

How to Tame the AMT

By [David R. Henderson](#)

There's a silver lining to the alternative minimum tax: tweak it the right way, and you can establish a flat tax. By **David R. Henderson**.

In the late 1970s, supply-side economists and journalists began and won a debate in economics. Their insight was that high marginal tax rates put a large "tax wedge" between the income people get from earnings and investments and the value that society places on the output of those investments, and that this stunts economic growth by discouraging earning and investing.

It wasn't a novel insight; James Mirrlees, an economist who had analyzed tax rates in Britain in the 1970s and who advised the Labour Party, concluded that the top marginal tax rate should be about 20 percent. But he published his conclusion only in a technical economics journal and therefore didn't affect popular thinking (though he was co-winner of the 1996 Nobel Prize in economics).

But when supply-siders came along and "went public," it became widely understood that tax rates are directly linked to economic growth. And only then did mainstream academic economists examine empirically the supply-siders' claims and find that the more moderate of these claims were correct.

Thus, supply-siders should now be leading the effort to reform the alternative minimum tax (AMT) in a way that encourages economic growth. And they could do so in a way that, over time, turns the AMT into a taxpayer-friendly, flat tax rate for the middle class.

The wrong reform is the one that congressional Democrats and many others advocate: raising the income threshold at which the AMT kicks in, making up the revenue loss by raising AMT tax rates on high-income people and on dividends and capital gains.

The right reform is to tweak the AMT around the edges so that more and more people face lower marginal tax rates. The AMT has been rightly called a "stealth tax" because so few people are aware of it until it reaches out and bites them. But it's also a modified flat tax rate, and further reforms should make it flatter and lower. That way, even moderate inflation could "stealthily" move us, over about 10 years or so, to a flat tax for most Americans.

Supply-siders should lead the effort to reform the AMT so it encourages economic growth. And they could do so in a way that, over time, turns the AMT into a taxpayer-friendly, flat tax for the middle class.

Consider how the AMT works. First, you compute your tax liability under the standard tax rules. Then you compute it under the AMT. You pay the greater of the two; minimum does not mean minimal. There are two main differences between the standard tax system and the AMT. The first is the structure of tax rates. Under the standard tax system, you get a relatively small basic deduction (\$10,700 in 2007 for married taxpayers filing jointly), and then the marginal tax rates rise with income, starting at 10 percent and going, in steps, up to 35 percent. Under the AMT, by contrast, there is no basic deduction. Instead, the first \$45,000 of income is exempt for a married couple filing jointly, and only two tax rates apply to taxable income, starting at 26 percent and rising to 28 percent. Second, many deductions that can be taken under

the standard tax system are prohibited under the AMT, including the per-person deduction and the deduction for state and local taxes. That's why, all things being equal, the AMT hits large families in high-tax states more heavily.

Notice something interesting? The alternative minimum tax sounds a lot like a flat tax rate, at least the kind that has been advocated in the United States. Most advocates want two rates: zero percent on the first X amount of income, with a deduction for each family member, and then a single rate, typically about 19 percent, on all income above this exempt amount. Flat tax advocates also recommend minimal, if any, deductions, whether for state and local taxes, mortgage interest, or anything else. The current AMT differs from this flat tax system in three ways. The basic exemption is higher, the marginal tax rates are higher, and the AMT allows deductions for expenses that would not be allowed under a flat tax.

The wrong reform is to raise the income threshold at which the AMT kicks in. The right reform is to tweak it around the edges so that more and more people will face lower marginal tax rates.

If a flat tax rate is desirable, then the sensible reform would be to modify the AMT to get it closer to a flat tax. The three ways to do so, as the above comparison suggests, would be to reduce the exempt level below \$45,000, reduce the AMT's marginal tax rates, and further limit the deductible items. Thus, raising the exempt-income level for the AMT, as Congress has done on an ad hoc basis every so often and as many taxpayers want it to do again this year, is exactly the wrong way to go. Lowering the exempt income below \$45,000 is probably not feasible politically, but leaving it at the current level is. Because even an inflation rate of 3 percent will erode this exempt amount by 26 percent in 10 years, inflation would slowly move a higher and higher percentage of U.S. taxpayers toward a flat tax system.

Along with lower rates could go a further limitation on deductible expenses, another longtime goal of flat tax advocates. All of these reforms could be done so that the federal government gets the same revenue as before.

But 26 percent and 28 percent are high tax rates for a flat tax system. So— and here's the good news for taxpayers—another reform of the AMT should be to lower these rates to a single rate, say 24 percent or even 20 percent. Although few people remember, the AMT rate as recently as 1986 was 20 percent. Then President Reagan and Congress raised it to 21 percent with the 1986 Tax Reform Act; President Bush and Congress raised it to 24 percent in the 1990 tax bill; and in the 1993 tax bill President Clinton and Congress imposed rates of 26 percent and 28 percent. Thus, along with lower rates could go a further limit on deductible expenses, another longtime goal of flat tax advocates. All these reforms could be accomplished so that the federal government gets the same revenue it would have had absent these reforms.

But why is a flat tax rate desirable? First, as supply-siders emphasize, it enhances the incentives to earn, save, and invest. The lower the marginal rate, the stronger those incentives. Someone offered a promotion or a job in a remote area for more money, for example, will be more likely to take it if he or she gets to keep a larger percentage of that additional pay. Critics of the supply-siders admit that the marginal dollars kept are an incentive to earn more income. But, they argue, cuts in tax rates throughout the brackets make taxpayers better off, meaning that they may use this higher real income to "buy" leisure—that is, work less. But this criticism does not apply to my proposal because, as noted, the AMT 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.

A flat tax rate is also desirable because it gives lower-income people a disincentive to advocate more federal government programs. They will see themselves as paying for those programs. On a state level it gives people, especially those with higher incomes, a reason not to support creating more state and local government programs, because they no longer will be able to deduct their state tax bills from their federally taxable income.

And finally, taking roughly the same percentage of everyone's income is more fair.

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