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TAX INDEXING: AT LAST A BREAK FOR THE LITTLE GUY

INTRODUCTION

During the 1970s, bracket creep became U.S. taxpayers' enemy No. 1. Even if workers received pay raises keeping up with inflation, real after-tax wages declined since many were pushed into higher tax brackets. The taxpayer found himself on an accelerating tax treadmill. Average- and lower-income Americans routinely faced tax rates once reserved for the rich. While only some 3 percent of taxpayers faced marginal tax rates of 30 percent or above in 1960, by 1981 bracket creep had shoved 34 percent of them up to the 30 percent level or higher.

Finally something was done about bracket creep. The Economic Recovery Tax Act (ERTA) of 1981 provides that all tax rate brackets, the zero bracket amount (formerly the standard deduction) and personal exemptions are to be indexed for inflation, beginning in 1985. No longer will taxpayers be pushed into higher tax brackets simply because inflation increases their nominal income. Bracket creep in effect was to be buried.

Now, some in Congress are having second thoughts and want to repeal the measure, before it even begins. They want to perpetuate bracket creep and, with it, their power to tax by the backdoor and enable the government to profit from inflation-causing programs. Without indexing, every 10 percent inflation will give the government a 17 percent tax windfall. Paying for this, of course, will be the American taxpayer, particularly average Americans and the working poor. They have been the most hurt over the last decade as inflation has pushed them into higher tax brackets. They would be the most hurt should indexing be eliminated.

About 80 percent of the relief generated by tax indexing benefits taxpayers earning less than $50,000 a year. Those taxpayers making above $200,000 a year will get only about 1.2 percent of the tax relief. If Congress repeals indexing, the tax liability of the lowest-income Americans would increase in one year by ten times the percentage increase of the highest income groups. The $10,000 bracket would face a 14 percent hike in the first year alone, but the $200,000 income groups would pay only about 1.3 percent higher taxes.

Even with moderate inflation the tax liability of the lowest income bracket would be 60 percent higher in 1988 than it would be with indexing. This would be balancing the budget on the backs of average Americans and the working poor. Repeal of indexing, according to a Department of Treasury study, essentially would eliminate the 25 percent income tax reductions for all taxpayers except the very rich by 1989. Tax rates on every income family, except the rich, would rise to record highs in only a few years. In short, indexing is a break for the average American taxpayer. To repeal indexing is to penalize the working man and woman.

The campaign by some members of Congress to repeal indexing would nullify probably the most important tax reform provision of the Reagan economic program. This program, designed to stimulate the economy by allowing individuals to keep and save more of what they earn, is a complex mosaic. Among its many components:

1. Private Capital Formation. Reducing the top rate of tax on individuals from 70 percent to 50 percent and expanding the eligibility for IRAs and Keoghs were moves designed to increase the capital available for new enterprises and investment. These measures have already boosted confidence for business startups and generated tangible economic benefits: the savings rate has surged 30 percent to 6.9 percent of disposable personal income in the third quarter of 1982, the stock market is at a record high, funds in IRAs and Keoghs have nearly doubled in just one year, and the venture capital industry has grown rapidly.[1]

2. Business Tax Reform. Accelerating and simplifying the depreciation allowances available for machine tools and other capital equipment was enacted to spur American business to invest in new factory equipment and tools. Although about 70 percent of the 1981 business tax cuts were repealed in last summer's tax hike package, American business is still expected to enjoy a vigorous recovery and begin to hike capital investment significantly. As it was, despite the severe recession, business and industrial outlays for capital equipment (after an inflation adjustment) shrunk only one-third of the amount experienced in the 1974-1975 economic downturn.

3. Tax Relief for Lower and Middle Income Americans. The 25 percent income tax cut and tax indexing provide average and

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1 See Thomas Humbert, "Reaganomics: Making Gains," Heritage Foundation Backgrounder #239, January 21, 1983.

working Americans with much needed relief after nearly two decades of skyrocketing taxation. When indexing begins in 1985, it will force the government to tax openly and deliberately and to stimulate work, savings, and jobs by lowering marginal tax rates.

Those aspects of the Reagan tax strategy that took effect during the first twelve months--the capital formation initiatives and the business tax cuts--generally provided corporations and upper-bracket Americans with the lion's share of the benefits. Of course, even these early provisions generate important benefits for a broad range of income groups as a quickened pace of investment and saving activity stimulates economic growth. But the remainder of the program--and especially tax bracket indexing--is targeted directly at the grass-roots taxpayer. It is this group that will gain the most from the ten percent tax cut scheduled for July. And it is this group that will be the primary beneficiaries when individual tax brackets are indexed to the rate of inflation. Only the 1983 income tax cut and indexing will save average and working Americans from the highest tax burden in history.

THE IMPORTANCE OF INDEXING

Bracket Creep is a Hidden Tax. Bracket creep is a hidden tax, requiring no action by Congress. Example: Under the terms of the 1984 tax code and without indexing,[2] a family of four making $25,000 a year in 1984 would have to make $27,500 one year later to earn the same pre-tax real income. With $27,500, the family's real income is effectively the same, but its tax bill increases from $1,621 to $1,953. Although the family's income has grown by 10 percent, bracket creep increases its federal taxes by over 20 percent. The family faces a marginal tax rate of 18 percent compared with the 16 percent it faced before, and its average tax rate has jumped from 6.5 percent to 7.1 percent.

If the family's taxes had remained constant with inflation, it would have paid $1,783, instead of the $1,953. As such, even though pre-tax income kept abreast of inflation, the family's real after-tax purchasing power was reduced by $170. This represents an inflation tax, and the taxpayer's loss becomes the government's gain. In this case, the 10 percent inflation raised government revenues over 20 percent. In the aggregate, for all income classes, a 10 percent increase in inflation generates a 17 percent increase in government revenues.[3] The higher the inflation rate, the higher the inflation tax.

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2 This example is based on the 1984 tax code and assumes that the third year of the tax cut is not repealed. The calculations are based on a family of four with all income from wages and salaries and no tax preferences or adjustments to income. Itemized deductions are assumed to be 23 percent of income.

3 The 1983 Joint Economic Report on the February 1983 Economic Report of the President, Joint Economic Committee, March 3, 1983.

Indexing would eliminate this inflation tax by adjusting both the top and bottom amounts of each tax bracket according to the inflation rate. The zero bracket amount (formerly the standard deduction) and the personal exemption also would be increased by the inflation rate. After indexing takes effect, every 10 percent increase in inflation would increase tax revenues by only 10 percent rather than 17 percent. In the case above, indexing would have ensured that the family's real after-tax income was unaffected by inflation--its marginal and average tax rates would be unaltered.

Indexing Helps the Lower-Paid. Taxpayers in the lowest income categories suffer most from inflation and, accordingly, will benefit disproportionately from indexing. The reasons:

1) with so many upper-income Americans now in the maximum tax bracket of 50 percent, bracket creep is of importance only to middle- and lower-income taxpayers;

2) changes in marginal tax rates are more frequent in lower-income categories, especially $15,000-$30,000, than in higher ones;

3) movement from one income tax bracket to another is more common at lower-income levels because the width of the brackets increases as income rises;

4) the zero bracket amount and personal exemptions erode in value as inflation rises, unlike most itemized deductions used by higher income groups.

Although all Americans are hurt by bracket creep, the effect is less at higher incomes. In a year of 8 percent inflation, for instance, the average tax bite increases by a high of 26 percent for the $12,000 income earner, to just 9.6 percent for taxpayers making $150,000.

The inflation tax accelerates over time, much like compound interest. As Chart I shows, ten years of 8 percent inflation would increase the taxes of Americans by between 130 and 430 percent, with the largest tax increases reserved for lower incomes, while money incomes would have increased over the same period by just 116 percent. Taxes for all income brackets increase by more than ten times the one-year increase. Taxes on the $18,000 income bracket, for example, increase 16½ percent in one year of 8 percent inflation, but taxes over ten years under such an inflation rate increase by 33 percent--twenty times the first year's tax hike.

With the inflation rate in the 1970s averaging about 6.5 percent a year, tax liabilities increased substantially for all income levels. On the average, taxes increased by 1.7 times faster than the inflation rate. Because of this, the nine major tax reductions enacted by Congress in the 1960s and 1970s did not reduce taxes at all. They simply offset about half of the cumulative tax increase due to inflation. While Congress claimed credit for cutting taxes, it actually was collecting tax windfalls from inflation. With this windfall, it enacted more programs and bloated the federal bureaucracy.

These skyrocketing taxes have exacted a heavy punishment on enterprise, investment, and saving. Why work, invest, or save when the government takes such a large chunk of profits or wages? It is no wonder that the American economy began sputtering and eventually fell into the worst recession in four decades.

CHART 1
Percentage increases in federal income taxes due to salary increases and the portions of the increases due to bracket creep
(8% annual inflation rate)

Initial salary	Increase in federal tax	Portion due to bracket creep
Part A -- after an interval of 1 year		
$ 12,000	25.8%	68.9%
15,000	18.1	55.8
18,000	16.5	51.6
21,000	16.3	51.0
24,000	16.7	52.0
27,000	15.8	49.3
30,000	15.5	48.4
50,000	15.3	47.7
100,000	10.6	24.7
150,000	9.6	16.4
Part B -- after an interval of 10 years		
$ 12,000	438.1%	73.5%
15,000	361.5	67.9
18,000	337.1	65.6
21,000	332.2	65.1
24,000	325.8	64.4
27,000	316.8	63.4
30,000	305.7	62.1
50,000	224.9	48.5
100,000	153.8	24.6
150,000	138.7	16.4

Source: Journal of Accountancy, January 1982.

THE IMPACT OF REPEALING INDEXING

Indexing was designed to arrest the steep climb of marginal tax rates with its damaging effects on incentives and enterprise. Indexing is, in effect, the most significant achievement of the taxpayer's revolt, representing the most far-reaching tax reform for the lower-bracket taxpayer--the little guy--in the past two decades. It is a guarantee that Washington no longer will take a bigger tax bite out of the workingman's paycheck just because inflation increases nominal income.

CHART II
The Effect of Repealing Indexing,
Distributed by Adjusted Gross Income Class
(1981 Levels, 1984 Law)

Adjusted gross income class	Share of all taxes paid as of 1984	Share of benefits dues indexing (assuming 4.5 percent inflation)
($000)	(percent)	(percent)
Less than 10	2.1%	6.5%
10 - 15	5.8	7.4
15 - 20	8.1	9.2
20 - 30	20.7	22.2
30 - 50	29.9	32.4
50 - 100	17.7	16.3
100 - 200	8.6	4.8
200 and over	7.1	1.2
Total	100.0%	100.0%

Source: Office of the Secretary of the Treasury
Office of Tax Analysis

With inflation expected to range betwen 4 and 5 percent a year after 1985, indexing will give taxpayers about $98 billion in relief from the inflation tax between 1985 and 1988. Taxpayers making below $50,000 a year will receive the lion's share of the relief--about $78 billion. Currently, this group pays about two-thirds of all income taxes and will receive about 80 percent of the tax relief from indexing. Taxpayers earning below $15,000 contribute 7.9 percent of the total taxes, but will receive 13.9 percent of the benefits from indexing. The wealthy, on the other hand, will receive much smaller benefits. Just 1.2 percent of the tax relief from indexing will go to taxpayers making $200,000 or more, although they contribute 7.1 percent of total taxes (see Chart II).

If Congress repeals tax indexing, the tax liability of low- and middle-income Americans would increase in the first year by a far greater percentage than that of Americans with income over $50,000. After only one year of an unindexed tax code, a wage earner making $10,000 would pay 14 percent higher taxes; the $30,000 tax bracket, 3 percent higher taxes; and the $200,000 bracket, only 1.3 percent higher (see Chart III).

This would occur in the first year. After four unindexed years, Americans, especially lower-income groups, would face even higher average and marginal taxes. Without indexing, taxes on the $0 to $5,000 income class would be 60 percent higher in 1988 than with indexing; taxes on the $15,000 to $20,000 income group would be 14 percent higher; taxes for the $200,000 to $500,000 group would be just 3 percent higher. The overall taxpayer liability, if indexing were repealed, would increase by 3 percent in 1985, 6.5 percent in 1986, almost 9 percent in 1987, and over 11 percent in 1988.[4]

Chart III
Change in Income Tax Liability Due to Repealing
the Indexing Provision Enacted in ERTA
(Four-Person, One-Earner Family)

(dollars)

Income	Tax liability under 1984 law	Change in tax liability due to repealing indexing	
		Amount	Percentage
$10,000	$ 291	$ 41	14.1%
20,000	1,549	41	2.7
30,000	3,003	94	3.1
40,000	4,874	169	3.5
50,000	7,165	249	3.5
100,000	22,056	463	2.1
200,000	58,190	777	1.3

Source: Office of the Secretary of the Treasury
Office of Tax Analysis

Note: Tax liabilities are calculated assuming that deductible expenses equal 23 percent of gross income and that all income is wages.

Repeal of indexing would mean an enormous increase in taxes. The median income family of four, earning $24,000 in 1982, would pay $1,000 in additional taxes between 1985 and 1988 if indexing were repealed. As Chart IV shows, the family's average tax rate would increase from 9.17 percent in 1984 to 10.41 percent by 1988. This means that the Reagan tax cuts would be wiped out after only four years of moderate inflation. Only the rich would stay ahead of the game.

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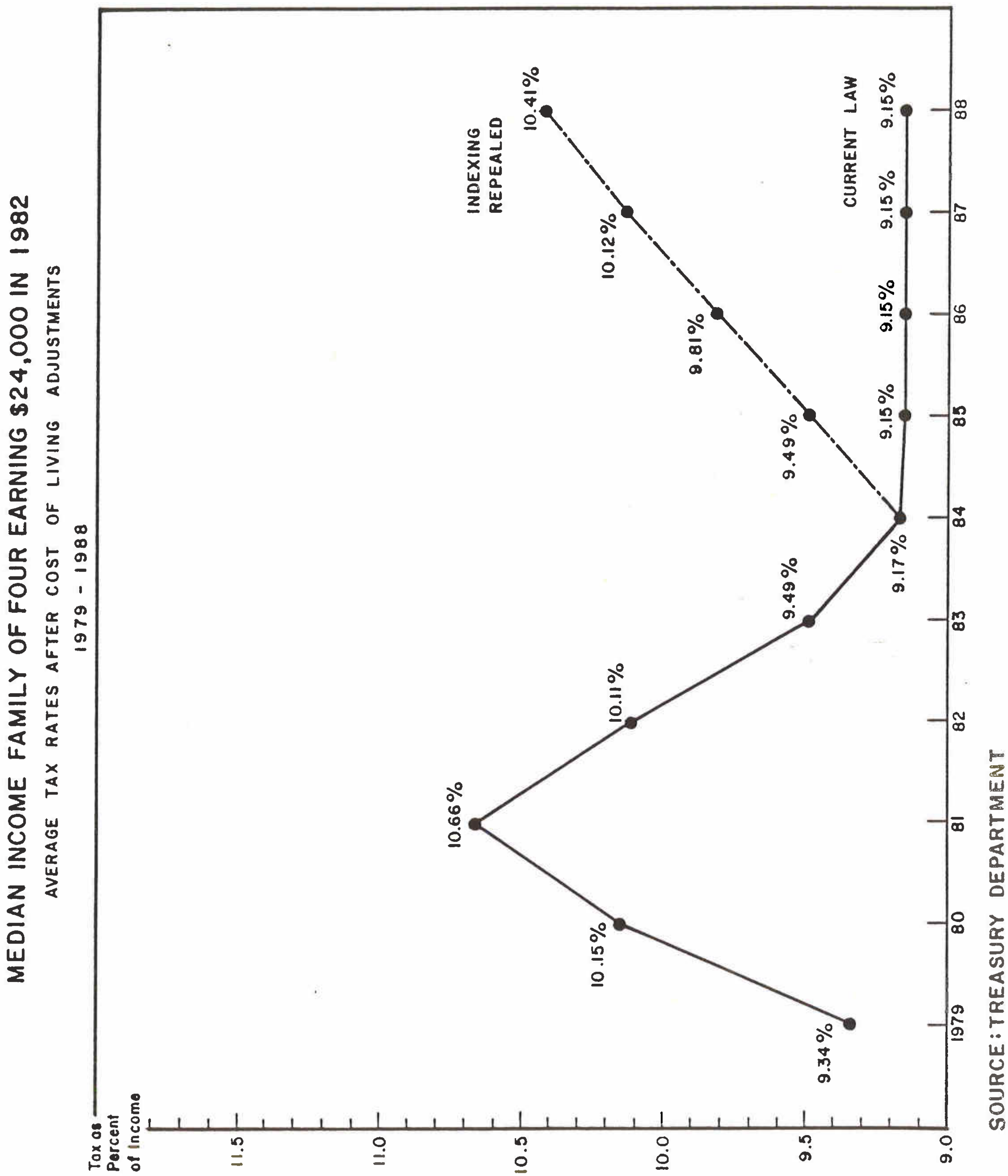
4 Figures are 1982 adjusted gross income levels, and 1984 law.

CHART V


MEDIAN INCOME FAMILY OF FOUR EARNING $24,000 IN 1982
AVERAGE TAX RATES AFTER COST OF LIVING ADJUSTMENTS
1979 - 1988
Tax as Percent of Income
11.5
11.0
10.5
10.0
9.5
9.0
1979
80
81
82
83
84
85
86
87
88
9.34%
10.15%
10.66%
10.11%
9.49%
9.17%
9.15%
9.15%
9.15%
9.15%
9.49%
9.81%
10.12%
10.41%
INDEXING REPEALED
CURRENT LAW
SOURCE: TREASURY DEPARTMENT

THE OBJECTIONS TO INDEXING

Deficits

Opponents argue that indexing will contribute to the burgeoning budget deficit. Some even claim that the U.S. is an undertaxed society. Yet indexing would not prevent Congress from increasing taxes if needed. It simply assures that legislators must go on record and vote for hikes, rather than simply depend on inflation to do it for them. And even with indexing and the Reagan tax cuts, taxes will not decrease. At best, they will remain at 1981's historically high levels, thanks to bracket creep, new social security taxes, and the 1982 tax bill hike, which, combined, will wipe out most of Reagan's $600 billion tax relief measure of 1981.

Without the Reagan tax cuts, of course, things would be much worse. Marginal tax rates would be from 4 to 10 percentage points higher, and tax revenues as a percentage of GNP would be up 3 to 4 percentage points. But even with the Reagan cuts, Americans in all income bracket will pay about the same percentage of their income in 1988 as they did in 1981. Chart V indicates that those in the half median income bracket, for example, in 1981 paid 20.11 percent of their income for income and social security taxes and will pay an estimated 20.9 percent in 1988. No tax cut there. The median income taxpayer paid 25 percent of income in income and social security taxes in 1981, and will still pay 24.74 percent in 1988. The twice median income earner goes from 26.87 percent in 1981 to about 25.83 by 1988. This hardly amounts to a huge tax cut. Clearly, the Reagan tax cuts are not causing the deficit-- because taxes have not been cut very much.

Chart V
Average Tax Rates Under FICA and Individual Income Tax

	half median	median	twice median
1980	18.28	23.68	24.77
1981	20.11	25.09	26.87
1985	20.60	24.36	25.24
1988	20.92	24.74	25.83

Source: Office of the Secretary of Treasury, Office of Tax Analysis

Inflation

Opponents of indexing claim that, if taxpayers are protected from the harmful effects of inflation induced bracket creep, the resolve to fight inflation will weaken. Indexing supporters counter that the reverse is true. Without indexing, the government has an incentive to encourage inflation since it receives the tax windfall from bracket creep. Indexing takes away this incentive by eliminating the windfalls.

CONCLUSION

Indexing provides, at long last, a tax break for the little guy. It introduces an extraordinary measure of fairness into the U.S. tax system. Indexing also preserves the integrity of the American democratic process. It means that if Congress desires higher taxes, each member must go on record and vote to increase taxes openly and deliberately. No longer can Congress depend on the subterfuge of bracket creep to raise taxes silently.

Indexing does not mandate a level of government spending nor does it freeze revenues at a specific level. It is simply a procedural reform to guarantee tax honesty by the nation's legislators. The integrity of American democratic institutions and elementary notions of fairness are at stake.

Yet some Republicans and Democrats want to eliminate indexing--ironically, in the name of fairness. But is it fairness when tax rates once reserved for the rich are imposed on middle- and even lower-income taxpayers? Is it fair that the federal government gains from inflation at the expense of those American working men and women least able to pay? Is it fair that Congress can raise taxes without recording a vote? Is it fair that Congressmen claim credit for cutting taxes when they are simply returning some of the revenue bonus from the inflation tax? Of course not. If Congress repeals indexing, it will overturn one of the fairest and most beneficial tax reforms in recent U.S. history. The little guy needs a tax break. Congress and President Reagan gave it to him in 1981. It would be unfair for Congress to take it back.

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