

AN INFORMATION REPORT

THE INFLATION TAX:

**The Case for
Indexing
Federal and State
Income Taxes**

Advisory Commission
on
Intergovernmental
Relations

WASHINGTON, D.C. 20575

JANUARY 1980



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Preface

When the Advisory Commission on Intergovernmental Relations first studied the effect of inflation on income tax burdens in 1976,¹ little consideration had been given to the matter in this country because the United States historically had not suffered from prolonged high rates of inflation. The Commission, however, found what it felt was a serious and growing problem. Namely, inflation automatically interacts with the progressive income tax systems of the federal government and of most states to increase personal income tax burdens at a faster rate than inflation. This not only makes it difficult for taxpayers to keep up with inflation, but it allows the government to receive windfall revenue gains without the Congress or state legislature overtly voting a tax increase. For several reasons, including prospects for continued rapid inflation, the Commission recommended that the federal and state governments index their personal income taxes for inflation—i.e., annually adjust the fixed-dollar features of the tax code, such as the personal exemptions, standard deduction, and income brackets, by the rate of inflation—to prevent the automatic, unlegislated “inflation tax” increases that would otherwise result.

While indexing the tax code for inflation may not yet be a household discussion topic, it has certainly captured the attention of a number of Americans and become a “front burner” political and economic issue since 1976. A majority

(57%) of the persons surveyed in a recent Roper Organization poll indicated that they preferred building an automatic inflation adjustment factor into the tax system—i.e., indexing—over periodic tax cuts as a means of controlling the effect of inflation on income taxes.² In addition, six states—Arizona, California, Colorado, Iowa, Minnesota, and Wisconsin—have enacted measures to index their personal income taxes in the last two years, and a dozen other state legislatures considered such bills in 1979. At the national level, a measure to index the capital gains tax was overwhelmingly approved by the House of Representatives, and two bills indexing the individual income tax were narrowly defeated in the Congressional tax-writing committees last year. Several indexation proposals have been re-introduced in the 96th Congress, one of which (H.R. 365) has attracted over 120 co-sponsors.

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The burgeoning interest in indexation is attributable to two factors that promise to make it a major issue as the U.S. moves into the 1980's. First, citizens want lower taxes and greater fiscal responsibility at all levels of government, as evidenced by the current drive for a balanced federal budget and the passage of California's Proposition 13 and similar measures in other states. Second, the U.S. continues to experience one of the most severe inflationary periods in its history. The Consumer Price Index has risen an average of 7.6% per year since 1972, and 1979 bodes to be the first double-digit inflation

year since 1974 as prices increased at more than a 13% annual rate through the first eight months of the year.

Continued high rates of inflation will fuel the flames of the "taxpayers' revolt" and make it imperative that government respond in an effective and equitable manner. Indexing state and federal personal income taxes has been supported by the ACIR and others as a way of relieving tax burdens and instilling greater fiscal responsibility.

The purpose of this report is to advance the discussion of the "inflation tax" and present the case for indexation. To this end, it attempts to answer three major questions:

1. What is the effect of inflation on federal and state income tax burdens?
2. What are the major arguments in support of indexing personal income taxes for inflation?
3. What are the major objections to this approach, and how can they be answered?

FOOTNOTES

¹ See ACIR, *Inflation and Federal and State Income Taxes*, A-63, Washington, DC, U.S. Government Printing Office, November 1976.

² The Roper Organization, Inc., *The American Public and the Income Tax System*, a poll conducted by the Roper Organization for H. and R. Block, Inc., Study No. 648, New York, NY, The Roper Organization, Inc., July 26, 1978.

The Effect of Inflation on Individual Federal Income Tax Burdens

THE "INFLATION TAX" DEFINED

1

Most of the basic provisions of the federal and state income tax codes were enacted when inflation was not a serious problem. As a result, the major features of these taxes, such as the income brackets which set the tax rates and the exemptions and deductions which protect income from taxation, are stated in nominal, or fixed-dollar, terms in the law. Inflation, however, diminishes the value of these items, and unless they are adjusted to reflect this erosion, their application will cause tax burdens to increase at a rate more than proportionate to inflation. It is this tax increase that is termed the "inflation tax."

To understand the inflation tax more clearly, consider a family of four whose money income increases from \$15,000 to \$16,500 to keep pace with one year of 10% inflation.¹ Although its purchasing power (its "real income," in economists' terms) is the same, the family has jumped from the 18% tax bracket to the 21% bracket, the value of its \$4,000 in personal exemptions has diminished by 10%, and its federal income tax bill has increased from \$1,242 to \$1,530. Overall, the family's tax bill has increased more than 23%, while its money income has grown only 10%, and its real income has not changed. While 8.3% of family income was paid in taxes before the increase in

money income, afterward the effective tax rate stood at 9.3% simply because of the natural interaction of inflation with the tax structure.

If this family's tax bill had increased only by the rate of inflation (i.e., remained constant in real terms), its liability would have been \$1,366, meaning that an extra "inflation tax" of \$164 (\$1,530 minus \$1,366) has been imposed without legislative enactment of a tax increase. The net result is that although the family thought it was keeping up with inflation, it now pays more of its income in taxes, and its after tax purchasing power is reduced by \$164, the amount of the inflation tax. In economists' language, the family has suffered a real tax increase even though its real income remained constant.

The federal treasury, meanwhile, gets a 2-to-1 return from inflation in this instance. When inflation enlarged the tax base (the family's income) by 10%, federal revenues increased over 20%, and Congress did not have to raise taxes to do so. In other words, the federal government received a real revenue increase even though its tax base remained constant in real terms.

Even if the family's money income does not rise, as in the above example, it will experience a real tax hike because of inflation. In such a case, the purchasing power of pre-tax income is reduced by inflation, but the tax bill remains the same. Thus, tax liability constitutes a greater proportion of real income, and after-tax purchasing power is reduced by more than the rate of inflation.

INDEXATION: A SOLUTION TO THE INFLATION TAX

One way to break this automatic inflation-income tax spiral and eliminate the inflation tax is to index the tax system for inflation. In an indexed system, the fixed-dollar provisions of the tax code, such as the standard deduction, personal exemptions, and income brackets, are increased every year by the rate of inflation as measured, for example, by the change in the U.S. Consumer Price Index (CPI).² With indexing, incomes which increase at the rate of inflation are no longer automatically subject to higher tax rates, and the real value of the exemptions and deductions is preserved. This results in the tax liability for an income which

rises at the rate of inflation also increasing by only the inflation rate. In economists' terms, indexing causes the tax on any given real income to remain constant in real terms. Consequently, the after tax purchasing power of the taxpayer's income is maintained, and the government does not reap a windfall in the form of the inflation tax.

Using our earlier example, indexing the tax code for 10% inflation would keep the family's \$16,500 income in the 18% tax bracket and increase the personal exemptions to \$4,400. Tax liability would increase by only 10% to \$1,366 rather than to \$1,530, and the effective tax rate would remain at 8.3%. Indexing would, in effect, reduce this family's tax burden by 10.7% compared to the liability without indexation. Federal revenues, in this instance, would also be limited to a 10% increase rather than the 23% jump that occurred without indexation.

If the family's income increased to \$17,250 (10% for inflation and 5% from real income growth or added purchasing power), however, its tax burden with indexing would be \$1,501—the 10% hike related to inflation plus a 10.9% increase on the added family purchasing power. Thus, under indexation, the responsiveness of the tax system to increases in purchasing power and its progressivity are preserved. But, the extra tax associated with inflation-related increases in income, the inflation tax, is eliminated.

It is easier to understand some of the taxpayers' frustration with government when the inflation tax phenomenon is considered. Even if a taxpayer receives a pay increase necessary to stay abreast of inflation, the inflation tax continues to erode after-tax purchasing power. As Donald Senese stated in his review of inflation and indexation "... the taxpayer feels that he is on a treadmill—that despite (income) gains, he can never really get ahead of inflationary pressures and may even be losing ground."³ Indexing the tax code can stop the treadmill. By eliminating the inflation tax, indexing should help ease the burden of inflation and quiet taxpayer discontent.

INFLATION AND INDEXATION: MORE SPECIFICS

To examine how the inflation tax affects different income groups, *Table I* compares the

Table I

EFFECT OF INFLATION ON U.S. INCOME TAX LIABILITY
Nominal Tax Liability for a Family of Four Filing a Joint Return under Indexed and Unindexed 1979 Tables
7% Annual Inflation—1979 Base—Constant Real Income

Income Structure	1979		1980			1982			1984		
	Tax	Effective Rate	Tax	Percent Increase	Effective Rate	Tax	Percent Increase	Effective Rate	Tax	Percent Increase	Effective Rate
\$10,000											
Indexed	\$ 374	3.7%	\$ 400	7.0%	3.7%	\$ 458	22.5%	3.7%	\$ 525	40.3%	3.7%
Unindexed	374	3.7	485	28.0	4.5	747	99.7	6.1	1,067	185.3	7.6
\$15,000											
Indexed	1,242	8.3	1,328	7.0	8.3	1,521	22.5	8.3	1,742	40.3	8.3
Unindexed	1,242	8.3	1,435	15.5	8.9	1,923	54.8	10.5	2,516	102.3	12.0
\$20,000											
Indexed	2,012	10.1	2,153	7.0	10.1	2,466	22.5	10.1	2,822	40.3	10.1
Unindexed	2,012	10.1	2,239	11.3	10.5	2,808	39.6	11.5	3,499	73.9	12.5
\$25,000											
Indexed	2,901	11.6	3,104	7.0	11.6	3,553	22.5	11.6	4,069	40.3	11.6
Unindexed	2,901	11.6	3,224	11.1	12.1	4,051	39.6	13.2	5,083	75.2	14.5
\$35,000											
Indexed	5,064	14.5	5,419	7.0	14.5	6,204	22.5	14.5	7,103	40.3	14.5
Unindexed	5,064	14.5	5,668	11.9	15.1	7,131	40.8	16.6	9,027	78.3	18.4
\$50,000											
Indexed	9,323	18.6	9,975	7.0	18.6	11,421	22.5	18.6	13,076	40.3	18.6
Unindexed	9,323	18.6	10,481	12.4	19.6	13,094	40.5	21.4	16,451	76.5	23.4

SOURCE: ACIR staff computations. All calculations assume a family of four with all income from wages and salaries and no tax preference items or adjustments to income. Itemized deductions assumed to be 23% of income except at the \$10,000 and \$15,000 levels where the zero

bracket amount, formerly the standard deduction, is used. Indexation takes effect in 1980. Under indexation, the personal exemption allowance and income brackets are increased annually by the rate of inflation.

federal income tax liability and effective tax rate under indexed and unindexed tax structures for a family of four at various income levels over a five-year period beginning in 1979. In the indexed calculations, the tax brackets and personal exemptions are adjusted annually for inflation beginning with 1980. All computations assume that inflation averages 7% per year over the five years, pre-tax income increases at the rate of inflation (i.e., remains constant in real terms), and no other legislative changes are made in the tax law.⁴

Without indexing, family tax liability increases significantly faster than inflation at all income levels, but inflation places its greatest burden, by far, on lower income groups. The tax on a \$10,000 real family income increases a whopping 28% in 1980 after just one year of 7% inflation. By 1984, the tax will have increased over 185% from its 1979 level while money income rises only 40.3%.

Under indexing, on the other hand, tax liability increases only at the rate of inflation and remains a constant percentage of family income (i.e., it remains constant in real terms). In 1984, the tax on a \$10,000 real income with indexation is less than one-half what it would otherwise be. Stated another way, unless the tax is indexed or some other change is made, a family at this level will pay over twice as much of its income in taxes by 1984, even though its purchasing power does not change.

Throughout the other income levels, the inflation-induced tax increase declines gradually as income increases until the \$35,000 income level when the incidence of the inflation tax picks up slightly again.⁵ The tax increase generated by one year of 7% inflation runs from a high of 15.5% at the \$15,000 level to a low of 11.1% on a \$25,000 income. While more moderate than at the \$10,000 level, the real tax increases at these higher incomes are still sizeable. Inflation causes the unindexed tax burden on a \$15,000 real income to more than double by 1984. Tax burdens at other income levels increase approximately 75% by 1984 in the absence of indexing, or approximately twice the nominal increase in income, 40.3%. The disproportionate impact of the inflation tax on low income families is presented graphically in Figure I.

The continuing decline in after tax purchasing power caused by the inflation-induced

real tax increases can be seen in Table II. Once again, the table assumes that the annual inflation rate is 7.0%, pre-tax income increases at the rate of inflation, and no changes are made in the tax law over the five-year period.

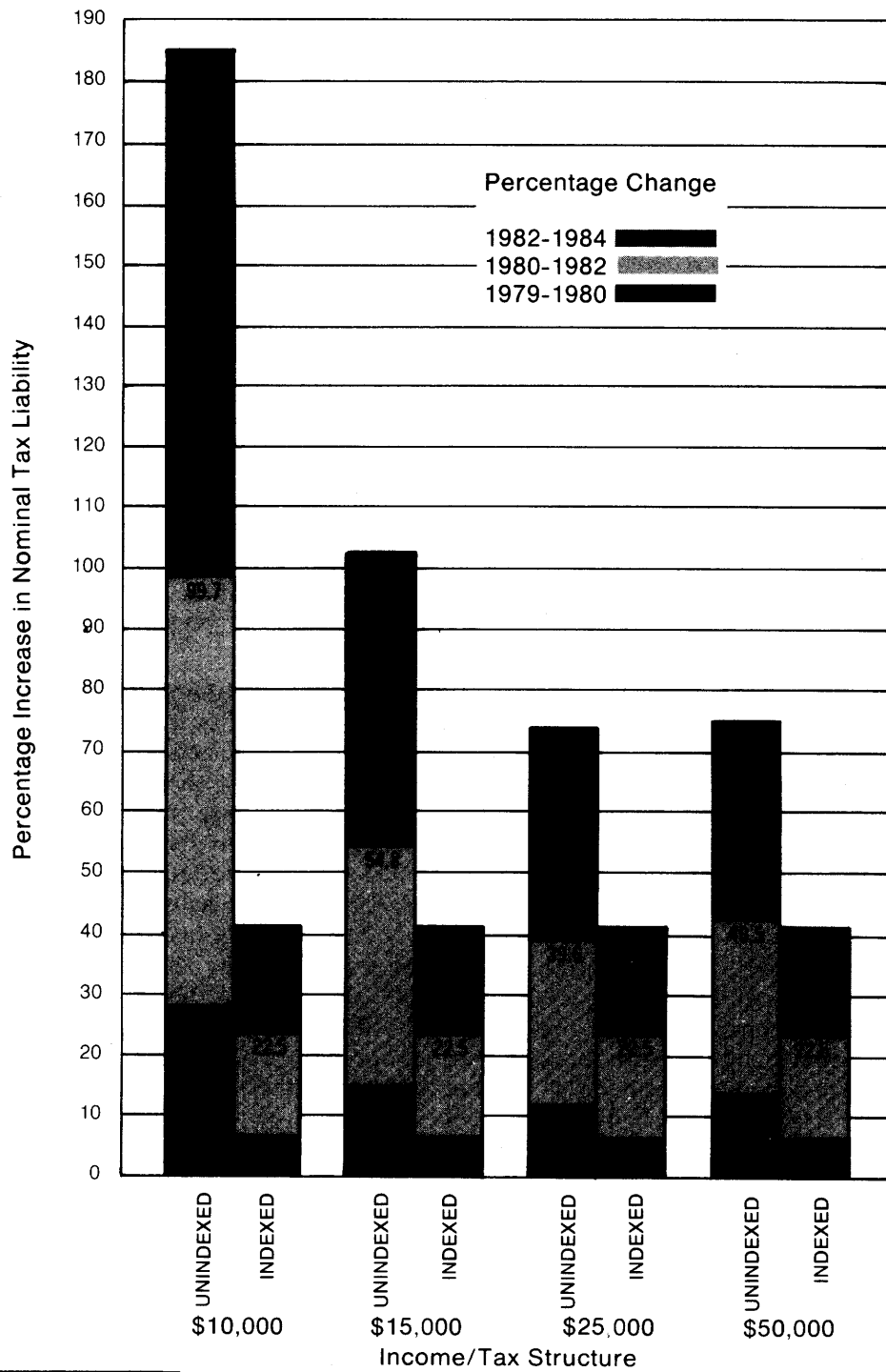
When tested by after-tax purchasing power, the disparity in the distribution of the inflation tax among family income groups is not as great as when the relative increase in tax liability is considered, and families at both the upper and lower ends of the income spectrum suffer the largest losses. The least effect is felt in the middle income range. By 1984, real after-tax income for the \$10,000 and \$15,000 income families will drop to 96.0% of its 1979 level, and families in the \$50,000 income range will experience nearly a 6.0% reduction in their purchasing power after taxes unless some change is made in the tax law. Indexing the income tax would cause the after-tax income at all levels to remain constant in real terms or equal to its 1979 level.

The different tax impacts of inflation among income groups can be explained by the two "components" of the inflation tax: (1) the inflation erosion of the fixed-dollar personal exemptions causing a greater proportion of income to be subjected to taxation, thus increasing tax liability; and (2) the pushing of taxpayers into higher marginal tax rate brackets, or "bracket creep," which also increases family tax bills.

Lower income families are most affected by the loss in value of the personal exemptions (\$1,000 per exemption in 1979) because the exemptions constitute a greater proportion of income at these levels; hence, their erosion by inflation has a greater relative tax effect on these income groups and all large families. In addition, lower income taxpayers generally do not itemize their deductions, but use the "zero bracket amount," formerly the standard deduction, to exclude income from taxation. The zero bracket amount is subject to erosion along with the other fixed-dollar amounts, which causes taxpayers who do not itemize their deductions to suffer proportionately more from the inflation tax.⁶

At higher income levels, the inflation tax is primarily attributable to inflation pushing many taxpayers into higher marginal tax rate brackets. This is particularly true if the relative width of the brackets decreases at any point in

FIGURE 1
How the Inflation Tax Affects Different Taxpayers



SOURCE: Table 1 pg. 00

Table II

IMPACT OF INFLATION ON AFTER TAX PURCHASING POWER
Change in After-Tax Real Income for a Family of Four
Filing a Joint Return without Indexation
7% Annual Inflation—1979 Base—Constant Real Pre-Tax Income

Real Pre-Tax Income	1979		1980		1982		1984	
	After-Tax Income	Real After-Tax Income	Percent of 1979 After-Tax Income	Real After-Tax Income	Percent of 1979 After-Tax Income	Real After-Tax Income	Percent of 1979 After-Tax Income	
\$10,000	\$ 9,626	\$ 9,545	99.2%	\$ 9,390	97.6%	\$ 9,242	96.0%	
15,000	13,758	13,658	99.3	13,429	97.6	13,211	96.0	
20,000	17,987	17,906	99.6	17,708	98.4	17,512	97.4	
25,000	22,099	21,986	99.5	21,693	98.2	21,384	96.8	
35,000	29,935	29,702	99.2	29,179	97.5	28,575	95.5	
50,000	40,677	40,203	98.8	39,312	96.6	38,286	94.1	

NOTE: With indexation, after-tax real income would remain equal to its 1979 level in each instance.
 SOURCE: ACIR staff computations. All calculations assume a family of four with all income from wages and salaries and no tax preference items or adjustments to income. Itemized deductions assumed to be 23% of income except at the \$10,000 and \$15,000 levels where the zero bracket amount, formerly the standard deduction, is used.

the income spectrum, as the federal tax brackets established in the Revenue Act of 1978 do for taxable incomes between \$20,000 and \$45,000. It is this narrowing of the brackets that causes the incidence of the inflation tax among families with pre-tax incomes of \$35,000 and \$50,000 to be greater than for \$20,000 and \$25,000-income families in the examples used here. Additionally, persons who itemize their tax deductions (generally those with higher incomes) are somewhat sheltered from the inflation tax because most itemized deductions are "self indexing." They are generally based on actual expenditures without fixed limits and their value tends to increase along with inflation, which prevents the tax exempt income of taxpayers who itemize from being diminished by inflation.

Middle income groups (\$20,000 and \$25,000 family incomes in our examples), meanwhile, avoid the worst of both the exemption and the bracket components of the inflation tax. The effect of the loss in dollar value of the personal exemptions is not quite as great as at the lower income levels, and the impact of the bracket creep is somewhat less than for higher income

families.

In sum, inflation automatically interacts with the U.S. income tax as it is now structured to create a substantial revenue windfall for the federal government without Congress being required to raise taxes. In the examples used here, family tax burdens increase 1.5 to 4 times faster than inflation, causing a continual loss of after-tax purchasing power even though family income before taxes was held constant in real terms. Other things remaining unchanged, the effect of the inflation tax is to arbitrarily distort the existing distribution of the tax burden with a substantial portion of the increased taxes being borne by lower income taxpayers—a seemingly undesirable event given the longstanding belief in the ability to pay criterion for distributing income tax burdens.

Indexing the tax structure would eliminate the silent, unlegislated inflation tax increases that otherwise occur and would provide substantial tax relief to a broad range of taxpayers. These would seem to be strong selling points in an era of taxpayer discontent and double-digit inflation.

WHAT HAPPENED TO THE 1978 TAX CUT?

Congress is not unmindful of the effect of inflation on income tax burdens, and part of the intent of past tax reductions has been to offset the inflation tax and prevent taxes from consuming an ever increasing proportion of taxpayers' incomes.⁷ Through periodic ad hoc tax cuts, Congress has, in fact, generally kept the aggregate federal personal income tax burden at a relatively stable percentage (9.0%–10.5%) of total personal income over the past two decades.⁸

Continued high inflation, however, makes it difficult to contend that these tax cuts have any lasting effect on the taxpaying public. The tax cuts, in many cases, are not tax reductions in real terms at all. They often accomplish little more than undoing one or two years of inflation and leave taxpayers in roughly the same position they would have been had the tax code been indexed for inflation—only a year or two later. These actions do, however, allow elected officials to campaign on a record of “cutting taxes,” often without acknowledging that they are only compensating for the inflation tax, or that inflation is likely to diminish any actual tax reduction in the near future.

Such is the case with the tax reductions approved by Congress in the *Revenue Act of 1978* (P.L. 95-600)⁹ if inflation persists at double-digit rates throughout 1979. The *Revenue Act* was intended to reduce individual tax burdens an average of 7.2% or \$13.2 billion overall, with the largest cuts directed toward low and middle income families. Our analysis (shown in *Table III*), however, reveals that if the 1979 inflation rate hits 10%—possibly a conservative estimate in light of the 13% rate over the first eight months—the nominal tax cuts legislated by Congress will be more than offset for all but a few groups of taxpayers by the tax increases induced by 10% inflation.

Table III compares the tax liability at various incomes for a family of four and a married couple with no children under: (a) the 1978 U.S. income tax law (column 2); (b) the new 1979 tax code (column 4); and (c) the 1978 tax law if the income brackets, personal exemption, and general tax credit as they existed at that time were indexed for one year of 10% inflation (column 3). The difference between the

liabilities under the 1978 law and 1979 law (column 5) is the nominal tax cut passed by Congress, and the difference in liabilities between the 1978 law and the indexed 1978 tax (column 6) is the real tax increase caused by 10% inflation or, alternatively, the tax cut that would have been provided by indexing the 1978 tax code.

As can be seen, while Congress provided substantial nominal tax cuts for all taxpayers, and all filing groups are better off than if no change had been made, the tax increases caused by 10% inflation more than offset the legislated tax reductions for most filing groups. Large numbers of taxpayers will experience real tax increases despite the Congressionally enacted “tax cut.” Only married couples with two children earning \$20,000 or more will actually receive a tax reduction in real terms, and this will generally be less than 25% of the amount Congress intended when it passed the *Revenue Act*. Stated another way, all taxpayers except families of four earning more than \$20,000 would be better off in 1979 if Congress had indexed the 1978 tax structure, rather than approved the \$13.2 billion tax reduction that it did, assuming that inflation is 10% in 1979.¹⁰

In short, Congressionally enacted “tax cuts” are more apparent than real for the taxpayer in a period of rapid inflation. That some of the public is well aware of the limited effect of these actions is evident from the Roper Survey in which a majority of Americans indicated their preference for indexing over periodic tax cuts as a method of coping with inflation.¹¹

Even if Congress were to regularly enact tax cuts sufficient to offset the inflation tax fully, such a system raises questions of accountability in our political system. Voters cannot focus responsibility for their tax burdens when their elected representatives campaign on a record of cutting taxes yet their tax bills do not decline. The consequence of this was stated by Robert Samuelson:

Bombarded from Washington with propaganda about the beneficence of tax cuts and confronted with a largely static tax bill, the average taxpayer sooner or later is bound to react in anger and disillusionment.¹²

Indexation would clearly help solve this ac-

countability problem. With indexing, rising real tax burdens could result only from legislatively enacted tax increases or real income growth, rather than being a natural consequence of inflation. Likewise, by removing the inflation tax automatically, indexation forces legislated tax cuts to be real reductions in tax burdens, rather than just a method of compensating for inflation.

While Congress has enacted periodic tax cuts to help cope with inflation in the past, taxpayers should be concerned about the willingness to continue this practice. As pressures to reduce the federal deficit and balance the budget grow, some policymakers are increasingly inclined to spend the inflation tax revenues rather than rebate them to the taxpayer.

A *Washington Post* survey of Congressmen who had introduced balanced budget measures revealed very few ideas for program cuts to help bring the budget into balance. Rather, most were willing to rely on revenue increases to match receipts with outlays. As one Representative put it:

I think you could do it without cutting a single federal program. With just the natural growth in tax collections, we could balance the budget and still have some increase in spending year to year. (Emphasis added.)¹³

Another Congressman described balancing the budget as "an easily achievable goal" as long as tax revenues continue to increase as rapidly

Table III

**EFFECT OF INFLATION ON THE 1978 TAX CUT
Comparison of Tax Liability with 10% Inflation in 1979**

Married Couple, Two Dependents

(1) Income	(2) 1978 Law Tax	(3) 1978 Indexed Tax ¹	(4) 1979 Law Tax	(5) Tax Cut ² (Col. 2 Minus Col. 4)	(6) Inflation Tax Increase ³ (Col. 2 Minus Col. 3)	(7) Gain or Loss (Col. 5 Minus Col. 6)
\$10,000	\$ 446	\$ 296	\$ 374	\$ 72	\$150	\$(- 78)
15,000	1,380	1,206	1,242	138	174	(- 36)
20,000	2,180	2,045	2,012	168	135	33
25,000	3,149	2,975	2,901	248	174	74
35,000	5,463	5,148	5,064	399	315	84
50,000	9,950	9,327	9,323	627	623	4

Married Couple, No Dependents

\$10,000	761	663	702	59	98	(- 39)
15,000	1,706	1,546	1,635	71	160	(- 89)
20,000	2,555	2,425	2,457	98	130	(- 32)
25,000	3,570	3,388	3,399	171	182	(- 9)
35,000	6,002	5,676	5,705	297	326	(- 29)
50,000	10,610	10,021	10,183	427	589	(-162)

¹ This column represents the tax if the income brackets, personal exemption, general tax credit, and zero bracket amount under the 1978 tax law were indexed for one year of 10% inflation.

² This column represents the nominal tax reduction provided by the Revenue Act of 1978 (P.L. 95-600). It does not include changes in capital gains taxes.

³ This column represents the amount by which taxes would have to be cut in 1979 to offset the effects of 10% inflation.

SOURCE: ACIR staff computations. All calculations assume that all income is from wages and salaries with no tax preference items and no adjustments to income. Assumes deductions equal to 23% of income except at the \$10,000 and \$15,000 level where the zero bracket amount is used.

as they did last year.¹⁴

Other policymakers, notably President Carter and Rep. Al Ullman (OR), Chairman of the House Ways and Means Committee, have stated that federal tax cuts in the near future will depend on the state of the U.S. economy and whether continued inflation or a potential recession is seen as the overriding problem. Regardless of the outcome of this debate, it is

clear that alleviating the inflation tax burden is not the primary consideration in federal tax policy. Taxpayers face an increasingly uncertain situation regarding the propensity of Congress to continue its past practice of offsetting the inflation tax through periodic tax cuts even though indexing would not disrupt the ability to use the federal income tax to achieve economic stabilization policies. (See pp. 30-31.)

FOOTNOTES

¹ To simplify matters, this example uses 1979 federal income tax provisions as established in the Revenue Act of 1978 (P.L. 95-600) and the zero bracket amount, or standard deduction, rather than itemized deductions. For a discussion of the effect of inflation on the tax cuts contained in the Revenue Act, see pp. 7-9.

² Other indices such as a national income index or a Gross National Product price deflator might also be appropriate, but the Consumer Price Index prepared by the U.S. Bureau of Labor Statistics is most widely understood and is generally used in state and federal indexation legislation.

³ Donald J. Senese, *Indexing the Inflationary Impact of Taxes: The Necessary Economic Reform*, Washington, DC, The Heritage Foundation, 1978, p. 51.

⁴ This report concerns only personal income taxes on wage and salary income and does not address the effect of inflation on property income. Some contend that inflation causes property income to be overstated, and consequently, overtaxed; others argue that Congress has compensated for this by excluding a percentage of capital gains from taxation, and accelerated depreciation. Involved here is a complex set of economic, political, and tax accounting postulates that are excluded from the Commission's earlier work and this report as areas in need of further research. For a discussion of this issue, see Henry J. Aaron, ed., *Inflation and the Income Tax*, Washington, DC, The Brookings Institution, 1976, and several other references cited in the bibliography appended to this volume.

⁵ This is reflective of the Revenue Act of 1978 which substantially widened the brackets in the middle income ranges to make them less susceptible to erosion by inflation.

⁶ Use of the zero bracket amount at the \$10,000 and \$15,000 incomes and the estimated itemized deductions at other levels is based on data from the Internal Revenue Service, *1976 Preliminary Statistics of Income, Individual Tax Returns*, Washington, DC, U.S. Government Printing Office, April 1978.

⁷ For further discussion of this issue, see pp. 27-28.

⁸ Emil M. Sunley and Joseph A. Pechman, "Inflation Adjustment for the Individual Income Tax," in Henry J. Aaron, ed., *Inflation and the Income Tax*, op. cit., pp. 153-66.

⁹ In the act, Congress eliminated the general tax credit, increased the personal exemption and zero bracket amount, widened other income brackets, and reduced some marginal tax rates.

¹⁰ For a more complete analysis, see Thomas Gallagher and Gregg Esenwein, *Effect of the Revenue Act of 1978, Inflation, and Social Security Taxes on the Tax Payments of Typical Taxpayers*, Report 79-64E, Washington, DC, Library of Congress, Congressional Research Service, March 1979.

¹¹ Roper Organization Study No. 648, op. cit.

¹² Robert Samuelson, "The Future is Now," *The National Journal*, Vol. 10, No. 4, Washington, DC, Government Research Corporation, January 28, 1978, p. 157.

¹³ Quoted in T.R. Reid, "Most Hill Budget Mechanics Offer No Tools for Balancing," *The Washington Post*, Washington, DC, Post Publishing Co., March 30, 1979, p. A-4.

¹⁴ *Ibid.*

The States and the Inflation Tax

11

It is difficult to generalize about the impact of inflation on state income taxes because of the great diversity in tax structures among the 41 states using a broad-based personal income tax. Yet, the basic principles of the inflation tax and indexation developed for the federal level can be applied to states. Most state income taxes utilize fixed-dollar personal exemptions, standard deductions (zero bracket amount in the federal tax), and tax bracket boundaries so that any inflation-related increases in income will automatically cause tax burdens to increase more than proportionately to inflation. Indexing state income taxes will, as at the federal level, eliminate the inflation tax or the real tax increase associated with nominal increases in income.

THE SERIOUSNESS OF THE PROBLEM

The magnitude of the inflation tax problem in a particular state bears a direct relationship to the progressivity of the state income tax and the reliance by the state on the income tax as a revenue raising vehicle. The greater the progressivity of the income tax and the larger the proportion of state revenues derived from the personal income tax, the more likely it is that taxpayers will experience a sizeable real tax increase as a result of inflation-related gains in income.

As the degree of progressivity declines, the inflation tax diminishes until it reaches the

point under a proportional tax with no fixed exemptions where there would be no inflation tax because all income is taxed at the same rate. Similarly, as a state's reliance on the income tax for revenue decreases, its tax rates are likely to be lower, which will make the inflation tax smaller in absolute dollar terms.

To obtain a sense of the need for indexing at the state level, Figure II ranks the states using a graduated personal income tax according to the progressivity of the tax (as measured by the ratio of effective tax rates at various income

levels) and the percentage of total state tax revenues derived from the personal income tax in 1977. The ranking shows that the inflation tax is a serious state problem, as well as a federal one.

Over one-half of the income tax states (21 of 41) rank in the high or medium category under both the progressivity and reliance measures, and an additional 11 states receive a high rating under one of the measures (e.g., Iowa and New Mexico). As a result, taxpayers in over three-fourths of the states using a broad-based,

Figure II

THE PROGRESSIVE INCOME TAX STATES RANKED ACCORDING TO THE DEGREE OF PROGRESSIVITY AND RELIANCE ON THE PERSONAL INCOME TAX, 1977

		Income Tax Progressivity ¹		
		High	Medium	Low
Personal Income Tax Receipts as Percent of Total State Tax Revenues ²	High	Idaho Minnesota Vermont U.S. Income Tax	Delaware New York Colorado Oregon Virginia Wisconsin	Iowa Maryland Massachusetts Montana North Carolina
	Medium	California Nebraska Georgia Hawaii Rhode Island	Alaska Arkansas District of Columbia Kansas Missouri New Jersey South Carolina Utah	Michigan Pennsylvania Illinois Indiana Kentucky
	Low	New Mexico Maine Mississippi North Dakota Oklahoma Ohio	Louisiana West Virginia Arizona	Alabama

¹Progressivity is measured by the ratio of the effective tax rate for a family of four at \$50,000 to the effective rate of \$10,000. A tax has high progressivity if the ratio is greater than 4.5, medium if from 2.0 to 4.5, and low if less than 2.0. For comparison, the ratio for the U.S. income tax is 4.7, and for the median state tax rate, it is 2.8.

²Low, 0%-20%; medium, 20%-30%; high, greater than 30%. For comparison, the average of all states is 25.2%.

SOURCE: ACIR, *Significant Features of Fiscal Federalism*, 1978-79 ed., M-115, Washington, DC, U.S. Government Printing Office, May 1979.

graduated income tax can expect to experience a significant real increase in their tax burdens as a result of inflation-related increases in income.

Figure II also gives an indication of the potential impact of indexation on state revenues. The higher the ranking a state receives under either measure, the greater the relative effect of indexation on its income tax receipts. It is interesting to note in this regard that only three states—Idaho, Minnesota, and Vermont—fall in the high category under both measures and can, thus, expect to experience the “worst case” results in terms of revenue forgone as a result of indexation. All other states exhibit a lesser ranking under one or both measures which will moderate the effect of eliminating the inflation tax on state revenues. In other words, indexation may be a relatively “affordable” tax reform in a revenue sense, at least as gauged under the measures of progressivity and reliance used here.

THE DISTRIBUTION OF THE INFLATION TAX

The taxpayer groups which get hit the hardest by the inflation tax will not be the same in all states, and they will not necessarily be the same as those most affected under the federal income tax. Rather, the incidence of the inflation tax depends on whether the state income tax maintains a reasonably uniform degree of progressivity throughout a broad income range. Figure III ranks the personal income tax states according to the degree of progressivity exhibited between \$10,000 and \$25,000 family incomes and between \$25,000 and \$50,000 as a guide in determining which taxpayers are likely to bear the brunt of the inflation tax burden in a particular state.

Twenty-two states maintain a uniform degree of progressivity throughout the income range in Figure III which indicates that the incidence of the inflation tax in these states will be similar to that under the federal income tax. Lower income groups will suffer the largest relative increases in their tax bills, but taxpayers at the upper and lower ends of the income spectrum will experience similar reductions in after tax purchasing power as a consequence of the inflation tax.

In a dozen states, however, the degree of

progressivity falls at least one rank from the lower to the upper income groups, i.e., from the high progressivity ranking at lower income levels to a medium or low category at higher incomes (as in Idaho and Missouri), or from a medium to a low ranking (as in New Jersey and Virginia). The inflation tax burden in these states is likely to fall on lower income taxpayers to an even greater degree than it does under a more uniformly progressive tax. Most of these states have set their maximum tax rate bracket at a rather low level, but they use large personal exemptions and standard deductions to moderate the tax burden on lower income groups and achieve some progressivity. For example, the highest tax bracket in Mississippi and Georgia is \$5,000 and \$10,000, respectively, but with a personal exemption allowance for a family of four of \$8,000 and \$4,400, respectively, they show a high degree of progressivity in the low income ranges. The inflation erosion of these large exemptions and deductions, and the lack of any “bracket component” to the inflation tax once taxable income exceeds the highest bracket, however, causes the inflation-induced tax increases to fall more heavily on lower income groups and all taxpayers with large families.

In several states, the degree of progressivity climbs at least one ranking between the income levels (e.g., from medium to high in Arizona and New York and from low to high in Michigan). The incidence of the inflation tax is likely to be more proportional or equal among income groups in these states.

TWO CASE EXAMPLES

To add some specifics to this discussion of the inflation tax at the state level, the effect of inflation on the income tax liability for a family of four in Alaska and Virginia—two states with quite different tax structures—is compared in Table IV. As in previous examples, it is assumed that inflation averages 7% per year for five years, pre-tax income increases at the rate of inflation, and no legislative changes are made in the tax code.

The Alaska tax is structured much like the federal tax and displays a relatively high degree of progressivity at all incomes. It has 22 tax rate brackets, ranging from 3.0% on the first \$4,000 of taxable income to 14.5% on taxable

income in excess of \$300,000, and it uses the federal personal exemption allowance and standard deduction for state tax purposes.¹⁵ In Virginia, there are only four tax brackets, ranging from 2.0% on the first \$3,000 of taxable income to 5.75% on all taxable income over \$12,000; the personal exemption allow-

ance is \$800 per exemption, and the standard deduction is \$2,000 on a joint return. The Virginia tax exhibits a more modest degree of progressivity, particularly at higher income levels, because of the \$12,000 maximum tax bracket. (See Figure III.)

As is evident from Table IV, inflation causes

Figure III

**THE PROGRESSIVE INCOME TAX STATES
RANKED ACCORDING TO THE DEGREE OF PROGRESSIVITY, 1977**

Progressivity at Lower Income Levels¹

	High	Medium	Low	
Progressivity at Higher Income Levels ²	High	New Mexico	Alaska	Michigan
		California	New York	
		Nebraska		
		Maine		
		Oklahoma		
	Medium	Mississippi	Vermont	Arizona
		North Dakota	Rhode Island	Oregon
		Idaho	South Carolina	West Virginia
		Georgia	Kansas	Montana
		Hawaii	Colorado	
		Ohio	Delaware	
			Arkansas	
			Louisiana	
			District of Columbia	
			U.S. Income Tax	
Low	Minnesota	New Jersey	North Carolina	
	Missouri	Wisconsin	Massachusetts	
		Virginia	Alabama	
		Utah	Illinois	
			Indiana	
			Iowa	
			Kentucky	
			Maryland	
			Pennsylvania	

¹Progressivity at lower income levels is measured by the ratio of the effective tax rate for a family of four at \$25,000 to the effective rate at \$10,000. A tax has high progressivity if the ratio is greater than 3.0, medium if from 1.7 to 3.0, and low if below 1.7. For comparison, the ratio for the U.S. income tax is 2.8, and for the median state tax rate, it is 1.8

²Progressivity at the upper income levels is measured by the ratio of the effective tax rate for a family of four at \$50,000 to the effective rate at \$25,000. A tax has high progressivity if the ratio is greater than 1.8, medium if from 1.4 to 1.7, and low if below 1.4. For comparison, the ratio for the federal tax is 1.7, and for the median state tax rate, it is 1.5.

SOURCE: ACIR, *Significant Features of Fiscal Federalism*, 1978-79 ed., M-115, Washington, DC, U.S. Government Printing Office, May 1979, p. 76.

Table IV

EFFECT OF INFLATION ON STATE INCOME TAX LIABILITY
Nominal Tax Liability for a Family of Four in Selected States
7% Annual Inflation—1979 Base—Constant Real Income

Income State and Structure	1979		1980			1982			1984		
	Tax	Effective Rate	Tax	Percent Increase	Effective Rate	Tax	Percent Increase	Effective Rate	Tax	Percent Increase	Effective Rate
\$10,000 - 14,025											
ALASKA											
Indexed	\$ 114	1.1%	\$ 121	7.0%	1.1%	\$ 139	22.5%	1.1%	\$ 159	40.3%	1.1%
Unindexed	114	1.1	137	20.2	1.3	191	67.5	1.6	253	121.9	1.8
VIRGINIA											
Indexed	175	1.7	187	7.0	1.7	214	22.5	1.7	245	40.3	1.7
Unindexed	175	1.7	204	16.6	1.9	270	54.3	2.2	351	100.6	2.5
\$25,000 - 35,064											
ALASKA											
Indexed	633	2.5	678	7.0	2.5	776	22.5	2.5	888	40.3	2.5
Unindexed	633	2.5	707	11.7	2.6	874	38.1	2.9	1,079	70.5	3.1
VIRGINIA											
Indexed	748	3.0	801	7.0	3.0	\$ 917	22.5	3.0	1,050	40.3	3.0
Unindexed	748	3.0	826	10.4	3.1	997	33.3	3.3	1,194	59.6	3.4
\$50,000 - 70,127											
ALASKA											
Indexed	1,939	3.9	2,075	7.0	3.9	2,376	22.5	3.9	2,720	40.3	3.9
Unindexed	1,939	3.9	2,166	11.7	4.0	2,695	39.0	4.4	3,344	72.5	4.8
VIRGINIA											
Indexed	1,855	3.7	1,985	7.0	3.7	2,273	22.5	3.7	2,602	40.3	3.7
Unindexed	1,855	3.7	2,010	8.4	3.8	2,353	26.9	3.8	2,746	48.0	3.9

SOURCE: ACIR staff computations based on the Commerce Clearing House, State Tax Reporter. All calculations assume a family of four with all income from wages and salaries of one spouse and no adjust-

ments to gross income. Itemized deductions assumed to be 23% of income except at \$10,000 level where the standard deduction is used.

tax burdens in the two states to increase significantly faster than the assumed increases in income. By 1984, the tax on \$10,000 real income more than doubles in both states while nominal income and the tax with indexation increases only 40.3%. The real inflation tax increases are greater at all income levels under the more progressive Alaska tax, and the difference between the two states grows as income rises and the progressivity of the Virginia tax tapers off. Still, at the \$50,000 level in Virginia, family tax burdens are increasing approximately 20% faster than income (48.0% vs. a 40.3% increase in nominal income).

In both states, inflation has the greatest impact on the tax liability of lower income families. This is even more pronounced in Virginia where the top tax bracket is set at a relatively low level. The tax on a \$10,000 real income in Virginia increases twice as much, in percentage terms, as the tax on a \$50,000 real income (100.6% vs. 48.0%); in Alaska, the growth rate at the \$10,000 level is only 1.7 times that at the \$50,000 level (121.9% vs. 72.5%). In other words, indexation is more important to low income families in states like Virginia where the degree of progressivity declines sharply among upper income groups.

While some of these tax increases may seem small in dollar terms, the aggregate effect on a national basis is substantial. The ACIR, using certain economic assumptions about inflation and real income growth prepared by the U.S. Congressional Budget Office, estimates that the inflation tax windfall for state governments in 1978 was approximately \$1.2 billion, and it could reach as high as \$11 billion by 1982, a figure equal to nearly 20% of total projected state income tax revenues in that year.¹⁶ In addition, based on an annual ACIR survey of state revenue officials, rough estimates indicate that the inflation tax alone has accounted for approximately \$5.1 billion (21%) of the reported increases in personal income tax receipts resulting from both economic factors and legislative action of \$24.3 billion from 1966-78.¹⁷

In sum, the effect of inflation and its distribution among taxpayers will vary on a state-to-state basis depending on the tax structure and the role of the personal income tax in the state revenue system. Taxpayers in over three-fourths of the states using a broad-based personal income tax, however, can expect inflation to increase their tax burdens substantially, and conversely, could expect significant tax reductions from indexing.

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FOOTNOTES

¹⁵ The increases in the federal personal exemption and standard deduction contained in the Revenue Act of 1978 (P.L. 95-600) will not be effective for Alaska state tax purposes until 1980. Accordingly, this analysis uses the existing \$750 personal exemption and \$3,200 standard deduction. Using the higher figures from the 1978 Revenue Act would not materially affect the relative magnitude or distribution of the inflation tax increases.

¹⁶ ACIR, "States Tackle Tough Fiscal Issues," *Intergovernmental Perspective*, Vol. 5, No. 1, Washington, DC, U.S. Government Printing Office, Winter 1979, p. 11.

¹⁷ The annual ACIR survey divides the revenue increases from selected state taxes into those resulting from economic factors and political (legislative and administrative) actions. The economic component is further divided into "real" and inflation-related growth based on the proportion that the rate of growth in real Gross National Product represents to the growth of nominal GNP. The estimated inflation tax component of total income tax revenue increases from inflation is based on a state income tax elasticity of 1.65. For a breakdown of the sources of increased state tax collections from 1966-78, see ACIR, *Significant Features of Fiscal Federalism*, 1978-79 ed., M-115, Washington, DC, U.S. Government Printing Office, May 1979, p. 54. Data on individual taxes are available from the Commission.

The Policy Case for Indexing

The preceding discussion has centered on the economic principles underlying the Commission's recommendation that the federal and state governments index their graduated personal income taxes. Simply put, indexing eliminates the real tax increase on inflation-related gains in income and prevents the government from reaping an unlegislated revenue windfall. In addition, indexing carries with it several desirable policy implications. They are summarized below. 17

TAX EQUITY

Indexing the personal income tax will preserve the existing legislated distribution of the tax burden. In the absence of indexing, the inflation-income tax interaction automatically and arbitrarily distorts the current equity in the tax structure because it does not affect equally all taxpayers. Rather, the real tax increases generated by inflation depend on differences in family size, level of income, and the degree to which various dollar limitations affect tax liability. They tend to fall more heavily on low income taxpayers, particularly those with large families, and those at the upper income levels.

Indexing the individual income tax would promote the goal of tax equity in two ways. By neutralizing the effects of inflation on tax burdens, it preserves the tax burden distribution as approved by Congress or the state legislature so that legislative intent and existing equity are

maintained despite inflation. Second, indexing will, in effect, move state and federal income taxes toward true equity—i.e., based on ability to pay—because it shifts the tax base toward real income or real purchasing power. The latter is a better measure of ability to pay than money income, which becomes bloated by inflation with no increase in purchasing power.

POLITICAL ACCOUNTABILITY

18

The inflation-income tax phenomenon raises serious questions of accountability in our political system because the inflation tax increases occur automatically with little public debate and no legislative action to raise taxes. Taxpayers are not able to voice their objections to the tax hikes, and there is no body of elected officials to hold responsible for the increase. Rather, voters are expected simply to attribute the tax increases, along with a myriad of other ills, to inflation. Likewise, the existence of the inflation tax allows elected officials to enact tax cuts which may have no real lasting effect on tax burdens, but do allow legislators to campaign on a record of “cutting taxes.” Holding elected officials accountable for their decisions is exceedingly difficult under such circumstances.

Indexing the tax code for inflation would insert a new measure of accountability in the political process. With indexing, government officials can no longer rely on inflation tax windfalls to keep tax revenues growing faster than inflation. Rather, real increases in revenue must result from real economic growth or overt, publicly made legislative decisions to increase taxes upon which the voters can pass judgment at the next election. Conversely, tax cuts under an indexed system can be clearly identified as such because they must cause a real reduction in tax burdens. In short, indexing allows the electorate to clearly fix responsibility for their tax bills and to hold elected officials accountable.

PUBLIC SECTOR GROWTH

In the absence of indexing or other legislative action, the inflation-income tax interaction may foster a shift of resources from the private to the public sector and may impart an upward bias to the size of government. By generating

revenue increases that are more than proportionate to inflation, the existing tax structure permits current programs to be funded at their present levels plus an allowance for inflation, and it may still leave enough money in government coffers to start new programs, expand existing services, or return some money to the taxpayers. Stated another way, without indexation, elected officials have often been able to cut taxes and increase spending.

While indexation will not cut government revenues in absolute terms, it will slow down the rate of growth in revenues by eliminating the real revenue increases associated with inflation-related gains in income. This slowdown will help preserve the existing public-private sector division of resources and should cause elected officials to evaluate their spending decisions more carefully. Without the inflation windfall, funds to establish or expand programs and services will have to come from improved efficiency, cutbacks in current services, real economic growth (from which income tax revenues will still increase more than proportionately to the growth rate), deficit financing, or decisions to increase taxes. This should promote a more careful review of existing programs and more considered expenditure decisions at all levels of government. In effect, by focusing the “political accountability” spotlight on public officials, indexation may serve to slow the growth of the public sector.¹⁸

INTERGOVERNMENTAL FISCAL BALANCE

Continued high rates of inflation could, in the absence of indexing or other legislative action, cause a shift in the current intergovernmental mix of programs to higher levels of government. Of the three levels of government, the federal government has the greatest capacity to realize increased revenues from inflation because of its heavy reliance on the graduated income tax and its dominance of the income tax field. In 1978, federal individual income tax receipts accounted for 84% of the personal income tax revenues of all levels of government, and they comprised over 65% of all federal tax collections. State governments, which receive approximately 25% of their revenues through the personal income tax, have the second

greatest capacity for revenue gains from inflation, and local governments can expect few direct benefits from inflation as very few localities utilize a graduated income tax.

The concentration of resources at the state and federal levels could, depending on the policies adopted for the use of those funds, increase the reliance of local governments on federal and state financial assistance and cause more decisionmaking power to flow to those levels of government along with the money. Indexing helps preserve the existing program mix among the levels of government and should help check any deterioration of state and local autonomy.

In summary, while indexing the personal income tax for inflation is not a panacea for all the concerns of American taxpayers, it can be a reasoned, effective first step toward mitigating the burdens imposed by inflation and quieting some of the current discontent among the electorate. The case for indexation is based on several sound economic and policy arguments.

- It removes the automatic, hidden tax increases that would otherwise result from the interaction of inflation and a progressive income tax.
- It prevents arbitrary distortions of the legislated distribution of the tax burden and provides significant tax relief, particularly to those at the lower and upper ends of the income range.
- It improves the ability of the voters to hold elected officials accountable for their taxing and spending decisions.
- It helps slow the rate of growth in government and preserves the current balance of resources between the public and private sector.
- It sustains the current intergovernmental fiscal balance and impedes the flow of resources and decisionmaking to higher levels of government.

The Experience with Indexing

THE STATES

21

In response to persistently high inflation rates and taxpayers' calls for fiscal relief, six states have enacted measures to index their personal income taxes in the last two years. Arizona, California, and Colorado passed indexing bills in 1978; they were followed by Iowa, Minnesota, and Wisconsin in 1979. An indexing measure also passed the Montana Legislature, but was vetoed by the Governor. These states demonstrate a number of ways in which indexing can be accomplished. Table V compares the major characteristics of the six state indexing laws.

Only three of the statutes are comprehensive indexation measures in the sense that they provide for annually adjusting the three primary fixed-dollar features of the personal income tax—the income brackets, personal exemptions, and standard deduction. Even then, differences among them in the index used to make the adjustment and limitations on the amount of the adjustment mean that the inflation tax will not be fully eliminated.

The Minnesota indexing measure was passed as part of a \$715 million tax reform and relief package and provides that the personal credits (the counterpart of personal exemptions in most states), maximum standard deduction, and maximum exclusion level for the low income allowance will be indexed by the annual percentage change in the Minneapolis-St. Paul

CHARACTERISTICS OF

	Arizona	California	Colorado
FEATURES INDEXED	Personal exemption, standard deduction, and property tax and renter's credit.	Personal credits, standard deduction, income brackets, and low income credit.	Personal exemption, standard deduction, and income brackets.
INDEX USED	Percent change in Phoenix area CPI from second quarter 1977 to second quarter of tax year.	Brackets indexed by change in state CPI from June to June minus 3% in 1978-79 and full change in CPI in 1980-81; other features indexed by full CPI change.	Set annually by the general assembly based on various price data.
EFFECTIVE DATE	1978 and 1979 tax years only.	Brackets indexed effective 1978 tax year; other features indexed beginning 1979 tax year. All indexed permanently.	1978 tax year and permanently thereafter.
LEGAL CITATION	Chapter 211, <i>Arizona Laws of 1978</i> and S.B. 1145 as passed by 1979 legislature.	Chapter 569, <i>California Laws of 1978</i> and A.B. 276 as passed by 1979 legislature.	Chapter 105, <i>Colorado Laws of 1978</i> .

SOURCE: ACIR staff compilation.

Metropolitan CPI beginning in 1981. The income brackets will be indexed effective with the 1979 tax year, but by only 85% of the change in the CPI.

California is implementing its 1978 indexation measure in two steps, and the 1979 legislature has amended the original law. Under the original measure, the income tax brackets were indexed, effective in 1978, by the change in the state CPI minus three percentage points, and beginning with 1979, the personal credits, standard deduction, and low income credits will be adjusted annually by the full change in the state CPI. Under the 1979 amendments, the tax brackets will also be indexed for tax years 1980 and 1981 by the change in the state CPI without the 3% deduction.

The *Colorado* law also indexes the brackets, personal exemptions, and standard deduction, but provides that the General Assembly shall set the annual inflation factor by which they

are adjusted, rather than specifying in law that a particular index be used. The factor is to be based on the "best statistics available" regarding price changes in the previous year and was set at 6.0% for 1978 and 7.0% for 1979. The indexing law specifies that if the assembly fails to establish a new inflation factor by May 1, each year, the department of revenue is to assume it is 6.0% and make the necessary adjustments in the tax tables.

Two states with partial indexation—*Wisconsin* and *Iowa*—limit the inflation adjustment to the income brackets and leave the exemptions and deductions unchanged. The *Wisconsin* law, passed as part of \$940 million tax reform package, calls for indexation of the income brackets by the percentage change in the U.S. CPI up to a maximum of 10% in any one year. The act is effective with the 1980 tax year.

The 1979 *Iowa* law is the most restrictive. Not only does it pertain to just the income

STATE INDEXING LAWS

Iowa	Minnesota	Wisconsin
Income brackets and maximum annuity excludable from taxable income.	Personal credits, standard deduction, income brackets, and low income allowance.	Income brackets.
Percent change in U.S. CPI for previous calendar year divided by 4 for 1979 and divided by 2 for 1980.	Brackets indexed by 85% of the percent change in Minneapolis-St. Paul CPI from August to August; other features indexed by full CPI change.	Percent change in U.S. CPI from June to June, not to exceed 10% in a single year.
1979 and 1980 tax years only if the June 30 general fund balance exceeds \$60 million in each year.	Brackets indexed effective 1979 tax year; other features indexed beginning 1981 tax year. All indexed permanently.	1980 tax year and permanently thereafter.
S.F. 494 as passed by 1979 legislature.	H.F. 1495 as passed by 1979 legislature.	Chapter 1, <i>Wisconsin Laws of 1979</i> .

brackets, but it is effective for the 1979 and 1980 tax years only, and the amount of the inflation adjustment is quite limited. The inflation factor applied to the brackets for 1979 is one-fourth of the percentage change in the U.S. CPI during calendar year 1978 (approximately 2.0-2.25%); for 1980, the factor is one-half of the change in the CPI during 1979. The maximum federal retirement annuity excludable from taxable income will also be indexed by this factor. The law provides, however, that indexing shall not take effect unless the unobligated general fund cash balance, as certified by the state comptroller, exceeds \$60 million each year. An interim legislative committee will examine expanding this limited indexation to other parts of the income tax and extending it beyond 1980.

As originally enacted, the *Arizona* indexation law was effective for only the 1978 tax year; it was extended for an additional year by

the 1979 legislature. Under the act, the personal exemption, standard deduction, and property tax and renters' credits, but not the income brackets, are indexed annually by the percentage change in the Phoenix area CPI, 10% in 1978. A special legislative session on tax reform, scheduled for the fall of 1979, will address making indexation a permanent feature of the state tax code, and one state official has stated that because of the tax relief it provides, he has "no doubt" that indexing will be made permanent.¹⁹

The vetoed *Montana* legislation would have indexed the personal exemptions, standard deduction, and income brackets by the annual change in the U.S. CPI. In his veto message, Governor Thomas Judge listed several objections to the bill including the fact that the revenue effects would be substantially more than contemplated because of a separate enactment increasing the personal exemption level. He

also felt that indexing would make the tax structure more complicated, and since the measure would not have become fully effective until 1981, he considered it best that Montana learn from the experience of other states now implementing indexing laws and reconsider it at the next legislative session. The legislature's Revenue Oversight Committee will, as it did in 1978, study the feasibility of indexing, including the tax on such items as capital gains, interest expense, and business income.

The effect of these laws on tax burdens and state revenues, of course, varies from state to state depending on the progressivity of the tax structure and the proportion of state revenues derived from the personal income tax. The states fall in the high or medium progressivity category used in *Figure II* (p. 12) with the exception of Iowa which is in the low progressivity category. The six states, with the exception of Arizona, also exhibit a high or medium degree of reliance on personal income tax revenues. Personal income tax receipts accounted for 16.4% of Arizona tax revenue in 1977 and approximately 30% to 40% of total tax revenue in the other five states.²⁰

In general terms, then, it can be expected that the impact of indexation on tax burdens and revenues in these six states will be slightly higher than it would be in the "average" state. In addition, low income taxpayers in Minnesota can expect to receive a substantial share of the benefits of indexation because of the drop in progressivity from the high to low progressivity category as income increases in that state. (See *Figure III*, p. 14.)

Some specific estimates are also available. The Colorado Department of Revenue projects that its comprehensive indexation measure, with a 6% inflation factor, will reduce state income tax revenues approximately 6.7% or \$28.3 million in 1979. This amounts to individual tax reductions ranging from 13.8% for taxpayers with incomes below \$5,000 to 1.0% for those with greater than \$100,000 incomes.²¹

A somewhat smaller relative effect is expected in California which relies less extensively on the personal income tax. The California Franchise Tax Board projects a reduction in income tax revenues of approximately \$40 to \$50 million for each 1.0% increase in the CPI in excess of 3.0%. For 1979, revenues are estimated to be about \$273 million, or 4.6%, less

than they would be without indexing, based on a projected change in the state CPI from June 1978 to June 1979 of 8.6% (somewhat less than the probable change in the U.S. CPI because of the effect of Proposition 13).²²

The Arizona Department of Revenue estimates that each percentage point increase in its inflation factor will reduce tax liability in 1979 by approximately \$1.2 million and that with 10% inflation, the tax reduction on a joint return will range from \$2 to \$128.²³ With a 10.1% indexing factor in 1978, personal income tax receipts totalled approximately \$220 million, some \$10.8 million or 4.7% less than they would have been without indexing.²⁴

In Wisconsin, where only the income brackets are indexed, the legislative fiscal office estimates that with 7% inflation, individual tax burdens will be reduced approximately \$39 million. The maximum savings for an individual taxpayer is estimated at \$47.²⁵ Individual income tax collections were \$1.3 billion in 1978.

Thirteen other state legislatures considered indexing bills in 1979—Georgia, Illinois, Kansas, Kentucky, Maine, Missouri, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, South Carolina, and Utah. Most proposals would have indexed the income brackets, personal exemption, and standard deduction by the change in a state, local, or U.S. Consumer Price Index. The Maine and Utah bills, similar to the Colorado statute enacted last year, had the legislature setting the inflation factor based on price index data from executive agencies.

THE CANADIAN INDEXING SYSTEM

While indexing is relatively new in the U.S., a number of foreign countries have indexed their personal income taxes for several years, including Australia, Denmark, the Netherlands, Brazil, Chile, and Canada. The Canadian experience bears some examination because its tax structure is much like that in this country.

The Canadian indexing law was adopted in 1974 primarily in response to a sudden surge in inflation which, after averaging about 1% to 2% throughout the 1960s, hit 9.1% in 1973. Under the law, the personal exemption and the tax brackets are adjusted annually by the rate of inflation as measured by the change in the Canadian Consumer Price Index for the 12

months ending September 30, prior to the tax year. A child tax credit enacted in 1978 will also be indexed beginning in 1979. The actual inflation factor was 6.6% in 1974, 10.1% in 1975, 11.3% in 1976, 8.6% in 1977, 7.0% in 1978, and 9.0% in 1979, for a compound effect amounting to a 65.8% increase in the brackets and exemption in the first six years. Specifically, indexing has increased the personal exemption allowance for a taxpayer with a dependent spouse and two children from \$3,700 in 1974 to \$6,070 for 1979. The maximum tax rate bracket has increased from \$60,000 to \$99,480 in 1979.²⁶

Indexing has provided substantial tax relief to Canadian citizens. The department of finance estimates that indexing will reduce the 1979 federal tax burden by \$1.2 billion, and the total reduction from indexing alone is over \$6 billion since 1974. Moreover, the relief goes largely to low and middle income taxpayers; over 70% of the tax reductions have gone to taxpayers with incomes in the \$15,000–\$25,000 range.²⁷

What is the effect of indexation on government revenues in Canada? The \$1.2 billion reduction in 1979 amounts to approximately 8.0% of the projected \$14.9 billion in individual federal income tax collections and less than 3% of total federal revenue projections of \$40.5 billion.²⁸ Similar revenue reductions can be expected at the provincial level because, with the exception of Quebec, all provincial income taxes are expressed as a percentage of federal tax liability. Through 1978, federal revenues have still increased at a 9.0% annual rate since the introduction of indexing, and provincial revenues have grown at an even faster clip—some 14.2% per year from their 1973 levels.²⁹

In addition, both the national government and the provinces have pursued an expansionist fiscal policy through further discretionary income tax cuts in the years since the personal income tax was indexed.³⁰ Part of this expansionism, however, was financed through a growing federal government deficit which reached a level of roughly \$10 billion in 1978, approximately one-third of which is attributed to the effects of an economic slowdown.³¹

While there are no immediate signs of fiscal stress, there is some concern that the provincial governments may experience some fiscal

problems in the future if inflation is not reduced substantially to limit the upward pressures on government costs and ease the impact of indexing. Nonetheless, it is felt that indexing has become an important and accepted feature of the Canadian tax system, and to abandon it now would be politically quite unpopular.³² The long-run potential for fiscal trouble at the provincial level is not directly applicable to the United States. Unlike the Canadian provinces, only three states (Nebraska, Rhode Island, and Vermont) base their state income tax on a fixed percentage of federal tax liability.

FEDERAL INDEXING PROPOSALS

A variety of proposals to index the U.S. federal income tax have been presented to Congress since the first indexing bill was introduced by Sen. James Buckley (NY) in 1974. Indexing bills have reached various stages of the legislative process, but none has yet gained the approval of both houses. The most significant actions transpired in 1978.

Late in the year, the House of Representatives approved, by a 249 to 167 vote, an amendment to the Revenue Act of 1978 that would have indexed the basis for computing capital gains effective in 1981. The measure was, however, deleted by the House-Senate conference committee that put together the final tax package. Additionally, a bill to index the personal income tax brackets introduced by Rep. Willis Gradison (OH), along with over 100 co-sponsors, failed to reach the floor on a close vote in the House Ways and Means Committee.

On the Senate side, the Subcommittee on Taxation and Debt of the Finance Committee held hearings in April 1978, on S. 2738, introduced by Sen. Robert Dole (KS). This measure was more far reaching than most indexing proposals; it would have indexed the personal exemptions, tax brackets, and some other parts of the individual income tax, as well as parts of the estate and gift taxes and the capital gains tax. A version of the bill missed adoption in the full committee by two votes.

Interest in indexing has not waned in the 96th Congress. Rep. Gradison and Sen. Dole have gathered over 120 co-sponsors on their "Tax Indexing Act of 1979" (H.R. 365 and S.

12). The bills would index the personal exemptions and the income brackets by the annual change in the U.S. Consumer Price Index. They are awaiting hearings in the House Ways and Means Committee and Senate Finance Committee. Other bills to index the personal income tax have also been introduced in the 96th Congress (e.g., S. 211 by Sen. Hart (CO)) and indexing is part of a tax stimulus package recently introduced by Republican congressional leaders and a major tax reduction program introduced by Sen. William Roth (DE)

and Rep. Jack Kemp (NY).

In sum, indexation of the personal income tax is not an untried economic theory as a number of foreign countries and several states have successfully implemented indexation systems. With the sudden surge in inflation rates in the last two years has come an increasing interest at both the state and federal level in indexation as a tax reform and relief tool. The experience with indexation to date seems to buttress the economic and policy arguments supporting its adoption.

FOOTNOTES

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- ¹⁸ For further discussion, see John Shannon and Bruce Wallin, "Restraining the Federal Budget: Alternative Policies and Strategies," ACIR, *Intergovernmental Perspective*, Vol. 5, No. 2, Washington, DC, U.S. Government Printing Office, Spring 1979, pp. 8-14.
- ¹⁹ Neal Trasente, "Income Tax Indexing—Early Experience," paper presented to the 47th Annual Meeting of the National Association of Tax Administrators, Madison, WI, June 1979, p. 5.
- ²⁰ ACIR, *Significant Features of Fiscal Federalism*, *op. cit.*, p. 14.
- ²¹ Stanley Schwartz, "Indexation of the Income Tax in Colorado," *Revenue Administration-1978*, Washington, DC, Federation of Tax Administrators, 1978, pp. 167-73.
- ²² Robert Summers, "An Early Evaluation of State Tax Indexation in California," paper presented to the 47th Annual Meeting of the National Association of Tax Administrators, Madison, WI, June 1979, p. 3.
- ²³ Neal Trasente, *op. cit.*, pp. 8-10.
- ²⁴ David Jankofsky, "Income Tax Indexing," paper presented to the Western States Association of Tax Administrators, Stateline, NV, October 9, 1978, pp. 9-10.
- ²⁵ Wisconsin Legislative Fiscal Bureau, *Summary of Chapters I and II, Laws of 1979, Tax Reform and Reduction Program*, Madison, WI, Legislative Fiscal Bureau, March 1979, p. 15.
- ²⁶ Canadian Department of Finance, *Budget Papers*, Ottawa, Ontario, Department of Finance, November 16, 1978, pp. 27-28.
- ²⁷ *Ibid.*, pp. 29-30.
- ²⁸ Canadian Department of Finance, *The Budget*, Ottawa, Ontario, Department of Finance, April 10, 1978, pp. 19-21.
- ²⁹ Canadian Department of Finance, *Economic Review*, Hull, Quebec, Government Publishing Centre, April 1979, pp. 184 and 186.
- ³⁰ See Canadian Department of Finance, *Economic Review*, *op. cit.*, pp. 87 and 92-94; and ACIR, *Inflation and Federal and State Income Taxes*, *op. cit.*, pp. 74-75.
- ³¹ Canadian Department of Finance, *Economic Review*, *op. cit.*, pp. 85-86.
- ³² C.F. Steiss, "Indexation of Canada's Individual Income Tax System," *Tax Review*, Vol. XXXIX, No. 5, New York, NY, Tax Foundation, Inc., May 1978, p. 22.

Indexation: Challenge and Response

The concept of automatically adjusting personal income taxes for inflation does not meet with approval in all quarters. The purpose of this section is to highlight the major arguments made against indexation and to offer a rebuttal to those challenges. 27

PERIODIC TAX CUTS SHOULD BE PREFERRED

Challenge: Periodic, ad hoc tax reductions are a superior means of controlling the effects of inflation on individual tax burdens. Previous Congressional tax cuts have, in the aggregate, more than offset inflation-induced tax increases for the last two decades, and Congress has used these opportunities to make the tax system more progressive.

Response: While Congressional tax cuts have kept federal income tax receipts at 9.0% to 10.5% of personal income since 1960, viewing only the total tax burden overstates the record of Congress in compensating for the inflation tax. An analysis of historical tax liabilities by The Brookings Institution in 1975 revealed that the burden on taxpayers with \$25,000 to \$200,000 incomes had increased from 1960 to 1975 despite several tax cuts and that these income groups would have been better off had Congress indexed the 1960 tax code rather than enacting periodic tax reductions.³³

The analysis also found that the stable total tax burden was due primarily to the large 1964

tax cut and that Congress had not kept up with the inflation tax from 1964-75.³⁴ Moreover, the average tax burden is estimated to have increased from 1975-78³⁵ indicating further slippage on the part of Congress. In addition, ACIR's analysis shows nearly all real tax reductions from the Revenue Act of 1978 will be eliminated by 10% inflation in 1979. These developments point up both the difficulty of offsetting the tax effects of high inflation rates through periodic tax cuts and the uncertainty the public faces in relying on discretionary Congressional actions for relief from the inflation tax.

Regardless of whether Congress can or does offset the inflation tax, indexing holds an immense advantage for the taxpayer over the current system of discretionary tax reductions because it is an automatic, annual adjustment for the inflation tax. It removes the uncertainty taxpayers face when Congress seems disposed to use the inflation windfall for other purposes and balances tax cuts against the perceived need for restraint or stimulus in the economy. It insures that taxpayers will not suffer a silent increase in their tax burdens while Congress debates how to use the windfall revenues. With indexing, Congress will be forced to rely on real economic growth, deficit financing, or raising taxes to keep revenues increasing faster than inflation. Its ability to enact tax cuts with the inflation tax revenue will also be curbed. In short, indexing forces policymakers to address income tax issues in a manner for which they can clearly be held accountable by the public.

A similar measure of accountability will be imposed on state legislatures by the adoption of indexing at the state level. Indexing will eliminate the flexibility of legislatures to use inflation tax revenues for other purposes and improve the ability of citizens to focus responsibility for their state tax bills.

Indexing will not, however, eliminate the ability or the need for Congress and state legislatures to enact ad hoc tax cuts and make other adjustments in the tax code. Real income growth will still be taxed more than proportionately to its growth rate, and if the goal is to keep income tax revenues at a stable percentage of personal income, additional tax reductions will be necessary with indexing. Through these actions, such tax policy goals as redistributing income, stimulating savings, or

promoting economic expansion can still be achieved.

In the final analysis, the issue of indexation is more political than economic. That is, the question is primarily whether the increased real tax burden from inflation is eliminated automatically through indexing or whether taxpayers must continue to rely on ad hoc legislative actions for relief. The reduced flexibility and increased accountability imposed by indexing will, no doubt, make political life more difficult, as noted by Nobel Prize winning economist, Milton Friedman:

These reforms [tax indexation, among others] deserve wide support. They would reduce the harm done by inflation and would ease the withdrawal pains from reducing inflation. They would also lower the revenue that the government gets from inflation and hence the government's incentive to engage in inflation. This is at one and the same time a major argument in their behalf and the chief obstacle to their enactment.³⁶

In a representative democracy that rests on the ability of the public to hold elected officials accountable for their decisions, however, removing the unlegislated inflation tax through indexing seems a necessary reform.

LOSS OF FEDERAL REVENUE

Challenge: Indexation will reduce federal revenues substantially. This will limit the ability of government to respond to emerging public problems, impede the balancing of the federal budget, and in all likelihood, reduce the flow of aid to states and localities.

Response: Indexation will not cause federal revenues to decline in absolute terms, but will only slow the rate of growth in federal receipts. If one assumes that the responsiveness of the federal income tax is such that a 10% increase in income creates a 15% growth in tax collections (i.e., the income tax has an elasticity of 1.5), it can be said that indexing will reduce the *nominal growth rate from inflation* by one-third. Federal revenues will still increase in real terms along with real increases personal

income. If, as the Congressional Budget Office projects, real economic growth totals 14.3% from 1979-82,³⁷ income tax receipts will increase, in real terms, by 21.5% over that period in addition to increases just proportionate to inflation. In other words, indexing will not keep federal revenues from increasing; it only eliminates the windfall revenue bonuses now received from inflation.

The major difference indexing makes in the taxing-spending equation is the increased accountability imposed on elected officials. Congress will not be able to continue enacting tax cuts and still increase spending levels with the frequency and magnitude that it has in recent years. If increased revenues are necessary to balance the budget or implement new programs, Congress may be forced to raise taxes rather than relying on the unlegislated inflation tax for fiscal flexibility. The political constraints posed by tax increases, however, make it likely that federal policymakers will first consider their spending decisions more carefully in an effort to make federal revenues stretch further.

Because indexation will introduce a new measure of fiscal discipline in the budgetary process, the nearly 500 federal aid programs will be forced to operate in a more competitive environment. Indexing, however, would be only one of several factors that have caused federal assistance to states and localities to crest in recent years.³⁸ These constraints may encourage Congress to consolidate related categorical grants and give state and local governments greater flexibility but fewer dollars, a position some state and local policymakers are willing to accept. These belt-tightening developments should work in the right direction—toward a better allocation of federal resources and a healthier intergovernmental system. There is, however, no economic link between indexing and federal aid levels that would lead to an automatic reduction in the aid.

If the revenue effects of indexing are considered too onerous in the short run, it could be phased in over a period of time, or some form of partial indexing adopted. Those states and foreign countries that have enacted indexing measures offer a range of ways a limited or phased indexation could be structured.³⁹ Partial indexing schemes will not, however, accomplish the goal of keeping taxpayers with a

constant real income in the same relative tax position despite ongoing inflation, and the impact of limited indexation on different taxpayer groups will vary substantially depending on the system chosen. The better situation seems to be to phase in full indexation over a relatively short period of time.

STATE AND LOCAL FISCAL STRESS

Challenge: The reduced fiscal flexibility from indexing state income taxes could cause a greater reliance at the state and local level on more regressive property and sales taxes. States cannot resort to deficit financing for operating purposes as the federal government can, and they may be forced to enact sales and use tax increases or cutback on programs such as aid to local governments and state-financed property tax relief to meet growing expenditure needs.

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Response: As at the national level, indexing state income taxes will not cause an absolute reduction in state revenues. Income tax receipts will still increase more than proportionately to the rate of real growth in personal income and at a rate just equal to inflation for increases in income related to inflation. The ACIR estimates that if all states were to adopt indexing, income tax collections would still rise at an average annual rate of 13% from 1977-81, a decrease of only 2.5 percentage points from the yearly growth in actual state income tax collections between 1971 and 1975—a period in which several states enacted substantial income tax increases.⁴⁰

The impact of indexation on state revenues will, of course, vary among the states. It seems noteworthy, though, that the revenue effects in the six states that have adopted indexing are likely to be greater than in the majority of states because with few exceptions, their reliance on income tax revenues and the progressivity of their tax structures is above the national average. (See Figure II, p. 12.) Despite this, indexing has not prevented these states from providing additional state and local tax relief. Indexing was adopted as part of major income and property tax relief measures in Arizona, Minnesota, Iowa, and Wisconsin. California's indexation law was enacted the same year that most surplus state revenues were used to re-

place local property tax collections lost as a result of Proposition 13.

In addition, these six states have major property tax circuit-breaker programs financed through the income tax. A circuit-breaker is a property tax relief mechanism wherein property tax payments in excess of a specified percentage of household income are rebated to the taxpayer through an income tax refund or credit.⁴¹ In 1977, circuit-breaker programs in the six states with indexing accounted for over 30% (\$295.7 million) of the total property tax relief provided through the 29 state circuit-breaker programs.⁴² Either these states feel indexing will not impair these programs, or they consider the merits of indexing to outweigh the reduced revenue flexibility.

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States would not automatically be forced to raise existing sales and property taxes if additional revenues were needed subsequent to the adoption of indexing. They could use such an occasion to examine the overall state-local fiscal structure as well as make a careful evaluation of existing expenditure programs to provide additional funds. Alternative local revenue sources, user fees, and a thorough review of the income tax structure including such items as the range of the income brackets, the rate structure, and the deductibility of federal income taxes would appear to be candidates for review. If tax increases were necessary, it seems that a public education program on tax reductions and the benefits of indexing would help offset the political liabilities associated with tax hikes.

ECONOMIC STABILIZATION POLICY

Challenge: Indexation will add a degree of instability to the U.S. economy by eliminating the “automatic stabilizer” effect of the graduated income tax. An unindexed progressive tax helps restrain inflation by restricting consumer spending during an expansionary or inflationary period, and similarly, promotes an increase in consumer purchasing during a recession.

Response: Several recent studies have found that indexing will have a negligible impact on the stabilizing attributes of the income tax, and some have concluded that an unindexed tax may, under certain economic conditions, have

a destabilizing effect which indexing would moderate. Indexing may not affect the stabilizing capacity of the income tax because the increased tax collections to keep the economy from overheating during an expansion result from both increases in production and increases in prices (inflation). Recent research suggests that most of the increased tax receipts during an expansion come from production, and thus, indexation, which eliminates only the increased taxes from inflation, will have little effect on economic stability during an expansion.

This was the conclusion of James Pierce and Jared Enzler in their analysis of the U.S. economy under three types of expansionary changes if the income tax were indexed. Although they tried to accentuate the potential impacts of indexing, their conclusion was unequivocal:

There is simply no evidence that indexing the tax system would be harmful to economic stability. . . . In light of the undesirable effects that inflation has on the tax system, it would appear from our results that indexing should be adopted.⁴³

Similar results were achieved by two Canadian economists in an analysis of the issue in that country. They found that prices did not begin to increase until nearly a year after the expansionary change and concluded that nearly all the built-in stability of the income tax was attributable to its responsiveness to changes in production rather than inflation.⁴⁴

In addition, Dr. Thomas Dernburg, in a study for the Joint Economic Committee of the Congress, found that under certain circumstances, the nonindexed graduated tax may be a “destabilizer” and that indexing may, in fact, add stability in such cases.⁴⁵ His conclusion is based on the premise that during periods of inflation caused by cutbacks in supply—such as OPEC oil price increases and poor food harvests—prices and nominal income will increase as they would in periods of excess demand, but real income and real output will decline. This means that without indexation, income tax collections will be increasing at a time when money should be going into the economy to stimulate production. Unless other policies are adopted, this can lead to an eco-

conomic downturn with further production losses and increased unemployment even though inflation remains high—a set of circumstances sometimes called “stagflation.” Dernburg found that, in fact, this did happen during the 1974 recession when both inflation and unemployment were at very high levels. He concluded that by reducing federal tax collections “indexed taxes would have moderated the collapse in 1974.”⁴⁶

A study of the effect of indexing in Canada in 1974 produced the same conclusion:

The additional fiscal drag (increased tax collections) which inflation would have generated . . . without indexation would have been sufficient to plunge the economy into recession in early 1975 unless offset by discretionary fiscal changes.⁴⁷

With the recent recurrence of economic conditions very similar to 1974—a projected economic recession while inflation remains high in the wake of the June 1979 OPEC oil price increases—it seems an appropriate time for the Congress to consider indexation. Indexing might help moderate any recession, and there is little evidence suggesting that it would add instability to the economy under other economic conditions.

EFFECT ON WAGE DEMANDS

Challenge: Indexation will make it advantageous for labor unions with cost-of-living escalators in their contracts to push for greater wage increases in an effort to push up the rate of inflation. The combination of cost-of-living raises and indexing will make unions the beneficiaries of inflation and weaken any desire to bring the rate of inflation down.

Response: On the contrary, there is a reason to believe that indexing will have the opposite effect—that by preserving after-tax purchasing power, indexing may lead to more moderate wage demands and actually help control inflation.

It seems reasonable that indexation will help lessen wage demands because its purpose is to preserve a taxpayer’s after-tax purchasing power. To the worker what really matters is

take home pay rather than gross income because this is the money actually at the worker’s disposal to spend as he or she wishes. Under an unindexed tax structure where taxes increase more than proportionately to wage gains, the worker and union must push for a higher pre-tax income to achieve a given level of net income. In fact, they must push for a wage gain greater than inflation to keep after-tax purchasing power from being reduced by the inflation tax. Thus, higher income taxes can lead to higher wage demands. With an indexed tax structure, the after-tax income goal can be achieved with a smaller increase in pre-tax income meaning that the effect of union wage demands on inflation should be reduced with indexation.

The recent decision of the Australian government to index the income tax was prompted in no small measure by the demands of labor unions for this remedial action to preserve after-tax purchasing power. There is also evidence in European countries that after-tax income is becoming the bargaining goal of the labor unions. In Austria and Finland, income tax cuts have actually been negotiated by the government and unions as part of their wage discussions, and unions have begun expressing their wage targets on an after-tax basis in Germany and the Netherlands.⁴⁸

While there is less collaboration between unions and the government in this country, it seems plausible that the foreign experience should, in at least some respects, be applicable to the U.S., particularly as the government attempts to gain compliance with its wage-price guidelines and becomes more involved in labor negotiations. Certainly, unions must consider the effect of higher taxes in their wage negotiations.

Professor Dernburg in his study stated that the tax-wage interaction was a problem which should not be “underestimated” in the U.S. He found, from reviewing the history of wage increases after the 1964 tax cut and after the imposition of the tax surcharge in 1968, that higher income taxes may, indeed, stimulate higher wage demands—and lower taxes accomplish the reverse. As he put it:

This is, after all, quite reasonable. To the worker what counts is his net income after tax . . . and he may very rea-

sonably view a tax reduction as a substitute for a wage increase and vice versa.⁴⁹

Dernburg went on to point out that continuation of the higher taxes begetting higher wages cycle could act much the same as an OPEC oil price increase or an "exogenous supply shock" and lead to a period of stagflation with declining production and increasing inflation unless other policies were adopted. He concluded that indexing the income tax should help reduce wage demands and control inflation.⁵⁰

COMPLEXITY AND INEQUITIES

Challenge: Indexation of the personal income tax will add further complexity to an already complicated tax system. It will also lead to gross inequities because it does not address the effect of inflation on property income.

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Response: Indexing the personal income tax is not a complex process, and it will not make it more difficult for individual taxpayers to complete their tax forms. It simply requires the tax collection agency to compute an adjustment factor based on the rate of inflation as measured by the change in an established price index, such as the U.S. Consumer Price Index, and multiply the indexed parts of the tax code by the adjustment factor. If, for example, the inflation rate is 10%, the upper and lower boundaries of each income bracket and the personal exemption allowance would be multiplied by 1.10, and all other tax computations would proceed normally.

The inflation factor is generally based on the CPI change for a 12-month period ending prior to the completion of the tax year (e.g., June 30) which allows the tax agency sufficient time to refigure the tax tables and have the tax forms printed so that the taxpayers need not make any additional computations. To recompute the withholding tables in effect throughout the tax year will require the tax agency to estimate the inflation factor before the end of the applicable 12-month period which could result in over or under withholding depending on the accuracy of the forecasted inflation rate. While this obviously entails some additional administrative steps and costs for the tax agency, it is not unlike any other legislative changes in the tax law

made during the tax year.

The second part of this argument is correct in the sense that indexing the income brackets and personal exemptions, as is advocated here, does not eliminate the effect of inflation on items such as capital gains and business income.⁵¹ The effect of inflation on property income involves a complex set of economic, political, and tax accounting arguments about such topics as the measurement of income from capital, the treatment of debt payments during inflation, and the depreciation of capital assets. No consensus exists on how inflation affects these types of income, and they are excluded from the Commission's earlier deliberations and this report as areas in need of further research.

This should not, however, detract from the importance and merits of indexing the personal income tax brackets and exemptions which would eliminate the inflation tax on wage and salary income. As a practical matter, this indexing would solve most of the problem as wages and salaries accounted for 83.5% of the federal personal income tax base in 1976. To deny the benefits of indexing to the majority of American taxpayers because an inflation adjustment for property income cannot be perfected brings to mind the adage that "the counsel of perfection is the counsel of delay."

Indexing the personal exemptions and income brackets might serve as a first step toward attempting the more complex reforms needed for property income. At least, it should allow Congress to devote more attention to grappling with the issue.

YIELDING TO THE INFLATION PSYCHOLOGY

Challenge: By protecting taxpayers from the inflation tax, indexation builds inflation into our economic system and weakens the desire of both the citizens and government to bring it under control. Evidence for this exists in those countries that have indexed their tax codes; inflation continues to be a major problem, particularly in Latin America where 100% or more annual inflation is not uncommon.

Response: This challenge rests not so much on economic theory about inflationary cycles as it

does on certain perceptions about the American public and its governmental institutions. In effect, opponents of indexing are saying that as long as the public is assured it will not fall further behind inflation *solely* because of an increase in its tax liability, it will no longer consider inflation a problem and will learn to live with it. This seems unconvincing.

While it is true that indexation will enable the taxpayer whose pre-tax income increases at the rate of inflation to maintain his after-tax purchasing power and standard of living, indexing does nothing to assure that the taxpayer will receive the wage increase necessary to keep up with inflation in the first instance. If the taxpayer does not receive a salary increase sufficient to offset inflation, his purchasing power and standard of living will still decline even with indexing; all indexing does in such a case is adjust his tax burden to prevent him from losing even more ground to inflation. To contend that indexing insures the taxpayer against a loss of purchasing power is to credit it with more than it can do.

As syndicated columnist George F. Will stated:

It is preposterous to say . . . that indexing will cause people to become apathetic about inflation. People who suffer from inflation a dozen times a day, at every cash register, will not sink into complacency about inflation just because it no longer injures them in their capacity as federal taxpayers.⁵²

Furthermore, this challenge treats indexing

is if it were a new phenomenon in the U.S. In point of fact, a number of public expenditure programs have been indexed to the cost-of-living for quite some time. A 1976 study by the Congressional Budget Office indicated that approximately 63% of federal expenditures, including such programs as social security and school lunches, were fully indexed or "quasi-indexed" for inflation.⁵³ If indexing implies foregoing the fight against inflation, it seems that the ghost was given up before indexing the personal income tax was given serious consideration.

The contention that persistence of inflation in countries that have indexed their tax codes indicates they have abandoned efforts to control inflation is unpersuasive. Most of these countries continue to pursue anti-inflation programs that are often stronger than those of the U.S. In addition, it is difficult to believe that any industrialized country could have withstood the shock to the international economic system from the OPEC cartel without experiencing some increase in the inflation rate.

Most importantly, this allegation erroneously assumes that the primary aim of indexation is to combat inflation. The primary purpose of indexation is to eliminate one of inflation's many undesirable side effects—namely, the extraordinary increases in tax liability that it causes—rather than bring a halt to inflation. In so doing, however, it may have a beneficial impact in the fight against inflation by slowing the rate of public sector growth and moderating wage demands.

FOOTNOTES

³³ Emil M. Sunley and Joseph A. Pechman, *op. cit.*, pp. 160-61.

³⁴ *Ibid.*

³⁵ Robert Samuelson, *op. cit.*, p. 157.

³⁶ Milton Friedman, *Living with Inflation, Three Essays*, Washington, DC, American Enterprise Institute, 1979, p. 7.

³⁷ U.S. Congressional Budget Office, *Five-Year Budget Projections and Alternative Budgetary Strategies for Fiscal Years 1980-1984*, Washington, DC, U.S. Government Printing Office, 1979, p. 2.

³⁸ ACIR, *Significant Features of Fiscal Federalism*, *op. cit.*, pp 1-3.

³⁹ For a discussion of indexing in foreign countries, see Organization for Economic Cooperation and Develop-

ment, *The Adjustment of Personal Income Tax Systems for Inflation*, A Report of the Committee on Fiscal Affairs, Paris, France, Organization for Economic Cooperation and Development, 1976.

⁴⁰ ACIR, *Inflation and Federal and State Income Taxes*, *op. cit.*, p. 63.

⁴¹ For a complete discussion, see ACIR, *Property Tax Circuit-Breakers: Current Status and Policy Issues*, M-87, Washington, DC, U.S. Government Printing Office, February 1975.

⁴² ACIR, *Significant Features of Fiscal Federalism*, *op. cit.*, p. 63.

⁴³ James L. Pierce and Jared J. Enzler, "The Implication for Economic Stability of Indexing the Individual Income Tax," in Henry J. Aaron, ed., *Inflation and the Income Tax*, *op. cit.*, p. 188.

⁴⁴ John Bossons and Thomas A. Wilson, "Adjusting Tax Rates for Inflation," *Canadian Tax Journal*, Vol. XXI,

- No. 3, Toronto, Ontario, Canadian Tax Foundation, May-June 1973, pp. 185-99.
- ⁴⁵ Thomas F. Dernburg, *Indexing the Individual Income Tax for Inflation: Will This Help Stabilize the Economy?* A study prepared for the use of the Subcommittee on Fiscal Policy of the U.S. Joint Economic Committee, Washington, DC, U.S. Government Printing Office, 1976.
- ⁴⁶ *Ibid.*, pp. 10-11.
- ⁴⁷ G.V. Jump and T.A. Wilson, "Macro-Economic Effect of Federal Fiscal Policies: 1974-1975," *Canadian Tax Journal*, Vol. XXIII, No. 1, Toronto, Ontario, Canadian Tax Foundation, January 1975, p. 56.
- ⁴⁸ Organization for Economic Cooperation and Development, *op. cit.*, pp. 25-26.
- ⁴⁹ Thomas F. Dernburg, *op. cit.*, p. 12.
- ⁵⁰ *Ibid.*, pp. 6 and 12.
- ⁵¹ The tax on capital gains income would be reduced because it is computed on the basis of the rate brackets that are indexed under this proposal.
- ⁵² George F. Will, "A Cure for Income 'Taxflation'," *The Washington Post*, Washington, DC, Post Publishing Co., August 16, 1979, p. A-21.
- ⁵³ U.S. Congressional Budget Office., *The Effect of Inflation on Federal Expenditures*, Background Paper No. 9, Washington, DC, U.S. Government Printing Office, June 1976, p. 1.

The Time is Now

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Indexation of the federal and state personal income taxes is neither a panacea for all the perceived ills besetting the American public nor a cure for inflation itself. To some, it will seem weak medicine in the struggle for less government; others will view it as an overreaction that undermines the ability of government to effectively meet the needs of the people. Neither is an apt characterization. Seen in light of its purposes and limitations, indexing is, as stated at the outset, a reasoned and effective response to the political pressures of the taxpayers' revolt and the economic burdens imposed by inflation.

Indexation simply requires the government to play fair with the taxpayers. It prevents the public from continually losing ground to inflation solely because of the way the tax structure is set in law, and it eliminates the windfall bonus the government now receives from inflation. It shines the spotlight of political accountability on elected officials and forces them to publicly confront the taxing and spending issues of the day in a manner for which they can clearly be held responsible by the voters. In so doing, indexation would go far in easing the impact of inflation and restoring citizen confidence in our representative system of government. The time seems ripe for its adoption.

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Reviews theoretical impact of inflation on income taxes, particularly as it relates to property income measurement. Concludes that substantially more research is needed on questions of income measurement, equity during transition to an indexed system, and administrative costs.

2. Aaron, Henry J., ed., *Inflation and the Income Tax*, Washington, DC, The Brookings Institution, 1976, 390 pp.

Report of a conference on indexation. Partial contents (in addition to those cited elsewhere in this bibliography) include: "Inflation and the Definition of Taxable Income," by Roger E. Brinner; "Price Series for Indexing the Income Tax System," by Edward F. Denison; "The Economic and Budgetary Effects of Indexing the Tax System," by Edward M. Gramlich; and "Inflationary Distortions and Taxes," by Martin J. Bailey.

3. Allan, J. R., et. al., "Indexing the Personal Income Tax: A Federal Perspective," *Canadian Tax Journal*, Vol. XXII, No. 4, Toronto, Ontario, Canadian Tax Foundation, July-August 1974, pp. 355-69.

Reviews mechanics and justification for indexing the Canadian personal income tax from a federal perspective. Concludes that

indexing is "unambiguously" a progressive tax measure, superior to discretionary tax reductions from an accountability standpoint, and will not materially affect the built-in stabilizing capacity of a progressive income tax.

4. Arak, Marcelle, "The Effect of the Federal Individual Income Tax on Real After-Tax Incomes During Inflation," *Southern Economic Journal*, Vol. 42, No. 10, Chapel Hill, NC, Southern Economic Association, April 1976, pp. 720-23.

Demonstrates methodology for estimating reduction in real after-tax income as a result of inflation-induced tax increases and for determining relative contribution of various fixed dollar amounts to the inflation tax. Finds that decline in real after-tax income is felt least in the \$9,500-\$22,500 income range under 1975 tax law.

5. Bossons, John, and Thomas A. Wilson, "Adjusting Tax Rates for Inflation," *Canadian Tax Journal*, Vol. XXI, No. 3, Toronto, Ontario, Canadian Tax Foundation, May-June 1973, pp. 185-99.

Examines Canadian indexing system. Finds that indexing would be beneficial in removing tax inequities caused by inflation, slowing growth in government revenue, and would not substantially affect macroeconomic stabilization policy.

6. Dernburg, Thomas F., *Indexing the Individual Income Tax for Inflation: Will This*

Help to Stabilize the Economy?, a study for the Subcommittee on Fiscal Policy of the Joint Economic Committee of the U.S. Congress, Studies in Fiscal Policy, Paper No. 2, Washington, DC, U.S. Government Printing Office, December 27, 1976, 20 pp.

Concludes that allowing aggregate income tax burden to rise as a result of inflation is an inefficient means of slowing inflation and that indexing the personal income tax may have beneficial impact on stabilization policy.

7. Federation of Tax Administrators, *Income Tax Indexing: Recent State Laws*, Washington, DC, Federation of Tax Administrators, 1978, 25 pp.

Reviews Canadian indexing experience, federal indexing proposals, state indexing laws, and studies of indexing at state level.

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8. Feldstein, Martin S., "Adjusting Tax Rules for Inflation—Capital Gains and Capital Income," *Tax Review*, Vol. XL, No. 1, New York, NY, Tax Foundation, Inc., January 1979, pp. 55–58.

Reviews several studies of the effect of inflation on the taxation of property income and concludes that the tax distortions caused by inflation are a major obstacle to capital formation.

9. Fellner, William, et. al., *Correcting Taxes for Inflation*, Washington, DC, American Enterprise Institute for Public Policy Research, 1975, 47 pp.

Analyzes effect of inflation on 1974 personal and business income tax liability and compares tax reductions from 1974 tax rebate and *Tax Reduction Act of 1975* to what would have been provided with indexing. Concludes that indexing is necessary in order to separate legislative corrections of inflationary distortions from intentional modifications of basic tax structure.

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11. Friedman, Milton, "Monetary Correction," *Essays on Inflation and Indexation*, Washington, DC, American Enterprise Institute for Public Policy Research, 1974, pp. 25–62.

Proposes indexing the personal, capital gains, and business income tax as one part of program for reducing inflation through widespread use of escalator and index clauses.

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Examines effect of inflation and increased Social Security taxes on tax cuts in the *Revenue Act of 1978* at 14 real income levels. Finds that the combination of tax increases induced by approximately 7% inflation and higher payroll taxes will offset legislated reduction for all income groups except those below \$5,000 and above \$100,000 by 1980.

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Analyzes effect of inflation on federal real income tax rates at various income levels from 1954–70. Despite 1964 tax cut, real tax rates rose for many taxpayer groups, particularly those with low incomes and large families.

14. Hull, Brian, and Lawrence Leonard, "Indexing the Personal Income Tax: An Ontario Perspective," *Canadian Tax Journal*, Vol. XXII, No. 4, Toronto, Ontario, Canadian Tax Foundation, July–August 1974, pp. 370–77.

Examines effect of indexing in Canada on provincial government revenues. Contends that tax reductions for individuals may be offset, in long run, by increased tax rates or other types of taxes if revenue growth is not sufficient to meet growing demands for public services.

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16. Jankofsky, David P., "Income Tax Indexing," paper presented to Western States Association of Tax Administrators, Stateline, NV, October 1978, 15 pp.

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Uses series of mathematical equations to demonstrate that in the absence of indexation, an expansionary fiscal policy of increased government expenditures may lead to stagflation. Suggests that indexation is necessary to re-establish effectiveness of fiscal policy and alleviate random inflation-induced tax burden.

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Reviews pro and con arguments, technical aspects, and policy implications of indexing personal income taxes, and summarizes indexation systems of several foreign countries.

22. Perry, David B., "Taxation and Real Income," *Canadian Tax Journal*, Vol. XXVII, No. 3, Toronto, Ontario, Canadian Tax Foundation, May-June 1979, pp. 367-70.

Compares pre-tax and after-tax income growth for various hypothetical Canadian taxpayers from 1968-78. Evidence indicates that indexation and other tax actions have enabled Canadian taxpayers to enjoy a growing real after-tax income.

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Simulates response of the economy to three types of expansionary shocks with an indexed personal income tax. Concludes that indexing will not affect economic stability and, in light of the undesirable effects of inflation on tax burdens, that indexing should be adopted.

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Reviews Colorado indexation statute and estimates its impact on state revenues and various taxpayer groups. Expresses concern over long-run revenue effects.

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Reviews indexing system and experience of Canada. Concludes that indexing has become a popular, but costly, part of the tax system, and that it is not likely to be extended to other parts of the tax law.

- 40 27. Summers, Robert C., "An Early Evaluation of State Tax Indexation in California," paper presented to the National Association of Tax Administrators, Madison, WI, June 1979, 7 pp.

Examines California indexing plan and its effects on state revenues.

28. Sunley, Emil M., "Indexing the Income Tax for Inflation," paper presented to the NTA-TIA Symposium on Federal Tax Policy and the Tax Legislative Process, Washington, DC, May 15, 1979, 10 pp.

Contends that past Congressional actions have offset the effect of inflation on personal and corporate tax burdens. Concludes that indexing must be weighed against the complexity it adds to the tax system and the lack of consensus on measuring income from capital during an inflationary period.

29. Sunley, Emil M., and Joseph A. Pechman, "Inflation Adjustment for the Individual Income Tax," in Henry J. Aaron, ed., *Inflation and the Income Tax*, Washington, DC, The Brookings Institution, 1976, pp. 153-71.

Examines effect of tax reductions from 1960-75 on individual tax liabilities and effects of indexing on federal revenues. Finds that, in the aggregate, tax cuts have offset the effect of inflation, but with a different distribution among income groups than would have been the case with indexing.

30. Trasente, Neal G., "Income Tax Indexing—Early Experience," paper presented to National Association of Tax Administrators, Madison, WI, June 1979, 10 pp.

Examines first-year experience with indexing in Arizona including estimate of the impact on state revenues and tax savings among income groups.

31. U.S. Advisory Commission on Intergovernmental Relations, *Inflation and Federal and State Income Taxes*, A-63, Washington, DC, U.S. Government Printing Office, 1976, 88 pp.

Analyzes impact of inflation and indexation on federal and state individual income tax burdens and revenues, and examines the intergovernmental issues involved in indexing. Recommends that federal and state governments index their personal income taxes, and until such time as indexation is accomplished, that the amount of inflation-induced federal and state personal income tax increases be estimated and publicized each year.

32. U.S. Congress, Senate, Committee on Finance, Subcommittee on Taxation and Debt Management Generally, *Indexation of Certain Provisions of the Tax Laws*, Hearings before the . . . on S. 2738, Washington, DC, U.S. Government Printing Office, 1978, 160 pp.

Hearings on legislation to index the personal income tax, estate and gift tax, and the asset basis for computing capital gains. Contains testimony from Congressional supporters and testimony of U.S. Treasury Department in opposition to the bill.

33. Von Furstenberg, George, M., "Individual Income Taxation and Inflation," *National Tax Journal*, Vol. XXVIII, No. 1, Columbus, OH, National Tax Association, March 1975, pp. 117-25.

Measures average tax rates for several real income classes for period 1965-72. Finds that Congressional tax cuts during the period offset the inflation-induced tax increases only for the lowest income groups.

34. Will, George F., "A Cure for Income 'Taxflation'," *The Washington Post*, August 16, 1979, p. A-21.

Concise summary of the case for indexing.

An ACIR Legislative Guide to State-Local Financial Management

The Advisory Commission on Intergovernmental Relations has long been concerned with the problems state and local governments have in organizing their financial management systems, especially when these efforts are hampered by outdated, unduly restrictive, or nonexistent state legislation. Recognizing the need for timely assistance in this area, the ACIR, in January 1978, embarked upon a project to encourage state initiatives in local financial management capacity building.

41

The initial phase of the project involved drafting and revising 19 pieces of model legislation governing a broad range of financial management topics. The bills are based on a wealth of ACIR policy recommendations and existing state statutes in the financial management field and are intended as a useful reference for state and local officials interested in improving state-local financial management. The model bills fall roughly into three categories—increased accountability; improving administration and oversight procedures; and removing unnecessary shackles on state and local fiscal operations—and cover areas ranging from indexation of the state individual income tax to preventing and controlling local financial emergencies.

In addition, the ACIR is now providing technical assistance to states in the areas covered by the 19 model bills. The types of assistance available include providing drafting assistance to tailor legislation to specific needs, providing

consultants for one or two days of in-depth technical aid, conducting "in-state" seminars, meeting with legislators from several states to discuss specific areas of mutual concern, and providing background research reports and copies of statutes on which the bills are based.

The project is funded by a grant from the U.S. Department of Housing and Urban Development, as part of its Local Financial Management Capacity Sharing Program, and is operated in conjunction with the National Governors' Association and the National Conference of State Legislatures. For more information on the project or copies of the 19 model bills, please contact ACIR, Policy Implementation, 1111-20th Street, NW, Washington, DC 20575.

The model bills in the ACIR financial management legislative package include:

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INCREASED ACCOUNTABILITY

Full Disclosure of Property Tax Increases (Truth in Taxation). Establishes a procedure for local legislative bodies to set the property tax rate each year to produce the same amount of revenue as the previous year with optional allowances for new construction or a specified percentage of revenue growth. In order to raise the rate, the proposed increase must be advertised and a public hearing held.

Indexation of the State Individual Income Tax. Requires annual adjustment of the personal exemptions, low income allowances, maximum limit of the standard deduction, per capita credits, and tax rate brackets by the rate of inflation to prevent the automatic, real tax increases that would otherwise result from inflation-related gains in income. Requires the Governor to highlight in the budget the individual income tax revenues attributable to inflation for the prior year, current year, and upcoming year. The text of this bill follows these summaries.

State Mandates. Provides that costs imposed on local governments by state mandates for new programs, increased service levels, and improved personnel or retirement benefits will be reimbursed, wholly or in part, by the state. Also provides for a catalog of state mandates and a procedure for filing, reviewing, and appealing reimbursement applications.

Legislative Notes on the Fiscal Impact of State Legislative Actions on Local Governments. Requires all proposed legislation and administrative rules affecting local governments to contain a realistic estimate of the effect on local government expenditures and revenues of implementing or complying with the proposed action.

State Compensation to Local Governments for State-Owned Property. Provides for an inventory of state-owned property and compensation to local governments for the tax exempt property under one of three mechanisms: service charges for improved property; tax equivalency for undeveloped land holdings; and shared revenue from revenue-producing property.

State Budgeting and Appropriation of Federal Monies Received by the State. Requires state agencies to notify the state budget officer or appropriate legislative committee chairperson prior to applying for federal monies and prohibits state agencies from expending federal money unless it is appropriated by the legislature. Because of varying state budgetary practices, a variety of exemptions and options is provided as are statutory and constitutional language allowing the legislature to delegate the appropriation authority to a special committee to act when the legislature is not in session.

Citizen Participation in the Budget Process. Requires public notice and hearing on the adoption of the local budget and provides that the full budget is to be made available for inspection after its adoption.

IMPROVED ADMINISTRATION AND OVERSIGHT PROCEDURES

State Aid Administration. Provides for the codification, review, and periodic evaluation of all programs of state aid to local governments. State aid formulas are to be reviewed annually and the performance of all programs is to be reviewed periodically.

Establishment of a Consolidated State-Administered Pension System. Creates a consolidated statewide retirement system to supersede existing state and local programs. Provides alternative procedures for supersession and

holds harmless benefit rights for existing employees absorbed into the new system.

State Standards, Review and Assistance Regarding Local Retirement Systems. Establishes a pension review commission to provide technical assistance to local retirement systems and to study and analyze existing programs and proposed changes in benefits. Requires periodic actuarial valuations of existing systems and estimates of the cost of all proposed changes.

Preventing and Controlling Local Financial Emergencies. Prescribes the conditions under which a financial emergency shall be declared. Establishes a board to review and supervise the financial management of the affected locality and requires the adoption of a plan for restoring fiscal soundness.

Pooled Insurance. Establishes a voluntary, cooperative risk management program for state and local governments and authorizes local governments to form joint cooperative insurance programs.

Public Deposits and Investment of Idle Funds. Provides for state assistance to local governments in the management of their funds and prescribes qualified investments for local funds. Establishes a state-administered pool for investing idle local government funds on a voluntary basis.

State Supervision and Assistance in Regard to Local Debt Issuances. Authorizes a state agency to set standards governing the issuance of debt instruments by local governments and to provide technical and other assistance in the marketing and management of local debt.

State Regulation of Local Accounting, Auditing and Financial Reporting. Requires local gov-

ernments to comply with generally accepted principles of governmental accounting, to issue an annual financial report in accordance with such principles, and to have an annual audit of financial operations performed. Establishes a commission to promulgate accounting and auditing standards and provide technical assistance in complying with the standards. Provides for a three-year transition period.

Intergovernmental Cooperation in Tax Administration. Provides for the exchange of tax records among states, the federal government, and local governments for tax enforcement purposes and authorizes state officials to require proof of payment of local taxes prior to the issuance of automobile and liquor licenses and papers of incorporation.

REMOVING UNNECESSARY SHACKLES ON STATE AND LOCAL GOVERNMENTS

43

Removal of Constitutional Restrictions on State Borrowing. Allows states to incur debt for any public purpose. The debt is to be secured by the full faith and credit of the state.

State Constitutional Restrictions on Local Borrowing Powers. Removes details regarding local government borrowing powers from the state constitution and authorizes the legislature to establish local debt policy through the normal legislative process.

Repeal of Constitutional Restrictions on Local Taxing Powers. Removes details regarding local taxing powers from the state constitution and authorizes the legislature to establish local tax policy through the normal legislative process.

4.108 Indexation of the State Individual Income Tax¹

Inflation interacts with any progressive individual income tax to generate increases in tax revenue more than proportionate to the rate of inflation. These increases occur with practically no public debate or disclosure of the fact. Therefore, the Advisory Commission on Intergovernmental Relations recommended, in the interest of complete public information, that the amount of the inflation-induced, state personal income tax increase be calculated and publicized for each tax year. The Commission further recommended that the states give early and favorable consideration to indexation—the annual adjustment of the personal exemptions, the low-income allowance, the maximum limit of the standard deduction, any per capita credits, and the tax rate brackets—of the state individual income tax by the rate of increase in the general price level.

Four major considerations prompted this recommendation:

Fiscal Accountability. Indexation is needed to insure that higher effective income tax rates are the product of overt legislative action rather than the automatic consequence of inflation.

Tax Equity. The maintenance of tax equity requires that increases in tax liability be based on real rather than normal income. Inflation is

especially hard on low-income families and all families with many dependents because it erodes the value of personal exemptions, the low-income allowance, the maximum limit of the standard deduction and per capita credits.

Public Sector Growth. Without indexation, there is a bias in favor of an expanded public sector because inflation automatically pushes taxpayers into higher tax brackets with the consequent unlegislated increase in governmental revenues.

Current Inflation Rates. The significance of the above considerations takes on increased importance in these times when inflation is well above historic rates.

The suggested legislation that follows requires the Governor to estimate and publicize the impact of inflation on individual income tax revenues. It also requires the annual adjustment of tax rate brackets, personal exemptions, credits, and standard deductions by an inflation factor defined as the ratio of the U.S. Department of Labor Consumer Price Index (CPI) for the tax year to the CPI for the previous year. Because the U.S. Department of Labor does not develop a separate CPI for each state, a state may wish to modify the national, regional, and metropolitan area indices to fit its own situation.

The legislation was drawn in part from bills introduced (but not enacted) in the U.S. Congress and the Illinois General Assembly, and on indexation provi-

¹Derived from ACIR, *Inflation and Federal and State Income Taxes*, A-63, Washington, DC, U.S. Government Printing Office, November 1976. See also suggested state legislation *Full Disclosure of the Effect of Rate and Base Changes on Local Revenue*.

sions of the Canadian income tax act, enacted in 1973, and the Colorado income tax act (H.B. 1194) enacted in April 1978.

Section 1 states the title of the act.

Section 2 is a statement of findings and purpose of the act.

Section 3 defines key terms.

Section 4 requires the Governor to prepare and

publicize an estimate of the inflationary impact on individual income tax revenue.

Section 5 provides for indexation of rate brackets, personal exemptions and credits, and maximum and minimum standard deductions by the rate of inflation.

Sections 6 and 7 are separability and effective date clauses, respectively.

Suggested Legislation

**[AN ACT TO REQUIRE DISCLOSURE OF
THE INFLATIONARY IMPACT ON
INDIVIDUAL INCOME TAX REVENUE
AND TO PROVIDE FOR ANNUAL ADJUSTMENT OF
KEY PERSONAL INCOME TAX ELEMENTS
FOR INFLATION]**

(Be it enacted, etc.)

1 SECTION 1. *Short Title.* This act may be cited as the “[*State*] Income Tax Indexation Act.”

2 SECTION 2. *Findings and Purpose.*

3 (a) The [*legislature*] finds that inflation erodes the value of personal exemptions, deductions, and
4 tax credits in the [*state*] individual income tax structure and distorts fiscal equity among taxpayers. The
5 [*legislature*] finds, further, that inflation-induced increases in individual income tax revenues result in
6 annual collections that exceed the amounts anticipated by legislative actions establishing rates,
7 exemptions, deductions, and other features of the [*state*] individual income tax.

8 (b) It is the purpose of this act to correct these situations by:

9 (1) requiring that the Governor prepare an annual estimate of the impact of inflation
10 on individual income tax collections; and

11 (2) requiring that certain elements of the individual income tax structure be adjusted in
12 accordance with annual increases in the Consumer Price Index.

13 SECTION 3. *Definitions.* As used in this act:

14 (a) “Inflation factor” means the ratio of the Consumer Price Index for the 12-month period
15 ending [June 30] [September 30] of the current tax year to the Consumer Price Index for the
16 immediately preceding tax year, rounded to the nearest one-thousandth.

17 (b) “Consumer Price Index” means the average over a 12-month period of the Consumer
18 Price Index published monthly by the Bureau of Labor Statistics, U.S. Department of Labor [as
19 adjusted by the [*state statistical or economic development agency*]].

20 SECTION 4. *Annual [Biennial] Estimate of Inflationary Impact on Individual Income Tax*
21 *Revenues.* The Governor shall include in the [annual] [biennial] executive budget an estimate for the
22 previous year, the current year and the following [budgeted] year of the amount of actual or anticipated
23 revenue from the individual income tax that can be reasonably attributed to inflation. These estimates
24 shall be highlighted in the budget message, [the economic message, and the state of the state address]
25 and included prominently in press releases relating to the budget.

26 SECTION 5. *Adjustments for Inflation.*

1 (a) The [*state statistical agency*] [*state economic development agency*] shall annually by [July 15]
2 [October 15] prepare and promulgate an inflation factor for the tax year for use by the [*state*
3 *department of revenue*] in making the adjustments required in subsection (b) of this section. In
4 preparing the inflation factor, the [*state statistical agency*][*state economic development agency*] shall,
5 using the best statistical techniques compatible with those used by the U.S. Department of Labor in
6 preparing the monthly Consumer Price Index, adjust the Consumer Price Index to conform most nearly
7 to the situation that exists in this state.

8 (b) Sections [*refer to sections of the state individual income tax law relating to tax rate brackets,*
9 *personal exemptions, per capita credits, and minimum and maximum standard deductions*] are amended
10 by adding to the end of each the following new subsection:

11 “(*insert codification*) Upon promulgation of the inflation factor under Section 5(a) of this act, the
12 [*head of the department of revenue*] shall multiply each dollar amount set forth in this section, as
13 adjusted under this subsection in the immediately preceding tax year, by the inflation factor. If the
14 inflation factor for the current tax year is less than [1.000] [1.030] [*other*], no further adjustment shall
15 be made and the [*exemption, brackets, deductions, etc.*] shall be as determined for the immediaely
16 preceding tax year.¹

17 SECTION 6. *Separability.* [*Insert separability clause.*]

18 SECTION 7. *Effective Date.* [*Insert effective date.*]

¹The dollar amount to which the inflation factor is applied in each year is the dollar amount determined in the preceding tax year through the use of the inflation factor.

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What is ACIR?

The Advisory Commission on Intergovernmental Relations (ACIR) was created by the Congress in 1959 to monitor the operation of the American federal system and to recommend improvements. ACIR is a permanent national bipartisan body representing the executive and legislative branches of Federal, state, and local government and the public.

The Commission is composed of 26 members—nine representing the Federal government, 14 representing state and local government, and three representing the public. The President appoints 20—three private citizens and three Federal executive officials directly and four governors, three state legislators, four mayors, and three elected county officials from states nominated by the National Governors' Conference, the Council of State Governments, the National League of Cities/U.S. Conference of Mayors, and the National Association of Counties. The three Senators are chosen by the President of the Senate and the three Congressmen by the Speaker of the House.

Each Commission member serves a two year term and may be reappointed.

As a continuing body, the Commission approaches its work by addressing itself to specific issues and problems, the resolution of which would produce improved cooperation among the levels of government and more effective functioning of the federal system. In addition to dealing with the all important functional and structural relationships among the various governments, the Commission has also extensively studied critical stresses currently being placed on traditional governmental taxing practices. One of the long range efforts of the Commission has been to seek ways to improve Federal, state, and local governmental taxing practices and policies to achieve equitable allocation of resources, increased efficiency in collection and administration, and reduced compliance burdens upon the taxpayers.

Studies undertaken by the Commission have dealt with subjects as diverse as transportation and as specific as state taxation of out-of-state depositories; as wide ranging as substate regionalism to the more specialized issue of local revenue diversification. In selecting items for the work program, the Commission considers the relative importance and urgency of the problem, its manageability from the point of view of finances and staff available to ACIR and the extent to which the Commission can make a fruitful contribution toward the solution of the problem.

After selecting specific intergovernmental issues for investigation, ACIR follows a multistep procedure that assures review and comment by representatives of all points of view, all affected levels of government, technical experts, and interested groups. The Commission then debates each issue and formulates its policy position. Commission findings and recommendations are published and draft bills and executive orders developed to assist in implementing ACIR policies.