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The Six Worst Tax Cuts in the Senate Stimulus Bill[1]

Senate Removes Spending When It Should Remove Tax Cuts for Business and Well-Off Individuals

The economic stimulus bill that the Senate approved today includes several tax cuts that are not in the stimulus bill approved by the House of Representatives two weeks ago and which should be excluded from the final bill that goes to the President.

The bill approved by the House of Representatives two weeks ago has a total cost of about $819 billion, while the cost of the Senate bill had grown last week to about $940 billion. A group of self-styled centrist Senators then put forth a compromise that took exactly the wrong approach to cutting down the costs: They mostly removed government spending that economists believe will stimulate the economy — like aid to state governments, school construction, food stamps — while they left in most of the regressive tax cuts that Senators have added to the bill.

Lawmakers who are sincere in their desire to stimulate the economy in the most cost-effective manner should seek to exclude from the final bill the following tax cuts, which economists believe will do little to boost consumer demand. The following six provisions add $124 billion (according to official projections) to the cost of the Senate's stimulus bill compared to the House stimulus bill. The real cost of these provisions is considerably more. That's quite a price for provisions that hardly anyone thinks will stimulate the economy.

1. The Alternative Minimum Tax "Patch"

Projected Additional Cost Compared to House Bill: $70 Billion
Why It Won't Help the Economy: Bulk of benefits go to richest 10%.

The Senate bill includes a $70 billion provision that would prevent the Alternative Minimum Tax (AMT) from expanding its reach to tens of millions of families who have previously been unaffected by it. The House of Representatives did not include this provision in its stimulus bill.

The Senate provision, which is a one-year "patch" for the AMT for 2009, does not belong in an economic stimulus bill. Economists have argued that a tax cut will not provide the immediate boost to demand for goods and services that can prevent the recession from deepening unless it is targeted to the families most likely to immediately spend any new money they receive — poor and middle-income families.

High-income families save, rather than spend, much more of their income than poor and middle-income families, who often have little left to save after they pay for necessities. So tax cuts targeted to poor and working class families are more likely to be stimulative. Unfortunately, poor and working class families would receive almost no benefit from AMT relief.

[1]For a two-page summary, see Citizens for Tax Justice, "The Six Worst Tax Cuts in the Senate Stimulus Bill: Summary," February 10, 2009. www.ctj.org/pdf/sixworsttaxcutssummary.pdf

The AMT is a backstop tax that is meant to ensure that relatively wealthy families pay some minimum amount of income tax no matter how proficient they are at finding loopholes that would otherwise reduce or even wipe out their income tax liability.

There are exemptions in the AMT that keep most of us from being affected by it, but those have not been permanently increased to keep up with income growth since the Clinton years. More important, the Bush tax cuts reduced regular income taxes for many families but made no permanent reduction in the AMT. (The Bush administration intentionally left AMT reform out of its tax cut proposals to avoid revealing their ultimate costs.) The result is that many families who are relatively well-off but not among the very rich will find themselves paying the AMT if no action is taken.

In recent years Congress has decided to enact, every year or so, a "patch," to the AMT, which refers to legislation that increases the exemptions in the AMT to prevent it from reaching more taxpayers for one year. Any patch or permanent reduction in the AMT should, in normal circumstances, be offset by other revenue-raising provisions to prevent an increase in the budget deficit.

The following table shows that nearly 70 percent of the benefits of AMT relief in 2009 would go to the richest 10 percent of taxpayers. The bottom 60 percent of taxpayers (the true "middle-class" and everyone below) would get a mere half a percent of the benefits.

Effects of AMT Relief Provision in Senate Stimulus Bill (increase in AMT exemptions for tax year 2009)

Income Group	Income Range	Average Income	# with tax cut	% with tax cut	Ave. tax cut for those with	Ave. tax cut for all	% of total tax cut
Lowest 20%	Less than $18,500	$ 12,140	—	—	$ —	$ —	—
Second 20%	$18,500 to $31,000	24,526	—	—	—	—	—
Middle 20%	$31,000 to $50,500	39,875	465,000	1.6%	726	12	0.5%
Fourth 20%	$50,500 to $84,000	65,440	4,712,000	16.5%	947	157	6.9%
Next 15%	$84,000 to $169,000	113,398	14,679,000	68.6%	2,195	1,506	49.6%
Next 4%	$169,000 to $436,000	244,172	5,277,000	92.5%	4,980	4,604	40.5%
Top 1%	Over $436,000	1,314,582	391,000	27.4%	4,123	1,132	2.5%
ALL		**$ 67,224**	**25,524,000**	**17.7%**	**$ 2,542**	**$ 449**	**100.0%**
Bottom 60%	Less than $50,500	$ 25,514	465,000	0.6%	$ 723	$ 4	0.5%

Source: ITEP Microsimulation Model, February 2009

2. Home Ownership Tax Credit

Projected Additional Cost Compared to House Bill: $35 Billion
Why It Won't Help the Economy: Benefits wealthy taxpayers and could inflate housing prices.

The Senate adopted an amendment, offered by Senator Johnny Isakson (R-GA), that would provide a tax credit to subsidize the purchase of a home. According to the Congressional Joint Committee on Taxation (JCT), this provision will cost $35 billion more than the more restricted home buyers' tax credit included in the House bill. The Senate's home buyers' credit would also be far more targeted to the wealthy.

The phenomenon of the housing bubble over the last nine years and the subsequent bursting of that bubble are widely believed to be the cause of the current economic downturn. Many people simply invested far too much in their homes, paying at inflated prices during the frenzy of easy credit and now living in homes that are worth less than what they owe on their mortgages. In these circumstances, it is bizarre for Congress to try to reinflate home prices.

On the other hand, if this provision does not actually increase the number of home purchases, it will simply be a costly tax break for home purchases that would have taken place anyway. This seems likely, since the credit would not provide any cash at the time when a family makes a down payment on a house. It would only be received later, when the household files federal income taxes for that year. For this reason, it seems unlikely that this tax break would facilitate a home purchase by someone who would otherwise be unable to make such a purchase.

At least the House version of this provision is less expensive and more targeted to people who could actually use some help. The House bill alters the existing temporary home buyers' tax credit (a refundable $7,500 credit for first-time home buyers that must be paid back over several years) by removing the repayment requirement for most beneficiaries.

The Senate bill takes a much more expensive, and regressive, approach. It would provide a non-refundable credit of 10 percent of the home's cost, with a maximum credit of $15,000, taken over one or two years. In order to get the full benefit of the $15,000 credit in one year, a married couple with two children would need to have gross income of $116,500. If the family elects to take the credit over two years, they would not get the maximum credit unless their gross income was at least $78,250 each year.

Since the Senate's credit is not refundable, it will only help taxpayers who have a federal tax liability. As if all of this were not enough, the home buyers' credit in the Senate bill, unlike the one in the House bill, has no income limits, meaning even the richest families can enjoy it. And, unlike the House bill, the Senate bill would make this credit available for all home purchases, not just first-time home purchases.

3. Above-the-line Deduction for Automobile Purchases

Projected Additional Cost Compared to House Bill: $11 Billion
Why It Won't Help the Economy: Encourages debt and doesn't target those who need help.

The Senate adopted an amendment offered by Senator Barbara Mikulski (D-MD) that would allow an "above-the line" deduction (a deduction available to people who use the standard deduction rather than itemizing deductions) for the interest paid on a automobile loan and for the excise taxes paid on the purchase of an automobile. This tax break, which is projected by JCT to cost $11 billion, would apply to purchases made after November 12, 2008, and before the end of 2009, of cars costing up to $49,500. (Why someone should get a tax break for a car purchase they made back in November of last year is unknown.) The House version of the stimulus bill does not include any such tax break for automobile purchases.

It's difficult to imagine how using the tax code to encourage families to take on more debt could be good policy. In addition, this would be a significant tax cut targeted to a specific industry rather than targeted to families who most need help. If the automobile industry needs aid, Congress should debate that issue and consider providing aid directly and more efficiently rather than through the tax code.

4. Suspension of Tax on Unemployment Benefits

Projected Additional Cost Compared to House Bill: $4.7 Billion

Why It Won't Help the Economy: Benefits high-earners more than families who need help.

The Senate bill would eliminate federal income taxes on the first $2,400 of unemployment insurance benefits in tax year 2009. This might seem like a reasonable idea to someone who doesn't stop to think about it. Surely the best way to target aid to those who could use some help is to target aid by income. But this provisions would target aid to those whose income takes a particular form rather than those whose income is below a particular level.

Very low-income people do not have to pay any income tax, and excluding any form of income from taxation obviously offers the greatest benefits to those in the highest income brackets. The people most likely to benefit from an income tax break for UI benefits are those who earned a great deal before being laid off, or those with a high-earning spouse.

Consider two married couples, each with income of $100,000. One couple has $95,000 in earnings for the year and $5,000 in UI benefits, while the other couple has $100,000 in earnings. There is no reason why one couple should need a tax break more than the other, but the Senate bill would give a tax break to the couple that has some UI benefits, but not the other couple despite their identical incomes.

To think of this a different way, consider an executive who makes $200,000 or so during the year, and is then laid off for a few months. She would receive a tax break equal to 28% of the first $2,400 in unemployment benefits she receives (about $672) because she is in the 28 percent income tax bracket. The same is true of someone who is laid off for the full year but is married to a spouse who earns $200,000 that year.

Now consider a family of four with modest earnings. If their income (including UI benefits) is less than $26,000, they would receive no benefit at all from this tax break. If their income is between $26,000 and $42,700 for the year, this tax break is only worth 10% of the first $2,400 in UI benefits ($240) because they are in the 10 percent income tax bracket.

5. Five-year Carryback of Net Operating Losses

Projected Additional Cost Compared to House Bill: $2.2 Billion

Why It Won't Help the Economy: Puts more cash in the hands of business owners without changing their incentives to invest or create jobs.

The House and Senate bills both include a provision to make it easier for corporations to use tax losses to get a refund of taxes paid in prior years (i.e., to get a check from the IRS) while doing nothing to change companies' incentives to invest or create jobs. The House of Representatives was at least ashamed of this provision enough to slightly limit its benefits by requiring businesses who use this provision to reduce the tax losses they "carry back" by ten percent. The Senate felt no such compunction, which is why the Senate version of this provision has been projected to cost $17 billion over 10 years while the House version is projected to cost "only" $15 billion.

Both these cost estimates significantly understate the true cost of this provision. For example, The Senate version will cost $67.5 billion in its first two years, with paybacks thereafter, as deductions taken early are no longer available. Its present-value cost (its lump-sum equivalent if paid in full right away) is $24 billion.

As a general rule, a company operating at a loss (for tax purposes) in a given year will not have to pay taxes for that year, because its deductions will wipe out its taxable income. Under current law, if a company has excess deductions for net operating losses (NOLs) beyond its taxable income for the year, it can apply those excess deductions not only against earnings in later years, but also against income taxed in the previous two years. That allows it to get previously paid taxes refunded.

The House and Senate stimulus bills would allow a company to apply those excess deductions against income that was taxed in the previous 5 years (instead of just the previous 2 years).

There is no reason to think this change would lead to the creation or retention of jobs. Allowing a company to use its current year losses to get a refund of taxes paid in the past does not lower the costs of doing business or make it easier to profit. It would simply hand cash to business-owners who are not profiting currently. Smart business people will expand their business only if they can profit by doing so, regardless of how much cash they have on hand. A business owner is likely to lay off workers if she cannot earn enough to cover expenses and enjoy a profit. Simply giving the business owner some cash with no strings attached will not change that.

Worse, this provision would funnel tax cuts to the financial and construction industries, which many analysts believe played a significant part in inflating the housing bubble that turned into the current recession.

This provision does not belong in an economic stimulus bill. If lawmakers are unable to resist the urge to have the IRS send checks to business owners with absolutely no strings attached, they should at least follow the House's lead and make those checks (slightly) smaller.

6. Delayed Recognition of Certain Cancellation of Debt Income

Projected Additional Cost Compared to House Bill: $0.813 Billion
Why It Won't Help the Economy: Rewards the behavior that got us here in the first place.

One business tax cut that was included in the Senate bill but not in the House bill is a provision that would allow companies with cancellation of indebtedness income (CODI) to defer taxes on that income.

While this might sound like a nice break for companies that are facing hard times, in reality it would provide a backdoor "bailout" for several industries that taxpayers might not be so keen to bail out.

Under current tax law, any forgiveness of debt is income that is subject to the income tax. For example, if you borrowed $20,000 from your employer and then, several months later, your employer forgave your entire debt, the tax law says that you have received $20,000 in income in the form of debt cancellation.

You can see why the tax rules must treat debt cancellation this way. If it was not treated as income, we would all want our employers to simply issue us loans and then later forgive them, instead of just paying us taxable salaries.

Businesses would want the same thing. To the extent that they could convert their income into cancellation of debt income (CODI), they would completely avoid taxes. So it's essential to a working tax system to treat CODI as taxable.

But the Senate bill would temporarily undermine this essential rule. The Senate bill would allow companies with CODI in 2009-2010 to spread their tax payments on that income over eight years.

It's worth taking a step back and considering what exactly would be subsidized by a tax break for CODI. A company could generally get a tax break because it found itself unable to repay its debts, no matter why the company took on the debt.

This includes companies that borrowed in the last few years, not to expand or invest, but to *pay dividends*. Many companies did this when borrowing rates were low and their balance sheets were "under-leveraged." Their shareholders who received the dividends should bear the loss — not the American taxpayers.

Equally alarming, a tax break for CODI would essentially serve as a bailout for the investors who most aggressively and recklessly borrowed and contributed to the current economic collapse. For example, private equity firms (a euphemism for leveraged-buyout firms) could realize a particularly substantial windfall. Private equity firms buy up companies, which take on debt to facilitate their own takeover. So private equity firms try to engineer buyouts without putting very much money down and then turn big profits for their investors.

But many of these deals are in trouble today. (A recent study estimates about 60% of the debt is trading at "distressed" levels.) Private equity firms are trying to refinance these deals and are hoping for a tax break for cancellation of debt.

There is widespread sentiment that the aggressive borrowing of the private equity firms contributed substantially to the financial markets meltdown. And, after bitter debates over bailing out financial institutions and automobile manufacturers, it seems unlikely that Congress could rescue buyout firms through the sort of direct aid that would catch the attention of the public.

The official estimated cost of the CODI tax break would be a mere $0.8 billion over 10 years. But in reality it could cost much more. In its first two years, the cost would be $26.2 billion. After that, when the deferred income begins to be recognized, there would be tax increases. But the present-value cost of the tax break (its lump-sum equivalent if paid in full right away) is still more than $5 billion.

Excluding the interest costs from the price of a tax cut might not make much of a difference for many types of tax cuts. But in situations where the main benefit provided by a provision is allowing someone to defer taxes to a later date, the interests adds enormously to the total cost of the provision.

Many of the business tax cuts in the stimulus bills allow corporations to delay tax payments, but not reduce tax liability by nearly as much over the long term. So the official cost projections from JCT assume the Treasury will lose revenue in the two years in which these provisions are in effect, but then recoup much of it in later years. But that leaves out the significant costs of borrowing to pay for the tax cuts — what economists call the "time value of money."

Obviously, money in your hand today is worth a lot more than the same nominal amount of money in your hand ten years from now, in part because inflation erodes the value of money over time, but mostly because money now can be invested to earn a profit over time. Of course, business people are perfectly aware of this, which is why they lobby for this type of "deferral" tax break in the first place.

Tax Cuts That ARE Effective Stimulus Should STAY in the Stimulus Bill

The Senate bill, like the House bill, does include some tax cuts that could actually achieve the goal of stimulating the economy because they are targeted to the people who are likely to quickly spend any new money they receive — working class families. These provisions are effectively targeted because they include refundable income tax credits.

Essentially all working families pay federal payroll taxes, but many do not earn enough to owe any federal income tax. Congress and presidents since Jimmy Carter (including President George W. Bush) created or expanded refundable income tax credits, which can result in families of modest income having negative income tax liability.

The checks sent from the IRS to such taxpayers can be thought of as a way of offsetting payroll taxes for these families, because the main refundable credits (both under current law and under the House and Senate stimulus bills) are available only to people who work.

The House and Senate bills would create a Making Work Pay Credit (MWPC), a refundable credit of up to $500 ($1,000 for couples) for virtually all working class people with earnings. (The credit would be equal to 6.2 percent of the first $8,100 of earnings, or $16,200 for a couple, and phased out for high-income families).

The House and Senate versions of the MWPC are slightly different in that income limits are a little more strict in the Senate version.[2]

The House and Senate bills would also modestly increase the Earned Income Tax Credit (EITC) for low-income families with three or more children and for married couples.

House Bill Does a Better Job of Targeting the Child Tax Credit

Both the House and Senate stimulus bills would also improve another tax credit that is (partially) refundable, the Child Tax Credit (CTC). Both the House and Senate stimulus bills would make the CTC more readily available to very poor families, but the House bill does a better job of this.

Currently a parent who earns less than $12,550 in 2009 is *too poor* to benefit from the CTC. Under current law, the refundable portion of the CTC is limited to 15 percent of earnings *above* $12,550 in 2009 (this threshold is indexed for inflation).

The House bill would remove this earnings threshold so that the refundable portion of the CTC would be equal to 15 percent of any earnings (the maximum credit would remain unchanged at $1,000 per child). The Senate bill retains the earnings threshold but lowers it to $8,100.

[2]Under the House bill the credit is restricted for taxpayers with adjusted gross income exceeding $75,000 for unmarried taxpayers and $150,000 for married taxpayers, and is phased out at a rate of 2 percent for each dollar of income above those levels. Under the Senate bill the phase out begins at $70,000 and $140,000 and the phase out rate is 4 percent.

Three Tax Provisions That Are Most Likely to Be Effective Stimulus

These three provisions (MWPC, EITC, CTC) are examples of tax breaks that are effectively targeted to low- and middle-income families, as illustrated in the tables below. If Congress wants to give a boost to consumption so that companies continue to have customers for their goods and services, then these provisions are the most promising of all the tax cuts in the stimulus bills.[3]

Benefits of Selected Tax Cuts in the House Stimulus Proposals in 2009 in the United States

Income group	Ave. 2009 Income	Making Work Pay Credit (MWPC) Ave. tax cuts	MWPC % of tax cut	Earned Income Tax Credit (EITC) Ave. tax cuts	EITC % of tax cut	Child Tax Credit (CTC) Ave. tax cuts	CTC % of tax cut
Lowest 20%	$12,100	$ –283	11.4%	$ –8	10.2%	$ –168	52.9%
Second 20%	24,500	–395	16.0%	–33	41.4%	–109	34.2%
Middle 20%	39,900	–510	20.6%	–35	44.0%	–34	10.8%
Fourth 20%	65,400	–679	27.4%	–3	3.9%	–5	1.6%
Next 15%	113,400	–754	22.8%	–0	0.4%	–1	0.3%
Next 4%	244,200	–208	1.7%	—	—	–0	0.0%
Top 1%	1,314,600	–7	0.0%	—	—	–0	0.0%
ALL	**$ 67,200**	**$ –488**	**100.0%**	**$ –16**	**100.0%**	**$ –63**	**100.0%**
Bottom 60%	$25,500	$ –396	47.9%	$ –26	95.6%	$ –104	97.9%

Source: Institute on Taxation and Economic Policy Tax Model, February 2009

Benefits of Selected Tax Cuts in the Senate Stimulus Proposals in 2009 in the United States

Income group	Ave. 2009 Income	Making Work Pay Credit (MWPC) Ave. tax cuts	MWPC % of tax cut	Earned Income Tax Credit (EITC) Ave. tax cuts	EITC % of tax cut	Child Tax Credit (CTC) Ave. tax cuts	CTC % of tax cut	Alternative Minimum Tax (AMT) Relief Ave. tax cuts	AMT % of tax cut
Lowest 20%	$12,100	$ –283	11.8%	$ –8	10.2%	$ –53	43.0%	$ —	—
Second 20%	24,500	–395	16.4%	–33	41.4%	–51	41.7%	—	—
Middle 20%	39,900	–510	21.2%	–35	44.0%	–16	13.3%	–12	0.5%
Fourth 20%	65,400	–667	27.7%	–3	3.9%	–2	1.7%	–157	6.9%
Next 15%	113,400	–710	22.1%	–0	0.4%	–0	0.2%	–1,506	49.6%
Next 4%	244,200	–79	0.7%	—	—	–0	0.0%	–4,604	40.5%
Top 1%	1,314,600	–7	0.0%	—	—	–0	0.0%	–1,132	2.5%
ALL	**$ 67,200**	**$ –474**	**100.0%**	**$ –16**	**100.0%**	**$ –24**	**100.0%**	**$ –449**	**100.0%**
Bottom 60%	$25,500	$ –396	49.4%	$ –26	95.6%	$ –40	98.0%	$ –4	0.5%

Source: Institute on Taxation and Economic Policy Tax Model, February 2009

[3] This table illustrates the effects of the selected tax provisions across all taxpayers. The average benefits from some of these tax cuts would be much higher for families with children (as opposed to the average benefits for all taxpayers regardless of whether or not they have children). To see the average benefit of each tax provision for families with children in a particular state, see CTJ's state fact sheets at http://www.ctj.org/stimulus/stimulusandchildrenbystate.htm These facts sheets will be updated shortly to reflect changes in the Senate stimulus bill included in the "compromise" Senators adopted this week.