

July 17, 2008

Honorable Kent Conrad
Chairman
Committee on the Budget
United States Senate
Washington, DC 20510

Dear Mr. Chairman:

Over the next few years, the alternative minimum tax (AMT) will affect an increasing number of taxpayers and generate a growing share of income tax revenues. In addition, personal income taxes are scheduled to increase when the tax reductions originally enacted in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) expire after 2010. Legislation to limit the growth of the AMT or to extend the tax reductions beyond 2010 would increase federal budget deficits and federal debt, relative to those that would occur under current law, unless offsetting changes in federal taxes or spending were also enacted.

In response to your letter of July 8, 2008, the Congressional Budget Office (CBO) has estimated the long-term fiscal impact of two proposals you described (see the attachment). The first would limit the impact of the AMT by indexing it for inflation beginning in 2008. The second would make that change and permanently extend the personal income tax provisions of EGTRRA and JGTRRA that otherwise expire after 2010. Per your request, CBO compared the effects on the budget and the economy of financing those two policies with additional borrowing instead of financing them immediately via changes in other policies. In keeping with CBO's mandate to provide objective, impartial analysis, this report makes no policy recommendations.

Honorable Kent Conrad

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CBO would be pleased to address any further questions you have. I can be reached at (202) 226-2700. The staff contact for the tax analysis is David Weiner, who can be reached at (202) 226-2689; the contact for the macroeconomic analysis is Doug Hamilton, who can be reached at (202) 226-2770.

Sincerely,

A handwritten signature in black ink, appearing to read "Peter R. Orszag". The signature is fluid and cursive, with the first name "Peter" being the most prominent.

Peter R. Orszag
Director

Attachment

cc: Honorable Judd Gregg
Ranking Member

Honorable John M. Spratt, Jr.
Chairman
House Committee on the Budget

Honorable Paul Ryan
Ranking Member
House Committee on the Budget

Honorable Max Baucus
Chairman
Senate Finance Committee

Honorable Charles E. Grassley
Ranking Member
Senate Finance Committee

Honorable Charles B. Rangel
Chairman
House Ways and Means Committee

Honorable Jim McCrery
Ranking Member
House Ways and Means Committee

Long-Term Effects of Indexing the Alternative Minimum Tax and Extending the Tax Reductions of 2001 and 2003

In the next few years, the alternative minimum tax (AMT) will affect a growing share of taxpayers and generate a larger share of revenues. Personal income taxes will also rise as a share of income after 2010 as the tax reductions enacted in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) expire.

The AMT was originally designed to limit the use of tax preferences (exclusions or deductions from a comprehensive measure of income) and tax credits by high-income households to ensure that they paid at least some income tax. The AMT is a parallel tax system with a more limited set of tax preferences and credits than those that exist under the regular income tax and with its own set of exemptions and rate schedule. Households are required to pay whichever is greater—the tax they owe under the AMT or the tax they owe under the regular income tax. The number of households affected by the AMT and the revenues that are collected as a result have been growing over time. To date, the AMT has affected relatively few households and represented a relatively small share of total personal income tax revenues—less than 3 percent of households and revenues in 2007, for example.

Under current law, however, the AMT is expected to extend its reach for two reasons. First, a temporary increase in the amount of income exempt from the tax expired at the end of 2007. As a result, without a further change in law, the number of affected households is expected to rise from about 4 million in 2007 to about 27 million in 2008. Second, that number will continue to grow under current law because the AMT is not indexed for inflation, whereas the regular tax is.¹ In the *Long-Term Budget Outlook* (December 2007), the Congressional Budget Office (CBO) projected that if current law remained in place, by 2082 roughly three-quarters of households would pay the AMT. The incremental revenues generated by the AMT would account for about 18 percent of all personal income tax revenues generated in that year.

EGTRRA and JGTRRA contained a number of provisions that temporarily reduced personal income tax revenues. Those provisions included lower tax rates under the regular tax schedule, lower tax rates on dividend and capital gains income, an increase in the child tax credit, and a reduction in so-called marriage penalties. Most of the

1. Although the number of taxpayers affected by the AMT is generally rising over time, it is projected to fall between 2010 and 2011 under current law. The expiration of provisions of EGTRRA and JGTRRA after 2010 results in fewer taxpayers affected by the AMT in 2011, and thereafter, the number affected continues to rise.

reductions are scheduled to expire after 2010. As a result, for example, between 2010 and 2011, the top statutory income tax rate will rise from 35 percent to 39.6 percent and the child tax credit will fall from \$1,000 to \$500 per child.

In a July 8, 2008, letter, the Chairman of the Senate Budget Committee asked CBO to estimate the long-term fiscal impact of (1) eliminating the growth in the AMT by indexing the 2007 parameters of the tax for inflation beginning in tax year 2008 and (2) both indexing the 2007 parameters of the AMT for inflation and permanently extending the personal income tax provisions of EGTRRA and JGTRRA that are scheduled to expire after 2010. At the Chairman's request, CBO compared the economic effects of financing those two policies with additional borrowing and financing them immediately through changes in other policies.

Budgetary Impact

Indexing the AMT would reduce the amount of revenues collected by the federal government in the long run and, if it was not financed by other changes in policy, would increase the deficit and the debt held by the public. Those deficits and the debt would be larger if the indexation of the AMT was combined with an extension of EGTRRA and JGTRRA.

At the Chairman's request, CBO estimated the budgetary impact of those policies against the "extended-baseline" scenario presented in the agency's *Long-Term Budget Outlook*. Under that scenario, revenues and outlays match CBO's baseline projection (from January 2007) for the first 10 years and then are projected for an additional 65 years under the assumption that current law remains in place.² In the extended-baseline scenario, revenues rise from 18.8 percent of gross domestic product (GDP) in 2007 to 25.5 percent in 2082 but nevertheless fall short of projected spending (see Table 1). As a result, deficits rise to about 5 percent of GDP in 2050 and to 18 percent by 2082; debt rises to more than twice GDP by 2082 (well above its highest historical value).

Compared with the extended-baseline scenario, indexing the AMT, by itself, would reduce revenues by 2.5 percent of GDP in 2050 and by 2.6 percent in 2082.³ If those revenue losses were not offset by other changes in policy, the budget deficit would grow to 10 percent of GDP in 2050 and to 30 percent in 2082.

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2. The extended-baseline scenario assumes the continuation of current law for all of the major sources of revenues: income taxes, payroll taxes, excise taxes, and estate and gift taxes. Other revenues follow CBO's baseline through 2017 and are assumed to be constant as a share of gross domestic product (GDP) thereafter. Spending for Medicare, Medicaid, and Social Security is projected to occur as scheduled under current law. Other noninterest federal spending follows CBO's baseline through 2017 and is held constant as a share of GDP thereafter.
 3. The budgetary and economic analyses presented here are based on the economic assumptions used in CBO's *Long-Term Budget Outlook* (December 2007).

Table 1.**The Budgetary Effects of Indexing the AMT and Extending EGTRRA and JGTRRA**

(Percentage of gross domestic product)

	2007 ^a	2030	2050	2082
		Extended-Baseline Scenario		
Primary Spending	18.2	21.8	25.7	32.5
Interest	<u>1.7</u>	<u>0.6</u>	<u>2.3</u>	<u>11.0</u>
Total, Federal Spending	20.0	22.4	28.1	43.6
Revenues	18.8	21.4	23.5	25.5
Deficit (-) or Surplus				
Primary deficit (-) or surplus	0.5	-0.4	-2.3	-7.1
Total deficit	-1.2	-1.0	-4.6	-18.1
Federal Debt Held by the Public	37	12	50	240
		Extended-Baseline Scenario Plus Indexing the AMT		
Primary Spending	18.2	21.8	25.7	32.5
Interest	<u>1.7</u>	<u>1.3</u>	<u>5.3</u>	<u>20.2</u>
Total, Federal Spending	20.0	23.1	31.0	52.7
Revenues	18.8	20.1	21.0	22.9
Deficit (-) or Surplus				
Primary deficit (-) or surplus	0.5	-1.7	-4.7	-9.6
Total deficit	-1.2	-3.0	-10.0	-29.8
Federal Debt Held by the Public	37	29	115	435
		Extended-Baseline Scenario Plus Indexing the AMT and Extending EGTRRA and JGTRRA		
Primary Spending	18.2	21.8	25.7	32.5
Interest	<u>1.7</u>	<u>3.0</u>	<u>8.8</u>	<u>28.1</u>
Total, Federal Spending	20.0	24.7	34.6	60.6
Revenues	18.8	18.6	19.5	21.3
Deficit (-) or Surplus				
Primary deficit (-) or surplus	0.5	-3.2	-6.2	-11.2
Total deficit	-1.2	-6.1	-15.0	-39.3
Federal Debt Held by the Public	37	63	190	602

Source: Congressional Budget Office.

Notes: AMT = alternative minimum tax; EGTRRA = Economic Growth and Tax Relief Reconciliation Act of 2001; JGTRRA = Jobs and Growth Tax Relief Reconciliation Act of 2003.

The extended-baseline scenario adheres closely to current law, following CBO's 10-year baseline budget projections from 2008 to 2017 and then extending the baseline concept in its projections for the rest of the years in the 75-year projection period, to 2082.

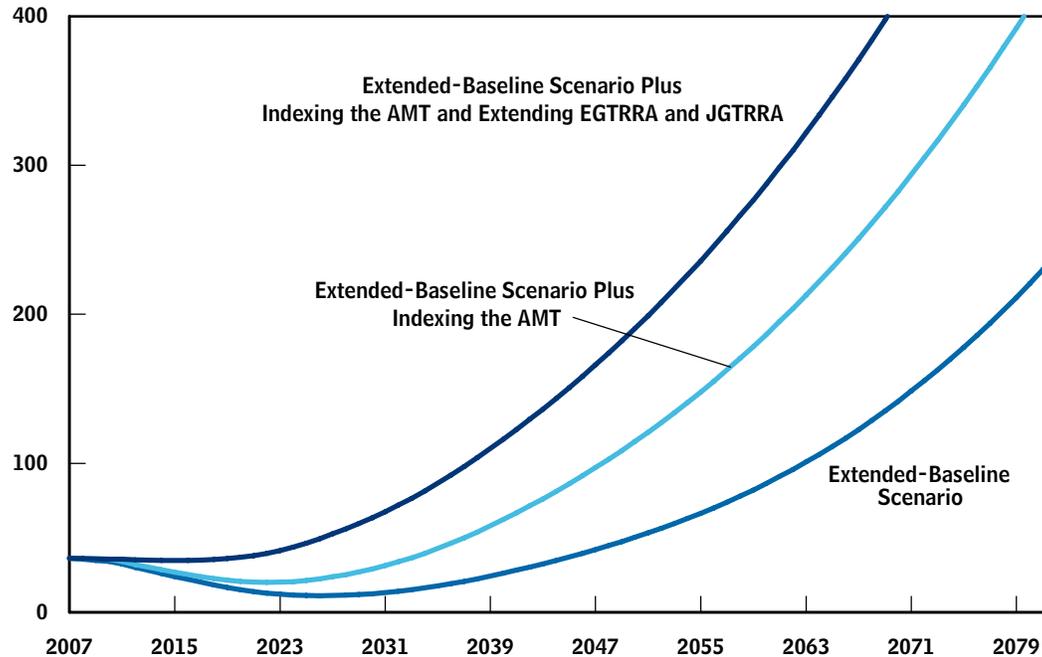
Numbers may not add up to totals because of rounding.

a. For 2007, numbers are actual and on a fiscal year basis.

Figure 1.

Federal Debt Held by the Public Under CBO's Extended-Baseline Scenario and Alternative Scenarios

(Percentage of gross domestic product)



Source: Congressional Budget Office.

Notes: AMT = alternative minimum tax; EGTRRA = Economic Growth and Tax Relief Reconciliation Act of 2001; JGTRRA = Jobs and Growth Tax Relief Reconciliation Act of 2003.

The extended-baseline scenario adheres closely to current law, following CBO's 10-year baseline budget projections from 2008 to 2017 and then extending the baseline concept in its projections for the rest of the years in the 75-year projection period, to 2082.

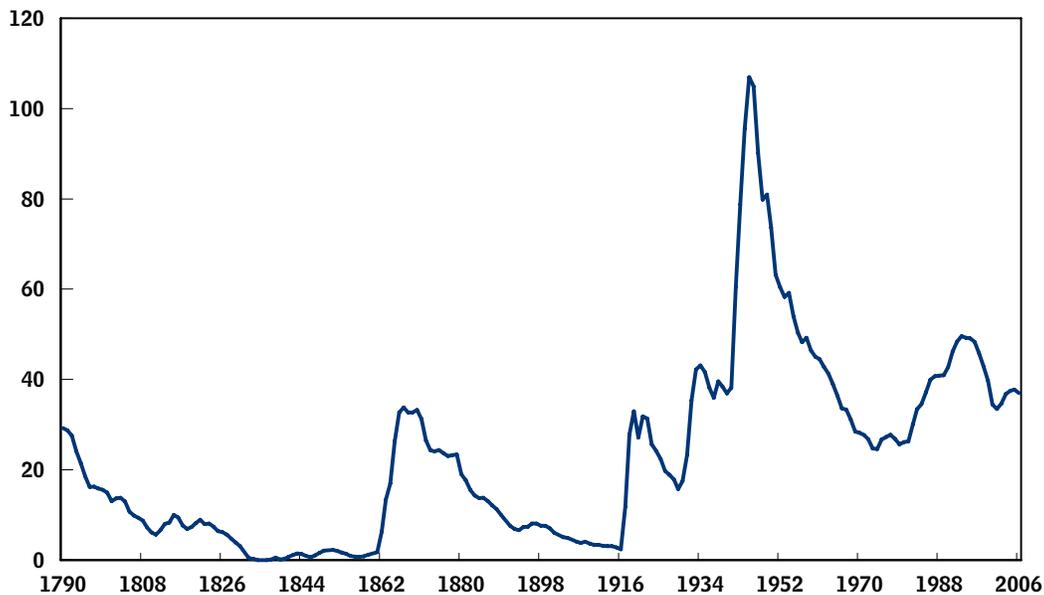
Federal debt held by the public would increase from 37 percent of GDP in 2007 to 115 percent in 2050 and to 435 percent in 2082 (see Figure 1).

Extending EGTRRA and JGTRRA, along with indexing the AMT, would have even larger budgetary effects. By CBO's estimates, that combination of policy changes would reduce revenues by 3.9 percent of GDP in 2050 and by 4.1 percent in 2082. If those revenue losses were not offset by other changes in policy, the budget deficit would increase to 15 percent of GDP in 2050 and to 39 percent in 2082. Under those policies, federal debt held by the public would increase to 190 percent of GDP in 2050 and to more than 600 percent in 2082—pushing federal debt as a share of GDP outside of its historical range by 2040 (see Figure 2).

The change in the fiscal gap is another way to measure the long-term budgetary impact of policy changes. The fiscal gap is the difference between the present value of

Figure 2.

Federal Debt Held by the Public as a Percentage of Gross Domestic Product, 1790 to 2007



Source: Congressional Budget Office.

outlays and the present value of revenues over an extended period of time.⁴ The difference is then divided by the present value of GDP over the same time period to measure the fiscal imbalance relative to the size of the economy. Thus, the fiscal gap represents the extent to which the government would need to immediately and permanently raise revenues or cut spending or do both to make the government's debt the same size (in relation to the economy) at the end of that period as it was at the beginning.

In the *Long-Term Budget Outlook*, CBO estimated the fiscal gap under the extended-baseline scenario to be 0.6 percent of GDP between 2008 and 2057 and 1.7 percent of GDP between 2008 and 2082 (see Table 2). For the specified proposals, CBO estimates the following:

- If the parameters of the AMT were indexed for inflation beginning in 2008, the fiscal gap between 2008 and 2057 would increase to 1.9 percent of GDP (equivalent to about \$275 billion in 2008); and between 2008 and 2082, the gap would increase to 3.3 percent of GDP (equivalent to about \$475 billion in 2008).

4. A present-value calculation adjusts future payments for the time value of money to make them comparable with payments today.

Table 2.**Federal Fiscal Gap Under CBO's Extended-Baseline Scenario and Alternative Scenarios**

(Percentage of the present value of gross domestic product)

	Projection Period		
	25 Years (2008–2032)	50 Years (2008–2057)	75 Years (2008–2082)
Extended-Baseline Scenario			
Outlays	19.5	21.9	23.8
Revenues	<u>20.2</u>	<u>21.3</u>	<u>22.1</u>
Fiscal Gap	-0.7	0.6	1.7
Extended-Baseline Scenario Plus Indexing the AMT			
Fiscal Gap	0	1.9	3.3
Extended-Baseline Scenario Plus Indexing the AMT and Extending EGTRRA and JGTRRA			
Fiscal Gap	1.3	3.3	4.7

Source: Congressional Budget Office.

Note: AMT = alternative minimum tax; EGTRRA = Economic Growth and Tax Relief Reconciliation Act of 2001; JGTRRA = Jobs and Growth Tax Relief Reconciliation Act of 2003.

The extended-baseline scenario adheres closely to current law, following CBO's 10-year baseline budget projections from 2008 to 2017 and then extending the baseline concept in its projections for the rest of the years in the 75-year projection period, to 2082.

- If, in addition to indexing the parameters of the AMT, the expiring personal income tax provisions of EGTRRA and JGTRRA were made permanent, the fiscal gap between 2008 and 2057 would increase to 3.3 percent of GDP (about \$475 billion in 2008) and between 2008 and 2082 the gap would increase to 4.7 percent of GDP (about \$675 billion in 2008).⁵

Thus, indexing the AMT and making the tax reductions permanent would increase the fiscal gap between 2008 and 2057 by 1.4 percent of GDP more than indexing the AMT alone. Of the total 1.4 percentage-point increase, 0.8 percentage points can be attributed to the permanent extension of EGTRRA and JGTRRA, and the remaining 0.6 percentage points can be attributed to interactions between indexing the AMT and extending the expiring provisions. The increase in the fiscal gap and the decomposition of the difference between the two proposals is similar through 2082.

5. This scenario for personal income tax revenues is similar to the alternative fiscal scenario outlined in CBO's *Long-Term Budget Outlook*. Under that scenario, the expiring provisions of EGTRRA and JGTRRA were extended permanently and the AMT was indexed. However, the 2007 AMT exemption amounts were lower under the alternative fiscal scenario than those assumed here because the Congress had not yet enacted the higher exemption amounts for 2007 when that report was completed.

Economic Effects

CBO assessed the economic effects of financing the tax changes through added borrowing. To clearly delineate the magnitude of those effects, CBO compared that scenario with an alternative scenario in which the tax changes were financed fully from the start via changes in other policies.⁶ Because the analysis assumes that the tax changes are enacted in either case, the difference between the two scenarios highlights the effects of using deficits to finance them.

CBO projects unsustainable budget deficits even under its extended-baseline scenario, largely the result of rapidly increasing spending for Medicare. Enactment of the tax changes discussed here, without other changes in policy, would add significantly to those deficits, which would affect the economy. Growing budget deficits would absorb funds from the nation's pool of savings and reduce investment in the domestic capital stock and in foreign assets. As capital investment dwindled, the growth of workers' productivity and of real (inflation-adjusted) wages would gradually slow and begin to stagnate. As capital became scarce relative to labor, real interest rates would rise. In the near term, foreign investors would probably increase their financing of investment in the United States, which would help soften the impact of rising deficits on productivity in the United States, but borrowing from abroad would not be without its costs. Over time, foreign investors would claim larger and larger shares of the nation's output, and fewer resources would be available for domestic consumption.

Budget deficits that grew faster than the economy would ultimately become unsustainable. As the government attempted to finance its interest payments by issuing more debt, the growth in the deficit would become increasingly rapid. That, in turn, would lead to a vicious circle in which the government issued ever-larger amounts of debt in order to pay ever-higher interest charges. At the same time, investors would become less willing to hold government debt because they would fear rising interest rates and losses on their debt. In the end, the costs of servicing the debt would outstrip the economic resources available for financing those expenditures. At some point, then, policy would have to change: Taxes would have to be raised, spending would have to be reduced, or both.

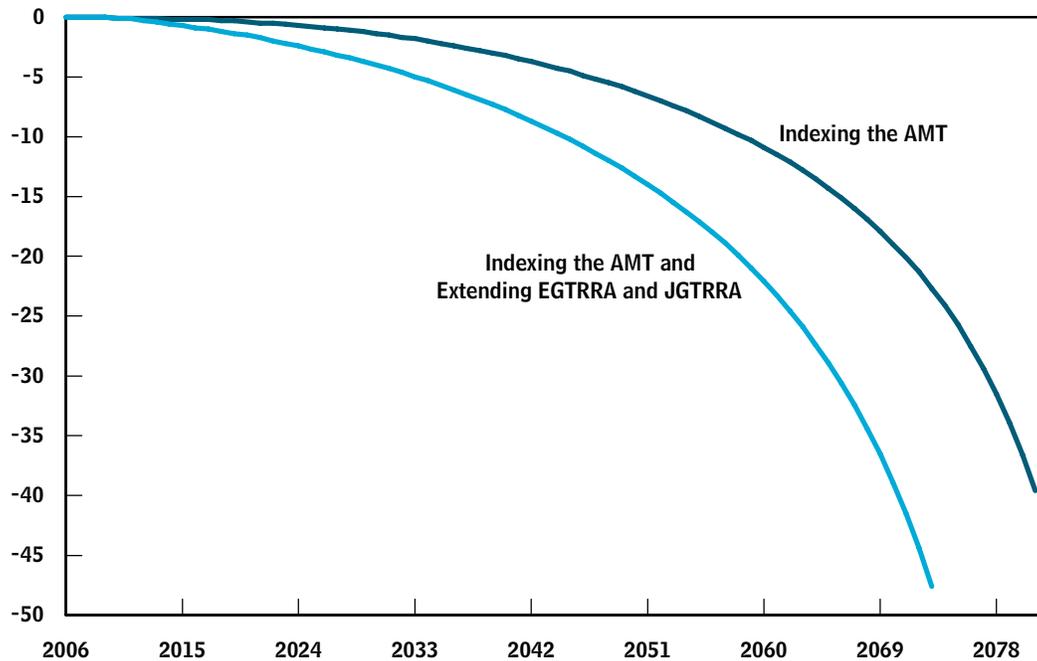
The quantitative effects of financing the tax changes with deficits are uncertain because the projected deficits would grow to levels well beyond the range for which economic models have been developed. However, illustrative calculations using a variety of economic models indicate that the deficit financing would reduce real gross national product (GNP) per person in the long run and that those long-run losses

6. At the request of the committee staff, CBO assumed a balanced set of policy changes that included reductions in government consumption, broadening of the tax base, and increases in tax rates. The changes were equally split among those three categories. Alternative assumptions would not alter CBO's judgment that deficit financing eventually reduces real gross national product per capita.

Figure 3.

An Illustration of the Economic Effects of Deficit Financing

(Percentage reduction in real GNP per person)



Source: Congressional Budget Office.

Notes: GNP = gross national product; AMT = alternative minimum tax; EGTRRA = Economic Growth and Tax Relief Reconciliation Act of 2001; JGTRRA = Jobs and Growth Tax Relief Reconciliation Act of 2003.

The figure shows the effects on real (inflation-adjusted) GNP per person of financing the tax reductions with deficits compared with financing them from the start with a balanced mix of other policy changes that did not increase the deficit. The analysis relies on CBO's textbook growth model.

would grow as the deficits rose.⁷ For example, simulations using one model—a textbook growth model that incorporates the assumption that deficits affect capital investment in the future as they have in the past—indicate that the rising federal budget deficits created by deficit financing of the indexation of the AMT would reduce real GNP per person by 6 percent in 2050 and by about 37 percent in 2080, compared with the results of a scenario in which the budgetary impact of that change

7. Gross national product measures the income of residents in the United States after deducting net payments to foreigners. Gross domestic product, by contrast, measures the income that is generated by the production on U.S. soil, including the production that is financed by foreign investors. Because rising deficits can increase borrowing from foreigners, GNP is a better measure of the economic effects of deficits than is GDP.

in the AMT was offset by other policy changes from the start (see Figure 3).⁸ If both the AMT were indexed and EGTRRA's and JGTRRA's personal income tax provisions were extended, and those changes were financed by additional borrowing, the economic costs would be even larger. By CBO's estimates, real GNP per person would decline by 13 percent in 2050. Beyond 2073, projected deficits under those tax policies would become so large and unsustainable that CBO's model cannot calculate their effects.

Despite the substantial economic costs generated by deficits in that model, such estimates may significantly understate the potential loss to economic growth from financing the tax changes with deficits. In particular, the estimates are based on a model in which people do not anticipate future changes in debt; as a result, the model predicts a gradual change in the economy as federal debt rises. In reality, the economic effects of rapidly growing debt would probably be much more disorderly and could occur well before the time frame indicated in the scenario. If foreign investors began to expect a crisis, they might significantly reduce their purchases of U.S. securities, causing the exchange value of the dollar to plunge, interest rates to climb, consumer prices to shoot up, and the economy to contract sharply. Amid the anticipation of declining profits and rising inflation and interest rates, stock prices might fall and consumers might sharply reduce their purchases. In such circumstances, the economic problems in the United States would probably spill over to the rest of the world and seriously weaken the economies of the country's trading partners.

Simulations using CBO's other economic models (which are more responsive to changes in tax rates than the agency's textbook growth model is) also show that deficits reduce real GNP in the long run.⁹ As before, the analysis focuses solely on the effects of using borrowing to finance the changes in tax policy rather than financing them from the start with other changes in policy. Although the effects on real GNP in the long run depend on how the deficits are ultimately financed, alternative assumptions about financing produced results that were about the same or worse as those produced by the textbook growth model. Using a balanced mix of policy changes (equally split between broadening the tax base, reducing government consumption, and increasing tax rates), the models produce long-run losses in GNP per person that are twice those estimated using the textbook growth model during the years for which the models can calculate results.

8. For a description of the textbook growth model, see Congressional Budget Office, *An Analysis of the President's Budgetary Proposals for Fiscal Year 2009* (March 2008), Appendix C.

9. The other models were CBO's infinite-horizon model with idiosyncratic wage uncertainty and incomplete markets and its overlapping generations model. For more details on the models, see Congressional Budget Office, *An Analysis of the President's Budgetary Proposals for Fiscal Year 2009*.