

Statement of

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Tax Fairness, the 2001-2006 Tax Cuts, and the AMT

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Chairman Rangel, Ranking Member McCrery, Members of the Committee: Thank you for inviting me to discuss the issues of tax fairness, the 2001 to 2006 tax cuts, and the individual alternative minimum tax (AMT).

In brief, my testimony makes the following points:

- Income inequality has been rising since the mid-1980s and now approaches levels not seen since the Great Depression.
- The federal tax system mitigates economic inequality—and potentially at lower economic cost than other alternatives, such as trade restrictions or labor market regulations—but the recent tax cuts have disproportionately benefited those at the top, exacerbating the trend in pre-tax income.
- The tax cuts have also vastly increased the number of people potentially subject to the AMT. Barring a change in law, more than twice as many people will owe AMT in 2007 as would have under pre-2001 law. Many of the new AMT taxpayers have modest incomes.

¹ My testimony draws heavily on joint work with my Tax Policy Center colleagues, Bill Gale, Greg Leiserson, and Jeff Rohaly. All views expressed are, of course, my own, and should not be attributed to the Urban Institute, its trustees, or its funders.

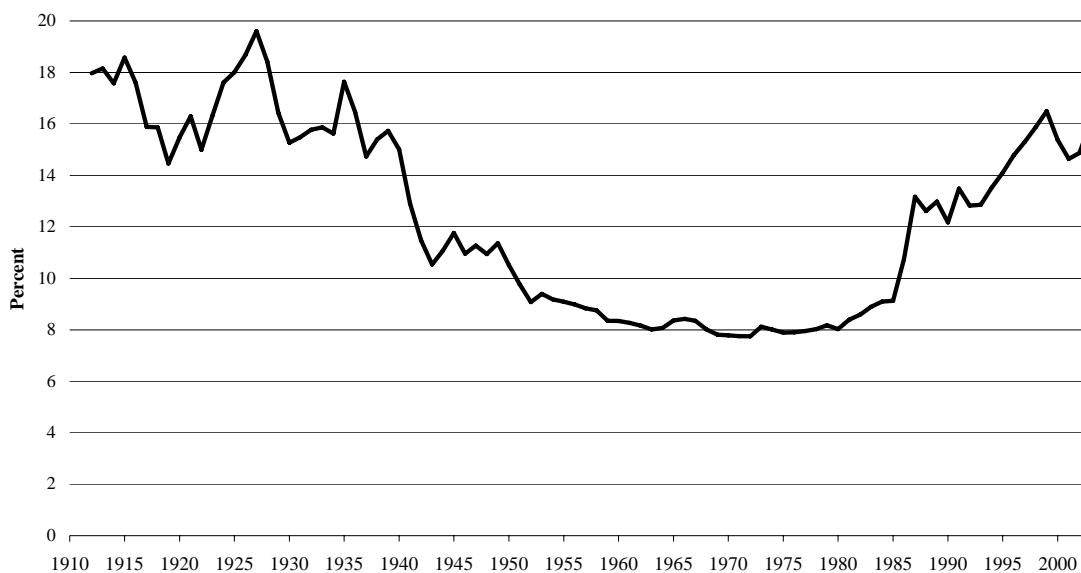
- While the periodic temporary increases in the AMT exemption have blunted the tax's impact on the middle class, they also lead to great uncertainty about individual income tax liability and can undermine fiscal discipline.
- The AMT has also masked the cost of the tax cuts. For example, in principle, the AMT will take back almost 20 percent of the income tax cuts enacted for 2007. In practice, Congress is almost sure to spare tens of millions of families from this ultra-complicated tax, so the price tag for the tax cuts is much higher than advertised.

My testimony will summarize evidence on economic inequality and the effect of the 2001–2006 tax cuts. Then I briefly describe how the AMT works and its interaction with the tax cuts. I conclude with a brief discussion of how to fix the AMT in a fiscally responsible manner.

Economic Inequality and Federal Taxes

By various measures, economic inequality has been on the rise since the mid-1980s.² For example, economists Thomas Piketty and Emmanuel Saez (2003) have calculated that the 1 percent of households with the highest incomes now earn about 16 percent of all income (excluding volatile capital gains)—a level last seen just before the Great Depression, and twice the share seen in the 1960s and 1970s (figure 1). Data from the Congressional Budget Office (CBO) show similar trends since 1979.

**Figure 1. Income Share of Top 1 Percent
(excluding capital gains), 1913-2004**



Source: Piketty and Saez (2003) and updated data from <http://elsa.berkeley.edu/~saez/TabFig2004.xls>.

² This is a very abbreviated summary of data I present in Burman (2007).

Explanations for rising inequality include the decline in the power of labor unions, increased immigration, and the effects of international trade and the growth in information technology (Goldin and Margo 1992). Despite remarkable gains in labor productivity, the benefits of those gains have mostly accrued to the 10 percent of Americans with the highest incomes. All other income classes have seen their wages grow more slowly than productivity. Economists Ian Dew-Becker and Robert Gordon (2005) attribute the increasing skew in earnings to “the economics of superstars,” which richly rewards the top performers relative to others who are nearly as productive.

Increased inequality has *not* arisen because the middle class has become a bunch of slackers. On the contrary, sociologists Michael Hout and Caroline Hanley (2003) report that married women with children increased their average time at paid work by nearly half between 1979 and 2001, and married women without children worked over 25 percent more hours each week in 2001 than in 1979. Together, married couples increased their hours worked by more than 10 percent, whether they had children or not. The average American family is working harder than ever but, except at the top of the income scale, its income does not reflect the extra effort.

The federal tax system is one mechanism for reducing economic inequality. Although higher marginal tax rates on those with very high incomes entail an economic cost, that cost may be lower than for alternative ways of aiding working families, such as trade restrictions or regulations on firms’ hiring and compensation practices. However, even while economic inequality has been approaching record levels, the tax cuts enacted since 2001 have sharply reduced progressivity.

Congress has enacted more than \$2 trillion in tax cuts since 2001, disproportionately concentrated on the rich. The cuts have almost exclusively applied to the most progressive federal taxes—income and estate taxes. Only 12 percent of tax units in the bottom income quintile received any benefit, and the average tax savings for that group was about \$20 in 2006 (table 1). Middle-income taxpayers received an average tax cut of \$744, barely an eighth of the average \$5,790 cut going to the top quintile.

Within the upper strata, the distribution of gains is even more startling. The top 1 percent—the same income group that has reaped most of the income gains in recent decades—got an average tax cut of over \$44,000. The richest 0.1 percent—that is, 1 in 1,000 taxpayers—averaged over \$230,000 in tax savings.

Table 1. Distribution of the 2001-2006 Tax Cuts in 2006

Cash Income Percentile	Percent of Tax Units With Tax Cut	Average Tax Change (\$)	Change as Percent of After-Tax Income	Share of Total Federal Tax Change
Lowest Quintile	12.0	-20	0.3	0.3
Second Quintile	64.6	-349	2.0	4.3
Middle Quintile	87.2	-744	2.5	9.1
Fourth Quintile	97.9	-1,232	2.5	15.1
Top Quintile	99.4	-5,790	4.1	71.2
All	72.2	-1,628	3.3	100.0
Addendum				
Top 10 Percent	99.6	-8,985	4.4	55.2
Top 5 Percent	99.5	-14,039	4.6	43.1
Top 1 Percent	99.3	-44,212	5.4	27.2
Top 0.5 Percent	99.4	-74,249	5.8	22.8
Top 0.1 Percent	99.5	-230,136	6.2	14.1

Source: Tax Policy Center Table T06-0279, <http://www.taxpolicycenter.org/estimates/T06-0279>.

Of course, since income is highly skewed, one would expect income tax cuts to fall disproportionately on high-income taxpayers, but the recent tax cuts were much more skewed than income. For the bottom 20 percent, the tax cuts amounted to 0.3 percent of income. For the middle-income group, they were 2.5 percent, but the top 1 percent got tax cuts more than twice as large—5.4 percent of after-tax income. The top 0.1 percent saw their after-tax income increase by 6.2 percent.

How the AMT Works³

The individual AMT operates parallel to the regular income tax with a different income definition, rate structure, and allowable deductions, exemptions, and credits. In short, after calculating regular tax liability, taxpayers must calculate their “tentative AMT” under the alternative rules and rates and pay whichever amount is larger. To calculate tentative AMT, taxpayers must first determine their alternative minimum taxable income (AMTI) and then subtract the applicable AMT exemption amount (which phases out), calculate tax under the AMT rate schedule, and subtract any applicable credits. Technically, AMT liability is the excess, if any, of tentative AMT above the amount of taxes due under the regular income tax alone.

AMTI is the sum of three components: regular taxable income for AMT purposes, AMT preferences, and AMT adjustments. Regular taxable income for AMT purposes is basically the same as taxable income used for regular tax purposes, except it is allowed to be negative if deductions exceed gross income.

³ For much more information and analysis related to the AMT, see the Tax Policy Center’s AMT web page, available at <http://www.taxpolicycenter.org/taxtopics/AMT.cfm>.

An AMT preference is an item identified as a potential tax saving in the regular income tax that is not permitted in the AMT. An AMT adjustment is simply any other exclusion, exemption, deduction, credit, or other treatment (such as a method for computing depreciation) in the regular income tax that is either restricted or disallowed in the AMT. Because there is generally no important economic distinction between preferences and adjustments, I refer to both as preferences.

Interesting distinctions emerge among the preferences themselves, however. Preferences are of two types: exemptions or deferrals. Exemption preferences broaden the AMT tax base and include the disallowance of personal exemptions, the standard deduction, and itemized deductions for miscellaneous expenses and state and local taxes. Deferral provisions change the timing of the recognition of income and deductions, typically to accelerate income and postpone deductions. Thus, they tend to raise the current-year tax revenues at the expense of future tax collections.

The Joint Committee on Taxation (2007) estimates that the three largest AMT preference items in 2006 were exemption preferences that few would consider aggressive tax shelters: deductions for state and local taxes (63 percent of the dollar total); personal exemptions, including for dependent children (22 percent); and miscellaneous itemized deductions, such as for unreimbursed business expenses (11 percent). As the AMT encroaches on more middle-income taxpayers, the share of tax preferences accounted for by personal exemptions will rise to more than 40 percent as the share accounted for by the deduction for state and local taxes falls. The standard deduction will increase from 1 percent of the total in 2006 to 6 percent in 2007 as more modest-income taxpayers who do not itemize deductions become subject to the AMT.

After adding back their preference items and determining alternative minimum taxable income, taxpayers may then subtract an AMT exemption of \$45,000 for couples or \$33,750 for singles and heads of household in 2007. That exemption is reduced, however, for taxpayers filing joint returns with AMTI over \$150,000 (\$112,500 for singles and heads of household).⁴ AMTI less any applicable exemption is taxed at two rates—26 percent on the first \$175,000 and 28 percent on any excess above that amount. As under the regular income tax, long term capital gains and qualifying dividends face much lower tax rates: usually 15 percent. If the resulting “tentative AMT” is greater than tax before credits calculated under the regular income tax, the difference is payable as AMT. In addition, most nonrefundable tax credits (other than the foreign tax credit) are effectively disallowed by the AMT.⁵

⁴ The exemption is reduced by 25 percent of the amount that AMTI exceeds the relevant threshold. As a result, married couples filing joint returns can claim no exemption if their AMTI exceeds \$330,000; single filers and heads of household get no exemption if their AMTI is greater than \$247,500.

⁵ To be precise, the foreign tax credit is calculated before calculating the AMT and incorporated into the comparison between regular tax liability and AMT liability. Most credits are calculated after both regular tax and AMT liability and do not affect the taxpayer’s direct AMT liability. With the exception of the child tax credit and earned income tax credit, however, those credits are reduced or eliminated for taxpayers whose regular tax after credits would otherwise fall below the AMT. Effectively, the AMT disallows the

Although the two tax rates seem to make the AMT a slightly progressive tax on people with higher-than-average incomes, the phaseout of the AMT exemption at a 25 percent rate at higher incomes creates *effective* rates that are much higher in the phaseout range. Every dollar of income in the AMT phaseout range increases AMT taxable income by \$1.25 (because the dollar of income reduces deductions by 25 cents). Thus, effective tax rates reach 32.5 and 35 percent in the exemption phaseout range before the advertised top rate of 28 percent kicks in at very high income levels. (The 32.5 and 35 percent rates correspond to 1.25 times 26 and 28 percent, respectively). What's more, since long-term capital gains and dividends also increase AMTI, the phaseout creates effective tax rates on capital gains and dividends of 21.5 and 22 percent, depending on the AMT tax bracket, well above the statutory maximum 15 percent rate (Leiserson 2007).

Table 2. Effective Tax Rates on Ordinary Income and Long-Term Capital Gains under the AMT, by Income, 2007

AMTI in Dollars		Tax Rate (Percent)	
Single filers	Joint filers	Ordinary income	Capital gains
33,750–112,499	45,000–149,999	26	15
112,500–189,499	150,000–205,999	32.5	21.5
190,000–247,499	206,000–329,999	35	22
247,500 and over	330,000 and over	28	15

Thus, families with moderately high incomes face much higher AMT tax rates than people with very high incomes (above the phaseout range for the AMT exemption: \$247,500 for singles and \$330,000 for joint returns). The much higher AMT tax rates in the phaseout range help explain why most taxpayers with incomes between \$200,000 and \$500,000 are on the AMT while most with incomes over \$1 million are not.

Congress has limited the AMT's reach in recent years by temporarily increasing the AMT exemption and allowing the use of personal nonrefundable credits against the AMT.⁶ For the 2006 tax year, for example, Congress raised the exemption from \$45,000 to \$62,550 for couples and from \$33,750 to \$42,500 for single filers and heads of household. Those changes kept 16.5 million taxpayers from falling into the AMT's clutches. Because those adjustments were temporary, however, Congress must pass additional legislation to prevent a sharp rise in the number of taxpayers subject to the AMT, from about 4 million in 2006 to more than 23 million in 2007.

credits. Temporary legislation that expired at the end of 2006 allowed the use of personal nonrefundable tax credits, such as education and dependent care tax credits, against the AMT.

⁶ The Economic Growth and Tax Relief Reconciliation Act of 2001 allowed the use of the child tax credit and earned income tax credit against the AMT through 2010.

Effect of the 2001 to 2006 Tax Cuts

Even before the first of President Bush's tax cuts was enacted in 2001, the AMT was on course to grow dramatically because its parameters were not indexed for inflation. But the tax cuts enacted since 2001 magnified the problem—or would have, absent the periodic “patches” enacted to stem the effect of the big tax cuts. In 2007, about 23 million taxpayers will pay the AMT under current law (assuming no patch), more than double the 10 million that would have been affected had the tax cuts not been enacted.

Regular income taxes were cut dramatically without corresponding changes to the AMT. (As noted, the AMT exemption changes were only temporary.) Since AMT is the difference between tax calculated under the AMT rules and tax calculated under the regular income tax, anything that cuts the regular income tax without a corresponding cut in the AMT puts more taxpayers onto the AMT (and increases the AMT liability of those already affected by the tax). This problem could have been avoided by cutting AMT rates when regular income tax rates were reduced. For example, in 2001, cutting AMT rates by 4 percentage points to 22 and 24 percent would have cut the number of people subject to the AMT but would also have added about \$300 billion to the cost of the 2001 act. Faced with a limited budget for tax cuts, lawmakers opted instead to postpone acknowledging the effect of the tax cuts on the AMT.

As a result, the costs of the AMT portion of the tax cuts have been paid on a kind of installment plan. Congress has increased or extended the AMT exemption three times since 2001. The last extension expired at the end of 2006.

Unless Congress acts, the AMT will take back almost 20 percent of the Bush tax cuts in 2007. (See table 3.) That take-back is not uniform, however. Households with low or very high incomes are relatively unaffected by the AMT, but those with incomes between \$75,000 and \$100,000 lose more than 11 percent of the putative tax cut, and those with incomes between \$100,000 and \$200,000 lose 34 percent. Most affected are households with incomes between \$200,000 and \$500,000: they lose more than half of the tax cuts they would otherwise have received, and more than 10 percent of them will receive no benefit at all from the Bush tax cuts in 2007 if Congress doesn't once again modify the AMT. As the number of people on the AMT increases through 2010, the AMT take-back also grows, to almost 28 percent (Leiserson and Rohaly 2006).

Table 3**Effect of the AMT on 2001-2006 Individual Income Tax Cuts, 2007¹**

Cash Income Class (thousands of 2006 dollars)²	Percent of Tax Units With No Cut Due to AMT	Percent of Tax Cut Taken Back By AMT	Percent of Tax Units on AMT⁴	
			Current Law	Pre-EGTRRA Law
All	1.4	19.1	15.7	6.8
Less than 30	*	*	0.0	0.0
30-50	0.1	0.3	1.2	1.3
50-75	0.5	1.8	8.9	6.8
75-100	2.3	11.1	36.2	18.1
100-200	6.3	34.0	70.8	23.4
200-500	11.7	55.3	89.7	41.3
500-1,000	1.3	16.3	57.1	22.0
More than 1,000	0.3	4.6	33.7	20.3

Source: Urban-Brookings Tax Policy Center

* Less than 0.05 percent.

(1) Calendar year. Tax cuts are calculated as a comparison of pre-EGTRRA law without the AMT and current law without the AMT. The share of the tax cuts taken back by the AMT is calculated using the increase in the AMT between pre-EGTRRA law and current law.

(2) Tax units with negative cash income are excluded from the lowest income class but are included in the totals. For a description of cash income, see

(3) Includes both filing and non-filing units. Tax units that are dependents of other taxpayers are excluded from the analysis.

(4) Includes those with direct AMT liability on Form 6251, those with lost credits, and those with reduced deductions.

It may seem odd that a household earning as little as \$75,000 can be subject to the AMT—a tax designed to affect rich people. In fact, this can happen to households with very simple tax situations, as illustrated in the box. A married couple with four children earning \$75,000 from wages and perhaps interest on a savings account would see their income tax more than double as a result of the AMT in 2007. They are on the AMT solely because they have four children. They don't take any special deductions. They get no benefit from the new 10 percent rate bracket or the higher standard deduction for couples enacted in 2001. They do, however, benefit from the higher child tax credit, if their children qualify, because that credit is allowed against both the AMT and the regular income tax (through 2010). They do not benefit from other personal tax credits, such as the child and dependent care tax credit or education tax credits, because those are not currently allowed against the AMT.

Box. A Couple with Four Children and \$75,000 of Income on AMT in 2007

A married couple with four children under age 17 has an income of \$75,000 from salaries and interest on their savings account. Under the regular income tax, the family can deduct \$20,400 in personal exemptions for themselves and their children. They can also claim a \$10,700 standard deduction. For the regular tax, their taxable income of \$43,900 places them in the 15 percent tax bracket, and they owe \$5,803 in taxes before calculating the AMT or tax credits. A child tax credit of \$4,000 (\$1,000 per child) is allowed against both the AMT and the regular income tax. Their regular income tax after credits would be \$1,803.

To calculate AMT liability, the couple adds preference items—personal exemptions of \$20,400 and the standard deduction of \$10,700—to taxable income and subtracts the married-couple exemption of \$45,000, yielding \$30,000 in income subject to AMT. That amount is taxed at the first AMT rate of 26 percent, for a tentative AMT liability of \$7,800. The AMT equals the difference between the couple's tentative AMT and their regular income tax, or \$1,997. Thus, the AMT more than doubles this couple's taxes—from \$1,803 to \$3,800

AMT Calculation

Married couple filing jointly with four children, 2007

Calculate Regular Tax		Calculate Tentative AMT	
Gross income	\$75,000	Taxable income	\$43,900
<i>Subtract deductions</i>		<i>Add preference items</i>	
Personal exemptions (6 x \$3,400)	\$20,400	Personal exemptions	\$20,400
Standard deduction	\$10,700	Standard deduction	\$10,700
		AMTI	\$75,000
Taxable income	\$43,900	<i>Subtract AMT exemption</i>	
Tax before credits	\$5,803	AMT exemption	\$45,000
Child tax credit	\$4,000	Taxable under AMT	\$30,000
Tax after credits	\$1,803	Tax (tentative AMT)	\$7,800
<i>Tax bracket</i>	15%	<i>AMT bracket</i>	26%

AMT = the excess of tentative AMT over regular income tax before credits

$$\text{AMT} = \$7,800 - \$5,803 = \$1,997$$

$$\text{Tax after AMT and credits} = \$1,803 + \$1,997 = 3,800$$

Why the AMT is a Problem

Does it matter that the tax cuts threaten millions of middle-class families with the AMT? Yes. The AMT violates virtually every principle of tax policy. It is not fair: it penalizes married couples, includes nasty bracket creep (largely eliminated from the regular income tax in 1981, but still alive and well in the unindexed AMT), and disallows many legitimate deductions, such as certain legal fees. The AMT is inefficient: most taxpayers face higher effective marginal tax rates under the AMT than they would under the regular income tax—and that problem is getting much worse as more middle-income people (who face relatively low rates under the regular income tax) become subject to the AMT. The high tax rates discourage saving and working and encourage tax avoidance. And the AMT is hideously complex. It confounds taxpayers trying to comply with the law.

The recent practice of patching the AMT retroactively compounds the confusion. Right now, it is virtually impossible for the 23 million taxpayers who might become subject to the tax to predict their tax liability or whether they will be able to benefit from the various tax credits and deductions that are currently disallowed under the AMT. It all depends on whether Congress fixes the AMT and how it chooses to do so.

The only plausible defense for the AMT is that it is potentially a great revenue raiser. Because its parameters are not indexed for inflation, the AMT, over time, could become a money machine. The Congressional Budget Office has projected that if the AMT continues in its present form, tax revenues will increase from about 18 percent of GDP in 2005 to 24 percent by the year 2050. Personal tax revenues would nearly double.

Of course, these projections assume that almost everybody becomes subject to the AMT. That seems extraordinarily unlikely. Lawmakers have repeatedly scaled back the AMT to keep the number of its victims to a politically palatable 4 million or less, and this trend is sure to continue. The amazing revenue capacity of the AMT has gone almost entirely unrealized.

Indeed, one could argue that the AMT has damaged our fiscal situation by masking a large portion of the tax cuts enacted since 2001. In 2001, legislators understood that the AMT would take back a significant portion of the tax cuts and therefore keep their estimated cost within the tax bill's \$1.35 trillion target.⁷ As noted, the AMT is set to reclaim almost 20 percent of the individual income tax cuts in 2007 and 28 percent by 2010 barring a change in law.

But that would mean that 32 million taxpayers pay the AMT in 2010. That is unlikely to happen. If Congress continues to protect almost all taxpayers from the AMT, taxpayers

⁷ House Ways and Means Committee Democratic staffer Al Davis (2000) pointed out the interaction of the president's proposals with the AMT a year before the legislation was considered by Congress. Larry Lindsey (2000), who advised the Bush campaign and later became a top economic adviser to the president, said that the failure to reform or eliminate the AMT was a matter of priorities given budget constraints: "Should additional revenue become available, reductions in the AMT might well be desirable." The logical corollary to that statement given the dramatic deterioration of budget projections since 2000—when large surpluses were anticipated—is that AMT reform should only occur in a fiscally responsible way.

will get much larger tax cuts than the Joint Committee on Taxation had projected. Put differently, the actual cost of the tax cuts will be much larger than budgeted.

And the AMT can undermine fiscal discipline one more way. Since members of Congress in both parties don't want to face the wrath of 23 million angry new AMT taxpayers, extending the AMT patch becomes a piece of "must pass" legislation as each Congressional session comes to an end. Savvy lawmakers know that they can attach less popular items to AMT extension and still be guaranteed a hefty majority. Although Congress has agreed to abide by PAYGO rules that require that any additional budget costs be offset, the support for AMT relief is so strong that PAYGO rules might fall by the wayside. (A 60-vote supermajority overrules them in the Senate.) Thus the recurring AMT relief could serve as a vehicle for new spending or tax cuts that are not offset by other spending cuts or tax increases.

What to Do about It?

There are many ways to reform or repeal the AMT in a fiscally responsible way and prevent it both from plaguing the middle class and from masking the cost of future tax cuts. The best approach would be to finance repeal of the AMT by broadening the tax base—for example, eliminate the deductibility of state and local taxes—rather than raising rates. Even better, AMT repeal could be part of fundamental tax reform, but there are obvious political challenges to either approach.

Some incremental options could also represent significant improvements. My colleague, Greg Leiserson, and I have suggested financing AMT repeal with a surtax that would apply only to high-income taxpayers (Burman and Leiserson 2007). It would be very simple for taxpayers to comprehend and comply with. The Ways and Means Committee majority staff has reportedly considered retargeting the AMT at those with very high incomes and offsetting the revenue loss through an additional income tax.

Any of those options would make the tax system more progressive than current law—that is, more of the tax burden would fall on the very high income households who were the AMT's original target. Other alternatives could be designed to mimic the distribution of current law. My colleagues and I have developed a smorgasbord of such plans (Burman, Gale, Leiserson, and Rohaly 2007) from which you might choose.

It is important, however, that any repeal or reform option be designed to be budget neutral, as the PAYGO rules require. Repealing the AMT without offsetting tax increases or spending cuts would drain federal tax revenues just as the baby boomers start retiring and demands on the federal government begin to swell. Outright repeal of the AMT without any other offsetting changes would reduce tax revenues by more than \$800 billion through fiscal year 2017, *assuming that the 2001–2006 tax cuts expire after 2010*. If the tax cuts are extended, the revenue loss nearly doubles to almost \$1.6 trillion.

This concludes my testimony. I'd be happy to answer any questions.

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