The Effect of the 2001-06 Tax Cuts on After-Tax Incomes

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Mr. Chairman and other members of the Committee, thank you for the invitation to testify today at this hearing on fair and equitable tax policy for America's working families. I would like to start with a confession: as an economist I have no special expertise in fairness or equity. The members of this committee were elected, in part, to make critical value judgments about these fundamental questions. But in order to make these value judgments you need the understand who is impacted by the tax changes and how they are impacted. And economists do have a special expertise that can help further this understanding and thus inform the debate on the bigger issues.

Evaluating a tax change requires understanding the impact it has on households through three different channels: (1) the direct impact of the tax changes on take-home pay; (2) the economic effects of the tax change on before-tax incomes; and (3) the impact that the associated budgetary changes have on future taxes or government spending on households. All three channels can be usefully summarized in a single variable: the change in the after-tax incomes of households.[2]

Policy analysts and official scorekeepers have made varying degrees of progress on each of these three channels but have seldom integrated them into one comprehensive assessment of tax proposals. My testimony today applies such an integrated approach, potentially termed "dynamic distributional analysis," to examine the long-run impact of the tax cuts enacted from 2001 to 2006 on the after-tax income of American families.

Some of the key findings of this analysis are:

- **The direct effect of the tax cuts enacted from 2001-06 is to increase after-tax income inequality.** Ignoring the effects on the economy and the budget, making the tax cuts permanent would result in a 0.7 percent increase in the after-tax income of the bottom

[1] The views expressed in this testimony are those of the author alone and do not necessarily represent those of the staff, officers, or trustees of The Brookings Institution or the members of the Advisory Council of The Hamilton Project. Parts of this testimony draw on Furman, Summers, and Bordoff. 2007. "Achieving Progressive Tax Reform in an Increasingly Global Economy". Hamilton Project Strategy Paper. (June); Furman, Jason. 2006. "A short guide to dynamic scoring." Washington, DC: Center for Budget and Policy Priorities (August 24) and Furman, Jason. 2006. "Do Revenue Surprises Tell Us Much About The Cost of Tax Cuts?" Washington, DC: Center for Budget and Policy Priorities (July 18).

[2] A fuller analysis would consider the impact on the *welfare* of households, including not just after-tax income but also the impact on leisure and the time profile of consumption.

quintile and a 6.7 percent increase in the after-tax income of the top 1 percent. As a result, the gap between these incomes would grow.

- **Economic models generally rule out the possibility of a large, positive impact of the tax cuts on the economy and incomes.** In one favorable – but highly unrealistic – scenario the Treasury found that making the tax cuts permanent would be equivalent to raising the growth rate by 0.04 percentage points annually spread out over 20 years. In other words, the growth rate could rise from 3.00 percent to 3.04 percent – a change that would barely be perceptible in quarterly data on the economy. In more realistic scenarios the Treasury found the tax cuts would result in higher debt and lower savings – thus reducing long-run output.

- **Economic models show that the need to eventually finance the tax cuts could result in a large, negative impact on the disposable income of households, for example through reduced Social Security benefits, Medicare benefits, or higher future taxes.** This occurs because no economic model finds that tax cuts pay for themselves. The results of dynamic macroeconomic feedback show that the tax cuts are only slightly more expensive or slightly less expensive than shown by the official estimates that ignore such feedback.

- **Taken together, illustrative estimates show that even in the unrealistic best case scenario – in which tax cuts boost incomes and pay for part of their long-run cost through higher economic output – the financing costs of the tax cuts would leave 74 percent of households with lower after-tax incomes.** If the increased debt and reduced savings associated with the tax cuts leads to lower incomes, then 76 percent of households would end up with lower after-tax incomes.

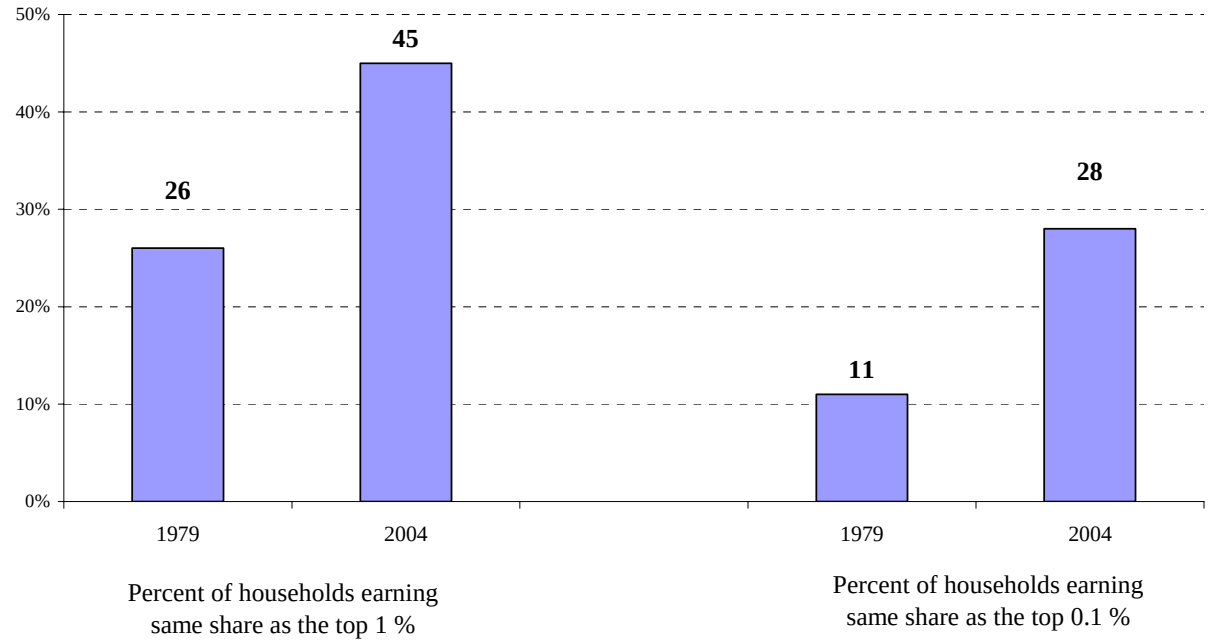
The Context: Increasing Inequality

America has experienced a large increase in income inequality in recent decades. The changes have been particularly pronounced at the very top of the income distribution. In 1979, the earliest year for which data are available, the before-tax income of the most affluent 1 percent of the U.S. population already equaled that of the bottom 26 percent (Figure 1). That share has since risen nearly continuously, reaching 45 percent in 2004. Also in 2004, the top *one-tenth* of 1 percent had a before-tax income equaling the total income of the bottom 28 percent—a group 280 times larger in number. Several factors account for these shifts: primarily technological change that rewards skilled workers, but also declining unionization, the reduction in the real value of the minimum wage, increased immigration, and globalization more generally.[3]

[3] See Autor, David H., Lawrence F. Katz, and Melissa S. Kearney. 2007. "Trends in U.S. wage inequality: Revising the revisionists." Revised from January 2004. http://post.economics.harvard.edu/faculty/katz/papers/AKK=ReStatRevision.pdf.; Acemoglu, Daron. 2002. "Technical change, inequality, and the labor market." *Journal of Economic Literature* 40 (march): 7-22; Card, David, Thomas Lemieux, and W. Craig Riddell. 2003. "Unionization and wage inequality: A comparative study of the U.S., the U.K, and Canada." Working Paper 9473. Cambridge, MA: National Bureau of Economic Research;

Figure1

Percent of Households at the Bottom of the Income Distribution Earning Same Share of Income as the Top Percentiles, 1979 and 2004



Sources: Authors' calculations based on Congressional Budget Office. 2006. "Historical effective federal tax rates. 1979 to 2004." Supplemental Tables. Washington, DC (December). www.cbo.gov/ftpdocs/77xx/doc7718/SupplementalTables.xls and Picketty, Thomas and Emmanuel Saez. 2007. Income Inequality in the United States, 1913-2005, Table A3: Top fractile income shares (including capital gains) in the U.S.., 1913-2005 (March). elsa.berkeley.edu/~saez/TabFig2005.prel.xls

Note: Each bar represents the percentage of the income distribution, starting with the lowest-income household, whose combined incomes would just equal those of the top 1 or 0.1 percent of the distribution

One way to put these trends in perspective is to estimate the magnitude of the income shift implied by these numbers. From 1979 to 2004 the share of before-tax income going to the top 1 percent of income earners has risen by 7.0 percentage points while the share going to the bottom 80 percent of households fell by 7.4 percentage points (the share of income going to the remainder of the population – upper-middle-income families in the 80th through the 99th percentile – has remained roughly stable).[4] To fully offset the income shift in 2004 would have required transferring $664 billion from the top 1 percent of households to the bottom 80 percent—the equivalent of nearly $600,000 from every household in the top 1 percent and $7,000 to each household in the bottom 80 percent. No one would suggest this is feasible or even desirable, but it provides one potential benchmark for gauging the magnitude of the public policy interventions that would be necessary to address increases of inequality of this scale.

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and Levy, Frank, and Peter Temin. 2007. "Inequality and institutions in 20th century America." Working Paper 07-17. Cambridge, MA: Department of Economics, Massachusetts Institute of Technology.

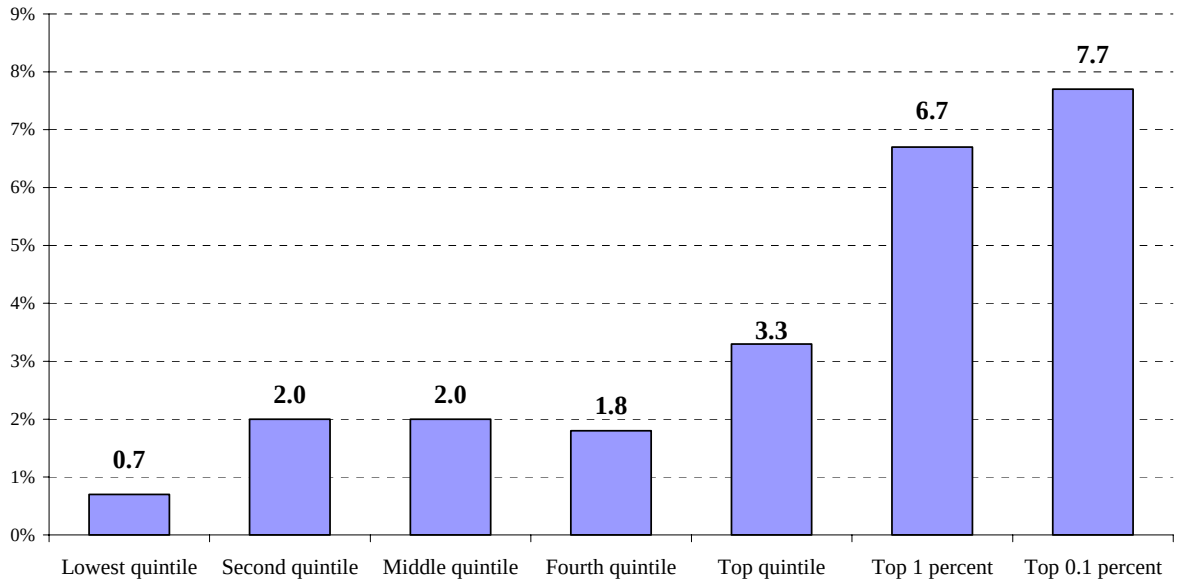
[4] For a family of four, the bottom 80 percent of families have incomes below $128,600 in 2004 and the top 1 percent have incomes over $533,600. Furman, Summers, and Bordoff,. 2007. "Achieving Progressive Tax Reform in an Increasingly Global Economy." Hamilton Project Strategy Paper. (June).

The Direct Impact of the 2001-2006 Tax Cuts: Widening Income Inequality

The direct impact of tax changes can be measured through the standard distributional tables prepared by the Joint Committee on Taxation (JCT), the Department of the Treasury, or outside organizations like the Urban-Brookings Tax Policy Center (TPC). In most cases the distributional analysis is largely a straightforward exercise in simulating the impact of tax changes on a representative sample of households using a relatively mechanical tax calculator. Estimates by JCT, Treasury, TPC, and others are generally relatively similar.[5]

Figure 2 shows the percentage change in after-tax income in 2017 assuming the tax cuts are extended. This is probably the best measure of the change in the relative well-being of different income groups.[6]

Figure 2
Effects of the 2001-2006 Tax Cuts Made Permanent
Percent Change in Income from Selected Income Groups When Tax Cuts are Fully in Effect in 2012



Source: Authors' calculations based on Urban-Brookings Microsimulation Model

[5] There is some academic debate over how to distribute the burden of corporate taxes to individuals. For this discussion, see Auerbach, Alan. 2006. "Who bears the corporate tax?" In *Tax policy and the economy*, vol. 20, ed. J. M. Poterba, 1-40. Cambridge, MA: MIT Press. But this debate is of little relevance to assessing the 2001-06 tax cuts because they included very little corporate rate cuts.
[6] Gale, William G, Peter R. Orszag. 2003. "The administration's proposal to cut dividend and capital gains taxes. *Tax Notes* 98 (3): 415-20 (January 20).

The bottom quintile sees a relatively small increase in its purchasing power, while the middle quintiles see a modest increase, and the top 1 percent see a very large increase. As a result the gap between the after-tax incomes of the top 1 percent and the bottom 20 percent widens from 99-to-1 to 104-to-1. In absolute dollars the discrepancies are even larger. In 2006 dollars the bottom quintile sees an $80 increase in its after-tax income, while the increase is $889 for the middle quintile and $79,713 for the top 1 percent.

Although taxes are still progressive they have done relatively little to offset the increase in inequality. As noted, since 1979 the share of before-tax income going to the top 1 percent has increased by 7.0 percentage points. Absent the tax cuts from 2001 through 2004 the corresponding after-tax income share would have risen by 5.6 percent, as shown in Table 1. Put another way, the progressive tax code would have automatically offset 20 percent of the increase in before-tax inequality. The tax cuts from 2001-06, however, undid most of this automatic stabilizer. As a result, the tax code offset less than 10 percent of the increase in inequality.

Table 1. Share of Income Going To Each Group

	1979	**1990**	**2004**	**Change from 1979 to 2004**
BEFORE-TAX INCOME				
Bottom 80 Percent	54.7	51.3	47.3	-7.4
Next 19 Percent	36.2	37.4	37.2	1.0
Top 1 Percent	9.3	12.1	16.3	7.0
AFTER-TAX INCOME (Actual)				
Bottom 80 Percent	57.9	53.8	51.0	-6.9
Next 19 Percent	34.9	36.3	36.0	1.1
Top 1 Percent	7.5	11.0	14.0	6.5
AFTER-TAX INCOME (Assuming no tax changes after 2000)				
Bottom 80 Percent	57.9	53.8	51.7	-6.2
Next 19 Percent	34.9	36.3	36.2	1.3
Top 1 Percent	7.5	11.0	13.1	5.6

Note: Incomes are adjusted for family size. For a family of four in 2004, the bottom 80 percent is below $128,600, the next 19 percent makes up to $533,600, and the top 1 percent makes more than that.
Source: Furman, Summers, and Bordoff. 2007. "Achieving Progressive Tax Reform in an Increasingly Global Economy." Hamilton Project Strategy Paper. (June).

These distributional estimates tell only part of the story because they ignore both the economic effect of the tax cuts and the fact that the tax cuts eventually need to be financed by some combination of future spending reductions or future tax increases. As a result, these results create the artificial impression that cutting taxes can raise incomes for everyone – a misleading result that comes from ignoring the "no free lunch" implication of the government's budget constraint.

The Economic Impact of the Tax Cuts: No Large, Beneficial Change

The second stage in the analysis of the impact of tax cuts on the after-tax incomes of households is to assess their impact on macroeconomic variables like national income and employment.[7] Although there is considerably less consensus on this issue than on the static distribution, every available modeling estimate rules out large, beneficial changes from the tax cuts enacted from 2001-06. Moreover, realistic estimates of the impact of tax cuts on the economy find that the higher debt and reduced national savings can reduce long-run national income and thus the before-tax incomes of households.

Assessing the economic impact of tax changes is complicated and somewhat uncertain for two reasons. First, estimates of the macroeconomic effects of tax cuts depend on the particular economic model being used and the specific parameters assumed for that model. For example, the impact of tax cuts depends critically on the poorly measured and somewhat controversial parameters that measure how much people's work and savings decisions change in response to changes in after-tax wages or rates of return. In the absence of a consensus on the correct model and parameters, official scorekeepers have been reluctant to provide a single, featured dynamic estimate.

Second, even if economists agreed about the correct models and parameters, there would still be a major hurdle in implementing and interpreting dynamic scoring: the economic impact of tax cuts depends critically on how and when tax cuts are paid for. In a sense, tax-cut proposals are incomplete and thus impossible to subject to dynamic scoring. For example, taken literally, making the 2001-06 tax cuts permanent would result in an explosion of deficits and debt that would last forever (on top of the already unsustainable fiscal situation). Not only is this impossible in reality, but it also makes it impossible to use modern economic models to estimate the macroeconomic impact of those policies.[8]

Economic models of the macroeconomic effects of tax cuts must reflect both the proposed policy and an assumption about how and when the policy will be paid for. Consequently, the results of these models often tell less about the proposed policy itself (e.g., making the 2001-06 tax cuts permanent) and more about the other policies that are assumed in the model (i.e., the assumptions about how and when the tax cuts will be paid for).

Generally, research has found that tax cuts that are not accompanied by other tax increases or spending cuts — such as the tax cuts in recent years — will increase the deficit, reduce national savings, and reduce economic output over the long run. This occurs because any economic benefits that tax cuts have in encouraging work and personal savings are more than

[7] For more discussion see Furman, Jason. 2006. "A short guide to dynamic scoring." Washington, DC: Center for Budget and Policy Priorities (August 24) and Auerbach, Alan J. 2005. "Dynamic Scoring: An Introduction to the Issues." *American Economic Association Papers and Proceedings*, vol 95, no 2 (May).

[8] Modern economic models assume that individuals and businesses are forward looking, changing their behavior in response to expectations about future taxes, transfers such as Social Security, and government spending. Since an infinite explosion of the debt is impossible, individuals will not be able to decide how to behave without an assumption about the future policy changes that will be implemented to prevent an explosion of the debt. As a result, modern economic models cannot estimate even the *short-run* impact of a tax proposal without making assumptions about the full *long-run* policy.

offset by the economic cost of the larger deficits, which reduce national savings. In contrast, tax cuts that are paid for contemporaneously can contribute to economic growth, depending on their design. In neither case are the effects very large. (Note that dynamic scoring models do not address the possibility that cuts in government funding for research, education and other investments that could help pay for tax cuts might slow long-run growth.)

JCT used what economists call an "overlapping generations model" to examine the economic impact of a hypothetical 10 percent reduction in individual income tax rates. As shown in Table 2, in four of JCT's five financing scenarios, the tax cuts *reduced* long-term GDP.

Table 2. JCT Estimates of the Impact of a 10 Percent Income Tax Cut on Long-Run GDP
(Estimates Using an Overlapping Generations Model)

Financing Assumption	**Impact on Long-Run GDP**
Cut non-valued government spending after ten years	-0.04%
Cut government transfer payments after ten years	+0.10%
Increase tax rates on labor income after ten years	-0.10%
Increase tax rate on capital income after fifteen years	-0.43%
Cut government transfer payments after twenty years	-0.21%

Source: JCT, "Exploring Issues in the Development of Macroeconomic Models for use in Tax Policy Analysis," June 16, 2006, Table 3.

These results show that the longer you wait to pay for the cuts, the more negative the long-term economic effects. If, for example, Social Security payments are cut enough to fully pay for the hypothetical 10-percent rate reduction after ten years, the proposal would increase long-run GDP by 0.1 percent. But waiting 20 years would lead to larger government debt and *reduce* long-run GDP by 0.21 percent.

These same general principles apply to the tax cuts enacted from 2001-06. The Department of the Treasury conducted a dynamic analysis of the bulk of the tax cuts enacted starting in 2001.[9] One of their best case scenarios found that making the tax cuts permanent would result in a very modest economic gain (totaling 0.7 percent of national income – equivalent to a 0.04 percentage point increase in the annual growth rate spread over twenty years). Even this result was premised on the highly unrealistic assumption that the tax cuts were financed by a 1.3 percent of GDP reduction in all government spending starting in 2017, a sum equivalent to cutting domestic discretionary spending in half. The Treasury did not model more gradual and realistic reduction in spending but the generic modeling by JCT and others suggests that this scenario could well result in a reduction in economic output.

The Treasury study also estimated that if the tax cuts are financed by income-tax increases, they will reduce long-run national output by 0.9 percent. Under this scenario – if the large spending cuts do not materialize relatively quickly – the economic damage caused by the tax cuts would be minimized by reversing them more quickly. This is simply the corollary of a basic result in economics that it is better to finance a given level of government expenditures

[9] Office of Tax Analysis. 2006. "Dynamic Analysis of the Permanent Extension of the President's Tax Relief." U.S. Department of Treasury. (July 25).
http://www.ustreas.gov/press/releases/reports/treasurydynamicanalysisreporjjuly252006.pdf

with a "smooth" level of taxes.[10] For example, if the long-run budget is in deficit, it is better to act sooner and raise taxes by a smaller amount today than to wait for the deficits to grow so large that taxes have to be raised by a larger amount in the future. This is a basic implication of the old adage that it is better to act sooner to prepare for future challenges.

In no scenario were the economic benefits of the tax cuts so large that they would appreciably change the conclusions based on examining the tax cuts themselves and ignoring any economic effects. In some cases the economic harm caused by the tax cuts could result in even less favorable results than the static analysis would indicate.

The Budgetary Impact of the Tax Cuts: Negative and Potentially Large

The economic impact of the tax cuts has a relatively small impact on the disposable income of households that can be positive or negative. But the third channel in the analysis – the budgetary impact of the tax cuts – has an unambiguously negative impact on the disposable income of households. Moreover, this negative impact can be sizable relative to the income of low- and middle-income households – more than offsetting any direct benefits of the tax cuts or even the relatively unlikely possibility of stronger economic performance.

Tax cuts inevitably require reductions in government spending or increases in future taxes. In either case, this indirect budgetary effect serves to reduce disposable incomes, either by reducing government benefits or raising taxes. Although some of these financing costs will likely fall on future generations, many of them will fall on the exact same households that receive the tax cuts today.[11] For example, a person might get a $500 tax cut today but lose $700 in present value terms in future Medicare benefits.

It is common in dynamic analysis to explicitly specify how tax cuts are financed in order to calculate the impact of the tax cuts on economic performance. These same financing assumptions have major implications for the distribution of the tax cuts that should also be presented in these analyses.

The budgetary impact of tax cuts is negative because the tax cuts do not pay for themselves through stronger growth. Every official scoring agency and credible economist has consistently stated that tax cuts do not pay for themselves through stronger growth. For example, the 2003 Economic Report of the President stated, "Although the economy grows in response to tax reductions (because of higher consumption in the short run and improved incentives in the long run), it is unlikely to grow so much that lost revenue is completely recovered by the higher level of economic activity." Similarly, in an early edition of his leading economics textbook, N. Gregory Mankiw wrote that there is "no credible evidence" that "tax revenues … rise in the face of lower tax rates." He compared economists who say that tax cuts pay for themselves to a "snake oil salesman who is trying to sell a miracle cure."[12]

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[10] Barro, Robert J. 1979. "On the determination of public debt." *Journal of Political Economy* 87 (5): 940-71

[11] In fact, most of the dynamic analysis of tax cuts assumes that they are financed relatively quickly and not passed in significant measure onto future generations.

[12] N. Gregory Mankiw, *Principles of Economics* (Fort Worth, TX: Dryden, 1998), pp. 29-30.

Not only do tax cuts not pay for themselves, but depending on the specific policy dynamic effects can partially offset the cost of tax cuts or can partially augment the cost of tax cuts. For example, the Treasury's dynamic analysis of the tax cuts enacted since 2001 found that in the favorable case the dynamic effects of the tax cuts would offset 10 percent of their long-run cost while in the unfavorable case the economic harm from the added debt would add 13 percent to the long-run cost of the tax cuts.

In general, the conventional scoring – which includes microeconomic feedback but ignores macroeconomic feedback – is reasonably accurate. Former CBO Director Rudolph Penner, for example, recently commented that "for a very long time, the Congress will have to be satisfied with static scoring. That is not so bad. The CBO's dynamic analysis suggests that static scoring is usually pretty accurate." Nothing in the recent revenue surprises should lead us to alter this conclusion (see Box).

Do the Revenue Surprises Mean Tax Cuts Pay for Themselves?

The economy witnessed a series of large, positive revenue surprises following the tax increases in 1990 and 1993. All else being equal, these revenue increases would lead one to suspect that tax increases help the economy, perhaps by reducing debt and increasing national savings. This conclusion is strengthened by the observation that the economy witnessed a series of large, negative revenue surprises following the 1981 tax cuts – suggesting that dynamic effects magnify the conventional costs of tax cuts.* The same conclusion could be drawn from the experience of 2001-04. As the Congressional Research Service noted, "Actual tax receipts fell significantly more than predicted by the ex ante scores, even after controlling for economic conditions. This suggests that the tax cuts may have resulted in more revenue loss than predicted."† In contrast, the positive revenue surprises of the last three years would suggest the opposite conclusion.

But none of these experiences tells us very much for the simple reason that revenues are highly variable and fluctuate for numerous reasons that are unrelated to the dynamic feedback from tax cuts. Moreover, these dynamic feedbacks are expected to be relatively small and thus extremely hard to detect using the highly variable indicator of actual revenue levels.

Over the past 25 years**,** CBO's projection of the level of revenues that will be collected in the following fiscal year has been either too high or too low by an average of 6.1 percent, which is the equivalent of an overestimate or underestimate of $150 billion in fiscal year 2006. These projections have been just as likely to overstate revenues (i.e., to be too high) as to understate them. In contrast, even under optimistic assumptions the dynamic effect of the dividend and capital gains tax cuts enacted in 2003 would be predicted to be about $5 billion in fiscal year 2007 (20 percent of the $25 billion so-called static score). Even if true, an effect of this magnitude would be virtually undetectable when the underlying revenue numbers themselves are so volatile.

*This analysis is based on Furman "Do Revenue Surprises Tell Us Much About the Cost of Tax Cuts?" 2006
† Marc Labonte, "What Effects Have the Recent Tax Cuts Had on the Economy?" Congressional Research Service, updated April 14, 2006.

The Impact of the Tax Cuts on American Households

We can now assess the potential long-run impact of making the 2001-06 tax cuts permanent by combing the three factors discussed above. Specifically, after-tax incomes are affected by three factors:

1. The direct effect of the tax cuts is to increase after-tax incomes, with the largest increases (in both dollar and percentage terms) for the highest income households.

2. The indirect effect of the tax cuts on the macroeconomy can raise or lower average incomes depending on both the economic model and the financing of the tax cuts but these effects are unlikely to be large or important for most families.

3. The financing of the tax cuts generally lowers disposable incomes by reducing government transfers or increasing government revenues.

For illustrative purposes the following shows the effects of tax cuts under two scenarios. The first scenario gives the tax cuts the full benefit of the doubt, granting the Treasury's finding that under some circumstances the tax cuts could result in higher national output, resulting in both higher family incomes (by 0.7 percent) and partially offsetting the cost of the tax cuts (paying for 10 percent of them). This scenario assumes a large reduction in government consumption which, for the purpose of this illustrative distributional analysis, is modeled as a reduction in government transfers and thus a reduction in disposable income.[13] The second scenario assumes that large tax cuts are followed by even larger tax increases to recoup their cost – reducing economic output and magnifying the cost of the initial round of tax cuts.

Table 3 shows the impact of making the tax cuts permanent under these two scenarios, combining the direct effect of the tax cuts with the indirect effects on before-tax incomes and the assumed financing of the tax cuts.

[13] The Treasury model treats government consumption differently than government transfers, a distinction that is ignored here.

Table 3. Illustrative Dynamic Distributional Analysis of the 2001-06 Tax Cuts in the Long Run							
	Static Tax Cut	Income Change	Finance Cost	Total After-Tax Income Change	Percent Change in After-tax Income	% with Income Increase	% with Income Decrease
Tax Cuts Financed By a Per Person Spending Reduction (Income increases by 0.7 percent and tax cuts pay for 10 percent of themselves)							
Bottom Quintile	$79	$55	-$1,576	-$1,442	-12.1%	0%	100%
Second Quintile	$546	$119	-$1,576	-$911	-3.3%	8%	92%
Third Quintile	$887	$219	-$1,576	-$470	-1.1%	22%	78%
Fourth Quintile	$1,275	$358	-$1,576	$57	0.1%	44%	56%
Fifth Quintile	$6,763	$957	-$1,576	$6,243	3.0%	57%	43%
Top 1%	$84,582	$7,576	-$1,576	$90,581	7.7%	99%	1%
All	**$1,939**	**$339**	**-$1,576**	**$701**	**1.0%**	**26%**	**74%**
Tax Cuts Financed by Future Tax Increases (Income falls by 0.9 percent and tax cuts cost 13 percent more than expected)							
Bottom Quintile	$79	-$72	-$54	-$48	-0.4%	19%	63%
Second Quintile	$546	-$160	-$294	$91	0.3%	32%	58%
Third Quintile	$887	-$294	-$936	-$344	-0.8%	26%	72%
Fourth Quintile	$1,275	-$525	-$2,219	-$1,470	-2.0%	10%	90%
Fifth Quintile	$6,763	-$1,921	-$8,811	-$3,871	-1.9%	5%	95%
Top 1%	$84,582	-$11,401	-$56,630	$16,551	1.4%	43%	57%
All	**$1,939**	**-$592**	**-$2,467**	**-$1,120**	**-1.6%**	**19%**	**76%**

Note: Income change column includes interaction effect with tax cuts. Winners and losers do not total 100 percent because after-tax income is unchanged in some cases.
Source: Very preliminary estimates using the Urban-Brookings Tax Policy Center Microsimulation Model.

In both scenarios roughly three-quarters of households end up with lower after tax incomes. As the Treasury study and others have pointed out, financing tax cuts with spending reductions is more efficient on average – resulting in higher average incomes rather than lower average incomes in the scenario where the tax cuts are financed by future tax increases. The flip side is that the spending reduction scenario is substantially more regressive, with the large majority of the bottom 80 percent of households witnessing reductions in their after-tax incomes. For the bottom quintile these reductions average 12 percent of after-tax income. In contrast, the other scenario assumes a more progressive funding source for the tax cuts and thus has somewhat fewer middle-class losers. Finally, if the goal of policymakers is to minimize the number of losers both scenarios are inferior to not having the tax cuts in the first place, in which case there are no losers.

Conclusion

The analysis in this testimony contains two important conclusions. The first conclusion is analytic: CBO, JCT, Treasury and academic researchers should begin to conduct "dynamic distributional analyses." A number of researchers have conducted dynamic analyses of tax cuts that are premised on specific assumptions about the financing of tax cuts. These dynamic

analyses should also present information on the distributional impact of these tax cuts using the same financing assumptions employed in the efficiency analysis. As a general matter, such analysis would often show that tax cuts that appear to result in substantial efficiency gains are also likely to be highly regressive and possibly even harmful to much of the population.[14] Ultimately such analyses offer the hope of telling policymakers what they should really care about in evaluating tax policies: how will it affect the after-tax income of various income groups in society.

The second conclusion is specific to the tax cuts enacted from 2001-06. By themselves these tax cuts have exacerbated after-tax income disparities, thus resulting in more inequality. A more complete analysis that incorporates the economic and budgetary effects of the tax cuts finds that even in the unlikely scenario in which the 2001-06 tax cuts boost incomes and help pay for themselves, 74 percent of households are made worse off. In the potentially more realistic scenario that tax cuts are paid for with future tax increases 76 percent of households are made worse off, although the harm for low- and moderate-income families is relatively small compared to the "optimistic" scenario. This finding does not imply any specific stance towards the tax cuts. But it reinforces that there is no free lunch because ultimately the government faces a budget constraint. As a result, reducing taxes for the most affluent households almost inevitably results in long-run reductions in disposable incomes for working families.

[14] For example, the Mankiw-Weinzierl model referred to above assumes that tax cuts are paid for by simultaneous increases in lump-sum taxes or reductions in government transfers like Social Security, Medicare, Medicaid and food stamps.