In the alternative minimum tax, America may have a ready-made route to tax reform

GEORGE BUSH wants to overhaul America's tax code. The newly re-elected president has declared tax reform to be a top economic goal for his second term, alongside the revamping of Social Security (the public pension system). A commission is being set up, to mull over options. Washington's tax wonks are busily speculating about what Mr Bush might do.

So far, the president has done no more than mention general principles. He wants to make the tax code simpler and fairer, and to encourage saving and investment. He wants to eliminate loopholes—although he has also hinted that some tax incentives for buying homes and giving to charity must stay. In addition, he has promised that reform will not mean an increase in the total taxes Americans pay.

Much of this makes sense. To economists, a good tax system is one that raises money with minimal distortion to the economy. That means marginal tax rates should be low and the tax base should be broad, with few if any exemptions. The system should be simple, to keep down the costs of compliance and monitoring. America's tax system falls far short of this ideal. It is monstrously complicated. The cost of complying with taxes is estimated to be well over $100 billion a year, or more than 10% of income-tax receipts. A lot of the trouble is that America's tax code is not only a means of raising money, but also the government's main social-policy tool, not to mention a prime source of pork-barrel patronage dispensed by congressmen. Refundable tax credits are also the chief form of income support for the working poor. When politicians want to encourage home ownership, the purchase of health insurance or attendance at college, or merely to help a favoured industry, they reach for tax breaks.

All this makes the chances of radical reform slim. Nonetheless, some change is possible, thanks to the alternative minimum tax (AMT). Introduced in 1969, this little-known back-up to the income tax was designed to ensure that rich Americans could not avoid paying income tax entirely by claiming too many deductions. It allows fewer deductions than the normal income tax (mortgage interest, donations to charity and a few other things). It is also less progressive, with two rates, of 26% and 28%, levied on income above a certain, tax-free amount, which for a married couple has long been $45,000. Under today's law, Americans have to pay either income tax or the AMT, whichever is higher.

Until recently, few Americans owed more under the AMT than under the standard system. Only 1.3m people paid the AMT in 2000. But because the AMT's tax-exempt amount is not indexed to inflation and because Mr Bush's tax cuts are reducing Americans' bills under the standard income-tax, the number of AMT payers is rising and is set to climb dramatically in the next few years. The number is already 3m. According to economists at the Tax Policy Centre in Washington, DC, by 2010 it could reach almost 30m, around one in four taxpayers.
Not the problem, but the solution

Most politicians regard the advance of the AMT as a problem that needs to be fixed. The notion that 30m Americans would be forced to calculate their tax liabilities twice and that they would lose their many (popular) tax incentives, particularly deductions for children, is seen as politically unfeasible. Already the exemption has been raised, temporarily, to $58,000, to keep a lid on the number paying the AMT. Unfortunately, this will be an expensive course to maintain. Increasing the exemption in line with inflation would cost $400 billion in forgone tax revenue over the next decade. If Mr Bush's tax cuts are made permanent, that figure rises to over $600 billion.

From the perspective of tax reform, however, the AMT is less an expensive problem than an opportunity. Why not use the AMT as the vehicle for tax reform? By 2009, it will be less costly to ditch the income tax and keep the AMT than to repeal the AMT and carry on with the income tax. The AMT is far from perfect—its personal exemption is not indexed; quirks in its structure can mean high marginal rates for some taxpayers; and it allows some needless deductions—but it is less riddled with loopholes than the current income tax. Thus it is a good starting-place for base-broadening, exemption-ending reform.

In theory, it might be better to shift to a national sales tax, a flat tax or another type of consumption tax than to pursue tax reform via the AMT. But practicalities count too, and the advance of the AMT could be used to make big improvements on the income tax. The AMT could be made more progressive, and the most popular incentives of today's income tax retained, without bringing in all the more outrageous exemptions. This could be a stepping stone to further change later.

Michael Graetz, a tax expert at Yale University, has come up with an innovative way to do this. He proposes simplifying America's tax code dramatically. He would replace the income tax with the AMT, but with an exemption of $100,000 per family and a single rate of 25%. With a $100,000 exemption, only 25m people would need to pay income taxes, around one-fifth of today's figure. To make up for the lost revenue, Mr Graetz suggests introducing a value-added tax of between 10% and 15%. This would shift the tax base towards consumption rather than income, and would thus be friendlier to saving. Marginal rates would be low. And the system would be simpler. To retain progressivity and mitigate the impact on the poor, Mr Graetz suggests that poorer Americans could get tax relief on their contributions to Social Security.

Taken together, Mr Graetz's plans imply a wholesale change to America's tax system. That may render them politically unrealistic. Nonetheless, the looming AMT crisis suggests that America has a rare opportunity to clean up its tax code. If he is really serious about reform, Mr Bush should grasp it.