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Indexing the Inflationary Impact of Taxes:

The Necessary Economic Reform

Donald J. Senese

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Donald J. Senese

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Introduction

Public officials have become more aware of a continuing problem for the American economy and for the American taxpayer—the problem of inflation. Economic wisdom proclaimed that a sound economic policy had to make an undesirable but necessary choice: inflation or unemployment. Federal programs which pumped money into the economy to produce jobs also brought increased inflation; a set of decisions by the federal government to keep the inflation rate down had the effect of accepting a certain higher level of unemployment in the economy. Yet, recent developments in the American economy have brought about *both* a high inflation rate and a relatively high unemployment rate. Economists, politicians, and informed taxpayers have been giving more and more attention to examining and seeking solutions to some of the unique distortions brought about in the economy from the ever present inflation problem. American University Economics Professor Thomas F. Dernburg pointed out this problem in a special study prepared for the Joint Economic Committee:

> *Inflation alters both the size and the composition of the Federal Budget in terms of real purchasing power. The mere fact of inflation therefore has profound implications for the impact of the budget on aggregate expenditures; for the equity of our system of taxation; for the size of the Federal government sector; and for the formation of budgetary strategy and policy.*[1]

Nobel prize winning economist Dr. Milton Friedman has written widely on the subject of inflation, especially noting the propensity of governments throughout history to use inflation as a tool of economic and political policy. Analyzing the phenomenon we know as inflation, Professor Friedman has defined it as "a hidden tax that at first appears painless or even pleasant, and, above all, because it is a tax that can be imposed without specific legislation," and he labels it as "truly taxation without representation."[2] Inflation has become a factor

[1]Thomas F. Dernburg, *Indexing the Individual Income Tax for Inflation: Will This Help to Stabilize the Economy* Studies in Fiscal Policy, Paper No. 2, A Study Prepared for the Use of the Subcommittee on Fiscal Policy of the Joint Economic Committee (December 27, 1976), p. 1. Also see James L. Rowe Jr., "Slowing the Tax Treadmill," *Wall Street Journal* (February 13, 1975) editorial and James L. Rowe Jr., "A Call for Tax Indexing," *The Washington Post* (January 2, 1977), editorial.

[2] Milton Friedman, "Monetary Correction," in *Essays on Inflation and Indexation* (Washington, D.C.: American Enterprise Institute for Public Policy Research, 1974), p. 29.

which every taxpayer must take into consideration in his everyday lifestyle. Some of the implications of inflation are obvious—notably that an individual's nominal or regular income must increase in order to continue to purchase the same goods and services. Most taxpayers are also aware that as they receive higher levels of income, they will have to pay higher rates of taxation. Yet, it is not as frequently recognized that as a person's income increases to match inflation, the person's tax burden increases still faster and thus income taxes take an increasingly larger share of the budget of the consumer taxpayer, even if real income remains constant or even declines. The taxpayer experiences the effects of an increased cost of living and a disproportionate increase in taxes as part of this increasing cost. Considering this major effect of inflation, a larger proportion of the national income has been switched from the private to the public sector through increased government revenues from tax collections.

Government thus makes a "profit" from inflation as the rising cost of living forces the individual taxpayer into a higher tax bracket (with no real change in real income) and produces a greater amount of revenue for the government. Economically, the individual taxpayer suffers a loss, and the government realizes a gain. Professor Milton Friedman has effectively identified that the revenue yield from inflation takes three major forms. First, the additional government-created fiat money will finance expenditures and pay debts as well as provide a base upon which the banking system can create additional money in the form of bank deposits. Second, the thrust by government-induced inflation of pushing individuals and corporations into higher income groups for taxation purposes generates artificial (or paper) capital gains on which higher taxes must be paid; the end result is to make the allowable depreciation amounts in existing law unrealistic and thus seriously limits the efforts to replace capital. Finally, there is a reduction in the real amount of outstanding national debt since the debt had been incurred at a time when the inflation rate was lower and money was worth more. After examining these factors, Friedman estimated that the federal government's revenue from inflation totaled more than $25 billion in 1973 alone![3]

Professor Dernburg concentrated on the inflationary period from the fourth quarter of 1973 to the third quarter of 1974 in a study of the operation of the tax system. Joint Economic Committee Executive Director John R. Stark summarized the conclusion of the study:

> *Inflation pushed individuals into higher tax brackets during this period, even though real incomes were declining, and total*

[3] *Ibid*, pp. 29-30.

Federal personal income tax collections measured as a percent of personal income rose rapidly. This further reduced after-tax real incomes and worked to intensify the severe downturn of 1974-75.[4]

This inflation push on the individual taxpayer will intensify as inflation increases and will likely add further complications for any future economic downturn. The taxpayer becomes involved in a game of seeking constantly to raise income to meet the rising prices from inflation—and losing the battle year after year. Tax Lawyer Robert J. McDonald has concluded that the progressive rates of the American income tax system have "exacerbated the economic effects of inflation by imposing a tax increase marginally greater than the inflation rate in each annual accounting period during which the tax is imposed," resulting in a proportionally higher tax.[5] While admitting that at one time this method (e.g., taking money away from consumers by tax increases so that their purchases are reduced) did have a deflationary result, McDonald argues that under the present circumstances of a "cost push inflation" (e.g., with inflation increasing, unemployment increasing, and demand decreasing), the past economic analyses are not valid. He urges that despite talk of a tax decrease, it is important to realize there is already "a built-in tax increase as this double-digit inflation continues with escalating wages and prices."[6] It is important to recognize that even recent tax reductions (e.g., Tax Reduction Act of 1975, PL 94-12, Tax Reform Act of 1976, PL 94-455, and the Tax Reduction and Simplification Act of 1977, PL 95-30) were not reductions in the real amount of taxes, but represent a correction for inflation-caused overtaxation and may, in effect, limit the real purpose of a tax reduction. While the Tax Reduction Act of 1975 resulted in a reduction of $17 billion, one academic study pointed out that merely correcting the one year inflation-caused distortion from 1973 to 1974 would have made necessary reducing federal tax liabilities for 1974 by about $16 billion![7]

What is the best way to resolve the effect of inflation on the tax rates for individuals and corporations? One solution is to slow down the rate of inflation by curtailing one of the major causes of

[4] Dernburg, *Indexing the Individual Income Tax for Inflation*, p. iv.

[5] Robert J. McDonald, "Inflation: Concepts of Income, Tax Reform," *Tax Lawyer*, Vol. 28 (Spring 1975), p. 536.

[6] *Ibid.*

[7] William Fellner, Kenneth W. Clarkson, and John H. Moore, *Correcting Taxes for Inflation* (Washington, D.C.: American Enterprise Institute for Public Policy Research, 1974), pp. 1, 8.

inflation—federal government spending. A second approach is an attempt to alleviate the hardship of inflation by making necessary adjustments in the tax rates to meet inflationary increases, such as a proposal for indexation of the tax rates. Efforts to encourage restraint and discipline in federal spending on the part of recent presidential administrations and a majority of the Congress have not been encouraging; the other alternative of indexing the tax rates may prove to be a simpler and yet more attainable objective. The failure to significantly reduce the rates of inflation should not mean that attempts to do so must be abandoned; attempts to index tax rates to reflect economic reality could be pursued while attempts are continued to reduce and slow down inflationary pressures.

Government officials, politicians, and special interest groups who advocate larger and larger programs are not enthusiastic about indexation since it would take the "profit" out of inflation for the government and provide a reduction of government revenues and, thus, less government funds to cover their particular programs. In commenting on the loss of this inflation-induced revenue gain for government, Professor Milton Friedman stated the major political problem which has to be dealt with in proposing indexation:

> *Ending inflation would end this source of revenue. Government would have to reduce expenditures, increase explicit taxes, or borrow additional funds from the public at whatever interest rate would clear the market. None of these sources is politically attractive.*[8]

The U.S. Advisory Commission on Intergovernmental Relations, in supporting a system of indexation, has stressed that if taxes need to be increased, they should be increased by overt action of Congress and not by an automatic consequence of inflation. Assuming an annual inflation rate of 6 per cent, inflation induced tax increases alone could bring the U.S. government an estimated $6 billion in 1977 and $50 billion more by 1980.[9] It is likely that this is a very conservative estimate and that the federal government would gain additional billions if all consequences are taken into consideration.

The problem of rapid inflation and the tax rates was not a problem in the early years of the Internal Revenue Code when our economic problems were less serious; recent inflationary problems make it

[8] Friedman, "Monetary Correction," p. 30.

[9] Allan Merridew, "How Inflation Raises Your Taxes," *The Chicago Tribune* (September 16, 1976). The U.S. Senate version of the tax reform bill in 1976 had an added section which would have directed the federal government to inform the taxpayers how much extra tax they pay because of inflation; this section was deleted in the final version of the Tax Reform Act of 1976.

necessary to consider indexation of the tax system as a viable policy option. The purpose of this study is to examine the effects of inflation on the personal and corporate income tax structures and to evaluate the desirability of tax indexing.

1

Major Arguments for Indexing: Theoretical Justifications

It is important to look at the chief arguments for tax indexing. Tax indexing, similar to other policy recommendations, is based on acceptance and identification of certain national goals and normative judgments. Four major principles are asserted to support a tax indexing proposal.

First, there are several generally accepted macroeconomic goals which could be more easily attained in an indexed tax system, including a progressive personal income tax structure, adequate capital formation, automatic stabilization of recessions, and a minimization of inflation.

Second, tax indexing has been advocated for reasons of equity for the taxpayer. For example, when inflation changes or alters the value of regular or nominal income on the basis of property, we may find that a taxpayer may pay different real tax rates at different times. It may be possible that two taxpayers with the same real income (or capital gain) may pay different rates. This discrimination in tax rates occurs because of inflation, not because of legislative enactments increasing taxes.

Third, the adoption of an indexed structure would have a practical benefit by simplifying the future work of Congress. The Tax Reduction Act of 1975 can be cited as an illustration of a tax cut which was enacted to help solve the problems which resulted at least partly from inflation over-taxation; the result was a haphazard mix of inflation correction changes combined with some basic changes in the tax structure. If an indexed tax system were in place, Congress would no longer need to devote its time to inflation-compensation in the tax structure every few years. It would help to eliminate the confusion and complications which result every time that Congress embarks on the path of "tax reform." Thus, a tax cut would be a real tax cut for real income. Tax indexation would allow Congress to focus more thoroughly on the issues involved in meaningful tax reform.

Fourth, tax indexation would be a major step in promoting responsibility and accountability in government especially at a time when

public trust in governmental institutions and governmental leaders has suffered a decline. Although the question may surface whether Congress consciously overspends in order to stimulate inflation and thus increase its income, one conclusion becomes obvious: Congress has a major conflict of interest in the area of inflation. Congress becomes the beneficiary of its own excesses: if it will spend beyond its income each year, it will gain an increase in its real spendable income, the equivalent of a legislated tax increase. It also gains a reduction of its real debt by the result of the inflation stimulated by its deficits. This process and the results remove any incentive for Congress to attempt to control inflation. Tax indexing is a means to effectively halt the "windfall profit" that Congress gets automatically from the inflationary process.

Responsibility and accountability are provided in other areas of tax policy. If Congress wishes to raise taxes, it must do so openly by voting a tax increase to increase revenues rather than relying on inflation, which depends on a lack of taxpayer awareness for automatic increases. If Congress wishes to reduce taxes, it can openly vote for a tax reduction. Tax indexation would remove the farce of Congress seemingly voting for "tax reductions" when in reality its action is merely an attempt to restore the real tax rate of a few years earlier before inflation. Members of Congress thus have been able to gain political credit for a "tax reduction" which in reality did not take place while reaping the political benefits of additional income resulting from largely-unperceived tax increases in the intervening years.

Another consideration is in the long range effect—resources are being shifted from the private to the public sector for the taxpayer and the economy in general.

In analyzing this problem, it will be necessary to examine two areas where inflation and the personal income tax structure interact to produce higher rates of taxation: (1) regular income (e.g., salaries, wages, commissions, fees, etc.) and (2) capital gains.

A. Personal Income Tax Indexing

There are certain obvious conclusions which emerge from an examination of our tax system and its effect on the individual taxpayer. When a person's nominal income increases, we discover that not only is there an increase in the nominal tax liability incurred, but in addition to the nominal tax, there is an increase in the average tax rate and thus the *real* tax liability also increases. We realize that the real tax liability increases at a faster rate than real income.

The victim is the taxpayer. In the first instance, as a person's nominal income moves upward within a certain tax bracket, it is the

marginal tax rate which exceeds the average rate and thus forces the average rate to increase with income. Secondly, as the person moves to higher tax brackets, a new and higher marginal tax rate takes place with the effect resulting in raising the average tax rate. Finally, the standard deduction and the exemptions are specified in dollar amounts. As nominal income increases, the standard deduction and exemptions decline as a share of total income and the proportion of income that is taxable increases. Consider that even if taxable income were taxed at a constant rate, we discover that the real value of the standard deduction and exemptions would cause the average tax rate on adjusted gross income and real tax liability to increase in a period of inflation if real income is held constant.[10]

1. Analysis of How the Individual Taxpayer is Affected

The case for tax indexing becomes even stronger when illustrations of a more empirical nature are presented.

Even if the consumer/taxpayer becomes aware that his taxes are rising because of inflationary pressures, the individual may not be aware of how quickly inflation is eroding the value of his nominal income nor how quickly his tax burden is increasing.

Table 1 presents the case for the effect of inflation for a family of four, filing a joint return using a standard deduction at two different adjusted gross income (AGI) levels. The illustration is a hypothetical one with the following assumptions: that real income has held constant throughout a five year period; the inflation rate remains at a 7 per cent level annually; the tax structure has not been changed legislatively. The taxpayer, without the benefit of tax indexing or tax reduction in this hypothetical situation, will find that maintaining one's real adjusted gross income through a five year inflationary period will cause an increase in nominal and real tax and a reduction in real disposable income.

[10] The estimates of the exact impact of inflation on aggregate tax revenues may vary somewhat. Randall Kau and Michael Schler cite three studies which estimate the change in federal tax revenue resulting from a 1 per cent aggregate increase in adjusted gross income to be approximately 1.4 per cent. See Randall Kau and Michael Schler, "Inflation and the Federal Income Tax," *Yale Law Journal,* Vol. 82 (March, 1973), p. 740. A study by George M. Von Furstenberg, former Senior Staff Economist of the Council of Economic Advisors, indicates that taxes are raised by more than 16 per cent after 10 per cent inflation. See George M. Von Furstenberg, "Individual Income Taxation and Inflation," *National Tax Journal* XXVIII (March 1975), pp. 117-125. The Joint Economic Committee cites another estimate by J.M. Buchanan and J.M. Dean who conclude that one year of 10 per cent inflation will increase tax revenues by 14.7 per cent. See Lucy Falcone, *Inflation and the Consumer in 1974,* Paper No. 1 of the "Studies in Price Stability and Economic Growth," a study prepared for the use of the Joint Economic Committee, February 10, 1975, 16 pp.

Table 1:
EFFECT OF INFLATION ON INCOME AND INCOME TAX AT TWO INCOME LEVELS, OVER A FIVE YEAR PERIOD*
(7 percent Inflation Each Year)

	Adjusted Gross Income (AGI)		Tax	After-Tax Income	
	Nominal	Real		Nominal	Real
(Lower Income Level:)					
Base*	5,000	5,000	98	4,902	4,902
5	7,013	5,000	404	6,609	4,712
Change:	+40	0%	+312%	+35%	- 4%
(Higher Income Level)					
Base*	13,000	13,000	1,380	11,620	11,620
5	18,233	13,000	2,566	15,667	11,170
Change:	+40%	0%	+86%	+ 35%	- 4%

*The base year is not of the five; it is used to show what figures are being inflated. If 1970 were the base year, 1975 would be year #5, and the change would ref;ect inflation during the period 1971 through 1975.

Table 2 presents a change in average tax rate occurring at various adjusted gross income levels during a ten year period of inflation. Each horizontal line represents a constant real AGI level. The chart was presented by former Senator James L. Buckley, who testified on indexing the tax system in the hearings before the Subcommittee on Production and Stabilization of the Senate Committee on Banking, Housing and Urban Affairs, June 11, 1974. (P. 38 of the printed hearings.)

Table 2:
HYPOTHETICAL TAX COLLECTIONS AT CURRENT TAX RATES, 1974 & 1984
(assuming inflation causes prices and incomes to double in 10 years)

1974 Nominal Income	1974 Percent of income paid in taxes	1984 Nominal Income	1984 Percent of income paid in taxes
$5,000	2	$10,000	10
10,000	10	20,000	15
20,000	15	40,000	25
50,000	29	100,000	42
100,000	42	200,000	54
1,000,000	67	2,000,000	68

2. Recent Experience and the Tax Reduction Act of 1975

Considering that nominal tax rates remained constant from 1965 to 1969, the tax burden on real incomes increases.[11] However, from 1969 to 1972, higher exemptions and deductions were implemented and the

[11] A discussion of the effect of the inflation "tax bite" in the individual can be found in Allan C. Brownfeld, "'Tax Indexing' — Aid for American Earners," *Manchester* (N.H.) *Union Leader,* November 1, 1975, and Rep. Phil Crane, "Tax Indexing: Adjusting Government's Bite to Offset Inflation," *Congressional Record,* September 30, 1975, p. E5123ff.

tax rate at low and moderate real income levels declined.[12] We have a trade-off where the effect of inflation in raising tax rates on taxable income was offset by the reduction in the proportion of adjusted gross income that is taxable.[13]

It might not be completely accurate to state that a primary or major purpose of the Tax Reduction Act of 1975 was inflation correction. However, a careful examination of that act with the reduction/correction that would have been necessary to eliminate the distortions caused by inflation is still appropriate. We find: (1) the economic stimulus provided by the 1975 Act reduced aggregate taxes by only slightly more than inflation had increased taxes in the preceding twelve months;[14] (2) the Congress, in seeking to counteract the recession by eliminating the taxes they considered excessive, recognized in effect that the tax excess (and more) had been caused roughly by one year of inflation; (3) there appeared no conscious formula by Congress that the amount of tax reductions in the 1975 Act was based on a standard needed for inflation correction; and (4) the hit-and-miss concept of tax reduction as a means to correct tax inflation may bring significant distortions into the tax system. In other words, a sound system of tax change would require Congress to be aware of the inflationary distortion and exactly how much each income class was over- compensated or under-compensated by the tax measure.

Table 3:
REAL INCOME TAX INCREASE IN 1974 CAUSED BY INFLATION[15]

AGI Class	Present law tax (millions)	Inflation-induced tax increase (millions)	Inflation-induced increase as percent of present law tax
0 to $3,000	289	130	45.0
$3,000 to $5,000	1,779	295	16.6
$5,000 to $7,000	4,093	398	9.7
$7,000 to $10,000	9,251	637	6.9
$10,000 to $15,000	21,239	1,249	5.9
$15,000 to $20,000	20,910	1,210	5.8
$20,000 to $50,000	38,419	2,279	5.9
$50,000 to $100,000	11,883	637	5.4
$100,000 and over	10,992	289	2.6
Total	118,855	7,122	6.0

[12] A discussion of the period thereafter can be found by William Fellner, "Inflation and Overtaxation," *The Wall Street Journal,* July 3, 1975.

[13] Von Furstenberg, "Individual Income Taxation and Inflation," pp. 122-123.

[14] Fellner, *et. al., Correcting Taxes for Inflation,* p. 11.

[15] The chart is from the Joint Committee on Internal Revenue Taxation, "Analysis of the House Version of the Tax Reduction Act of 1975 (H.R. 2166) and Possible Alternatives," prepared for the use of the Senate Finance Committee, March 13, 1975, p. 12.

Table 3 includes an estimate of the actual taxes in 1974 over what taxes would have been had tax brackets, the personal exemption, and the minimum and maximum standard deductions been adjusted upward for inflation.

Table 4 provides a statistical comparison of tax liabilities, tax reductions that would correspond to an indexed system, and the tax reductions actually enacted. The chart is based on an estimate of the tax reduction necessary in order to eliminate the effects of a 10 per cent inflation which would be a total reduction of $6,743,000; the equivalent for 12 per cent inflation would be $7,999,000; for 20 per cent inflation, $12,763,000. If the tax structure had been purged of the effect of inflation, 9 per cent of the total reduction should have gone to taxpayers in the $50,000 to $100,000 income class. The total rebate was estimated at $8.1 billion with the total 1975 individual income tax estimated at $9.3 billion. For comparability, the provisions resulting in this cut were applied to 1974 incomes in which case the total cut still remains about $9 billion. (The special $50 payment to Social Security

Table 4:
RELATIVE SHARE (By Income Class) OF TAX LIABILITY AND TAX REDUCTIONS TO COMPENSATE INFLATION

	Tax Liabilities (% of Total)	Tax Reductions		
			Enacted	
		Needed[1]	74 Rebate	75 Reduction
		(All figures: % of total reduction.)[2]		
0 - 3,000	0.24	1.50	2.83	5.03
3,000 - 5,000	1.50	4.29	8.43	14.10
5,000 - 7,000	3.44	5.92	9.78	14.82
7,000 - 10,000	7.79	10.03	14.73	16.07
10,000 - 15,000	17.88	17.43	26.81	19.97
15,000 - 20,000	17.60	17.32	22.10	15.78
20,000 - 50,000	32.34	30.76	14.30	13.15
50,000 - 100,000	10.00	9.00	0.80	0.89
100,000 +	9.22	3.75	0.20	0.20

recipients was not included.) In this table, the direction of the basic shifts in the tax structure enacted with the compensation for inflation is indicated by the line drawn. Those income classes above the line were overcompensated for inflationary tax increases while those below were undercompensated.[16]

A number of points should be taken into consideration. If we look at the combination of the 1974 rebate and the 1975 tax reduction, we

[16] The above chart is adapted from Tables 1 and 2 in William Fellner, *et. al., Correcting Taxes for Inflation,* pp. 18-19.

find that they correspond for a roughly 30 per cent inflation in the aggregate which is approximately equal to the overtaxation between late 1971 and somewhere in 1975. Considering the regressive nature of the inflationary tax increases, those individuals in the lower income categories ought to receive a reduction larger than the increased tax they experienced. Yet, the lower income categories were overcompensated while the upper-income categories were undercompensated. For example, those individuals with an adjusted gross income of $100,000 or over should have received 3.75 per cent of the tax reduction but received only 0.2 per cent instead (e.g., the far right column in Table 4).

The observer is tempted to speculate on a number of possibilities involving the 1975 Act. Congress may have sought to attempt a real tax reduction since the 1975 Act (1) involves basic revisions in the tax structure and (2) there is no real evidence that Congress as a whole was aware of the degree of inflationary distortion or the degree the measure departs from inflationary correction. Yet, assuming that Congress desired to provide real tax reduction, this effort was negated or rendered ineffective in the aggregate by the year's resulting inflation.

Considering the alternative—that Congress wishes to correct for inflation in the aggregate while modifying the basic tax structure—we can conclude that Congress did so by intuition which is a very dubious formula for any type of tax reform proposal.

Another possibility is that Congress sought the benefits of such credit for a "tax reduction" while pursuing an income transfer program—a heavier burden on upper income level and easing the burden on lower income individuals.

3. Practical Aspects of the Indexation of the Personal Income Tax

The major changes necessary for indexing the personal income tax are upward adjustment of the dollar amount specified for the personal exemption, the low income allowance, the maximum standard deduction and the limits of each taxable income bracket. Comparisons of the 1975 and 1976 percentage deduction and low income allowance are listed below:

> Percentage Standard Deduction[17]
>
> Percentage Standard Deduction.—The percentage standard deduction for 1976 and later years is an amount equal to 16 per cent of an individual taxpayer's adjusted gross income, with

[17] *Tax Reform Act of 1976, Law and Explanation* (Chicago: Commerce Clearing House Inc., 1976), p. 23.

maximum limits based upon the individual's filing status. The maximum deduction amounts, as contrasted with the 1975 levels, are as follows:

	1975	1975
Single taxpayer	$2,300	$2,400
Married taxpayer filing jointly	2,600	2,800
Married taxpayer filing separately	1,300	1,400
Surviving spouse	2,600	2,800

Low Income Allowance

Low Income Allowance.—The levels of the low income allowance (or minimum standard deduction) are also extended on a full-year basis for 1976 and later years. The differences between the 1975 and 1976 levels are illustrated as follows:

	1975	1976
Single taxpayer	$1,600	$1,700
Married taxpayer filing jointly	1,900	2,100
Married taxpayer filing separately	950	1,050
Surviving spouse	1,900	2,100

Therefore, tax tables, forms, etc., would all be adjusted prior to the taxpayer receiving the tax form so that the general procedure followed by the taxpayer in computing tax liability would be unchanged. A number of bills have been introduced in the Congress incorporating this approach. (A more detailed discussion of specific legislative proposals will be made later in this study.) Although it might be less important than correcting tax liability, the withholding tables ought to be adjusted in a similar manner. However, a time lag is unavoidable in adjusting the withholding tables.

There has been a greater recognition at all levels of the difficulties suffered by the individual taxpayer from inflation-induced tax increases. Discussing his objective as the reestablishment of a stable, noninflationary, full employment economy as the goal of his Administration, former President Ford recognized this problem in urging enactment of his proposed economic program in his final economic report:

> We need reductions to support a lasting economic recovery and to provide relief from the increases in real tax burdens induced by inflation. In the long run, inflation and real economic growth will constantly push taxpayers into higher and higher tax brackets unless tax laws are changed.[18]

[18] *Economic Report of the President,* House Document 95-40, (Washington, D.C.: U.S. Government Printing Office, 1977), p. 4.

It is encouraging that government officials are becoming more cognizant of the problem which has been stressed by such economists as Milton Friedman and Grove City College Professor Hans F. Sennholz. Professor Sennholz has stressed that government is the greatest profiteer from inflation "as its tax revenues are boosted by the built-in progression in higher income brackets and through the depreciation of government debt."[19] General support for some type of indexation to meet this problem has been endorsed in some form by former Treasury Secretary William Simon, Milton Friedman, former member of the President's Council of Economic Advisors William Fellner, First National City Bank of New York President Walter Wriston, former United Auto Workers President Leonard Woodcock, former Senator James L. Buckley and current officeholders such as Representatives Phil Crane (R-Ill.), Lawrence Coughlin (R-Pa.), Dawson Mathis (D-Ga.) and Matthew J. Rinaldo (R-N.J.).

There is a major gap between recognizing the problem and actually enacting legislation which will solve the difficulty for the taxpayer on his personal income tax.

B. Capital Gains Taxation and the Inflation Problem

A capital gain is said to occur when the value of a piece of property increases (e.g., land, a home, stocks and bonds). Such a gain is "realized" when the property is sold at a price greater than the property's "adjusted basis." The "adjusted basis" is considered the value of the property at the time of acquisition plus permanent improvements and other capital charges minus depreciation and depletion. Although there are some exceptions, a capital gain is taxed when it is "realized" by being sold or transferred in ownership.

All short term gains are taxed as regular income while long term gains are taxed at a different rate. Short term gains are realized on property held less than six months. However, the Tax Reform Act of 1976 increased the holding period from 6 months to 9 months in 1977 and 12 months in 1978 and thereafter. The law also raised the $1000 ordinary income level against which net capital losses can be offset—$2000 in 1977 and $3000 in 1978 and thereafter.[20] Individuals being taxed on long-term capital gains may exclude one-half of a long term gain from gross income or may elect a 25 per cent tax on the first $50,000 of long term gains. Corporations may elect an alternative tax of 30 per cent on long term capital gains.

[19] Hans F. Sennholz, "Two Digit Inflation," *The Freeman*, Vol. 25 (January, 1975), p. 24.

[20] *Tax Reform Act of 1976*, Sections 1401 and 1402.

Since gains on both capital assets and business property are subject to tax, both individuals and businesses are affected by the interaction of inflation and capital gains taxation. Inflation causes great difficulties in the capital gains area of taxation because inflationary increases bring the tax code in this area beyond its intended function.

The real problem arises when nominal property values increase to keep up with inflation, while the real value of property may increase, decrease, or remain constant. The true distortion of inflation regarding real value occurs in the following case: when the nominal value of an asset increases at a rate slower than inflation, a real capital loss occurs despite an apparent nominal capital gain, which is illusory, but taxable.

Thus the net effect of the combination of inflation and the tax structure is that real capital losses are either minimized or converted to taxable capital gains. A certain capital loss may occur but is not recognized and the tax levied on *net* capital gains (capital gains minus capital losses). The overall effect is that real capital gains are exaggerated and overtaxed. Whether a real capital gain or a real capital loss occurs, the situation is distorted and overtaxation of capital gains becomes the direct end result of inflation. If the economic system is properly indexed, then the individual taxpayer will pay taxes only on real capital gains.

The basic error which leads to overtaxation is an invalid assumption—that dollars used to purchase the property earlier have the same value as an equal number of dollars at the time of the sale. Rep. Phil Crane (R-Ill.), an advocate of indexing, illustrates this point with the following example: a person buying a piece of property in 1966 for a price of $10,000 and deciding to sell the property in 1974 would have to receive $15,000 for the property just to stay even. However, the assumption of the tax code is that a $5,000 gain has taken place even though in actuality no real gain has taken place.[21]

We can ascertain that inequity results in two respects. First, the amount of the tax liability is not justified by the existence of a real

[21] Rep. Phil Crane, "Tax Indexing: An Overdue Reform I," *Congressional Record* (July 29, 1975), p. H7800. Crane quotes the estimate of George Schultz, former Secretary of the Treasury, who estimated that forty percent of the capital gains realized on common stock in the 15 years prior to 1972 was the result of inflation. James F. Nasuti and Charles A. Nickerson present the following illustration: "Capital appreciation is frequently due to inflation, not to a real increase in economic value. For example, a person who bought a share of stock in 1950 for $100 and sold it in 1976 for $249 had no economic or real gain at all. The $100 that he invested in 1950 had exactly the same purchasing power as the $249 he received in 1976. Yet, under the Internal Revenue Code he has $149 of income, when in fact he had no real income and his apparent gain ought not be taxed at all." See James F. Nasuti and Charles A. Nickerson, "Capital Gains Should Be Indexed," *The Wall Street Journal,* August 12, 1977, p. 6.

gain since the nominal or apparent gain is either created exclusively by or exaggerated significantly by inflation. Assuming that inflation could be kept to a rate of six percent for future years, a family which bought a home in 1977 for $40,000 and kept it for 20 years would have to receive $130,000 upon its sale in 1997 in order to receive back their initial investment without suffering a capital loss. If so, this family would have to pay a capital gains tax on $90,000 even though we know that the real value of their property has not increased at all. The inequity is only escalated by higher rates of inflation. If a family purchased a $40,000 home in 1977 and had to face an inflation rate of 12.2 per cent, it would have to be sold for slightly under $400,000 in 1997 in order to hold its real value constant.

We can also view a second problem of inequity when different taxpayers with different amounts of gain pay the same tax or those individuals with the same real gain may pay different amounts of tax. An individual who bought a piece of property in early 1966 for $20,000 and then decided to sell it at the end of 1974 would have to sell it for $30,000 just to maintain the real value. Another taxpayer might buy the piece of property in 1973 for $20,000 and sell it for $30,000 in 1974. This person would realize a gain of $10,000, 80 per cent of which, considering the rate of inflation, was a real gain. *This second taxpayer would pay the same tax as the first individual who realized no gain.* Assuming that the tax system had been indexed, the first taxpayer would not have owed any tax on the illusory "gain" while the second taxpayer would have owed tax on a gain of $7,806 in 1974 dollars.[22]

1. The Problem of the Homeowner

Although the problem of inflation distorting capital gains occurs with a variety of forms of property (e.g., real estate, stocks, residential property), the problem is especially severe for the homeowner. And it is the homeowner who would realize the effect of indexing, especially at the time of sale or purchase of a home.

The inflation problem hits the homeowner especially hard in the tax area because of three factors. First, the homeowner has usually planned for the future inadequately, mainly because of ignorance of the full effect of inflation in future years. Second, a person is likely to hold a home for a longer period of time than many other capital assets. Since under a provision of the Internal Revenue Code, the

[22] This figure has been arrived at by an adjustment of the basis of property upward by the 10.97 per cent rate of inflation and then deducting the inflation-adjusted basis of property from the amount realized upon sale: capital gain = $30,000 minus (1.1079 x $20,000, or $22,194), and thus the gain is $7,806.

capital gain from one residence can be transferred to a new residence instead of being recognized and taxed upon sale, the capital gain realized on the individual's residences may accumulate throughout a lifetime. And third, the homeowner is generally believed to be protected from excessive capital gains taxation by two so-called "benefits" or provisions of the IRS Code. One provision of the code states that if the sale of a person's principal residence is followed within eighteen months by the purchase of a new residence, any gain realized on the sale of the old residence will be recognized only to the extent that its sale price exceeds the cost of the new residence.[23] If an individual whose residence has an adjusted basis of $20,000 sells his home for $30,000, he will realize a gain of $10,000. If he purchases a home within the prescribed period and his new residence costs more than $30,000, he will not be taxed; if his new residence costs $25,000, then a $5000 capital gain is recognized for tax purposes. The basis of the new residence must be adjusted downward by the amount of the unrecognized gain. This permits the accumulation of capital gains through a lifetime, from residence to residence. A second so-called "tax benefit" is the provision that allows a taxpayer over the age of sixty-five to exclude any capital gains attributable to the first $35,000 of the adjusted sales price of the residence.[24] Despite the protection offered to the homeowner (the latter only applying to senior citizens), the individual taxpayer may still be seriously hurt by the interaction of inflation and capital gains taxes. These problems are magnified as the individual approaches retirement—with the prospect of living on a fixed income (Social Security and/or a private pension) and faced with increasing local property taxes.

2. Practical Aspects of Indexing

Although in certain circumstances the actual computation of capital gains under an indexed system might be complex, the adjustment necessary is conceptually simple and is not likely to increase the complexity of the current tax code significantly in practice. The approach might be the following. Tax liability is stated in current dollars. Therefore, the simplest method of adjustment would probably be to: (1) state the unadjusted basis of property in current dollars; (2) state any basis adjustments in current dollars; and (3) compare the adjusted inflation basis of property with the amount realized in sale of the pro-

[23] *Internal Revenue Code of 1976,* Section 1034, Part A.

[24] The Tax Reform Act of 1976 raised this amount from $20,000 to $35,000. *Tax Reform Act,* Section 1404 (Public Law 94-455). See *Internal Revenue Code* of 1976, Section 121(b).

perty to determine the real inflation-adjusted capital gain which is subject to tax.

The first of the three steps requires multiplying the original capital investment by a number equal to the ratio of the current price level to the price level that existed at the time of acquisition of the property. The second step would require making a similar adjustment in each addition to or subtraction from the basis of property (such as permanent improvements). The adjustment would only take into account inflation occurring between the time when the addition/subtraction was made and the present, rather than the inflation occurring after the date of acquisition. The final step is essentially the same as the calculation required by the current tax code provisions but the Adjusted basis of property (adjusted basis of property including the inflation adjustment) is used in lieu of the adjusted basis of property.

C. Indexing Business Income

With the United States economy facing the challenge of raising the necessary capital to create more than 19 million jobs between 1977 and 1981, almost twice the number that the U.S. economy generated during the past five years,[25] it is essential that the necessary capital be available for the American economy to accomplish this task. A 1974 study by the New York Stock Exchange concluded that the United States would face a capital shortfall on the order of $650 billion through 1985.[26] During a time period when business must expand and new jobs must be created, anything which impedes such a growth will have serious consequences for the economy. Thus, inflation-generated excess taxes are hitting businesses at a time when they can least afford them. President Ford, in his final economic message, observed that his proposed reductions in both personal and corporate income taxes "can be justified in part as an offset to the bias against private investment created by our tax structure, under which the real tax burdens for business as well as individuals rise in periods of high inflation."[27] It was a similar theme emphasized by Roland M. Bixler, Chairman of the National Association of Manufacturers Taxation Committee, in his February 7, 1977 presentation to the Ways and Means Committee. Testifying on the tax aspects of President Carter's economic stimulus program, Bixler pleaded for attention to "how to deal on a more per-

[25] "Jobs—A Look at the Nation's Most Nagging Problem," *U.S. News and World Report* (February 21, 1977), p. 55.

[26] A.F. Ehrbar, *The Capital Shortage: A Different Perspective* (Oyster Bay, New York: Institute for Economic and Legal Analysis, 1976), p. 17.

[27] *Economic Report of the President* (1977), p. 162.

manent basis with inflation's double tax bite—moving people into progressively higher tax brackets without accompanying increases in ability to pay and making capital consumption allowances increasingly inadequate.''[28]

Inflation exaggerates business income in two major ways in addition to the inflationary effect on capital gains already discussed: First, inflation may exaggerate or create "inventory value." During a period of inflation, the price for which a product is sold must exceed the cost of producing it by the rate of inflation in order to account for the changing value of the dollar. Therefore, a short-term capital gain occurs on inventories between production and sale. We have a problem we discussed before in a different context: *the income of the firm is increased in nominal terms but in real terms income is exaggerated.* As a result of this distortion, a greater proportion of corporate income is taxed and in effect the amount of capital available to the firm is reduced.[29]

Second, the effect of inflation is experienced in a reduction of capital consumption allowances in real terms, making capital replacement more difficult.[30] The capital consumption or depreciation under the current tax law is derived mathematically from the original pur-

[28] Roland M. Bixler, "Tax Policy and Economic Stimulus," in *Taxation Report,* February 7, 1977, p. 4.

[29] An example of the problem can be found in Kenneth W. Clarkson's *Intangible Capital and Rates of Return* (Washington, D.C.: American Enterprise Institute for Public Policy Research, 1977). Clarkson stresses that in order to measure a realistic rate of return for firms with extensive promotional, research, development and other intangible capital expenditures, accounting rates of return need to take account of inflation, opportunity cost of capital, life-cycle differences, and depreciation. He concludes that conventional accounting rates of return fail to incorporate these corrections.

[30] One attempt to solve the problem of capital shortage was embodied in the Capital Recovery Act of 1975 introduced in the 94th Congress by Representatives Bill Archer (R-Tx) and Joe Waggonner, (D-La.). The bill would replace the present system of depreciation with a simple, rapid cost recovery system (e.g., a five year recovery period for all productive machinery equipment and for pollution control facilities and a ten year recovery period for industrial buildings). This approach was promoted as a means to reduce, though not eliminate, the impact of inflation on recovered costs and thus assist in increasing the internal funds which would be available for new investment in plant and equipment. See statement of Rep. Waggonner, "H.R. 7543—The Capital Recovery Act of 1975," *Congressional Record* (June 5, 1975), pp.H5033-H5035, and the statement of Rep. Archer, "We Need A New Capital Recovery System," *Congressional Record* (September 5, 1975), pp. E4547-E4548.
Rep. Jack Kemp, (R-NY) incorporated the Archer-Waggonner approach in his more comprehensive bill to stimulate the economy, "The Jobs Creation Act," which was introduced in the 94th Congress and reintroduced in the 95th Congress, the latter as H.R. 427. See statement of Rep. Jack Kemp, "First Priority Must Be to Lower Federal Tax Rates to Fight Both Inflation and Unemployment," *Congressional Record* (January 4, 1977), pp. H31-H33.

chase price of the plant or equipment. However, the implication of inflation in most instances is that the original purchase price is far less than the replacement cost. Since true or actual profits represent what a firm earns *after providing for replacement of real capital,* and since during a period of inflation the capital consumption allowance provided under the tax code is generally inadequate or less than adequate for capital replacement, earnings of the firm are exaggerated and consequently overtaxed. For example, capital consumption allowances in 1973 totaled $68.1 billion. However, if the calculation had been based on replacement costs, the allowances would have been $11 billion higher (using the double declining balance method) or $4.3 billion higher (using straight-line depreciation).[31]

A description of recent past aggregate experience provides a conceptual illustration of how indexing would adjust the business income tax. The pre-tax profits of non-financial corporations in 1974 totaled $110 billion. In the same year the changes in the value of inventories more than doubled representing $35 billion or roughly one-third of total pre-tax profits.[32] Profits would have to be reduced by another $15 billion if one calculates depreciation to provide for capital replacement. Yet, it is necessary to carry this adjustment further.

Of the $35 billion of the inventory valuation adjustment, $15 billion was due to an increase in *real* value while $20 billion resulted from inflation. The $15 billion under-depreciation figure (e.g., the difference between replacement cost and historical depreciation) corrects for price increases occurring over several years (e.g., inflation from 1973 to 1974 produced $7 billion of the profit overstatement). We can say in summary that the total pre-tax profit figure ought to be adjusted downward by about $27 billion to account for the inflation in 1974.

In addition, equitable inflation adjustments require a realization that significant portions of the investments undertaken are debt financed. Thus, the tax exemptions for inflationary inventory profits have to be carried over to creditors whose tax returns reflect the nominal gain. The result is that about $13 billion of the $27 billion inflation of the tax base was to the detriment of the creditors. In considering the reduction of tax liability under an indexing system, the corporations would have gained $6 billion and the creditors $3 billion. If we expand the scope of this analysis from non-financial corporations and their creditors to take account of the remainder of the

[31] Edward M. Bernstein, "Indexing Money Payments in a Large and Prolonged Inflation," in *Essays on Inflation and Indexation* (Washington, D.C.: American Enterprise Institute for Public Policy Research, 1974), pp. 82-83.

[32] *Monthly Economic Letter,* First National Bank of New York (April 1975), p. 6.

business sector, we find it increases the tax base reduction from $27 billion to $30 billion and the tax reduction from $9 billion to $10 billion which becomes the extent of aggregate overtaxation of business income.

If we combine this $10 billion figure with the overtaxation of personal income for the same year (e.g., $7 billion) and the overtaxation of capital gains (no real figure is available), we can safely conclude that the government is truly.reaping enormous profits because of inflation—all from unlegislated tax increases.

Senator Orrin G. Hatch (R-Utah) has pointed out that if inflation resulted in higher profits for business, then the period of double-digit inflation in 1974 would have produced prosperity in 1975 rather than a sharp recession. The Utah Senator has repeatedly stressed that inflation has had the effect of raising the effective tax rate on corporate income above the statutory rate because "inflation overstates profits by understanding depreciation costs and by causing the firm's accounting practices to register inventory profits by neglecting the replacement costs of the inventory." The conclusion is obvious: when inflation raises the effective tax rate, the profitability of business is reduced. The result is felt throughout the economy since more business activity cannot be generated by making it less profitable. It is only with the decline of the inflation rate that economic activity picks up. Inflation thus not only gives enormous profits to government but distorts and slows down the whole business cycle. In a magazine article, Senator Hatch included a chart which shows how inflation has raised the effect tax rates on corporations.[33]

Table 5:

Year	Inflation Rate (CPI)	Effective Tax Rate
1968	4.7%	46%
1969	6.1	49
1970	5.5	51
1971	3.4	49
1972	3.4	45
1973	8.8	49
1974	12.2	62
1975	7.0	54
1976	4.8	55

*Tax liability as a percentage of corporate profits with inventory valuation and capital consumption adjustments.

[33] Orrin G. Hatch, "More Appropriations—More Unemployment," *National Review*, XXIX (August 19, 1977), p. 943.

George M. Von Furstenberg, former senior staff economist with the Council of Economic Advisors, has noted that the distortion caused by inflation on the normal workings of our tax and financing system is especially evident in the case of non-financial corporations. He observes:

> *If the prices of products sold are determined by current market conditions, but the expenses incurred in producing them are all determined on an historical cost basis, tax liabilities will be raised in real terms as a result of inflation even if the margin of return over replacement costs has not risen at all. In the long-run, however, the tax raising effects of inflation may be reversed, and other effects that can cause balance sheet determination and a significant reduction in the investment incentives for non-financial corporations may increase in importance.*[34]

He adds that even if the effective tax rates on profits are not raised permanently by inflation, the higher inflation rates will lower the rate of investment in the non-financial corporate sector. He expresses the fear that the corrosive effects of high inflation may not become apparent until the following decade, when it may be too late to summon the political will to prevent the damage.[35]

Rep. Jack Kemp has stressed that the only real way to raise the standard of living is to increase the amount of capital per capita by reducing the tax barriers to investment and employment. In observing that increased federal spending adds nothing to the supply of food, clothing, housing, or other goods, nor does it add to the lowering of prices, the New York Congressman adds that the federal deficit produced by excessive federal spending leads to some form of tax increase, either through higher taxes to pay interest on the expanded public debt or the inflation tax. A vicious circle results: when taxes rise, a firm is likely to hire fewer workers; the take home pay of workers is reduced; and workers lose incentive and opportunity. Whether higher taxes are legislated or raised by inflation, the overall effect is the same.[36]

Considering the overall problem of capital formation, business expansion, and the creation of new jobs, inflation-inspired tax increases distort the true economic picture. A wise economic policy has to in-

[34] George M. Von Furstenberg, "Corporate Taxes and Financing Under Continuing Inflation," in William Fellner (ed.), *Contemporary Economic Problems* (Washington, D.C.: American Enterprise Institute for Public Policy Research, 1976), p. 225.

[35] *Ibid.*, p. 226, 254.

[36] Rep. Jack Kemp, "First Priority . . .," *Congressional Record* (January 4, 1977), pp. H31-H33.

clude the effect of inflation on the economy and make the necessary economic correction (e.g., indexing). In emphasizing a program to insure the long run health of the economy, Representative Kemp observes:

> *Tax policy must be considered from the standpoint of its effects on the incentives of people to work and produce, to save and invest, to build and employ. When tax rates go up and investment and employment opportunities in the private sector goes down, it is not the rich who have been soaked, but the unfortunate workers who either become unemployed or must work with less productive tools and machinery.*[37]

And Milton Friedman notes that the fallacy in discussing the stimulative effect of government spending is easy to find since the reduction in funds for private use because of "government borrowing to finance the spending—or the hidden tax of inflation imposed by money created to finance the spending—reduce the public's ability to provide employment."[38] A major step toward providing for strong economic growth is the consideration of the inflation factor and its minimization by indexing of business income taxes.

[37] *Ibid.*, p. H31.

[38] Milton Friedman, "When Is A Tax Cut Not A Tax Cut?," *Newsweek* (January 17, 1977), p. 72.

2

The Advantages of Tax Indexation

Certain macroeconomic goals are more easily attained under an indexed tax structure. A review of some of the leading advantages should prove useful for those individuals considering indexation as a policy option.

A. The Availability and Mobility of Capital

Indexing would help the economic growth of the country by encouraging capital formation or the free movement of existing capital in two major respects. Since part of the increases in capital gains are illusory because of inflation, removal of the tax on inflationary, though imaginary, capital gains would aid capital formation by allowing taxpayers who have been holding securities and real estate because of the huge tax that would result from a sale to sell these valuables and pay tax only on the real, not the nominal, capital gains.[39] A second advantage is that capital formation would be aided because of the prevention of excess business taxation resulting from inadequate or less than adequate depreciation allowances. Tax indexing would correct this problem by permitting depreciation to be based on replacement costs and thus taxing only the real income. After this excess tax is removed, additional revenues which would become available could be used to meet the chronic need for capital investment.

B. The Progressive Income Tax

The point has been made that the real tax rate increases with inflation and part of this distortion in the economy results in the taxpayers in the lowest income categories suffering the greatest relative increases in taxes.[40] There are four factors which bring about this result. First, change from one income bracket to another income bracket is more

[39] Douglas Holm, "Compensating for Inflation in Tax Laws," *Tax Executive,* XXV (January, 1973), p. 105.

[40] Randall Kau and Michael Schler, "Inflation and the Federal Income Tax," p. 738. The authors assert that "the marginal rate of taxation increases with taxable income at a diminishing rate, and thus the real tax burden on individuals in the upper brackets does not increase as rapidly as that on those in the lower brackets."

frequent at lower income levels because the width of the brackets grows as income rises. The expected result is that the lower the income level, the more frequent the change in marginal tax rates. Second, such changes which occur in marginal tax rates are larger at lower income levels. Third, the maximum marginal tax rate of 70 per cent prevents any further bracket movement. (All three of these factors are closely related even though they are conceptually and mathematically distinct.) Fourth, itemized deductions, unlike the standard deduction, tend to increase nominally with the rate of inflation or, possibly faster, than the rate of inflation, with the higher income taxpayers being most likely to utilize itemized deductions in the preparation of their income tax returns. Although they do feel the effect of inflation-induced tax increases, it is easier for higher-income taxpayers to resist inflation-generated tax increases.[41] If the current progessive tax system is maintained and it is to be fair and equitable, it will be necessary to provide for indexation of the tax system.

Dr. Milton Friedman notes that a tax cut is not a tax cut when the so-called cut in taxes merely offsets a rise in tax rates produced by the automatic effects of inflation and when this so-called cut in taxes is made along with a larger rise in government spending than in prices. He presents this interesting observation:

> *All in all, if your income goes up by 10 per cent, your taxes will, on the average, go up by about 15 per cent. That is why, despite several supposed cuts in personal income taxes in the past decade, taxes paid were the same percentage of total personal income in 1976 as in 1966. The legislated tax cuts have been wholly offset by the unlegislated increases.*[42]

Friedman notes that the politicians can get the credit for voting for tax reductions while the effective tax rates continue to increase. His answer is that this "fraud" can be ended by indexing the tax system.[43]

[41] Studying the effect of inflation on the taxpayer in Britain, R.I.G. Allen and D. Savage of the National Institute of Economic and Social Research concluded that the effect of inflation over the period 1961-1962 to 1972-1973 had been "to raise substantially average tax rates for all taxpayers." In addition they found that inflationary tax increases were not distributed progressively throughout the income scale but bore more heavily on taxpayers at both extremes and that intervention by the government had mitigated but not eliminated inflationary tax increases. R.I.G. Allen and D. Savage, "Inflation and the Personal Income Tax," *National Institute Economic Review,* No. 70, (November, 1974), p. 65.

[42] Friedman, "When is a Tax Cut . . .," p. 72.

[43] *Ibid.* Friedman also proposes a simplified tax formula for the personal income tax replacing every tax rate above 25 percent by a 25 percent tax rate. See Milton Friedman, "Tax Reform: An Impossible Dream," *Newsweek* (April 12, 1976), p. 93.

C. Indexing as an Automatic Stabilizer of Recession

One of the supposed advantages of a progressive income tax structure takes place during a period of recession or economic slowdown—when real income declines, the tax revenues decline at a faster rate and have the effect of restoring part of the real income loss and thus assist in stimulating the economy. It is helpful to look at recent economic activity. During three of the past five-year post-war recessions, the burden of taxes fell by almost a full percentage point (e.g., taxes as a percent of personal income, excluding transfer payments by the government). Yet, in 1974, the rate of inflation was sufficiently high to cause an increase in real taxes despite the decline in real income. In this recent example, the automatic stabilization normally brought about by the progressive tax structure did not occur. The economic result brought a unique set of circumstances: real GNP (Gross National Product) declined by two percent through 1974 while real tax receipts rose two percent. Even when government transfer payments (e.g., Social Security, etc.) are included in income, taxes as a percentage of personal income increased so much in the recent recession that not even the transfer payments were sufficient to offset the inflation-generated tax increases.[44] As mentioned earlier, the inflation-induced tax increases intensified the economic downturn of 1974-1975.[45]

The point has been made that the current tax system does not tax real income. In effect it disregards the forces that generate income, but is concerned only with income received. Professor Henry Aaron stresses that between 1960 to 1975 real growth in the United States would have increased revenues from 10.7 per cent to 12.3 per cent of adjusted personal income. Yet, he observes, during that same period, if Congress had not modified income tax laws, the combination of inflation and growth would have been responsible for increasing personal tax collections from 10.7 per cent to 16.3 per cent of adjusted personal income.[46]

If an indexed system was adopted into law, only real income would be taxed and, as this real income declined during a recession, a progressive income tax would cause tax revenues to decline still faster,

[44] Falcone, *Inflation and the Consumer in 1974,* pp. 12-13, and Fellner, *et.al., Correcting Taxes for Inflation,* p. 3.

[45] Thomas F. Dernburg, *Indexing the Individual Income Tax,* p. iv.

[46] Henry Aaron, "Inflation and the Income Tax" in *Inflation and the Income Tax* (Washington, D.C.: The Brookings Institution, 1976) p. 196. Aaron cites the conclusions of E. Sunley and J. Pechman in their paper "Inflation Adjustments for the Individual Income Tax," a paper presented at the Brookings Conference on Inflation and the Income Tax System published in the Aaron book.

stabilizing the recession. Indexing would help minimize the effect of an economic downturn of the economy and protect the individual taxpayer from the double effect of the ramifications of an economic decline *and* inflationary tax increases.

D. Inflation and Wage Demands

Our economic experience has been that demands for higher wages have had a tendency to follow inflationary increases in the cost of living as well as the expectations of future inflation. Personal income taxes and social security taxes have accounted for the most significant increases in the cost of living, especially in recent years. The average worker, facing higher taxes, may attempt to maintain his previous level of after-tax real income. In order to do so, this worker must receive wage increases to compensate for the increased taxes and wage increases to compensate for the increase in the general price level.

A major question to examine is not only whether such wage increases actually keep up with or exceed the rate of inflation, but whether an increase in real taxes *per se* raises wage demands, thus providing a stimulus for additional inflation. Sennholz makes the point that even indexation can't completely protect the workers from the problem of monetary depreciation since the index is calculated on the basis of past prices that differ from the price of goods when wages are paid and spent.[47] Yet, indexation does allow the worker to overcome some of the harmful effects of inflation-induced tax increases. Although there may be some uncertainty about real taxes *per se* raising wage demands in the long run, it does appear that in the short run real tax increases do increase wages.[48] Two British scholars conclude from their studies that by preventing purely inflationary increases in personal incomes from raising the effective tax rates, "index-linking might contribute to reducing the long-term rate of inflation by mitigating cost-push pressure."[49] Studying this problem of increased governmental revenues from inflation-induced tax increases, a group of American academic experts concludes: "No reasonable case can be

[47] Sennholz, "Two Digit Inflation," p. 26.

[48] This area is discussed more thoroughly in Robert J. Gordon's "Inflation in Recession and Recovery," in the *Brookings Papers on Economic Activity, 1971,* Volume 1, pp. 105-158, especially p. 113; also see Otto Eckstein and Roger Brinner's *The Inflation Process in the United States,* a Study Prepared for the Use of the Joint Economic Committee, February 22, 1972, pp. 17-18. Both studies conclude that in the long run, the cost of increased real taxes is born by the worker, whose wage is dependent upon the marginal product of labor.

[49] Allen and Savage, "Inflation and the Income Tax," p. 72.

made for channeling additional resources to the government by such a method."[50] The indexing of the tax structure would help prevent real tax increases for workers and others in the population unless these taxes were legislatively enacted. The minimization of inflation would be aided by indexation. As former Deputy to the Secretary of the Treasury and Harvard University Professor Emeritus Dan Throop Smith has stated:

> " . . . if there is to be redistribution of the tax burden among income classes it should be recognized as such. It should not be accomplished unintentionally and certainly not unknowingly."[51]

[50] Fellner, *et. al., Correcting Taxes for Inflation,* p. 3.

[51] Dan Tl.roop Smith, "Progressive Income Taxation Discriminates Against Larger Incomes During Inflation," *Tax Review,* XXXVI (June 1975), p. 28.

3

How and What to Index

Dr. William J. Fellner, a former member of the President's Council of Economic Advisors, switched from being an opponent of indexing the tax system to a proponent of indexing. Noting the distorting effect of inflation on the tax structure, he declared in a 1975 speech:

> *The only systematic way of gradually removing these distortions would be to use an indexed tax system as the point of departure for any tax rate adjustments we may wish to make in the future.*[52]

What should be indexed? Supporters of indexation may desire a partial or a complete indexation of.the economy. A leading proponent, Milton Friedman, proposes a two part formula: escalator clauses which would be legislated for the federal government, but escalator clauses which would be voluntary for the rest of the economy. The latter approach would allow the removal of any legal barriers to the use of these clauses. He would favor the use of the cost-of-living index number calculated by the Bureau of Labor Statistics.[53] Noting that such items as Social Security payments and retirement benefits for federal employees have been put on an escalator basis, Friedman stresses that the key additional requirement is to adopt escalator clauses for the personal and corporate income tax and government securities. He suggests the following revisions in the current tax system:

The Personal tax

> *(1) The personal exemption, the standard deduction, and the low-income allowance should be expressed not as a given number of dollars, but as a given number of dollars multiplied by the ratio of a price index for the year in question to the index for the base year in which "indexation" starts. For example, if*

[52] William J. Fellner, "Why Indexed Tax Systems Provide the Needed Frame of Reference," inserted in the *Congressional Record* by Rep. Phil Crane (February 13, 1975), p. E870).

[53] Milton Friedman, "Monetary Correction," in *Essays on Inflation and Indexation,* pp. 35-36.

in the first year prices rise by 10 percent, then the present amounts should be multiplied by 110/100 or 1.10.

(2) The brackets in the tax tables should be adjusted similarly, so that, in the examples given, 0-$500 would become 0-$550, and so on.

(3) The base for calculating capital gains should be multiplied by the ratio of the price index in the year of sale to the price index in the year of purchase. This would prevent the taxing of non-existent, purely paper capital gains.

(4) The base for calculating depreciation on fixed capital assets should be adjusted in the same way as the base for calculating capital gains.

The Corporate tax

(1) The present $25,000 dividing line between normal tax and surtax should be replaced by that sum multiplied by a price index number.

(2) The cost of inventories used in sales should be adjusted to eliminate book profit (or losses) resulting from changes in prices between initial purchase and final sale.

(3) The base for calculating capital gains and depreciation of fixed capital assets should be adjusted as for the personal tax.

Government securities. Except for short-term bills and notes, all government securities should be issued in purchasing-power form. (For example, Series E bonds should promise a redemption value equal to the product of the face value calculated at, say, 3 percent per year and the ratio of the price index in the year of redemption to the price index in the year of purchase.) Coupon securities should carry coupons redeemable for the face amount multiplied by the relevant price ratio, and bear a maturity value equal to the face amount similarly multiplied by the relevant price ratio.[54]

Friedman defends this change as follows in both practical and moral terms:

These changes in taxes and in borrowing would reduce both the incentive for government to resort to inflation and the side effects of changes in the rate of inflation on the private economy. But they are called for also by elementary principles of ethics, justice, and representative government, which is why I propose making them permanent.[55]

[54] *Ibid.*, pp. 36-37.

[55] *Ibid.*, p. 37.

Henry Aaron, formerly a Senior Fellow in Economics at the Brookings Institution and presently Assistant Secretary of Health, Education and Welfare for Program Planning and Evaluation, set out four areas which must be considered in indexation: inventory costs must be inflated by the increase in the general price level; depreciation would have to be similarly adjusted; a firm would have to be taxed on the capital gains arising from the decline in the real value of net debt; an adjustment must be made for capital gains.[56] And Professor Dernburg recognizes that although indexing the bracket structure would be essential in eliminating inflation-caused distortions, additional tax reforms which need to be considered would be those relating to tax treatment of capital gains and taxing interest income.[57]

The essential items included in the Friedman proposal were incorporated in the measures introduced by Senator James L. Buckley (Conservative-Republican) of New York and Rep. Lawrence Coughlin (R-Pa.) during the 94th Congress. Indexation proposals, referred to as the "Cost of Living Adjustment Act," have been introduced in the U.S. House of Representatives in the 95th Congress by Members spanning the political and philosophical spectrum. Supporters on the Republican side of the aisle include Representatives Phil Crane (R-Ill.), Jack Kemp (R-N.Y.), George O'Brien (R-Ill.), Lawrence Coughlin (R-Pa.), and Philip E. Ruppe (R-Mich.); Democratic supporters include Representatives James H. Scheuer (D-N.Y.), Robert A. Roe (D-N.J.), Max Baucus (D-Mont.), Dawson Mathis (D-Ga.), and Dan Daniel (D-Va.). One of the earliest supporters of the measure was Rep. Phil Crane who introduced a tax indexing bill in the 93rd Congress.[58]

[56] Henry Aaron, *Inflation and the Income Tax,* p. 194.

[57] Dernburg, *Indexing the Income Tax,* pp. 3-4. He notes that the treatment of interest income is one of the worst problems from the standpoint of the low income savers. He observes that the operation of the tax law makes one wonder why a person saves at all.

[58] The "Cost of Living Adjustment Act," providing for indexing of the tax rates, has been introduced in the 95th Congress by Representatives Lawrence Coughlin (R-Pa.), H.R. 818, H.R. 2406, H.R. 2407, H.R. 3870, and H.R. 6808; Jack Kemp (R-N.Y.), H.R. 426, H.R. 8335; George M. O'Brien (R-Ill.), H.R. 1690; J. Kenneth Robinson (R-Va.), H.R. 656; Robert A. Roe (D-N.J.), H.R. 1206; and Philip E. Ruppe (R-Mich.), H.R. 3033. Members of the House who have joined as co-sponsors of such a measure include Representatives James Abdnor (R-S.D.), Robert E. Bauman (R-Md.), Max Baucus (D-Mont.), Clair W. Burgener (R-Calif.), Tim Lee Carter (R-Ky.), Thad Cochran (R-Miss.), Jim Collins (R-Tex.), Tom Corcoran (R-Ill.), Phil Crane (R-Ill.), Dan Daniel (D-Va.), William L. Dickinson (R-Ala.), Robert K. Dornan (R-Calif.), John J. Duncan (R-Tenn.), Robert W. Edgar (D-Pa.), Hamilton Fish Jr. (R-N.Y.), Walter Flowers (D-Ala.), Barry M. Goldwater Jr. (R-Calif.), William F. Goodling (R-Pa.), Charles E. Grassley (R-Iowa), William M. Ketchum (R-Calif.), Robert J. Lagomarsino (R-Calif.), Trent Lott (R-Miss.), James G. Martin (R-N.C.), Dawson

The idea of indexing or typing certain economic values to a rise in the cost of living is neither a new nor a unique idea. The approach can be traced back historically to early economists, especially in England. Noting the rise and fall in prices following the Napoleonic Wars, Milton Friedman identifies three leading writers in the 1820's and 1830's who studied the effects of inflation and urged a change in the standard of value in order to meet changes in the cost of living. These three—Joseph Lowe, G. Poulett Scrope, and G.R. Porter—began constructing an index of consumer prices.[59]

Indexation or escalator clauses have been applied, or are being applied in varying degrees, by other nations throughout the world in areas of wages and salaries, money and capital transactions, rents and leases, social insurance programs, life insurance programs, and taxation. The most notable recent example of indexation has been that of Brazil.[60]

However, the concept of indexation or the escalator clause has not been totally alien to the American experience. In the private sector, union contracts have contained cost of living clauses. Congress provided in 1975 for an automatic cost of living salary increase for Members of Congress and other federal employees. Thus, in areas where Congress does not have a conflict of interest (e.g., seeking extra tax revenues), the Congress has adopted cost of living benefits for themselves and the indexing mechanism for special transfer programs (e.g., Social Security, food stamps). Since inflation appears to be a continuing phenomenon, indexing is likely to be one of the options which will get more attention any time discussions arise on tax policy and tax reform.

The Congressional Budget Office undertook a study involving the effect of inflation on the federal budget and included analyses of how the prices of federal government expenditure items change when the price level changes, which programs are indexed for inflation and the

Mathis (D-Ga.), Clarence E. Miller (R-Ohio), Joe Moakley (D-Mass.), Stephen J. Neal (D-N.C.), Albert H. Quie (R-Minn.), Matthew J. Rinaldo (R-N.J.), Eldon Rudd (R-Ariz.), Ronald A. Sarasin (R-Conn.), James H. Scheuer (D-N.Y.), Richard T. Schulze (R-Pa.), Newton I. Steers (R-Md.), Charles Thone (R-Nebr.), David C. Treen (R-La.), Paul S. Trible Jr. (R-Va.), Guy Vander Jagt (R-Mich.), Robert S. Walker (R-Pa.), Charles Wilson (D-Tex.), and Larry Winn, Jr. (R-Kans.).

[59] Friedman, "Monetary Correction," in *Essays on Inflation and Indexation,* pp. 51-52. The author provides a detailed discussion from pp. 46-61 with a bibliography of sources.

[60] A status report of the attempts of various nations to use escalator clauses to meet inflationary cost of living problems is discussed by Herbert Giersch, "Index Causes and the Fight Against Inflation," in *Essays on Inflation and Indexation,* pp. 1-23, but see especially pp. 16-23. The same book also contains an informative chapter on the Brazilian experience: Alexandre Kafka, "Indexing for Inflation in Brazil," pp. 87-98.

effect of indexation, the effect on real expenditures during a period of high inflation, and which federal programs tend to gain and which ones tend to lose during inflationary times. The study reported that since all taxes are levied in current dollar terms, "almost all tax receipts are directly affected by inflation."[61]

This CBO analysis pointed out that in Fiscal Year 1975 approximately 63 per cent of all federal expenditures were completely indexed or quasi-indexed. Of this total the 28 per cent completely indexed included Social Security (Old Age, Survivors, and Disabled Insurance Trust Funds, OASDI), civil service and military retirement, supplemental social security income (SSI), food stamps, railroad retirement, and school lunch programs. The other 35 per cent were quasi-indexed by making government payments based on items whose prices increased at the same rate as the price level. The latter include programs adjusted on a cost basis like Medicare and those on a less rigid indexation provision such as federal pay. Noting that five-eighths of the programs in FY 75 were those programs which are adjusted automatically for increases in the price level, it nevertheless noted that spending on a large majority of the "non-indexed" programs had increased fast enough to leave their real size constant.[62] The following charts (Tables 2, 3 and 7) from the CBO study provide relevant information on the totally indexed programs, the quasi-indexed programs, and the real expenditures of ten non-indexed programs.[63]

A concern for the taxpayer and the increasing tax burden he must bear in inflationary times should lead Members of Congress to sacrifice the extra revenue from inflation-induced tax increases and provide fairness and equity to the already overburdened taxpayer. The Tax Foundation estimated that the average taxpayer in 1976 worked from January 1 to May 1, 1976 just in order to pay all taxes and on May 1, 1976, "Tax Freedom Day," the taxpayer began earning money for himself to pay other expenses. In his study, Professor Dernburg sums up the policy question in the following way:

> *The basic question comes down to whether it is best to respond to inflation (whatever its cause) with an automatic response that raises the aggregate tax rate, as is the case with the present system, or whether it is best to have a neutral response*

[61] *The Effect of Inflation on Federal Expenditures,* Background Paper No. 9 (June 18, 1976), Congressional Budget Office, (Washington, D.C.: U.S. Government Printing Office, 1976), pp. 1, 2, 13, 21.

[62] *Ibid.,* p. ix. See also reference by Dernburg, *Indexing the Individual Income Tax,* p. 1.

[63] *Ibid.,* pp. 7, 9, 17.

that keeps the aggregate tax rate constant and maintains proportionality between taxes and personal incomes when the price level changes.[64]

Table 2:

INDEXED PROGRAMS: BUDGET PERCENTAGES FOR FISCAL YEAR 1975 AND INFLATION SENSITIVITY ESTIMATES

	1975 Outlays (billion $)	1975 Outlays as Percent of Total	Inflation Sensitivity
Social Security (OASDI)	62.5	19.3%	1.00
Supplemental Security Income (SSI)	4.2	1.3%	1.00
Railroad Retirement	3.1	1.0%	.75
Federal Civilian Retirement	7.1	2.2%	1.30
Military Retired Pay	6.3	1.9%	1.30
Food Stamps	4.4	1.3%	1.00
Nutrition Program	2.1	0.6%	1.00
Total Indexed	89.7	27.6%	1.04

This is the inflation sensitivity after 2 years. The inflation sensitivity of some of these programs may be almost zero in a time interval of a year or less, due to lags in some indexation schemes, such as social security which represents a large proportion of the indexed programs.

Table 3:

QUASI-INDEXED PROGRAMS: INFLATION SENSITIVITIES AND BUDGET PERCENTAGES FOR FISCAL YEAR 1975

	1975 Outlays (billion $)	1975 Outlays as Percent of Total	Inflation Sensitivity
Medicare	14.5	4.5%	1.00
Medicaid	6.7	2.1%	1.00
Veterans' Medical Care	3.4	1.1%	1.00
Unemployment Insurance	13.5	4.1%	.75 - 1.00
Federal Civilian Pay	29.7	9.1%	.75 - 1.00
Military Pay	25.0	7.7%	.75 - 1.00
Offshore Oil Lease Receipts	-2.4	-.7%	2.8 - 14.0
Net Interest	23.3	7.2%	2.8 - 14.0
(Inflation Premium in Interest Payments Excluded)	—	—	(1.00)
Total Quasi-Indexed	113.6	35.0%	1.22 - 3.67
(Inflation Premium in Interest Payments Excluded)	—	—	(.85 - 1.00)

When two inflation sensitivity estimates appear, the first is the short-run (2 year) sensitivity, while the second is the long-run (3 or more years) sensitivity.

[64] Thomas F. Dernburg, *Indexing the Individual Income Tax,* p. 8.

Table 7:

REAL EXPENDITURES: TEN NONINDEXED PROGRAMS, FISCAL YEARS 1971-75 (Billions of 1972 dollars)

	1971	1972	1973	1974	1975
Defense Purchases	39.7	37.0	32.4	32.1	29.4
Veterans' Compensation	6.1	6.2	6.4	5.9	6.1
G.I. Bill	1.7	2.0	2.6	2.9	3.6
AFDC	3.2	3.7	3.7	3.6	3.6
Employment & Training	2.1	3.0	3.2	2.6	3.3
Housing Payments	0.8	1.1	1.6	1.6	1.8
Elementary & Secondary Education	3.9	4.1	3.6	3.5	4.0
Higher Education	1.6	1.5	1.5	1.3	1.7
EPA Construction Grants	0.6	0.4	0.7	1.4	1.4
Highway Construction	5.0	4.8	4.6	3.5	3.2
Total	64.7	63.8	60.3	58.4	58.1

Considering the plight of the taxpayer and the ravages of prolonged inflation, indexation of the tax system on a cost of living basis may be an idea whose time has come. The initiative on this matter remains with the Congress in its consideration of future tax legislation. As Representative Phil Crane has pointed out:

> *The Members of Congress and the Federal bureaucracy are the only group in the United States to profit from inflation. They are also the only group to control it and retain the power to limit it. For many years, they have enjoyed the benefits of increased real tax rates through the hidden taxes resulting from inflation, and at the same time unjustifiably received credit for occasional tax "reductions" which had the effect of restoring the former rate.*[65]

[65] Representative Phil Crane, "Tax Indexing: An Overdue Reform II," *Congressional Record,* (July 30, 1975), p. H7918.

4

Tax Indexing Objections

While most of this study has focused on arguments for indexing, there exist a number of arguments in opposition. Although these may be valid and effective objections, they, nevertheless, would not be significant enough to justify continuing an unindexed tax structure. Professor Thomas Dernburg noted that the arguments for indexing, once dismissed without debate, are receiving serious attention because of two factors: the belief that inequities created in the present tax system by steady and substantial inflation cannot go uncorrected and a realization that the impact of income indexation would be largely different and more complex than has been pictured in conventional economic textbooks. He adds that the question of whether to index or not to index raises three broad questions involving (1) the question of equity and a socially desirable distribution of income, (2) the size of the public sector versus the role of the private sector, and (3) the question of economic stability.[66] A look at the objections to indexing for inflation should help us to put the arguments in perspective.

A. Loss of Revenue

The charge is made that if the tax structure were to be indexed, the taxpayers might gain since they would not suffer inflationary tax increases, but the government would lose since there would be a reduction in income for the federal government. The major refutation of this objection is that the indexing does not cause a *loss* of revenues, but it merely *prevents* automatic real increases. We can only say that the increase is "loss" if it is assumed that the federal government has a right to inflation-induced increases in tax revenues in the absence of specific legislation raising taxes. Tax indexing does not prevent increases in taxes but it does prevent *automatic* increases. If the Congress feels that present revenue is not adequate to meet what they see as the needs of public policy in the federal budget and they wish to eliminate or reduce the deficit, they have the power to enact further increases. Yet, politicians benefit when inflation increases taxes and they can enact "tax cuts" or "tax rebates" which appear to the public

[66] Dernburg, *Indexing the Individual Income Tax*, p. 5.

to be a reduction in taxes; the tax reductions are only a part of the amount inflation has added to the tax bills of the taxpayers. The politicians get credit for additional spending programs *and* reductions in taxes while the taxpayer gets hit by a higher tax bill and inflation runs rampant in the economy. A call for tax indexing is actually a call for fiscal responsibility since an indexed tax system requires the Congress to control its spending or take the necessary actions to acquire additional funds (e.g., raising taxes) rather than resorting to a fraud on the taxpayers by acquiring additional revenues through unlegislated tax increases.[67]

B. Periodic Tax Cuts

Tax cuts are widely publicized, but in reality are these tax cuts really tax cuts? If recent tax cuts do nothing more than try to make up the harm resulting from automatic tax increases, wouldn't it be better to have Congress devote its time to more substantial issues than to work on a process which could be completed automatically? Opponents of indexing argue that Congress has the power to cut or reduce taxes. If inflation has caused exceptional problems, Congress could take care of the problem and it should not be by a system of automatic indexing. The political reason becomes obvious: legislated tax cuts are visible and widely publicized; inflationary tax increases are less visible and less publicized (until just recent times). Even with the publicity on inflationary-induced tax increases (though limited), it seems that the magnitude and the distorting effects of the increases for the entire economy are not widely recognized. It would be generally recognized that several billions of dollars of taxes on 1974 income were rebated but it would not generally be recognized that inflation during that year had *increased* taxes by roughly the same amount! Thus tax cuts by Congress, with resulting political benefits, are *not real* tax cuts but merely a restoration of the rate of taxation that existed before the government reaped the advantage of several years of inflation-generated increases. A distorted picture of Congressional tax policy is presented when the tax cuts are publicized but the constant inflation-induced increases are minimized by virtual non-recognition. Tax indexing offers the advantage of accountability—only legislated tax increases may occur, any tax cuts or rebates or reduction would be *real* reductions in taxes, and credit will be given to Congress only for *real and actual* decreases in the tax burden.

[67] In examining the case for indexing in the British economy, R.I.G. Allen and D. Savage note that it (indexing) would reduce "the size of fiscal drag precluding Chancellors from claiming that they have reduced the total burden of taxation when all they have done is to offset the automatic growth of tax receipts." *Inflation and the Personal Income Tax,* p. 72.

C. Stabilization of the Economy

Opponents of indexation argue that the automatic stabilization of inflation that is incorporated into a progressive tax system will be lost. They maintain that under a system where automatic real tax increases occur during an inflationary period, the increased tax will reduce aggregate consumption, and therefore reduce aggregate demand (of which consumption is a major component). There are several reasons why this objection to tax indexing lacks credibility.

First, it assumes that as taxes increase, the decreased aggregate consumption will not be offset by a concomitant increase in some other component of aggregate demand. They argue that minimization of inflation requires a reduction of aggregate demand. It is assumed by implication that the government will take in additional revenues and then refuse to spend them, for, if government spending (another component of aggregate demand) increases when it has additional resources to spend, no aggregate demand reduction will occur. The result then is merely a transfer of resources from private consumption to government use. Yet, the possibility that increased revenues will not be spent is unlikely.

Second, the opponent of indexing makes the assumption that increased demand in the private sector is the source of inflationary pressure. Yet, it is more plausible to argue as Milton Friedman and others do that inflation is generated by government spending and large deficits.[68] Proponents of indexing counter that higher taxation is a relatively inefficient way to control inflation and that considerable harm can be done to the economy when there are better ways to control inflation (e.g., reduction of expenditures by government, more restrictive monetary policy, etc.). The line of criticism by opponents of indexing seems to assume that inflation-generated tax increases can occur only when the economy is overheated and demand needs to be reduced. As pointed out earlier in this paper through various studies, the experience of the recent recession demonstrated that nominal income may rise though real income declines, and a whole series of problems results from inflation-induced tax increases which help distort the economy and may intensify the effects of a recession.

Thus, it is the push in the private sector for higher wages which results from the increase in taxes due to inflation. If this push continues, then the stabilization effect of the progressive income tax will be reduced significantly as the push in the private sector is to catch up with inflation, expected inflation, and inflationary tax increases.

[68] *Indexing and Inflation,* AEI Roundtable Discussion, (Washington, D.C.: American Enterprise Institute for Public Policy Research, 1974), pp. 18, 28-29, 48, 53-54.

Robert J. Gordon, Professor of Economics at Northwestern University, points out that the working man will gain by indexing since the gains on the way up when there is an inflationary surprise (e.g., increase in oil prices) will not be as great as gains on the way down since recessions are not going to be as long and layoffs and unemployment are not going to be that bad. He concludes that "indexing is a way of stabilizing the economy and reducing the impact on the ordinary person of those surprises that we are not going to be able to prevent."[69]

Another argument against indexing may come from those who would generally favor a reduction in federal programs and spending, namely, that by a system of indexing, the presumption is that inflation is going to be here and that such a system will avoid the real issue and cure for inflation—reduction of governmental expenditures. Proponents of indexing argue that inflation has been a serious problem recently and is likely to continue to be so, that despite inflation federal expenditures have increased, and that assuming reduced federal spending is a desirable goal, the whole economy and the taxpayers should not be continually penalized for the excesses of government. Indexing is promoted as a way to mitigate the harmful effects of inflation while seeking other avenues to reduce inflation in the economy. If there is little or no inflation, tax rates will remain the same; if inflation becomes a problem, then the taxpayer can be eased into the adjustment through indexation. Indexation provides an emergency relief for the individual taxpayer and the economy. Milton Friedman has pointed out that in a world where inflation is 1 percent, 2 percent, or even 3 percent, it is unlikely that widespread indexation could improve matters. Yet, he observes that the world we are experiencing has inflation rates of 10 or 12 percent over a short period and in other countries inflation rates over 20 percent. He added:

> *We're talking about a world in which there is very large inflation, and in such a world, even an imperfect and crude adjustment for inflation is better than no adjustment.*[70]

The arguments for and against indexing the American economy rest on certain basic policy assumptions and goals. Although the issue may find Conservatives and Liberals on both sides of the issue, it is generally true that more Conservatives would support indexing and more Liberals would oppose it. Professor Dernberg sums up the policy arguments from the two philosophical polls as follows.

> *Conservatives have been greatly disturbed by this characteristic of the revenue system. They protest that the*

[69] *Ibid.*, pp. 53-54.

[70] *Indexing and Inflation,* p. 32.

unindexed tax structure supplies government with an "inflation bonus" of additional revenue, and that politicians are quite likely to develop a taste for inflation because the added revenue it yields averts the necessity of voting for politically unpopular discretionary tax increases to finance new and expanded expenditure programs.

Against this view is the liberal position that Congress finds it difficult to raise taxes and that the high responsiveness (or elasticity) of the revenue system with respect to both real and nominal income growth is the salvation that generates the revenues that finance growing social needs. Such persons feel that the "fiscal dividend" which is provided by growth of revenue should be preserved to make room for new initiatives. Indexing of the income tax would eliminate that part of the dividend that arises from inflation (although it would not eliminate that part that arises from real economic growth), and would therefore narrow the scope for the expansion of government services.[71]

D. Inflation, Taxes, and the Carter Program

President Carter submitted his economic stimulus plan to the Congress for quick action in early 1977 with the promise that a more comprehensive plan for extensive tax reform would be submitted later to the 95th Congress. Yet, the extension of certain individual and corporation tax cuts passed in 1976 (even with the defeat of the $50 tax rebate) could only provide temporary relief—and relief of a questionable value for a long range economic growth.

The Tax Reduction and Simplification Act (Public Law 95-30), signed by the President on May 23, 1977, failed to address the real problem of inflation-induced tax increases. While questioning the need for an economic stimulus plan and the resulting increase in the deficit from the tax reduction package, the minority report of Ways and Means Committee members stressed that if an economic stimulus is necessary, it would be better to cut individual taxes for all Americans on a permanent basis since this action "would help offset the effects inflation has had in increasing taxes (and decreasing purchasing power) of all Americans."[72] Roland M. Bixler, who testified

[71] Dernburg, *Indexing the Individual Income Tax,* p. 5.

[72] *Tax Reduction and Simplification Act of 1977,* Report of the Committee on Ways and Means, Report No. 95-27, p.154. The minority views were signed by Representatives Barber B. Conable Jr. (R-N.Y.), William M. Ketchum (R-Calif.), William A. Steiger (R-Wisc.), Bill Frenzel (R-Minn.), Bill Gradison (R-Ohio), Bill Archer (R-Tex.), Jim Martin (R-N.C.), and Guy Vander Jagt (R-Mich.). Minority views are on pages 153-155 with supplemental views on pages 157-165.

before the Ways and Means Committee in February of 1977 representing the National Association of Manufacturers, criticized the Carter Administration approach and urged a less restrictive but reasonably stable tax policy. Bixler declared:

> *Inflation has reduced purchasing power of individuals at all income levels, and other economic dislocations have affected many in the middle income classes . . . But continual emphasis on income redistribution and shrinkage of the tax base through low-income allowances and increases in the standard deduction seem inappropriate in legislation designed primarily to help get the economy moving.*[73]

Dr. Milton Friedman has been especially critical of the approach of the Tax Reduction and Simplification Act. He observes that it will be the American people who will have to bear the burden of the resulting federal deficits which will be increased by this tax package. Friedman states:

> *It's paid in the form of the hidden tax of inflation or, if it's financed by borrowing from the public, then in the form of higher taxes that will be needed in the future to pay the interest and the principal. That means that it lowers the value of all property today to the extent that property will be subject to higher future tax burdens.*[74]

As an alternative approach, Friedman proposes having the Federal Reserve reduce the rate of monetary growth, cutting all governmental spending by ten per cent across the board, and indexing personal and corporate income taxes. On this latter proposal he adds:

> *That would keep inflation from automatically driving taxes up and be far more effective than the measures Mr. Carter and others have proposed. Congress has been very prompt in protecting its own salaries against inflation. It has done nothing to protect the public . . . The only way Congress can spend more without appearing to raise taxes is through inflation.*[75]

[73] Roland M. Bixler, "Tax Policy and Economic Stimulus," p. 3.

[74] "Where Carter is Going Wrong: Interview with Nobel Prize Winner Milton Friedman," *U.S. News and World Report,* LXXXII (March 7, 1977), p. 20.

[75] *Ibid.,* p. 21.

It is still the decision of those serving in Congress on how to deal with the problem of inflation and the effect on the taxpayers. Newspaper columnist Hobart Rowen contrasted the approach toward tax reform of Joseph A. Pechman, Director of Economic Studies at Brookings Institution and a tax expert, who favors a broadening of the tax base by closing so-called loopholes, with that of William Fellner, presently Resident Scholar with the American Enterprise Institute, who favors indexing the tax system through boosting the exemptions, credits, and the lower and upper limit of each tax bracket by the amount of inflation. While Pechman opposes indexing because he believes it would ensure and accelerate inflation, Fellner maintains that the uncertainty created by the effects of inflation is a cloud hanging over the stock market and future business decisions. Hints of what is likely to be contained in the Carter Administration's tax reform package appear to be closer to the Pechman view than the Fellner view. Observing that the overtaxation resulting from inflation "is a problem that the administration brushes off, but it won't go away," Rowen concludes by stressing that, despite any effort by the Carter Administration to alleviate double taxation of dividends and improvements in the business tax structure, "inflation will continue to have as much to do with the real taxes we pay as any changes evolving through tax reform."[76] Reviewing the whole problem of the future of the U.S. economy, Fellner urges that inflation be reduced to insignificance (similar to the rate in the 1951-1965 period in the United States) and that correcting the tax structure for inflation should be separated from structural changes which would fall under the heading of tax reform proper.[77]

[76] Hobart Rowen, "A Turning Point on Tax Reform?," *The Washington Post*, September 22, 1977. Rowen quotes an illustrative example provided by the First National City Bank to show how inflation causes taxes to be levied at higher marginal rates as income rises with inflation. Assuming that a family of four (earning $15,000 in 1955) had increases in income to match inflation exactly over the resulting twenty-one years, the family would have earnings of $32,900 in 1976 or a gain of 120 percent. Yet, this same family would have been moved from a tax bracket of 22 percent fo 36 percent increasing its tax bill from $1,540 to $6,600 or an increase of 330 percent. Assessing the entire situation, the family in terms of real income was 11 percent worse off in 1976 than they were in 1955.

[77] William Fellner, "Money Supply and the Budget: Current and Future Problems of Demand Management," pp. 113, 116, in William Fellner (ed.), *Contemporary Economic Problems 1977* (Washington, D.C.: American Enterprise Institute for Public Policy Research, 1977). Fellner estimates that the cost of correcting taxes for inflation in Fiscal Year 1978 would be not more expensive than the proposals for tax cuts and additions to public employment expenditures (e.g., $20 billion) proposed by the Carter Administration. He bases this estimate on a five percent inflationary rate in FY 78 and on the assumption that a ten percent inflation rate raises the intake of federal individual income tax by sixteen percent. The adjustment for individual income tax would be about $6 billion with about $13 billion accounting for inflation adjustment of corporation taxes and the extra cost of the adjustment of capital gains taxes.
Ibid., pp. 112-113.

Conclusion

The American public has shown a greater awareness of taxation as the burden has become heavier and heavier. In 1953, the average family had an income of $5,000 and paid 11.8 percent of it in direct taxes of all kinds—federal, state and local, federal Social Security, state and local sales taxes and local property taxes. According to the Advisory Commission on Intergovernmental Relations, the average family income had risen to $14,000 by 1975 with taxes taking a total of 22.7 percent of income—nearly twice the amount taken in the 1950's.[78] The problem of inflation has contributed to making this tax load even more burdensome. Despite pay increases, the taxpayer feels he is on a treadmill—that despite gains, he can never really get ahead of inflationary pressures and may even be losing ground.

Table 9 reveals the direct tax burdens borne by average and upper income families from 1953 through 1975.

A thorough study of the issue reveals indexation of the tax system to be a viable option to protect the American people from inflation- induced tax increases. The continuing problems of inflation, and prospects of future escalation of inflation, may bring the indexation proposal under more serious discussion. Already an increasing number of Members of Congress from both political parties, public officials, economists, and policy analysts are expressing increasing interest and support for the proposal.

Professor Dernburg has succinctly stated what the operation of an indexed tax system would accomplish:

> *An inflation corrected or indexed tax is one whose real revenue yield and progressivity is independent of the rate of inflation. Put differently, if a tax is fully indexed, the average rate of tax for individuals or firms will remain unchanged if the real value of the base of the tax remain unchanged. This means as well that in the aggregate the average rate of tax would remain constant, and the share of national income yielded by the tax would remain fixed.*[79]

[78] Peter Milius, "The 'Cheapest of All Taxes' Still Hurts," *The Washington Post,* (April 15, 1977), p. 1.

[79] Dernburg, *Indexing The Individual Income Tax,* p. 4.

DIRECT TAX BURDENS BORNE BY AVERAGE AND UPPER-INCOME FAMILIES, 1953 and 1975

Type of Tax	Family with Average Income			Family With Twice Average Income			Family With Four Times Average Income		
	Tax as Percent Of Family Income		Percent Increase 1953-1975	Tax as Percent Of Family Income		Percent Increase 1953-1975	Tax as Percent Of Family Income		Percent Increase 1953-1975
	1953	1975		1953	1975		1953	1975	
Total	**11.8**	**22.7**	**92.4**	**16.5**	**24.6**	**49.1**	**20.2**	**29.5**	**46.0**
Federal personal income tax	7.6	9.6	26.3	12.8	14.7	14.8	16.6	21.1	27.1
Social Security tax	1.1.	5.9	436.4	0.5	2.9	480.0	0.3	1.5	400.0
Local residential property	2.2	4.0	81.8	1.8	3.2	77.8	1.7	2.5	47.1
State-local personal income	0.3	1.9	533.3	0.9	2.9	222.2	1.2	3.7	208.3
State-local general sales	0.6	1.3	116.7	0.5	0.9	80.0	0.4	0.7	75.0

Estimates for average family earning $5,000 in 1953 and $14,000 in 1975 assuming all income from wages and salaries and earned by one spouse

Estimate for twice the average family. Family earning $10,000 in 1953 and $28,000 in 1975 and assumes that earnings include $105 (interest on state and local debt and excludable dividends) in 1975 and $25 in 1953; also assumes the inclusion of net long-term capital gains of $1,040 in 1975 and $350 in 1953.

Estimates for four times the average family. Family earning $20,000 in 1953 and $56,000 in 1975 and assumes that earnings include $965 (interest on state and local debt and excludable dividends) in 1975 and $265 in 1953; also assumes the inclusion of net long-term capital gains of $6,400 in 1975 and $1,730 in 1953.

Source: Advisory commission on Intergovernmental Relations.

The legislation which would bring about tax indexation, the "Cost of Living Adjustment Act," had been introduced, but only a concerned citizenry and a more concerned Congress will be able to enact this measure to aid the taxpayer to bear the burden of inflation in the tax system and remove, or at least mitigate, the distorting effect of inflation on the American economy. The prospect of public hearings in the House of Representatives and Senate on tax reform proposals in 1978 should be the proper forum for a thorough discussion of the need to index our present tax system.

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