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Tax System Is America's Biggest Spender

By Betsey Stevenson and Justin Wolfers - Apr 16, 2012

If you're at all like us, chances are you'll spend Tuesday evening finishing your taxes. As you search for every last deduction and credit, it's worth asking: Does any of this make sense?

Here's a way to see through the fog. Instead of looking at all the breaks for mortgage interest, health care, retirement savings and so on as deductions, picture the government writing you a check for each item. This equivalence between tax deductions and government spending leads economists to call them "tax expenditures." Reformers have hit on an even more pointed description: spending through the tax code.

The tax system is also equivalent to a collection of individual mandates, like the one in the Obama health-care law, with penalties for Americans who fail to buy insurance. For many people, that's how our system works. You and your neighbor might have the same income, but if, unlike your neighbor, you fail to have a mortgage or buy as much health insurance, then you have to pay higher taxes.

You may feel very differently about tax deductions, government handouts and mandates backed by penalties. Economically, though, they are identical. They yield the same outcomes and provide the same incentives.

Insidious Mechanism

In principle, there's nothing wrong with spending through the tax code. Politically, though, the mechanism can be insidious. Unlike typical government spending, tax expenditures aren't reauthorized each year by Congress, so they have immense staying power. Because they aren't as visible as outright spending, they aren't subject to the scrutiny of campaigns to pare back waste or assess effectiveness.

Indeed, spending through the tax code is so politically stealthy that it has won over enemies of government largesse, such as Grover Norquist, president of Americans for Tax Reform. These are the same people who hate mandates, as the current debate about the legality of Obamacare demonstrates. It's a tribute to our psychological biases that getting a subsidy through the tax system is treated so differently from receiving a government check or copping a fine.

The result: Even as many areas of government spending have been cut to the bone, our tax code remains larded up with expenditures that cost taxpayers $1.3 trillion every year. According to the nonpartisan Tax Policy Center, the biggest tax expenditures apply to employer-provided health insurance, pension contributions and mortgages.

Popular as such tax breaks may be, they differ from typical government spending in that they give bigger subsidies to wealthier families. Imagine if we mailed checks to all homeowners to help them pay their mortgages. Would you support giving millionaires with mansions 25 times more than the typical family? That's effectively what we do: Middle-class families get an average benefit from the mortgage interest deduction of $139, while families in the top 1 percent get $3,752.

Taken together, individual income tax expenditures are the equivalent of sending $686 each year to those in the bottom fifth of the income distribution, $3,175 to those in the middle fifth, and $30,714 to those in the upper fifth. The average member of the top 1 percent gets nearly a quarter of a million dollars a year -- a statistic that might have proved useful for the folks protesting in Zuccotti Park.

The rich get such big subsidies for three reasons. First, they spend more on the things the tax system favors, such as homes and health care. Second, they are subject to higher tax rates, so they get more benefit from each dollar of deductions. Finally, they're rich enough to take full advantage of their deductions. The poor typically have too little income to itemize, while many families in the upper middle class find themselves siphoned off into a separate tax system known as the alternative minimum tax, which allows fewer deductions.

Honest Discussion

Because spending through the tax code disproportionately goes to the rich, those commentators who fail to account for it come to the mistaken conclusion that our tax code is more progressive than it actually is. If we had a simpler system, we could have an honest discussion of how much people at the top should pay.

President Barack Obama's proposed Buffett Rule gets rid of many tax expenditures for some of the very wealthy. It's a good idea, but why stop there?

Here's our proposal: Let's replace all tax expenditures with explicit subsidies -- that is, with actual federal payments -- so we can really see the costs and debate all spending programs on an equal footing. Doing so would help us answer crucial questions, such as whether we get more bang for our buck by subsidizing homeownership or by spending more on schools.

There's one more payoff to getting rid of the myriad breaks hidden in our byzantine tax code: It will be a lot easier to get your taxes done before midnight.

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