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MOST HOUSEHOLDS LIKELY TO BE NET LOSERS WHEN THE 2001 AND 2003 TAX CUTS ARE FINALLY PAID FOR

If the 2001 and 2003 tax cuts are made permanent, they will eventually have to be paid for — through some combination of budget cuts and tax increases — to avoid crushing deficits. A new report jointly issued by the Urban Institute-Brookings Institution Tax Policy Center (TPC) and the Center on Budget and Policy Priorities examines ways the tax cuts might be financed and finds that most Americans would likely lose more from the financing measures than they would gain from the tax cuts.

When Congress enacted the tax cuts, it chose to finance them through higher budget deficits, pushing their costs into future years. “That makes the tax cuts look free, but of course they’re no more free than any other item bought on credit,” said Isaac Shapiro, senior fellow at the Center and a co-author of the report.

To correct the misperception that the tax cuts have no costs, the report examines two possible ways of paying for them and finds that under both scenarios, the bottom four-fifths of households (i.e., those with incomes of approximately $76,400 or less) would be net losers, on average, by substantial amounts. In contrast, the highest-income fifth of households — especially those with exceptionally high incomes — would be net winners by large amounts.

Households in the middle fifth of the income spectrum, for example, will receive an average tax cut of around $650 (in 2004 dollars) when the tax cuts are fully phased in, but they would end up about $230 or $870 *worse* off per year when the tax cuts are paid for, depending on which of the two scenarios examined by the report is used. Households earning over $1 million would end up about $60,000 or $135,000 ahead per year, on net, again depending on the scenario examined.

In all, the spending cuts and/or tax increases would cost the bottom 80 percent of households $27 billion or $113 billion (depending on which scenario is used) more per year than these households gained from the tax cuts. This amount would effectively be transferred to the top 20 percent of households, which would gain $27 billion or $113 billion more per year from the tax cuts than they lose from the spending cuts and/or tax increases. The bulk of the transferred funds would go to households with incomes above $200,000.

“Basically, the bottom 80 percent of households will end up paying for substantial tax cuts for the top fifth of the population,” said William G. Gale, co-director of the TPC and a co-author of the report.

Average Change in Incomes Under the Tax Cuts with Cost of Financing Included, Two Hypothetical Scenarios (annual effects, in 2004 dollars)			
Income Class	Average size of tax cut	Average net effect if each household pays same dollar amount to finance tax cuts	Average net effect if each household pays same % of income to finance tax cuts
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

Top-Heavy Tax Cuts Difficult to Pay for Equitably

Under the first of the report's two scenarios for paying for the tax cuts, each household would "pay" an equal dollar amount each year, as could occur if the tax cuts are financed largely or entirely through spending cuts. Under the second scenario, each household would "pay" the same percentage of its income each year. This could occur if the tax cuts are financed through a combination of spending cuts and progressive tax increases.

While other scenarios can be imagined, most households are likely to wind up as net losers under almost any scenario other than repealing major parts of the tax cuts:

- Because the tax cuts' gains are so heavily concentrated among high-income households, a similarly large share of the tax cuts' *costs* would have to be imposed on these same households to ensure that low- and middle-income households do not end up worse off.

- The tax cuts eliminated or weakened the most important taxes on higher-income households, including the estate tax, capital gains and dividend taxes, and the highest marginal tax rates. It would be difficult to recover the needed revenue from these households without restoring these taxes.

Not Paying for the Tax Cuts Isn't an Option

Some tax-cut advocates have argued that payment for the tax cuts can be postponed indefinitely. However, independent researchers, the Congressional Budget Office, the Office of Management and Budget, and the General Accounting Office have all projected that deficits will reach unsustainably large levels over the long term even without the tax cuts, as a result of the aging of the population and rising health care costs.

The tax cuts will worsen this situation, forcing even more drastic measures to avert very large, persistent deficits that threaten significant economic damage over time and are virtually certain to become unacceptable to financial markets.

Other tax-cut advocates contend that the tax cuts will pay for themselves by generating new economic growth. Yet studies by the Congressional Budget Office, the Joint Committee on Taxation, and economists from the Federal Reserve have found that the tax cuts will have little or no positive effect on long-term economic growth and may well *reduce* it if they are financed through higher deficits.

"There's no getting around the fact that eventually, we're going to have to pay for these tax cuts through spending cuts and/or tax increases," said Peter R. Orszag, co-director of the TPC and a co-author of the report. "Right now we're only seeing half the story — the benefits many people are receiving from the tax cuts. But when the bill comes due, most Americans are likely to find that they've lost more than they gained."

The **Center on Budget and Policy Priorities** is a nonprofit, nonpartisan research organization and policy institute that conducts research and analysis on a range of government policies and programs. It is supported primarily by foundation grants. The **Tax Policy Center**, a joint venture of the Urban Institute and Brookings Institution, aims to clarify the nation's tax and fiscal choices by providing independent, timely, and accessible analysis of current and emerging issues.

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