CENTER ON BUDGET AND POLICY PRIORITIES
820 First Street, NE, Suite 510, Washington, DC 20002
Tel: 202-408-1080 Fax: 202-408-1056 center@cbpp.org http://www.cbpp.org

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ACCELERATING IMPLEMENTATION OF THE 25 PERCENT INCOME TAX RATE WOULD BE INEFFECTIVE STIMULUS

by Robert Greenstein and Joel Friedman

Under the tax-cut package enacted last year, the 28 percent marginal income tax rate was reduced to 27 percent, effective on July 1, 2001, with further one-percentage point reductions scheduled for 2004 and 2006. The House-passed stimulus bill includes a provision to accelerate those rate reductions, so that the 25 percent rate would become effective on January 1, 2002. Amendments are pending to the stimulus package on the Senate floor to write this measure into the Senate legislation as well. This proposal would, however, constitute a poorly targeted and ineffective means of stimulating the economy.

- In a recent analysis, "Economic Stimulus: Evaluating Proposed Changes in Tax Policy," the Congressional Budget Office concluded that "compared with other personal tax cuts, the first-year stimulus that this proposal would generate relative to its total revenue loss is probably small." CBO essentially gave this proposal a failing grade as a stimulus measure.

  CBO noted that the bulk of the measure's cost would occur after 2002 — that is, well after the recession is expected to be over. CBO also noted that higher-income taxpayers, who would be the primary beneficiaries of this tax cut, are likely to spend less and save more of any tax-cut dollars they receive than taxpayers with lower incomes.

- Furthermore, this costly proposal — the most expensive over ten years in the House-passed package — is all the more inappropriate in light of new CBO projections showing the dramatic deterioration in the budget outlook.

Poorly Targeted Stimulus

More than three-quarters of the cost of this proposal would be incurred *after* the economy is expected to have recovered. According to Joint Committee on Taxation estimates, the proposal would cost $53.7 billion. Only $12.8 billion of the cost — or less than 24 percent — would result in 2002. The remainder would occur in 2003 through 2006, years in which the economy should already have recovered from the current slowdown.

Proposal to Accelerate Reduction of 27 Percent Rate to 25 Percent

Cost (In Billions)		Share of Cost Occurring:	
2002	**Ten Years**	**In 2002**	**After 2002**
12.8	53.7	24%	76%

Ineffective Stimulus

Accelerating the implementation of the 25 percent rate would exclusively benefit the top one-quarter of all tax filers — not middle-income taxpayers, as supporters of this proposal frequently claim. Congressional Budget Office estimates show that in 2000, more than three-quarters of all tax filers either had no taxable income (because their income was less than their deductions and exemptions) or faced a marginal tax rate of no more than 15 percent. Fewer than one-quarter had incomes sufficiently high to be in the 28 percent bracket or a higher bracket.

Distribution of Tax Filers By Marginal Income Tax Rate, 2000

Highest marginal rate faced by tax filer	Percentage of Tax filers
owe no income tax	31.5%
15 percent	45.3 %
28 percent*	18.9 %
31 percent*	2.6 %
36 percent*	0.9 %
39.6 percent*	0.9 %
Total	100.0%
Addendum:	
28 percent rate and above	23.3%
Higher than 28 percent rate	4.4%

* These rates were reduced 1 percentage point on July 1, 2001.

Source: Congressional Budget Office

These more affluent taxpayers are likely to save more — and spend less — of a tax cut than taxpayers with lower incomes. Yet for the economy to receive the desired boost in the short run, tax-cut beneficiaries must spend their extra dollars. Saving these dollars has no short-term stimulative effect and will not speed economic recovery. As CBO noted: "As a general proposition, higher-income households save more of their income than do lower-income households....Consequently, tax cuts that are targeted toward lower-income households are likely to generate more stimulus dollar for dollar of revenue loss — that is, be more cost-effective and have more bang for the buck — than those concentrated among higher-income households."

Moreover, the taxpayers who would benefit the most from this proposal are those in brackets *higher than* the 27 percent bracket (i.e., what was the 28 percent bracket prior to July 1, 2001). It is only these individuals who would be able to apply the lower tax rate against the full amount of income that the 27 percent bracket covers.[1] A married couple with two children that has taxable income of $50,000 — and thus has adjusted gross income of at least $69,850 — has $3,300 of income that falls in the 27 percent bracket. This taxpayer would receive a tax cut of $66 this year as a result of dropping the rate from the 27 percent rate that otherwise would be in effect in 2002 to 25 percent. By contrast, a similar family of four with taxable income of more than $112,850 (and adjusted gross income of at least $132,700) — the top of the bracket — would receive a tax cut of more than $1,300 next year, since the two percentage-point rate

[1] In 2002, the 27 percent bracket for married couple begins with taxable income of $46,700 (which corresponds to a minimum of $66,550 in adjusted gross income if the taxpayer has two children) and ends with taxable income of $112,850.

reduction would be applied to more than $66,000 in income (i.e., to the full amount of income that falls in the 27 percent bracket).

Those who would receive the largest tax cuts from this proposal — those in tax brackets higher than the 27 percent bracket — constitute the top four percent to five percent of tax filers. These individuals, who also would receive windfall tax reductions from other provisions of last spring's tax cut legislation, have a low "propensity to consume."

Fiscally Irresponsible

Accelerating these rate reductions represents unsound policy at a time when a premium should be placed on fiscal prudence. New CBO projections show that the budget outlook has deteriorated markedly from just one year ago. At that time, the cumulative budget surpluses between 2002 and 2011 totaled $5.6 trillion; the new CBO estimates place the total surpluses at $1.6 trillion — a $4 trillion reduction.

Furthermore, even these new, more pessimistic baseline projections are likely to overstate the remaining surplus by a substantial amount. Robert Reischauer, president of the Urban Institute and former director of CBO, made this point in testimony last week before the Senate Budget Committee, stating that "the baseline projections may prove to be a somewhat misleading indicator of the attainable, let alone the likely, future budget outlook. Rarely have the policies underlying the baseline projections been as disconnected from the policy makers' agendas as they are today."[2] The new baseline estimates do not include the cost of increased defense and homeland security expenditures or of a number of other tax and expenditure measures that are virtually certain to be enacted, such as a farm bill, the extension of expiring tax credits that always are extended, and relief from the burgeoning individual Alternative Minimum Tax. The virtually-certain-to-be-enacted items are expected to subtract another $1 trillion or more from the projected surplus.

Locking in these rate cuts would weaken the nation's ability to address future fiscal problems. Policymakers will have to consider significant adjustments to budget policies when the recession ends, especially in light of increased defense and homeland security needs. One advantage of having the enacted rate reductions phase in over time is that if the need for resources to meet other contingencies grows, policymakers will have the option of postponing or cancelling future rate cuts. Doing so would generate additional revenues without increasing current tax rates. If the scheduled rate reductions are implemented sooner, however, these lower rates will be locked in, and undoing the rate reductions if the nation's fiscal difficulties intensify will entail enacting tax increases.

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[2] Robert D. Reischauer, "Framing the Budget Debate for the Future," Testimony before the Senate Budget Committee, January 29, 2002.

The Committee for Economic Development, an organization of leading corporate executives and university presidents, issued a report in early October warning of the long-term fiscal difficulties the nation faces. The report specifically points to the gradual phase-in of provisions of the tax cut enacted this spring as providing a possible budgetary safety valve, since tax cuts could be deferred or removed before taking effect. Proposals to accelerate implementation of the 25 percent rate would weaken this safety valve. At a time when the budgetary outlook is highly uncertain, fiscal prudence militates against accelerating these tax rate cuts.