

CENTER ON BUDGET AND POLICY PRIORITIES

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\$300 BILLION DEFICITS, AS FAR AS THE EYE CAN SEE

By Richard Kogan

“Rarely have the policies underlying the baseline projections been as disconnected from the policy makers’ agendas as they are today.”

-- Robert Reischauer¹

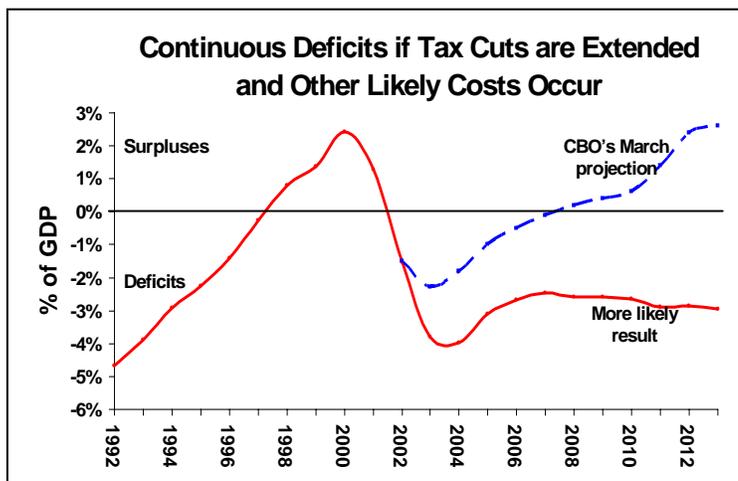
In March of this year, the Congressional Budget Office projected that large deficits in 2003 and 2004 would be followed by falling deficits thereafter, a budget surplus within five years, and large and growing surpluses within ten years. Even accounting for the recently enacted tax cuts and supplemental appropriations to fund the Iraq war, CBO’s projections imply steadily improving budgets. But such a conclusion would be considerably too optimistic:

CBO’s figures omit as much as *\$4.3 trillion* in costs over the next ten years, costs that result from legislation that Congress is likely — and in many cases, virtually certain — to enact. With these extra costs, the deficit over the ten year from 2004 through 2013 would total *\$4.1 trillion*.

If the tax cuts are extended and other likely costs occur, deficits will total \$4.1 trillion over the next ten years, will never fall below \$325 billion in any year, and will reach \$530 billion by 2013.

- With the enactment of the 2001, 2002, and 2003 tax cuts, the federal tax code is now rife with tax cuts that are scheduled to expire between 2004 and 2010. If Congress makes all these tax cuts permanent — and there will be considerable pressure to do so — projected 10-year deficits will increase by

\$1.7 trillion. If Congress also amends the Alternative Minimum Tax so that no more than 3 million tax filers are subject to it in any year, the ten-year deficit could increase by another \$760 billion.



¹ Robert D. Reischauer, President of the Urban Institute and former Director of the Congressional Budget Office, “Framing the Budget Debate for the Future,” testimony before the Senate Budget Committee, January 29, 2002.

- Program increases — for the military, for Iraq reconstruction, for a Medicare prescription drug benefit, and possibly for other needs — could swell the deficit by up to an additional \$1.9 trillion over the ten-year period.

**CBO Projections Do Not Include Likely Costs:
Surpluses (+) or Deficits (-), 2004-2013**
Dollars in trillions

	10-yr total	in 2013
CBO March “baseline” projections	+0.9	+0.5
Since March: Iraq war, new tax cuts	-0.7	*
Updated projections	+0.2	+0.4
Omitted costs discussed in this analysis: extending tax cuts, funding defense plans, providing Rx drug benefits, etc.	-4.3	-0.9
Resulting deficits	-4.1	-0.5
2013 deficit as a percent of GDP		3.0%

* less than \$50 billion; may not add due to rounding.

- The costs of the items not included in the CBO baseline projection convert projected surpluses to substantial deficits. If all these costs occur, deficits will total \$4.1 trillion over the next ten years, will never fall below \$325 billion in any year, and will reach \$530 billion by 2013.
- If, in contrast, the 2001 and 2003 tax cuts had not been enacted, the budget would return to surplus as early as 2007, even *with* the budget increases enacted since 2001, the additional budget increases (e.g., for defense and prescription drugs) assumed in this analysis, and AMT relief.
- Other analysts have reached similar conclusions about likely deficits if Congress and the Administration continue on what appears their likely path: Peter G. Peterson, Chairman of the Concord Coalition, estimates \$4.0 trillion in deficits over the next ten years, for example, and Goldman Sachs projects \$4.5 trillion in deficits.
- Our projection of \$4.1 trillion in deficits over ten years includes within that figure \$2.6 trillion in surpluses in the Social Security trust funds. Outside of Social Security, our figures show that ten-year deficits may total \$6.7 trillion.
- Higher deficits cause higher debt and thereby increase the level of government interest payments on the debt. In March, CBO estimated that the government would pay \$2.1 trillion in interest on debt held by the public over the next ten years. The cost of legislation enacted since March and the additional legislation assumed in this analysis would increase projected 10-year interest payments by \$1.0 trillion, to \$3.1 trillion. Both debt and interest would be a rising share of GDP. (By contrast, in January 2001, CBO’s projections implied that interest costs would net to approximately zero over the same period as a result of the projected elimination of the debt.)
- The \$530 billion deficit we project for 2013 would equal 3.0 percent of Gross Domestic Product. Today, 3.0 percent of GDP is almost six times the entire annual

budget of the Department of Education. Stated differently, it is equivalent to \$2,300 for each household in America.²

A deficit of 3.0 percent of GDP at a time when the retirement of the vast bulk of the baby-boom generation is just starting is a prescription for severe fiscal distress in the following decades. When the baby boom generation retires over the course of the next few decades, the costs of Medicare, Medicaid, and Social Security will grow quite substantially as a share of GDP, while the revenues needed to support these programs will not. The best way to prepare for the extra costs of these programs would be to reduce or eliminate the debt during this decade and thereby reduce or eliminate interest costs. Saving for the future — and shrinking the debt constitutes saving for the future — would offset a portion of the inevitable cost increases in Medicare, Medicaid, and Social Security, and thereby partly relieve the pressure to cut these programs, to cut other federal programs, or to raise taxes. Yet debt and interest costs are now on track to rise rather than fall; instead of preparing for the future by putting our finances in order before the baby boomers retire, we are going deeper into debt, and at just the wrong time. It is perhaps for this reason that Goldman Sachs calls the nation's long-term budget outlook "terrible, far worse than the official projections suggest."³

The CBO Baseline and What It Does Not Include

The most recent CBO baseline projection was issued in March, 2003, and showed deficits through 2006 but surpluses thereafter. Over the ten-year period from 2004 through 2013, CBO's March baseline projected a net surplus of \$890 billion. Unfortunately, this figure of \$0.9 trillion in surpluses is both out of date and a poor predictor of likely future budget results.

Since publication of CBO's March baseline, Congress has enacted a new tax cut officially scored as costing \$350 billion through 2013, supplemental appropriations that fund this year's cost of the Iraq war, and a seven-month extension of the Temporary Emergency Unemployment Compensation program. In addition, CBO has reported that revenues for 2003 are already falling well below expectations and are likely to end up \$50 billion to \$80 billion below the level CBO projected in March 2003, even *before* accounting for the new tax cut. Even if one considers all of these costs to be temporary and assumes all of the new tax cuts will end on their artificial "sunset" dates, these costs plus interest on them reduce the projected 2004-2013 surplus from \$0.9 trillion to about \$0.2 trillion. (See Table 1 on the next page.)

² We do not mean to imply that a typical family will have to pay \$2,300 to balance the budget in 2013. The purpose of this figure is to give a sense of the magnitude of 3.0 percent of GDP. In reality, a typical middle-income family may find itself worse off or less badly off than that figure implies, depending on the type of actions the nation takes to deal with these deficits. Policymakers might reduce programs of special benefits to such a family; they might raise taxes in a proportional or regressive manner, reducing the family's income by \$2,300 or more; they might raise taxes in a progressive manner, sparing middle-income families much of the brunt of the pain; or they might fail to deal with the deficit, in which case the cost to middle-income families of the resulting slower long-term economic growth is not clear. The possible range of outcomes is even more extreme, for good or ill, with respect to low-income families.

³ Bill Dudley and Ed McKelvey, "Budget Blues: Play It Again, Uncle Sam," Goldman Sachs, March 14, 2003.

Table 1
Bringing CBO's March Baseline Up to Date⁴
Dollars in billions

	10-yr total	in 2013
CBO's projected net surplus, 2004-2013, as of March 2003	891	459
less: cost of new tax cut (HR 2) as officially scored.	-289	+2
less: cost of extended unemployment compensation.	-4	0
less: cost of Iraq supplemental appropriations to date.	-38	0
less: possible revenue shortfalls in 2004 and 2005.	-34	0
less: extra interest payments on extra borrowing to finance above items.	<u>-296</u>	<u>-41</u>
Projected net surplus based on actions to date	230	420

NOTES: Each of the listed items also results in costs in 2003; for example, the tax cut costs \$61 billion in 2003, so that its total cost through 2013 is \$350 billion. The large amount of 2003 costs explains the large amount of extra interest payments shown above. CBO estimates that 2003 revenues will fall short of expectations by \$50 billion to \$80 billion in 2003; this analysis conservatively uses the \$50 billion figure and also assumes that these revenue shortfalls will only persist in mild form after 2003. The House Budget Committee Democratic staff, in contrast, estimates that the 2003 revenue shortfalls could presage as much as \$0.5 trillion in revenue shortfalls over the next decade.

CBO baseline estimates are a projection of future expenditures and revenues that are calculated according to a set of rules that are based on current law and thus assume, among other things, that all tax cuts scheduled to expire will indeed terminate on schedule, even when such tax measures are routinely renewed. These projections are the basic benchmark against which analysts assess the costs of proposed and actual changes in policy. These projections do not necessarily provide a realistic assessment of the future fiscal outlook, however, and are not intended to do so. Because they are based on these rules, the new CBO projections present a far rosier picture of the future than is likely to occur.

The CBO projections are unrealistically rosy for a number of reasons: they omit the cost of extending tax breaks that are scheduled to expire but that Congress always renews, as well as the costs of extending the 2001 and 2003 tax cuts beyond their scheduled expiration dates and providing relief from the mushrooming alternative minimum tax; they understate the costs of appropriated programs, especially for defense, Iraq occupation, and homeland security; they do not include any costs of a Medicare prescription drug benefit; and they do not include the costs of responding to major natural disasters such as hurricanes or floods. Table 2, on the next page, summarizes the omitted costs that are likely, and in some cases virtually certain, to occur over the next decade.

Specifically:

- **Routine "Tax Extenders."** CBO's projection of revenue collections is based on current tax law, regardless of whether provisions of tax law that are scheduled to expire are virtually certain to be renewed. If a tax provision that is scheduled to expire has very strong bipartisan support, has repeatedly been extended in the past,

⁴ Table 1 treats the Iraq supplemental appropriations enacted this spring as a one-time event. Following mechanical baseline rules, CBO's August baseline will treat the Iraq war as a recurring event, in effect projecting another Iraq-sized war for each of the next ten years. We consider our approach more realistic.

Table 2
Likely Costs Not Included in the CBO Baseline

Ten-year totals, 2004-2013, dollars in billions; surpluses shown as negative; costs as positive

	Total, 2004-2013		In 2013
Projected net surplus, CBO March baseline updated (from Table 1)		-230	-420
Costs not included in the baseline:	without interest	including interest	including interest
extend tax cut provisions scheduled to expire in the future	1,470	1,730	430
provide relief from the Alternative Minimum Tax	640	760	180
fund military and antiterrorism activities consistent with Administration plans	670	810	160
fund continued occupation of Iraq*	0 - 360	0 - 470	0 - 60
provide Medicare prescription drug benefit	400	490	90
budget for the average historical cost of natural disasters	80	100	10
assume domestic appropriations will cover a growing population	<u>190</u>	<u>230</u>	<u>50</u>
Total, omitted costs	3,630	4,350	950
Resulting deficits assuming additional costs		4,120	530

* Note: In the case of a possible occupation of Iraq, the future situation is highly uncertain; we show costs ranging from zero to \$3 billion per month for ten years. For purposes of calculating a total, we use the mid-point of the range. See discussion below. All costs are rounded to the nearest \$10 billion, then added.

and is virtually certain to be extended again, CBO will nevertheless assume that the provision will expire. CBO data show that the cost of extending expiring tax benefits that have always been routinely renewed is likely to be about \$145 billion over the next ten years, not counting interest.

- **Extending the 2001 tax cut.** CBO’s projections likewise assume that the large 2001 tax cut will expire on schedule in 2010. The President has proposed making that tax cut permanent. According to the Joint Committee on Taxation, doing so would cost an estimated \$610 billion over the next ten years, not counting interest, with almost all the 10-year costs occurring in 2011, 2012, and 2013.
- **Extending the recent tax cut.** The newly enacted tax cut legislation is advertised as costing \$350 billion through 2013, but that figure assumes seven of the eight tax-cutting provisions in that legislation will expire in 2004, 2005, or 2008. As explained in other Center analyses, if these expirations are removed from the recent legislation — and the President and Congressional Leadership seem intent on extending most or all of the provisions — the costs of the new tax-cut legislation will grow by \$710 billion beyond the official estimate of \$350 billion, for a total cost of \$1.06 trillion through 2013. (A recent analysis by two Brookings Institution scholars produced a very similar estimate.⁵)

Combining the \$145 billion in extra costs from the extension of routine expiring tax breaks, the \$610 billion in extra costs from the extension after 2010 of the 2001 tax-cut law, and the \$710 billion in extra costs from the removal of artificial sunsets from the new tax cut results in a total of almost \$1.5 trillion in additional revenue losses.

⁵ William G. Gale and Peter R. Orszag, “Sunsets in the Tax Code,” *Tax Notes*, June 9, 2003, pp 1553-1561. This analysis is also available through the Urban Institute – Brookings Institution Tax Policy Center at <http://www.taxpolicycenter.org/research/author.cfm?PubID=1000499>.

With interest, such extensions would add \$1.7 trillion to the 10-year deficit, as shown in Table 2 on the prior page.

- **The Alternative Minimum Tax.** In addition, Congress and the Administration have made clear that their agendas include relief from the individual Alternative Minimum Tax. Without such relief, the number of taxpayers subject to the AMT will explode from about 2½ million today to 30 million in 2010 and more than 41 million by 2013 if the 2001 tax cut is extended past its 2010 expiration date. Virtually all observers consider AMT relief inevitable. The Administration has said that it plans to address the AMT issue in 2005. The cost of limiting the AMT so that it affects about 2 percent of all tax filers in future years (as it will in 2004) amounts to \$640 billion through 2013 not counting interest, according to the Tax Policy Center. This policy would keep the number of AMT filers between 2½ million and 4 million. (See the Appendix for a more complete discussion of the AMT.)
- **Defense and the War on Terrorism.** The CBO baseline projections assume discretionary (or non-entitlement) programs will grow only by enough to cover inflation. As a result, the baseline projections do not account for the increases in defense funding that are very likely to be proposed and enacted. The Bush budget proposes increases in the defense budget above the CBO baseline. In addition, a recent analysis by the Center for Strategic and Budgetary Assessments concludes that the Bush budget: a) understates the actual costs of the weapons procurement and operations and support plans that the Department of Defense has adopted; b) does not include expected costs for the global war on terrorism; and c) does not include the costs of the war and occupation in Iraq. If the multiyear estimates of the Center for Strategic and Budgetary Assessments for items a) and b) prove correct, expenditures for defense and anti-terrorism efforts will exceed CBO's baseline by \$670 billion through 2013, not counting interest.⁶
- **Occupation of Iraq and Afghanistan.** Neither the CBO baseline nor the Bush budget includes the costs of an ongoing occupation of Iraq, and the Iraq funding enacted this spring was designed to cover only the costs of this year's military engagements. Recent testimony by the Department of Defense suggests that "U.S. forces might remain in Iraq for as long as a decade and that permanent facilities need to be built to house them there." One senior member of Congress estimated the cost of such an occupation at \$36 billion per year, and the Administration did not dispute

⁶ Steven M. Kosiak, "Cost Growth in Defense Plans, Wars and Occupation of Iraq Could Add Nearly \$700 Billion to Decade's Deficits," Center for Strategic and Budgetary Assessments, May 6, 2003. The figure of \$670 billion used here is derived as follows: The Bush budget proposes a ten-year expenditure increase above CBO's March baseline of \$210 billion; the CSBA estimates that the Bush budget is \$360 billion short of the amount needed to cover the Department of Defense's plans for weapons procurement and operations and support; and the CSBA estimates that the Bush budget is \$100 billion short of the costs that the Department of Defense may incur over the decade in the global war on terrorism, a figure CSBA describes as "conservative." (The CSBA also estimated that more funds will be needed for the occupation of Iraq than have currently been appropriated. Our analysis addresses Iraq costs separately.)

these figures.⁷ Because the future course of action in Iraq is so uncertain, our analysis shows a range of from zero to \$360 billion over the decade, excluding interest, and uses a figure half that size in calculating the total deficits over the period.

- **Medicare Prescription Drugs.** Under the baseline rules, CBO also projects entitlement costs based on current law. Public demand for a prescription drug benefit for the elderly has increased considerably, making the enactment of such a benefit very likely, probably this year. Such a benefit could cost anywhere from \$400 billion to \$750 billion over the decade, not counting interest, depending on how many of the elderly are covered and how comprehensive the benefit is. The House and Senate have recently approved competing prescription drug plans costing almost \$400 billion over ten years, and that figure is used in our analysis, although there is reason to expect benefits and costs to be enlarged in future years.
- **Natural Disasters.** Because few natural disasters have occurred so far in 2003, there is little funding for disaster relief in the CBO baseline. Yet hurricanes, floods, or earthquakes are likely to occur at some points over the decade. It is inconceivable there will be virtually no such events for the next 10 years, as the baseline implicitly assumes. If history is a guide, disaster relief is likely to cost \$80 billion over the period, not counting interest. This figure reflects average annual costs for relief from natural disasters in the past.
- **Domestic Appropriations.** Finally, as noted, CBO projects that discretionary funding will grow only to cover inflation. In 10 of the last 14 years, funding for domestic appropriations has grown faster than inflation *and* population growth combined. Although the Administration's budget and the congressional budget resolution assume that domestic appropriations will grow more slowly than inflation, over a decade the historical funding pattern may reassert itself. Note that the Department of Homeland Security is considered a domestic agency and is widely viewed as being underfunded. If domestic funding simply grows with inflation and the rise in the U.S. population (rather than only with inflation), and thus stays even in real per-capita terms (and shrinks as a share of GDP), expenditures for these programs will be approximately \$190 billion higher over ten years than CBO's baseline currently shows, not counting interest.⁸

The list of items not included in the CBO baseline thus is both lengthy and costly. Counting interest, it exceeds \$4.3 trillion over the decade (see table 2 on page 5). With the

⁷ Tom Squitieri, "U.S. troops may be in Iraq for 10 years," *USA Today*, June 19, 2003, page 4A. The article reports that Rep. John Spratt, D. South Carolina, a senior member of the Armed Services Committee and Ranking Member on the Budget Committee, estimated that the occupation of Iraq would cost about \$3 billion per month and the occupation of Afghanistan, \$1½ billion per month, for a total of \$54 billion per year for a decade or longer. The amounts for Afghanistan are presumably subsumed within the CBO baseline since that occupation has been in place for more than a year, but the amounts for Iraq are in addition to the amounts reflected in the CBO baseline and the Bush budget.

⁸ The Concord Coalition and the Committee on Economic Development state that it is more prudent to assume that domestic appropriations will keep pace with GDP, which would cost more than we assume.

Other Analyses Produce Similar Results

Other analysts also conclude that the CBO baseline should not be used to infer likely future surpluses. Making adjustments similar to those in this analysis, others find deficits of:

- \$4.0 trillion over ten years: Peter G. Peterson (President of Concord Coalition), April 30, 2003.
- \$4.0 trillion over ten years, \$476 billion in 2013: Rep. John Spratt, Ranking Member, House Budget Committee, May 29, 2003.
- \$4.1 trillion over ten years, \$530 billion in 2013: this analysis.
- \$500-\$575 billion in 2013: Committee on Economic Development, March 2003.

exception of a Medicare prescription drug benefit, the \$4.3 trillion in additional costs can be viewed as representing tax and program policies that are in place today but that CBO does not include in its baseline for technical reasons. In the past, when the significance of expirations in the tax code was trivial, the baseline functioned both as a benchmark against which to measure the cost of legislation and as a plausible predictor of future deficits. Now it no longer does the latter. As former CBO Director (and current Urban Institute President) Robert Reischauer remarked, “Rarely have the policies underlying the baseline projections been as disconnected from the policy makers’ agendas as they are today.”

While it is possible that some fraction of the \$4.3 trillion in costs in Table 2 might be avoided, it should also be noted that some of these estimates are conservative. For example, if a prescription drug benefit of the type currently under discussion is enacted, the pressure to expand the benefit to cover a higher share of the costs of drugs may become immense. Moreover, the Administration and the Congressional Leadership intend to enact additional tax cuts not reflected in our analysis.

How Much is \$530 Billion?

Table 2 shows that if the costs not included in CBO’s baseline are incurred, the budget deficit will reach \$530 billion in 2013 alone. Figures of that magnitude are often hard to comprehend; this section attempts to put that figure in context.

To start with, \$530 billion in 2013 equals 3.0 percent of GDP in that year. In today’s terms, 3.0 percent of GDP is \$324 billion. That amount, \$324 billion, equals:

- about \$2,300 for each household in America;
- a string of \$20 bills, laid end to end, stretching around the globe 62 times;

- almost six times the entire annual budget of the Education Department, or the Veterans Department, or the Transportation Department;
- about nine times the annual budget of the Department of Housing and Urban Development;
- approximately 13 times the annual budget of the Department of Homeland Security, more than 14 times the budget of the Department of Justice, some 22 times NASA's budget, and 41 times the budget of the Environmental Protection Agency; or
- approximately 10,300 years of counting dollars, if you could count \$1 each second, 24 hours per day (without pausing to eat or sleep).

Squandering the Opportunity to Reduce Debt and Failing to Prepare for the “Age Wave”

To prepare for the imminent retirement of the baby boom generation, the nation should decrease the national debt, not increase it. During the 1990s, debt held by the public fell from 49.5 percent of the Gross Domestic Product in 1993 to 33.1 percent by 2001. This analysis finds that deficits will total \$4.1 trillion over the period 2004-2013 if the costs not included in CBO's projections are incurred; if so, the debt will grow to almost 46 percent of GDP by 2013 and higher levels in years after that.

It is widely understood that when the “age wave” hits — when the baby boom generation starts to retire in 2008 — the costs of Medicare, Medicaid, and Social Security will grow faster than the economy, i.e., faster than the tax base. Over the course of the two subsequent decades, the gap between the cost of these three programs and the revenue needed to support them will widen substantially. To address this funding gap, the nation will have no choice but to raise revenues, reduce the benefits provided by these or other programs, or both. The best way to reduce the magnitude of this impending budget problem is to reduce or eliminate debt *during this decade*, in advance of the baby boomers retirement. Here is why.

By substantially decreasing debt during this decade, the government would avoid hundreds of billions of dollars per year in *interest payments* in all future years. Instead of using a few hundred billion per year in revenues to pay interest, those same revenues could be used to cover some of the growing costs of Medicare, Medicaid, and Social Security. Stated differently, budget pressures will grow from 2008 on and will ultimately force large tax increases, major benefit cuts in these programs, deep cuts in other federal programs, or some combination of these approaches. By shrinking the debt during this decade, we would directly cut the cost of one of the largest of the “other” federal programs — interest payments on the debt. These interest savings would reduce the degree to which the nation will in the future need to raise taxes or reduce benefits provided by Medicare, Medicaid, Social Security, or the rest of the government.

In short, the best way to protect future generations is to run surpluses, not deficits, in the present, once the economy recovers.⁹

In March of this year, CBO projected that interest payments would fall from 2.1 percent of GDP in 2001 to 1.0 percent by 2013. Under the assumptions of this analysis, however — with tax cuts extended beyond their scheduled expirations dates, defense plans fully funded, a prescription drug benefit enacted, and none of these policies paid for — interest costs would increase by \$1 trillion and total \$3.1 trillion over the ten-year period (rather than the \$2.1 trillion projected by CBO in March). The cost of interest would rise rather than fall, reaching \$425 billion — or 2.4 percent of GDP — in 2013 alone.

Conclusion

CBO's March 2003 assessment of the budget situation looked disturbing in the short run but noticeably better over the coming decade (followed eventually by serious shortfalls in the government's ability to cover the costs of existing commitments). A more realistic view of the budget suggests that even CBO's relatively benign March projection is far too optimistic, unless Congress and the Administration reverse course and determine that program increases and new tax cuts (including the extension of existing, officially temporary tax cuts) must be paid for. Acting now to reduce future deficits will make the burden imposed on future generations noticeably smaller than if we wait five, ten, or more years to act.

⁹ We are not advocating immediate tax increases or program cuts while the economy is functioning well below capacity. However, enactment now of a program of deficit reduction to be effective a year or more from now, when the economy has presumably recovered to a significant degree, seems warranted.

Appendix: AMT Relief

The recent tax-cut legislation includes a provision to protect taxpayers from the swelling Alternative Minimum Tax, but only through 2004. The Administration had requested AMT relief in its budget, but only through 2005. The *New York Times* recently quoted Pamela Olson, Assistant Secretary of the Treasury for Tax Policy, as stating that the Administration plans to propose a long-term solution to the AMT, but not until President Bush's second term. The article reported, "The target date [for a longer-term AMT proposal] is 2005, she said. 'We are working on it,' Ms. Olson said."¹⁰ Although addressing the AMT problem is clearly part of Administration and congressional plans, the costs of doing so beyond 2004 are not reflected in the new tax law.

Source of the AMT Problem

The Alternative Minimum Tax is a parallel tax system originally designed to ensure that tax filers with high incomes could not avoid paying taxes altogether by aggressively using available deductions, exemptions, and tax shelters. Such taxpayers calculate their tax liability according to both the regular income tax and the AMT and pay whichever amount is higher.

Unlike the regular income tax code, however, the key components of the AMT are not indexed for inflation. As a result, as incomes rise over time to reflect the effects of inflation, more taxpayers become subject to the AMT. This problem was exacerbated by the tax cuts enacted in 2001, which reduced tax liabilities under the regular income tax code, particularly for those with high incomes, without making corresponding adjustments in the AMT.

About two and one-half million taxpayers are currently subject to the AMT. The Tax Policy Center estimates that the number of taxpayers subject to the AMT will soar to more than 41 million by 2013, assuming that the 2001 tax cuts are made permanent, and the Treasury has issued estimates that corroborate this finding. The AMT would hit one of every three taxpayers in the nation by that year, with many middle-class families finding themselves subject to it and its complexities. By that time, the AMT would be "taking back" a goodly share of the 2001 tax cut from many of these families, and *more revenue would be collected under the AMT than the regular income tax*. It is inconceivable the President or the Congressional leadership of either party will allow the AMT to mushroom in this manner.

High Cost of AMT Relief

Preventing the individual Alternative Minimum Tax from exploding in size and encroaching heavily upon middle-class taxpayers in the years to come could be very costly. Because current law only provides AMT relief through 2004, however, the apparent cost of making the 2001 tax cuts permanent is kept down, since the official estimates rest upon the unrealistic assumption that AMT relief will end after 2004, the number of taxpayers subject to

¹⁰ David Cay Johnston, "Alternative Tax Looms Large Despite Plans for Other Cuts," *The New York Times*, January 10, 2003.

the AMT will explode after that year as a result, and the swollen AMT will cancel out a sizeable share of the tax cuts. This enables the Administration to show the cost of making the tax cut permanent as being much lower than that cost actually will be.

In reality, of course, AMT relief will be continued beyond 2004. The Bush Administration clearly intends to propose that such relief be maintained.¹¹ The cost of extending AMT relief beyond 2004 thus is essentially an "off-book liability" that must be considered part of the long-term cost of any proposal to make the 2001 tax cut permanent. It is necessary to include the cost of addressing the AMT problem when assessing the long-term cost implications of congressional or Administration tax-cut proposals.

Revenue-Neutral AMT Relief?

The Tax Policy Center has designed an option to provide AMT relief by restructuring the AMT in a cost-neutral manner; this option would free large numbers of middle-class taxpayers from the AMT and offset the cost by making the AMT tougher on high-income taxpayers (especially taxpayers with very high incomes, who currently are generally not affected by the AMT). There is virtually no chance the Administration will propose such a cost-neutral approach, even though the large, growing, and permanent deficits the nation faces suggests that all future tax cuts should be offset.

The Urban Institute - Brookings Institution Tax Policy Center has undertaken the most thorough review of the AMT issue to date.¹² Based on the Tax Policy Center analysis and recent estimates the Tax Policy Center has prepared, the loss in revenue from extending beyond 2004 the approach to AMT relief that is now in law would equal approximately \$640 billion through 2013, and result in a total cost of about \$760 billion when increased interest payments on the debt are taken into account.¹³

¹¹ The new tax-cut law's temporary AMT relief builds on and expands a similar provision in the 2001 tax-cut package that also provided AMT relief through 2004. The cost of providing permanent AMT relief would have driven the cost of the 2001 tax-cut package well above what the fiscal year 2002 Congressional budget resolution allowed, unless other elements of that package were scaled back. The framers of the 2001 tax cut consequently resorted to the gimmick of letting the AMT relief sunset at the end of 2004, knowing that Congress would have no choice but to extend AMT relief before the provision expired. This scenario occurred again this year, when AMT relief for 2004 was increased but AMT relief *after* 2004 could not be squeezed into the Senate's informal \$350 billion target for the newly enacted tax cut.

¹² Leonard Burman, William Gale, Jeffery Rohaly, and Benjamin Harris, "The Individual AMT: Problems and Potential Solutions," Urban-Brookings Tax Policy Center Discussion Paper No. 5, September 2002.

¹³ This estimate reflects an AMT option that would hold the share of AMT filers at approximately 2 percent of all tax filers (the 2004 share), according to the Tax Policy Center. We chose this AMT approach as consistent with the Congressional approach to the AMT; each of the temporary increases in the AMT exemption proposed in the various versions of this year's tax cut would have kept the share of AMT filers at about this percentage in the two or three years that the increased exemption would be in effect. (The estimate is based on the assumption that the 2001 tax cut will be made permanent rather than expire in 2010.) Specifically, under this approach, we assumed the permanent extension of the treatment of non-refundable tax credits as a "preference" for purposes of the AMT, and also assumed that the AMT exemption amount would be increased to \$60,000 for married couples in 2005, \$70,000 in 2008, and \$80,000 in 2013. (The exemption amount for single filers and heads of households would continue to be 75 percent of the amount for married filers in all years, as under current law.)