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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

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I. Introduction and 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.

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

¹ We thank Joel Friedman, Robert Greenstein, Matt Hall, David Kamin, Richard Kogan, 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.

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

Table 1
Average Change in Incomes Under the Tax Cuts with Cost of Financing
Included, Two Hypothetical Scenarios
(annual effects, in 2004 dollars)

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.

II. Distribution of the Tax Cuts Without Financing

The first component of our analysis is standard. We examine the direct impact of the 2001 and 2003 tax cuts when they are fully in effect, assuming that the tax cuts are made permanent as the Administration has proposed and ignoring the need to finance the tax cuts. These effects are expressed in 2004 (or current) dollars. Appendix Table 1 (which groups tax units, referred to here as “households”, into percentiles, based on cash income) and Appendix Table 2 (which groups households into income ranges, based on their income levels) show the distribution of these tax cuts before any offsetting costs of financing the tax cuts are taken into account.

Figures similar to these have dominated the public discussion of the tax cuts to date. While they demonstrate that high-income households gain much more than other households from the tax cuts under a variety of metrics, the tables also show that the vast majority of households receive some direct tax cuts and no one appears to be worse off. Even if one were to be critical of the degree to which high-income households benefit more than middle- and low-income households, the strength of the criticism might be muted by the appearance that there are no losers from the tax cuts. This appearance, however, is quite misleading.

III. Why Society Has to Pay for Tax Cuts

Some advocates claim that tax cuts today do not necessarily imply future tax increases or future spending cuts — that is, that the tax cuts are essentially free. The claim is usually accompanied by any of a variety of assertions, each of which contains a grain of truth, but none

of which implies that the tax cuts are free or that payment can be avoided. The assertions are dissected below.

Before turning to those claims, though, we note that the view that tax cuts are essentially free of cost does not pass even the most cursory test of logic. If tax cuts were truly free, we should not have taxes at all. We should simply cut taxes to zero. Anyone who believes that cutting taxes to zero would be a reckless policy — and not even the fiercest tax cut advocates go so far as to propose that we have *no* taxes — must at some level agree that tax cuts must be accompanied by other changes in fiscal policy, either spending cuts or compensating tax increases.

Claim: “We can postpone payment forever as deficit levels are manageable.”

In a stable long-term economy, government debt can safely grow as fast as the economy. Thus, *if* government debt were slated to grow more slowly than the economy, then raising the growth rate of debt (for example, by cutting taxes) so it were equal to the growth rate of the economy would be possible and sustainable. Under such a scenario, or under a scenario of expected permanent surpluses, paying for the tax cuts could be deferred indefinitely.

These scenarios, however, are not relevant to the U.S. economy: the underlying premise that public debt will grow more slowly than the economy is starkly inconsistent with every plausible scenario for the federal government’s finances.⁴ Independent researchers, the Congressional Budget Office, the Office of Management and Budget, and the General Accounting Office have all projected exploding debt-to-GDP ratios under current policy (i.e., if we continue the tax cuts, and maintain current entitlement and other spending policies).⁵

To date, payment for the tax cuts has been postponed, but not eliminated, by increasing the budget deficit. But since the nation already faced an unsustainable fiscal position before the tax cuts (due to the aging of the population and rising health care costs), such postponement can not go on forever. The Administration itself acknowledges that under its own policies, over the long-run “the budget is on an unsustainable path.”⁶

Claim: “Deficit-financed tax cuts raise revenue by generating economic growth.”

Advocates of tax cuts frequently claim that tax reductions will significantly increase economic growth and thus boost tax revenues. Some go as far as to claim that the recent tax cuts

⁴ In addition, even if the U.S. were on a stable fiscal path, the tax cuts would still not be free. The resources used for the tax cut could have been used for other purposes — that is, there still is a trade-off between tax cuts now and other policy options. For example, the resources could have been used to further boost spending programs in areas such as education, health, or homeland security instead of being used for the tax cuts.

⁵ Alan J. Auerbach, William G. Gale, and Peter R. Orszag, 2004, “Sources of the Long-Term Fiscal Gap,” Tax Notes 103: 8, 1049-1059. Congressional Budget Office, 2003, “The Long-Term Budget Outlook,” December. Jagadeesh Gokhale and Kent Smetters, 2003, “Fiscal and Generational Imbalances: New Budget Measures for New Budget Priorities,” Washington, DC: AEI Press. David M. Walker, Comptroller General of the United States, “The Nation’s Growing Fiscal Balance,” GAO presentation at Syracuse University, March 31, 2004. U.S. Office of Management and Budget, 2004, “Analytical Perspectives: Fiscal Year 2005 Budget of the United States.” Center on Budget and Policy Priorities, Committee for Economic Development, and the Concord Coalition, “Mid-Term and Long-Term Deficit Projections,” September 29, 2003.

⁶ U.S. Office of Management and Budget, *Analytical Perspectives*, February 2004, page 191.

will spawn so much economic growth that they will fully “pay for themselves” by generating a flood of new revenues from a more rapidly expanding economy.⁷

There is no credible evidence to support the view that tax cuts will generate sufficient growth to actually raise revenues above the levels that would have occurred had the tax cuts not taken place. As discussed further below, a substantial body of literature shows that deficit-financed tax cuts *reduce* growth.

Deficit-financed tax cuts generate two sets of effects on the economy. First, to the extent that they reduce marginal income tax rates, they can encourage people to work more and save more. Major economic studies indicate that these “supply-side” effects are likely to be small in practice; Americans’ decisions about how much to work and save are relatively insensitive to changes in tax rates.⁸ Even the Bush Administration, in the 2003 *Economic Report of the President* states that in the wake of the tax cuts, the economy “is unlikely to grow so much that lost tax revenue is completely recovered by the higher level of economic activity.”⁹ Furthermore, the short-run costs of the tax cuts are diminished only modestly even using the Administration’s own assumptions about the additional growth they produce and the additional revenues they thus generate.¹⁰

The second effect is that the increase in budget deficits reduces national saving and hence reduces future national income. These effects can be substantial, as several studies — including one co-authored by the current chair of the Council of Economic Advisers — have concluded.¹¹

⁷ House Budget Committee Chair Jim Nussle made this claim in March 2004, echoing earlier statements by President Bush and Vice President Cheney. Chairman’s Nussle’s quote was reported in *The Daily Tax Report*, Bureau of National Affairs, March 17, 2004. For an examination of previous Administration statements, see Richard Kogan, “Will the Tax Cuts Ultimately Pay for Themselves,” Center on Budget and Policy Priorities, March 3, 2003.

⁸ For example, “overall, labor supply is not greatly affected by taxes,” Joel Slemrod and Jon Bakija, *Taxing Ourselves: A Citizen’s Guide to the Great Debate over Tax Reform*, (MIT Press: Cambridge, 1996), p. 106. Also, “saving is not very responsive to the after-tax rate of return,” B. Douglas Bernheim and John Karl Scholz, “Savings and taxes...,” in Joseph Cordes, Robert Ebel, and Jane Gravelle, eds., *Encyclopedia of Taxation and Tax Policy*, (Urban Institute Press: Washington, 1999), p. 326. Overall, marginal tax rate reductions have “only modest effects on broad income,” Jonathan Gruber and Emmanuel Saez, “The Elasticity of Taxable Income: Evidence and Implications,” NBER Working Paper 7512, January 2000. For a more complete discussion of the academic literature on tax rates and economic growth, see Peter R. Orszag, “Marginal Tax Rate Reductions and the Economy: What Would Be the Long-Term Effects of the Bush Tax Cut?” Center on Budget and Policy Priorities, March 16, 2001, available at <http://www.cbpp.org/3-15-01tax.pdf>. William G. Gale and Samara R. Potter survey the literature on these effects and apply the results to the 2001 tax cut, “An Economic Evaluation of the Economic Growth and Tax Relief Reconciliation Act,” *National Tax Journal*, March 2002, 55:1, 133-86.

⁹ Page 58.

¹⁰ Isaac Shapiro and Joel Friedman, *Tax Returns: A Comprehensive Assessment of the Bush Administration Tax Cuts*, Center on Budget and Policy Priorities, April 2004, page 13.

¹¹ See William G. Gale and Peter R. Orszag, 2003, “The Economic Effects of Fiscal Discipline,” *National Tax Journal* LVI, No. 3, 463-486. Gale and Potter, *op cit*. Laurence Ball and N. Gregory Mankiw, “What Do Budget Deficits Do?” *Budget Deficits and Debt: Issues and Options*, 95-119, Kansas City: Federal Reserve Bank of Kansas City, 1995. *Economic Report of the President*, 2003, Washington, DC: US Government Printing Office, p. 57, Box 1-4.

The overall effect of deficit-financed tax cuts on economic growth is the sum of the usually positive effect created by reductions in marginal tax rates and the negative effect of increases in the deficit. A number of studies have examined this issue and weighed these competing effects. These studies have generally concluded that, to the extent that they are financed for extended periods of time by borrowing, the recent tax cuts will have little or no positive effect on long-term economic growth and may well reduce it. These include studies by the Congressional Budget Office, the Joint Committee on Taxation, and economists from the Federal Reserve, among others.¹²

Thus, the net reduction in revenues due to deficit-financed tax cuts is likely to be *larger* in the long term than official cost estimates imply, not smaller or zero, as some tax-cut advocates claim.

Claim: “Tax cuts generate revenue by reducing avoidance and evasion.”

A related claim is that even if tax cuts do not generate much growth, they can raise revenue by reducing tax avoidance (legal efforts to reduce tax liability) and tax evasion (illegal efforts to reduce tax liability). The notion is that to the extent tax cuts reduce marginal tax rates, they reduce the “return” to avoiding or evading taxes. Although avoidance and evasion likely do depend on tax rates, there is no evidence to support the view that avoidance and evasion activity are sufficiently responsive to tax rates to turn reductions in marginal income tax rates into anything close to self-financing measures.¹³

IV. Net Effects Once the Financing of the Tax Cuts is Considered

So in the end, the tax cuts need to be paid for. The nature and timing of the ultimate policy adjustments are currently unknown, of course. We consider two possibilities here. In the first, each family pays an equal dollar amount in each year. In the second, each family pays an equal share of income in each year. In both scenarios, the “payments” are set at levels so the tax cuts would be paid for fully in each future year — so that the net effect on the budget would be zero in that year. The reasoning behind these two scenarios, and their distributional effects, are discussed next.

Equal Dollar Burdens

In the first scenario, each family pays the same dollar amount per year to finance the tax cuts. Under this scenario, each household would “pay” \$1,520 each year.

¹² Congressional Budget Office, “Economic Effects of Tax Cuts: Effects of Model Simulations. Background notes and tables,” CBO Director’s Conference on Dynamic Scoring, August 7, 2002. The Joint Tax Committee study was printed on May 8, 2003, in the *Congressional Record*, pages H3829-H3832. Douglas W. Elmendorf and David L. Reifschneider of the Federal Reserve, “Short-Run Effects of Fiscal Policy with Forward-Looking Financial Markets,” prepared for the National Tax Association’s 2002 Spring Symposium. Alan J. Auerbach “The Bush Tax Cut and National Saving”, *National Tax Journal* 55: 387-407, September 2002. Gale and Potter (2002), *op cit.*, and Orszag (2001), *op cit.*

¹³ Gale and Potter, *op. cit.*

The Generational Transfer

This analysis focuses on the redistribution of income that will occur from low- and middle-income households to high-income households once the tax cuts are paid for. It does not examine another important redistributive effect: the significant transfer of income that will occur from future generations to current ones.

This transfer will occur because current taxpayers are not footing the costs of the tax cuts but are reaping the benefits. Future taxpayers, by contrast, will ultimately have to pay not only for the costs of their tax cuts but also will pick up the tab for the tax cuts for current taxpayers.

The size of this transfer will depend upon how long it takes before policies are put into place to finance the tax cuts. The longer this takes, the greater the transfer will be because the delay increases the amount of federal debt that future taxpayers will have to pay off.

Specifying the scenario in terms of the burden paid may seem somewhat abstract, and it may be helpful to think of this scenario in terms of what it would mean for actual policy adjustments. For example, something similar to this scenario could occur if the tax cuts were financed largely or primarily through spending cuts. (The Appendix discusses this example further and explains why a spending-cut package could hurt low-income households more than is shown under this scenario.)

As Appendix Table 3 shows, under this scenario, households in the bottom 80 percent of the income distribution would lose significantly. For example:

- Low-income households would be hit extraordinarily hard. As Table 4 shows, the average direct tax cut for the bottom fifth of households would be \$19, but their payments would amount to \$1,520 per household. Thus, these households would lose an average of \$1,502 per year, a sizable share of their incomes.
- For the middle fifth of households, the average loss would be \$869 per year.
- In sharp contrast, the top one percent of households would experience an average net gain of \$38,800 per year. Their payments of \$1,520 per household would be the same as the payments of all other households, but those payments equal only a tiny fraction — four percent — of the direct tax cuts that these households would receive.

Table 4
Net Effect Of Tax Cuts and Financing on After-Tax Income
(Average Amounts in 2004 dollars)

	Tax Cut	Effects of the Financing Options		Net Effect (Tax Cut + Financing)		Change in After-Tax Income	
		Equal dollar burden scenario	Proportional income burden scenario	Equal dollar burden scenario	Proportional income burden scenario	Equal dollar burden scenario	Proportional income burden scenario
Bottom 20%	\$19	-\$1,520	-\$196	-\$1,502	-\$177	-21.1%	-2.5%
Middle 20%	\$652	-\$1,520	-\$880	-\$869	-\$228	-3.1%	-0.8%
Over \$1 million	\$136,398	-\$1,520	-\$76,761	\$134,877	\$59,637	7.0%	3.1%
All	\$1,520	-\$1,520	-\$1,520	\$0	\$0	0%	0%

Source: Urban-Brookings Tax Policy Center microsimulation model

- Households with annual incomes of more than \$1 million would gain the most, to the average tune of nearly \$135,000 per household per year. (See Appendix Table 4.)

Appendix Tables 3 and 4 also estimate how many net losers and winners there would be in each income category. More than three-quarters of households — 76 percent, or close to 110 million households — would be worse off than if there had been no tax cuts. The vast majority of households in the bottom 80 percent of the income distribution would be net losers, while the vast majority of those with the highest incomes would be net winners.

- Almost all low-income households would be worse off, including nearly 100 percent of the bottom fifth of households and 98 percent of those in the next-to-bottom fifth.
- About 91 percent of those in the middle fifth would be net losers. Even 80 percent of households in the fourth quintile would be worse off.
- In contrast, among the highest-income fifth of households, 86 percent of households would be *better* off, even after including the offsetting financing. About 95 percent of households in the top 1 percent of the income distribution would get a net tax cut.

Equal Percentage-of-Income or “Proportional Income” Burdens

In the second scenario, we assume that tax cuts are financed with spending cuts or tax increases that impose burdens that are proportional to income. Specifically, each household would bear a burden equal to 2.6 percent of its cash income each year. An outcome resembling

this scenario might occur, for example, if the tax cuts were paid for through a combination of spending cuts and progressive tax increases.

Under this scenario, the net effects would be somewhat less regressive than under the other scenario. High-income households would still be the big net winners under this approach, while most other households would still be net losers.

- The bottom four-fifths of households would be net losers. For instance, the middle fifth of households would lose \$228, on average.
- In contrast, the top one percent of households would experience an average net gain of \$14,800. (See Appendix Table 5.)

Looking at the results by household income level, millionaires would gain \$59,600, on average. (See Appendix Table 6 for more detailed breakouts by income group.)

How Much Income Would Be Shifted Around?

Another way of assessing the effects on different income groups once the financing measures are taken into account is to examine the total amount of dollars that would be lost or gained by various income groups. As Table 5 indicates, the amounts involved are quite large.

Consistent with the results already described, the net transfers from low- and moderate-income households to affluent households are more substantial under the equal-dollar-burden scenario. Once the tax cuts are fully paid for:

- The bottom four-fifths of households would be *\$113 billion worse off every year* due to the tax cuts. Of this loss, \$76 billion of the net losses would be borne by the bottom two-fifths of households.
- Conversely, the fifth of households with the highest incomes — that is, those with incomes above \$76,400 — would be \$113 billion better off every year. Of this amount, \$35 billion would go to the nation's millionaires, who comprise just 0.2 percent of all households.

Under the proportional financing scenario:

- The bottom four-fifths of households would lose \$27 billion each year.
- Of the \$27 billion in gains received by the top fifth of households, some \$15 billion would go to the millionaire group.

Appendix Table 7 provides similar breakouts for households with incomes of less than \$30,000, those with incomes between \$30,000 and \$75,000, those with incomes between \$75,000 and \$200,000; and those with incomes above \$200,000.

Table 5
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 20 percent	-\$42 billion	-\$5 billion
Second 20 percent	-\$34 billion	-\$5 billion
Middle 20 percent	-\$25 billion	-\$7 billion
Fourth 20 percent	-\$11 billion	-\$12 billion
Top 20 percent	+\$113 billion	+\$27 billion
Total	0	0
Over \$1 million	+\$35 billion	+\$15 billion

Source: Urban-Brookings Tax Policy Center microsimulation model

V. Is a Substantially Different Outcome Possible?

Our analysis yields two broad results regarding two possible financing scenarios for the 2001 and 2003 tax cuts. First, most households would end up worse off after the tax cuts and the financing are taken into account than they would have been if the tax cuts had never taken place. Second, there would be large transfers from low- and middle-income households to high-income households.

A number of factors might affect the particular numbers presented, but the basic tenor of the results is likely to be very robust to reasonable adjustments. For example, although the burden of financing the tax cut could be allocated in ways other than those shown here, the general results are likely to hold for almost any method of financing. The reason is that the 2001 and 2003 tax cuts undermine the most progressive features of the tax system, including the estate tax, taxes on capital gains and dividends, and the highest marginal tax rates. Thus, low- and middle-income households are likely to come out as net losers under the tax cuts unless the tax cuts are paid for in a manner that affects high-income households far more than other households. Finding such a progressive offset is unlikely, unless the tax cuts are repealed in substantial part (especially the tax cuts geared to higher-income households).

Second, positive revenue feedback effects from positive economic growth or reduced tax avoidance and evasion could reduce the size of the necessary policy adjustments, but these are likely to be small for reasons noted above. Furthermore, the necessary policy adjustments shown above may *understate* the required changes because they do not incorporate the higher debt service costs from the deficit-financed tax cuts in all the years before the tax cuts are paid for. In other words, the estimated policy adjustments pay for the tax cuts in the year in question; they do not pay for the tax cuts up to that time. Thus, the longer it takes to impose the corrective policy adjustment, the larger would be the adjustment required to pay all of the tax cuts since 2001 that had not yet been financed.

Appendix Distributing Spending Cuts

As discussed in the main text, we suggest that the “equal dollar burden” scenario might occur if the tax cuts were ultimately paid for primarily or exclusively through spending cuts. This is not to suggest that all spending cuts would affect all households in equal dollar amounts. The precise distribution of any spending cut would depend on its design.

However, some preliminary calculations suggest that if all spending programs were cut by an equal percentage, then the “equal dollar burden” scenario could well provide a reasonable approximation of the likely burden of paying for the tax cuts.

Based on the distribution of government spending programs calculated from unpublished Census Bureau data for 2002, the Center on Budget and Policy Priorities has estimated the distribution of all mandatory spending programs (including Social Security and Medicare), as well as low-income discretionary spending programs. These programs constituted two-thirds of government spending (outside of interest payments) that year. On a per-household basis, the bottom two-fifths of households received twice as much dollar benefit from these programs as the upper fifth of households.

It is much more difficult, if not impossible, to know how to distribute reductions in spending on programs that provide “public goods” — such as infrastructure investment or crime protection programs that benefit the economy and population broadly. One assumption is that the benefits are proportional to a household's income. This could occur, for example, because high-income households receive a larger share of the income generated by economic growth than lower-income households do. On the other hand, it is perhaps equally plausible, at least in certain cases, that the benefits accrue particularly to low-income households. Reductions in crime due to increased expenditures on public safety, for example, may occur predominantly in low-income neighborhoods. Ultimately, it is extremely difficult to pin down the distributional benefits of such programs with any confidence.

However, if the benefits of government spending outside of mandatory and low-income discretionary programs are assumed to be distributed based on the percentage of overall national income that different income groups receive — and this is combined with the afore-mentioned distribution of mandatory programs and low-income discretionary programs — then overall government spending provides close to an equal dollar value per household. This is why we suggest that the “equal dollar amount” scenario might occur if the tax cuts are financed largely or entirely through spending cuts.

“Equal dollar” Scenario May Understate Potential Losses Among Low-income Households

The equal dollar scenario, however, may *understate* the degree to which the actual financing of the tax cuts primarily or entirely through spending cuts would disadvantage lower-income households. First, it is possible that future spending cuts will target low-income programs

more heavily than other programs that serve broader constituencies and/or more affluent or better politically-connected constituencies. Programs targeted on lower-income households tend to have less powerful political support.

Second, it is possible that defense and homeland security programs — which constitute the lion's share of spending outside of mandatory programs — would be partly or entirely exempt from spending cuts. In this event, the cuts in programs outside of defense and homeland security would have to be steeper. This outcome, too, would likely result in low-income households bearing larger dollar spending cuts than high-income households.

Finally, it should be noted that as the years pass, Social Security and Medicare will constitute a growing share of the budget. If paying for the tax cuts is delayed for five or ten years but a spending-cut package is then enacted that includes reductions in Medicare and possibly in Social Security, the share of the cuts borne by low- and middle-income people would be likely to rise relative to the share borne by the better off, since the bulk of Medicare and Social Security expenditures go to people at middle or lower-income levels.

The Distribution of Spending Cuts under the 1995 Budget Resolution

Of further interest here, the deficit-reduction package reflected in the Congressional budget resolution adopted in 1995 illustrates how a spending-oriented package could hit lower-income households considerably harder than is assumed in this analysis. Both the Clinton Administration and the Democratic Staff of the Joint Economic Committee analyzed the distribution of many (but not all, due to technical constraints) of the spending cuts assumed in that budget resolution.¹⁴ (Legislation along the lines of the budget resolution ultimately was vetoed). Both analyses found that, on a per-household basis, the cuts would hit low-income households several times harder than high-income households.

¹⁴ Office of Management and Budget Press Briefing, "Tax Cuts for the Wealthy Financed by Benefit Cuts to Middle and Low Income Families," October 13, 1995. "A Distributional Analysis of Republican Budget Proposals: Impacts in Fiscal Year 2002," prepared by Democratic Staff of the Joint Economic Committee of the U.S. Congress, October 13, 1995.

Appendix Table 1
Distribution of Tax Cuts Enacted in 2001 and 2003 When Fully in Effect¹
(annual effects, in 2004 dollars, on tax units categorized by income percentile)

Cash Income Class ²	Percent of Tax Units with Tax Cut	Percent Change in After-Tax Income ³	Percent of Total Tax Change	Average Tax Cut (\$)	Average Federal Tax Rate ⁴	
					Pre-EGTRRA Law	Proposal
Lowest Quintile	13.6	0.3	0.2	19	3.7	3.4
Second Quintile	66.5	1.9	4.3	330	9.1	7.4
Middle Quintile	83.8	2.3	8.6	652	15.9	13.9
Fourth Quintile	97.3	2.5	14.9	1,132	20.2	18.3
Top Quintile	99.2	4.4	71.8	5,455	26.8	23.6
All	72.1	3.4	100.0	1,520	22.6	19.9
Addendum						
Top 10 Percent	99.2	4.8	55.9	8,495	28.2	24.7
Top 5 Percent	99.2	5.2	43.7	13,303	29.3	25.7
Top 1 Percent	98.5	6.1	26.5	40,304	31.7	27.5
Top 0.5 Percent	98.5	6.7	22.1	67,206	32.6	28.1
Top 0.1 Percent	98.3	7.4	13.4	204,386	34.6	29.8

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0304-2)

(1) Reflects the individual income tax and estate tax provisions enacted since 2001 that the Administration proposes to make permanent. The estimates assume the policies in 2010, when all of the provisions are fully in effect, are applied in 2004.

(2) Tax units with negative cash income are excluded from the lowest quintile but are included in the totals. Includes both filing and non-filing units. Tax units that are dependents of other taxpayers are excluded from the analysis. For a description of cash income, see <http://www.taxpolicycenter.org/TaxModel/income.cfm>. Tax units with incomes below \$13,017 are in the first quintile; those with incomes between \$13,017 and \$25,002 are in the second quintile; those with incomes between \$25,002 and \$42,939 are in the third quintile; those with incomes between \$42,939 and \$76,368 are in the fourth quintile. Tax units with incomes above \$76,368 are in the fifth quintile. Tax units with incomes above \$356,709 are in the top one percent.

(3) After-tax income is cash income less: individual income tax net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax.

(4) Average federal tax (individual income tax, net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax) as a percentage of average cash income.

Appendix Table 2
Distribution of Tax Cuts Enacted in 2001 and 2003 When Fully in Effect¹
(annual effects, in 2004 Dollars)

Cash Income Class (thousands of 2003 dollars) ²	Tax Units ³		Percent Change in After-Tax Income ⁴	Percent of Total Tax Change	Average Tax Cut (\$)	Average Federal Tax Rate ⁵	
	Number (thousands)	Percent of Total				Percent with Tax Cut	Pre-Tax Cuts
Less than 10	20,428	14.2	5.9	0.1	6	3.6	3.4
10-20	26,467	18.4	52.9	1.4	192	6.6	5.3
20-30	20,379	14.2	79.1	2.4	532	12.8	10.7
30-40	15,377	10.7	84.9	2.3	677	16.6	14.7
40-50	11,446	8.0	93.3	2.3	864	18.7	16.8
50-75	20,054	14.0	98.4	2.5	1,232	20.6	18.7
75-100	11,395	7.9	99.1	3.3	2,224	22.7	20.2
100-200	13,281	9.3	99.3	3.9	3,905	25.1	22.2
200-500	3,339	2.3	99.1	4.2	9,012	27.6	24.5
500-1,000	527	0.4	98.5	5.6	27,150	29.7	25.7
More than 1,000	257	0.2	98.5	7.1	136,398	33.8	29.1
All	143,509	100.0	72.1	3.4	1,520	22.6	19.9

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0304-2).

(1) Reflects the individual income tax and estate tax provisions enacted since 2001 that the Administration proposes to make permanent. The estimates assume the policies in 2010, when all of the provisions are fully in effect, are applied in 2004.

(2) Tax units with negative cash income are excluded from the lowest income class but are included in the totals. For a description of cash income, see <http://www.taxpolicycenter.org/TaxModel/income.cfm>

(3) Includes both filing and non-filing units. Tax units that are dependents of other taxpayers are excluded from the analysis. For simplicity's sake, in the text, the term "households" is used instead of tax unit.

(4) After-tax income is cash income less: individual income tax net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax.

(5) Average federal tax (individual income tax, net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax) as a percentage of average cash income.

Appendix Table 3

**Average Change in Incomes Under the Tax Cuts with Cost of Financing Included,
"Equal Dollar Burden" Scenario¹**
(annual effects, in 2004 dollars, on tax units categorized by income percentile)

Cash Income Class	Units with Net Income Loss			Units with Net Income Gain			All Tax Units	
	Number (thousands)	Percent of Total	Average Change (\$)	Number (thousands)	Percent of Total	Average Change (\$)	Average Income Change (\$)	% Change in after-tax income
Lowest Quintile	28,123	99.9	-1,505	20	0.1	3,656	-1,502	-21.1
Second Quintile	28,078	97.8	-1,228	623	2.2	523	-1,190	-7.0
Middle Quintile	26,066	90.8	-1,029	2,637	9.2	713	-869	-3.1
Fourth Quintile	23,033	80.2	-672	5,671	19.8	765	-388	-0.8
Top Quintile	3,904	13.6	-497	24,797	86.4	4,632	3,934	3.2
All	109,743	76.5	-1,110	33,766	23.5	3,609	0	0.0
Addendum								
Top 10 Percent	586	4.1	-787	13,766	95.9	7,305	6,974	3.9
Top 5 Percent	244	3.4	-872	6,931	96.6	12,229	11,783	4.6
Top 1 Percent	72	5.0	-1,024	1,363	95.0	40,875	38,784	5.9
Top 0.5 Percent	30	4.1	-1,116	688	95.9	68,575	65,686	6.5
Top 0.1 Percent	4	2.7	-1,683	140	97.3	208,547	202,866	7.3

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0304-2)

(1) "Equal dollar burden" financing amounts to \$1,520 per tax unit.

Appendix Table 4
Average Change in Incomes Under the Tax Cuts with Cost of Financing Included,
"Equal Dollar Burden" Scenario¹
(annual effects, in 2004 dollars)

Cash Income Class (thousands of 2003 dollars)	Units with Net Income Loss			Units with Net Income Gain			All Tax Units	
	Number (thousands)	Percent of Total	Average Change (\$)	Number (thousands)	Percent of Total	Average Change (\$)	Average Income Change (\$)	% Change in after-tax income
Less than 10	20,419	100.0	-1,517	9	0.0	4,249	-1,514	-27.2
10-20	26,321	99.4	-1,340	146	0.6	724	-1,328	-9.4
20-30	19,134	93.9	-1,089	1,245	6.1	561	-988	-4.5
30-40	13,817	89.9	-1,026	1,560	10.1	773	-844	-2.9
40-50	10,038	87.7	-853	1,408	12.3	745	-656	-1.8
50-75	15,511	77.3	-597	4,543	22.7	767	-288	-0.6
75-100	3,153	27.7	-437	8,242	72.3	1,140	704	1.0
100-200	650	4.9	-683	12,632	95.1	2,543	2,385	2.4
200-500	128	3.8	-896	3,212	96.2	7,825	7,492	3.5
500-1,000	26	4.9	-982	502	95.1	27,003	25,630	5.3
More than 1,000	7	2.7	-1,585	250	97.3	138,644	134,877	7.0
All	109,743	76.5	-1,110	33,766	23.5	3,609	0	0.0

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0304-2)

(1) "Equal dollar burden" financing amounts to \$1,520 per tax unit.

Appendix Table 5
Average Change in Incomes Under the Tax Cuts with Cost of Financing Included,
"Proportional to Income" Scenario
(annual effects, in 2004 dollars, on tax units categorized by income percentile)

Cash Income Class	Units with Net Income Loss			Units with Net Income Gain			All Tax Units	
	Number (thousands)	Percent of Total	Average Change (\$)	Number (thousands)	Percent of Total	Average Change (\$)	Average Income Change (\$)	% Change in after-tax income
Lowest Quintile	28,049	99.7	-182	95	0.3	1,425	-177	-2.5
Second Quintile	23,449	81.7	-308	5,252	18.3	473	-165	-1.0
Middle Quintile	21,380	74.5	-536	7,323	25.5	671	-228	-0.8
Fourth Quintile	23,033	80.2	-681	5,670	19.8	731	-402	-0.9
Top Quintile	17,090	59.5	-1,232	11,611	40.5	4,171	954	0.8
All	113,509	79.1	-533	30,000	20.9	2,018	0	0.0
Addendum								
Top 10 Percent	8,350	58.2	-1,770	6,001	41.8	7,075	1,928	1.1
Top 5 Percent	4,208	58.7	-2,793	2,967	41.3	12,717	3,621	1.4
Top 1 Percent	651	45.4	-9,494	784	54.6	34,985	14,793	2.2
Top 0.5 Percent	236	32.9	-16,980	481	67.1	49,513	27,634	2.7
Top 0.1 Percent	27	18.6	-55,311	117	81.4	125,763	92,174	3.3

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0304-2)

(1) Financing "proportional to income" amounts to 2.6% of cash income per tax unit.

Appendix Table 6
Average Change in Incomes Under the Tax Cuts with Cost of Financing Included,
"Proportional to Income" Scenario
(annual effects, in 2004 dollars)¹

Cash Income Class (thousands of 2003 dollars)	Units with Net Income Loss			Units with Net Income Gain			All Tax Units	
	Number (thousands)	Percent of Total	Average Change (\$)	Number (thousands)	Percent of Total	Average Change (\$)	Average Income Change (\$)	% Change in after-tax income
Less than 10	20,380	99.8	-151	49	0.2	1,423	-147	-2.6
10-20	23,621	89.2	-280	2,846	10.8	377	-209	-1.5
20-30	15,150	74.3	-400	5,229	25.7	626	-137	-0.6
30-40	11,486	74.7	-578	3,891	25.3	686	-259	-0.9
40-50	8,888	77.7	-635	2,558	22.3	672	-343	-0.9
50-75	16,306	81.3	-698	3,748	18.7	762	-425	-0.9
75-100	7,222	63.4	-729	4,173	36.6	985	-101	-0.1
100-200	7,759	58.4	-781	5,522	41.6	1,863	319	0.3
200-500	1,920	57.5	-2,901	1,419	42.5	6,869	1,251	0.6
500-1,000	208	39.4	-9,935	319	60.6	21,282	8,973	1.9
More than 1,000	60	23.5	-35,816	197	76.5	88,983	59,637	3.1
All	113,509	79.1	-533	30,000	20.9	2,018	0	0.0

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0304-2)

(1) Financing proportional to cash income amounts to 2.6% of cash income per tax unit.

Appendix Table 7

**Total Dollar Effect of Tax Cuts With Financing Included, Broken out
by Income Categories
(annual effects in 2004 dollars)**

Income Class	Share of households	Financing with equal dollar burden per household	Financing with payments proportional to income
Less than \$30,000	45.1%	-\$86 billion	-\$11 billion
\$30,000 - \$75,000	31.7%	-\$26 billion	-\$16 billion
\$75,000 - \$200,000	19.2%	+\$40 billion	+\$3 billion
\$200,000 +	3.7%	+\$73 billion	+\$24 billion
total	100%	0	0
Over \$1 million	0.2%	+\$35 billion	+\$15 billion

Source: Urban-Brookings Tax Policy Center microsimulation model