

August 26, 2003

DEFICIT PICTURE EVEN GRIMMER THAN NEW CBO PROJECTIONS SUGGEST

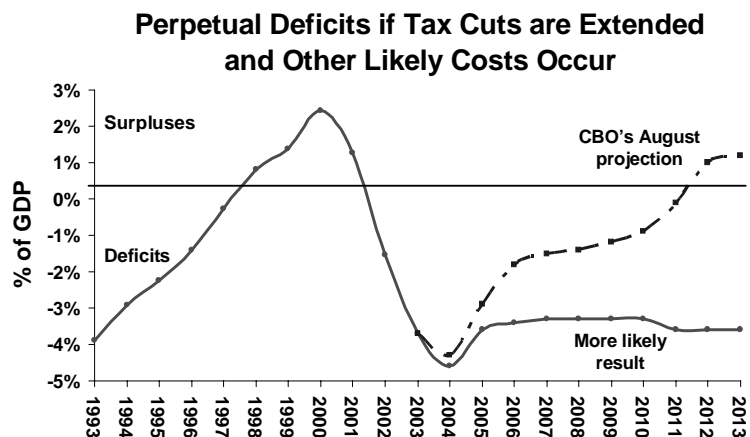
By Richard Kogan

On August 26, the Congressional Budget Office issued new budget estimates and projections. Four aspects of CBO's new figures should be understood.

- The new CBO ten-year projections, like those CBO has issued over the last 24 months, significantly understate the likely size of future deficits because they do not fully reflect the future costs of policies currently in effect; for example, CBO assumes existing tax cuts enacted since 2001 all will be allowed to expire. In addition, CBO does not include the costs of new policies that are very likely to be enacted, such as a Medicare prescription drug benefit.

If the tax cuts are extended and other likely costs occur, deficits will total \$5.1 trillion over the next ten years, will never fall below \$400 billion in any year, and will reach \$650 billion by 2013.

CBO's new report, which is considerably more pessimistic than the projections CBO issued just five months ago, projects deficits totaling \$1.4 trillion over the ten-year period from 2004 through 2013. A more realistic assessment of the budget that uses the CBO estimates but incorporates likely or inevitable costs produces a ten-year deficit projection of \$5.1 trillion, with deficits exceeding \$400 billion in every year and reaching \$650 billion by 2013. Moreover, under this more realistic assessment, the national debt is projected to rise from \$4.0 trillion today to \$9.1 trillion by 2013. (CBO itself projects in its new report that if expiring tax cuts are extended, a Medicare prescription drug benefit costing \$400 billion over ten years is enacted, and relief that lessens the explosive growth of the Alternative Minimum Tax is provided, deficits will total \$4.4 trillion over ten years. This CBO estimate does not include several other likely or inevitable costs that are included in our analysis.)



- The budget projections the Office of Management and Budget issued in July showed deficits

of \$455 billion in 2003 and \$226 billion in 2008, and Administration officials have cited these figures in recent weeks in claiming their policies will “cut the deficit in half” over five years. However, the more realistic ten-year projection that is based on the CBO estimates issued today and that reflects likely or inevitable costs shows the deficit *rising* by 15 percent over this period despite an improving economy, a far cry from the 50 percent drop that Administration officials cite. The Administration’s estimate shows a large decline in the deficit by 2008 because the Administration projection omits a series of likely or inevitable costs in areas such as taxes and defense spending. The more realistic projection shows the deficit rising from \$401 billion in 2003 to \$460 billion in 2008, and then climbing to \$650 billion by 2013.

- In January 2001, CBO projected surpluses over the ten-year period from 2002 through 2011 totaling \$5.6 trillion. Our projection of \$5.1 trillion in deficits covers a different ten-year period. Over the same ten years, 2002-2011, we project cumulative deficits of \$4.4 trillion. What caused a projected surplus of \$5.6 trillion to become a projected deficit of \$4.4 trillion? Of this extraordinary \$10 trillion deterioration, approximately 36 percent comes from enacted or expected tax cuts, 31 percent from budget increases, especially for defense and homeland security, and the remainder from the view CBO now holds that the economic and technical underpinnings of its 2001 projection were much too rosy, both in the short run and in the long run.
- The large deficits we project for the coming decade are much more a reflection of a historically low level of revenues, measured as a share of the economy, than of an unusually high level of federal spending. CBO projects that federal revenues will equal 16.5 percent of the Gross Domestic Product this year, the lowest level since 1959, and will fall to 16.2 percent of GDP next year. (GDP is a basic measure of the size of the economy.) If the tax cuts are extended and AMT relief is provided, federal revenues will average about 17.5 percent of GDP in years after the economy recovers, which is below the average levels for the 1960s, the 1970s, the 1980s, and the 1990s.

On the spending side, assuming enactment of a prescription drug benefit and the other likely expenditures included in our ten-year deficit projection, federal spending will average about 20.8 percent of GDP. This is below its level for almost every year from 1975 to 1995.

This analysis also concludes that the path of large and permanent deficits on which the government has embarked is unsound public policy and should be reversed as soon as the economy permits.

CBO’s 10-year Projections Do Not Reflect Trillions in Likely Costs

CBO now projects that large deficits in 2003 and 2004 will be followed by falling deficits thereafter and budget surpluses starting in 2012. Over the ten-year period from 2004 through 2013, the sum of CBO’s projected deficits and surpluses nets to a deficit of \$1.4 trillion. CBO’s projections imply steadily improving budgets after 2004.

Table 1
CBO Projections Do Not Include Likely Costs: Surpluses (+) or Deficits (-), 2004-2013
 (in trillions of dollars)

	10-yr total	in 2013
CBO August “baseline” projections	-1.4	+0.2
Omitted costs discussed in this analysis: extending tax cuts, funding defense plans, providing Rx drug benefits, etc.	-3.7	-0.9
Resulting deficits	-5.1	-0.6

* May not add due to rounding.

CBO’s figures, however, are considerably too optimistic. They omit as much as \$3.7 trillion in costs over the next ten years, which result from legislation Congress is likely — and in many cases, virtually certain — to enact.

- Enactment of the 2001, 2002, and 2003 tax cuts has filled the federal tax code with tax breaks that are scheduled to expire between 2004 and 2010. If Congress makes these tax cuts permanent — and there will be very strong pressure to do so — projected 10-year deficits will increase by \$1.85 trillion (including the additional interest payments on the debt). In addition, while two percent of tax filers will be subject to the Alternative Minimum Tax in 2004, that figure is set to explode in subsequent years. If Congress amends the AMT so no more than two percent will be subject to it in years after 2004, the ten-year deficit will increase by another \$760 billion.
- Program increases — primarily for the military, Iraq occupation and reconstruction, and a Medicare prescription drug benefit — are expected to swell the deficit by up to an additional \$1.1 trillion over the ten-year period.

CBO does not include the costs of these items in its projection because it follows rules that permit the inclusion only of tax and entitlement provisions that have already been enacted. When these \$3.7 trillion in likely or inevitable costs are included, projected deficits over the next ten years climb to \$5.1 trillion. (See Table 1.)

This projection of \$5.1 trillion in cumulative deficits over ten years includes \$2.4 trillion in surpluses in the Social Security trust funds. Outside of Social Security, we project ten-year deficits totaling \$7.5 trillion.

Other analysts have reached very similar conclusions about likely deficits. Earlier this year, Peter G. Peterson, Chairman of the Concord Coalition, estimated \$4.0 trillion in deficits over the next ten years. In June, Goldman Sachs projected \$4.5 trillion in deficits over this

The CBO Baseline and What It Does Not Include

CBO's new projections show deficits through 2011 and surpluses thereafter. Over the ten-year period from 2004 through 2013, CBO's baseline projects a net deficit of \$1.4 trillion. This figure of \$1.4 trillion in deficits is, however, a poor predictor of likely future budget results.

CBO's official baseline estimates are a projection of future expenditures and revenues, calculated according to a rigid set of rules that are based on current law as it is scheduled to apply in future years. CBO's official projections consequently assume, among other things, that all tax cuts scheduled to expire will terminate on schedule, even when such tax measures are routinely renewed.

These projections are the basic benchmark against which analysts routinely assess the costs of proposed and actual changes in policy. These projections do not necessarily provide a realistic assessment of the future fiscal outlook, and they are not intended to do so. Because they are based on these inflexible rules, the CBO projections present a far rosier picture of the future than is likely to occur.

In the past — when the significance of scheduled expirations of tax cuts was trivial — the budget 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 has remarked, “Rarely have the policies underlying the baseline projections been as disconnected from the policy makers’ agendas as they are today.”*

The official CBO projections are unrealistically rosy for the following 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 summarizes the omitted costs that are likely, and in some cases virtually certain, to occur over the coming decade. (The omitted costs are described in more detail in Appendix A.)

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 deficit (+) or surplus (-), CBO's August baseline	1,400	-210
Likely or inevitable costs not included in the baseline:	without interest	including interest
extend tax cut provisions scheduled to expire in the future	1,560	1,850
provide relief from the Alternative Minimum Tax	650	760
fund military and antiterrorism activities consistent with Administration plans	390	480
provide Medicare prescription drug benefit	400	480
budget for the average historical cost of natural disasters	30	40
adjust domestic funding for population increases and one-time costs	<u>80</u>	<u>90</u>
Total, omitted costs	3,110	3,690
Resulting deficits assuming additional costs	5,090	650

Note: All costs are rounded to the nearest \$10 billion, then added.

* Robert D. Reischauer, president of the Urban Institute and former Director of CBO, “Framing the Budget Debate for the Future,” testimony before the Senate Budget Committee, January 29, 2002.

period. Both such estimates would likely be higher if they were revised to reflect the new CBO figures.

Rising Debt and Interest Payments on the Debt

Higher deficits cause higher debt and thereby increase the amount of interest that the government must pay on the debt. CBO estimates that the government will pay \$2.6 trillion in interest on the publicly held debt over the next ten years. When the likely costs for the extension of the tax cuts, full funding of the Administration's defense plans, Iraqi occupation and reconstruction, a Medicare prescription drug benefit, and so on are taken into account, projected interest payments rise to \$3.2 trillion over ten years.

We project that interest payments will reach \$480 billion by 2013, and that the publicly held debt will exceed \$9.1 trillion by that year, or 52 percent of the GDP, the highest share of GDP since 1956. 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 Magnitude of Spending Cuts that Would be Required to Balance the Budget

Returning the budget to balance while allowing the tax-cut agenda to move forward would require budget cuts of stunning depth. If tax increases and cuts in Social Security, Medicare, defense, and homeland security are ruled out, achieving budget balance by 2008 would require cutting all remaining programs *by 41 percent*. This would entail reducing education, veterans programs, law enforcement, transportation and infrastructure, environmental protection, and biomedical research by that percentage, as well as unemployment compensation, Medicaid, the Children's Health Insurance Program, child care, the school lunch and food stamp programs, and Supplemental Security Income for the elderly and disabled poor, among other areas of government expenditure.

Implications for the Nation's Long-Term Fiscal Health

To run deficits of this magnitude even after the economy recovers — and to do so at a time when the vast bulk of the baby-boom generation is starting to retire — is a prescription for severe fiscal distress in the decades ahead. When the baby boom generation retires over the course of coming decades, the costs of Medicare, Medicaid, and Social Security will grow substantially as a share of the economy, while the revenues needed to support these programs will not. The best way to prepare for the added costs of these programs would be to reduce or eliminate the national debt during this decade and thereby to 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 sharply, to cut other programs sharply, or to raise taxes substantially in the decades ahead. (See Appendix B for a further discussion of this issue.)

How Much is \$650 Billion?

Table 2 shows that if the costs not included in CBO's baseline are incurred, the deficit will reach \$650 billion in 2013 alone, which would equal 3.6 percent of GDP in that year. In today's terms, 3.6 percent of GDP is \$389 billion. That amount, \$389 billion, equals:

- about \$2,800 for each household in America;
- about seven times the entire annual budget of the Education Department, or the Veterans Department, or the Transportation Department;
- about 11 times the annual budget of the Department of Housing and Urban Development;
- approximately 16 times the annual budget of the Department of Homeland Security, more than 17 times the budget of the Department of Justice, some 26 times NASA's budget, and 49 times the budget of the Environmental Protection Agency;
- a string of \$20 bills, laid end to end, stretching around the globe 74 times; or
- approximately 12,300 years of counting dollars, if you could count \$1 each second, 24 hours per day, without pausing to eat or sleep.

Yet debt and interest costs are now on track to rise markedly rather than to 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 has called the nation's long-term budget outlook "terrible, far worse than the official projections suggest."¹

¹ Bill Dudley and Ed McKelvey, "Budget Blues: Play It Again, Uncle Sam," Goldman Sachs, March 14, 2003.

Appendix A

Likely or Inevitable Costs Not Reflected in the CBO Baseline

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 strong bipartisan support, has repeatedly been extended in the past, and is virtually certain to be extended again, CBO will nevertheless assume that the provision will expire.

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 and the congressional budget plan adopted this year also assumes the extension of these provisions.

Extending the 2003 tax cut: The tax-cut legislation enacted in May is advertised as costing \$350 billion through 2013. That figure assumes, however, that 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 and the tax cuts remain in place — a likely occurrence given that 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 far beyond the official estimate of \$350 billion, for a total cost exceeding \$1 trillion through 2013.

Combining the added costs from the routine extension of expiring tax breaks, the added costs from the extension after 2010 of the 2001 tax-cut law, and the added costs from the removal of artificial sunsets in the new tax-cut law results in a total of \$1.56 trillion in additional revenue losses. With interest, such extensions would add \$1.85 trillion to the 10-year deficit, as Table 2 indicates.

The Alternative Minimum Tax: Congress and the Administration also 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 33 million in 2010 and close to 42 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 it plans to address the AMT issue in 2005. Based on estimates by the Tax Policy Center, the cost of limiting the AMT so it affects 2.2 percent of all tax filers in future years — the same percentage that it will affect in 2004 — amounts to almost \$650 billion through 2013, not counting interest. This policy would keep the number of AMT filers between 3 million and 3½ million. (See Appendix C for a more complete discussion of the AMT.)

Defense, the War on Terrorism, and the Occupation of Iraq: CBO’s baseline projections assume discretionary (or non-entitlement) programs will continue to be funded at 2003 levels, adjusted only to cover inflation. As a result, the baseline projections overstate defense costs in some respects and understate them in others. To begin with, the CBO baseline projects that the supplemental appropriations bill enacted this spring to fund the war in Iraq will be repeated in each of the next ten years, instead of treating the costs of the military engagement

as a one-time event. This assumption overstates defense expenditures by more than \$650 billion over the next ten years.

On the other hand, the CBO baseline *understates* likely defense expenditures in that it does not reflect the increases that the Bush Administration's budget proposes in the structure of the armed forces and the military hardware the armed forces use. This results in an understatement of approximately \$210 billion over ten years. It is more realistic to project future defense costs based on the Administration's budget than on CBO's mechanically derived baseline.

In addition, both a recent CBO analysis and a just-released analysis by the Center for Strategic and Budgetary Assessments find that the Bush budget itself understates the costs of the weapons procurement and operations and support plans the Defense Department has adopted. The Pentagon publishes its "Future-Year Defense Plan" periodically, and CBO regularly compares the specifics of this Plan with the amount in the Administration's budget. CBO recently published an analysis which found that the Administration's budget does not reflect the full costs of the plan. CSBA estimates the shortfall at \$500 billion over the next ten years, based on the CBO analysis.

The Administration's budget also fails to include expected costs for the global war on terrorism and does not include *any* costs for the occupation of Iraq and Afghanistan after September 30, 2003. If the multi-year estimates of CBO and the CSBA for these costs prove correct, expenditures for anti-terrorism and occupation efforts will exceed the amounts reflected in the Administration's budget by \$330 billion over ten years.

Accounting for these various defense-related overstatements and understatements in the CBO baseline yields an estimate that defense-related expenditures will exceed CBO's baseline projection by \$390 billion through 2013, not counting interest.²

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, and enactment of such a benefit is 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 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: In most years, funding for natural disasters is small because serious disasters are relatively rare. This year is no exception, so there is little funding for disaster relief in CBO's August baseline. Looking back over more than two decades, however, reminds us that

² Steven M. Kosiak, "Cost Growth in Defense Plans, Occupation of Iraq and War on Terrorism Could Add Nearly \$1.1 Trillion to Projected Deficits," Center for Strategic and Budgetary Assessments, August 26, 2003. The CSBA in turn based its calculations on estimates included in CBO, "The Long-Term Implications of Current Defense Plans: Summary Update for Fiscal Year 2004," July 2003.

at least one major and costly hurricane, flood, or earthquake is likely to occur at some point over the decade. It is hard to imagine there will be virtually no such events for the next 10 years, as the CBO baseline implicitly assumes. If history is a guide, disaster relief is likely to cost an additional \$30 billion over the ten-year period, not counting interest. This figure reflects past average costs over a ten-year period for relief from natural disasters, minus the modest amounts for natural disasters included in the baseline.

Domestic Appropriations: Finally, 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, the historical funding pattern may eventually reassert itself over the decade. 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 increase in the U.S. population (rather than only with inflation), and thus stays even in real per-capita terms, expenditures for these programs will be approximately \$190 billion higher over ten years than CBO's baseline currently shows, not counting interest.³ Partly offsetting this \$190 billion increase is our assumption that the portions of this year's Iraq supplemental appropriations bill that increase foreign assistance and provide a subsidy to the airline industry are one-time events. (CBO treats these appropriations like any others, assuming these costs are repeated in each of the next ten years.) Our treatment of this item removes \$110 billion in non-defense discretionary expenditures from CBO's baseline. Our net increase in this category thus is \$80 billion over ten years, not counting interest.

The list of items not included in CBO's baseline thus is both lengthy and costly. Counting interest, it reaches almost \$3.7 trillion over the decade (see Table 2 on page 5) and raises the total deficits over the decade to \$5.1 trillion, leaving a publicly held debt of \$9.1 trillion by the end of 2013. With the exception of a Medicare prescription drug benefit, the \$3.7 trillion in additional costs can generally be viewed as representing tax and program policies that already apply to today's budget but that CBO does not include in its future projections for technical reasons.

It is possible that some fraction of the \$3.7 trillion in costs in Table 2 might be avoided. It also should be noted, however, that some of these estimates are conservative and may underestimate costs. For example, if a prescription drug benefit of the type currently under discussion is enacted, the pressure to expand the benefit to cover a larger share of the costs of drugs may become intense. Moreover, the Administration and the Congressional Leadership intend to enact additional tax cuts not reflected in our analysis — a number of such tax cuts have already been approved by the House — and the CBO/CSBA estimate of the costs of occupying Iraq and Afghanistan assume these costs will diminish each year and end before 2008.

³ The Concord Coalition and the Committee on Economic Development have stated that it is more prudent to assume that domestic appropriations will keep pace with GDP, which would cost more than we assume.

Appendix B

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

Debt held by the public fell from 49.5 percent of the GDP in 1993 to 33.1 percent of GDP by 2001. This analysis finds that deficits are likely to total \$5.1 trillion over the period 2004-2013 under realistic assumptions. If so, the debt will grow to almost 52 percent of GDP (or \$9.1 trillion) by 2013 and to substantially 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 and thus faster than the nation’s revenue 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 the debt *during this decade*, in advance of the baby boomers retirement.

- 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 several hundred billion dollars 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 ultimately need to raise taxes, cut the benefits provided by Medicare, Medicaid, Social Security, or cut other public services. In short, the best way to protect future generations is to run surpluses, not deficits, in the present, once the economy recovers.⁴
- In its new report, CBO projects that interest payments will fall from 2.1 percent of GDP in 2001 to 1.7 percent by 2013. Under the assumptions of this analysis, however — with tax cuts extended beyond their scheduled expiration dates, the Administration’s defense plans fully funded, and a prescription drug benefit enacted — interest costs will exceed CBO’s projections by \$590 billion, will total \$3.2 trillion over the ten-year period (rather than the \$2.6 trillion CBO projects), and will increase as a share of GDP. We project interest costs to reach \$480 billion — or 2.7 percent of GDP — in 2013 alone.

⁴ 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 C

AMT Relief

The recent tax-cut legislation includes a provision to protect taxpayers from the swelling Alternative Minimum Tax, but only through 2004. Similarly, the Administration requested AMT relief in its budget, but only through 2005.

The *New York Times* has 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 in the first year of 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."⁵ Addressing the AMT problem is clearly part of Administration and congressional plans. The costs of doing so beyond 2004, however, are not reflected in the new tax law and thus are not included in the new CBO budget estimates.

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 almost 42 million by 2013, assuming that the 2001 tax cuts are made permanent. The Treasury has issued estimates that corroborate this finding. The AMT will 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 will 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 under the regular income tax*. It is inconceivable that the President or either party in Congress 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 is likely to be very costly.

⁵ David Cay Johnston, "Alternative Tax Looms Large Despite Plans for Other Cuts," *The New York Times*, January 10, 2003.

Because current law provides AMT relief only through 2004, however, the apparent cost of making the 2001 tax cuts permanent is kept down; official budget estimates rest upon the unrealistic assumption that AMT relief will end after 2004, the number of taxpayers subject to the AMT will explode after that year, 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.⁶ The cost of extending AMT relief beyond 2004 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.

The Urban Institute - Brookings Institution Tax Policy Center has undertaken the most thorough review of the AMT issue to date.⁷ Based on the Tax Policy Center analysis and recent estimates that the Tax Policy Center has prepared, the loss in revenue from extending beyond 2004 the approach to AMT relief now in law would equal approximately \$650 billion over ten years. The total cost would be approximately \$770 billion when the increased interest payments on the debt are taken into account.⁸

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 affected only slightly by the AMT. There is virtually no chance that the Administration will propose such a cost-neutral approach.

⁶ The new tax-cut law's temporary AMT relief builds on and expands a similar provision in the 2001 tax-cut package, which also provided AMT relief through 2004. The 2001 tax-cut law took this approach because the cost of providing permanent AMT relief would have driven the cost of that legislation well beyond what the fiscal year 2002 Congressional budget resolution allowed, unless other provisions in the bill were pared back. The framers of the 2001 tax cut 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 relief actually expired. This same scenario occurred again this year, when AMT relief for 2004 was increased (so that the acceleration of tax rate cuts into 2003 did not cause millions of additional filers to become subject to the AMT this year). Such relief was provided only through 2004 because continued relief *after* 2004 could not be squeezed into the Senate's unofficial \$350 billion target for the tax-cut package.

⁷ 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.

⁸ This estimate reflects an AMT approach that would hold the share of tax filers subject to the AMT at 2.2 percent of all tax filers (its 2004 share), based on estimates supplied by the Tax Policy Center. We use this AMT approach because it is 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 approximately this percentage during the two or three years over which the increased exemption would be in effect.