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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MIDDLE-INCOME TAXPAYERS WILL RECEIVE LITTLE OR NO BENEFIT FROM PROPOSALS TO ACCELERATE IMPLEMENTATION OF THE 25 PERCENT RATE

by Robert Greenstein and Joel Friedman

The debate over a proposal to reduce the 27 percent income tax rate to 25 percent in 2002 — and thereby accelerate implementation of rate reductions scheduled to take effect in 2004 and 2006 — has been hampered by a misconception that this proposal is targeted on moderate-income families, such as those with incomes between $27,000 and $65,000. In fact, Congressional Budget Office data conclusively demonstrate that accelerating the implementation of the 25 percent rate would benefit only the top one-quarter of all tax filers and offer no benefit to the other 75 percent of filers.

The mistaken belief that accelerating implementation of the 25 percent rate would benefit those with moderate incomes appears to be the result of policymakers either confusing — or obfuscating — two crucial distinctions. These crucial distinctions are: 1) the difference between a family's full income and its "*taxable* income;" and 2) the wide differences among the income levels at which the 27 percent bracket begins for taxpayers with different filing statuses and family sizes.

Families with Two Children With Income Below $66,550 Would Receive No Benefit

In a televised appearance with Republican Congressional leaders and three Democratic senators last month, the President declared that this rate reduction "affects those making $27,000 to $65,000 a year."[1] The President's statement conveys the impression that many or all families in this income range would benefit, while families above this income range would not. For families with children, however, almost the opposite is true. The President's statement was misleading for several reasons.

- The $27,000 figure is the level of *taxable* income at which the 27 percent begins *for a single individual*. The level of taxable income at which the 27 percent bracket begins is higher than this for other tax filers — married couples filing jointly and single parents.

- Furthermore, a filer's *taxable* income is considerably lower than his or her *full* income. Taxable income is a tax term that refers to a tax filer's income *after*

[1] President Bush stated: "The income tax rate reduction affects those making $27,000 to $65,000 a year, hardworking Americans who could use help coming into the holiday season." *The White House Bulletin*, December 19, 2001.

either the standard deduction or itemized deductions, as well as all of the personal exemptions for which the tax filer qualifies, are subtracted. To have a level of taxable income of $27,000 in 2002, a single person would need actual income of at least $34,700. For tax filers who are not single individuals, the difference between their taxable income and their full income is considerably greater, because they qualify for larger standard deductions and more personal exemptions.

- For example, a married couple with two children does not face the 27 percent tax rate (that is, does not have taxable income of at least $46,700) until its full income exceeds $66,550. (An income of $66,550 minus the standard deduction of $7,850 for a married couple and $12,000 for four personal exemptions equals $46,700.) If such a family itemizes its deductions rather than taking the standard deduction, the level of income at which it first becomes subject to the 27 percent rate generally is higher than $66,550.

The President's statement also implied that those with incomes above $65,000 would *not* benefit from the rate reduction. A literal reading of Mr. Bush's statement would lead one to believe this is a tax cut from which the wealthy would not secure a gain. Yet taxpayers in higher brackets *would* benefit. In fact, the group of taxpayers that would benefit the most are those in tax brackets higher than the 27 percent bracket — a group that consists of the five percent of Americans with the highest incomes. (Why these individuals would benefit most is explained in the box on page 3.)

As a result, a married couple with two children would not benefit significantly unless it had a substantial income.

- A married couple with two children that had income of less than $66,550 would receive *no* benefit from acceleration of the 25 percent rate.

- If such a family had income of $70,000, it would receive a tax cut of just $70 in 2002 — and $210 over the next four years.

- But if the family had income more than $135,000, it would receive a tax cut of $1,300 in 2002 and nearly $4,000 over four years.

Why Three-Quarters of All Tax Filers Would Get Nothing

Congressional Budget Office data demonstrate that more than three-quarters of all tax filers would receive no benefit from this proposal.[2] The CBO data show that in 2000, some 76.7

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[2] Committee on Ways and Means Committee, U.S. House of Representatives, *2000 Green Book: Background Material and Data on Programs Within the Jurisdiction of the Committee on Ways and Means*, October 6, 2000,

Why Only The Top Five Percent of Tax Filers Would Receive the Full Benefit of the Reduction in the 27 Percent Rate

Marginal Income Tax Rates for a Married Couple, 2002

Taxable Income*	**Marginal Income Tax Rate**
$0 to $12,000	10 percent
$12,001 to $46,700	15 percent
$46,701 to $112,850	27 percent
$112,851 to $171,950	30 percent
$171,951 to $307,050	35 percent
over $307,050	38.6 percent

*Income after subtracting allowable deductions and exemptions.

Under the graduated rate structure of the federal income tax system, higher levels of income are taxed at progressively higher rates. The marginal tax rate is the rate paid on each additional dollar of income.

As shown in the accompanying table, the marginal tax rate increases in steps as income rises. For a married couple, the first $12,000 of taxable income — that is, income after subtracting allowable deductions and exemptions — is taxed at a rate of 10 percent. The next $34,700 of taxable income (up to a total of $46,700) is taxed at 15 percent. The next $66,150 of taxable income (up to a total of $112,850) is taxed at the 27 percent rate. This continues until taxable income reaches $307,050, at which point all income above that level is taxed at the 38.6 percent rate. Thus, even those who face the highest marginal tax rate have a portion of their taxable income taxed at lower rates.

A two percentage point reduction in the 27 percent rate to 25 percent would affect only that portion of a married couple's taxable income that is between $46,700 and $112,850. If the couple has taxable income of $50,000, it would receive a benefit of $66 (two percent of $3,300, which is the amount of its taxable income subject to the 27 percent rate). The *maximum* benefit that a couple could receive from a two percentage point reduction in the tax rate is $1,323 (two percent of $66,150, which is the difference between the $112,850 taxable income level at which the 27 percent tax bracket ends and the $46,700 income level at which the bracket starts). To receive this maximum tax-cut benefit, the couple thus must have at least $112,850 of taxable income; in other words, the couple must fall into a tax bracket where some of its income is taxed at a higher rate than 27 percent. Fewer than five percent of tax filers have income that high. (See the table on page 4.) It is only these upper-income tax filers who would receive the maximum benefit from the reduction in the 27 percent rate.

percent of all tax filers either had income too low to owe federal income tax or were in the 15 percent tax bracket.[3] These tax filers would be unaffected by changes in the 27 percent tax bracket.

Table 13-21.

[3] Beginning in 2002, a portion of these tax filers will be moved from the 15 percent bracket to a new bracket with a marginal tax rate of 10 percent.

These data indicate that fewer than one-quarter of tax filers — 23.3 percent — have incomes high enough to be in the 27 percent bracket or a higher bracket. Only this group could benefit from the scheduled reduction in the 27 percent rate to 25 percent and thus from the proposed acceleration of this rate reduction.

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

In its recent report "Economic Stimulus: Evaluating Proposed Changes in Tax Policy," the Congressional Budget Office finds that the proposal to implement the 25 percent rate beginning in 2002 would not be effective stimulus. It states 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 reaches this conclusion for two principal reasons. First, these rate cuts would only benefit the top one-quarter of taxpayers, leaving out lower-income households that would be more likely to spend additional income and thus boost the economy.[4] Second, the costs of this provision extend through 2006, with the result that three-quarters of the total cost occurs in 2003 through 2006, years after the economic downturn is expected to be over.

[4] In its analysis, CBO stated that "approximately 30 percent of taxpayers would see their taxes fall" as a result of the rate reduction. This approximately 30 percent of *taxpayers* is consistent with the one-quarter of *tax filers* noted above. As shown in the table above, 31.5 percent of tax filers have incomes sufficiently low that they owe no income tax; CBO excludes these tax filers from its definition of taxpayer. Most of these tax filers do pay payroll taxes.