



Quick Study

A Policy Report Summary by the Institute for Policy Innovation

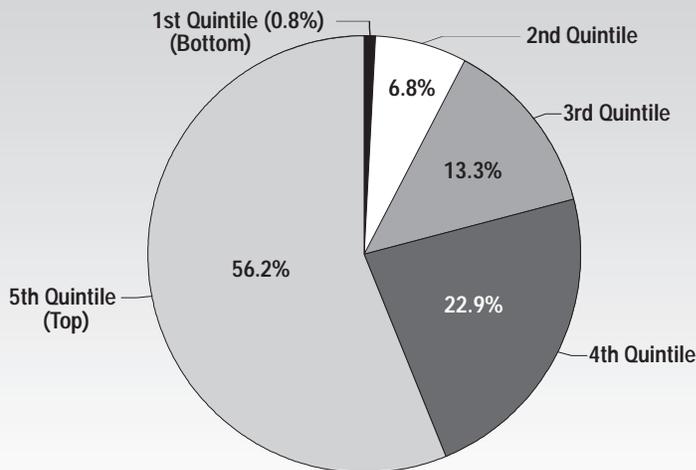
Tax Cuts: Who Wins? Who Loses?

A Summary of IPI Policy Report #140

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Figure 1

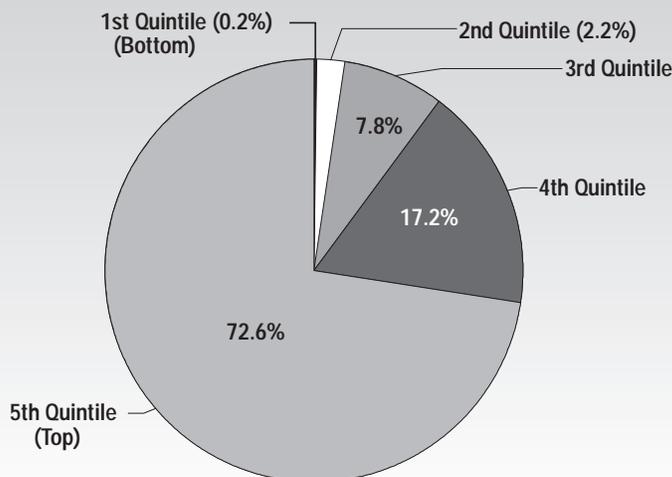
Distribution of Adjusted Gross Income by Quintile, 1996



Note: One quintile is 20 percent of taxpayers

Figure 2

Distribution of Tax Liability by Quintile, 1996



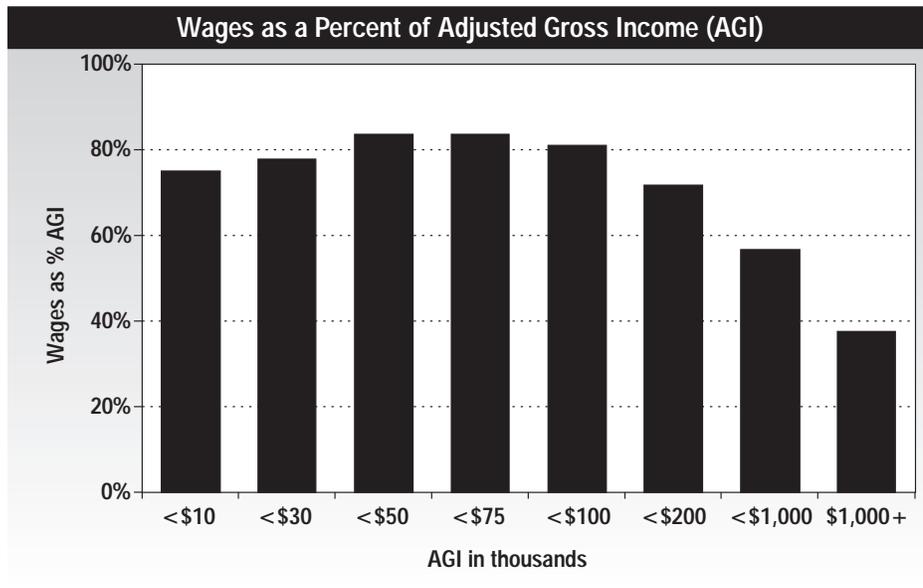
Who wins and who loses? Does a proposed tax cut help “working people,” or is it another “tax cut for the rich?” The fate of most tax proposals often rests with how they stack up against the “fairness” test.

Unfortunately, traditional forecasting methods are usually wrong. They simply apply the proposed change to the existing income distribution of taxpayers. This “static” method ignores the effects on taxpayer income that might result from a change in economic activity caused by a change in tax policy.

Both Adjusted Gross Incomes (AGI) and taxes are heavily concentrated in the middle and upper ends of income distribution. For example, the top 20 percent of taxpayers (which starts around \$50,000) accounts for 56.2 percent of AGI and pays 72.6 percent of federal income taxes. The bottom 40 percent (below \$17,500) accounts for 7.6 percent of AGI and pays 2.4 percent of income taxes. [See Figures 1 and 2.]

Because higher income taxpayers pay such a disproportionate share of taxes, static analysis will inevitably conclude that most tax cuts benefit only the “rich.” For example, 73 percent of any across-the-board rate cut would go to the top fifth of taxpayers because they pay 73 percent

Figure 3



of the tax. In a battle dominated by class warfare rhetoric, this result is enough to doom many tax cuts.

But what if the tax cut helps stimulate the economy? Could careful consideration of the resulting benefits—namely higher incomes—be enough to change the verdict on a tax cut?

Who Benefits from Economic Growth?

Higher economic growth is desirable because it raises incomes. But who benefits—the rich, investors, workers, average Americans?

Wages form the bulk of U.S. income, with lower income taxpayers receiving more of their income from wages than higher income taxpayers. Wages contribute at least 80 percent of the income for taxpayers with AGI between \$25,000 and \$100,000. Higher income taxpayers are less dependent on wages. Those between \$200,000 and \$1,000,000 receive over half their incomes from wages while those over a million receive only a third. [See Figure 3.] The balance of non-wage income comes mostly from interest, dividends, capital gains, rents, royalties, and other business income. This helps explain why tax changes that

seemingly benefit only investors, such as a reduction in capital gains taxes, often flunk the static “fairness” test.

Where Does Added Growth Go?

When the economy grows, what happens to an extra dollar produced? Initially, that dollar goes to compensate the factors of production—labor and capital—that produced the added output. However, not all of that compensation ends up in the pockets of workers and owners of capital (i.e., investors, savers, business owners). Taxes take a chunk as does replenishment of the stock of capital (or depreciation).

Using Commerce Department data, we show how an extra dollar produced by the corporate sector is split among workers, stockholders, government and depreciation. While a more complicated procedure would be needed for the non-corporate sector, the results would be about the same.

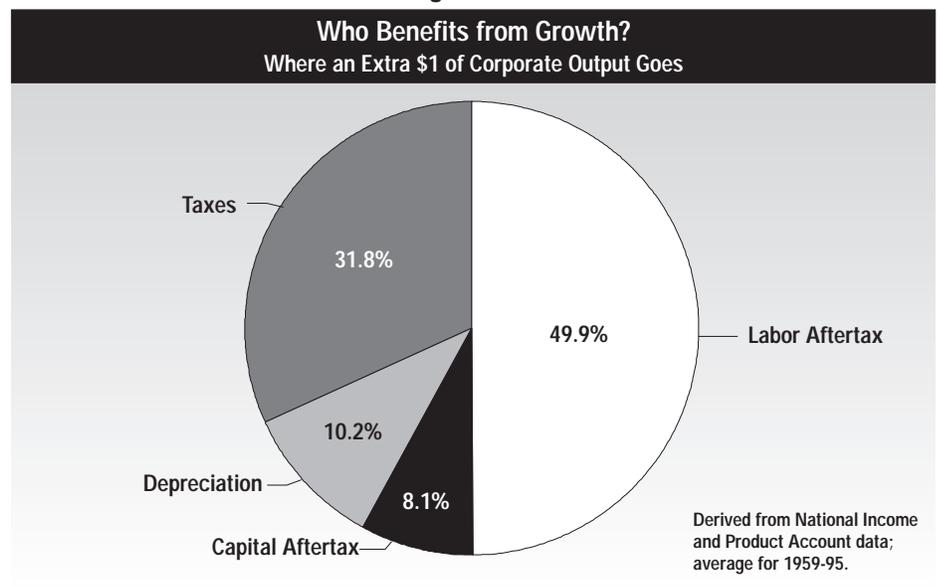
The distribution of an extra dollar of corporate output has been remarkably stable over the period 1959 to 1995. Workers received the biggest share, 50 cents on average. The next largest slice, 32 cents, went to government as taxes. Depreciation took up 10 cents. Owners of capital (stockholders here) receive the smallest share, 8 cents. [See Figure 4.]

Using the past as a guide, additions to growth in the future will be distributed in roughly the same manner. Thus when the economy grows, wage-earners receive the largest portion of additional growth. Since lower income taxpayers depend mostly on wages for income, their income will rise by a greater percentage than other taxpayers.

Pro-growth Tax Cuts and Static Distributional Analysis

Tax cuts do affect the economy. However, some types of tax cuts will boost growth to a greater extent than other cuts. Similarly, some tax increases do more harm to the economy than others.

Figure 4



The following observation emerges from our recent survey of federal tax policy over the last four decades: *tax cuts with the potential to do the most economic good are those that lower tax rates on the next dollar of income earned through work, saving and investment.* These tax cuts are also the ones that current static estimation practices will judge most harshly. Conversely, static analysis would judge more favorably the distributional effects of tax cuts that do little for economic growth.

Income Distribution Effects for Two Pro-growth Tax Changes

To illustrate how the economic effects resulting from pro-growth tax changes can affect income distributions, we have chosen *two simple policy changes.* One is a 15 percent, across-the-board cut in individual income tax rates. The other is a 15 percent cut in corporate income tax rates.

15% Cut in Individual Income Tax Rates

Economic Effects

Cutting individual income tax rates would increase the aftertax returns to workers, investors and savers. Letting workers keep more of what they earn would increase the supply of labor and reduce the cost of hiring. These changes in the labor market would lead to almost 2 million more jobs by the year 2000 and 3.2 million by 2010.

Distribution Effects

Revenue estimates produced by static analysis would ignore these economic effects. They would show 87 percent of the benefits from the tax cut going to the top 40 percent of taxpayers (those with incomes above \$47,000). Despite the fact that those people pay the lion's share of federal individual income taxes, that result would be enough to subject the proposal to charges of "tax cut for the rich."

What should be of concern, however, is the extent to which people are better off after the tax cut, something that static analysis does not measure correctly. That is, what happens to people's incomes after tax?

On average, taxpayers in the middle of the income distribution would experience roughly a 5 percent increase in aftertax income. Those in the top fifth would see their aftertax incomes increase by 7.2 percent. Taxpayers in the bottom fifth would experience the largest increase in aftertax income, 11.2 percent, because they pay little or no income tax and, therefore, keep more of their gains from growth. [See Table 1, lower half.]

15% Cut in Corporate Income Tax Rates

Economic Effects

Reducing corporate income tax rates would increase the aftertax returns to investors and savers. Initially, the economy-wide, aftertax return to capital would increase by over 9 percent.

The expansion of capital would increase job opportunities and worker productivity. By 2010, there would be almost half a million more jobs.

These results are smaller than those for the individual rate cut because the size of the corporate tax cut is only one-fourth as large in terms of total "static" revenue reduction.

However, in terms of "bang for the buck" the corporate tax cut does as well or better than the individual rate cut. Tailoring the rate cuts to have the same static revenue consequences would mean either scaling back the individual cut to 4 percent to match a 15 percent corporate cut or increasing the corporate cut to 50 percent to match a 15 percent individual cut. Not surprisingly, the corporate cut would increase the stock of capital by up to 75 percent more than the individual rate cut. As a result, the corporate cut would yield up to a 27 percent greater increase in GDP than the individual cut.

Distributional Effects

Some economists, including those with the Treasury Dept. and the Joint Committee on Taxation (JCT), arbitrarily attribute corporate taxes to individuals. Their methods typically assume that corporate taxes are "shifted" from corporations (which write the tax check) either to consumers in the form of higher prices, to workers in the form of lower wages or shareholders in the form of lower returns. This is not a static assumption, but a dynamic assumption that when carried logically in the other direc-

Table 1

Comparison of Distributional Effects of Across-the-Board Reductions In Individual and Corporate Tax Rates (Assuming the Same Static Revenue Consequences)			
Increase in Aftertax Income, 2005			
4% Reduction in Individual Rates versus 15% Reduction in Corporate Rates¹			
Quintile	Individual	Corporate	Corporate/Individual
All	1.7%	1.6%	0.92
First	3.3%	4.7%	1.40
Second	1.2%	1.3%	1.10
Third	1.4%	1.3%	0.96
Fourth	1.5%	1.4%	0.93
Fifth	2.0%	1.8%	0.89
15% Reduction in Individual Rates versus 50% Reduction in Corporate Rates²			
Quintile	Individual	Corporate	Corporate/Individual
All	6.1%	4.9%	0.80
First	11.2%	14.1%	1.26
Second	4.2%	4.1%	0.97
Third	4.9%	4.1%	0.84
Fourth	5.2%	4.2%	0.82
Fifth	7.2%	5.4%	0.75

¹ The reduction in individual rates is simulated so that the static revenue loss equals that for the 15 percent reduction in corporate rates.

² The reduction in corporate rates is simulated so that the static revenue loss equals that for the 15 percent reduction in individual rates.

³ The ratio of effects of the corporate tax cut to the individual tax cut. A value of 1.00 means the effects are the same; a value > 1.00 means the corporate rate cut has a stronger effect; a value < 1.00 means the individual rate cut has a stronger effect.

tion would say that lower corporate taxes produce higher productivity, employment, wages, and lower prices.

Ironically, some who use these shifting assumptions maintain the contradictory position that a change in corporate taxes has no effect on aggregate output. We believe using arbitrary rules-of-thumb to distribute the results of a corporate tax change is mis-

leading. Our method relies on the empirical fact that the long-run, aftertax rate of return to capital is constant.

Compared to the individual rate cut, the corporate cut does almost as well in terms of aftertax incomes. However, for lowest 20 percent of taxpayers, the corporate cut does better, increasing aftertax incomes by up to 40 percent more than the individual rate cut. [See Table 1, Page 3.]

pro-growth tax cuts. Because workers receive the bulk of benefits from growth, people in the lower and middle parts of the income distribution, who rely heavily on wages, experience sizable increases in their aftertax incomes. The lowest income taxpayers receive the largest relative gain because they generally pay little or no tax and, therefore, get to keep most of the benefits from higher growth.

Slow growth is a cruel, hidden tax on those with lower incomes. While the rich will find opportunities in any economic climate, slow growth provides fewer opportunities for those toward the lower end of the income distribution. It is not surprising that a widening of the gap between the rich and poor has accompanied the tepid, 2.3 percent real growth of the last six years.

Reducing income disparity will require pro-growth tax policies. Bringing those policies to fruition will require abandoning class warfare rhetoric and adopting estimation methods that take account of growth fairly and accurately.

Conclusion

Static distributional analysis is biased against tax cuts that could help the economy. Because pro-growth tax cuts reduce marginal tax rates, static analysis will always show most of the tax cut going to higher-income taxpayers because they pay the bulk of taxes. Although reductions in marginal tax rates on capital income have the most economic bang for the buck, static analysis judges them harshly because higher income taxpayers rely more heavily on income from saving and investment.

Incorporating economic effects into distributional analysis can change the verdict on



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Want More Info?

This study is a summary of IPI Policy Report # 140, *Tax Cuts: Who Wins? Who Loses?*

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