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Distribution of the 2001 and 2003 Tax Cuts and Their Financing

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I. Introduction

Popular discourse about tax cuts frequently ignores 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 or reductions in government programs; it may occur now or later; it may be transparent or hidden. But iron laws of arithmetic and fiscal solvency imply that the payment has to occur.

To date, the tax cuts enacted in 2001 and 2003 have been funded with increased borrowing. This postpones but does not eliminate the required payments. 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, while the ultimate costs are delayed and disguised and therefore often ignored.

The central goal of this analysis is to correct the misimpression that the tax cuts make everyone better off. We estimate not only who benefits directly and immediately 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 (when fully in effect and reflecting the president's proposal to make most of the tax cuts permanent) combined with the costs of paying for them. We therefore examine the "net effects" of the tax cuts, accounting for both the direct benefits and the costs of financing those benefits.

Because it is uncertain how the tax cuts will 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 fully paid for, so the net effect of the tax cuts that year on the budget would be zero.

The first scenario assumes that each household pays an *equal-dollar amount* each year to finance the tax cuts. Under that scenario, each household receives a direct tax cut based on the 2001 and 2003 legislation, but it also "pays" \$1,520 per year (2004 dollars) in some combina-

tion of reductions in benefits from government spending or increases in other taxes to finance the 2001 and 2003 tax cuts. Something close to that scenario could occur if the tax cuts were financed largely or entirely through spending cuts. We refer to this as "equal-dollar" financing.

The second scenario assumes each household pays the *same percentage of income* to finance the tax cuts. In that case, each household receives a direct tax cut based on the 2001 and 2003 laws, but also pays 2.6 percent of its cash 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 "proportional financing." Our principal findings include:

- *Once the financing is included, the 2001 and 2003 "tax cuts" are best seen as net tax cuts for about 20-25 percent of households, financed by net tax increases or benefit reductions for the remaining 75-80 percent of households. Not surprisingly, equal-dollar financing is significantly more regressive than proportional financing.*
- *Under either scenario, more than 75 percent of households would be worse off: They lose more from the financing than they gain directly from the tax cuts. The "losers" would be concentrated among low- and middle-income households. Under equal-dollar financing, the losers include 90 percent of households in the middle fifth of the income distribution and nearly all households in the bottom 40 percent.*
- *The annual net transfer of resources from low- and middle-income households to high-income households would be sizable. The annual transfer from the 80 percent of households with incomes below \$76,400 to the top 20 percent of households with incomes above that level would be \$113 billion under equal-dollar financing and \$27 billion under proportional financing. The annual transfer to households with incomes exceeding \$1 million would be \$35 billion under equal-dollar financing and \$15 billion under the proportional scenario.*
- *Middle-income households would be losers under both scenarios, but would fare worse under equal-dollar financing. Under equal-dollar financing, households in the middle quintile would average losses of \$869 per year, 3.1 percent of after-tax income. With proportional financing, the loss would be \$228, or 0.8 percent of after-tax income.*
- *Low-income households would be worse off under either scenario, but would face enormous costs under equal-dollar financing. Under equal-dollar financing, households in the bottom quintile lose an average of \$1,500 a year, or 21 percent of their income. Under proportional financing, they lose 2.5 percent of after-tax income.*

Table 1
Distribution of 2001 and 2003 Tax Cuts When Fully in Effect (No Financing)¹
(annual effects, in 2004 dollars, by income percentile)

Cash Income Percentile ²	Percent of Tax Units With Tax Cut ³	Percent Change in After-Tax Income ⁴	Percent of Total Tax Change	Average Tax Cut (\$)	Average Federal Tax Rate ⁵	
					Pre-Tax Cuts	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).

¹Reflects 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.

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

³Includes both filing and nonfiling units. Tax units that are dependents of other taxpayers are excluded from the analysis.

⁴After-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.

⁵Average 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.

- *High-income households would be net winners, and the gains among the highest-income households would be large.* People with annual incomes exceeding \$1 million would gain an average of \$59,600 a year, or 3.1 percent of after-tax income, under proportional financing and \$135,000 a year, or 7 percent of after-tax income, under equal-dollar financing.

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 a majority of American households will be made worse off by the tax cuts, because the tax cuts will ultimately have to be financed. Different methods of financing would generate variation in the particular results, but the basic findings — that most households end up being worse off and transfers would flow from low- and middle-income households to more affluent households — are likely to continue to hold unless a significant portion of the tax cuts are repealed. The reason is that the tax cuts scale back or 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 phaseouts of certain exemptions and deductions for households with high incomes. It is unlikely that any method of financing those changes, other than repeal of the tax cuts, will be as progressive as the tax provisions that have been scaled back.

Section II provides conventional distributional analysis of the tax cuts, ignoring the financing. Section III discusses the seemingly obvious point that tax cuts need to be financed. Section IV examines the distributional

effects under alternative methods of financing. Section V discusses the robustness of the results and provides concluding remarks.

II. Distribution of the Tax Cuts Without Financing

The first component of our analysis is standard. We examine the direct effect 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 dollars. Table 1 above (which groups tax units, referred to here as “households,” into percentiles, based on cash income) and Table 2 on p. 3 (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.

Distributional tables similar to these — tables that ignore financing — have dominated the public discussion of distributional effects of the tax cuts. 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. That appearance, however, is quite misleading.

Table 2
Distribution of 2001 and 2003 Tax Cuts When Fully in Effect (No Financing)¹
 (annual effects, in 2004 dollars, by income level)

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	Proposal
Less than 10	20,428	14.2	5.9	0.1	0.1	6	3.6	3.4
10-20	26,467	18.4	52.9	1.4	2.3	192	6.6	5.3
20-30	20,379	14.2	79.1	2.4	5.0	532	12.8	10.7
30-40	15,377	10.7	84.9	2.3	4.8	677	16.6	14.7
40-50	11,446	8.0	93.3	2.3	4.5	864	18.7	16.8
50-75	20,054	14.0	98.4	2.5	11.3	1,232	20.6	18.7
75-100	11,395	7.9	99.1	3.3	11.6	2,224	22.7	20.2
100-200	13,281	9.3	99.3	3.9	23.8	3,905	25.1	22.2
200-500	3,339	2.3	99.1	4.2	13.8	9,012	27.6	24.5
500-1,000	527	0.4	98.5	5.6	6.6	27,150	29.7	25.7
More than 1,000	257	0.2	98.5	7.1	16.1	136,398	33.8	29.1
All	143,509	100.0	72.1	3.4	100.0	1,520	22.6	19.9

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

¹Reflects 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.

²Tax 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>.

³Includes both filing and nonfiling units. Tax units that are dependents of other taxpayers are excluded from the analysis.

⁴After-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.

⁵Average 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.

III. Tax Cuts Aren't Free

Some advocates claim that the 2001 and 2003 tax cuts do not necessarily imply future tax increases or future spending cuts — that is, that the tax cuts are essentially free. Almost all of these claims fall under two categories, discussed below.

A. Claim: 'Payment for the tax cuts can be postponed indefinitely.'

In a stable long-term economy, government debt can safely grow as fast as the economy. Therefore, 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 was equal to the growth rate of the economy would be possible and sustainable. Under that scenario, or under a scenario of expected permanent surpluses, paying for the tax cuts could be deferred indefinitely.

Those scenarios outline an interesting theoretical case, but they are simply not relevant to the U.S. economy. The underlying premise in the scenario — that public debt will grow more slowly than the economy — is starkly inconsistent with every plausible scenario for the federal government's finances.¹ 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 policies.²

To date, payment for the tax cuts has been postponed, but not eliminated, by increasing the budget deficit. But because the nation already faced an unsustainable fiscal position before the tax cuts (due to the aging of the population and rising healthcare costs), that postponement can not go on forever. The administration itself

cut could have been used for other purposes — there still would be a trade-off between tax cuts now and other policy options.

²Alan J. Auerbach, William G. Gale, and Peter R. Orszag, "Sources of the Long-Term Fiscal Gap," *Tax Notes*, May 24, 2004, p. 1049; Congressional Budget Office, "The Long-Term Budget Outlook," December 2003; Jagadeesh Gokhale and Kent Smetters, "Fiscal and Generational Imbalances: New Budget Measures for New Budget Priorities," (Washington, DC: AEI Press 2003); 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, "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.

¹Furthermore, 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

(Footnote 2 continued in next column.)

Table 3
Distributional Effects of the 2001 and 2003 Tax Cuts With Equal-Dollar Financing¹
(annual effects, in 2004 dollars, by income percentile)

Cash Income Percentile	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 Change (\$)	% Change in ATI
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.
¹"Equal Dollar Burden" financing amounts to \$1,520 per tax unit.

Table 4
Distributional Effects of the 2001 and 2003 Tax Cuts With Equal-Dollar Financing¹
(annual effects, in 2004 dollars, by income level)

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 Change (\$)	% Change in ATI
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.
¹"Equal Dollar Burden" financing amounts to \$1,520 per tax unit.

acknowledges that under its own policies, over the long run, "the budget is on an unsustainable path."³

B. Claim: 'Tax cuts pay for themselves with behavioral changes.'

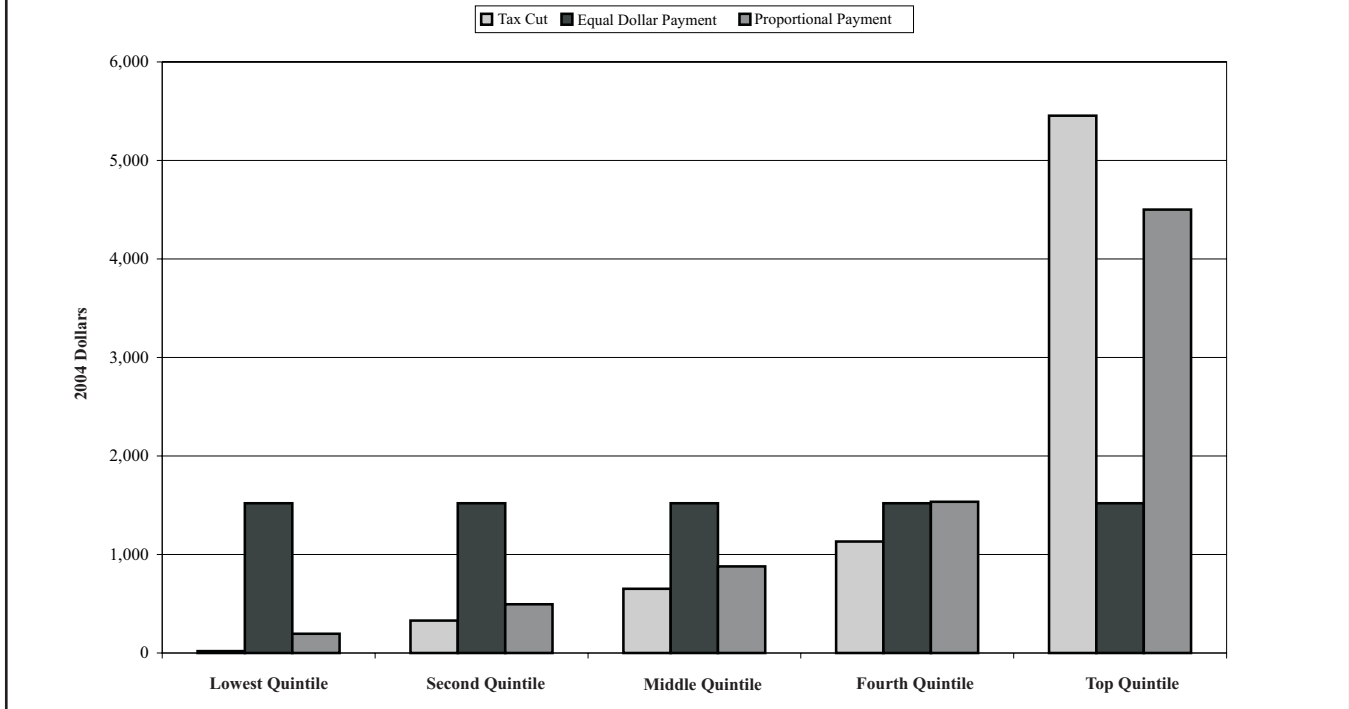
Tax cut advocates frequently claim that tax reductions will significantly increase economic growth and boost tax revenues. Some claim that the recent tax cuts will spawn so much economic growth that they will fully "pay for themselves" by generating a flood of new revenues from

³U.S. Office of Management and Budget, *Analytical Perspectives*, February 2004, p. 191.

a more rapidly expanding economy.⁴ There is no credible evidence to support that view. In fact, evidence indicates that given the form of the tax cuts and their deficit financing, the tax cuts will *reduce* growth.

⁴House Budget Committee Chair Jim Nussle made this claim in March 2004, echoing earlier statements by President Bush and Vice President Cheney. Chairman Nussle's quote was reported in *Daily Tax Report*, 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.

Figure 1a
Distribution of 2001 and 2003 Tax Cuts and Financing Costs
(by Income Quintile)



Deficit-financed tax cuts generate two types of effects on the economy. First, to the extent that they reduce marginal income tax rates, they encourage people to work more and save more. Those “supply-side” effects are likely to be positive but small.⁵ Even the Bush administration, in the 2003 *Economic Report of the President* (p. 58) 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.” Furthermore, the short-run costs of the tax cuts are diminished only modestly, even using the administration’s assumptions about the additional growth they produce and the additional revenues they generate.⁶ The second effect is that the increase in budget deficits reduces national saving and therefore reduces future national income. The effects can be substantial, as several studies — including one coauthored by the current chair of the Council of Economic Advisers — have concluded.⁷

The overall effect of deficit-financed tax cuts on economic growth is the sum of the usually positive effects created by reductions in marginal tax rates and the negative effect of increases in the deficit. Studies that weigh the competing effects have found that to the extent that they are financed for extended periods of time by borrowing, the recent tax cuts will have little or no

⁵For 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. See also 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 in “An Economic Evaluation of the Economic Growth and Tax Relief Reconciliation Act,” 55(1) *National Tax Journal* 133 (March 2002).

⁶Isaac Shapiro and Joel Friedman, *Tax Returns: A Comprehensive Assessment of the Bush Administration Tax Cuts*, Center on Budget and Policy Priorities, April 2004, p. 13.

⁷See William G. Gale and Peter R. Orszag, 2003, “The Economic Effects of Fiscal Discipline,” LVI(3) *National Tax Journal* 463; Gale and Potter, note 5 *supra*; Laurence Ball and N. Gregory Mankiw, “What Do Budget Deficits Do?” in *Budget Deficits and Debt: Issues and Options*, p. 95 (Kansas City: Federal Reserve Bank of Kansas City, 1995); *Economic Report of the President*, 2003, p. 57, Box 1-4 (Washington, DC: US Government Printing Office).

Table 5
Distributional Effects of the 2001 and 2003 Tax Cuts With Proportional Financing¹
 (annual effects, in 2004 dollars, by income percentile)

Cash Income Percentile	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 Change (\$)	% Change in ATI
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.

¹Financing proportional to income amounts to 2.6 percent of cash income per tax unit.

positive effect on long-term economic growth and may well reduce it. These include studies by the Congressional Budget Office, economists from the Federal Reserve, and others.⁸ Therefore, 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.⁹

IV. Distributional Effects With Financing

The nature and timing of the ultimate policy adjustments are currently unknown. We consider two possibilities. 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 in each future year would be paid for in full each future year and the net effect on the budget from the tax cut in that year would be zero.

⁸Congressional 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. Douglas W. Elmendorf and David L. Reifschneider, “Short-Run Effects of Fiscal Policy with Forward-Looking Financial Markets,” 55 *National Tax Journal* 357 (Sept. 2002); Alan J. Auerbach “The Bush Tax Cut and National Saving,” 55 *National Tax Journal* 387 (Sept. 2002); Gale and Potter, note 5 *supra*; Orszag, note 5 *supra*.

⁹A related claim is that tax cuts can raise revenue by reducing tax avoidance (legal efforts to reduce tax liability) and tax evasion (illegal efforts to reduce tax liability). 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. See the discussion in Gale and Potter, note 5 *supra*.

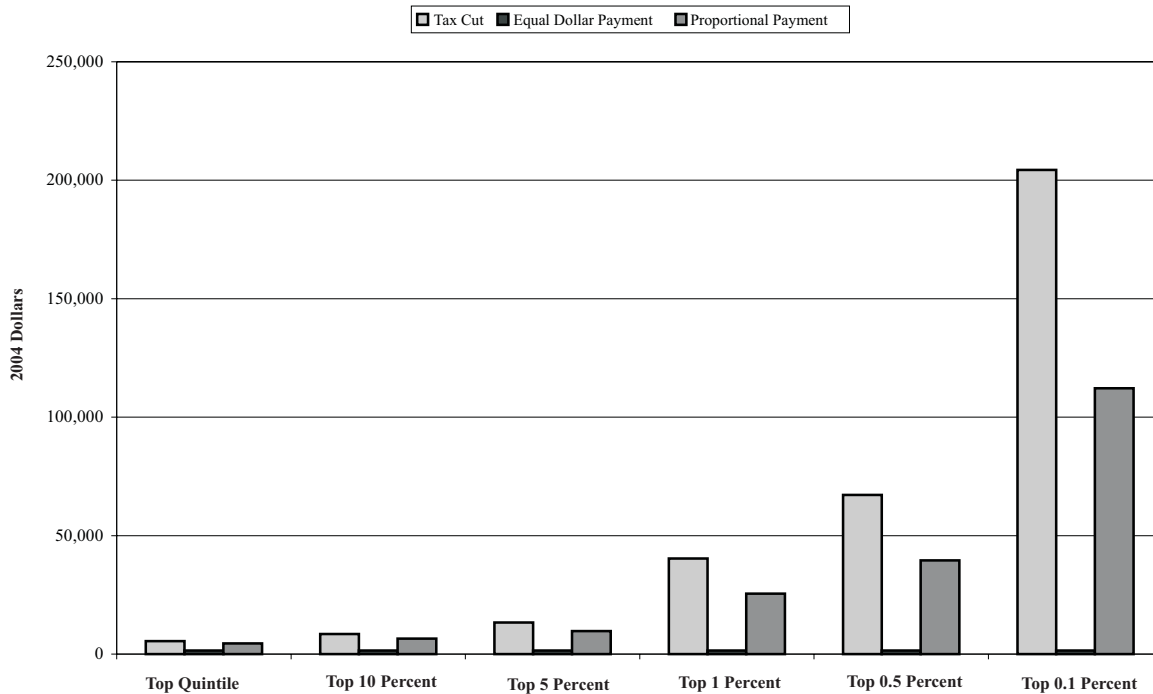
A. Equal-Dollar Burdens

Under this scenario each household would “pay” \$1,520 each year. Specifying the scenario in terms of the burden paid may seem somewhat abstract, and it may be helpful to think of the 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 even more than this scenario suggests.)

Results are shown in Tables 3 and 4 and in Figures 1a, 1b, 2a, and 2b. Low-income households would be hit extraordinarily hard. Their average direct tax cut would be \$19, but with payments of \$1,520, the average loss would be about \$1,500 per year. For the middle fifth of households, the average loss would be \$869 per year. In sharp contrast, the top 1 percent of households would receive an average net gain of \$38,800 per year, even after paying \$1,520. Households with incomes exceeding \$1 million would gain nearly \$135,000 per year.

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 — close to 110 million households — would be worse off than if there had been no tax cuts. Almost all low-income households would be worse off, including nearly 100 percent of the bottom fifth of households, 98 percent in the second quintile, and 91 percent in the middle fifth. Even 80 percent of households in the fourth quintile would be worse off. In contrast, in the top quintile, 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.

Figure 1b
Distribution of 2001 and 2003 Tax Cuts and Financing Costs
(Within the Top Income Quintile)



B. Equal Percentage-of-Income or Prop. Financing

In the second scenario, we assume that tax cuts are financed with spending cuts or tax increases that impose burdens that are proportional to cash 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.

This scenario is somewhat less regressive than equal-dollar financing, but high-income households would still be the big winners and the bottom four-fifths of households would still lose (Tables 5 and 6 and Figures 1a, 1b, 2a, and 2b). The middle fifth of households would lose \$228 on average. In contrast, the top 1 percent of households would gain an average of \$14,800, and households with incomes exceeding \$1 million would gain \$59,600 on average.

C. Aggregate Transfers of Income

Another way of assessing the effects is to examine the total flow of resources transferred to or from various income groups (Table 7). Under equal-dollar financing, the bottom four-fifths of households would be \$113 billion worse off every year because of the tax cuts. Of that amount, \$76 billion would be borne by the bottom two-fifths of households. Conversely, the top quintile — households with incomes exceeding \$76,400 — would be \$113 billion better off every year. Of that amount, \$35 billion would go to the nation's millionaires, just 0.2

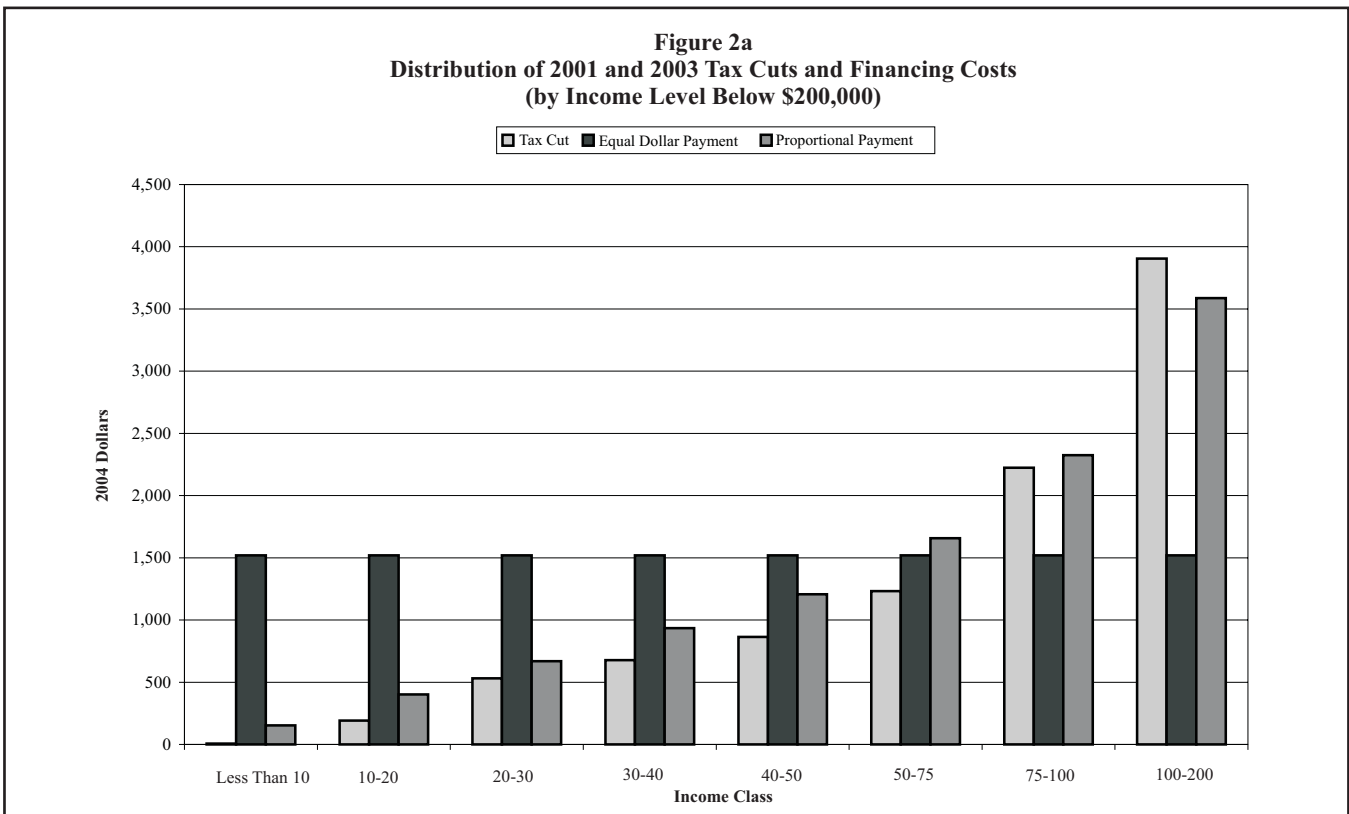
percent of all households. Under the proportional financing scenario the bottom four-fifths of households would lose \$27 billion each year, \$15 billion of which would accrue to the millionaire group. Under either scenario, the large majority of the gains received by the top fifth of households would be received by those with incomes exceeding \$200,000.

V. Conclusion

The notion that tax cuts are free or painless is flawed and misleading. Tax cuts have to be paid for with either reduced, current, or future spending or increased future taxes, relative to what would have occurred in the absence of the tax cuts. That simple fact fundamentally alters the way to think about who benefits and who loses from tax cuts. In particular, we show that under two possible approaches to financing the 2001 and 2003 tax cuts, most households will end up worse off, and substantial income will be transferred on an ongoing basis from the vast majority of low- and middle-income households to an affluent minority.

The notion that tax cuts are free or painless is flawed and misleading.

The basic tenor of the results is likely to be robust to reasonable adjustments. Although the burden of financing the tax cut could be allocated in ways other than



those shown here, the broad findings are likely to hold for almost any method of financing.¹⁰ 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. Therefore, low- and middle-income households are likely to come out as net losers under the tax cuts plus financing unless the financing affects high-income households far more than other households. Finding a progressive offset is unlikely unless the tax cuts for higher-income households are repealed.

In fact, the examples 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. Our analysis does not deal with the transfer of income from future generations to current ones. That transfer will occur because current taxpayers have not financed the costs of the tax cuts to date. Future taxpayers will have to pay not only for the costs of their tax cuts but also for the tax cuts for current taxpayers. The longer it takes to impose the corrective policy adjustments, the larger would be the adjustment required to pay all of the tax cuts since 2001 that had not yet been financed.

¹⁰For example, if the 2001 and 2003 tax cuts were financed with a value-added tax, the results fall between the two scenarios described in the text.

Appendix Distributing Spending Cuts

A. Aggregate Distribution

As discussed in the text, we suggest that “equal-dollar” financing might occur if the tax cuts were paid for through spending cuts. That 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.

Some preliminary calculations, however, suggest that if all spending programs were cut by an equal percentage, then the “equal dollar burden” scenario could provide a reasonable approximation of the likely burden of paying for the tax cuts. Based on the distribution of federal 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. Those 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 those 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, if high-income households

Figure 2b
Distribution of 2001 and 2003 Tax Cuts and Financing Costs
(by Income Level Above \$200,000)

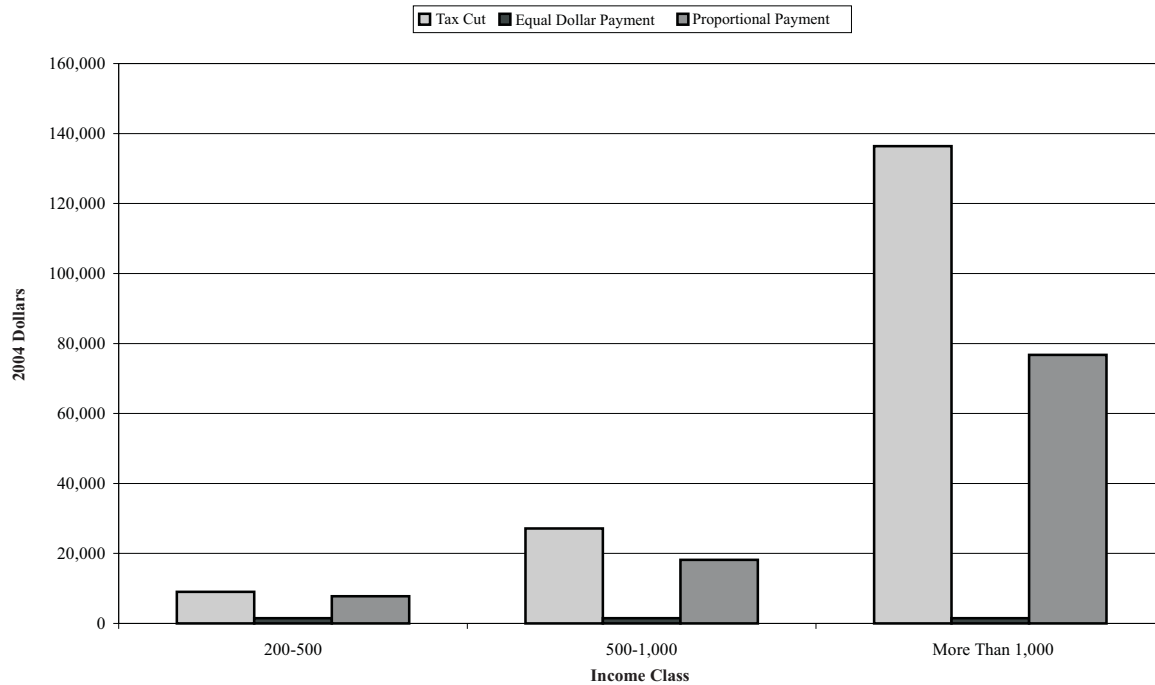


Table 6
Distributional Effects of the 2001 and 2003 Tax Cuts With Proportional Financing¹
(annual effects, in 2004 dollars, by income level)

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 Change (\$)	% Change in ATI
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.

¹Financing proportional to income amounts to 2.6 percent of cash income per tax unit.

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 primarily to low-income households. For example, increased expenditures

on public safety may reduce crime predominantly in low-income neighborhoods. Ultimately, it is extremely difficult to pin down the distributional benefits of those programs with any confidence.

Table 7
Aggregate Annual Transfers Under the 2001 and 2003 Tax Cuts with Financing
(annual effects, in 2004 dollars)

Income Class	Share of Tax Units	Equal-Dollar Financing	Proportional Financing
Quintiles			
Lowest Quintile	20.0%	-\$42 billion	-\$5 billion
Second Quintile	20.0%	-\$34 billion	-\$5 billion
Middle Quintile	20.0%	-\$25 billion	-\$7 billion
Fourth Quintile	20.0%	-\$11 billion	-\$12 billion
Top Quintile	20.0%	+\$113 billion	+\$27 billion
All	100.0%	0	0
Levels			
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
All	100.0%	0	0
Memo			
Over \$1 million	0.2%	+\$35 billion	+\$15 billion

Source: Urban-Brookings Tax Policy Center microsimulation model.

If, however, 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 aforementioned 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.

B. 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 or more affluent or better politically connected constituencies. Programs targeted to 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 would likely result in low-income households bearing larger dollar spending cuts than high-income households.

Finally, 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 5 or 10 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, because the bulk of Medicare and Social Security expenditures go to people at middle or lower income levels.

C. The 1995 Budget Resolution

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, because of technical constraints) of the spending cuts assumed in that budget resolution.¹¹ (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.

¹¹Office of Management and Budget Press Briefing, “Tax Cuts for the Wealthy Financed by Benefit Cuts to Middle and Low Income Families,” Oct. 13, 1995; “A Distributional Analysis of Republican Budget Proposals: Impacts in Fiscal Year 2002,” prepared by Democratic Staff of the Joint Economic Committee, Oct. 13, 1995.