Repealing AMT, Reforming the Tax Code

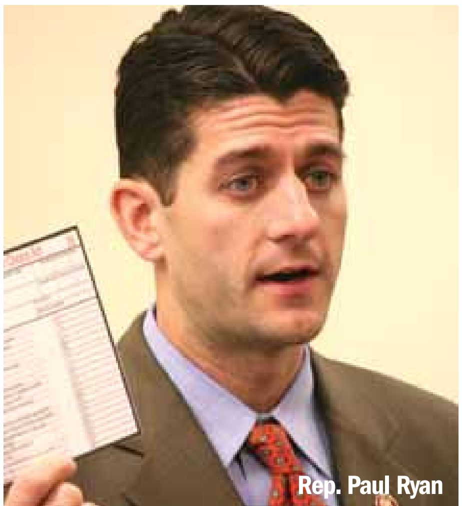
Thanks to a last-minute "patch," 23 million Americans were saved from paying an average of $2,000 in additional taxes under the Alternative Minimum Tax in 2007. But the debate over AMT, which is poised to strike again in 2008, continues. On December 6, 2007, on the eve of the AMT patch, Rep. Paul Ryan (R-WI) spoke at a Cato Capitol Hill Briefing on his proposal to repeal AMT and overhaul the current income tax code with a simplified, two-rate plan. He was joined by Cato senior fellow Daniel J. Mitchell and Chris Edwards, director of tax policy.

REP. PAUL RYAN: This is about more than just the Alternative Minimum Tax or what kind of tax policy we ought to have. The AMT debate we are in right now is the beginning of an enormous fight we are going to have in this country. We are talking about whether we sanction an ever-higher trajectory of federal spending. Fundamentally, we are talking about how big our government is going to get.

The AMT is a federal income tax that is imposed on top of the existing income tax system. In 1969, AMT was passed to go after 155 rich people who were using deductions and loopholes to avoid paying any taxes. And while subsequent tax reform closed those loopholes, the AMT remained. Most critically, the AMT was never tied to inflation, so that today the AMT is targeting an ever-increasing fraction of the middle class.

About 20 million Americans were subject to AMT in 2006; 23 million in 2007. Their estimated increased tax liability was about $2,000 per person. According to the Congressional Budget Office, by 2010, if nothing is changed, one in five taxpayers will have AMT liability. Nearly every married taxpayer with income between $100,000 and $500,000 will owe the alternative tax.

So the AMT represents an enormous tax hike on the middle class. Going forward, it will represent an even larger tax increase. That is a major reason it must be repealed. But more centrally, the AMT



Rep. Paul Ryan

"The AMT would massively expand government revenue, which would in turn allow increased government outlays, increased government involvement in the economy, and increased government control over our lives."

would massively expand government revenue, which would in turn allow increased government outlays, increased government involvement in the economy, and increased government control over our lives. Meanwhile, many of the proposals to reform AMT come with additional tax hikes that would also mean continued government growth.

Federal revenues as a share of GDP have been about 18.5 percent historically. How much money has the federal government taken out of the U.S. economy, U.S. income, U.S. productivity? About 18.5 percent on average for the past 40 years. The AMT puts a new tax system on top of the current one, bringing us to a historically unprecedented level of taxation in the not so distant future. Of course, most people in Washington think that that's fine.

That's why the debate until recently has not just been about getting rid of AMT. It has been about how to replace the supposed "lost revenue." Congressional Democrats don't like the AMT because it targets mainly the middle class. Although they want to repeal it, they want to replace it with another revenue machine. For instance, Rep. Charles Rangel (D-NY), House Ways and Means Committee chairman, introduced a major piece of tax legislation in October that, while repealing AMT, would "offset" it through a host of new taxes on high-income households and on the private equity industry.

If you want to see what the future of taxation will look like under a Democratic president and Democratic Congress, look no further than Charlie Rangel's tax bill. It is what he believes in. It is his philosophy. It puts the top federal marginal tax rate in this country at 44.2 percent. That's the rate small businesses will pay. Meanwhile it raises the rate paid by private equity, venture capitalists, and hedge fund managers from 15 percent to 35 percent.

Now that is what you have to do to the tax code to replace the revenue from an AMT repeal. But as a conservative, I believe we shouldn't replace that revenue. Let's agree to keep government where it is. A lot of us could make a good argument for cutting taxes to below where they are now. But let's at least agree to keep government at about 18.5 percent of GDP, after which we can focus on cutting spending, in particular on entitlement programs.

Because if we buy into this notion that we should have an ever-higher revenue baseline, we will take more freedom away from individuals, raise taxes, and make ourselves much less internationally competitive. And it will also lull us into a false sense of having a balanced budget or even a small surplus.

Along with Rep. Jeb Hensarling (R-TX), Rep. Michele Bachmann (R-MN), and Rep. John Campbell (R-CA), I've introduced the Taxpayer Choice Act, a bill that would not only eliminate the AMT and the massive tax hike that would come from its automatic expansion. It would also establish a highly simplified alternative to the current income tax system that individuals could choose. Under the current tax system, you fill out an income tax form and an AMT form, and you are obligated to go by whichever is the higher figure. By contrast, our bill gives people the choice of whether they want to pay taxes under the regular income tax or a much simpler and transparent tax system.

The plan woud raise approximately the same amount of revenue that we raise today under the current tax code. It also spreads the income tax burden basically the same as it does today. For those who are concerned about distributional tables, at the recent historical average of 18.5 percent, this is what we call distributionally neutral and revenue neutral.

Now, I want you to think about all the tax expenditure lobbyists who come to get members of Congress to promise not to touch their pet preference in the tax code. From a political perspective, it's going to be hard to get members of Congress to vote against particular deductions or exemptions given the influence these lobbyists have. It will be much easier to get members of Congress to vote for a clean bill, one that puts that decision in the hands of individual taxpayers.

What would the effect of my plan be on those taxpayers? If they already have their affairs arranged to deal with the exemptions and deductions in the current code, they may opt to continue filing under the current system. But if they prefer a simplified tax form, one with two rates of 10 and 25 percent and little more than that to worry about, then they can opt for that.

At the heart of this is a pro-growth, pro-family, pro-entrepreneurial tax system. We're putting a stake in the ground and saying we don't want government to grow beyond its current size. We do not accept this Washington doctrine—this Washington dogma—that we have to keep growing government at this ever higher rate.


Chris Edwards

"If a sales tax started moving through Congress, there is no doubt in my mind it would end up being an add-on tax to the income tax system, which would be a disaster."

If my three kids, who are three, four, and five years old, want to have this government for them when they are my age, they will have to pay twice the level of taxation that we have today. Take today's government, add no new programs to it, take none away, and look ahead 40 years to when my three children will be approximately my age. At that point, they will have to pay 40 percent of GDP in taxes to the federal government just to keep it afloat. This is basically due to entitlement spending.

You can't have a free and prosperous America with levels of taxation like that. You can't have an internationally competitive country that can compete with China and India with levels of taxation like that. Yet that is the path we are on right now. And the left is trying to make it worse by proposing new entitlements on top of the ones we have already today.

Let's recognize the path we are on right now and let's put out an alternative that is bold but doable to prevent that from happening, so that we can preserve the American legacy: leaving your kids and the next generation with a country and a standard of living that is better than what you have now. That is what this is all about. That is what we hope to achieve.

CHRIS EDWARDS: There is no doubt that tax reform has been stuck in a rut for a while. This year, Congress has been more focused on raising taxes than doing anything about tax reform. A flat tax hasn't been championed in over a decade when Steve Forbes and Dick Armey did so.

One alternative to our current system is the national sales tax. One version of this, the FairTax has lately been endorsed by Arkansas governor Mike Huckabee to much press and praise. A national sales tax would in principle replace all current federal income with a single national retail sales tax, levied once at the point of purchase of new goods and services. The income tax, the payroll tax, the Medicare tax, capital gains tax, estate taxes, and even the AMT would go in favor of this national sales tax. But in my judgment it's too dangerous in today's political climate to even think about moving ahead with the idea of a national sales tax. If a sales tax started moving through Congress, there is no doubt in my mind it would end up being an add-on tax to the income tax system, which would be a disaster.

Rep. Charles Rangel (D-NY) has his own problematic proposal to reform the tax code. On the plus side, his bill would abolish AMT. It would also cut corporate tax rates, an area where the U.S. woefully lags behind the rest of the world. But it would replace this "lost revenue" with new tax hikes. In effect, this would amount to a trillion dollar tax hike, because the ever-expanding AMT represents a new, additional tax on top of the current system. Congress should consider the pro-growth elements of Rangel's package such as the corporate rate cut, without imposing new taxes on individuals and businesses.

Paul Ryan's plan is by far the best of the bunch. It is a very credible, very pro-growth proposal, a way of moving ahead with tax reform, and a big step toward a Dick Armey or Steve Forbes flat tax.

Let me just give you a couple of things that I think are interesting about the Taxpayer Choice Act. I'm all for a flat tax. A flat tax would be optimal in terms of efficiency and fairness, in my view. But unfortunately, the current static revenue estimation methods up here on Capitol Hill provide easy fodder for opponents of a flat tax, who claim the flat tax is unfair.

So to move ahead with tax reform, I think a good idea is to enact essentially a flat tax but with two rates. The Taxpayer Choice Act has two tax rates, one at 10 and one at 25 percent. Those aren't picked out of the air. If you look at people at the very top of the income distribution, they pay an effective rate of about 25 percent. That is to say, their total taxes divided by income comes to about 25 percent.

If you look at the broad middle class, people making from about $50,000 to $100,000, they have an effective tax rate currently of about 10 percent. This plan hits the same sort of distribution, in a static sense, as the current tax code.

Some folks looking at the details might criticize dropping the top rate from 35 to 25 percent. They might claim that it is a giveaway to the rich. But, again, the effective rate of those at the top of the distribution is 25 percent currently.

What's interesting about the current tax codes is that the 25 percent tax rate starts at a very low income level. If you're single and you earn an adjusted gross income of $40,000, you start getting hit by the high 25 percent tax rate. Under Ryan's plan, that 25 percent tax rate doesn't start until about $66,000. So there is a big chunk of people in the middle who would have a sharp marginal tax rate cut under the plan.

I think that the Taxpayer Choice Act is an excellent plan. Admittedly, one of the reasons why I think so is that I introduced something similar a few years ago in a February 2005 Cato Tax & Budget Bulletin, "A Proposal for a 'Dual-Rate Income Tax.'" One thing that I included in my plan was a sharp corporate tax rate cut as well. If I were to add one thing to Ryan's plan it would be to lower the corporate rate 35 percent down to 25 percent—at the least.


Daniel J. Mitchell

"Lots of empirical data shows that once you get tax rates at 20 percent or below, people aren't really going to worry about evasion and avoidance; they are going to focus on being productive."

There has been a lot of discussion this year about corporate tax rate cuts. As mentioned before, even Rangel's proposal includes one. Bear in mind that in Europe right now the average corporate tax rate is just 24 percent. At 35 percent, the United States has the second highest corporate tax rate in the world. And yet despite this, we have fairly low corporate revenues. Indeed, according to my analysis, we are in the Laffer curve range for the corporate tax rate, where cutting the rate down to 25 percent would mean no revenue loss for government at all.

A corporate tax cut is long overdue. We should add a corporate rate cut to the Paul Ryan tax plan, after which we would have a real winner for businesses and, frankly, for the government, which would probably get more revenue.

DANIEL J. MITCHELL: What is good tax policy? Rates should be low. You shouldn't double tax. There should be no special loopholes. It's that simple.

Why have a low rate? Because that's the price on productive behavior. Politicians understand this, whether they admit it or not. For instance, they institute higher cigarette taxes to diminish smoking. While I may not think that is government's job, they get an A+ for economics. The higher the tax on something, the less you get of it. But I get frustrated by the fact that they don't apply this same lesson to work, saving, investment, and entrepreneurship.

Meanwhile, lots of empirical data shows that once you get tax rates at 20 percent or below, people aren't really going to worry about evasion and avoidance; they are going to focus on being productive. That's another reason to keep rates low.

Now, why should income only be taxed one time? Because even if you have low tax rates, if you cycle income through the tax code more than once your effective tax rate can be very high.

Every economic theory agrees that capital formation via saving and investment is the key to long-run growth. Even radical socialists who believe government should do the saving and investing agree on this point. But in America there are four different

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Lessons from Russia, India, Brazil, and Katrina

Cato Journal: De Jasay Takes on Anti-Market Fallacies

China's economic growth has been miraculous. Over the last 25 years, China has featured a breakneck 10 percent per annum growth rate, and 400 million people have been lifted out of poverty. But the real miracle is that China has gone from a Soviet-style command-and-control system to a market-oriented economy fully integrated into the global economy.

In the Winter 2008 edition of *Cato Journal* (vol. 28, no. 1), Deepak Lal, renowned development economist and senior fellow at the Cato Institute, asks: Could India be next? On the one hand, since sweeping pro-market reforms were introduced in 1990, India's economy has seen rapid expansion. But only in certain sectors: the "Green Revolution" of new tools and technologies in agriculture has seen rice yields triple since 1970, turning formerly famine-prone India into a net agricultural exporter. India's service sector is similarly booming. Meanwhile the manufacturing sector—long subject to state industrial policy—has seen only anemic growth thus far. India's continued economic development depends on the growth of this lagging sector, and of continued integration into world markets. Lal sees India's liberalization continuing, and makes a bold prediction: 8.5 percent to 9 percent per annum growth for the next 20 years.

Meanwhile, Erich Weede, professor emeritus at the University of Bonn, Germany, surveys India's pre-1990 past and uncovers what was ultimately at fault for India's slow growth to that point. Extensive government interference and involvement in the economy yielded the expected results: weakened incentives for investing and entrepreneurship, distorted hiring and firing decisions, and diminished output. Further, he cites these interventions as the major reason behind India's sectoral disparities in economic growth. In a word: Indian call centers flourish while "Made in India" products are rare due to government's uneven intervention in the economy.

Also in this issue, Anthony de Jasay debunks some popular anti-market fallacies. Among them: the notion that the production and distribution of economic goods are divisible from one another; the notion that property rights are a protected by the state rather than emerging endogenously; and the idea that equality of outcome should be privileged over equality of opportunity.

Meanwhile, Andrei Illarionov, senior fellow at the Cato Institute and former chief economic adviser to Vladmir Putin, asks whether Milton Friedman could have made it if he had been a Russian economist. Without freedom, Friedman's opportunities to engage in pathbreaking research and to report his results to the world would have been nonexistent.

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layers of taxes that a single dollar of income may be hit with: the capital gains tax, the corporate income tax, personal income tax, and the estate tax.

So even if you get all those rates down to 20 percent, by the time the IRS gets four different bites at the apple, your effective tax rate can be very, very high. The government should not punish the very thing that everyone agrees is critical to long-run growth.

Why should the tax code be neutral? Because the government should not be in the business of picking winners and losers. Issues of fairness aside, this leads to the misallocation of resources.

If you do everything right, you wind up with a postcard-size tax form. And even if you do a few compromises with it, like Congressman Ryan does, you can just have a bigger postcard. But if you go to the IRS Web site and you go to "Forms and Publications," there are more than 1,100 different forms and publications you can download. Wouldn't a postcard-size form be better?

Now, let me bring it back to some of the things that are relevant to policy work on Capitol Hill. Some people make the interesting argument that the AMT is like a flat tax. After all, it doesn't have many of the exemptions and deductions of our current tax code. Meanwhile, it taxes income at, alternately, 26 or 28 percent depending on income, which is pretty close to a single tax rate.

But a flat tax isn't just about having one rate. It's also getting rid of double taxation. And the only thing similar between the tax base of an AMT and the tax base of a flat tax is you get rid of state and local tax deductions. That's actually privately one of the reasons I'm amused by the AMT. You have all these high-tax states, like California and New York, complaining about it.

Now, what about Mr. Ryan's plan? It's not a flat tax either. It too has two rates. But marginal tax rates are going down. Productive behavior is not being excessively penalized. Government will be prevented from growing as it would under an all-encompassing AMT. It represents progress.