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# How to Fix the Alternative Minimum Tax

**by David R. Henderson**

The Alternative Minimum Tax (AMT) is an income tax monstrosity that denies middle-to-high-income people deductions that would otherwise be legitimate. The AMT requires an increasing number of taxpayers to compute their tax liability under the standard tax rules. Then, they compute it under the AMT. Then, they pay the greater of the two; minimum does not mean minimal.

The AMT prohibits many deductions available under the standard tax system, including deductions for each person, and for state and local taxes. That is why, other things equal, the AMT hits large families in high-tax states more heavily than small families in low-tax states.

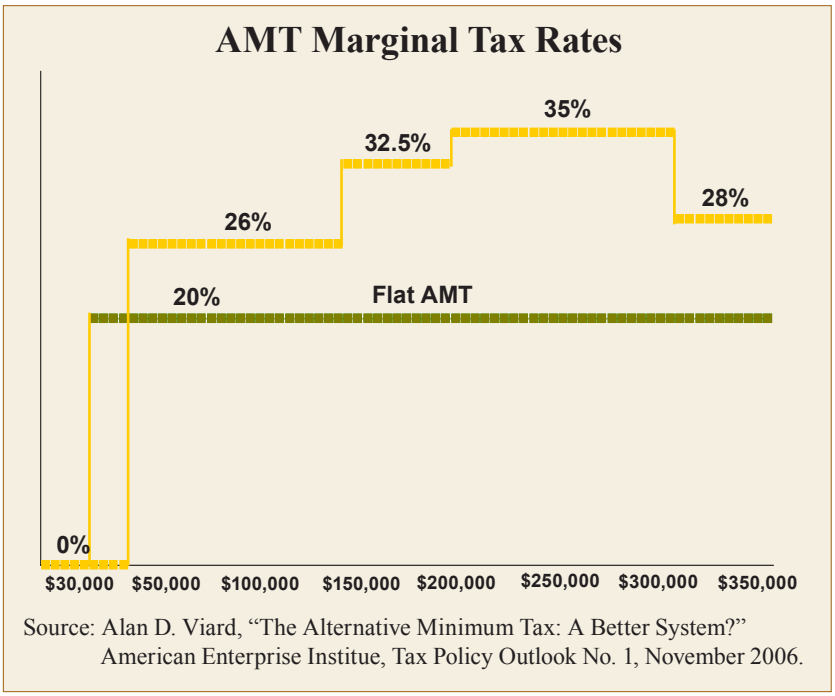
Many people advocate either repealing the AMT or raising the income exemption used in computations of AMT liability. Instead, Congress could recognize that the AMT contains elements of a flat-rate tax and reform it by further flattening the rates. Doing so would apply the lessons Americans have learned about the harm done by high marginal tax rates.

**The Regular Income Tax versus the AMT.** In the 1970s and 1980s, supply-side economists and journalists noted that high marginal tax rates create a large "tax wedge" between the after-tax income workers receive and the value society places on their output — and between the after-tax return on investment and the value of the production that investment makes possible. A big tax wedge stunts economic growth by discouraging work and investment. For a given amount of tax revenue raised, the lower the marginal tax rate the better.

The supply-siders' insight wasn't novel. In the United Kingdom, the top marginal tax rate in the 1970s was 83 percent on earned income and 98 percent on interest and dividends. James Mirrlees, a "left-wing" economist and Labour Party adviser, concluded that the optimal top marginal tax rate was only about 20 percent and that rates for other income groups should be close to 20 percent. An optimal tax rate would generate substantial government revenue while not greatly reducing individual incentives to work and invest.

In other words, Mirrlees provided an economic rationale for a "flat tax," such as an income tax that imposes the same rate at all income levels. Although such a reform is desirable, the odds that such a flat rate will ever be implemented are small. But it is possible to get much of the way there by flattening the AMT.

**The AMT versus a Flat Tax.** Most flat tax advocates want a zero percent tax rate on a minimum level of income and a tax rate of about 19 percent on all ad-

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ditional income, with few, if any, deductions allowed. The current AMT differs from this flat tax system in three main ways: 1) The basic exemption is higher, 2) the marginal tax rates are substantially higher, and 3) the expenses that are deductible are more numerous than under a flat-tax regime. All three aspects of the AMT could be modified easily, while raising the same amount of revenue for the federal government.

*"Congress could reduce the basic exemption, eliminate more deductions and cut AMT marginal tax rates."*

Under the AMT, instead of basic deductions, the first $45,000 of income is exempt for a married couple filing jointly. The tax rate on this income is zero. As the figure shows:

- On income above $45,000 the marginal tax rate is 26 percent, up to $150,000.
- Above $150,000 the marginal tax rate is 32.5 percent up to $206,000.
- Above $206,000 the marginal rate is 35 percent up to $330,000.
- Above $330,000 the marginal tax rate falls to 28 percent.

The reason the rates go above the IRS-published AMT tax rates of 26 percent and 28 percent is that the exemption on the first $45,000 is phased out at higher income levels. The rate falls to 28 percent after the exemption is completely phased out.

With four rates — 26 percent, 32.5 percent, 35 percent and 28 percent — the AMT is like a modified flat tax. AMT reformers usually advocate raising the amount of income that is exempted, which has been done in past years. Instead, Congress could *reduce* the exemption, further limit deductions and cut the AMT marginal tax rate to 24 percent, or even 20 percent. As recently as 1986, the AMT marginal tax rate was 20 percent. (The 1986 Tax Reform Act raised the marginal AMT rate to 21 percent, the 1990 tax bill raised it to 24 percent and the 1993 tax bill imposed the current nominal rates of 26 percent and 28 percent.)

**Why Is a Flat Tax-Rate Desirable?** As supply-siders have emphasized, a flat tax-rate has a positive effect on the incentives to earn, save, invest and become more productive, whether through training, education or experience. The lower the marginal rate, the stronger the incentives.

Critics of supply-side economics have admitted that the marginal dollars taxpayers are allowed to keep are an incentive to earn more income. But they also argue that since cuts in tax rates make taxpayers better off, they may use this higher real income to "buy" leisure — that is, work less. But this criticism warrants little attention unless the choice to work less resulted in less government revenue. Instead, the tax system could be changed to keep the federal government's revenues constant by reducing AMT deductions in exchange for lower marginal tax rates. In economics jargon, the system could be changed so that there is a substitution effect (working harder in response to higher after-tax incentives), but no income effect (that is, working less hard because of the tax break on nonmarginal dollars). The net effect would be more work and more output.

**Conclusion.** A flat-rate tax would discourage lower-income people from supporting more federal government programs, since they themselves would pay for those programs. It would also discourage support for more state and local government programs among state taxpayers, especially those with higher incomes, because they would no longer be able to deduct their state tax bills from their federally taxable income. A flat tax is also what most people view as fair. In fact, a recent survey by the Tax Foundation found that a majority of Americans (71 percent) think no one's combined local, state and federal tax bill should exceed 19 percent of their income.

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