WebMemo
Published by The Heritage Foundation

No. 2240
January 26, 2009

"Making Work Pay" Credit Will Not Stimulate the Economy

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President Barack Obama's "Making Work Pay" tax credit is a major piece of the fiscal stimulus plan currently being debated in Congress. The new credit is being touted as a tax cut, but in reality it is just more spending through the tax code. Moreover, since it is also "refundable," it would send money directly to low-income taxpayers who pay no income taxes.

This Making Work Pay credit does nothing to create jobs. A better approach would be growth-promoting tax cuts that increase taxpayers' incentives to work, save, invest, and take on risk.[1] The best way to do that is to lower rates on individual income, capital gains, and corporate taxes and to eliminate the death tax.[2]

Spending Through the Tax Code. The Making Work Pay credit would fulfill President Obama's campaign promise to cut taxes for 95 percent of working families. It is worth $500 for an individual or $1,000 for a couple. The credit is refundable, so if it is greater than the total that the taxpayer owes in income taxes, they will get a check from the government for the remaining amount of the credit. For instance, if a couple has an income tax liability of $800 (after all other credits and deductions in the tax code), the new Making Work Pay credit would completely wipe out their tax liability. Then, they would receive a $200 check from the IRS from the refundable portion of the credit.

This kind of credit is actually a spending program because it directs money to a targeted group based on political considerations. Economically, it is no different than if Congress passed a spending bill that simply sent checks in the same amount to the same people. The only difference is that it is run through the tax code.

Using the tax code for this kind of spending is favored politically because spending is unpopular with the American public. Tax cuts, however, are popular. This misleading brand of spending as a tax cut gives lawmakers a freer hand to institute, through the tax code, the same programs that would be unpopular if rightly called spending. Moreover, spending through the tax code is a stealth off-budget expansion of the federal government and circumvents the standard budgetary process where spending would ordinarily receive intense scrutiny.

Paying Those Who Pay No Income Taxes. The Making Work Pay credit will send money directly to millions of taxpayers who pay no income taxes at all. It is impossible to cut taxes for a taxpayer who pays no taxes. Thus, refunds to taxpayers who pay no income taxes cannot, by definition, be a tax cut. This is spending pure and simple, and it is misleading to pretend otherwise.

In 2009 alone, the IRS will already mail checks worth an estimated $57.8 billion to taxpayers who

This paper, in its entirety, can be found at:
www.heritage.org/Research/Taxes/wm2240.cfm

Produced by the Thomas A. Roe Institute
for Economic Policy Studies

Published by The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002–4999
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pay no income taxes but still get a refund from the two largest refundable credits—the Earned Income Tax Credit and the Child Tax Credit.[3]

The tax code should not be used to direct payments to targeted groups. The merits of such programs should be discussed and debated in the budgeting process instead of obscured in the tax code and misnamed a tax cut. This would increase the transparency of government and give taxpayers a better sense of how their money is spent.

Credits Reward Politically Favored Activities. More tax credits in addition to the Making Work Pay credit are likely to be proposed in the near future. It is important to remember that tax credits are often misused to influence behavior and achieve political goals. This is not a new development, as the very first income tax in 1913 had a deduction for interest paid to encourage home ownership. Tax credits designed to influence behavior are not tax cuts, however. They are social or political policy implemented through the tax code. If taxpayers must undertake a certain behavior to receive a reduction of their tax bills, they are being paid to engage in a politically favored activity.

There are already countless provisions in the tax code that pay taxpayers to engage in behavior deemed beneficial by Washington. The federal government spends almost $1 trillion annually through 161 different credits or deductions for education, energy production, energy use, the environment, agriculture, housing, transportation, community development, health care, and many others. These are no different economically than if the government directly paid taxpayers through spending programs to undertake the politically favored activities. Such policies, therefore, should be regarded for what they are: spending, not tax cuts.

Thus, the Making Work Pay credit is another step down an increasingly slippery slope.

Making Work Pay Credit Will Not Boost the Economy. The Making Work Pay credit, or any new credit, will fail to stimulate the economy because government spending cannot create new purchasing power out of thin air.[4] The money that would go out through this credit would have to be taken out of the private sector by either taxing or borrowing, negating any effect of new government spending. The only sure way to stimulate the economy is through permanently lower tax rates, because they improve taxpayers' incentives to create income through working, saving, and investing.

The Heritage Foundation recently released a plan that would create 3.6 million jobs through 2012 by lowering tax rates. The plan calls for making the 2001 and 2003 tax cuts permanent, an additional cut of 10 percentage points in the top individual income and corporate income tax rates, and reductions of other income tax rates by similar amounts from their current levels.[5] The plan would cost less than half of the current stimulus package, would actually create new private sector jobs, and would really be a tax cut.

Spending in Disguise. Congress should do away with the Making Work Pay credit, but at the very least it should limit its damage by making the credit non-refundable. Not only would this prevent non-taxpayers from getting government handouts through the tax code, but it would also reverse the trend of using the tax code as a spending mechanism.

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1. Stuart Butler, "Permanent Tax Relief—Not Tax 'Holidays'—Stimulates Economic Growth," Heritage Foundation *WebMemo* No. 2152, December 3, 2008, at *http://www.heritage.org/Research/Taxes/wm2152.cfm.*
2. Alison Acosta Fraser and Curtis Dubay, "Cutting Taxes to Promote Growth and Restore Fairness: A Memo to President Obama," Heritage Foundation *Special Report* No. 29, December 2, 2008, at *http://www.heritage.org/Research/Taxes/sr29.cfm*
3. Office of Management and Budget, *Analytical Perspectives*, Fiscal Year 2009, p. 291, at *http://www.whitehouse.gov/omb/budget/fy2009/pdf/spec.pdf* (January 8, 2009).
4. Brian Riedl, "Why Government Spending Does Not Stimulate Economic Growth," Heritage Foundation *Backgrounder* No. 2208, November 12, 2008, at *http://www.heritage.org/Research/Budget/bg2208.cfm.*
5. J. D. Foster and William W. Beach, "Economic Recovery: How Best to End the Recession," Heritage Foundation *WebMemo* No. 2191, January 7, 2009, at *http://www.heritage.org/Research/Economy/wm2191.cfm.*

The Making Work Pay tax credit now in the stimulus is not a tax cut at all. It is spending through the tax code. It will function like a spending program and send checks to taxpayers who pay no income taxes. Even worse, it will not stimulate the economy. Lawmakers should focus instead on real tax cuts such as cutting tax rates.

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