

The Blur Between Spending and Taxes

By N. GREGORY MANKIW

SHOULD the government cut spending or raise taxes to deal with its long-term fiscal imbalance? As President Obama's deficit commission rolls out its final report in the coming weeks, this issue will most likely divide the political right and left. But, in many ways, the question is the wrong one. The distinction between spending and taxation is often murky and sometimes meaningless.

Imagine that there is some activity — say, snipe hunting — that members of Congress want to encourage. Senator Porkbelly proposes a government subsidy. “America needs more snipe hunters,” he says. “I propose that every time an American bags a snipe, the federal government should pay him or her \$100.”

“No, no,” says Congressman Blowhard. “The Porkbelly plan would increase the size of an already bloated government. Let's instead reduce the burden of taxation. I propose that every time an American tracks down a snipe, the hunter should get a \$100 credit to reduce his or her tax liabilities.”

To be sure, government accountants may treat the Porkbelly and Blowhard plans differently. They would likely deem the subsidy to be a spending increase and the credit to be a tax cut. Moreover, the rhetoric of the two politicians about spending and taxes may appeal to different political bases.

But it hardly takes an economic genius to see how little difference there is between the two plans. Both policies enrich the nation's snipe hunters. And because the government must balance its books, at least in the long run, the gains of the snipe hunters must come at the cost of higher taxes or lower government benefits for the rest of us.

Economists call the Blowhard plan a “tax expenditure.” The tax code is filled with them — although not yet one for snipe hunting. Every time a politician promises a “targeted tax cut,” he or she is probably offering up a form of government spending in disguise.

Erskine B. Bowles and Alan K. Simpson, the chairmen of President Obama's deficit reduction commission, have taken a hard look at these tax expenditures — and they don't like what they see. In their draft proposal, released earlier this month, they proposed doing away with tax expenditures, which together cost the Treasury over \$1 trillion a year.

Such a drastic step would allow Mr. Bowles and Mr. Simpson to move the budget toward fiscal sustainability, while simultaneously reducing all income tax rates. Under their plan, the top tax rate would fall to 23 percent from the 35 percent in today's law (and the 39.6 percent currently advocated by Democratic leadership).

This approach has long been the basic recipe for tax reform. By broadening the tax base and lowering tax rates, we can increase government revenue and distort incentives less. That should command widespread applause across the ideological spectrum. Unfortunately, the reaction has been less enthusiastic.

Pundits on the left are suspicious of any plan that reduces marginal tax rates on the rich. But, as Mr. Bowles and Mr. Simpson point out, tax expenditures disproportionately benefit those at the top of the economic ladder. According to their figures, tax expenditures increase the after-tax income of those in the bottom quintile by about 6 percent. Those in the top 1 percent of the income distribution enjoy about twice that gain. Progressives who are concerned about the gap between rich and poor should be eager to scale back tax expenditures.

Pundits on the right, meanwhile, are suspicious of anything that increases government revenue. But they should recognize that tax expenditures are best viewed as a hidden form of spending. If we eliminate tax expenditures and reduce marginal tax rates, as Mr. Bowles and Mr. Simpson propose, we are essentially doing what economic conservatives have long advocated: cutting spending and taxes.

Yet another political problem is that each tax expenditure has its own political constituency. If Congressman Blowhard ever got his way, the snipe hunters of the world would surely fight to keep their tax break.

One major tax expenditure that the Bowles-Simpson plan would curtail or eliminate is the mortgage interest deduction. Without doubt, many homeowners and the real estate industry will object. But they won't have the merits on their side.

This subsidy to homeownership is neither economically efficient nor particularly equitable. Economists have long pointed out that tax subsidies to housing, together with the high taxes on corporations, cause too much of the economy's capital stock to be tied up in residential structures and too little in corporate capital. This misallocation of resources results in lower productivity and reduced real wages.

Moreover, there is nothing particularly ignoble about renting that deserves the scorn of the tax code. But let's face it: subsidizing homeowners is the same as penalizing renters. In the end, someone has to pick up the tab.

THERE are certain tax expenditures that I like. My personal favorite is the deduction for charitable giving. It encourages philanthropy and, thus, private rather than governmental solutions to society's problems.

But I know that solving the long-term fiscal problem won't be easy. Everyone will have to give a little, and perhaps even more than a little. I am willing to give up my favorite tax expenditure if everyone else is willing to give up theirs.

The Bowles-Simpson proposal is not perfect, but it is far better than the status quo. The question ahead is whether we can get Senator Porkbelly and Congressman Blowhard to agree.