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**Special Series: Economic Recovery Watch**

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## PROPOSAL TO LOWER BOTTOM TAX RATES LESS EFFECTIVE AS STIMULUS THAN “MAKING WORK PAY” CREDIT

### Only Top Fifth of Households Would Receive Full Tax Cut

Chye-Ching Huang and Robert Greenstein

A proposal to cut income tax rates, which Senate Minority Leader Mitch McConnell wants to include in economic recovery legislation, would provide its largest benefit to the top fifth of households and prove less effective as economic stimulus than the provision it would replace — President Obama’s “Making Work Pay” tax credit.

The proposal, which was first unveiled January 23 by House Minority Leader John Boehner and House Minority Whip Eric Cantor, would cut the 10 percent rate to 5 percent and the 15 percent rate to 10 percent. It would replace Obama’s proposed “Making Work Pay” credit, which is now in both the House and Senate economic recovery packages, of \$500 for individual workers and \$1,000 for couples.

Tax cuts must be spent quickly if they are to stimulate the economy, and research shows that people at lower income levels spend more of any tax cuts they receive than families at higher income levels do. Thus, the proposal — which gives its biggest benefits to upper-income households and leaves out millions of lower-income families entirely — is the *reverse* of what policymakers should do to boost the economy.

Under the proposal:

- **Only about the top fifth of households would get the full tax cut.**<sup>1</sup> Only those with incomes high enough to place them in the 25 percent bracket or higher — which for a married couple with two children means income of over \$90,000<sup>2</sup> — would fully benefit from the cut in the 10 percent and 15 percent brackets.
- **Higher-income households would get a much bigger tax cut than less-affluent ones.** A married couple with two children with income of \$100,000 or more would get a tax cut of \$3,395. This is 17 times the \$200 tax cut that the couple would receive if its income were \$30,000.

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<sup>1</sup> Based on TPC estimates for 2007, and assuming that the AMT is adjusted in order to prevent the AMT from “clawing back” the benefit of the tax cut for some upper-income households.

<sup>2</sup> Assuming the household takes the standard deduction and does not qualify for other deductions or credits.

- **The Tax Policy Center estimates that more than 47 million low- and moderate-income filers would receive *no tax benefit at all* from the proposal.**<sup>3</sup> To receive even a partial tax cut, a married couple with two children would need income of more than \$26,000.<sup>4</sup>

In contrast, the “Making Work Pay” provision would provide a tax reduction of \$500 per individual worker and \$1,000 per couple to all workers earning at least \$8,100 and would phase out at high income levels. As a result, people at high income levels would *not* receive much larger tax cuts than hard-pressed lower- and middle-income families.

### Only Higher-Income Households Would Fully Benefit from GOP Leadership Proposal

The most efficient way to boost consumer spending is to put money into the hands of people who will spend it quickly rather than save it.<sup>5</sup> As a result, tax cuts targeted at moderate- and low-income households are more effective as stimulus than tax cuts that are biggest for people with higher incomes; people at lower income levels spend a larger share of the tax cuts they receive than more affluent people do.

A reduction in the bottom two individual income tax rates would miss this target because it would focus tax reductions on upper-income individuals.

- A cut in the bottom two income tax rates would exclude all working families who don’t earn enough to owe federal income tax, even though many of these families pay significant federal payroll and excise taxes. For example, a married couple with two children needs income of more than \$26,000 in 2009 to owe federal income tax.<sup>6</sup> More than 47 million low- and moderate- income filers would receive no tax benefit at all under the proposal.<sup>7</sup>
- To receive the full benefit of the cut in the 10 percent tax rate, a married couple with two children would need more than \$42,700 of income. (The couple would need to be in a tax bracket *higher* than the 10 percent bracket.) And to receive the full benefit of the reductions in *both* the 10 percent and 15 percent tax rates, the family would need income of more than \$93,900. (The family would need to be in the 25 percent bracket or higher.)
- As a result, only about the top 20 percent of households would be able to receive the full tax cut of about \$3,400, while low- and middle-income families would get smaller tax cuts (or no tax cut at all).<sup>8</sup>
- Consequently, less than ten percent of the benefits of the proposal would go to households in

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<sup>3</sup> Urban Institute and Brookings Institution Tax Policy Center estimates, compared to current law and assuming that an AMT “patch” is enacted for 2009.

<sup>4</sup> See footnote 2.

<sup>5</sup> See Congressional Budget Office, “Options for Responding to Short-Term Economic Weakness,” January 2008, [http://www.cbo.gov/ftpdocs/89xx/doc8916/01-15-Econ\\_Stimulus.pdf](http://www.cbo.gov/ftpdocs/89xx/doc8916/01-15-Econ_Stimulus.pdf); Jane G. Gravelle, “Tax Cuts and Economic Stimulus: How Effective Are the Alternatives?” Congressional Research Service, December 5, 2008.

<sup>6</sup> See footnote 2.

<sup>7</sup> See footnote 3.

<sup>8</sup> See footnote 1 above.

the bottom 40 percent of the income distribution.<sup>9</sup> The proposal delivers very little of its benefit to households most likely to spend the tax cut quickly.

## **Economists Agree That Stimulus Tax Cuts Should Focus on Lower-Income Households**

Economists generally agree that a tax cut designed like the proposal to lower the bottom two rates, which misses many lower-income households and gives its biggest benefits to upper-income households, is not very effective at stimulating the economy.

- As the Congressional Research Service (CRS) has stated, “[individual] income tax cuts directed at lower income individuals will likely have a larger effect than cuts directed at higher income individuals, other things equal. This distributional effect suggests that the most effective tax cut would be a rebate which is not only a flat amount but specifically directed at lower income individuals (who did not have tax liability).”<sup>10</sup> The GOP tax cut achieves the opposite of the CRS recommendation.
- Similarly, the Congressional Budget Office has commented that “[across-the-board] reductions in income tax rates have the disadvantage of placing much more of the tax reduction in the hands of upper-income taxpayers, who, although they have a much larger tax liability, are less likely to spend the additional money.”<sup>11</sup>

The “Making Work Pay” credit that President Obama proposed and the House and Senate packages include fits these principles much better. Under that credit:

- All low-income workers would receive at least a partial credit equal to 6.2 percent of their earnings.
- Workers earning at least \$8,100 would receive the full credit of \$500 for working individuals (\$1,000 for couples); their tax cuts would not be smaller than those that higher-income households receive.
- The credit would phase out for high-income workers.
- One-third of the benefits of the Making Work Pay credit go to households in the bottom 40 percent of the income distribution, more than triple the percentage under the proposal to lower the 10 percent and 15 percent tax rates.<sup>12</sup> The Making Work Pay credit would therefore do better than the rival proposal in targeting relief to the low- and middle- income households most likely to spend quickly any tax cut they receive. As a result, the Making Work Pay credit would be more effective in increasing consumer expenditures, lifting overall GDP, and creating or preserving jobs.

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<sup>9</sup> Urban-Brookings Tax Policy Center distributional estimate of the Making Work Pay proposal as reported by the Senate Finance Committee.

<sup>10</sup> Gravelle

<sup>11</sup> CBO.

<sup>12</sup> See footnote 10.