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The Tax Expenditures Muddle

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Though often misunderstood, they can ease our deficit dilemma.

The current impasse over the debt ceiling has been resolved, at least in the short run, by a set of compromises that leaves no one satisfied. At the same time, the long-term imbalance of government expenditures outpacing its revenues remains largely unsolved. It is to that issue that I devote this column, which builds on the work of my last two essays for Defining Ideas (you can find those essays here and here).

What political and economic forces have led the United States on its downward path to fiscal irresponsibility? To be sure, the uneasy combination of high government expenditures and modest government revenues is the surface cause of the current situation. But the techniques deployed to fuel the expansion of government power are truly driving the current malaise.


Illustration by Barbara Kelley

Two ways to make government bigger involve borrowing money and imposing progressive taxes. A third notable technique is tax expenditures. Tax expenditures allow the scope of government activities to increase without going through the nasty process of an explicit government appropriation and transfer payment.

Under conventional wisdom, tax expenditures can take many different forms. A useful catalogue has been provided by economist Donald B. Marron in his recent article, Spending by Disguise, which lists credits, deductions, deferrals, exclusions, and preferential rates as the means whereby the government can funnel real resources to its favored participants without having to go through the hassle of cutting a check on their behalf.

The basic claim of Marron and others is that there are trillions of dollars in tax expenditures that are waiting to be canceled out—enough in fact to ease the deficit woes. Unfortunately, the matter is more complex than this for the simple reason that not all tax expenditures are cut from the same cloth.

To be sure, there are lots of bad tax expenditures, often of recent vintage. But other tax expenditures could well be justified. For now, let's start with the worst of the breed. The various tax credits that are given to the producers of ethanol, for example, are a cardinal illustration of gross government misbehavior. The payments in question take the production of ethanol, which normally would occur at a loss, and convert it into a gain. The subsidy thus increases the ethanol supply, which in turn diverts vital farmland, crops, and other inputs that have greater social value in other uses to less efficient aims that now yield smaller returns to the resource producer. For instance, the massive overuse of grain for ethanol has imposed burdens on other sectors of the economy. It has led to an unwarranted increase in the price of grain for food. And it has roiled domestic and foreign agricultural markets. Apart from the gains that line the pockets of Iowa farmers, the tax expenditure program is an unmitigated disaster—as are similar programs for solar energy, clunky cars, and new homes.

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While it is easy to identify and denounce these tax expenditures, the issue is more complex when we consider others, like home interest deductions, the health care insurance exclusion, charitable deductions, state and local income and property taxes, capital gains, and tax deferment on pension contributions. Unlike the industry-specific tax expenditures that deserve universal condemnation, these issues resist easy fixes.

The root of the difficulty is this: it is not all that easy to figure out which downward adjustment in taxable income counts as a tax expenditure, and which does not. Right now the current income tax system starts with gross income, a number that is then reduced in various ways to get an "adjusted gross income" figure, which is the normal taxable base.

For example, an ordinary business deduction for inventory reduces the amount of taxable income, but no one thinks of that deduction as a tax expenditure. Why? The proper economic definition of taxable income must subtract out, from the revenues received, the expenses incurred to obtain the gross receipts. To recognize the income but to disallow the deduction makes taxation punitive, thereby unwisely discouraging individuals to invest in socially productive activities by forcing them to pay taxes on a nonexistent economic gain.

Isolating tax expenditures, therefore, requires a strong understanding that the best definition of income is: appreciation in net worth plus consumption during the relevant tax period. Once that is done, the next task is to look for some administrative justification for not taxing certain kinds of income.

Long before tax expenditures became a political game, huge chunks of the Internal Revenue Code had to test various deductions, credits, deferrals, exclusions, and preferences against this tax ideal. One clear case of a tax expenditure is the interest deduction on a home mortgage. There is no question that interest payments count as expenditures, and thus a reduction to gross revenues. But that expenditure is offset, not quite perfectly, by the consumption value of the home purchased with a home mortgage.

A precise economic test would first allow the interest deduction but bring the imputed income attributable from home use into the system, even though it is not a receipt of any kind. But since calculating that imputed income is too costly, the law should follow the simpler rule that treats the consumption enjoyed as a perfect income offset to the interest deduction. In fact in most cases, the consumption value of the home is probably greater than the interest payments on the loan, especially toward the end of the life of the mortgage. Nonetheless, that excess imputed income goes untaxed, because of the insoluble difficulties of its direct measure.

> *Political forces cannot redistribute the wealth that the economic system does not produce.*

Unfortunately, the sound economic treatment of taxable income is often subject to a political override. Thus the current law does indeed allow for a home mortgage interest deduction, but only for the first million dollars. The upshot is yet another distinction based on wealth, which fails to account for the difference in the cost of housing between Midland, Texas on the one hand and midtown, Manhattan on the other. Sometimes the partial repeal of a tax expenditure introduces a second tier of distortions that raise the hard choice of whether to create tax parity for all taxpayers or to resort to a partial repeal of the unprincipled tax deduction. Democrats will support the repeal; the Republicans will support the parity.

It is easier to identify the tax expenditure subsidy with health care, where the cost of employee medical insurance is deductible by the employer but not taxable to the employee at any time. Similarly, senior citizens do not have to treat as taxable income the subsidized portion of their Medicare payments. In these cases, once the subsidy is embedded in the system, nothing can rip it out, including the recent debt ceiling negotiations. The result is that people consume more and more scarce resources, causing the entire health care system to be badly out of whack. An alternative would be to knock out the subsidy and use lower taxes to spur growth. The last thing we need is to use the money for explicit health care expenditures that, given the current track record, are likely to be indefensible as direct expenditures.

In contrast, the charitable deduction raises far harder questions. A charitable deduction counts as a tax expenditure that induces greater contributions to one’s favorite church, school, or other designated charity. But these payments are for the benefit of third persons, often needy, so some additional fancy footwork is needed to decide whether to let this tax expenditure ride.

In a world where government is limited, the view is that it is inappropriate for the state to make direct contributions in cash or kind to charitable institutions. In that world, a charitable deduction would work an end-run around the government prohibition against redistribution.

But today we have cast limited government aside. In this changed environment, the case for the charitable deduction becomes very strong because it allows for a system of decentralized giving by individuals with a matching grant from the government. The private market for charity will do on average far better than central government grants, and should be encouraged because of how it reduces government activity. The situation with religion is, however, more complicated because in that context powerful constraints limit the level of state support to religious institutions, so that the charitable deduction, which has long been enshrined in our history, has sufficient staying power so it will never be displaced.

Next, it is often difficult to figure out whether deductions for state and local income and property taxes should count as a tax expenditure. One argument in favor of disallowing these deductions is that they create an implicit subsidy of high-taxed states from low-taxed states, which counts as a further inducement to larger government. Property taxes are exceedingly difficult to deal with because the deduction should be allowed if these taxes are used to support activities from which the taxpayer receives no direct benefit. But by the same token, if individuals cannot get a tax deduction when they pay for their own garbage removal or other services, they should not get a deduction if the city supplies those services out of local tax revenues.

> *If we do not cut entitlement spending, the death of the American economy will soon be upon us.*

Finally, capital gains and pension preferences also raise difficult second-best problems. In my view, the optimal tax structure is a flat consumption tax. This tax shares the simplicity of the flat income tax, and has the further advantage of favoring long-term savings and investment over immediate consumption. That change, which eliminates the tax preference for immediate expenditure, should lead to further growth.

On this model, lower capital gains rates are justified because they facilitate the mobility of capital, which should generate larger chunks of ordinary income in the long run. Capital gains taxes are only triggered by a voluntary sale, which are less likely to take place under a high tax regime. Lowering the rate "unlocks" the market, leading to more ordinary income down the road. Why then castigate as tax expenditures overdue changes in the taxation system that improve economic performance? It is just for this reason that the estate tax—the ultimate tax on savings—should be scrapped as well.

The hard cases have, however, to be kept in perspective, for most of the big dollars and the large distortions come in areas where there is no credible justification for allowing individuals to receive funding through the tax system that they could not receive through a direct subsidy. The correct political approach is to target these cases first, allowing the other embedded subsidies to remain.

At this point, the key question is what should be done with the additional revenue that is raised by ridding the system of tax expenditures. The "no new taxes" group insists that this money be returned to individuals in the form of an overall reduction in rates, and not be added to government budgets that are already bloated. That is, of course, the counsel of perfection in the current situation where government tax revenues now account for only about 60 percent of government spending.

Poorly designed tax expenditures distort the relative preferences between private goods and they increase the overall size of the government budget. Getting rid of the first of these vices is the easier task by far. Shrinking the level of taxes is a much tougher fix if only because much of the new revenue has to go towards paying debts that have already been accrued by a series of past mistakes. Using a flat tax will help shrink the size of government. But in my view, it will not do enough. One alternative is to raise overall taxes, but that will come at the expense of long-term growth, with devastating consequences.

The only real solution is painful cuts in entitlement spending. As long as Democratic politicians treat those expenditures as untouchable, then the death of the American economy will soon be upon us. We cannot shrink this nation’s economic base and expand its elaborate system of transfer payments and hope to survive. Political forces cannot redistribute the wealth that the economic system does not produce.

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