

# WebMemo



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## Obama's Stimulus Has "Spread the Wealth Around": Are Tax Hikes Next?

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President Obama famously said during the campaign that he thinks the economy works best when "we spread the wealth around." He is wasting no time pursuing this redistributionist agenda, and he is using the tax code to do it.

**The Wrong Medicine.** The so-called "stimulus" bill (H.R. 1, the American Recovery and Reinvestment Act of 2009) created the refundable Making Work Pay Credit, increased and made refundable the Hope Scholarship Credit (now renamed the American Opportunity Education Credit), and increased the two largest existing refundable credits, the Earned Income Tax Credit (EITC) and the Child Tax Credit. To the extent these credits are refundable, they are really spending run through the tax code and as such will do nothing to boost the ailing economy.

**These Credits Will Not Stimulate the Economy.** These credits are accurately described as spending programs, because they are all refundable. Refundable credits send checks to low-income taxpayers when their value is more than the taxpayer's income tax liability. For example, if a taxpayer with an \$800 income tax liability claims a refundable credit worth \$1,000, he will pay no income taxes and receive a check for \$200 from the IRS.

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. The checks sent to taxpayers from refundable credits are spending pure and simple, and it is misleading to pretend otherwise. So low-income taxpayers that claim the refundable portion of these credits

will have their entire income tax liability wiped out and receive checks from the IRS. This spreads income to low-income groups and those engaged in preferential behaviors while doing nothing to encourage economic growth.

Increased government spending does not increase economic growth in the near term because Congress cannot create purchasing power out of thin air. Before it can spend, it must first take money out of the economy through taxes or borrowing.<sup>1</sup> No new spending power is created; it is merely redistributed from one group of people to another. In this case, the credits spread income to low- and middle-income taxpayers because they are not available for upper-income taxpayers. Single taxpayers who earn over \$95,000 and married taxpayers earning over \$190,000 receive no benefit from any of the credits.

**Making Work Pay Credit.** The Making Work Pay Credit is a refundable credit on wages (called "wage income") up to \$400 for individuals and \$800 for married couples. It phases out at 2 percent for taxpayers with over \$75,000 (\$150,000 for married couples) of adjusted gross income (AGI) until it is completely phased out for taxpayers with AGI over

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\$95,000 (\$190,000 for married couples). The credit applies only to wages, so it specifically targets low- and middle-income workers.

The Making Work Pay Credit is the most widely available of the credits affected by H.R. 1 because it can be taken by all taxpayers earning wage income so long as they are working, but it is not applicable to income from other sources such as interest, dividends, pensions, or Social Security. The Making Work Pay Credit is a step toward fulfilling Obama's campaign promise to cut taxes for 95 percent of workers, but rather than providing a general tax cut for all, it provides a tax cut for some, an expansion of welfare payments to others, and absolutely nothing to others.

**American Opportunity Education Credit.** The American Opportunity Education Credit is a \$2,500 credit applied to college tuition and related expenses for four years. It is refundable up to 40 percent of the credit, so it could send checks of up to \$1,000 to low-income taxpayers who qualify. It begins to phase out for taxpayers with AGI of \$80,000 (\$160,000 for married couples) and completely phases out at \$90,000 (\$180,000 for married couples). Alarming, a provision in the bill requires the Treasury secretary to study the feasibility of requiring students to perform community service in order to receive the credit.

The American Opportunity Education Credit reduces the costs of investing in education, but requiring community service in exchange for the credit is an astonishing use of the tax code. Attending college and performing community service are certainly positive activities, but making the benefit of a tax provision contingent on additional favored behavior is not tax relief but social engineering.

**Child Tax Credit.** The Child Tax Credit is \$1,000 for every qualifying child claimed on a taxpayer's return and phases out for taxpayers with AGI over \$75,000 (\$110,000 for married couples). It is refundable at 15 percent of a taxpayer's income over \$3,000. H.R. 1 reduced the floor above which the credit is refundable from \$8,500 to \$3,000. For

example, a family needed to earn above \$8,500 per year to qualify for the refundable portion of the Child Tax Credit before passage of H.R. 1, but now the same family could receive a refundable benefit at only \$3,000 of earnings.

Unfortunately, the expansion of the refundability of the Child Tax Credit in H.R. 1 would do nothing to encourage workers to work more, investors to take on more risk, or businesses to expand operations: All it does is redistribute income to low-income families.

**Earned Income Tax Credit.** The EITC is a refundable credit for low-income working families and individuals. Its value ramps up at lower levels of income until it reaches a maximum point where it begins to phase down. The amount of the credit depends on the number of children in the family. For example, credits for qualifying families with no children are calculated at 7.65 percent of earned income, while payments to families with two or more children are calculated at 40 percent. H.R. 1 created a new category for families with three or more children and increased the amount of credit they can claim by raising their credit rate from 40 percent to 45 percent. The higher rate increases the value of the credit and therefore the amount of money these families receive through the credit's refundable portion.

H.R. 1 also increased the value of the credit to all married couples claiming the EITC, regardless of number of children, by lifting the level of income the EITC begins to phase out by \$1,880 to a maximum of \$21,420. Just like the expansion of the Child Tax Credit, the expansion of the EITC spreads income to low-income families but does nothing to stimulate economic growth.

**Spreading More Income Around.** The tax changes in H.R. 1 focus on rewarding targeted groups or behaviors, largely covering the President's campaign promises to "spread the wealth around." In doing so, the President missed an opportunity to actually stimulate economic growth and put money in the pockets of those he wanted to help at the

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1. Brian M. Riedl, "Why Government Spending Does Not Stimulate Economic Growth," Heritage Foundation *Background* No. 2208, November 12, 2008, at <http://www.heritage.org/Research/Budget/bg2208.cfm>.

same time by cutting tax rates, especially those on income and investment.<sup>2</sup>

H.R. 1 is the first step in President Obama's plan to "spread the wealth around." Step two is the President's proposed tax increases on high-income earners, as outlined in the recently released "Budget

Blueprint," which limits deductions and increases tax rates for high-income earners.

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2. 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>.