

Fix a Real Tax Mess

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With the elections now behind them, the Bush administration and congressional Republicans are salivating at the possibilities for more tax cuts. Already, party leaders have advocated accelerating and making permanent the 2001 tax cut, repealing the corporate tax, creating new tax subsidies for investors and businesses, and so on. But before the victors embark on another costly round of tax cuts, they should clean up the mess created by previous tax-cutting efforts.

That mess takes the form of the Alternative Minimum Tax — or AMT. Currently affecting only a few, mostly wealthy taxpayers, the AMT will expand dramatically over the next several years, visiting high tax rates and mind-numbingly complex paperwork on unsuspecting middle-class families.

A "minimum tax" got its start in 1969, in response to public outrage following a Treasury report that 155 high-income tax filers had paid no income tax. Today's version, introduced in 1978, parallels the income tax but involves different income definitions, deductions and tax rates. Taxpayers must pay the extra tax when their liability — as calculated under these alternative rules — exceeds their regular income tax liability.

About 1-million households paid the AMT in 1999. But by 2010, some 36-million taxpayers will face it, including virtually all upper-middle-class families with two or more children. Although the tax raises little revenue today, by 2008 it will bring in so much that it would cost the Treasury more to repeal the AMT than to zero out the regular income tax.

The projected expansion can be tied directly to the last two major tax cuts. In 1981 the regular income tax was indexed for inflation, but the AMT was not. As a result, AMT liabilities rise every year even if income just keeps up with inflation. Last year's tax cut reduces regular income-tax liabilities over the next decade. With AMT liability rising and regular taxes falling, more taxpayers will find themselves in the belly of this beast over time.

These trends are alarming because the AMT violates every tenet of good policy. The tax is notoriously complex, and the complications are largely pointless. Most required to plod through the forms don't end up owing any additional tax. Those who do pay are often subjected to higher rates than under the regular tax.

The AMT has veered sharply from its original goals. Originally intended to hamper tax-sheltering activity, it now gets less than 10 percent of its revenue from its anti-shelter provisions. Instead, the tax increasingly burdens families earning under \$100,000: By the end of the decade, they will constitute most AMT taxpayers. It imposes severe penalties on people who marry and have children, and it hammers residents of high-tax states because it treats state-income-tax payments as a tax shelter.

For all these reasons, reform should have broad appeal. Simply repealing the AMT without enacting other reforms is not the answer, though. It would cost about \$800 billion over the next decade and provide yet another major tax cut for the well-to-do. Given last year's tax cuts and the deteriorating federal budget, that change would be both undesirable and fiscally irresponsible. And the AMT's underlying goals do command widespread support.

Those goals could be maintained, and the middle class spared, with a few straightforward changes. This first would be to dramatically raise the AMT exemption and raise the rates as well. A more complete attack would repeal the tax and put its anti-shelter provisions directly into the regular income tax. Although income tax rates would have to rise to cover the revenue loss, it would be a small price to pay for a modicum of sanity in the tax system.

Indeed few policy-makers would explicitly choose the tax structure of the AMT, in which middle-income taxpayers implicitly pay higher rates than the very richest Americans. And if middle-income taxpayers faced not only simpler taxes, but lower taxes as well, that might provide some real comfort.

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