

Treasury's Upcoming Role in Formulating Tax Policy

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It is said that in every crisis is opportunity. In every political crisis, moreover, something will be done -- for good or ill -- to appear to deal with the crisis. While tax policy has generally been run out of the White House for a number of years in both Republican and Democratic administrations, that trend will be forced to reverse itself. Within the Executive Branch, only the Treasury Department is equipped to deal well with the upcoming political crisis surrounding the imposition of the alternative minimum tax on tens of millions of taxpayers. Whether it finds opportunity in this task -- one from which most politicians shy -- remains to be seen.

The convoluted nature of our tax system is worthy of reform, but it is not a crisis. The strange imposition of the AMT on so many taxpayers, along with its strong bias against families with children, is a crisis. It is not an economic or even administrative crisis so much as one of politics. The economy can certainly withstand the economic repercussions of this somewhat crazy tax policy, and IRS can certainly administer the tax: At least regarding the major items involved, a computer check will find most errors. But the political system is not going to be able to withstand the onslaught of complaints, as millions of ordinary citizens are "told" that they are sheltering too much income from tax and, therefore, subject to this alternative tax regime. For what? For raising children? For paying state and local tax? Dependent exemptions and state and local tax are two of the biggest items of "tax preference" under the AMT. The political system will be in a crisis demanding some resolution.

Recently some colleagues and I separately began a project to try to find some fixes for provisions affecting families with children. Our initial goal was not to look at the AMT, but we soon found out that we, too, could not avoid this juggernaut. Simply removing the dependent exemption from the AMT (no longer defining kids as tax shelters) would cost about \$34 billion per year in 2010. While this is only one example of AMT-related issues, it reveals how complicated some of the issues can become. It shows, in particular, how simple fixes such as merely removing taxpayers from the AMT probably are not feasible by themselves. Those who are worried about budget deficits would protest the cost, while those worried about the income distribution would object to the concentration of billions of additional benefits mainly on middle, upper-middle, and moderately high income taxpayers (very high income taxpayers generally do not pay the AMT). More complex trade-offs are required -- the type that can only be examined with the types of models that Treasury maintains and the type of expertise that it can put to the issue.

Removal of the dependent exemption from the AMT, for instance, forces movement on two fronts: fixing up child benefits more generally, and paying for some of the change. In addition to the dependent exemption, which is subject to the personal exemption phaseout in all years but 2008 to 2010, modest- and middle-income families also have access to a child credit, which phases out, while lower-income families have access to an earned income tax credit, which also phases out but at a lower income level. Obviously, it makes a lot of sense to try to sort through these three different benefits -- dependent exemption, child credit, and EITC -- all aimed at families with children, and to pull them together somehow. Indeed, once tens of billions of dollars are at stake in AMT reform regarding the dependent exemption, it becomes hard not to address the wider set of issues.

Removing the dependent exemption from the AMT also entails such a large revenue loss that some amount will probably need to be recaptured in a reform package. One approach that I do not favor but which will be considered will be to take back with one hand what is given away with the other. Thus, at the top of the income distribution, child benefits (whether unified or kept in the form of a dependent exemption) might still be phased out with some new substitute. This approach would contradict one of the other reforms in 2001 -- the eventual removal of the separate phaseout of the dependent exemption. The truth be told, the cost of

removal of this particular phaseout was fairly modest in the 2001 legislation because taxpayers no longer subject to this clause would then become subject to the phaseout effectively achieved by the inclusion of the dependent exemption as a preference item for the AMT.

A strong case can be made in favor of the 2001-type reform and against a new phaseout. A classic principle of government finance is that government actions ought to be transparent. Here it means that tax rates generally should be explicit rather than hidden in phaseouts. These phaseouts, after all, remove benefits as income goes up and, as a result, are nothing more than little back-door income taxes.

Still, the tax reduction due to the loss of AMT revenue will likely be compensated in whole or in part, and if not done through less transparent phaseouts, then through other reforms that take away some benefit or through the more transparent statutory rate schedule.

These interactions of the AMT with the design of child benefits and with revenue concerns illustrate the types of issues that will be examined under AMT reform. They simultaneously convey the difficulty and complexity of the tax reform analysis required. Many different trade-offs must be considered, and the only part of the Executive Branch with the data and the models and the capability of considering them efficiently is the Treasury Department.

Treasury's role is also enhanced for another reason: Trade-offs involve losers. Major reform of this type probably cannot avoid tax increases on some people. Oh, it is possible at times to engage in enactments that only cut taxes or increase expenditures, but over time balance sheet requirements rear their heads. Now is such a time. When it comes to identifying trade-offs -- here who might have to pay to keep the AMT at bay -- politicians often want to follow, not lead. It has always been the strength of the Treasury Department to recognize and deal with the trade-offs required for long-term and lasting tax reform. Its role rises in times like the present one, just as the role of those who only want to give things away recedes. When and how Treasury takes on this role -- one that I suggest cannot be avoided -- remains to be seen.

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