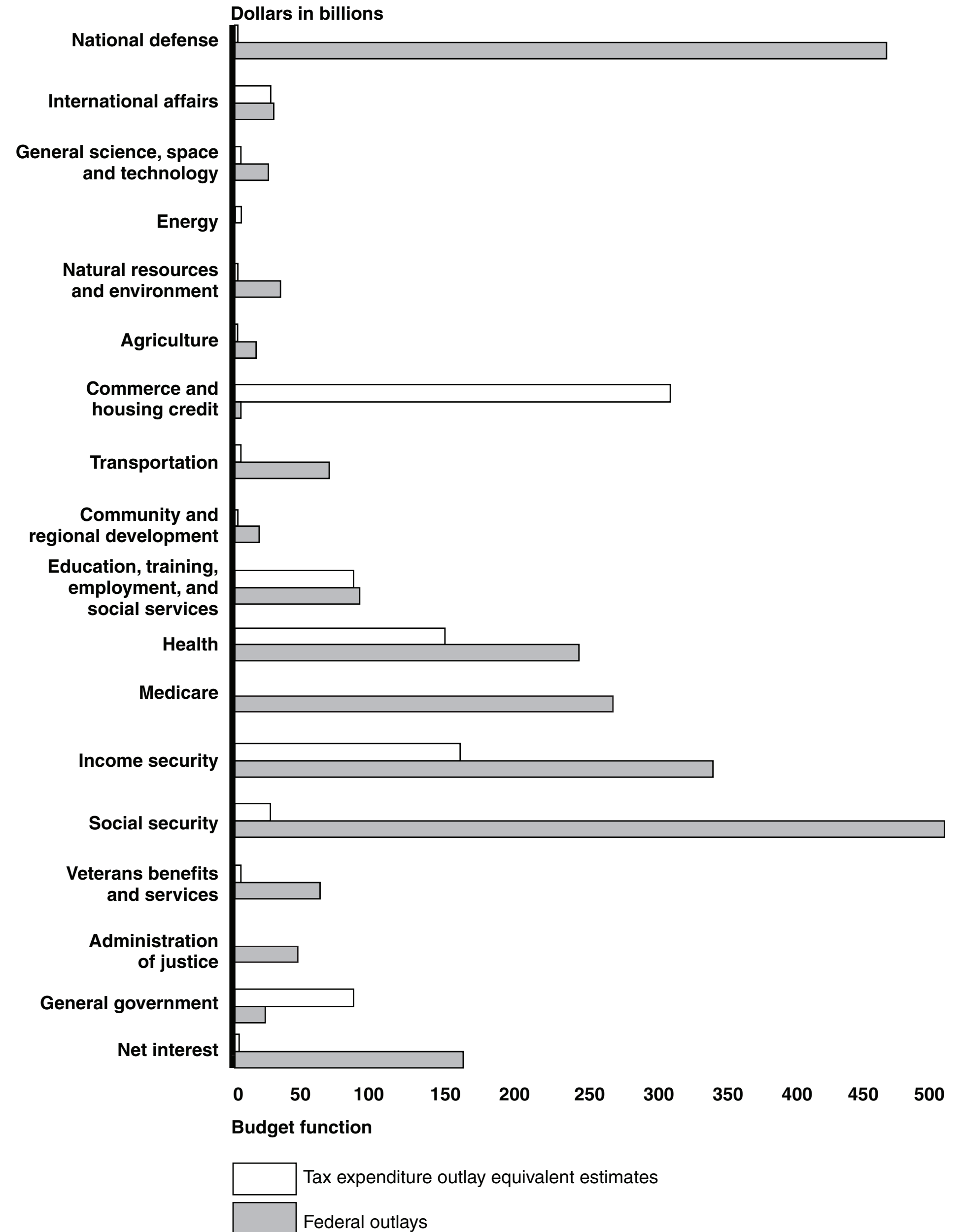
[46]Total outlays for the energy budget function were negative in fiscal year 2004; energy discretionary outlays were $3.4 billion and energy mandatory outlays were negative $3.6 billion. For more information on the major federal energy-related tax and spending programs, see GAO, *National Energy Policy: Inventory of Major Federal Energy Programs and Status of Policy Recommendations*, GAO-05-379 (Washington, D.C.: June 10, 2005).

[47]Within the commerce and housing credit budget function, outlays in fiscal year 2004 by subfunction were: $ 2.7 billion for mortgage credit, negative $4.1 billion for the Postal Service, negative $2 billion for deposit insurance, and $8.7 billion for other advancement of commerce.

[48]Housing assistance is a subfunction under the income security budget function.

[49]The deduction for property taxes on owner-occupied homes is listed under the commerce and housing credit budget function. Estimated at $19.9 billion in outlay-equivalent value, this deduction was one of the 15 largest tax expenditures in fiscal year 2004. Including this deduction, the sum of the outlay-equivalent estimates for tax expenditures related to state and local governments amounted to $102.7 billion in fiscal year 2004. The outlay-equivalent value of the exclusion for state-and local private purpose bonds totaled $9.4 billion in fiscal year 2004. These amounts are reflected across the related budget functions.

Figure 11: Tax Expenditure Outlay-equivalent Estimates Compared with Federal Outlays by Budget Function, Fiscal Year 2004



Source: GAO analysis of OMB budget reports on tax expenditures, fiscal year 2006.

Note: Federal outlays for the energy budget function were negative because revenues for this function exceeded spending in 2004. Summing the outlay-equivalent estimates by budget function does not

take into account possible interaction effects among the expenditures. Outlays associated with the refundable child credit and EITC are shown in the outlay bars.

As figure 11 shows, the sum of outlay-equivalent estimates for tax expenditures was nearly the same magnitude as outlays in two budget functions: international affairs and education, training, employment, and social services. Within the education, training, employment, and social services budget function, the sum of outlay-equivalent estimates of the tax expenditures represented 49 percent of the total federal support.[50] This budget function includes two of the largest tax expenditures—the child tax credit and charitable contributions other than for health. The sum of the outlay-equivalent estimates for tax expenditures was substantially less than total outlays in the health and income security budget functions.[51] The income tax exclusion for employer-provided health care—the largest single tax expenditure—accounted for 12 percent of the sum of tax expenditure outlay-equivalent estimates and represented about 27 percent of total federal support in the health function, which includes Medicaid. Outlays in the income security function include mandatory outlays refunded under the EITC and child tax credit. No tax expenditures are reported by Treasury for two budget functions: administration of justice and Medicare.[52]

[50]Total federal support includes federal outlays and tax expenditure outlay-equivalent amounts within the same budget function.

[51]Treasury and JCT list the EITC tax expenditure under the income security budget function and the child tax credit under the education, training, employment and social services budget function.

[52]JCT does not list any tax expenditures under the administration of justice budget function but does list exclusions for Medicare benefits as a tax expenditure under the Medicare budget function.

Systematic Review of Tax Expenditures Is Integral to Reexamining the Federal Base, but Little Progress Has Been Made Since 1994 to Increase Scrutiny

Although tax expenditures represent a substantial federal commitment of resources, little progress has been made in the Executive Branch to increase the transparency of and accountability for tax expenditures. The entire set of tools the federal government can use to address national objectives—including discretionary and mandatory spending, tax provisions, loans and loan guarantees—should be subject to periodic reviews and reexamination to ensure that they are achieving their intended purposes and designed in the most efficient and effective manner. The nation's current and projected fiscal imbalance provides an additional impetus for engaging in such a review and reassessment. Tax expenditures may not always be efficient, effective, or equitable, and consequently, information on these attributes can help policymakers make more informed decisions as they adapt current policies in light of our fiscal challenges and other overarching trends. In addition, some tax expenditures, at least as currently designed, may serve to exacerbate other key private sector and public policy challenges (e.g., controlling health care costs). To review tax expenditures, information is needed to assess economic efficiency, effectiveness, distributional equity, and administration and compliance costs, although data and methodological challenges may impede studies of some tax expenditures. Over the past decade, the Executive Branch made little progress to integrate tax expenditures in the budget presentation and review processes that apply to spending programs, as we recommended in 1994.

Long-Term Fiscal Challenge Provides Additional Impetus to Reexamine Federal Spending and Tax Policies, Including Tax Expenditures

Simply put, our nation's fiscal policy is on an unsustainable course. Long-term simulations by GAO, the Congressional Budget Office (CBO), and others show that over the long term we face large, escalating, and persistent deficits due primarily to known demographic trends and rising health care costs.[53] This unsustainable fiscal path will gradually erode the nation's economy and increasingly constrain the federal government's capacity to address emerging challenges and opportunities. The long-term fiscal challenge is too big to be solved by economic growth alone or by making modest changes to existing spending and tax policies, including tax

[53]For additional information on our long-term fiscal modeling, see GAO, *Our Nation's Fiscal Outlook: The Federal Government's Long-Term Budget Imbalance*, http://www.gao.gov/special.pubs/longterm/. See also U.S. Congressional Budget Office, *The Long-Term Budget Outlook* (Washington, D.C.: December 2003), and the Office of Management and Budget, *Analytical Perspectives*, *Budget of the United States Government*, *Fiscal Year 2006* (Washington, D.C.: 2005).

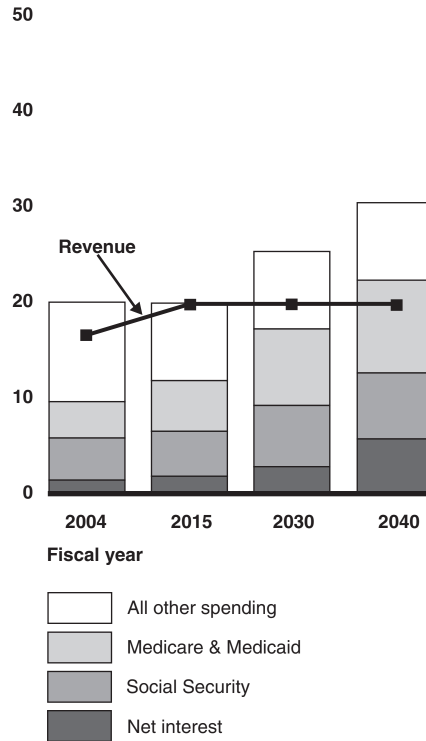
expenditures. In addition, the long-term fiscal challenge makes it all the more important to ensure all major federal spending and tax programs and policies—including tax expenditures—are efficient, effective, and relevant. The revenues forgone through tax expenditures either reduce resources available to fund other federal activities or require higher tax rates to raise a given amount of revenue.

Our long-term simulations illustrate the magnitude of fiscal challenges we will face in the future.[54] Figures 12 and 13 present these simulations under two different sets of assumptions. In figure 12, we begin with CBO's August 2005 baseline—constructed according to the statutory requirements for that baseline.[55] Consistent with these requirements, this simulation assumes that discretionary spending grows with inflation for the first 10 years, and that tax cuts which are currently scheduled to expire will expire. After 2015, discretionary spending is assumed to grow with the economy, and revenue is held constant as a share of GDP at the 2015 level. In figure 13, only two assumptions are changed: (1) discretionary spending is assumed to grow with the economy rather than merely with inflation for the entire period (not just after 2015), and (2) all tax cuts which are currently scheduled to expire are made permanent. For both simulations, Social Security and Medicare spending is based on the 2005 Trustees' intermediate projections, and we assume that benefits continue to be paid in full after the trust funds are exhausted. Medicaid spending is based on CBO's December 2003 long-term projections under mid-range assumptions.

[54]Long-term simulations illustrate the relative fiscal and economic outcomes associated with alternative policy paths and should not be viewed as precise forecasts.

[55] Congressional Budget Office, *The Budget and Economic Outlook: An Update* (Washington, D.C.: August 2005).

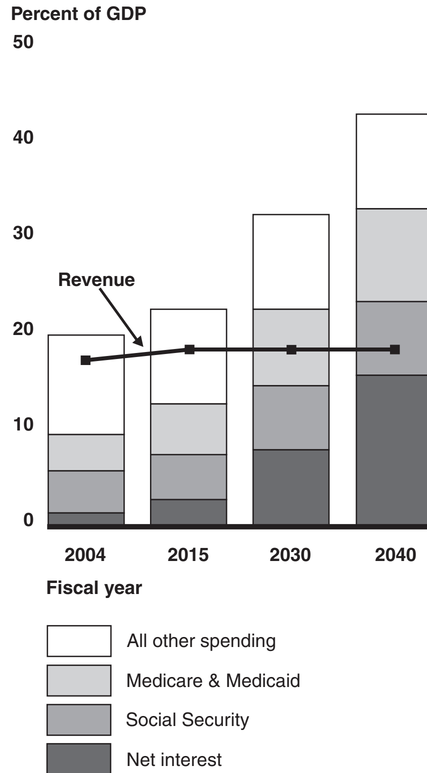
Figure 12: Composition of Spending as a Share of GDP under Baseline Extended



Source: GAO's August 2005 analysis.

Notes: In addition to the expiration of tax cuts, revenue as a share of GDP increases through 2015 due to (1) real bracket creep, (2) more taxpayers becoming subject to the AMT, and (3) increased revenue from tax-deferred retirement accounts. After 2015, revenue as a share of GDP is held constant.

Figure 13: Composition of Spending as a Share of GDP Assuming Discretionary Spending Grows with GDP after 2005 and All Expiring Tax Provisions Are Extended



Source: GAO's August 2005 analysis.

Notes: Although expiring tax provisions are extended, revenue as a share of GDP increases through 2015 due to (1) real bracket creep, (2) more taxpayers becoming subject to the AMT, and (3) increased revenue from tax-deferred retirement accounts. After 2015, revenue as a share of GDP is held constant.

Both of these simulations illustrate that, absent policy changes on the spending or revenue side of the budget, the growth in federal retirement and health entitlements will encumber an escalating share of the government's resources. Indeed, when we assume that recent tax reductions are made permanent and discretionary spending keeps pace with the economy, our long-term simulations suggest that by 2040 federal revenue may be adequate to pay little more than interest on the federal debt. Neither slowing the growth in discretionary spending nor allowing the tax provisions to expire—nor both combined—would eliminate the imbalance. Although revenues will be part of the debate about our fiscal future, making no changes to Social Security, Medicare, Medicaid, and

other drivers of the long-term fiscal gap would require at least a doubling of federal taxes in the future and that seems both unrealistic and inappropriate. Accordingly, substantive reform of Social Security and the major health programs remains critical to recapturing our fiscal flexibility.

While Social Security and Medicare dominate the long-term outlook, they are not the only federal programs or activities that bind the future. The federal government undertakes a wide range of programs, responsibilities, and activities that may explicitly or implicitly expose it to future spending. These "fiscal exposures" range from explicit liabilities, such as environmental cleanup and disposal, to the implicit promises embedded in current policy or public expectations, such as assistance following a major disaster.[56] Policymakers may benefit from a better understanding of the long-term costs of decisions when they are made. For large and significant spending programs and tax provisions, consideration of estimates of present values for the long-term commitments implied could facilitate analysis and decisionmaking.[57] While the fiscal exposure concept focuses only on items that may expose the government to future spending, some new or existing tax expenditures may have uncertain or accelerating future growth paths with long-term implications. These would need to be considered concurrently with long-term spending exposures in addressing long-term fiscal sustainability.

Confronting the nation's fiscal challenge will require a fundamental reexamination and reprioritization of the entire set of tools the federal government can use to address national objectives, including major spending and tax policies and programs. To effectively respond to social, economic, and security changes and challenges emerging in the 21st century, the federal government cannot accept what it does, how it does it, who does it, and how it is financed as "givens." To assist Congress in reexamining the base of government, we issued a report that provides examples of the kinds of difficult choices the nation faces with regard to discretionary spending; mandatory spending, including entitlements; as

[56]GAO, *Fiscal Exposures: Improving the Budgetary Focus on Long-Term Costs and Uncertainties*, GAO-03-213 (Washington, D.C.: Jan. 24, 2003).

[57]See app. III for information about Treasury's supplemental discounted present value estimates for select tax expenditures that involve deferrals or other long-term revenue effects.

well as tax policies and compliance activities.[58] The tax policies and programs financing the federal budget can be reviewed with an eye toward the overall level of revenue needed to fund federal operations and commitments, the mix of taxes that should be used, and the extent to which the tax code is being used to promote certain societal objectives.[59]

Some Tax Expenditures May Not Be Efficient, Effective, or Equitable

Some tax expenditures may not always be efficient, effective, or equitable, and consequently, information on these attributes can help policymakers make more informed decisions as they adapt current policies in light of our fiscal challenges and other overarching trends. Periodic reviews of tax expenditures could help to establish whether these programs are relevant to today's needs; if so, how well tax expenditures have worked to achieve their objectives; and whether the benefits from particular tax expenditures are greater than their costs. To measure benefits and costs, information is needed concerning their effects on economic efficiency, effectiveness, distributional equity, and administration and compliance costs. To the extent that periodic reviews show that specific tax expenditures are not effective, efficient, or equitable, those tax expenditures might be eliminated or redesigned, perhaps at a lower cost in revenue forgone. Coordinated reviews of tax expenditures with related federal spending programs could assess the relationships and interactions of programs within similar mission areas and identify which strategies are effective. Policymakers could use such evaluations to reduce overlap and inconsistencies and direct scarce resources to the most effective or least costly methods to deliver federal support.

Tax expenditures, if well designed and effectively implemented, can be an effective tool and appropriate to further some federal goals and objectives. For those activities that merit a subsidy (where too little of the activity would otherwise be undertaken), subsidies through the tax code are one option. For example, a tax expenditure for medical insurance would improve economic efficiency if, absent a subsidy, too few workers would purchase insurance and the tax expenditure encouraged workers to insure

[58]GAO-05-325SP.

[59]For background information, criteria, and key questions for assessing the pros and cons of tax reform proposals, both proposals for a major overhaul of the current federal tax system and incremental changes to the system, see GAO, *Understanding the Tax Reform Debate: Background, Criteria, and Questions*, GAO-05-1009SP (Washington, D.C.: September 2005).

in a cost-effective manner. Because the benefits from research may not fully accrue to the firms that bear the costs of research, a tax expenditure aimed at spurring private-sector investment in research and development may be an appropriate response assuming it stimulates additional research whose benefits exceed the social costs associated with the forgone revenues.

However, studies we and others have done raise concerns about the efficiency, effectiveness, or equity of some tax expenditures and about how tax expenditures relate to other federal activities aimed at the same mission area.

- While tax expenditures may be intended to improve economic efficiency, poor targeting or design may introduce additional economic inefficiencies. For example, the income tax exclusion of employer-paid health insurance premiums, by shifting a portion of the costs to all taxpayers, reduces the after-tax cost of insurance for the beneficiary.[60] The income tax exclusion is credited with increasing health care coverage for employees, and the risk pooling under group health insurance generally allows employees to obtain insurance at lower costs than in the individual insurance market. However, this tax benefit also leads people to obtain more coverage than they would otherwise and increases the demand for health care by enabling those insured to obtain services at discounted prices. Some researchers believe that the unlimited availability of the exclusion for employer-provided health insurance has led to excessive use of health care services, which, in turn, has helped to drive up health care prices faster than the overall price level.[61] Capping the exclusion at the average premium cost has been suggested as one option to improve the economic efficiency of this tax expenditure and reduce the associated revenue loss; another option suggested is replacing the tax exclusion with a tax credit to improve equity since the tax savings per dollar of premium would be the same for all taxpayers. In another example, the mortgage interest deduction encourages home ownership by lowering the costs of borrowing for taxpayers who itemize their deductions. However, by doing so, the deduction encourages households to invest more in housing and less in

[60]This tax-free benefit is not reported on the employee's W-2 form as the amount is not considered wages subject to federal and state income taxes or federal payroll taxes.

[61]Bob Lyke, *Tax Benefits for Health Insurance and Expenses: Current Legislation*. Congressional Research Service Issue Brief IB98037 (Washington, D.C.: February 2005).

other assets that might contribute more to the nation's productivity and economic capacity. According to CBO's *Budget Options*, limiting the deductibility of interest to $500,000 of mortgage debt might still provide taxpayers with a sizable incentive to become homeowners and could boost investment in businesses and education.[62]

- Tax expenditures may not be an effective way to achieve federal goals if targeting them to entities or activities meant to receive the benefits is difficult, if they subsidize activities that would have been undertaken without their stimulus, or if they serve to exacerbate other key private sector and public policy challenges. For example, the income tax exclusion of employer-paid health insurance premiums reduces the after-tax cost of insurance for the beneficiary. However, the exclusion offers no benefit to workers whose employers do not offer health benefits or who purchase their own insurance. Further, this tax benefit also leads people to obtain more comprehensive coverage than they would otherwise and could increase the demand for health care to the extent that it shields those insured from the full costs of health care, complicating efforts to moderate health care spending. The exclusion also tends to favor higher-income workers more likely to have employer-sponsored coverage. In another example, individual retirement accounts (IRAs) also receive preferential tax treatment with $7.5 billion in estimated revenue losses in fiscal year 2004. Contributions may be tax-deductible depending on the IRA type, and earnings generally are not taxable until distribution and not taxable at all in some cases.[63] Although the tax benefits indeed seem to encourage individuals to contribute to these kinds of accounts, the amounts contributed may not be totally new saving. Some contributions may represent amounts that would have occurred without the tax incentives or amounts shifted from taxable assets or financed by borrowing. In a 1996 symposium examining universal deductible IRAs available in the early 1980s, researchers reached three widely divergent conclusions: (1) yes, most contributions represented new saving, (2) no, most IRAs contributions were not new saving; and (3) maybe, about 26 cents of each dollar

[62]Congressional Budget Office, *Budget Options* (Washington, D.C.: February 2005).

[63]For more information on the types of IRAs as well as the rules and limit on contributions and distributions, see Department of the Treasury, Internal Revenue Service, *Individual Retirement Accounts (IRAs)*, Publication 590.

contributed may have represented new saving.[64] More recent research examining the universal IRA experience estimated that at most 9 cents of each dollar contributed represented new saving.[65] Since 1986, Congress has restricted IRA eligibility for higher-income taxpayers and increased the contribution limits, and the overall effect of IRAs on personal saving remains subject to considerable debate.

- Although tax expenditures, by design, result in individuals with similar incomes and expenses paying differing amounts of tax depending on whether they engage in tax-subsidized activities, tax expenditures still may raise equity concerns. Some tax expenditures benefit mainly upper-income taxpayers because they are most likely to itemize and because the value of tax expenditures is generally greatest for those in higher tax brackets.

Tax expenditures also can contribute to mission fragmentation and program overlap,[66] and this, in turn, creates the potential for duplication and service gaps. Though sometimes necessary to meet federal priorities, mission fragmentation and program overlap can create an environment in which programs do not serve participants as efficiently and effectively as possible. Like spending programs, tax expenditures may reduce government effectiveness to the extent that they duplicate or interfere with other federal programs. For example, in the higher education mission area, the federal government helps students and families save and pay for the costs of postsecondary education through tax expenditures and longer-standing federal financial aid programs, consisting of grants, loans, and work-study income. Since the 1990s, the federal government has offered multiple tax incentives to help families pay for post-secondary education, including the nonrefundable Lifetime Learning and HOPE tax credits, deductions for qualifying post-secondary expenses and interest on student loans, and two tax-preferred ways to save for future education expenses. The tax-preferred saving vehicles interact with the traditional federal aid

[64]GAO, *National Saving: Answers to Key Questions*, GAO-01-591SP (Washington, D.C.: June 2001).

[65]Orazio P. Attanasio and Thomas DeLeire, "The Effect of Individual Retirement Accounts on Household Consumption and National Saving," *The Economic Journal*, Vol. 112, July 2002, pp. 504-538.

[66]We define mission fragmentation as the involvement of multiple agencies in a similar programmatic area and program overlap as providing the same services to the same target groups.

system and can affect the net federal assistance received. Further, some tax filers do not appear to make the most effective use of certain education-related tax incentives, and we have found that some people who appear eligible for the tuition deduction and/or the tax credits did not claim them.[67] One reason may be that the differing income phaseouts and interactions among the tax credits and deductions are difficult for taxpayers to understand; CBO, JCT, IRS's National Taxpayer Advocate, Treasury, and others have suggested ways to consolidate the education tax credits and deductions.

Others have also questioned the efficiency, effectiveness, and equity of other tax expenditures and suggested ways to design and better target specific provisions.

- In December 2004, the IRS National Taxpayer Advocate designated the complexity of the Internal Revenue Code, including the complexity of reporting requirements related to tax expenditures, as the most serious problem facing taxpayers and the IRS.[68] The IRS National Taxpayer Advocate also recommended consolidating the various types of retirement saving vehicles and creating uniform rules regarding early withdrawals, plan loans, and portability.

- In its January 2005 report to the Senate Finance Committee, JCT staff presented various options to improve tax compliance and reform tax expenditures.[69] Options include repealing some tax expenditures and restructuring others to simplify the law or achieve the intended purpose in a more fair or efficient way.

- In its February 2005 budget options compendium prepared for the House and Senate Budget Committees, CBO listed several options to

[67]GAO, *Student Aid and Postsecondary Tax Preferences: Limited Research Exists on Effectiveness of Tools to Assist Students and Families Through Title IV Student Aid and Tax Preferences*, GAO-05-684 (Washington, D.C.: July 29, 2005).

[68]IRS, Taxpayer Advocate Service, *National Taxpayer Advocate 2004 Annual Report to Congress*, (Washington, D.C.: December 2004).

[69]Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures*, JCS-2-05. Prepared by the staff of the Joint Committee on Taxation. (Washington, D.C.: Jan. 27, 2005).

eliminate or restructure tax expenditures.[70] Options include further limiting the tax benefit of itemized deductions to the 15 percent rate for higher-bracket taxpayers and capping itemized deductions for state and local taxes and charitable contributions to the amount exceeding 2 percent of adjusted gross income.

- Finally, in December 2004 for the Senate Budget Committee, CRS updated its biennial compendium on tax expenditures.[71] This volume includes for each tax expenditure: JCT's revenue loss estimate, the legal authorization, a description of the tax provision, its impact including distribution of benefits when available, the rationale at the time of adoption, assessment summarizing the arguments for and against the provision, citations to relevant research. According to CRS, congressional budget decisions will take into account the full spectrum of federal programs only when tax expenditures are considered in conjunction with direct spending programs.

Assessing the Efficiency, Effectiveness, or Equity of Tax Expenditures Can Be Challenging

Inadequate or missing data and difficulties in quantifying the benefits of some tax expenditures can impede studies of their efficiency, effectiveness, and equity.[72] A key challenge is that data necessary to assess how often a tax expenditure is used and by whom generally would not be collected on tax returns unless IRS needs the information to know the correct amount of taxes owed or is legislatively mandated to collect or report the information. For example, tax exclusions—including those for employer-provided health insurance and pensions which are among the largest tax expenditures—generally are not reported on individual taxpayers' returns. In some cases, IRS may combine reporting requirements to minimize its workload and taxpayer burden, and as a result, the information collected may not identify specific beneficiaries or activities targeted by a tax expenditure. For example:

[70]Congressional Budget Office, *Budget Options*. (Washington, D.C.: February 2005).

[71]U.S. Congress, Senate Committee on the Budget, *Tax Expenditures: Compendium of Background Material on Individual Provisions*, S. Prt. 108-54. Prepared by the Congressional Research Service (Washington, D.C.: December 2004).

[72]We have also noted limitations in the quality of agency performance and evaluation information and agency capacity to produce rigorous evaluations of effectiveness for federal spending programs. See GAO, *Performance Budgeting: Current Developments and Future Prospects*, GAO-03-595T (Washington, D.C.: Apr. 1, 2003).

- In our 2002 report on three tax expenditures meant to encourage employment of the disabled among other economically disadvantaged workers, we could not determine the amounts used to hire, retain, and accommodate workers with disabilities.[73] We found that information on the work opportunity and disabled access credits was not available from tax data because tax returns provided only the total amount of credits reported, and employers could claim the work opportunity credit for employing other types of workers and claim the disabled access credit for expenditures made to accommodate customers with disabilities. Also, information regarding use of the barrier removal deduction for providing transportation or architectural accommodations was not available in IRS databases.

- As we reported in 2003, for one of the seven Liberty Zone tax benefits, the business employee credit, IRS was in the process of collecting but was not planning to report information about the number of taxpayers claiming the credit and the amount of credit claimed.[74] IRS was also not planning to collect or report information about the use of the other six benefits, and taxpayers do not report these benefits as separate items on the existing returns. For example, taxpayers added the amount of depreciation they are allowed under the Liberty Zone special depreciation allowance benefit to other depreciation expenses and report their total depreciation expenses on their returns. IRS officials said that they do not need information on each specific benefit claimed to properly target their enforcement efforts.

Further, IRS's financial management system does not currently have cost accounting capabilities. As a result, comparisons of the costs of administering existing or proposed tax expenditures with similar administrative costs for spending programs may be impossible. Regarding taxpayer compliance costs, although IRS is working to develop improved estimates of taxpayer compliance burden, it is not yet clear whether this modeling effort will provide estimates of additional compliance costs that may result from particular tax expenditures.

[73]GAO, *Business Tax Incentives: Incentives to Employ Workers with Disabilities Receive Limited Use and Have an Uncertain Impact*, GAO-03-39 (Washington, D.C.: Dec. 11, 2002).

[74]GAO, *Tax Administration: Information Is Not Available to Determine Whether $5 Billion in Liberty Zone Tax Benefits Will Be Realized*, GAO-03-1102 (Washington, D.C.: Sept. 30, 2003).

According to IRS officials, IRS seeks to collect information necessary to determine whether taxpayers have accurately reported their income and calculated the correct amount of tax liability. By focusing on information essential to administering the tax code, IRS aims to ensure that taxpayers are not burdened unnecessarily by record keeping and reporting, and IRS can minimize its own administrative costs for data collection and processing. For tax expenditures recorded on particular lines on tax forms, such as deductions and credits for individual taxpayers, data on the use of these tax expenditures are available. IRS Statistics of Income Division publications detail the number of individual tax returns on which taxpayers claimed each deduction or credit, the total amounts claimed, and the distribution of claims among taxpayers by income level.

If policymakers conclude that additional data would facilitate reexamining a particular tax expenditure, decisions would be required on what data are needed, who should provide the data, who should collect the data, how to collect the data, what it would cost to collect the data, and whether the benefits of collecting additional data warrant the cost of doing so. Another factor to consider is how to facilitate data sharing and collaborative evaluation efforts. For example:

- Limited data are available on the prevalence and use of business-owned life insurance, and GAO has reported that more comprehensive data could be useful in assessing the tax-favored treatment of this investment.[75] Data on the amount of tax-free income that businesses received from death benefits could help explain the potential effect of changes to the tax treatment of policies on tax revenues. Businesses holding the policies or insurance companies that sold them could provide this and other data. Several agencies, including Treasury and the Securities and Exchange Commission, already collect some financial information from businesses and insurers and could be tasked to collect additional data for tax policy purposes.

- In the higher education area, the Department of Education (Education) is unable to analyze the use of higher education tax credits or their effects because it lacks access to individual taxpayer data needed to identify users of the credits. Treasury has access to taxpayer data but has not used these data for evaluating the education tax credits since

[75]GAO, *Business-Owned Life Insurance: More Data Could Be Useful in Making Tax Policy Decisions*, GAO-04-303, (Washington, D.C.: May 13, 2004).

their implementation in 1998. In 2002, GAO recommended that Education and Treasury collaborate in studying the impact of tax credits and student aid programs on postsecondary attendance, choice, completion, and costs.[76] A key first step would be identifying opportunities for, and limits to, data sharing and develop a plan to address data needs, but little action has been taken.

- In the case of the empowerment zone, enterprise community, and renewal community programs, the lack of tax benefit data limits the ability of the Department of Housing and Urban Development (HUD) and the Department of Agriculture (USDA) to administer and evaluate the overall programs.[77] We recommended that HUD, USDA, and IRS collaborate to (1) identify the data needed to assess the use of the tax benefits and the various means of collecting such data; (2) determine the cost-effectiveness of collecting these data, including the potential impact on taxpayers and other program participants; (3) document the findings of their analysis; and, if necessary, (4) seek the authority to collect the data, if a cost-effective means is available.

When data on the cost and use of tax expenditures are available or can be reasonably estimated and other relevant data are available, economic analysis can be useful in evaluating whether a tax expenditure is efficient, effective, or equitable. Econometric modeling analysis can estimate how a tax expenditure affects the prices and quantities of targeted goods and services and determine how taxpayers' incomes are affected. Although isolating and quantifying the outcomes associated with tax expenditures is challenging—just as it is for spending programs, research results are useful in demonstrating how particular tax expenditures work or providing insight on ways to refine their design. For example, research has generally shown that the EITC effectively increases recipients' participation in the labor force, particularly for single parents, and lifts millions of recipients out of poverty. Some tax expenditures are enacted on a temporary basis, specifically to provide an opportunity for evaluating their effects before they are extended. For example, the research tax credit, enacted on a

[76] GAO, *Student Aid and Tax Benefits: Better Research and Guidance Will Facilitate Comparison of Effectiveness and Student Use*, GAO-02-751 (Washington, D.C.: Sept. 13, 2002).

[77] GAO, *Community Development: Federal Revitalization Programs are Being Implemented, but Data on the Use of Tax Benefits Are Limited*, GAO-04-306 (Washington, D.C.: Mar. 5, 2004).

temporary basis in 1981 and extended 11 times as of 2004, was substantially modified in 1989 after researchers showed the original credit formula undercut the incentive it was intended to provide to undertake additional research spending.

In some cases, economic research has not yielded definitive results or was limited by data and methodological issues. For example, although the various tax expenditures aimed at encouraging saving for, among other things, retirement, education, and health care have resulted in substantial sums being placed in these tax preferred accounts, economists disagree about whether tax incentives, such as for IRAs, are effective in increasing the overall level of personal saving. In the case of the research credit, GAO reported in 1996 that studies done at that time provided mixed evidence on the amount of spending stimulated and used publicly available data that were not a suitable proxy for tax return data.[78] To fully assess the value to society of the research tax credit, researchers need to look at more than just the amount of spending stimulated per dollar of revenue cost. Comparisons should include (1) the total benefits gained by society from research stimulated by the credit and (2) the estimated costs to society resulting from the collection of taxes required to fund the credit. The social benefits of the research conducted by individual companies include any new products, productivity increases, or cost reductions that benefit other companies and consumers throughout the economy. Although most economists agree that research spending can generate social benefits, the effects of the research on other companies and consumers are difficult to measure.

Ultimately, evaluation results could be used to identify how well tax expenditures are working, to both identify ways to better manage individual tax expenditures and decide how best to ensure prudent stewardship of taxpayers' resources. Whether in time of deficit or surplus, reexamining both the spending and tax sides of the budget is essential to ensure the reasonableness, relevancy, and sustainability of existing programs and position the nation for the future. In the case of the EITC, Treasury and IRS are using evaluation results to identify ways of reducing erroneous claims, while maintaining participation among eligible claimants and minimizing taxpayer and IRS's administrative burden. Additional evaluations of other tax expenditures may identify opportunities to retarget

[78]GAO, *Tax Policy and Administration: Review of Studies of the Effectiveness of the Research Tax Credit*, GAO/GGD-96-43 (Washington, D.C.: May 21, 1996).

or eliminate ineffective or outdated tax expenditures. Tax expenditures, unless well designed to correct market failures, can distort economic decisions in ways that reduce economic performance from what it otherwise could be and thereby lower our future economic well-being. If a tax expenditure or group of tax expenditures is reduced or eliminated, any resulting increase in tax revenues could be offset if policymakers deem that to be appropriate fiscal policy. In any event, in order to raise a given amount of federal revenue, tax rates must be raised higher than they otherwise need to be due to revenue losses from tax expenditures. Thus, the net change after tax rate adjustments could, depending on overall congressional priorities and preferences, result in tax reductions for many taxpayers in place of the preferential treatment for some taxpayers. According to a recent estimate, a broad-based income tax system—eliminating basically all credits, deductions, special rates, exclusions for employer-provided fringe benefits and employee contributions to retirement account as well as eliminating the AMT—could raise about the same amount of revenue as the current income tax system while lowering tax rates by about one-third.[79]

The Executive Branch Has Made Little Progress Since 1994 to Improve Scrutiny of Tax Expenditures

Although OMB and Treasury in 1994 supported expanding federal reviews of tax expenditures, the Executive Branch made little progress over the past decade to integrate tax expenditures in the budget presentation and to incorporate tax expenditures under review processes that apply to spending programs, as we recommended in 1994. Even though the sum of tax expenditure outlay-equivalent estimates is about the same magnitude as discretionary spending overall and greater than outlays in some budget functions, this is not readily visible to policymakers and the public because tax expenditures are not integrated in the budget presentation. Since their initial efforts to outline a framework for evaluating tax expenditures and preliminary performance measures, OMB and Treasury have largely ceased to make progress and have retreated from setting a schedule for evaluating tax expenditures. One of the key impediments to moving forward in conducting reviews of tax expenditures' performance is the continuing lack

[79]See the President's Advisory Panel on Federal Tax Reform, "Understanding Tax Bases: Staff Presentation," (presentation before the Panel's public meeting, Washington, D.C., July 20, 2005, http://taxreformpanel.gov/meetings/docs/understanding_tax_bases.ppt (downloaded September 13, 2005). The calculations for the presentation were produced by the U.S. Department of the Treasury, Office of Tax Analysis, at the request of the Panel. The broad income tax base scenario assumes integration of individual and corporate income taxes with the corporate tax rate set equal to the top individual rate.

of clarity about the roles of OMB, Treasury, IRS, and departments or agencies with outlay program responsibilities. So far, GPRA plans and reports are underutilized as a way to provide more information about the performance of tax expenditures and their contributions relative to spending programs. Tax expenditures are not subject to annual budget reviews, and OMB has not generally subjected them to scrutiny under PART in tandem with spending programs sharing common, crosscutting goals.

Tax Expenditures Are Not Integrated in the Annual Budget Presentation or Financial Statement Reporting

Integrating tax expenditure costs in the annual budget presentation is crucial to providing a comprehensive picture of federal resources to facilitate reexamining the base. As a start in acting on our 1994 recommendation, OMB began presenting revenue loss sums for tax expenditures alongside outlays and credit activity for each budget function in the fiscal year 1998 budget. These summary tables were a useful starting point in highlighting the relative magnitude of tax expenditures across mission areas. However, OMB discontinued the reporting practice after the fiscal year 2002 budget, and instead, the *Analytical Perspectives* contains Treasury's list of tax expenditures with associated revenue loss estimates for each one. Isolating tax expenditure cost information in a supplemental volume, however, provides a less comprehensive picture for policymakers and the public to compare all of the policy tools used within a mission area, such as health care or energy, because all the tools are not displayed together in the budget. OMB has demonstrated that it is feasible to display tax expenditure totals alongside spending programs in each budget function. Such a display is a first step in providing the public and policymakers with a more useful and accurate picture of the extent of federal support and activities.

GAO also recommended in 1994 that the budget presentation include, to the extent possible, information to highlight for policymakers and the public the effectiveness, distributional equity, and economic efficiency for all federal resources allocated in a mission area. In the tax expenditure chapter in *Analytical Perspectives*, OMB added a section outlining possible performance measures developed by Treasury, which could be used to present information about the performance of tax expenditures. Although this overview was initially introduced in the 1997 budget and expanded in the 1999 budget, no performance information is actually displayed. OMB states that the measure examples provided are "illustrative" in nature, acknowledges that the performance measure discussion "although broad, is nonetheless incomplete," and noted that many tax expenditures are not explicitly cited.

The Chief Financial Officers Act,[80] as expanded by the Government Management Reform Act of 1994,[81] required federal agencies to prepare annual audited financial statements beginning in fiscal year 1996. OMB Circular A–136 *Financial Reporting Requirements* requires agencies to combine the annual GPRA program performance report with the financial statements and other information in a combined performance and accountability report. In accordance with generally accepted accounting principles, the basis on which federal agencies are required to prepare their financial statements, tax expenditures may be presented as other accompanying information. The Federal Accounting Standards Advisory Board (FASAB), which promulgates federal accounting standards, recognized that tax expenditures, which can be large in relation to spending programs that are measured under federal accounting standards, may not be fully considered in entity reporting. FASAB based its views, in part, on the fact that, in some cases, the association of tax expenditures with particular programs is not clear and the information is available elsewhere. The Board agreed to permit reporting entities to present, as other accompanying information, information on tax expenditures that the reporting entity considers relevant to its programs, if suitable explanations and qualifications are provided. As a result, tax expenditure amounts, which in some cases are larger than similar spending programs, are not required to be disclosed to the public as part of federal agencies' financial statements nor are they disclosed in the consolidated financial statements of the federal government. Similarly, OMB's guidance for the performance and accountability reports does not require reporting of tax expenditure information in agencies' reports. Reporting such information would ensure greater transparency of and accountability for tax expenditures.

Progress on Developing Structure for Reviewing Tax Expenditures' Performance Has Stalled

OMB has not designed and implemented a structure for conducting reviews of tax expenditures' performance, as we recommended in 1994. Our recommendation was consistent with language in the Senate Committee on

Government Affairs' Report[82] on GPRA, which specified that the Director of OMB was to establish an appropriate framework for periodic analyses of the effects of tax expenditures in achieving performance goals. To

[80]Pub. L. No. 101-576, Nov. 15, 1990.

[81]Pub. L. No. 103-356, Oct. 13, 1994.

[82]S. Rep. No. 103-58, p. 29 (1993).

significantly increase the oversight and analysis of tax expenditures, the committee report also called for a schedule for periodic tax expenditure evaluations.

The ultimate goal of designing a structure for conducting performance reviews of tax expenditures was to begin developing and presenting performance information in the federal budget that would help demonstrate the relative effectiveness, efficiency, and equity of federal outlays and tax expenditure efforts within a mission area. In our 1994 report, we emphasized that in designing the structure for tax expenditure performance reviews, OMB should consider

- the roles of OMB, Treasury, and departments or agencies with outlay program responsibilities in assessing the performance of tax expenditures and their relationship and interaction with related spending programs; and
- which tax expenditures and outlay programs are related or interact and should be jointly considered.

GAO recommended that OMB and Treasury conduct case studies of the proposed review structure to identify (1) successful methods agencies devise for reviewing tax expenditures' performance, (2) how best to report the results of these reviews, and (3) how to ensure that adequate resources are available for such reviews.

Although OMB, working with Treasury, took a number of steps consistent with our recommendation, it has not resolved the roles of OMB, Treasury, and departments or agencies with outlay program responsibilities; established a schedule for reviewing tax expenditures; or addressed lessons learned from tax expenditure case study reviews that Treasury performed. If the Executive Branch cannot define roles and set firm plans, it will continue to face additional challenges in developing objective, measurable, and quantifiable performance measures for tax expenditures that support federal missions and goals.

Defining roles of agencies. One of the key impediments to moving forward in conducting reviews of tax expenditures' performance is the continuing lack of clarity about the roles of OMB, Treasury, IRS, and departments or agencies with outlay program responsibilities. According to officials at OMB, it is difficult to determine which agencies in addition to Treasury and IRS have jurisdiction over particular tax expenditures. For

example, one OMB official noted that tax expenditures meant to encourage savings were not the purview of any single agency. OMB officials also stated that OMB does not have the expertise or resources to conduct its own comprehensive analyses of tax expenditures, so individual agencies should take responsibility for identifying tax expenditures that affect their missions, with Treasury's Office of Tax Analysis leading efforts to evaluate tax expenditures.

Without clarification on the roles of federal agencies, inaction, overlap or inconsistency in evaluating tax expenditures can occur. For example, in 2002 we reported that gaps existed in monitoring the relative effectiveness of Title IV grants and loans and the HOPE and Lifetime Learning tax credits in promoting postsecondary education.[83] The lack of collaboration between the Department of Education and the Treasury left little information available to help Congress weigh the relative effectiveness of grants, loans, and tax credits. Although data and methodological challenges make it difficult to isolate the impact of these tools, some academic researchers have used statistical techniques and research designs to mitigate these challenges. We recommended in 2002 that the departments develop a plan to share data and collaborate to provide Congress with evidence about the impact of higher education tax credits and student aid, but little action has been taken to implement the recommendation.

To define the roles of federal agencies in reviewing tax expenditures, OMB, working with Treasury and other federal agencies, will need to exercise judgment in resolving how to address tax expenditures spanning mission areas. In some cases, Treasury could take the lead, such as in evaluating tax expenditures that broadly support investment and saving, or other agencies could work with Treasury to evaluate tax expenditures that directly affect their mission areas. For example, an evaluation of the various energy supply tax expenditures might involve both Treasury and the Department of Energy in assessing their effects on increasing production as well as on energy security and the environment.

Establishing a schedule for evaluations. Periodic reviews of tax expenditures are also impeded because OMB has not developed a schedule for such reviews. In its 1997 GPRA report and again in the fiscal year 1999 budget, OMB set the expectation that the Executive Branch would lay out a

[83]GAO-02-751.

schedule for tax expenditure evaluations. Beyond three initial pilot studies in 1997, however, no schedule has been set for further evaluations or case studies to explore methods and resource needs for measuring and reporting tax expenditure performance.

As the roles of federal agencies are clearly defined, OMB and Treasury, working with other agencies, would be positioned to establish a schedule for tax expenditure evaluations. Opportunities exist to develop a strategic approach to the selection and prioritization of areas in allocating scarce evaluation resources. In our January 2004 report on OMB's PART, we recommended that OMB target PART assessments based on such factors as the relative priorities, costs, and risks associated with related clusters of programs and activities and that OMB select similar programs for review in the same year to facilitate comparisons and tradeoffs.[84] Similar considerations would be useful in setting a schedule for tax expenditure evaluations.

Testing the evaluation framework. Although OMB outlined an initial framework for tax expenditure analysis in its May 1997 GPRA report to the President and Congress, OMB has not taken steps to address lessons learned from tax expenditure case study reviews that Treasury performed. OMB's framework focused on the methodology that could be used to assess the performance of tax expenditures. OMB emphasized that developing a framework that is comprehensive, accurate, and flexible to reflect the objectives and effects of the wide range of tax expenditures would be a significant challenge. The initial framework for evaluating tax expenditures was expected to follow the basic structure for performance measurement—inputs, outputs, and outcomes. For tax expenditures, the primary input is the revenue loss. The outputs are the quantitative or qualitative measures of goods and services, or changes in investment and income, produced by the tax expenditures. Outcomes, in turn, were defined as the changes in the economy, society, or environment that the tax expenditures aim to accomplish.

In 1997, Treasury did three pilot evaluations of selected tax expenditures to test the evaluation methods that OMB had described in its framework for tax expenditure analysis. In addition to seeking to learn lessons about applying the framework, the pilots were also intended to help identify

[84]GAO, *Performance Budgeting: Observations on the Use of OMB's Program Assessment Rating Tool for the Fiscal Year 2004 Budget*, GAO-04-174 (Washington, D.C.: Jan. 30, 2004).

resource needs for evaluating tax expenditures. Treasury selected one pilot each to be done by the individual, corporate, and international units within its Office of Tax Analysis. Results from the three tax expenditure pilots—the exclusion for worker's compensation benefits, the tax credit for non-conventional fuels, and the tax exclusion for certain amounts of income earned by Americans living abroad[85]—were summarized alongside each tax expenditure's description in the tax expenditure chapter of the *Analytical Perspective* volume of the fiscal year 1999 budget. Although OMB originally expected to complete additional evaluations to refine the tax expenditure framework and improve performance measures, no further pilot evaluations have been completed. In reporting the results of these pilots, Treasury said that much of the data needed for thorough analysis was not available and that in at least one case, it was difficult to identify a clear purpose for the tax expenditure. Treasury did not discuss the resources that would be needed to continue doing such evaluations.

However, OMB officials we interviewed reiterated that the data availability issues raised in the 1997 pilots remain a major challenge, and data constraints limit the assessment of the effectiveness of many tax expenditures. To improve the data available to assess the effects of some major tax expenditures, principally those aimed at personal savings, Treasury and IRS are developing a data set that is to follow a sample of individual income taxpayers over at least 10 years, beginning with tax year 1999. The new data set aims to capture the changing demographic and economic circumstances of individual taxpayers for use in analyzing the effects of changes in tax law over time. In addition to the panel sample, OMB reported in the fiscal year 2006 budget that it is working with Treasury's Office of Tax Analysis and other agencies to improve data available for assessment of saving-related tax expenditures. No time frame was given in the 2006 budget for when any results will be reported.

The challenges in producing credible performance information and the ability of federal agencies to produce evaluations of their programs' effectiveness are not unique to tax expenditures. As our work on GPRA and PART implementation shows, the credibility of performance data has

[85]Revenue loss estimates for the three tax expenditures included in Treasury's first pilot study amounted to approximately $7.8 billion (in 2004 dollars) or 1.4 percent of total revenue loss in fiscal year 1997; the three amounted to $9.2 billion or 1.3 percent of total revenue loss for fiscal year 2004.

been a long-standing weakness.[86] Developing and reporting credible information on outcomes achieved through federal programs remains a work in progress. In past reports, we have identified several promising ways agencies can maximize their evaluation capacity. For example, careful targeting of federal evaluation resources on key policy or performance questions and leveraging federal and nonfederal resources show promise for addressing key questions about program results. Other ways agencies might leverage their current evaluation resources include adapting existing information systems to yield data on program results, drawing on the findings of a wide array of evaluations and audits, making multiple use of an evaluation's findings, mining existing databases, and collaborating with state and local program partners to develop mutually useful performance data.

Statutory Impetus for Tax Expenditure Reviews Is Underutilized

Congressional expectations for reviews of tax expenditures in connection with agencies' reviews of related outlay and other programs generally have not been met. Enacted in 1993, GPRA is designed to inform congressional and executive decisionmaking by providing objective information on the effectiveness and efficiency of federal programs and spending.[87] GPRA requires agencies to measure performance toward the achievement of annual goals and report on their progress in annual program performance reports. Through the strategic planning requirement, GPRA requires federal agencies to consult with the Congress and key stakeholders to regularly reassess their missions and strategic goals as well as the strategies and resources they will need to achieve their goals. Although GPRA offers a promising opportunity for the Executive Branch to develop useful information about the results of tax expenditures, agencies are not using their GPRA strategic plans and annual performance plans and reports to assess tax expenditures and their performance relative to spending programs contributing to the same strategic goals and objectives. Without

[86]GAO has suggested various approaches to addressing this and other challenges. See GAO, *The Government Performance and Results Act: 1997 Governmentwide Implementation Will Be Uneven*, GAO/GGD-97-109 (Washington, D.C.: June 2, 1997); and GAO, *Results-Oriented Government: GPRA Has Established a Solid Foundation for Achieving Greater Results*, GAO-04-38 (Washington, D.C.: Mar. 10, 2004).

[87]GPRA is the centerpiece of a statutory framework for helping resolve long-standing management problems that have undermined the federal government's efficiency and effectiveness. The framework also includes the Chief Financial Officers Act of 1990 as amended by the Government Management Reform Act of 1994 and other reform legislation such as the Paperwork Reduction Act of 1995 and the Clinger-Cohen Act of 1996. For more information on the Government Performance and Results Act, see GAO-04-38.

integrating tax expenditures that have a direct bearing on federal missions and goals, policymakers may not have complete information to fully evaluate whether the government is achieving results or how the performance of tax expenditures interact with or compare to related spending programs.

The Senate Governmental Affairs Committee Report on GPRA stated that tax expenditures should be taken into consideration in a comprehensive examination of government performance. The report stated that a schedule for periodically assessing the effects of specific tax expenditures in achieving performance goals should be included in the annual performance plans and that annual performance reports would subsequently be used to report on these tax expenditure assessments. In addition, the report noted that these assessments should consider the relationship and interactions between spending programs and tax expenditures and the effects of tax expenditures in achieving federal performance goals.

Although GPRA expanded the supply of performance information generated by federal agencies, evaluating crosscutting federal efforts continues to be a challenge. GPRA requires the President to include in his annual budget submission a federal government performance plan. Congress intended that this plan provide a single cohesive picture of the annual performance goals for the fiscal year.[88] The governmentwide performance plan could help Congress and the Executive Branch address critical federal performance and management issues, including redundancy and other inefficiencies in how we do business. However, this provision has not been fully implemented, and the current agency-by-agency focus of the budget does not have a broad, integrated perspective of planned performance on governmentwide outcomes. As envisioned by Congress, the governmentwide plan could relate and address the contributions of alternative federal strategies, including tax expenditures, to governmentwide goals. Agencies' annual performance plans and reports could highlight crosscutting program efforts and provide evidence of the coordination of those efforts. We have previously recommended that OMB fully implement GPRA's requirement to develop a governmentwide plan to

[88]S. Rep. No. 103-58, p. 29 (1993).

provide a more cohesive picture of the federal government's goals and strategies.[89]

Prior to a 2003 revision, OMB's Circular A-11 guidance on GPRA reporting stated that descriptions should be provided for use of tax expenditures in annual performance plans when achievement of program or policy goals is dependent upon these governmental actions and annual performance reports must include the results of any assessment of how specific tax expenditures affect achieving its performance goals.[90] However, the circular also stated that few agencies were responsible for such analyses. In addition, as part of a broader A-11 revision update, OMB streamlined its GPRA guidance in 2003 and no longer describes tax expenditures as part of guidance on performance plans and performance reports in the circular. According to OMB, it is up to individual agencies to decide whether to address tax expenditures in their GPRA reports and that many agencies focus on outlay programs over which they have more direct control. OMB officials told us that some agencies see tax expenditures as closely related to what they do and some do not, or agencies might not have enough knowledge about tax expenditures to consider them carefully. Our review of selected GPRA Performance and Accountability reports indicated the acknowledgement of tax expenditures in achieving federal performance goals varied by agency. For example:

- The Department of Energy (DOE) and HUD both acknowledged tax expenditures or tax policy as factors that affect agency goals. However, the DOE's fiscal year 2004 report provided no further discussion on how the tax expenditures contributed to achieving the agencies' performance goals. HUD's fiscal year 2004 report acknowledged the tax incentives for renewal communities, empowerment zones, and enterprise communities as helping to achieve its objective of providing capital resources to improve economic conditions in distressed communities. As discussed previously, the outlay-equivalent value for tax expenditures amounts to more than other spending in the energy as well as the commerce and housing credit mission areas.

[89]GAO-04-38.

[90]OMB, "Preparation and Submission of Strategic Plans, Annual Performance Plans, and Annual Program Performance Report", Part 6 of Circular A-11, *Preparation, Submission, and Execution of the Budget* (Washington, D.C.: 2002).

- The fiscal year 2004 reports released by the Department of Commerce (Commerce), the Department of Veterans Affairs, and the Department of Health and Human Services (HHS) do not mention tax expenditures at all, even though tax expenditures exist under the different mission areas related to these departments. For instance, several large tax expenditures, such as capital gains and accelerated depreciation, are listed by Treasury as related to the Commerce mission area, but it is unclear how, if at all, these tax expenditures relate to Commerce's performance goals. Also, the income tax exclusion for employer-provided health care, the largest single tax expenditure, clearly intersects with HHS's mission to assure access to health care.

- Treasury's fiscal year 2004 report explicitly identified a few tax expenditures—the New Markets Tax Credit and a new health coverage tax credit—as related to achieving its strategic objective to stimulate U.S. economic growth. In the context of its strategic objective to improve and simplify the tax code, Treasury reported on its efforts to, among other things, simplify the EITC and consolidate the higher education tax benefits. Treasury also reported on its efforts to improve determination of EITC eligibility and educate taxpayers about this provision. Treasury did not include information about tax expenditures as other accompanying information in the financial statement in its 2004 report.

Tax Expenditures Are Not Subject to Annual Budget Reviews

Tax expenditures have not been incorporated into Executive Branch budget reviews, as we recommended in 1994. We recommended that OMB use information on outlay programs and tax expenditures to make recommendations to the President and Congress about the most effective methods for accomplishing federal objectives. We concluded that better targeting by Congress and the Executive Branch of all federal spending and subsidy programs could save resources and increase economic efficiency through (1) better coordination of spending programs with tax expenditures; (2) reduction of overlap and inconsistencies among all federal subsidy programs; and (3) encouragement of trade-offs among tax expenditures, outlays, and loans.

The congressional budget process is the annual vehicle through which Congress articulates both an overall fiscal stance—overall targets for spending and revenue—and its priorities across various broad categories. The process provides the overall constraints for spending and revenue actions by Congress for each year and the rules of procedure that can be used to constrain new entitlement and tax legislation not assumed in the

annual budget resolution. The conflicts and uncertainties entailed in budgeting and policymaking are often mitigated by focusing decisions on incremental changes in resources each year. As a result, this incremental process focuses disproportionate attention on proposed changes to existing programs and proposals for new programs, with the base of programs often being taken as “given.” Moreover, the process routinely examines only the one-third of federal spending subject to the annual appropriations process. Unlike discretionary spending programs, which are subject to periodic reauthorization and annual appropriation, tax expenditures—like entitlement programs—are permanent law and are generally not subject to a legislative process that would ensure systematic annual or periodic review. In addition, the budget rules that were grounded in statute—including discretionary spending caps, pay-as-you-go (PAYGO) limits on mandatory spending and tax cuts—and enforced by executive actions if violated, expired at the end of fiscal year 2002. Before their expiration, PAYGO procedures restricted Congress' ability to add new tax expenditures or expand existing ones unless offsetting funds could be raised. Because tax provisions are not as visible in the budget as spending programs, there is an incentive for policymakers to use tax provisions rather than spending programs to accomplish programmatic ends. However, both have a negative effect on the government's “bottom-line.” Reinstituting budget enforcement mechanisms, such as discretionary spending caps, PAYGO discipline on both the spending and tax side, and fiscal benchmarks, could help the President and Congress sort out the many claims on the federal budget, including tax expenditures.

Within the Executive Branch, OMB has not used its PART process, which is central to the Executive Branch's budget and performance integration initiative,[91] to systematically review tax expenditures and promote joint and integrated reviews of tax and spending programs sharing common, crosscutting goals. OMB describes PART as a diagnostic tool meant to provide a consistent approach to assessing federal programs as part of the executive budget formulation process. It applies 25 questions to all

[91]GAO, *21st Century Challenges: Performance Budgeting Could Help Promote Necessary Reexamination*, GAO-05-709T (Washington, D.C.: June 14, 2005). For a detailed examination of PART, see GAO-04-174. Another significant element of the performance and budget integration initiative is efforts to restructure budgets. See GAO, *Performance Budgeting: Efforts to Restructure Budgets to Better Align Resources with Performance*, GAO-05-117SP (Washington, D.C.: February 2005).

"programs"[92] under four broad topics: (1) program purpose and design, (2) strategic planning, (3) program management, and (4) program results (i.e., whether a program is meeting its long-term and annual goals) as well as additional questions that are specific to one of seven mechanisms or approaches used to deliver the program.[93] PART is designed to be evidence-based, drawing on a wide array of information, including authorizing legislation, GPRA strategic plans and performance plans and reports, financial statements, inspectors general and GAO reports, and independent program evaluations. Drawing on available performance and evaluation information, the PART questionnaire attempts to determine the strengths and weaknesses of federal programs with a particular focus on individual program results and improving outcome measures.

Since the fiscal year 2004 budget cycle, OMB has applied PART to 607 programs (about 60 percent of the federal budget), and given each program one of four overall ratings: (1) "effective," (2) "moderately effective," (3) "adequate," or (4) "ineffective" based on program design, strategic planning, management, and results. A fifth rating, "results not demonstrated," was given—independent of a program's numerical score—if OMB decided that a program's performance information, performance measures, or both were insufficient or inadequate. Over the next 2 years, OMB plans to assess nearly all remaining Executive Branch spending programs.[94]

Whereas OMB, through its development and use of PART, has provided agencies with a powerful incentive for improving data quality and availability on the spending side, relatively little progress has been made in evaluating the effectiveness of tax expenditures. So far, OMB has used

[92] There is no standard definition for the term "program." For purposes of PART, OMB described the unit of analysis (program) as (1) an activity or set of activities clearly recognized as a program by the public, OMB, and/or Congress; (2) having a discrete level of funding clearly associated with it; and (3) corresponding to the level at which budget decisions are made.

[93]The seven major categories are competitive grants, block/formula grants, capital assets and service acquisition programs, credit programs, regulatory-based programs, direct federal programs, and research and development programs.

[94]For the limited exceptions, the Administration is considering alternative methods and timelines for assessment of programs with limited impact and large activities where it is difficult to determine an appropriate unit of analysis.

PART to address tax expenditures in only two cases—the EITC compliance initiative and the New Markets Tax Credit (NMTC).[95]

- For the EITC, which has outlays for the refundable portion, the direct federal spending PART instrument was used to evaluate IRS' initiative to improve the payment accuracy rate for the EITC—and not the refundable EITC itself. OMB rated the compliance initiative as "ineffective" in the fiscal year 2004 budget because data showed no progress in reducing the high rates of erroneous payments. The review did not evaluate the effects of the EITC on workforce participation or examine its contribution relative to other federal programs aimed at reducing poverty.
- The NMTC, which is administered like a grant by CDFI, was evaluated as part of OMB's crosscutting review of community and economic development programs. OMB rated the NMTC as "adequate" and reported in 2005 that CDFI had established meaningful long-term and annual performance measures but that data were not yet available to evaluate the effectiveness of the NMTC or establish baselines for the performance measures.

We have urged a more comprehensive, consistent, and integrated approach to evaluating all programs relevant to common goals—encompassing spending, tax expenditures, and regulatory programs—using a common framework. Such an analysis is necessary to capture whether a program complements and supports other related programs, whether it is duplicative and redundant, or whether it actually works at cross-purposes to other initiatives. OMB officials we interviewed said that OMB would need Treasury's assistance to determine what information or criteria to include in a PART instrument tailored to examine tax expenditures. As of July 2005, OMB said that it was planning to review the health insurance tax credit program next year but that it has not decided whether the PART review will be limited to administration or will also cover the program's tax policy purpose.

[95]The NMTC program issues federal tax credits to private sector entities in return for investments in low-income communities, such as development or rehabilitation of real estate projects.

Conclusions

As we move forward in shaping government for this century, the federal government cannot accept all of its existing programs, policies, functions, and activities as "givens." Outmoded commitments and operations constitute an encumbrance on the future that can erode the capacity of the nation to better align its government with the needs and demands of a changing world and society. Reexamining the base of all major existing federal spending and tax programs, policies, functions, and activities by reviewing their results and testing their continued relevance and relative priority for our changing society is an important step in recapturing our fiscal flexibility and bringing the panoply of federal activities into line with 21st century trends and challenges. The decisions we face involve difficult choices about the appropriate size and role of the federal government and how to finance the federal government. The revenues forgone through tax expenditures reduce resources available to fund other federal activities or they require higher tax rates to raise a given amount of revenue. Reviewing their results and testing their continued relevance and relative priority is an important step in the process towards fiscal responsibility and national renewal. Such a fundamental review of major programs, policies, and activities, including tax expenditures, can serve the vital function of updating the federal government's approach to meet current and future challenges.

Regular and systematic evaluation will be necessary to inform policy decisions about the efficiency, effectiveness, and equity of tax expenditures or whether they are the best tool for accomplishing federal objectives within a functional area. Beginning the governmentwide reexamination process now would enable decisionmakers to be more strategic and selective in choosing areas for review over a period of years. Reexamining selected parts of the budget base over time may make the reviews more feasible and less burdensome, and it would allow decisionmakers to focus on all federal efforts—discretionary spending, mandatory spending, and tax expenditures—sharing common goals.

Unfortunately, over a decade has passed since Congress encouraged systematic reviews of tax expenditures and since we made recommendations to facilitate such reviews and to display information on tax expenditures in the federal budget in a manner that enables policymakers to look at resource commitments across related outlays and tax expenditures. Although specific tax expenditures, such as the EITC and Liberty Zone tax benefits, have received varying degrees of scrutiny, efforts to date have not provided the Congress and others with an

integrated perspective on the extent to which programs and tools—including tax expenditures—contribute to national goals and position the government to successfully meet 21st century demands. In addition, the lack of a requirement to disclose tax expenditures in agencies' annual performance and accountability reports may result in important performance and cost related data not being fully considered with other federal resources allocated to achieve similar objectives. Although challenges must be overcome to provide systematic reviews of tax expenditures, these challenges cannot be addressed absent effective leadership within the Executive Branch. Accordingly, we are making several recommendations to OMB.

Recommendations for Executive Action

To ensure that policymakers and the public have the necessary information to make informed decisions and to improve the progress toward exercising greater scrutiny of tax expenditures, we recommend that the Director of OMB, in consultation with the Secretary of the Treasury, take the following four actions:

- resume presenting tax expenditures in the budget together with related outlay programs to show a truer picture of the federal support within a mission area;

- develop and implement a framework for conducting performance reviews of tax expenditures. In developing the framework, (1) determine which agencies will have leadership responsibilities to review tax expenditures, how reviews will be coordinated among agencies with related responsibilities, and how to address the lack of credible performance information on tax expenditures; (2) set a schedule for conducting tax expenditure evaluations; (3) re-establish appropriate methods to test the overall evaluation framework and make improvements as experience is gained; and (4) to identify any additional resources that may be needed for tax expenditure reviews.

- develop clear and consistent guidance to Executive Branch agencies on how to incorporate tax expenditures in strategic plans, annual performance plans, and performance and accountability reports, to provide a broader perspective and more cohesive picture of the federal government's goals and strategies to address issues that cut across Executive Branch agencies; and

- require that tax expenditures be included in the PART process and any future such budget and performance review processes so that tax expenditures are considered along with related outlay programs in determining the adequacy of federal efforts to achieve national objectives.

Agency Comments and Our Evaluation

We provided a draft of this report to OMB, Treasury, and IRS for their review and comments. We received written comments from OMB's Associate Director for Economic Policy in a letter dated September 2, 2005. These comments are reprinted in app. II along with our analysis of certain issues raised by OMB. OMB disagreed with our recommendations and several of our findings, and also raised concerns about our use of Treasury's tax expenditure estimates. Where appropriate, we made changes in our report in response to these comments. The Secretary of the Treasury did not submit comments, instead deferring to OMB. IRS staff provided a technical correction that we incorporated.

In commenting on our report, OMB raised concerns about our use of tax expenditure estimates developed by Treasury and reported in the annual federal budget. For example, OMB commented that we accepted uncritically the concept of tax expenditures first advanced in the 1960s and said that we ignored limitations about the "volume" of total tax expenditures. To the contrary, the background section of our draft report, as well as several pages in app. III, clearly identified issues related to the tax expenditure concept, including that characterizing individual provisions as tax expenditures is a matter of judgment, and that disagreements exist about classifying what should be included in the income tax base. Pursuant to the Congressional Budget Act of 1974, the term tax expenditure, as our draft stated, has been used in the federal budget for three decades, and the tax expenditure concept—while not precisely defined—is nevertheless a valid representation of one tool that the federal government uses to allocate resources. Regarding the "volume" of tax expenditures, we acknowledged throughout our draft report limitations in the methodology of summing the individual tax expenditures. To provide an example of the extent that interaction effects among tax expenditure estimates can affect summing them, at our request, Treasury calculated total tax expenditures for five itemized deductions that took these effects into account; we included this information in our draft report. As our report stated, tax expenditure estimates—both those published in the budget as well as those produced by JCT—are the best and only data available to measure the value of tax expenditures and make comparisons

to other spending programs. In our opinion, summing the estimates provides perspective on the use of tax expenditures as a policy tool and represents a useful gauge of the general magnitude of government subsidies carried out through the tax code.

OMB also stated that we reported that more attention should be given to tax expenditures due to the severity of the nation's long-term fiscal imbalance and stated that the Administration rejects any attempt to address the long-term fiscal imbalance with tax increases. To the contrary, we believe that tax expenditures, like other federal programs and activities, should be reevaluated as to their effectiveness and continued relevance as part of a periodic reexamination of what the federal government does and how it does business. Although the long-term fiscal gap heightens the need to ensure resources are not wasted, this reexamination would be appropriate regardless of the fiscal position. Further, OMB's implication that focusing more attention on tax expenditures would automatically increase taxes is unfounded. As our report clearly stated, for any given level of revenue, the revenues forgone through tax expenditures require higher tax rates to obtain a given amount of revenue. Thus, if the evaluations of tax expenditures we call for lead to reducing or eliminating some tax expenditures, the net change after rate adjustments could, depending on overall congressional priorities and preferences, result in tax reductions for many taxpayers. We adjusted sections of our report to reinforce the point that reviewing tax expenditures is consistent with good stewardship of taxpayers' resources and does not automatically result in tax increases depending on other related changes. At the same time, our current and projected fiscal imbalance serves to reinforce the need for reassessing all activities. We also added a recent estimate calculated by the Department of the Treasury for the President's Advisory Panel on Federal Tax Reform which showed that a tax system where basically all tax expenditures were eliminated could raise the same amount of revenue as the current tax system while lowering tax rates by about a third.

OMB also stated that information on tax expenditures is not useful for budgeting and that tax expenditures have never been included in the congressional budget process. To the contrary, the tax expenditure list is legally required under the 1974 Congressional Budget Act and, before the expiration of the Budget Enforcement Act in 2002, PAYGO procedures restricted Congress' ability to add new tax expenditures or expand existing ones unless offsetting funds could be raised. Whereas OMB favors reporting tax expenditures separately from the rest of the budget, we believe an integrated presentation is also useful to show the relative

magnitude of tax expenditures compared to spending and credit programs across mission areas. This is not a recommendation to equate tax expenditures with outlays. We are recommending that OMB focus on integrating tax expenditures in the President's budget presentation to show a truer picture of federal support in a mission area and on including tax expenditures under budget and performance review processes that apply to related spending programs. As our report stated, OMB began presenting tax expenditure sums alongside outlays and credit activity for each budget function in the federal budget from fiscal year 1998 through fiscal year 2002, but has discontinued the practice.

Finally, OMB commented that it would be unwise to follow our recommendations for the conceptual and methodological reasons mentioned above, as well as for other practical reasons. We address OMB's comments on our recommendation to resume including tax expenditures in the budget together with related outlay programs in the paragraph above.

- Regarding our recommendation to develop a framework for conducting performance reviews of tax expenditures, OMB stated that it has some potential promise but it is clearly a job for Treasury because no other agency has access to the data that would be needed to conduct such an analysis. However, we are not recommending that OMB be responsible for conducting the actual reviews, just for developing and overseeing the implementation of a framework for conducting the performance reviews. OMB would not need to have access to taxpayer data to manage the process. In addition, we recognize the challenges in using taxpayer data, which is the reason we recommend that OMB work in consultation with Treasury to develop and implement the framework. Also, our report recognizes the scarcity of evaluation resources, and we suggest factors that would be useful in taking a strategic approach to selecting and prioritizing tax expenditure evaluations. To make this point more apparent in our report, we added a fourth requirement to our recommendation to identify any additional resources that may be needed for tax expenditure reviews.

- OMB said that our recommendation to develop clear and consistent guidance to Executive Branch agencies on how to incorporate tax expenditures in GPRA reports would be counterproductive because agencies do not administer the tax code, and they should not be saddled with responsibility for something they do not control. OMB misstated our recommendation; this report does not recommend that agencies be responsible for administering parts of the tax code. As the tax

expenditure chapter in OMB's *Analytical Perspectives* volume of the fiscal year 2006 budget states, tax expenditures may also contribute to achieving goals identified in Federal agencies annual and strategic plans for their programs and activities. The aim of our recommendation was to provide a more cohesive perspective of the government's programs and strategies—including tax expenditures—to address common federal goals. As our report states, in passing the Government Performance and Results Act, the Senate Governmental Affairs Committee called for inclusion of tax expenditures in the GPRA process so that more and better information would be available on the performance of tax expenditures themselves and the effects of tax expenditures would be considered in achieving federal performance goals. Our recommendation is consistent with this intent.

- Regarding our recommendation to require tax expenditures to be included in the PART process and any future such budget and performance review processes, OMB stated that it has no current plans to implement any of the recommendations in this report, but stated that other tax expenditures may be evaluated with the PART in the future. OMB also stated that the Department of the Treasury manages the tax code, so any new PARTs for tax expenditures would generally mean more PARTs for Treasury. Within the Executive Branch, major responsibility for management of the tax code was given to the Department of the Treasury. Given that the Administration is aiming to assess nearly 100 percent of federal outlay programs under PART, Treasury would be facing less scrutiny than other agencies to the extent that tax expenditures are not similarly evaluated under PART. Our recommendation merely calls for bringing tax expenditures in line with the performance management attention PART gives to outlay programs. Further, if our second recommendation to develop an evaluation framework for tax expenditures is implemented, OMB would be better positioned to target crosscutting reviews of related clusters of programs and activities.

We are sending copies of this report to the relevant congressional committees and other interested parties. Copies of this report will also be made available to others upon request. In addition, the report will also be available at no charge on GAO's Web site at http://www.gao.gov.

If you or your staff have any questions about this report, please contact Mike Brostek at (202) 512-9110 or brostekm@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made major contributions to this report are listed in appendix VI.

David M. Walker
Comptroller General
of the United States

Scope and Methodology

A decade ago, we examined the growth in tax expenditures and examined opportunities to focus policymakers' attention on tax expenditures.[1] To assist the Congress in reexamining the base of federal programs and policies critical to achieving fiscal discipline in the budget as a whole, this report updates our 1994 work. Specifically, this report describes (1) how tax expenditures have changed over the past three decades in reported number and aggregate size and in comparison to federal spending, revenue, and the economy; and (2) the progress that has been made since 1994 in how the Executive Branch scrutinizes tax expenditures. To meet each of our objectives, we relied on past GAO work, agency and congressional reports, and relevant tax expenditure literature. In addition, we interviewed agency officials from the Department of the Treasury's Office of Tax Analysis; the Internal Revenue Service's Office of Research, Analysis, and Statistics; the Office of Management and Budget (OMB); congressional staff from the Joint Committee on Taxation (JCT); and experts on tax policy to obtain a greater understanding of information gained through our literature review and to corroborate findings.

To identify how tax expenditures have changed over the past three decades in number and size in terms of aggregate revenue loss and outlay-equivalents, we analyzed tax expenditure estimates developed by Treasury and reported by OMB in the Federal Budget's Special Analyses, Appendixes, and Analytical Perspectives for fiscal years 1974 to 2004. Tax expenditure estimates are reported for individual and corporate taxpayer groups and categorized by budget function. We chose the tax expenditure estimates reported in the budget for our analysis because Treasury develops (1) revised estimates based on changes in tax policy and economic activity for the year prior to the reported fiscal budget year (i.e., retrospective estimates), and (2) outlay-equivalent estimates that facilitate comparison to federal spending. Even though Treasury's estimates are retrospective, the final reported numbers are still estimates and may not reflect additional policy changes. Although the tax expenditure concept can also be applied to other kinds of taxes, such as excise taxes, this report only covers tax expenditures for the federal income tax system.

We determined the number of tax expenditures for each fiscal year by adding the number of items in the list of tax expenditures reported by Treasury for each fiscal year. In certain fiscal years, Treasury reported

[1]GAO, *Tax Policy: Tax Expenditures Deserve More Scrutiny*, GAO/GGD/AIMD-94-122 (Washington, D.C.: June 3, 1994).

estimates for select tax expenditures as two line items on their list, such as the expensing of exploration and development costs, which was split out as two tax expenditures, one pertaining to oil and gas and one for other fuels between fiscal years 1980 and 1995. To be consistent with Treasury's reporting of these tax expenditures in years when they were listed as only one item, we summed the revenue loss estimates in the years they were listed as two tax expenditures and counted them as one. To determine the number of distinct tax expenditures across fiscal years, we reviewed the names and descriptions for each tax expenditure reported by OMB in the Budget's Special Analyses, Appendixes, and Analytical Perspectives for fiscal years 1974 to 2004. We conducted two independent reviews to verify that our list contained only distinct tax expenditures across fiscal years. To assist in our review, we also relied on the descriptions reported in the Congressional Research Service's compendiums on tax expenditures and legislative histories of certain tax expenditures, as needed. App. IV contains our compilation of all tax expenditures reported by Treasury between 1974 and 2004.

We aggregated tax expenditure revenue loss estimates to measure growth over time. We also summed the revenue loss estimates by their reported corporate and individual basis to see how the amounts differed between the two taxpayer groups. We converted all sums for each fiscal year into constant dollars to adjust for inflation using the chain price indexes reported in the fiscal year 2006 federal budget. While summing tax expenditure estimates provides a useful perspective, aggregate numbers should be interpreted carefully due to interactive effects between tax expenditures and potential behavioral changes.

To identify how tax expenditures have changed over the past three decades in comparison to federal spending, revenue, and the economy, we summed the outlay-equivalent estimates for each fiscal year and compared them to the federal budget position in aggregate. We used historical data on spending drawn from OMB historical tables and compared them to the sums for tax expenditure outlay-equivalent estimates in dollar value and as a percentage of GDP. We also used outlay-equivalent estimates to compare tax expenditure trends over time by budget function. Finally, we used historical data on spending by budget function from OMB historical tables and compared them to the sum of tax expenditures by budget functions for fiscal year 2004. We worked with Treasury officials to verify any discrepancies we found in using the tax expenditure estimates and modified our data accordingly.

To determine the amount of progress since 1994 in how the federal government scrutinizes tax expenditures, we examined actions taken to implement our earlier recommendations to OMB intended to encourage more informed policy debate about tax expenditures and to stimulate joint review of related tax and spending programs. We recommended (1) developing a structure for conducting reviews of tax expenditures' performance (2) conducting case studies to assess performance review structure (3) presenting tax expenditures in the annual budget, and (4) incorporating tax expenditures into the annual budgetary review process. We reviewed relevant literature, interviewed relevant agency officials and tax policy experts, and relied on previous GAO work to determine the progress that has been made in implementing our recommendations. We reviewed efforts to include tax expenditures under the Government Performance and Results Act's statutory framework for strategic planning, performance measurement, and program evaluation.[2] We also considered activities to include tax expenditures under OMB's Program Assessment Rating Tool process.

To describe how tax expenditures are measured and reported, we reviewed, but did not verify, the procedures used by the Joint Committee on Taxation and Treasury to estimate the magnitude of revenues forgone through tax expenditures or, in Treasury's case, their outlay-equivalent values as well. As described in app. III, JCT and Treasury use different conceptual approaches to identify the provisions of the tax code they label as tax expenditures. In addition, their estimating models, macroeconomic assumptions, and choice of data cause their revenue loss estimates to differ somewhat.

We conducted our work between August 2003 and July 2005 in accordance with generally accepted government auditing standards.

[2] Pub. L. No. 103-62.

Comments from the Office of Management and Budget

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

September 2, 2005

Mr. Michael Brostek
Director, Tax Policy and Administration
U.S. Government Accountability Office
Washington, D.C. 20548

Dear Mr. Brostek:

See comment 1.

Thank you for your August 15, 2005, message conveying the draft report, *Tax Expenditures Represent a Substantial Commitment of Federal Support and Need to Be Reexamined*, and requesting written comments from the Office of Management and Budget (OMB). The GAO analysis in this report is deeply flawed and it would be unwise for the Administration to follow its recommendations. GAO believes that the Administration should pay more attention to tax expenditures as it formulates the budget, because of "the severity of the nation's long-term fiscal imbalance." The Administration rejects any attempt to address the long-term fiscal imbalance with tax increases.

See comment 2.

The Administration clearly believes, and has consistently stated, that long-run Federal budget projections show an unsustainable rise in Federal deficits and Federal debt. The long-run budget problem results from projected increases in the retired population and expected increases in health care costs that exceed the overall rate of growth in the economy. In contrast, Federal receipts are now projected soon to return to and then steadily rise above the long-run average of receipts as a share of GDP. The long-run fiscal imbalance is solely related to Federal spending policies already in place. GAO does not attempt to explain how extra attention to tax expenditures would help address either of the root causes of the long-term budget problem.

See comment 3.

Tax expenditures have been included in the Administration's annual budget since the passage of the 1974 Congressional Budget Act, which established the modern budget process. Each year, Treasury's Office of Tax Analysis (OTA) identifies and computes the various tax expenditures, and these are published in the budget. Since the mid-1990s, the tax expenditure tables have appeared as a separate chapter in the *Analytical Perspectives* volume that accompanies the budget, before that they usually appeared as Special Analysis G. Although the list of tax expenditures and the assumptions used to estimate them have undergone changes, the presentation has not changed fundamentally since the tax expenditures first appeared in the budget thirty years ago.

See comment 1.

Tax expenditures have never been integrated with the rest of the budget, nor has Congress ever attempted to integrate tax expenditures in the Congressional budget process. GAO does not examine why this is so. Given that no major attempt at such integration has been made in the thirty years that tax expenditure estimates have been available, this would seem to be something that GAO might have considered before recommending such integration. In fact, there are

several reasons both conceptual and practical for firmly rejecting GAO's recommendations and maintaining the traditional separation between tax expenditures and the rest of the budget.

See comment 1.

In this report, GAO accepts uncritically the concept of tax expenditures first advanced in the 1960s. This view holds that many parts of the tax code function like Government spending programs, hence the term tax expenditures. Because these tax expenditures are seen as equivalent to other types of spending, it is argued that they ought to be budgeted and managed like other spending programs. This is essentially what GAO proposes to do in this report. To do this effectively, however, it is first necessary to identify exactly what parts of the tax code are really Government expenditures in disguise.

Early proponents of the tax expenditure concept assumed that it would be relatively easy to separate a normative tax structure intended to raise revenue from the various exceptions to that structure, which function like spending. The problem with this assumption was pointed out in the Fiscal Year 2002 Budget: "Underlying the 'tax expenditure' concept is the notion that the Federal Government would otherwise collect additional revenues but for these provisions. It assumes an arbitrary tax base is available to the Government in its entirety as a resource to be spent. Because of the breadth of this arbitrary tax base, the Administration believes that the concept of 'tax expenditure' is of questionable analytic value." A basic conceptual problem with GAO's recommendations is that the current list of tax expenditures is based on an arbitrary baseline and, consequently, lacks analytical rigor.

Although the normal tax baseline that has been used by OTA to identify tax expenditures is loosely patterned on a comprehensive income tax, it deviates from that concept in some significant ways. In the Fiscal Year 2003 Budget, OTA undertook to refine the tax expenditure list by eliminating the arbitrariness in the current definition, and it has continued to update that work for subsequent Budgets. OTA considered as alternatives to the normal tax baseline both a pure income tax and a pure consumption tax. Treasury's analysis revealed that many of the largest tax expenditures would not be classified as such with this change in baselines. For example, as of the 2006 Budget, only 15 of the 30 largest tax expenditures would be sure to continue as such under a comprehensive income tax baseline, while 9 others might possibly be considered. With a comprehensive consumption tax baseline, there are even fewer unambiguous tax expenditures. Using a consumption tax standard, only 2 of the 30 largest tax expenditures would be sure to remain, along with possibly 7 others. That is less than a third of the 30 current largest expenditures. With this degree of uncertainty about what constitutes a tax expenditure, GAO's recommendations for further integration are to say the least premature.

See comment 4.

OTA's analysis also points to another way to think about what constitutes a tax expenditure. On this approach, any tax provision that deviates from a clearly defined tax baseline would be considered a "tax expenditure." Such deviations would differ from the traditional concept of tax expenditures in two ways. First, they would not necessarily be similar to any direct Government spending program. Although tax expenditures can often be thought of as tax subsidies, they are frequently unlike any of the subsidies found on the spending side of the budget. The differences can be so great that comparing the two types of subsidy is like comparing apples with oranges. In fact, that has always been true of many of the traditional tax expenditures. GAO spends no time in its report considering how tax expenditures differ from other Government programs. It

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simply takes for granted that they are similar, perhaps because of the label, but many so-called tax expenditures have little resemblance to direct Government spending programs. The "expenditure" element is purely metaphorical.

Second, thinking of tax expenditures as deviations from a standard income or consumption tax implies that there can be negative as well as positive tax expenditures. Not all deviations will reduce tax revenue; some are likely to add to revenue creating a tax penalty or negative tax expenditure. It is hard to imagine what a negative tax expenditure would have in common with other spending programs.

See comment 5.

The information in the tax expenditure tables can be useful to policymakers and the public. Potentially, it indicates how the current tax code deviates from an ideal tax system. That appears to have been the main contribution of the tax expenditures currently published in the budget, even though the existing list of tax expenditures as measured against the normal tax base is conceptually flawed. Despite the conceptual limitations, the tables of tax expenditures have provided tax reformers with information about where the tax code deviates from a defined baseline and about tax preferences that ought to be limited or even eliminated to improve the tax code. Contrary to GAO, however, such information is not especially useful in budgeting.

See comments 1 and 6.

One serious limitation on current tax expenditure estimates is that they do not provide information about the volume of total tax expenditures. This is a second serious conceptual limitation on current tax expenditure estimates that GAO ignores. Such information is essential for budgeting, but it is not possible to obtain using current tax expenditure methodology. This is because the numerical estimate for each tax expenditure assumes that other tax expenditures and the rest of the tax code remain unchanged while the tax expenditure being analyzed is assumed to be removed from the code. If all tax expenditures were removed at once, however, or if all tax expenditures within a single budget function were removed at once, there would be interactions among the tax expenditures that would change the estimate. Furthermore, estimating methods and assumptions have changed over time, often significantly, so that past estimates of individual tax expenditures are analytically inconsistent with recent estimates. GAO spends a good part of this report totaling tax expenditures and comparing trends over time, an analytical exercise that the Treasury has for years warned against. Most of this analysis is wasted effort, because of these analytical restrictions. GAO is aware of the restrictions, and it offers no evidence to suggest that they are quantitatively insignificant, but it has chosen to ignore them in carrying out its calculations.

A further limitation on the use of tax expenditure estimates for budgeting is the convention used in preparing these estimates that economic behavior is not affected by tax expenditures. That is clearly not true, and if not corrected, it would lead to very misleading budget estimates. This convention is different from that used in preparing the budget's revenue estimates. The revenue estimates do reflect behavioral changes, although not all conceivable behavioral changes. The most likely microeconomic responses to changes in taxes are always reflected in the revenue estimates. Before tax expenditures could be used for budgeting, it would be necessary to include their likely behavioral effects as they are computed. The GAO report is silent on how this might be done, and GAO offers no reason for thinking that this problem is quantitatively insignificant. It would be a mistake to substitute the tax expenditure estimates for the budget's more accurate

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revenue estimates in budget planning and preparation. The distinction between revenue estimates and tax expenditure estimates is another reason for keeping tax expenditures separate from the rest of the budget.

See comment 1.

There is a final reason for thinking that the totals GAO computes drastically overstate, any realistic revenue gain that might be obtainable by eliminating or reducing tax expenditures. As has been pointed out many times in previous Budgets, "past tax changes entailing broad elimination of tax expenditures were generally accompanied by changes in tax rates or other basic provisions, so that the net effects on Federal revenues were considerably (if not totally) offset." Any future tax reform that removes or modifies substantial numbers of tax expenditures is likely to follow a similar pattern.

A third major conceptual shortcoming of the GAO report is that it reflects the belief that tax expenditures must be treated like direct Government spending programs or they will be neglected. GAO shows that tax expenditures are not treated like direct spending programs, but this does not prove that tax expenditures have been ignored. GAO has overlooked the fact that the tax expenditures are regularly reviewed as provisions of the tax code. It is not necessary to pretend that a tax provision is really a spending program in order to review its effectiveness or equity. The major tax expenditures have not been ignored in Administration or Congressional deliberations about tax policy. Indeed, the President's Advisory Panel on Federal Tax Reform, named in January 2005, is even now going over the tax expenditures along with other tax provisions looking for ways to reform and simplify the tax code. A similar exercise produced fundamental tax reform in 1986. Neither effort has required treating tax expenditures as if they belonged on the outlay side of the budget. Indeed, had tax expenditures been treated like outlays, it might have been more difficult to complete the complex trade-offs necessary to accomplish tax reform. Changes in income tax rates and in the basic structure of the tax system are apt to require adjustments in tax expenditures to "pay for" the reform. That could be more difficult if the tax expenditures were committed to an outlay function.

See comment 7.

Tax proposals including proposals to modify tax expenditures have always received considerable attention in the deliberations that produce the budget. The budget includes an extended discussion of Administration tax proposals. This material includes proposed changes in tax expenditures along with any changes proposed to other parts of the tax code. Contrary to the implication of the GAO report, it is not necessary to treat taxes like spending in order to study the effects of tax policy and to recommend changes as needed. This Administration has certainly not ignored taxes in formulating its fiscal policy. Tax policy changes since 2000 may conflict with GAO's policy preferences, but GAO should not confuse a disagreement about the substance of tax policy with a lack of attention to tax policy questions. This Administration, like previous Administrations, has paid and will continue to pay careful attention to all the key features of the Nation's tax system as it continues to seek out measures that will enhance the system's efficiency and equity.

GAO does provide some interesting comparisons of the tax expenditure list compiled by OTA with the similar list prepared by the Joint Committee on Taxation (JCT) and the different estimates made by the two agencies. The report also shows how the list of tax expenditures has changed over time. These are useful compilations for historical purposes. The very fact,

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however, that there are enough differences between the JCT and OTA estimates to warrant such a comparison suggests that such estimates are not ready for more extensive use in the budget.

GAO also makes four specific recommendations for action by OMB:

1. Present the tax expenditures in the budget side-by-side with outlays.
2. Develop a framework for conducting performance reviews and evaluations of tax expenditures by agencies with "leadership" responsibilities in the functional areas where tax expenditures fall.
3. Develop guidance on incorporating tax expenditures in agencies' strategic plans, annual performance plans, and performance and accountability reports.
4. Include tax expenditures in the PART process.

In addition to the broad conceptual and methodological reasons described above for rejecting the general approach GAO has adopted in this report, there are strong practical reasons for rejecting these recommendations.

See comment 8.

With respect to the first recommendation, OMB believes that the current presentation of tax expenditure information in the budget is more than adequate to provide the public and policymakers with what is useful to know about these provisions of the tax code. Further analytical refinement aimed at clarifying the definition of tax expenditures and removing the arbitrariness from the current tax expenditure list would be desirable, but that does not require combining tax expenditures with outlay data. Inserting extraneous tax expenditure information at other points in the budget is more likely to confuse than enlighten. As pointed out above, the tax expenditure estimates cannot be meaningfully added, nor can they be compared with current revenue estimates, and it would be misleading to present analytically inappropriate totals for separate budget functions.

The Department of Treasury has administrative responsibility for the tax expenditures, so the only "mission area" in the main budget volume where the tax expenditures could appear would be in the chapter devoted to Treasury's activities. This would be unwieldy at best. The chapter devoted to tax expenditures in *Analytical Perspectives* provides a clear functional breakdown of all the tax expenditures in great detail. Nothing would be gained by repeating this breakdown at other points in the budget.

See comment 9.

The second recommendation has some potential promise, but it is mainly a job for the Department of Treasury. No other agency has access to the data that would be needed to conduct such analysis. Confidentiality requirements pose a serious barrier to sharing such information outside Treasury. GAO gives no attention to the risks to confidentiality inherent in its recommendation. Care must also be taken in analyzing tax expenditures to consider how they operate as part of the tax system. No other agency but Treasury is in a position to do this. To the extent that there are overlapping interests in the effects of tax expenditures, Treasury should consult with other Departments and OMB can help coordinate such consultations as needed. Reviews of some tax expenditures have been conducted by OTA and others are ongoing. Such

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reviews inform recommendations for tax policy changes incorporated in the budget and in other legislative proposals.

See comment 10.

The third recommendation would be counterproductive. The agencies do not administer the tax code, and they should not be saddled with responsibility for something they do not control. Including tax expenditures in agency plans and performance reports would work against one of the main goals of improved strategic planning, which is the proper alignment of resources and responsibilities. If GAO were proposing to shift responsibility for major parts of the tax code away from Treasury to the agencies with Administrative responsibility for budget functions like commerce, housing, or health, then it might make sense to require the agencies to include tax expenditures in their planning, but that would require, among other wrenching changes, similar adjustments in the Congressional committee structure that GAO is surely not contemplating. Without responsibility for taxes, there is no reason for any agency except Treasury to include them in a plan or a performance report. Agencies may choose to discuss the effects of tax policy on the programs for which they are responsible, but if they are not charged with administering the tax code it would be wrong to include revisions to tax law in their plans or performance reports.

See comment 11.

GAO's final recommendation to OMB is to use the Program Assessment Rating Tool (PART) to assess tax expenditures. The PART is used by OMB and the agencies to assess program management and to suggest steps to improve performance. The Department of Treasury manages the tax code, so any new PARTs for tax expenditures would generally mean more PARTs for Treasury. The Treasury Department has already been examined using PARTs for a number of its programs including the New Markets Tax Credit (NMTC), which is a tax expenditure. Other tax expenditures may be evaluated with the PART in the future.

OMB has no current plans to implement the recommendations in this report. Tax expenditures are not being under analyzed. They are examined, but as part of the tax code not as spending programs in disguise. Tax expenditures have not been integrated with other Government spending programs either by the Administration or by Congress, but such integration is not necessary for these elements of the tax system to be scrutinized and modified if need be. Major changes in tax expenditures are likely to be proposed by the President's Advisory Panel on Federal Tax Reform, which is scheduled to issue its findings later in 2005. It is not necessary to treat tax expenditures like spending programs in disguise to examine them, manage them, or even reform them.

Sincerely,

James D. Foster
Associate Director for Economic Policy

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The agency comments and evaluation section of this report discusses our overall comments on the Office of Management and Budget's letter dated September 2, 2005. The following are our additional comments on issues raised by OMB.

GAO Comments

1. See the agency comments and evaluation section of this report.

2. While we believe that the nation's current and projected fiscal imbalance provides an additional impetus for engaging in such a review and reassessment, we believe tax expenditures should be reviewed and evaluated for efficiency and effectiveness even if there were no fiscal imbalance. We did not suggest that extra attention to tax expenditures would eliminate the long-term fiscal imbalance. As our report stated, substantive reform of Social Security and the major health programs remains critical to recapturing our fiscal flexibility.

3. Our report cites several examples of changes in the presentation of tax expenditures over time. For example, starting with the fiscal year 1999 budget, OMB began including a section outlining possible performance measures and issues in evaluating tax expenditures. This section was a first step in responding to congressional expectations for the Executive Branch to provide information about how tax expenditures meet their objectives and affect the performance of other federal programs.

4. We do not take for granted that tax expenditures are similar to spending programs. We devote a section of our background to describing how tax expenditures differ from, may substitute for, and work in conjunction with other spending programs to achieve policy objectives. Also, see the agency comments and evaluation section of this report.

5. In our report, we recommend adding useful comparisons to spending programs to the budget document, while not detracting from or changing in any way how the tax expenditure lists can be used to think about tax policies.

6. To the contrary, throughout our draft report we note and even emphasize the limitations in the methodology of summing the individual tax expenditures. In fact, to ensure that summing limitations of tax expenditures were clearly acknowledged, we discussed the limitations in (1) the introduction of our methodology, (2) a footnote in

the Results In Brief section, (3) the section devoted to explaining the limitations which precedes our presentation of the trends in tax expenditures over time, and (4) a footnote for all 10 figures where we summed the tax expenditure estimates. In addition, we report a quantitatively significant example of interaction effects of tax expenditure estimates, which was developed by Treasury at our request. The example shows that the revenue loss calculation assuming the simultaneous elimination of several itemized deductions would be less than the sum of the revenue loss estimates for each itemized deduction, each calculated assuming the rest of the tax code was unchanged. As our report stated, tax expenditure estimates produced by Treasury and JCT are the best and only available data to measure the value of tax expenditures and make comparisons to other spending programs. In our view, summing the estimates provides perspective on the use of tax expenditures as a policy tool and represents a useful gauge of the general magnitude of government subsidies carried out through the tax code. Our report also cites several other researchers who have summed tax expenditure estimates to help gain perspective on the use of this policy tool and examine trends in the aggregate growth of tax expenditure estimates over time.

7. In this report, we provide a number of examples of studies we and others have done of tax expenditures; our reviews often are at the request of Congress, and OMB examined two tax expenditures under the Administration's PART initiative. We also provide illustrations of the major legislation that has affected tax expenditures since the late 1970s. However, we stand by our statement that tax expenditures are not subject, or effectively subject, to several major processes that apply to outlay programs that increase the likelihood of reviews and, perhaps more importantly, increase the quantity and quality of information available to policymakers in determining whether and how to modify tax expenditures. Developing such enhanced information for policymakers and displaying it in a manner that facilitates their understanding of the total federal effort to address functionally related issues, e.g., ensuring adequate housing or stimulating economic development, is the thrust and intent of our report and recommendations.

8. We disagree with OMB's characterization that the current tax expenditure presentation is "more than adequate" for the public and policymakers. We realize that the current budget volume is not organized by separate budget functions; however, OMB had previously

presented revenue loss sums for tax expenditures alongside outlays and credit activity for each budget function in the federal budget from fiscal year 1998 through fiscal year 2002. As we state in our report, these summary tables were a useful starting point in highlighting the relative magnitude of tax expenditures and related outlay programs across mission areas. In addition, our current recommendation gives OMB latitude on how to present them with other outlay programs with similar purposes. Further, Congress has shown significant interest in reviewing all tools within a mission area. For example, recent congressionally-requested studies we conducted have reviewed all tools—including tax expenditures—used in the post-secondary education and energy areas.[1] Also, see comment 2 as well as the agency comments and evaluation section of this report.

9. We disagree with the opinion that OMB has implicitly expressed that it would not have a leadership role regarding our second recommendation. First, we are not recommending that OMB be responsible for conducting the actual reviews, just to develop and oversee the implementation of a framework for conducting the performance reviews. OMB would not need to have access to taxpayer data to manage the process. Secondly, we recognize the challenges in using taxpayer data, which is the reason we recommend that OMB work in consultation with Treasury to develop and implement the framework. Third, taxpayer data may not be the only source of performance information on tax expenditures, which is why we recommend that the framework address the lack of credible performance information on tax expenditures. Finally, our report recognizes the scarcity of evaluation resources and we suggest taking a strategic approach to select and prioritize tax expenditure evaluations based on such factors as the relative priorities, costs, and risks associated with related clusters of programs and activities and that OMB select similar programs for review in the same year to facilitate comparisons and tradeoffs. To make this point more apparent in our report, we added a fourth element to our recommendation that OMB and Treasury in developing a framework for evaluating tax

[1]GAO, *Student Aid and Postsecondary Tax Preferences: Limited Research Exists on Effectiveness of Tools to Assist Students and Families Through Title IV Student Aid and Tax Preferences*, GAO-05-684 (Washington, D.C.: Jul. 29, 2005), and *National Energy Policy: Inventory of Major Federal Energy Programs and Status of Policy Recommendations*, GAO-05-379 (Washington, D.C.: Jun. 10, 2005).

expenditures are to identify any additional resources that may be needed for tax expenditure reviews.

10. OMB misstated our recommendation. This report does not recommend that agencies be responsible for administering parts of the tax code. As we state in our report, in passing the Government Performance and Results Act, the Senate Governmental Affairs Committee called for inclusion of tax expenditures in the GPRA process so that more and better information would be available on the performance of tax expenditures themselves and the effects of tax expenditures would be considered in achieving federal performance goals. Our recommendation is consistent with this intent. Also, see the agency comments and evaluation section of this report.

11. Our recommendation aims to bring tax expenditures in line with the performance management attention PART gives to outlay programs. Our report discussed the two cases where OMB has applied PART to tax expenditures—the EITC compliance initiative and the New Markets Tax Credit. Within the executive branch, the Department of the Treasury has major responsibility for managing programs implemented through the tax system. Given that over the next 2 years the Administration plans to assess nearly all remaining executive branch outlay programs, Treasury would be facing relative less scrutiny than other agencies to the extent that the tax expenditure tool is not similarly evaluated under PART. Although OMB disagreed with our recommendations as a whole, we are encouraged that OMB is still considering how other tax expenditures could be evaluated with PART in the future. In moving forward, PART reviews of tax expenditures in isolation might be revealing, but we would urge a more comprehensive and crosscutting approach to assessing all tools—including tax expenditures—related to common goals.

How Tax Expenditures Are Measured and Reported

To understand the trends in the size of tax expenditures, it is helpful to understand how tax expenditures are measured and reported annually. This appendix explains the baselines used to distinguish tax expenditures from other provisions in the tax code and provides an explanation of the different methods that are used to measure tax expenditures.

Tax Expenditures Are Reported Annually by Law and Measurements Depend on Baselines Used

The Congressional Budget Act of 1974 defines tax expenditures as "those 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 tax liability. Both the congressional Joint Committee on Taxation (JCT) and the Department of the Treasury's Office of Tax Analysis annually compile a list of tax expenditures and estimates of their cost each year. The Department of the Treasury's (Treasury) tax expenditure estimates are included in the annual federal budget by the Office of Management and Budget (OMB).

While, in general, the tax expenditure lists published annually by JCT and Treasury are similar, they differ somewhat in the number of tax expenditures reported and the estimated revenue loss for particular expenditures. Part of this difference arises because the organizations use different income tax baselines to determine tax expenditures. To determine the tax code provisions that satisfy the definition of a tax expenditure, the existing tax law must be compared or measured against an alternative set of tax rules that represent a baseline. The Congressional Budget Act did not define a specific baseline tax structure. As a result, the Treasury and the staff of the JCT have used judgment to define the different baselines that they use to develop lists of tax expenditures. Before the fiscal year 1983 budget, there were few differences between the Treasury and JCT tax expenditure lists because both organizations used a baseline patterned on a comprehensive income tax, which was deemed the "normal" baseline. JCT has used this baseline consistently over time in producing its tax expenditure list, while Treasury has modified its normal baseline over time and provided alternative baselines. In general, the normal income tax law baseline developed by both Treasury and JCT represents a broad-based income tax on individuals and a separate income tax on corporations. The normal baseline includes income from all sources, including wages and salaries, fringe benefits and other forms of employee compensation, interest income, dividends, realized capital gains, and net income from non-corporate businesses such as sole proprietorships and partnerships. The

normal baseline generally allows for personal exemptions, deductions for costs incurred to earn income, and a standard deduction.

Currently, the normal baselines used by both Treasury and JCT differ somewhat. Treasury's normal baseline excludes several tax expenditures that are included in the normal baseline used by JCT and leads to several tax expenditures being reported by JCT only. For instance, the exclusion of Medicare hospital insurance benefits is included in the JCT list but this provision is not included in the federal budget tax expenditure list because Treasury views the exclusion of government benefits received in kind as part of its normal baseline. Additional examples of specific tax expenditures reported by only JCT or Treasury can be found at the end of this appendix in table 2.

In the fiscal year 1983 budget, Treasury introduced the concept of a reference baseline. The reference baseline used by Treasury is also patterned on a broad-based income tax, but it is closer to existing law because tax expenditures by definition are limited to special exceptions that serve programmatic functions, such as national defense, income security, and education. Under Treasury's reference baseline, two conditions are necessary for a provision to qualify as a tax expenditure: (1) The provision must be "special" in that it applies to a narrow class of transactions or taxpayers and (2) There must be a general provision to which the special provision is a clear exception. The set of general tax rules in the existing tax code is used as the standard by which various provisions are determined to be special. Whereas accelerated depreciation was considered a special rule exception under the normal baseline, these provisions were not considered tax expenditures under the reference baseline, because accelerated depreciation was considered to be the general treatment for the depreciation of business assets. The preferential tax rate for capital gains was included in Treasury's tax expenditure list based on the general tax code rule that income from any source is considered taxable. For fiscal year 1983, Treasury began to report estimates using the reference baseline for some tax expenditures and then reinstituted reporting estimates for the normal baseline in fiscal year 1985. This reporting practice has continued to the present.

In recent years, Treasury modified treatment of certain provisions under its normal and reference baselines and introduced two supplemental baselines. In the 2005 and 2006 budgets, Treasury excluded the reduced tax rate on dividends and capital gains that have already been taxed under the corporate income tax from the reference law baseline because it believes

that since current law taxes these forms of corporate income twice, it is an inappropriate baseline to use. Also, in the 2004, 2005, and 2006 budgets, Treasury changed how it computed the accelerated depreciation tax expenditure under the normal baseline by using a measure of economic depreciation rather than straight-line depreciation as the baseline depreciation method, which was used in prior years. The measure of economic depreciation is generally faster than the straight-line method, so the tax expenditure estimates for accelerated depreciation for fiscal years 2002, 2003, and 2004 (from the 2004, 2005, and 2006 budgets) are smaller than what they would have been if the straight-line depreciation method were used. In addition, in the 2004 budget, Treasury began reporting two supplemental baselines, as discussed in figure 14.

Figure 14: Treasury's Supplemental Reporting for Comprehensive Income and Consumption Tax Baselines

In the 2004 budget, Treasury began reporting estimates for the 30 largest tax expenditures using comprehensive income and consumption tax baselines.

- Treasury defines its comprehensive income baseline as the real—inflation adjusted—accrual of wealth arising between the beginning and end of the year. The comprehensive income baseline includes all accrual of wealth, whether or not realized, whether or not related to a market transaction, and whether it is a return to capital or labor. Inflation adjusted capital gains would be included in comprehensive income as they accrue. According to Treasury's reporting, 13 large tax expenditures under its normal and reference baselines, such as capital gains on home sales, would continue to be considered tax expenditures under a comprehensive baseline. Treasury was uncertain about whether 6 would still be considered tax expenditures and concluded 4 would probably not be tax expenditures under the comprehensive income tax baseline. The tax exemption of in-kind benefits from government programs such as food stamps, public housing, and Medicaid would be added to Treasury's tax expenditure list under the comprehensive income tax baseline.

- Treasury defines its consumption baseline as a combination of an income tax plus a deduction for net saving. The major difference between Treasury's comprehensive income and consumption baselines is the treatment of tax expenditures related to saving. According to Treasury, 4 tax expenditures under its normal or reference baseline would still be considered tax expenditures under its consumption baseline, and another 12 would probably still be considered tax expenditures as well, such as the child tax credit. The capital gains exclusion on home sales would not be considered a tax expenditure under the consumption tax baseline. However, tax expenditures unrelated to broad based saving incentives would remain tax expenditures under a consumption baseline.

Source: Office of Management and Budget. *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2006*, (Washington, D.C.: 2005).

Both Treasury and JCT provide estimates of revenue loss, which is the amount of revenue that the government forgoes as the result of each special provision in the tax code. Revenue loss is estimated for each tax expenditure separately by comparing the revenue raised under current law with the revenue that would have been raised if the single provision did not exist, assuming that taxpayer behavior and all other tax and spending provisions remain constant. A revenue loss estimate does not represent the amount of revenue that would be gained if a particular tax expenditure were repealed, since repeal of the expenditure would probably change taxpayer behavior in some way that would affect revenue.

Treasury and JCT tax expenditure lists will also differ because each organization uses a different de minimis amount, which is the minimum amount of revenue loss threshold for Treasury and JCT to report a tax expenditure. JCT excludes tax expenditure estimates that result in revenue losses that are less than $50 million over its 5-year projected period. For instance, the tax exemption for certain small insurance companies was not included in JCT's January 2005 list of tax expenditures because the estimated revenue loss was below its de minimis amount. Treasury rounds all yearly estimates to the nearest $10 million and excludes tax expenditures with estimates that round to zero in each of the 7 years that it reports tax expenditure estimates.

JCT and Treasury estimates of revenue loss also differ somewhat due to different economic and technical assumptions. For instance, JCT and Treasury use different sources for macroeconomic assumptions incorporated in their revenue loss estimates. JCT uses CBO macroeconomic assumptions in its tax expenditure projections and Treasury uses assumptions based on consultations with OMB, and the Council of Economic Advisers,[1] the same assumptions used for the President's budget. In addition to projecting future revenue losses, Treasury also reports re-estimates for the past fiscal year, which incorporate changes in tax policy and reflect more up-to-date economic and taxpayer data. Table 3 compares tax expenditure reporting by JCT and Treasury.

[1] At OMB, the economic forecast is produced by the Troika: economists drawn from the Council of Economic Advisers, the Department of the Treasury, and OMB.

Table 3: Comparison of Tax Expenditure Reporting by JCT and Treasury

Report Elements	Joint Committee on Taxation (JCT)	U.S. Department of the Treasury
Period covered	Current fiscal year and 4 future fiscal years	Last fiscal year, current fiscal year, and 5 future fiscal years
Baseline used	Normal	Reference (since 1983), normal
Measurement estimates produced	Revenue loss	Revenue loss, outlay-equivalent
Macroeconomic assumptions	Congressional Budget Office (CBO) (mid-year update)	OMB, Treasury, and Council of Economic Advisers[a]
De minimis rule	Excludes provisions with estimates of less than $50 million over the 5-year period	Rounds all yearly estimates to the nearest $10 million and excludes provisions with estimates that round to zero in each of the 7 years
Categorized by	Budget function, taxpayer group (i.e., individual or corporate)	Budget function, taxpayer group (i.e., individual or corporate)
Supplemental information	Distributional estimates by income class (for 9 expenditures); summary of recent legislation regarding tax expenditures; list of expiring tax expenditure provisions; and summary of differences between Treasury and JCT lists of tax expenditures	Present value estimates (for deferral expenditures); comprehensive and consumption baselines used (for select expenditures)

Sources: Office of Management and Budget, *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2006* (Washington, D.C.: 2005); Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2005-2009*, JCS-1-05 (Washington, D.C.: Jan. 12, 2005); and Polackova Brixi, Hana, and Christian M.A. Valenduc, and Zhicheng Li Swift, *Tax Expenditures—Shedding Light on Government Spending through the Tax System: Lessons from Developed and Transition Economies* (Washington, D.C.: The World Bank, 2004).

[a] Estimates are based on mid-session economic assumptions; exceptions are the earned income tax credit and the child tax credit, which involve outlay components and hence are updated to reflect the economic assumptions used elsewhere in the budget. At OMB, the economic forecast is produced by the Troika: economists drawn from the Council of Economic Advisers, the Department of the Treasury, and OMB. See *Analytical Perspectives*, "Economic Assumptions and Analyses" for a discussion of the Troika assumptions.

Outlay-Equivalent Estimates Facilitate Comparison to Direct Spending Programs

In addition to revenue loss estimates, Treasury also measures tax expenditures in terms of their outlay-equivalent value, which allows the cost of a tax expenditure to be compared with a direct federal outlay, were each to provide the same benefit to the taxpayer. JCT does not produce outlay-equivalent estimates. The underlying economic assumptions used

for the outlay-equivalent and revenue loss estimates are the same. However, to estimate outlay-equivalents, Treasury will increase—"gross up"—the revenue loss estimate by the average marginal tax rate that applies to the relevant taxpayers (the taxpayers that take the particular credit or deduction or earn the income that is excluded from tax).[2] The result is an estimate of the amount of direct spending that would be needed to leave the relevant taxpayer with the same amount of benefit, after he or she paid tax on the amount received through the spending, as the taxpayer would get from the tax provision itself. For example, the outlay-equivalent estimate for the housing and meal allowances for military personnel tax expenditure reflects the additional pre-tax income that military personnel would have to be paid to raise their income after federal taxes by the amount of the benefits, so that it can be compared with other defense outlays on a consistent basis. An exception to this general rule of increasing the revenue loss estimate is made for tax expenditures that are believed to reduce the price of particular goods and services. In this case no gross up is made because a spending program that led to the same price reduction would not increase the tax liability of the taxpayer. For instance, revenue loss estimates for accelerated depreciation on rental housing and state prepaid tuition do not differ from the outlay-equivalent estimates for these tax expenditures.

Outlay-equivalents can also differ from revenue loss estimates because they are calculated based on an even flow of virtual payments over the year to make the estimates comparable to actual outlay programs. Even for those tax expenditures that do not require a calculated adjustment, differences between the revenue losses and outlay-equivalents can occur solely because of differences in timing factors. Although revenue loss estimates can be affected by the collection patterns of the corporate and personal income taxes, the cash flow of direct spending programs can differ widely from the annual tax collection cycle. Of the 146 tax expenditures reported in the fiscal year 2006 budget, 91 were "grossed up" for the outlay-equivalent estimate with the implied rate varying across different provisions. Just as there is debate over which tax provisions should be listed as tax expenditures, tax experts do not always agree on whether specific tax expenditures should be grossed up or not. It may not

[2]The net revenue loss for the federal government would be unchanged. Assuming the comparable outlay program would be taxable, the recipients would pay taxes on the higher outlay amount, and federal revenue also would be higher—resulting in no net change in the federal budget position.

be apparent to observers why the outlay-equivalent and revenue loss estimates are the same for some tax expenditures and why they differ for other tax expenditures.[3]

Other estimates of tax expenditures produced by JCT and Treasury also may differ from revenue loss estimates. These supplemental estimates are discussed in figure 15.

Figure 15: Supplemental Estimates Developed by Treasury and JCT

- Since the 1995 fiscal year budget, Treasury has produced present value estimates for the approximately 20 tax expenditures that involve tax deferrals or other long-term revenue effects. Revenue loss estimates, which are cash based, can overstate the real effect on receipts to the government for tax deferrals because deferred taxes will ultimately be paid. To produce present value estimates Treasury must make certain assumptions. Assumptions also may be specific to individual tax expenditures, such as the time frame when people will retire and begin to collect funds from retirement accounts (and pay income taxes on them). Treasury uses the simplifying assumption that interest rates and tax rates remain constant over time.
- JCT also presents a distributional analysis of several tax expenditures. This analysis estimates the amount of benefits by income class for the deductions for medical expenses, real estate taxes, charitable contributions, and the child care and earned income credits. JCT does not report all individual tax expenditures because of the difficulty in making reliable estimates of the income distribution of items that do not appear on tax returns under present law.

Sources: Office of Management and Budget, *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2006* (Washington, D.C.: 2005); and Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2004-2008,* JCS-8-03 (Washington, D.C.: Dec. 22, 2003).

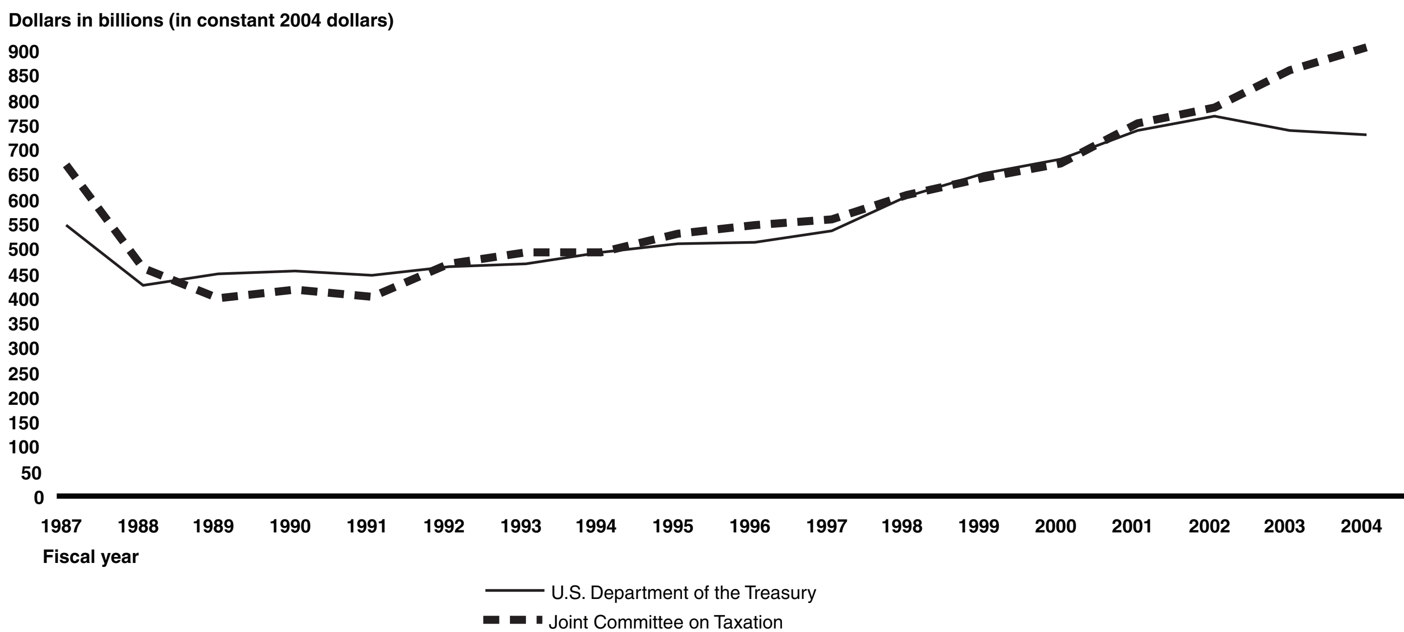
Comparison of JCT With Treasury Tax Expenditure Lists

Although there are differences between how Treasury and JCT develop and measure tax expenditures, the sum of revenue loss estimates from each list has followed relatively the same trend in the past. Figure 16 compares the sum of revenue loss estimates for JCT and Treasury since the last comprehensive tax reform, when the Tax Reform Act of 1986 was adopted. Since fiscal year 2002, the trends in the sums of the two sets of revenue loss estimates have diverged. Since the fiscal year 2004 Budget, Treasury's

[3]For more information on how outlay-equivalent estimates are measured, see the Office of Management and Budget, *Special Analysis G—Fiscal Year 1983* (Washington, D.C.: 1982); and the U.S. Congressional Budget Office, *Tax Expenditures: Current Issues and 5-Year Budget Projections for Fiscal Years 1984-1988* (Washington, D.C.: October 1983).

estimates of dividends and capital gains tax expenditures are lower than JCT's, at least in part, because Treasury changed its definition of the tax expenditures to reflect the reduced tax rates only on dividends and capital gains from sources other than corporate equity. Treasury also redefined the accelerated depreciation tax expenditures under the normal baseline to reflect depreciation relative to a replacement cost basis, rather than the historic cost basis previously used.

Figure 16: Sum of Revenue Loss Estimates Reported by the Joint Committee on Taxation and the U.S. Department of the Treasury (1987-2004)



Source: GAO analysis of OMB Fiscal Year Budget and Joint Committee on Taxation Reports on Tax Expenditures, fiscal years 1989-2005.

Notes: Summing the revenue loss estimates does not take into account possible interaction effects among the tax expenditures. Changes in economic conditions and estimation techniques, can affect revenue loss estimates for tax expenditures, making them differ from year to year. Changes to the number of tax expenditures reported by Treasury would also affect the amount of revenue loss reported if some tax expenditures were eliminated or added. Finally, revenue loss estimates include the effect of certain tax credits on receipts only and not the effect of the credits on outlays.

Table 4 lists the tax expenditures and their associated revenue loss estimates that were reported by both Treasury and JCT for fiscal year 2004. The table details the number and size of tax expenditure estimates between the two lists. For example, in the National Defense budget function, the revenue loss estimate for the exclusion of benefits and allowances to

armed forces personnel was estimated at $2.5 billion by Treasury and $2.7 billion by JCT. In the same function, JCT also reported revenue losses for two tax expenditures not listed by Treasury.

Table 4: List of Tax Expenditures Reported by the U.S. Department of the Treasury and the Joint Committee on Taxation for Fiscal Year 2004

Dollars in millions

		Treasury estimates		JCT estimates	
Budget function	**Tax expenditure name**	**Corporate**	**Individual**	**Corporate**	**Individual**
National Defense	Exclusion of benefits and allowances to Armed Forces personnel		2,460		2,700
	Exclusion of military disability benefits[b]				100
	Deduction for overnight-travel expenses of National Guard and Reserve Members[b]				100
International Affairs	Exclusion of income earned abroad by U.S. citizens		2,680		3,400
	Exclusion of certain allowances for federal employees abroad		850		400
	Extraterritorial income exclusion	5,500		5,200	
	Inventory property sales source rule exception	1,500		5,400	
	Deferral of income of controlled foreign corporations	7,240		4,600	
	Deferred taxes for financial firms on certain income earned overseas	2,130		1,900	
General Science, Space, and Technology	Expensing of research and experimental expenditures	-2,280	-50	3,500	100
	Credit for increasing research activities	4,630	50	3,900	[a]
Energy	Expensing of exploration and development costs [d]	230	30	500	[a]
	Expensing of exploration and development costs: other fuels [b]			[a]	[a]
	Excess of percentage over cost depletion[e]	1,210	110	400	[a]
	Excess of percentage over cost depletion: other fuels [b]			[a]	[a]
	Alternative fuel production credit	1,000	40	500	100
	Exception from passive loss limitation for working interests in oil and gas properties [c]		20		
	Capital gains treatment of royalties on coal [c]		70		
	Exclusion of interest on energy facility bonds	20	80	[a]	100
	Enhanced oil recovery credit	300	30	200	100
	New technology credit	330		[a]	[a]

(Continued From Previous Page)

Dollars in millions

		Treasury estimates		JCT estimates	
Budget function	Tax expenditure name	Corporate	Individual	Corporate	Individual
	Alcohol fuel credit[f]	20	10	[a]	
	Tax credit and deduction for clean fuel-burning vehicles[c]	20	50		
	Exclusion from income of conservation subsidies provided by public utilities		100		[a]
	Tax credit for electricity production from wind, biomass, and poultry waste[b]			200	[a]
Natural Resources and Environment	Expensing of exploration and development costs, nonfuel minerals	210	20	[a]	[a]
	Excess of percentage over cost depletion, nonfuel minerals			100	100
	Exclusion of interest on bonds for water, sewage, and hazardous waste facilities	110	390	200	500
	Capital gains treatment of certain timber income[c]		70		
	Expensing of multiperiod timber-growing costs	230	110	200	[a]
	Tax incentives for preservation of historic structures (under Commerce and housing credit budget function for JCT)	230	70	400	100
	Special rules for mining reclamation reserves[b]			[a]	[a]
	Special tax rate for nuclear decommissioning reserve fund[b]			300	
	Exclusion of contributions in aid of construction for water and sewer utilities[b]			[a]	
	Expensing of capital costs with respect to complying with EPA sulfur regulations[b]				
	Exclusion of gain or loss on sale or exchange of certain brownfield sites[b]				
Agriculture	Expensing of certain capital outlays	20	80	[a]	300
	Expensing of fertilizer and soil conditioner costs[b]			[a]	100
	Expensing of soil and water conservation expenditures[b]			[a]	[a]
	Expensing of certain multiperiod production costs[c]	10	40		
	Treatment of loans forgiven for solvent farmers		10		100
	Capital gains treatment of certain income[c]		670		
	Income averaging for farmers		40		[a]
	Deferral of gain on sales of farm refiners[c]	10			
	Bio-Diesel tax credit[b]				
	Exclusion of cost-sharing payments[b]			[a]	[a]

(Continued From Previous Page)

Dollars in millions

Budget function	Tax expenditure name	Treasury estimates		JCT estimates	
		Corporate	Individual	Corporate	Individual
	Expensing of the costs of raising dairy and breeding cattle [b]			[a]	100
	Five-year carryback period for net operating losses attributable to farming [b]			[a]	[a]
Commerce and Housing Credit	Exemption of credit union income	1,270		1,200	
	Excess bad debt reserves of financial institutions [c]	-20			
	Exclusion of interest on life insurance savings	2,010	18,820	1,400	24,700
	Special alternative tax on small property and casualty insurance companies [c]	10			
	Deduction of unpaid property loss reserves for property and casualty insurance companies [b]			1,500	
	Tax exemption of certain insurance companies owned by tax-exempt organizations [c]	180			
	Small life insurance company deduction	80		100	
	Special treatment of life insurance company reserves[b]			1,700	
	Exclusion of interest on owner-occupied mortgage subsidy bonds	220	800	300	800
	Exclusion of interest on rental housing bonds	80	280	100	200
	Deductibility of mortgage interest on owner-occupied homes		61,450		61,400
	Deductibility of state and local property tax on owner-occupied homes		19,930		18,700
	Capital gains exclusion on home sales		29,730		17,900
	Exclusion of net imputed rental income on owner-occupied homes [c]		24,590		
	Exception from passive loss rules for $25,000 of rental loss [c]		5,030		
	Credit for low-income housing investments	2,930	730	3,000	1,300
	Accelerated depreciation on rental housing	-10	760	300	3,000
	Deferral of income from post-1987 installment sales	290	810	600	400
	Cancellation of indebtedness [c]		30		
	Exceptions from imputed interest rules		50	[a]	300
	Capital gains (except agriculture, timber, iron ore, and coal)		25,150		66,100
	Capital gains exclusion of small corporation stock [c]		160		
	Step-up basis of capital gains at death		24,200		35,900

(Continued From Previous Page)

Dollars in millions

Budget function	Tax expenditure name	Treasury estimates		JCT estimates	
		Corporate	Individual	Corporate	Individual
	Carryover basis of capital gains on gifts		210		4,300
	Ordinary income treatment of loss from small business corporation stock sale [c]		50		
	Accelerated depreciation of buildings other than rental housing	-2,980	-280	1,800	1,900
	Accelerated depreciation of machinery and equipment	37,080	7,610	52,900	16,100
	Expensing of certain small investments (JCT did not report a revenue loss estimate)	680	840		
	Amortization of start-up costs	70	10	[a]	600
	Deduction for U.S. production activities [b]				
	Special rules for certain film and TV production[b]				
	Graduated corporation income tax rate	2,450		3,300	
	Exclusion of interest on small issue bonds	100	350	100	300
	Deferral of gain on like-kind exchanges [b]			1,200	400
	Deferral of gain on involuntary conversions resulting from Presidentially-declared disasters[b]				[a]
	Expensing of magazine circulation expenditures [b]			[a]	[a]
	Special rules for magazine, paperback book, and record returns [b]			[a]	[a]
	Completed contract rules [b]			200	[a]
	Cash accounting, other than agriculture [b]			[a]	700
	Exception from net operating loss limitations for corporations in bankruptcy proceedings [b]			700	
	Tax credit for employer-paid FICA taxes on tips[b]			200	300
Transportation	Deferral of tax on shipping companies	20		100	
	Deduction for clean fuel vehicles and refueling property [b]			[a]	200
	Exclusion of reimbursed employee parking expenses [c]		2,470		
	Exclusion of employer-provided transit passes		410		3,800
	Tax credit for certain expenditures for maintaining railroad tracks [b]				
Community and Regional Development	Investment credit for rehabilitation of structures, other than historic	20	20	100	[a]
	Exclusion of interest for airport, dock, and similar bonds	180	670	200	600

(Continued From Previous Page)

Dollars in millions

		Treasury estimates		JCT estimates	
Budget function	Tax expenditure name	Corporate	Individual	Corporate	Individual
	Exemption of certain mutuals and cooperatives income [c]	60			
	Empowerment zones, enterprise communities, and renewal communities [c]	280	800		
	Empowerment zone tax incentives [b]			300	300
	Renewal community tax incentives [b]			100	300
	New markets tax credit	70	220	100	200
	Expensing of environmental remediation costs	70	10	[a]	[a]
	Deferral of capital gains with respect of dispositions of transmission property [b]				
	New York City Liberty Zone tax incentives [b]			100	200
	District of Columbia tax incentives [b]			[a]	[a]
	Wage credit for Indian reservation employment[b]			[a]	[a]
	Accelerated depreciation for Indian reservation investments [b]			100	100
Education, Training, Employment, and Social Services	Exclusion of scholarship and fellowship income		1,320		1,500
	HOPE tax credit		3,320		4,300
	Lifetime Learning tax credit [c]		2,190		
	Education Individual Retirement Accounts		110		300
	Deductibility of student loan interest		760		700
	Deduction for higher education expenses		1,280		2,700
	State pre-paid tuition plans		210		500
	Exclusion of interest on student loan bonds	60	230	100	300
	Exclusion of interest on bonds for private nonprofit educational facilities	210	760	300	800
	Credit for holders of zone academy bonds	90		100	
	Exclusion of interest on savings bonds redeemed to finance educational expenses		10		[a]
	Parental personal exemption for students age 19 or over		3,200		1,500
	Deductibility for charitable contributions (education)	510	3,180	1,100	5,200
	Exclusion of employer-provided education assistance		530		800
	Special deduction for teacher expenses		150		100
	Work opportunity tax credit	240	40	200	[a]

(Continued From Previous Page)

Dollars in millions

		Treasury estimates		JCT estimates	
Budget function	Tax expenditure name	Corporate	Individual	Corporate	Individual
	Welfare-to-work tax credit	50	10	100	[a]
	Employer-provided child care exclusion [g]		600		800
	Employer-provided child care credit			100	[a]
	Assistance for adopted foster children [c]		290		
	Adoption credit and exclusion		450		100
	Exclusion of employee meals and lodging (other than military)		810		900
	Child credit [h]		22,400		44,100
	Credit for child and dependent care expenses		2,990		3,100
	Credit for disabled access expenditures	10	20	[a]	100
	Deductibility for charitable contributions, other than education and health	1,170	26,200	1,800	27,900
	Exclusion of certain foster care payments		440		600
	Exclusion of parsonage allowances		430		400
	Exclusion of benefits provided under cafeteria plans [b i]				16,900
	Exclusion of miscellaneous fringe benefits [b]				5,800
	Exclusion of employee awards [b]				100
	Exclusion of income earned by voluntary employees' beneficiary associations [b]				3,200
	Deferral of taxation on spread on acquisition of stock under incentive stock option plans and employee stock purchase plans [b j]				400
Health	Exclusion of employer contributions for medial insurance premiums and medical care[k]		102,250		96,000
	Deductibility of self-employed medical insurance premiums		3,300		3,300
	Medical savings accounts/health savings accounts		620		300
	Deductibility of medical expenses		7,380		5,900
	Exclusion of interest on hospital construction bonds	400	1,470	500	1,200
	Exclusion of workers' compensation benefits (medical benefits)[b]				3,700
	Deductibility of charitable contributions (health)	150	2,940	900	3,500
	Tax credit for orphan drug research	180		200	
	Special Blue Cross/Blue Shield deduction (in Commerce and housing credit budget function for JCT)	400		500	

(Continued From Previous Page)

Dollars in millions

Budget function	Tax expenditure name	Treasury estimates		JCT estimates	
		Corporate	Individual	Corporate	Individual
	Tax credit for health insurance purchased by certain displaced and retired individuals[l]		50	[a]	[a]
	Exclusion of medical care and CHAMPUS/TRICARE medical insurance for military dependents, retirees, and retiree dependents[b]				1,700
Medicare	Exclusion of untaxed Medicare benefits: hospital insurance (Part A)[b]				16,800
	Exclusion of untaxed Medicare benefits: supplementary medical insurance (Part B)[b]				11,000
	Exclusion of untaxed Medicare benefits: prescription drug insurance (Part D)[b]				
	Exclusion of certain subsidies to employers who maintain prescription drug plans for Medicare[b]				
Income Security	Exclusion of railroad retirement system benefits[c] (For JCT this is combined with the exclusion of Social Security benefits: retired workers)		400		
	Exclusion of worker's compensation benefits		5,490		4,800
	Exclusion of public assistance benefits		410		3,200
	Exclusion of special benefits for disabled coal miners		60		100
	Exclusion of military disability pensions[c]		100		
	Exclusion of damages on account of personal physical injuries or physical sickness[b]				1,400
	Net exclusion of pension contributions and earnings: employer plans		46,970		94,600
	Net exclusion of pension contributions and earnings: 401(k) plans[c]		47,730		
	Net exclusion of pension contributions and earnings: individual retirement plans		7,450		13,000
	Net exclusion of pension contributions and earnings: low and moderate income savers credit[c]		970		
	Net exclusion of pension contributions and earnings: Keogh plans		8,830		6,200
	Exclusion of other employee benefits: premiums on group term life insurance		2,070		2,400
	Exclusion of other employee benefits: premiums on accident and disability insurance		260		2,400
	Small business retirement plan credit	40	40	[a]	[a]
	Income of trusts to finance supplementary unemployment benefits[c]		20		

(Continued From Previous Page)

Dollars in millions

		Treasury estimates		JCT estimates	
Budget function	**Tax expenditure name**	**Corporate**	**Individual**	**Corporate**	**Individual**
	Special employee stock ownership plans (ESOPs) rules (Located under the Education budget function for JCT)	1,600	320	800	300
	Additional deduction for the blind [c]		30		
	Additional deduction for the elderly [c]		1,700		
	Additional standard deduction for the blind and the elderly [b]				2,000
	Tax credit for the elderly and disabled		20		[a]
	Deduction of casualty losses		550		200
	Earned income tax credit (EITC)[m]		4,893		34,100
	Tax credit for certain individuals for elective deferrals and IRA contributions [b]				2,500
Social Security	Exclusion of Social Security benefits: retired workers (JCT included railroad retirement benefits)		19,200		20,000
	Exclusion of Social Security benefits: disabled [c]		3,580		
	Exclusion of Social Security benefits: dependents and survivors [c]		4,140		
Veterans' Benefits and Services	Exclusion of veterans death benefits and disability compensation		3,300		3,100
	Exclusion of veterans' pensions		110		100
	Exclusion of GI bill benefits		130		200
	Exclusion of interest on veterans' housing bonds	10	40	[a]	[a]
General Purpose Fiscal Assistance	Exclusion of interest on public purpose state and local bonds	6,210	19,940	7,100	18,200
	Deductibility of nonbusiness state and local taxes other than owner-occupied homes		45,290		44,300
	Tax credit for corporations receiving income from doing business in U.S. possessions	1,000		1,400	
Interest	Deferral of interest on U.S. savings bonds		50		1,700

Source: OMB. *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2006.* (Washington, D.C.: 2005; and JCT, *Estimates of Federal Tax Expenditures for Fiscal Years 2004-2008*, JCS-8-03 (Washington, D.C.: December 22, 2003).

Notes: Treasury estimates were rounded to the nearest $10 million. Provisions with estimates that rounded to zero in each year were not reported by Treasury.

[a] An estimate was not reported by JCT because the positive tax expenditure was less than $50 million.

[b] Tax expenditure reported by JCT only. The exclusion of untaxed Medicare benefits: prescription drug insurance (Part D) and the exclusion of certain subsidies to employers who maintain prescription drug plans for Medcare were listed by JCT as tax expenditures, but revenue loss estimates were reported only for future years.

[c] Tax expenditure reported by Treasury only. Seven additional tax expenditures were reported on Treasury's list in the fiscal year 2006 budget, but estimates for these tax expenditures were reported

only for future years. The seven tax expenditures are: (1) expensing of capital costs with respect to complying with EPA sulfur regulations, (2) exclusion of gain or loss on sale or exchange of certain Brownfield sites, (3) Bio-diesel tax credit, (4) deduction for U.S. production activities, (5) special rules for certain film and TV production, (6) tax credit for certain expenditures for maintaining railroad tracks, and (7) deferral of capital gains with respect of dispositions of transmission property.

[d]JCT reported this tax expenditure as "expensing of exploration and development costs, oil and gas."

[e]JCT reported this tax expenditure as "excess of percentage over cost depletion, oil and gas."

[f]For the Treasury estimates, the partial exemption from the excise tax for alcohol fuels results in a reduction in excise tax receipts of $1.4 billion in 2004. For the JCT estimates, the exemption from the excise tax for alcohol fuels results in a reduction in excise tax receipts, net of income tax effect, of $1.1 billion in each of the fiscal years 2004 through 2006, and $1.2 billion per year in fiscal years 2007 and 2008.

[g]The JCT estimate includes employer-provided child care purchased through dependent care flexible spending accounts.

[h]The Treasury estimate in the table indicates the effect of the child tax credit on receipts. The effect of the credit on outlays is $8.9 billion in 2004. The JCT estimate includes refundable amounts, amounts used to offset income taxes, and amounts used to offset other taxes. The amount of refundable child tax credit and earned income tax credit used to offset taxes other than income tax or paid out as refunds is $44.3 billion in 2004.

[i]The estimate includes amounts of employer-provided health insurance purchased through cafeteria plans and employer-provided child care purchased through dependent care flexible spending accounts.

[j]The estimate does not include offsetting denial of corporate deduction for qualified stock option compensation.

[k]The JCT estimate includes employer-provided health insurance purchased through cafeteria plans.

[l]In addition to the receipts shown, there are outlays of $70 million in 2004.

[m]The Treasury estimate indicates the effect of the earned income tax credit on receipts. The effect of the credit on outlays is $33.1 billion in 2004. The JCT estimate includes refundable amounts, amounts used to offset income taxes, and amounts used to offset other taxes. The amount of refundable child tax credit and earned income tax credit used to offset taxes other than income tax or paid out as refunds is $44.3 billion in 2004.

For fiscal year 2004, table 5 lists the aggregate revenue loss estimates reported by both Treasury and JCT for each budget function. The table permits a comparison of the number and size of Treasury's versus JCT's tax expenditure estimates when summed by budget function.

Table 5: Sum of Revenue Loss Estimates for Tax Expenditures by Budget Function Reported by the U.S. Department of the Treasury and Joint Committee on Taxation, Fiscal Year 2004

Dollars in millions

	Treasury		JCT	
Budget Function	**Sum of Revenue Loss Estimates**	**Number of Tax Expenditures**	**Sum of Revenue Loss Estimates**	**Number of Tax Expenditures**
National defense	$2,460	1	$2,900	3
International affairs	19,900	6	20,900	6
General science, space, and technology	2,350	12	7,500	2
Energy	3,670	11	2,100	11
Natural resources and environment	1,440	5	1,900	8
Agriculture	880	6	600	8
Commerce and housing credit	265,750	29	325,900	33
Transportation	2,900	3	4,100	3
Community and regional development	2,400	6	2,700	10
Education, training, employment, and social services	74,270	27	128,000	32
Health	119,140	9	117,700	11
Medicare	N/A	N/A	27,800	4
Income security	129,953	20	168,000	16
Social security	26,920	3	20,000	1
Veterans' benefits and services	3,590	4	3,400	4
General purpose fiscal assistance	72,440	3	71,000	3
Interest	50	1	1,700	1

Source: GAO Analysis.

Note: Summing the revenue loss estimates by budget fuction does not take into account possible interaction effects among the tax expenditures.

Compilation of Tax Expenditures Reported by Treasury (1974 to 2004)

To identify how tax expenditures have changed over the past three decades in number and size, in terms of aggregate revenue loss, we analyzed the list of tax expenditures reported by the Department of the Treasury (Treasury) in the Budget's Special Analyses, Appendixes, and Analytical Perspectives for fiscal years 1974 to 2004. The tax expenditures reported by Treasury during this period are listed in table 6.

Table 6: Tax Expenditures Reported by the U.S. Department of the Treasury (1974 to 2004)

Name of Tax Expenditure (Organized by Budget Function)	First Year Reported by Treasury	Last Year Reported by Treasury	Type	Taxpayer Group
National defense				
Exclusion of benefits and allowances to armed forces personnel	1974	2004	Exclusion	Individual
International affairs				
Exclusion of gross-up on dividends of LDC corporations	1974	1976	Exclusion	Corporate
Special rate for Western Hemisphere trade corporations	1974	1979	Preferential tax rate	Corporate
Deferral of income of domestic international sales corporations (DISC)	1974	1985	Deferral	Corporate
Exclusion of income earned abroad by U.S. citizens	1974	2004	Exclusion	Individual
Deferral of income from controlled foreign corporations (normal tax method)	1977	2004	Deferral	Corporate
Exclusion of income of foreign sales corporations (FSC)	1984	2000	Exclusion	Corporate
Interest allocation rules exception for certain financial operations	1986	1995	Deduction	Corporate
Inventory property sales source rules exception	1986	2004	Credit	Corporate
Deferred taxes for financial firms on certain income earned overseas	1998	2004	Deferral	Corporate
Exclusion of certain allowances for federal employees abroad	1999	2004	Exclusion	Individual
Extraterritorial income exclusion	2000	2004	Exclusion	Corporate
General science, space, and technology				
Expensing of research and experimentation expenditures (normal tax method)	1974	2004	Deferral	Individual and Corporate
Credit for increasing research activities	1981	2004	Credit	Individual and Corporate
Suspension of the allocation of research and experimentation expenditures	1983	1995	Deduction	Corporate

(Continued From Previous Page)

Name of Tax Expenditure (Organized by Budget Function)	First Year Reported by Treasury	Last Year Reported by Treasury	Type	Taxpayer Group
Energy				
Capital gains treatment of royalties on coal	1974	2004	Preferential tax rate	Individual
Excess of percentage over cost depletion, fuels	1974	2004	Deduction	Individual and Corporate
Expensing of exploration and development costs, fuels	1974	2004	Deferral	Individual and Corporate
Residential energy credits	1978	1987	Credit	Individual
New technology credit	1978	2004	Credit	Corporate
Energy credit for intercity buses	1980	1989	Credit	Corporate
Alcohol fuel credits	1980	2004	Credit	Individual and Corporate
Alternative fuel production credit	1980	2004	Credit	Individual and Corporate
Exclusion of interest on energy facility bonds	1980	2004	Exclusion	Individual and Corporate
Exception from passive loss limitation for working interests in oil and gas properties	1988	2004	Deduction	Individual
Tax credit and deduction for clean-fuel burning vehicles	1992	2004	Credit/ Deduction	Individual and Corporate
Exclusion of conservation subsidies provided by public utilities	1993	2004	Exclusion	Individual
Enhanced oil recovery credit	1994	2004	Credit	Individual and Corporate
Natural resources and environment				
Pollution control: 5-year amortization	1974	1980	Deferral	Corporate
Capital gains treatment of certain timber income	1974	2004	Preferential tax rate	Individual
Exclusion of interest on bonds for water, sewage, and hazardous waste facilities	1975	2004	Exclusion	Individual and Corporate
Exclusion of payments in aid of construction of water, sewage, gas and electric utilities	1976	1981	Exclusion	Corporate
Capital gains treatment of iron ore	1977	1997	Preferential tax rate	Individual
Tax incentives for preservation of historic structures	1977	2004	Credit	Individual and Corporate
Investment credit and 7-year amortization for reforestation expenditures	1980	2000	Credit/ Deferral	Individual
Excess of percentage over cost depletion, nonfuel minerals	1980	2004	Deferral	Individual and Corporate
Expensing of exploration and development costs, nonfuel minerals	1980	2004	Deferral	Corporate

(Continued From Previous Page)

Name of Tax Expenditure (Organized by Budget Function)	First Year Reported by Treasury	Last Year Reported by Treasury	Type	Taxpayer Group
Special rules for mining reclamation reserves	1984	1997	Deduction	Individual and Corporate
Expensing of multiperiod timber growing costs	1986	2004	Deferral	Individual and Corporate
Expensing of capital costs with respect to complying with EPA sulfur regulations	2004	2004	Deferral	Corporate
Exclusion of gain or loss on sale or exchange of certain brownfield sites	2004	2004	Exclusion	Individual and Corporate
Agriculture				
Capital gain treatment of certain income	1974	2004	Preferential tax rate	Individual
Expensing of certain capital outlays	1974	2004	Deferral	Individual and Corporate
Deductibility of noncash patronage dividends and certain other items of cooperatives	1977	1981	Deduction	Individual and Corporate
Exclusion of certain cost-sharing payments	1978	1981	Exclusion	Individual
Special investment tax credit carryback rules for farming	1986	1987	Credit	Individual
Expensing of certain multiperiod production costs	1986	2004	Deferral	Individual and Corporate
Treatment of loans forgiven for solvent farmers	1986	2004	Exclusion	Individual
Deferral of 1988 drought-related payments	1988	1990	Deferral	Individual
Income averaging for farmers	1997	2004	Preferential tax rate	Individual
Deferral of gain on sale of farm refiners	1998	2004	Deferral	Corporate
Bio-diesel tax credit	2004	2004	Credit	Individual
Commerce and housing credit				
Surtax exemption (through 1978)	1974	1980	Preferential tax rate	Corporate
Dividend exclusion	1974	1987	Exclusion	Individual
Deductibility of interest on consumer credit	1974	1990	Deduction	Individual
Deferral of capital gain on home sales	1974	1997	Deferral	Individual
Capital gains (except agriculture, timber, iron ore, and coal)	1974	2004	Preferential tax rate	Individual
Deductibility of mortgage interest on owner-occupied homes	1974	2004	Deduction	Individual
Deductibility of state and local property tax on owner-occupied homes	1974	2004	Deduction	Individual
Accelerated depreciation of buildings other than rental housing (normal tax method)	1974	2004	Deferral	Individual and Corporate
Accelerated depreciation on rental housing (normal tax method)	1974	2004	Deferral	Individual and Corporate

(Continued From Previous Page)

Name of Tax Expenditure (Organized by Budget Function)	First Year Reported by Treasury	Last Year Reported by Treasury	Type	Taxpayer Group
Excess bad debt reserves of financial institutions	1974	2004	Deduction	Corporate
Exclusion of interest on life insurance savings	1974	2004	Exclusion	Individual and Corporate
Exemption of credit union income	1974	2004	Exemption	Corporate
Credit for purchase of new home	1975	1977	Credit	Individual
Excess first year depreciation	1975	1980	Deferral	Individual and Corporate
Expensing of construction period interest and taxes	1975	1981	Deferral	Individual and Corporate
Exclusion of interest on small issue bonds	1975	2004	Exclusion	Individual and Corporate
Exclusion of certain income of cooperatives	1976	1976	Exclusion	Individual and Corporate
Accelerated depreciation of machinery and equipment	1977	2004	Deferral	Individual and Corporate
Step-up basis of capital gains at death	1977	2004	Exclusion	Individual
Investment credit, other than employee stock ownership plans (ESOPs) and rehabilitation of structures, energy property, and reforestation expenditures	1978	1990	Credit	Corporate
Exclusion of capital gains on home sales for persons age 55 and over	1978	1997	Exclusion	Individual
Exclusion of interest on owner-occupied mortgage subsidy bonds	1978	2004	Exclusion	Individual and Corporate
Graduated corporation income tax rate (normal tax method)	1978	2004	Preferential tax rate	Corporate
Amortization of start-up costs	1980	2004	Deferral	Individual and Corporate
Exclusion of interest on rental housing bonds	1980	2004	Exclusion	Individual and Corporate
Exclusion of interest on certain savings certificates	1981	1984	Exclusion	Individual
Reinvestment of dividends in public utility stock	1981	1986	Exclusion	Individual
Safe harbor leasing rules	1981	1990	Deduction/ Credit	Corporate
Net interest exclusion	1983	1983	Exclusion	Individual
Small life insurance company deduction	1984	2004	Deduction	Corporate
Special investment tax credit carryback rules for steel companies	1986	1987	Credit	Corporate
Credit for low-income housing investments	1986	2004	Credit	Individual and Corporate
Exemption of RIC expenses from the 2% floor miscellaneous itemized deduction	1987	1993	Deduction	Individual

(Continued From Previous Page)

Name of Tax Expenditure (Organized by Budget Function)	First Year Reported by Treasury	Last Year Reported by Treasury	Type	Taxpayer Group
Deferral of income from post 1987 installment sales	1987	2004	Deferral	Individual and Corporate
Exception from passive loss rules for $25,000 of rental losses	1987	2004	Deduction	Individual
Small property and casualty insurance company deduction	1988	1988	Preferential tax rate	Corporate
Special merger rules for financial institutions	1988	1990	Deduction	Corporate
Treatment of Alaska Native Corporation	1988	1996	Exemption	Corporate
Carryover basis of capital gains on gifts	1988	2004	Deferral	Individual
Exceptions from imputed interest rules	1988	2004	Exclusion	Individual
Special alternative tax on small property and casualty insurance companies	1988	2004	Exemption	Corporate
Tax exemption of certain insurance companies owned by tax-exempt organizations	1988	2004	Exemption	Corporate
Ordinary income treatment of loss from small business corporation stock sale	1989	2004	Deduction	Individual
Deferral of gains from sale of broadcasting facilities to minority owned business	1990	1995	Deferral	Corporate
Cancellation of indebtness	1993	2004	Exclusion	Individual
Expensing of certain small investments	1993	2004	Deferral	Individual and Corporate
Capital gains exclusion of small corporation stock	1994	2004	Exclusion	Individual
Capital gains exclusion on home sales	1997	2004	Exclusion	Individual
Exclusion of net imputed rental income on owner-occupied homes	2004	2004	Exclusion	Individual
Deduction for U.S. production activities	2004	2004	Deduction	Individual and Corporate
Special rules for certain film and TV production	2004	2004	Deduction	Individual and Corporate
Transportation				
Deductibility of nonbusiness state gasoline taxes	1974	1979	Deduction	Individual
Five-year amortization on railroad rolling stock	1974	1980	Deferral	Corporate
Deferral of tax on shipping companies	1974	2004	Deferral	Corporate
Deduction for motor carrier operating rights	1981	1986	Deduction	Corporate
Exclusion of interest on state and local government bonds for mass commuting vehicles	1981	1990	Exclusion	Corporate
Exclusion for employer-provided transit passes	1993	2004	Exclusion	Individual
Exclusion of reimbursed employee parking expenses	1993	2004	Exclusion	Individual
Tax credit for certain expenditures for maintaining railroad tracks	2004	2004	Credit	Corporate

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Name of Tax Expenditure (Organized by Budget Function)	First Year Reported by Treasury	Last Year Reported by Treasury	Type	Taxpayer Group
Community and regional development				
Five-year amortization for housing rehabilitation	1974	1990	Deferral	Individual and Corporate
Investment credit for rehabilitation of structures (other than historic)	1974	2004	Credit	Individual and Corporate
Exclusion of interest for airport, dock, and similar bonds	1983	2004	Exclusion	Individual and Corporate
Exemption of certain mutuals and cooperatives income	1989	2004	Exemption	Corporate
Empowerment zones, enterprise communities, and renewal communities	1993	2004	Credit	Individual and Corporate
Expensing of environmental remediation costs	1997	2004	Deferral	Individual and Corporate
New market tax credit	2000	2004	Credit	Individual and Corporate
Deferral of capital gains with respect of dispositions of transmission property	2004	2004	Deferral	Corporate
Education, training, employment, and social services				
Child care facilities: 5-year amortization	1974	1975	Deferral	Corporate
Credit for employing AFDC recipients and public assistance recipients under work incentive program	1974	1982	Credit	Individual and Corporate
Credit for child and dependent care expenses	1974	2004	Credit	Individual
Deductibility of charitable contributions (education)	1974	2004	Deduction	Individual and Corporate
Deductibility of charitable contributions, other than education and health	1974	2004	Deduction	Individual and Corporate
Exclusion of employee meals and lodging (other than military)	1974	2004	Exclusion	Individual
Exclusion of scholarship and fellowship income	1974	2004	Exclusion	Individual
Parental personal exemption for students age 19 or over	1974	2004	Exemption	Individual
Maximum tax on personal service income	1975	1980	Exclusion	Individual
Investment credit for ESOPs	1976	1990	Credit	Corporate
Exclusion of other employee benefits: employer contributions to prepaid legal expense plan	1976	1992	Exclusion	Individual
Expensing of costs of removing certain architectural barriers to the handicapped	1976	1999	Deferral	Corporate
General jobs credit	1977	1984	Credit	Corporate
Exclusion of employer-provided educational assistance	1978	2004	Exclusion	Individual
Work opportunity tax credit	1978	2004	Credit	Individual and Corporate
Exclusion of interest on student loan bonds	1980	2004	Exclusion	Individual and Corporate

(Continued From Previous Page)

Name of Tax Expenditure (Organized by Budget Function)	First Year Reported by Treasury	Last Year Reported by Treasury	Type	Taxpayer Group
Deduction for certain adoption expenses	1981	1987	Deduction	Individual
Deduction for two earner married couples	1983	1987	Deduction	Individual
Employer-provided child care exclusion	1983	2004	Exclusion	Individual
Exclusion of interest on bonds for private nonprofit educational facilities	1983	2004	Exclusion	Individual and Corporate
Exclusion of parsonage allowances	1984	2004	Exclusion	Individual
Exclusion of certain foster care payments	1988	2004	Exclusion	Individual
Exclusion of interest on savings bonds redeemed to finance educational expenses	1988	2004	Exclusion	Individual
Credit for disabled access expenditures	1990	2004	Credit	Individual and Corporate
Adoption credit and exclusion	1996	2004	Credit/Exclusion	Individual
Child credit	1997	2004	Credit	Individual
Credit for holders of zone academy bonds	1997	2004	Credit	Corporate
Deductibility of student loan interest	1997	2004	Deduction	Individual
State prepaid tuition plans	1997	2004	Exclusion	Individual
Education individual retirement accounts	1997	2004	Exclusion	Individual
Welfare-to-work tax credit	1997	2004	Credit	Individual and Corporate
HOPE tax credit	1997	2004	Credit	Individual
Lifetime Learning tax credit	1997	2004	Credit	Individual
Assistance for adopted foster children	2000	2004	Exclusion	Individual
Deduction for higher education expenses	2001	2004	Deduction	Individual
Employer-provided child care credit	2001	2004	Credit	Corporate
Special deduction for teacher expenses	2003	2004	Deduction	Individual
Discharge of student loan indebtedness	2004	2004	Exclusion	Individual
Health				
Deductibility of medical expenses	1974	2004	Deduction	Individual
Exclusion of employer contributions for medical insurance premiums and medical care	1974	2004	Exclusion	Individual
Deductibility of charitable contributions (health)	1977	2004	Deduction	Individual and Corporate
Exclusion of interest on hospital construction bonds	1980	2004	Exclusion	Individual and Corporate
Tax credit for orphan drug research	1982	2004	Credit	Corporate
Exclusion of employer share of hospital insurance tax	1988	1992	Exclusion	Individual
Special Blue Cross/Blue Shield deduction	1988	2004	Deduction	Corporate
Credit for child medical insurance premiums	1990	1993	Credit	Individual

(Continued From Previous Page)

Name of Tax Expenditure (Organized by Budget Function)	First Year Reported by Treasury	Last Year Reported by Treasury	Type	Taxpayer Group
Medical Savings Accounts/Health Savings Accounts	1996	2004	Deduction	Individual
Workers' compensation insurance premiums	1998	2002	Deduction	Individual
Self-employed medical insurance premiums	1998	2004	Deduction	Individual
Tax credit for health insurance purchased by certain displaced and retired individuals	2002	2004	Credit	Individual
Income security				
Excess of percentage standard deduction over minimum standard deduction	1974	1977	Deduction	Individual
Exclusion on capital gains on home sales for persons age 65 and over	1974	1979	Exclusion	Individual
Exclusion of disability pay	1974	1984	Exclusion	Individual
Additional exemption for elderly	1974	1987	Exemption	Individual
Additional exemption for the blind	1974	1987	Exemption	Individual
Exclusion of untaxed unemployment insurance benefits	1974	1987	Exclusion	Individual
Deductibility of casualty losses	1974	2004	Deduction	Individual
Exclusion of military disability pensions	1974	2004	Exclusion	Individual
Exclusion of other employee benefits: premiums on accident and disability insurance	1974	2004	Exclusion	Individual
Exclusion of other employee benefits: premiums on group term life insurance	1974	2004	Exclusion	Individual
Income of trusts to finance supplementary unemployment benefits	1974	2004	Exclusion	Individual
Exclusion of public assistance benefits	1974	2004	Exclusion	Individual
Exclusion of railroad retirement system benefits	1974	2004	Exclusion	Individual
Exclusion of worker's compensation benefits	1974	2004	Exclusion	Individual
Net exclusion of pension contributions and earnings: employer plans	1974	2004	Exclusion	Individual
Net exclusion of pension contributions and earnings: individual retirement accounts	1974	2004	Exclusion	Individual
Tax credit for the elderly and disabled	1974	2004	Credit	Individual
Earned income tax credit	1975	2004	Credit	Individual
Exclusion of special benefits for disabled coal miners	1975	2004	Exclusion	Individual
Net exclusion of pension contributions and earnings: Keogh plans	1983	2004	Exclusion	Individual
Additional deduction for the blind	1986	2004	Deduction	Individual
Additional deduction for the elderly	1986	2004	Deduction	Individual
Extending tax-exempt organizations status to voluntary employee beneficiary and other associations	1988	1990	Exemption	Individual
Exclusion of employer provided death benefits	1988	1997	Exclusion	Individual

(Continued From Previous Page)

Name of Tax Expenditure (Organized by Budget Function)	First Year Reported by Treasury	Last Year Reported by Treasury	Type	Taxpayer Group
Special ESOP rules	1988	2004	Exemption	Individual and Corporate
Small business retirement plan credit	2001	2004	Credit	Individual and Corporate
Net exclusion of pension contributions and earnings: 401(k) plans	2001	2004	Exclusion	Individual
Net exclusion of pension contributions and earnings: low and moderate income savers credit	2001	2004	Exclusion	Individual
Social Security				
Exclusion of Social Security benefits: dependents and survivors	1974	2004	Exclusion	Individual
Exclusion of Social Security benefits: disabled	1974	2004	Exclusion	Individual
Exclusion of Social Security benefits: retired workers	1974	2004	Exclusion	Individual
Veterans' benefits and services				
Exclusion of GI bill benefits	1974	2004	Exclusion	Individual
Exclusion of veterans' death benefits and disability compensation	1974	2004	Exclusion	Individual
Exclusion of veterans' pensions	1974	2004	Exclusion	Individual
Exclusion of interest on veterans' housing bonds	1983	2004	Exclusion	Individual and Corporate
General Purpose Fiscal Assistance				
Credit for corporations in U.S. possessions	1974	1976	Credit	Corporate
Deductibility of nonbusiness state and local taxes (other than on owner-occupied homes and gasoline)	1974	2004	Deduction	Individual
Exclusion of interest on public purpose state and local bonds	1974	2004	Exclusion	Individual and Corporate
Tax credit for corporations receiving income from doing business in U.S. possessions	1977	2004	Credit	Corporate
Interest				
Deferral of interest on U.S. savings bonds	1975	2004	Deferral	Individual
General government				
Credits and deductions for political contributions	1974	1987	Credit/ Deduction	Individual

Source: GAO analysis of OMB budget reports on tax expenditures, fiscal years 1976-2006.

Note: Names of tax expenditures may have changed over time. Our list includes the most recent name reported by Treasury for each tax expenditure. The list of tax expenditures reflects all provisions reported by Treasury, including those enacted but effective for future fiscal years.

Glossary

Adjusted gross income (AGI): All income subject to taxation under the individual income tax after subtracting above-the-line deductions, such as certain contributions for individual retirement accounts and alimony payments. Personal exemptions and the standard or itemized deductions are subtracted from AGI to determine taxable income.

Alternative Minimum Tax (AMT): A separate tax system that applies to both individual and corporate taxpayers. It parallels the regular individual income tax system but with different rules for determining taxable income, different tax rates for computing tax liability, and different rules for allowing the use of tax credits.

Baseline: A benchmark for measuring the budgetary effects of proposed changes in federal revenues or spending. Or, a benchmark for identifying and measuring exceptions to the basic provisions of the tax structure.

- **CBO baseline**: CBO's estimate of spending, revenue, the deficit or surplus, and debt held by the public during a fiscal year under current laws and current policy. For revenues and mandatory spending, CBO projects the baseline under the assumption that present laws continue without change. For discretionary spending subject to annual appropriations, CBO is required to adjust the current year's discretionary budget authority to reflect inflation, among other factors.

- **Comprehensive income tax baseline**: This baseline, also called Haig-Simons income, is the real, inflation adjusted, accretion to wealth arising between the beginning and ending of the year. It includes all accretions to wealth, whether or not realized, whether or not related to a market transaction, and whether a return to capital or labor. Inflation adjusted capital gains would be included in comprehensive income as they accrue.

- **Consumption tax baseline**: A broad-based consumption tax is a combination of an income tax plus a deduction for net saving. Many current tax expenditures related to preferential taxation of capital income and savings would not be considered tax preferences under a consumption tax (e.g., capital gains), but preferences unrelated to broad-based saving or investment incentives would remain tax preferences under a consumption baseline.

- **Normal income tax baseline**: The Budget Act did not specify the baseline income tax against which tax preference provisions should be

measured, and deciding whether provisions are exceptions from the normal baseline is a matter of judgment. The normal income tax baseline 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. For the individual income tax, the Joint Committee on Taxation's (JCT) normal tax baseline includes one personal exemption for each taxpayer, one for each dependent, the standard deduction, the existing tax rate schedule, and deductions for investment and employee business expenses. Itemized deductions that are not necessary for the generation of income but exceed the standard deduction level are classified as tax expenditures. Very similar in scope to JCT's normal income tax baseline, Treasury's baseline is patterned on, but allows several major departures from, a comprehensive income tax, where income is defined as the sum of consumption and the change in net wealth during a given period.

- **Reference tax law baseline**: The reference baseline is closer to existing tax law and is also patterned on, but still allows several major departures from, a comprehensive income tax. Thus fewer tax provisions are considered tax preferences under the reference tax baseline than under the normal tax baseline. These include the lower tax rate for certain corporations, preferential rates on capital gains, accelerated depreciation, deferral of tax on income from controlled foreign corporations, etc.

Budget function: One of 20 broad categories into which budgetary resources are grouped so that all budget authority and outlays can be presented according to the national interests being addressed. There are 17 broad budget functions, including national defense, international affairs, energy, agriculture, health, income security, and general government. Three other functions—net interest, allowances, and undistributed offsetting receipts—are included to complete the budget.

De minimis rule: The level of revenue loss below which a revenue loss estimate is not reported for a tax preference.

Direct loans: A disbursement of funds by the government to a nonfederal borrower under a contract that requires the repayment of such funds with or without interest.

Discretionary spending: Outlays controlled by appropriation acts, other than those that fund mandatory programs.

Entitlement authority: Authority to make payments (including loans and grants) for which budget authority is provided in advance by appropriations acts to any person or government if, under the provisions of the law containing such authority, the U.S. government is obligated to make the payments to persons or governments who meet the requirements established by law.

Government Performance and Results Act (GPRA): Enacted in 1993, GPRA, also known as the Results Act, intends to improve the efficiency and effectiveness of federal programs by requiring federal agencies to develop strategic plans, annual performance plans, and annual program performance reports.

Grants: A federal financial assistance award making payment in cash or in kind for a specified purpose. The federal government is not expected to have substantial involvement with the state or local government or other recipient while the contemplated activity is being performed.

Gross domestic product (GDP): The value of all final goods and services produced within the borders of a country such as the United States during a given period. The components of GDP are consumption expenditures (both personal and government), gross investment (both private and government), and net exports.

Mandatory spending: Also known as direct spending. Mandatory spending includes outlays for entitlement authority (for example, the food stamp, Medicare, and veterans' pension programs), payment of interest on the public debt, and nonentitlements such as payments to the states from Forest Service receipts. By defining eligibility and setting the benefit or payment rules, the Congress controls spending for these programs indirectly rather than directly through appropriations acts.

Tax expenditure: A revenue loss attributable to a provision of the federal tax laws that grants special tax relief designed to encourage certain kinds of behavior by taxpayers or to aid taxpayers in special circumstances. The Congressional Budget and Impoundment Control Act of 1974[1] lists six types of tax expenditures: exclusions, exemptions, deductions, credits, preferential tax rates, and deferral of tax liability.

[1]Pub. L. No. 93-344, July 12, 1974.

- **Preferential tax rates:** A reduction of the tax rate on some forms of income, such as capital gains.

- **Tax credit:** An amount that offsets or reduces tax liability. When the allowable tax credit amount exceeds the tax liability, and the difference is paid to the taxpayer, the credit is considered refundable. Otherwise, the difference can be (1) allowed as a carryforward against future tax liability, (2) allowed as a carryback against past taxes paid, or (3) lost as a tax benefit.

- **Tax deduction:** An amount that is subtracted from the tax base before tax liability is calculated. Deductions claimed before and after the adjusted gross income line on the Form 1040 are sometimes called “above-the-line” and “below-the-line” deductions, respectively.

- **Tax deferral:** A provision allowing taxpayers to reduce current tax liability by delaying recognition of some income or accelerating some deductions otherwise attributable to future years. This can increase the taxpayer’s future tax liability, as the deferred income is eventually recognized, or reduce the deductions available on future income.

- **Tax exclusion:** An item of income that would otherwise constitute a part of the taxpayer’s gross income, but is excluded under a specific provision of the tax code. Exclusions generally do not appear on the U.S. Individual Income Tax Return (Form 1040), and excluded income is not reflected in total reported income.

- **Tax exemption:** A reduction in taxable income offered to taxpayers because of their status or circumstances.

Tax expenditure revenue loss estimate: The measure of the revenue cost of each tax expenditure. The revenue cost is the difference between tax liability under current law and the tax liability that would result if taxes were recomputed without that tax expenditure. Revenue cost estimates assume (1) economic behavior does not change, and (2) all other tax expenditures remain in the code unchanged.

Tax expenditure outlay-equivalent estimate: The amount of budget outlays that would be required to provide the taxpayer the same after-tax income as would be received through the tax provision. The outlay-equivalent measure allows the cost of a tax preference to be compared with

a direct federal outlay, were each to provide the same benefit to the taxpayer.

Unified budget: A comprehensive budget in which receipts and outlays from federal funds and trust funds are consolidated; generally a cash or cash equivalent measure in which receipts are recorded when received and expenditures are recorded when paid, regardless of the accounting period in which the receipts are earned or the costs incurred.

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