Economic Scene

One Tempting Remedy for the Alternative Minimum Tax Has Flaws of Its Own

by Alan B. Krueger

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The recommendations of President Bush's advisory panel on federal tax reform, announced last week, were greeted by Congress and the administration with all the enthusiasm of a recommendation for root canal surgery. Although the panel proposed two sensible plans to reduce distortions in the tax code and improve fairness, its proposal to cut the popular mortgage interest deduction, included in both plans, almost assures that the plans will not reach Congress as written.

Perhaps the most likely of the panel's proposals to be enacted is the elimination of the deduction for state and local taxes. This is a tempting but flawed way to "fix" the alternative minimum tax. Eliminating the state and local deduction would make it harder for state and local governments to raise revenue for essential public services and result in more distortions and inequities from the tax code.

"We should be very wary about getting rid of this worthwhile deduction unless it's our last resort," said James R. Hines Jr., a public finance economist at the University of Michigan.

The panel's report is now being reviewed by the Treasury secretary, John W. Snow, who will decide which, if any, of the proposals to send to the president. Without pressure from the White House - and a willingness by the president to roll back some of his previously enacted tax cuts - Congress is unlikely to consider a major tax overhaul anytime soon.

The report may do more than gather dust, however. Eventually, Congress will have to consider options to raise revenue, and the report will be a natural source of ideas.

More immediately, Congress is likely to address the alternative minimum tax, which will ensnare 21.6 million taxpayers in 2006, up from 4.1 million in 2005, absent changes. The A.M.T., which was established to make a small number of wealthy tax avoiders pay some income tax, sets up a parallel tax structure.

The definition of taxable income under the minimum tax is broader than under the regular tax code; most important, it does not allow deductions for state and local taxes.

Congress is likely to reduce the reach of the minimum tax. But reining in or repealing the A.M.T. will be expensive; full repeal could cost $1.2 trillion over the next 10 years if the president's tax cuts are made permanent, and $611 billion if they are not.

Eliminating the deduction for state and local taxes would bring in almost enough revenue to pay for repealing the A.M.T. if the president's tax cuts remain - and more than enough if the tax cuts expire - according to a study by Kim Rueben of the Urban Institute.

On the surface, that approach appears to make sense, since taxpayers caught in the A.M.T. lose the deduction. Why shouldn't everybody?

If state and local taxes were mainly used for services that taxpayers directly benefit from, like garbage collection, the case for deducting the taxes would be weak. But this is not the case. Most state and local tax revenue is used for education, health care, social services, highways and other programs that probably do not directly benefit the individual taxpayer nearly as much as the community at large.

Additionally, because people are geographically mobile, states and cities lose residents if they set taxes too high. The state and local deduction reduces this distortion.

Eliminating the state and local deduction would also cause a distortion between support for charities and similar government programs. Why allow people to deduct charitable contributions to a homeless shelter, but not their state taxes used for the same purpose? The tax panel's call for a tax credit for charitable donations, but not for state and local taxes, would worsen this distortion. A more rational approach would base deductibility on the function of the funds.

Eliminating the state and local deduction would also create a peculiar inequity in the tax code: American taxpayers would be allowed to deduct income taxes that they paid to foreign governments but not those paid to their state or local government.

State and local taxes have been deductible since the start of the federal income tax in 1913. After Hurricane Katrina revealed serious shortcomings in the infrastructure of state and local government, Congress should think carefully about making it harder for states and municipalities to raise funds for essential government functions.

Indeed, it would make more sense to allow deductions for state and local taxes from the A.M.T. income base than to eliminate the state and local deduction from the regular income tax.