

*For Immediate Release
June 2, 2004*

THE ULTIMATE BURDEN OF THE TAX CUTS

Once the Tax Cuts are Paid for, Low- and Middle-Income Households Likely To Be Net Losers, on Average

By William G. Gale, Peter R. Orszag, and Isaac Shapiro¹

Summary

Popular discussions about the advisability of recent tax cuts have frequently ignored a simple truism: someone, somewhere, at some time will have to pay for them. The payment may be in the form of increases in other taxes, reductions in government programs, or some combination of the two; the payment may occur now or later; it may be transparent or hidden. But iron laws of arithmetic and fiscal solvency tell us that the payment has to occur.

Some tax-cut advocates try to deny the fundamental fact that the tax cuts will need to be paid for. For example, some claim the cuts will generate enough economic growth to “pay for themselves.” As discussed below, the evidence not only does not support such claims, it implies precisely the opposite result — that sustained deficit financing of tax cuts will end up reducing long-term economic growth, thereby raising the cost of the tax cuts. Others claim the repayment can be postponed indefinitely. But given the nation’s large underlying long-term fiscal imbalance even without the tax cuts, such indefinite postponement of paying for the tax cuts is simply not possible — it eventually would spark a serious fiscal crisis. (Similarly, large increases in spending, such as occurred with the enactment of the Medicare drug benefit, will also need to be paid for.)

To date, the tax cuts have been funded with increased borrowing. This postpones but does not eliminate the required payments.² It can also create the misleading impression that tax cuts make almost everyone better off because the direct tax-cut benefits are immediate and quantifiable but the ultimate costs are delayed and disguised and thus often ignored.

¹ We thank Joel Friedman, Robert Greenstein, David Kamin, Richard Kogan, Matt Hall, and Arloc Sherman for their contributions to this analysis.

² The situation is analogous to a consumer charging a major purchase to a credit card. The charge postpones, but does not eliminate, the need for the ultimate payment.

The central goal of this analysis is to correct this misleading impression by showing not only who benefits directly from the recent tax cuts but also who benefits and who loses once the financing of the tax cuts is considered. Specifically, we examine the distribution of the 2001 and 2003 tax cuts (once they are fully in effect and reflecting the President’s proposal to make most of these tax cuts permanent) *combined with* the costs of paying for those tax cuts. We therefore examine the “net effects” of the tax cuts, accounting for both the direct benefits and the costs associated with financing those benefits.

Because there is uncertainty about how the tax cuts will ultimately be financed, we examine two hypothetical scenarios. In both scenarios, the burdens are set so that the annual cost of the tax cuts (when fully phased in) would be paid for fully — so that the net effect of the tax cuts that year on the budget thus would be zero.

The first scenario assumes that each household pays an *equal dollar amount* each year to finance the tax cuts. Under this scenario, each household receives a direct tax cut based on the 2001 and 2003 legislation, but it also “pays” \$1,520 per year in some combination of reductions in benefits from government spending or increases in other taxes to finance the 2001 and 2003 tax cuts. Something close to this scenario could occur if the tax cuts were financed largely or entirely through spending cuts. We refer to this as the “equal dollar burden” scenario.

The second scenario assumes that each household pays the *same percentage of income* to finance the tax cuts. Under this scenario, each household receives a direct tax cut based on the 2001 and 2003 legislation, but it also pays 2.6 percent of its income each year. Something close to this scenario could occur if the tax cuts were financed through a combination of spending cuts and progressive tax increases. We refer to this as the “proportional burden” scenario.

We estimate the effects of these two scenarios on households at different income levels, using the Tax Policy Center microsimulation model.³

Income Class	Average tax cut	Average net effect, financing with equal dollar burden per household	Average net effect, financing with payments proportional to income
Bottom 20 percent	\$19	-\$1,502	-\$177
Middle 20 percent	652	-869	-\$228
Over \$1 million	136,398	134,877	\$59,637

Source: Urban-Brookings Tax Policy Center microsimulation model

³ See <http://taxpolicycenter.org/TaxModel/tmdb/TMTemplate.cfm?DocID=299>.

Our principal findings include the following:

Winners and Losers by Group

- On average, the bottom four-fifths of households — households with income below about \$76,400 — would lose more than they gain from the tax cuts once the necessary financing is taken into account.** That is, once the need for financing is included, the 2001 and 2003 “tax cuts” are best seen as *net tax cuts* for the top 20 percent of households as a group, financed by *net tax increases or benefit reductions* for the remaining 80 percent of the population as a group.
- Middle-income households would be worse off under both scenarios for financing the tax cuts, but would fare much worse if tax cuts are financed entirely on an equal dollar burden basis (such as could occur if the adjustment were largely or entirely undertaken through spending cuts).** Under the equal dollar burden scenario, the middle fifth of households would lose an average of \$869 per year (Table 1) or 3.1 percent of their after-tax incomes (Table 2). (The average direct tax cut for these households is \$652. Coupled with a financing burden of \$1,520, the net effect is an average loss of \$869, or 3.1 percent of their after-tax incomes.) Under the proportional burden scenario (which could occur through a mixture of spending cuts and progressive tax increases), the middle fifth of households would lose an average of \$228 a year. This is substantially smaller than the losses under an equal dollar burden scenario, but it still amounts to 0.8 percent of their after-tax income.
- Low-income households would be worse off under either scenario, but face potentially enormous costs if the tax cuts are financed entirely on an equal dollar burden basis.** Low-income households would be hit extremely hard under the equal dollar burden approach to financing the tax cuts. They gain little from the tax cuts and would lose much from reductions in spending programs, which often target them, that would result in an equal dollar burden per household. On

Table 2
Percentage Change in After-tax Incomes Under the Tax Cuts with the Cost of Financing Included, Two Hypothetical Scenarios
 (annual effects, in 2004 dollars)

Income Class	Average tax cut (as a percentage of after-tax income)	Average net effect, financing with equal dollar burden per household	Average net effect, financing with payments proportional to income
Bottom 20 percent	0.3%	-21.1%	-2.5%
Middle 20 percent	2.3%	-3.1%	-0.8%
Over \$1 million	7.1%	7.0%	3.1%

Source: Urban-Brookings Tax Policy Center microsimulation model

average, they would lose an average of just over \$1,500 a year, or 21 percent of their income. Under proportional financing (which would very likely reflect less of a reliance on spending cuts), they lose about 2.5 percent of their after-tax income on average.

- **Conversely, high-income households would be net winners, and the gains among the highest-income households would be large.** People with annual incomes of more than \$1 million would gain an average of \$59,600 a year — a 3.1 percent gain in after-tax income — under the proportional burden scenario and \$135,000 a year — or 7 percent of income — under the equal dollar scenario. High-income households are hit less than other households by spending cuts, which are likely to play a more dominant role in the equal dollar burden scenario.
- **The net transfer in resources from low- and middle-income households to high-income households would be sizable.** The overall transfer of income from the lower four-fifths of households with incomes of less than \$76,400 to households with higher incomes would amount to \$113 billion per year under the equal dollar scenario and \$27 billion per year under the proportional financing scenario. The overall increase in the incomes of households whose incomes exceed \$1 million a year would be \$35 billion a year under the equal burden scenario and \$15 billion a year under the proportional scenario. (See Table 3.)

Table 3
Total Dollar Effect of the Tax Cuts with Cost of Financing Included,
Two Hypothetical Scenarios
(annual effects, in 2004 dollars)

Income Class	Average net effect, financing with equal dollar burden per household	Average net effect, financing with payments proportional to income
Bottom 80 percent	-\$113 billion	-\$27 billion
Top 20 percent	+\$113 billion	+\$27 billion
Over \$1 million	+\$35 billion	+\$15 billion

Source: Urban-Brookings Tax Policy Center microsimulation model

Individual Winners and Losers

The above data focus on how groups would fare on average. The Tax Policy Center model also allows determination of how many individual households would wind up better off and how many worse off.

- **Under both of the financing scenarios, more than three out of every four households would ultimately lose more than they gain from the tax cuts.** The

net “losers” would be concentrated among low- and middle-income households. For instance, under the equal dollar burden scenario, nine of every 10 households in the middle fifth of the income distribution would lose more from the tax cuts than they would gain, and nearly all of the households in the bottom two-fifths of the income distribution would come out as net losers.

Conclusion

The tax cuts are often portrayed by their supporters as painless and simply “giving people their money back.” But the numbers presented above indicate that the substantial majority of American households ultimately will be made worse off by the tax cuts, because the tax cuts ultimately will have to be financed. Different methods of financing would generate variation in the particular results, but this basic finding that most households end up being worse off is likely to continue to hold unless a significant portion of the tax cuts themselves are repealed. The reason is that the tax cuts scale back (or even eliminate) many of the most progressive elements of the federal tax system, including the estate tax, the taxation of capital gains and dividends, the top income tax rates, and the phase-outs of certain exemptions and deductions for households with high incomes. It is unlikely that any method of financing those changes, other than repeal, will be as progressive as the tax provisions that have been scaled back.

The details supporting the results and discussion above are provided in the remaining sections of this paper.