

LEG. FINANCE - BILLS 1979 - 1980 1321

SB 260 thru SB 266 1321



# RECORDS CERTIFICATION



I, the undersigned, an employee of the State of Alaska, do hereby certify that the microfilm images on this microform are accurate reproductions of the original records of the State of Alaska as accumulated during the regular course of business, and that it is the established policy and practice of this State to microfilm its records and to dispose of the original records after microfilm reproductions have been made.

James O. Smith  
Signature of Camera Operator

3/23/90  
Date

No fis. note

R/O

w/ bill

# COMMITTEE REPORT

4/22/80

## HOUSE

FURTHER:

Date: 5/14/80

Mr. Speaker:

The Committee on FINANCE has had CSSB 260

"An Act repealing the school tax, providing for refund of school tax payments for the 1980 tax year; and providing for an effective date."

under consideration and (a majority of the committee) (the committee) reports it back with the following recommendations:

- do pass  do not pass
- do pass with attached amendments(s)
- replace with <sup>H</sup>CS for CSSB 260  same title  
 new title
- and recommends Do Pass
- AND attaches a "Letter of Intent"  New Fiscal Note
- reports it back without recommendation
- referred to the \_\_\_\_\_ Committee

**MEMBERS SIGNING  
DO PASS**

[Signature]

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**MEMBERS HAVING  
OTHER RECOMMENDATIONS:**

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[Signature]  
CHAIRMAN

Original sponsor: Stimson

1 IN THE SENATE

BY THE FINANCE COMMITTEE

2 HOUSE CS FOR CS FOR SENATE BILL NO. 260

3 IN THE LEGISLATURE OF THE STATE OF ALASKA

4 ELEVENTH LEGISLATURE - SECOND SESSION

5 A BILL

6 For an Act entitled: "An Act relating to taxes: repealing the school tax  
7 and providing for the refund of school tax payments  
8 withheld for the 1980 tax year, and exempting the  
9 income of nonresident members of flight crews from the  
10 Alaska net income tax; and providing for an effective  
11 date."

12 BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF ALASKA:

13 \* Section 1. AS 43.20.035 is amended by adding a new subsection to read:

14 (d) The income earned by a nonresident from personal services  
15 provided in Alaska as a member of a flight crew on a regularly scheduled  
16 commercial aircraft flying to, from, or in Alaska is exempt from taxa-  
17 tion under this chapter.

18 \* Sec. 2. AS 43.45 is repealed.

19 \* Sec. 3. Section 2 of this Act is retroactive to January 1, 1980, and  
20 applies to tax years beginning after December 31, 1979.

21 \* Sec. 4. The Department of Revenue shall establish procedures for refund-  
22 ing to a taxpayer amounts received in payment of the school tax levied under  
23 AS 43.45 for the 1980 tax year and shall refund to the taxpayer the tax which  
24 was withheld for the 1980 tax year by an employer and paid to the department  
25 under AS 43.45.010(c). Other tax money paid to the Department of Revenue  
26 under AS 43.45 for the 1980 tax year shall be refunded to the taxpayer who  
27 made the payment.

28 \* Sec. 5. Section 1 of this Act is retroactive to January 1, 1976, and  
29 applies to tax years beginning after December 31, 1975.

1 \* Sec. 6. This Act takes effect immediately in accordance with AS 01.10.-  
2 070(c).  
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Original sponsor: Stimson

1. IN THE SENATE BY THE FINANCE COMMITTEE.

2 HOUSE CS FOR CS FOR SENATE BILL NO. 260

3 IN THE LEGISLATURE OF THE STATE OF ALASKA

4 ELEVENTH LEGISLATURE - SECOND SESSION

5 A BILL

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9 income of nonresident members of flight crews from the  
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THE LEGISLATURE OF THE STATE OF ALASKA  
ELEVENTH LEGISLATURE

FISCAL NOTE

I. REQUEST

Bill/Resolution No. CS for Senate Bill No. 260  
 Title An Act repealing school tax and providing for refund of 1980 payments  
 Requested by The Finance Committee Date April 30, 1980

II. FISCAL DETAIL

Agency Affected Revenue  
 Program Category Affected Fiscal Services  
 BRU, Program, or Subprogram(s) Affected Audit Division  
 (Note: If more than one budget component is affected, separate line-item amounts and funding for each component in the analysis section.)

EXPENDITURES (Thousands of Dollars)

	FY 80	FY 81	FY 82	FY 83	FY 84	FY 85
100 PERSONAL SERVICES						
200 TRAVEL						
300 CONTRACTUAL						
400 COMMODITIES						
500 EQUIPMENT						
600 LAND & STRUCTURES						
700 GRANTS, CLAIMS, ETC.						
<b>TOTAL</b>	<b>-0-</b>	<b>-0-</b>	<b>-0-</b>	<b>-0-</b>	<b>-0-</b>	<b>-0-</b>

FUNDING (Thousands of Dollars)

GENERAL FUND	-0-	-0-	-0-	-0-	-0-	-0-
FEDERAL FUNDS						
OTHER (Specify Fund Source)						

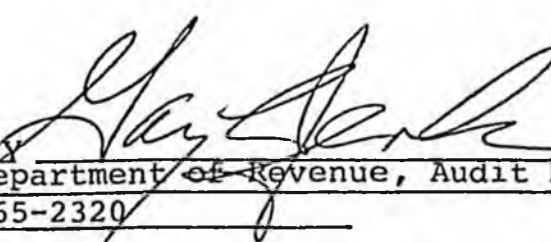
POSITIONS None

FULL TIME						
PART TIME						
TEMPORARY						

III. ANALYSIS (See Fiscal Note Preparation Instructions, Section III)

This bill will have no effect on the operation of this division.

IV. DATE April 30, 1980

PREPARED BY   
 AGENCY Department of Revenue, Audit Division  
 PHONE 465-2320

Original: Legislative Finance  
 cc: Budget and Management  
 Prime Sponsor (First Legislator Named)

THE LEGISLATURE OF THE STATE OF ALASKA  
ELEVENTH LEGISLATURE

FISCAL NOTE

I. REQUEST

Bill/Resolution No. CS for Senate Bill No. 260  
 Title An Act repealing the school tax and refunding 1980 school tax payments  
 Requested by House Finance Committee Date 4-28-80

II. FISCAL DETAIL

Agency Affected \_\_\_\_\_  
 Program Category Affected \_\_\_\_\_  
 BRU, Program, or Subprogram(s) Affected \_\_\_\_\_  
 (Note: If more than one budget component is affected, separate line-item amounts and funding for each component in the analysis section.)

EXPENDITURES (~~Thousands~~ of Dollars)  
Millions

	FY 80	FY 81	FY 82	FY 83	FY 84	FY 85
100 PERSONAL SERVICES						
200 TRAVEL						
300 CONTRACTUAL						
400 COMMODITIES						
500 EQUIPMENT						
600 LAND & STRUCTURES						
700 GRANTS, CLAIMS, ETC.		\$1.8				

TOTAL

FUNDING (~~Thousands~~ of Dollars)  
Millions

	FY 80	FY 81	FY 82	FY 83	FY 84	FY 85
GENERAL FUND	-0-	(\$2.7)	(\$2.8)	(\$2.9)	(\$3.0)	(\$3.1)
FEDERAL FUNDS						
OTHER (Specify Fund Source)						

POSITIONS

FULL TIME						
PART TIME						
TEMPORARY						

III. ANALYSIS (See Fiscal Note Preparation Instructions, Section III)

The \$1.8 million in refunds are for the school tax payments made during the first two quarters of calendar year 1980. It is assumed that these refunds will be made in FY 1981.

IV. DATE 4-28-80 PREPARED BY Bill Yankee  
 AGENCY Research/Department of Revenue  
 PHONE 465-2173  
 Original: Legislative Finance  
 cc: Budget and Management  
 Prime Sponsor (First Legislator Named)

THE LEGISLATURE OF THE STATE OF ALASKA  
ELEVENTH LEGISLATURE

FISCAL NOTE

I. REQUEST  
 Bill/Resolution No. Senate Bill No. 260  
 Title An Act repealing the school tax  
 Requested by Health, Education & Social Services, Date April 17, 1979  
Finance and Labor & Management Committees

II. FISCAL DETAIL  
 Agency Affected Revenue  
 Program Category Affected Fiscal Services  
 Budget Request Unit(s) Affected Audit Division

EXPENDITURES (Thousands of Dollars) None

	FY 79	FY 80	FY 81	FY 82	FY 83	FY 84
100 PERSONAL SERVICES						
200 TRAVEL						
300 CONTRACTUAL						
400 COMMODITIES						
500 EQUIPMENT						
600 LAND & STRUCTURES						
700 GRANTS, CLAIMS, ETC.						
TOTAL						

FUNDING (Thousands of Dollars) None

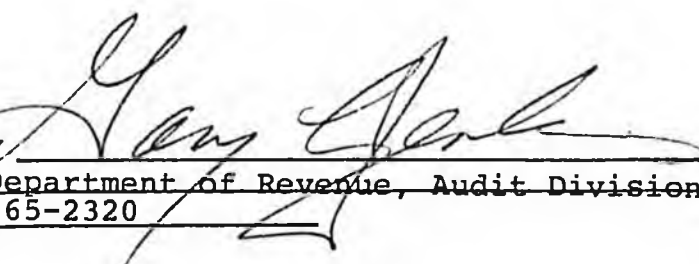
GENERAL FUND						
FEDERAL FUNDS						
OTHER (Specify)						

POSITIONS None

FULL TIME						
PART TIME						
TEMPORARY						

III. ANALYSIS (See Fiscal Note Preparation Instructions, Section III)

See memorandum to R. D. Stevenson dated 4/17/79, attached.

IV. DATE April 17, 1979 PREPARED BY   
 Original: Legislative Finance AGENCY Department of Revenue, Audit Division  
 cc: Budget and Management PHONE 465-2320  
Prime Sponsor (First Legislator Named)

STATE  
of ALASKA

## MEMORANDUM

TO:  R. D. Stevenson  
Special Assistant  
Department of Revenue

DATE: April 17, 1979

FILE NO:

TELEPHONE NO:

FROM: Gary L. Jenkins  
Director  
Audit Division

SUBJECT: Senate Bill No. 260

This bill would repeal the school tax which is ch. 45 of Title 43. The result of this action would be a loss of revenue to the State for 1980 of approximately \$2,500,000.

There would be no affect on the administrative costs as a result of this legislation.

Original sponsor: Stimson

Offered: 4/17/80  
Referred: Rules

1 IN THE SENATE

BY THE FINANCE COMMITTEE

2 CS FOR SENATE BILL NO. 260

3 IN THE LEGISLATURE OF THE STATE OF ALASKA

4 ELEVENTH LEGISLATURE - SECOND SESSION

5 A BILL

6 For an Act entitled: "An Act repealing the school tax, providing for refund  
7 of school tax payments for the 1980 tax year; and pro-  
8 viding for an effective date."

9 BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF ALASKA:

10 \* Section 1. AS 43.45 is repealed.

11 \* Sec. 2. Section 1 of this Act is retroactive to January 1, 1980 and  
12 applies to tax years beginning after December 31, 1979.

13 \* Sec. 3. (a) The Department of Revenue shall refund to the taxpayer the  
14 tax which was withheld for the 1980 tax year by an employer and paid to the  
15 department under AS 43.45.010(c).

16 (b) The Department of Revenue shall establish procedures for refunding  
17 school tax received by the department for the 1980 tax year.

18 (c) Other tax money paid to the Department of Revenue under AS 43.45  
19 for the 1980 tax year shall be refunded to the taxpayer who made the payment.

20 \* Sec. 4. This Act takes effect immediately in accordance with AS 01.10.-  
21 070(c).

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# RECORDS CERTIFICATION



I, the undersigned, an employee of the State of Alaska, do hereby certify that the microfilm images on this microform are accurate reproductions of the original records of the State of Alaska as accumulated during the regular course of business, and that it is the established policy and practice of this State to microfilm its records and to dispose of the original records after microfilm reproductions have been made.

James O. Smith  
Signature of Camera Operator

3/23/90  
Date

# COMMITTEE REPORT

## SENATE

FURTHER: Labor & Management

3/20/80

Date: 1-17-80

Mr. President:

The Committee on FINANCE has had SB 260

repealing the school tax

under consideration and (a majority of the committee) (the committee) reports it back with the following recommendations:

- do pass  do not pass
- do pass with attached amendments(s)
- replace with CS for SB 260  same title  
 new title
- and recommends \_\_\_\_\_
- AND attaches a "Letter of Intent"  New Fiscal Note
- reports it back <sup>repealed</sup> without recommendation
- referred to the \_\_\_\_\_ Committee

MEMBERS SIGNING  
DO PASS

[Signature]  
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MEMBERS HAVING  
OTHER RECOMMENDATIONS:

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[Signature]  
CHAIRMAN  
[Signature]

*Delivered  
to Legis  
Affairs  
4-17-80  
1:30 pm*

1 Original Sponsor: Stimson  
2

3 IN THE SENATE BY THE FINANCE COMMITTEE

4 CS FOR SENATE BILL NO. 260  
5 IN THE LEGISLATURE OF THE STATE OF ALASKA  
6 ELEVENTH LEGISLATURE - FIRST SESSION  
7 A BILL

8 For an Act entitled: "An Act repealing the school tax, providing for refund  
9 of school tax payments for 1980; and providing for an  
10 effective date."

11 BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF ALASKA:

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14 applies to tax years beginning after December 31, 1979.

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16 the tax which was withheld for tax year 1980 by an employer and paid to  
17 the Department under AS 43.45.010(c).

18 (b) The Department of Revenue shall establish procedures for  
19 refunding school tax withheld and received by the Department for 1980.

20 (c) Other tax money paid to the Department of Revenue under AS 43.45  
21 for the 1980 tax year shall be refunded to the taxpayer who made the payment.

22 Sec. 4. This Act takes effect immediately in accordance with  
23 AS 01.10.070(c).

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THE LEGISLATURE OF THE STATE OF ALASKA  
ELEVENTH LEGISLATURE

FISCAL NOTE

I. REQUEST

Bill/Resolution No. CS for Senate Bill No. 260  
 Title An Act repealing school tax and providing for refund of 1980 payments  
 Requested by The Finance Committee Date April 30, 1980

II. FISCAL DETAIL

Agency Affected Revenue  
 Program Category Affected Fiscal Services  
 BRU, Program, or Subprogram(s) Affected Audit Division

(Note: If more than one budget component is affected, separate line-item amounts and funding for each component in the analysis section.)

EXPENDITURES (Thousands of Dollars)

	FY 80	FY 81	FY 82	FY 83	FY 84	FY 85
100 PERSONAL SERVICES						
200 TRAVEL						
300 CONTRACTUAL						
400 COMMODITIES						
500 EQUIPMENT						
600 LAND & STRUCTURES						
700 GRANTS, CLAIMS, ETC.						
<b>TOTAL</b>	<b>-0-</b>	<b>-0-</b>	<b>-0-</b>	<b>-0-</b>	<b>-0-</b>	<b>-0-</b>

FUNDING (Thousands of Dollars)

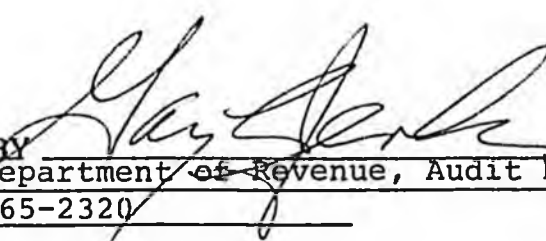
	FY 80	FY 81	FY 82	FY 83	FY 84	FY 85
GENERAL FUND	-0-	-0-	-0-	-0-	-0-	-0-
FEDERAL FUNDS						
OTHER (Specify Fund Source)						

POSITIONS None

FULL TIME						
PART TIME						
TEMPORARY						

III. ANALYSIS (See Fiscal Note Preparation Instructions, Section III)

This bill will have no effect on the operation of this division.

IV. DATE April 30, 1980 PREPARED BY   
 AGENCY Department of Revenue, Audit Division  
 PHONE 465-2320  
 Original: Legislative Finance  
 cc: Budget and Management  
Prime Sponsor (First Legislator Named)

THE LEGISLATURE OF THE STATE OF ALASKA  
ELEVENTH LEGISLATURE

FISCAL NOTE

I. REQUEST

Bill/Resolution No. CS for Senate Bill No. 260  
 Title An Act repealing the school tax and refunding 1980 school tax payments  
 Requested by House Finance Committee Date 4-28-80

II. FISCAL DETAIL

Agency Affected \_\_\_\_\_  
 Program Category Affected \_\_\_\_\_  
 BRU, Program, or Subprogram(s) Affected \_\_\_\_\_  
 (Note: If more than one budget component is affected, separate line-item amounts and funding for each component in the analysis section.)

EXPENDITURES (~~TENS~~ of Dollars)  
 Millions

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100 PERSONAL SERVICES						
200 TRAVEL						
300 CONTRACTUAL						
400 COMMODITIES						
500 EQUIPMENT						
600 LAND & STRUCTURES						
700 GRANTS, CLAIMS, ETC.		\$1.8				
TOTAL						

FUNDING (~~TENS~~ of Dollars)  
 Millions

	-0-	(\$2.7)	(\$2.8)	(\$2.9)	(\$3.0)	(\$3.1)
GENERAL FUND						
FEDERAL FUNDS						
OTHER (Specify Fund Source)						

POSITIONS

FULL TIME						
PART TIME						
TEMPORARY						

III. ANALYSIS (See Fiscal Note Preparation Instructions, Section III)

The \$1.8 million in refunds are for the school tax payments made during the first two quarters of calendar year 1980. It is assumed that these refunds will be made in FY 1981.

IV. DATE 4-28-80 PREPARED BY Bill Yankee  
 AGENCY Research/Department of Revenue  
 Original: Legislative Finance PHONE 465-2173  
 cc: Budget and Management  
Prime Sponsor (First Legislator Named)

Original sponsor: Stimson

Offered: 4/17/80  
Referred: Rules

1 IN THE SENATE

BY THE FINANCE COMMITTEE

2 CS FOR SENATE BILL NO. 260

3 IN THE LEGISLATURE OF THE STATE OF ALASKA

4 ELEVENTH LEGISLATURE - SECOND SESSION

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17 school tax received by the department for the 1980 tax year.

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21 070(c).

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# STATE OF ALASKA

JAY S. HAMMOND, GOVERNOR

## DEPARTMENT OF REVENUE

OFFICE OF THE COMMISSIONER

FOUCH 5 - JUNEAU 99811

April 19, 1979

The Honorable Glenn Hackney  
Chairman  
Senate Health, Education &  
Social Services Committee  
Assembly Building, Room 105  
Juneau, AK 99801

Dear Senator Hackney:

SENATE BILL NO. 260

Senate Bill 260, an Act repealing the school tax, was introduced in the Senate on April 3, 1979, and was referred to the Senate Health, Education and Social Services, Finance and Labor and Management Committees.

For the consideration of the Senate Health, Education and Social Services Committee, I am enclosing a copy of a Fiscal Note prepared by Mr. Gary L. Jenkins, Director, Audit Division, Department of Revenue, concerning the proposed legislation.

Sincerely,

R. D. Stevenson  
Special Assistant

Enclosure

cc: The Honorable John C. Sackett  
Chairman, Senate Finance Committee

The Honorable Frank Ferguson  
Chairman, Senate Labor & Management Committee

Thomas K. Williams, Commissioner  
Department of Revenue

Gary L. Jenkins, Director  
Audit Division  
Department of Revenue

STATE  
of ALASKA

# MEMORANDUM

TO:  R. D. Stevenson  
Special Assistant  
Department of Revenue

DATE: April 17, 1979

FILE NO:

TELEPHONE NO:

FROM: Gary L. Jenkins  
Director  
Audit Division

SUBJECT: Senate Bill No. 260

This bill would repeal the school tax which is ch. 45 of Title 43. The result of this action would be a loss of revenue to the State for 1980 of approximately \$2,500,000. ✓

There would be no affect on the administrative costs as a result of this legislation.

THE LEGISLATURE OF THE STATE OF ALASKA  
ELEVENTH LEGISLATURE

FISCAL NOTE

I. REQUEST

Bill/Resolution No. Senate Bill No. 260  
 Title An Act repealing the school tax  
 Requested by Health, Education & Social Services, Date April 17, 1979  
Finance and Labor & Management Committees

II. FISCAL DETAIL

Agency Affected Revenue  
 Program Category Affected Fiscal Services  
 Budget Request Unit(s) Affected Audit Division

EXPENDITURES (Thousands of Dollars) None

	FY 79	FY 80	FY 81	FY 82	FY 83	FY 84
100 PERSONAL SERVICES						
200 TRAVEL						
300 CONTRACTUAL						
400 COMMODITIES						
500 EQUIPMENT						
600 LAND & STRUCTURES						
700 GRANTS, CLAIMS, ETC.						
TOTAL						

FUNDING (Thousands of Dollars) None

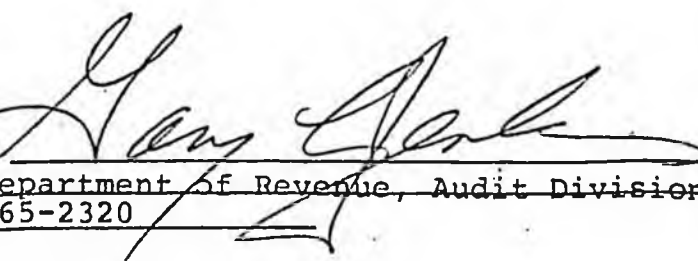
GENERAL FUND						
FEDERAL FUNDS						
OTHER (Specify)						

POSITIONS None

FULL TIME						
PART TIME						
TEMPORARY						

III. ANALYSIS (See Fiscal Note Preparation Instructions, Section III)

See memorandum to R. D. Stevenson dated 4/17/79, attached.

IV. DATE April 17, 1979 PREPARED BY   
 AGENCY Department of Revenue, Audit Division  
 PHONE 465-2320  
 Original: Legislative Finance  
 cc: Budget and Management  
Prime Sponsor (First Legislator Named)

**CATEGORY:** GENERAL GOVERNMENT  
**PROGRAM:** REVENUE COLLECTION AND MANAGEMENT

**AGENCY:** REVENUE  
**BRU (s):** AUDIT; PETROLEUM REVENUE; ENFORCEMENT; TREASURY MANAGEMENT; ADMINISTRATION AND SUPPORT

All Department of Revenue BRU's in the Revenue Collection and Management cover program are included herein. A major emphasis on identifying the "invisible taxpayer" is planned in the FY 81 budget, primarily in the BRUs of Audit, Enforcement, and Administration and Support.

The goals of the Audit BRU are to achieve effective compliance by taxpayers with the tax laws of Alaska, and to raise revenues through an effective audit program. The Revenue Audit staff concentrates on corporate and individual income tax, estate taxes, excise taxes, business license tax, fisheries tax, mining license tax, and the issuance of permits for games or skill or chance.

The goals of the Petroleum Revenue BRU are to administer state taxes on oil and gas production, which includes the State oil and gas property tax, oil and gas production tax and the oil and gas corporate income tax, and also to coordinate with local governments also taxing that property. The Division of Petroleum Revenue also generates revenue estimates for the State of projected oil and gas related revenues.

The goal of the Enforcement BRU is to enforce the collection of taxes from all taxpayers in a fair and equitable manner. The Division is responsible for billing and collecting all delinquent tax accounts.

The goals of the Treasury Management BRU are to manage available funds for a maximum return consistent with statutory limitations; to place general bonded debt as needed for capital projects at minimum cost to the State; and to report the management of funds in accordance with current reporting standards. The Treasury Management Division works closely with the State Bond Committee in performing these functions. Fund management is centralized for the Public Employees Retirement Fund, the Teachers Retirement Fund, and the General Fund, as well as other special funds.

The Administration and Support BRU includes the Office of the Commissioner, Administrative Services, and Fish and Game Licensing. The Commissioner's Office oversees all functions of the Department of Revenue. The Research Section, under the Office of the Commissioner, performs special studies in analyzing and developing revenue sources, as well as projecting State cash flow through revenue estimating models and information provided by State agencies. The Administrative Services component provides centralized general services for the Department of Revenue, including personnel, budget, payroll, purchasing, mail, etc. This section also provides certain technical services such as administering business licenses, processing tax and license remittances, and initial processing of tax returns. The Fish and Game Licensing component is being transferred to this BRU from the Natural Resources category for FY 81. This component processes revenues received from the sales of Fish and Game licenses statewide. Most of the licenses are sold by contract vendors such as sporting goods stores.

COMPONENT DESCRIPTION	79 AUTH	79 FINAL	79 ACT	80 AUTH	80 SUPL	80 RP	GOVERNOR
AUDIT	2461.5	2530.6	2513.1	2691.6			3223.6
PETROLEUM REVENUE	1279.6	1240.1	1187.3	1435.0			1447.2
ENFORCEMENT	1196.5	1335.4	1324.7	1217.0			1366.3
TREASURY MANAGEMENT	1232.3	1227.9	1120.3	1357.1			1436.9
OFFICE OF THE COMMISSIONER	877.3	1077.4	1054.4	757.6			964.5
ADMINISTRATIVE SERVICES	1630.0	1783.7	1746.5	1773.6			2361.4
FISH AND GAME LICENSING	572.1	580.6	531.6	259.0			298.0
MM TOTAL	9249.3	9775.7	9477.9	9490.9			11097.9
MM CHANGE VERSUS 80 AUTH							16.9%
OBJECT DESCRIPTION							
PERS. SERV.	6294.0	6685.5	6654.2	6784.4			7519.5
TRAVEL	336.8	333.8	316.3	315.7			419.6
CONTRACTUAL	2218.2	2320.1	2075.1	2031.5			2728.1
COMMODITIES	68.5	69.3	59.0	58.2			80.9
EQUIPMENT	23.5	58.7	65.3				37.0
LANDS/BLDGS	308.3	308.3	308.0	301.1			312.8
FUNDING SOURCE							
GENERAL FUND	8446.3	9040.7	8835.4	8956.9			10520.7
PGM RECEIPTS	308.0	240.0	217.5				
OTHER FUNDS	495.0	495.0	425.0	534.0			577.2
MM GENERAL FUND CHANGE VS. 80 AUTH							17.4%
POSITIONS							
FULL-TIME	220.0	220.0	220.0	224.0			237.0
PART-TIME	8.0	8.0	8.0	8.0			21.0
TEMPORARY	14.0	14.0	14.0	13.0			
STAFF MONTHS	2715.1	2715.1	2715.1	2784.0			2944.2



# RECORDS CERTIFICATION



I, the undersigned, an employee of the State of Alaska, do hereby certify that the microfilm images on this microform are accurate reproductions of the original records of the State of Alaska as accumulated during the regular course of business, and that it is the established policy and practice of this State to microfilm its records and to dispose of the original records after microfilm reproductions have been made.

James O. Smith  
Signature of Camera Operator

3/23/90  
Date

Date passed to Senate \_\_\_\_\_

Bill # SB266

SENATE FINANCE COMMITTEE  
BILL CHECKLIST

- 1. Committee Copy-Current Bill ✓
- 2. History Cover Form ✓
- 3. Printed Copies:
  - Original Bill ✓
  - Committee Substitutes or Amendments |
- 4. SFC Committee Report Form ✓
- 5. Fiscal Information:
  - Note in File \_\_\_\_\_
  - Note Requested \_\_\_\_\_ Date \_\_\_\_\_
  - Other Financial Backup \_\_\_\_\_
  - (See Below) \_\_\_\_\_
- Backup:
  - Handouts ✓
  - Letter from Governor |
  - Letter from Sponsor |
  - Completed Committee Reports |
  - Committee \_\_\_\_\_
  - Other \_\_\_\_\_



Introduced: 4/16/79  
Referred: Finance

BY KELLY, DANKWORTH, HACKNEY,  
STIMSON AND SUMNER

1 IN THE SENATE

2 SENATE BILL NO. 266

3 IN THE LEGISLATURE OF THE STATE OF ALASKA

4 ELEVENTH LEGISLATURE - FIRST SESSION

5 A BILL

6 For an Act entitled: "An Act relating to indexing of the state income tax;  
7 and providing for an effective date."

8 BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF ALASKA:

9 \* Section 1. AS 24.20.201(a) is amended by adding a new paragraph to  
10 read:

11 (8) determine, before October 15 of each year, an annual  
12 inflation factor for the taxable year beginning after December 31 of that  
13 year for use by the Department of Revenue in making the adjustments to  
14 the Alaska net income tax required under AS 43.20.025. In making this  
15 determination the committee shall use those statistics which in its  
16 judgment best reflect the magnitude of inflation in Alaska, including  
17 but not limited to the monthly consumer price index prepared by the  
18 Bureau of Labor Statistics, United States Department of Labor and the  
19 commodity indexes prepared by Dow Jones and Company and published in the  
20 Wall Street Journal.

21 \* Sec. 2. AS 43.20 is amended by adding a new section to read:

22 Sec. 43.20.025. INCOME TAX INDEXING. (a) For each tax year the  
23 department shall multiply the annual inflation factor determined by the  
24 Legislative Budget and Audit Committee under AS 24.20.201(a)(8) for that  
25 year, by the

- 26 (1) tax rate brackets set out in AS 43.20.011(a) - (c);  
27 (2) the minimum deduction (AS 43.20.031(a)(4));  
28 (3) the personal exemption; and  
29 (4) the tax credits allowed in AS 43.20.036 - 43.20.039.

1 (b) The calculation made under (a) of this section shall be  
2 adjusted by multiplication by the annual inflation factor for the pre-  
3 vious taxable years so that the application of the annual inflation  
4 factor will be cumulative.

5 (c) The resulting dollar amounts rounded to the nearest one dollar  
6 are the tax rate brackets, minimum deduction, credits and personal  
7 exemption for the next tax year and shall be incorporated into the  
8 income tax forms and instructions of the department.

9 (d) If the Legislative Budget and Audit Committee has not  
10 determined an annual inflation factor before October 15 of a tax year,  
11 the annual inflation factor for that tax year is 110 per cent.

12 \* Sec. 3. AS 43.20.025 enacted by sec. 2 of this Act applies to all tax  
13 years beginning after December 31, 1978.

14 \* Sec. 4. This Act takes effect immediately in accordance with AS 01.10.-  
15 070(c).

**ALASKA STATE LEGISLATURE**

ELEVENTH Legislature FIRST Session

SENATE BILL NO. 266

By KELLY, DANKWORTH, HACKNEY,  
STIMSON AND SUMNER

"An Act relating to indexing of the state income tax; and providing for an effective date."

Introduced in the Senate 4/16/19

**HISTORY IN THE SENATE**

19	79	Read first time and referred to Committee on Finance										
4	16	Reported back with recommendation that										
		Read second time and										
		Read third time and										
		<table border="0"> <tr> <td>PASS</td> <td>Effective Date</td> </tr> <tr> <td>Yeas</td> <td>Yeas</td> </tr> <tr> <td>Nays</td> <td>Nays</td> </tr> <tr> <td>Absent</td> <td>Absent</td> </tr> <tr> <td>Excused</td> <td>Excused</td> </tr> </table>	PASS	Effective Date	Yeas	Yeas	Nays	Nays	Absent	Absent	Excused	Excused
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Excused	Excused											
		Reconsideration										
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PASS	Effective Date											
Yeas	Yeas											
Nays	Nays											
Absent	Absent											
Excused	Excused											
		Reported correctly engrossed										
		Signed by President										
		Sent to House										
SECRETARY OF THE SENATE												

**HISTORY IN THE HOUSE**

19		Read first time and referred to Committee on										
		Reported back with recommendation that										
		Read second time and										
		Read third time and										
		<table border="0"> <tr> <td>PASS</td> <td>Effective Date</td> </tr> <tr> <td>Yeas</td> <td>Yeas</td> </tr> <tr> <td>Nays</td> <td>Nays</td> </tr> <tr> <td>Absent</td> <td>Absent</td> </tr> <tr> <td>Excused</td> <td>Excused</td> </tr> </table>	PASS	Effective Date	Yeas	Yeas	Nays	Nays	Absent	Absent	Excused	Excused
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		Reconsideration										
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PASS	Effective Date											
Yeas	Yeas											
Nays	Nays											
Absent	Absent											
Excused	Excused											
		Reported correctly engrossed										
		Signed by Speaker										
		Returned to Senate										
CHIEF CLERK OF THE HOUSE												

**HISTORY IN THE SENATE**

19		Received from House
		To enrolling
		Reported correctly enrolled
		Sent to Governor
		..... by Governor
		Filed with Lt. Governor
		Chapter No. ....

THE LEGISLATURE OF THE STATE OF ALASKA  
ELEVENTH LEGISLATURE

FISCAL NOTE

I. REQUEST

Bill/Resolution No. Senate Bill No. 266  
 Title An Act relating to indexing of the State income tax.  
 Requested by Senate Finance Committee Date 4/26/79

II. FISCAL DETAIL

Agency Affected \_\_\_\_\_ Revenue \_\_\_\_\_  
 Program Category Affected Fiscal Services  
 BRU, Program, or Subprogram(s) Affected Audit Division  
 (Note: If more than one budget component is affected, separate line-item amounts and funding for each component in the analysis section.)

EXPENDITURES (Thousands of Dollars)

	FY 79	FY 80	FY 81	FY 82	FY 83	FY 84
100 PERSONAL SERVICES		34.3	37.7	41.4	45.5	50.0
200 TRAVEL		1.0	1.1	1.2	1.3	1.4
300 CONTRACTUAL						
400 COMMODITIES		.5	.5	.6	.6	.7
500 EQUIPMENT		2.5				
600 LAND & STRUCTURES						
700 GRANTS, CLAIMS, ETC.						
<b>TOTAL</b>		<b>38.3</b>	<b>39.3</b>	<b>43.2</b>	<b>47.4</b>	<b>52.1</b>

FUNDING (Thousands of Dollars)

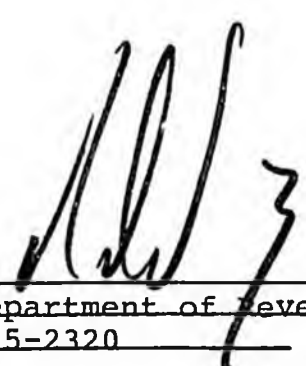
GENERAL FUND		38.3	39.3	43.2	47.4	52.1
FEDERAL FUNDS						
OTHER (Specify Fund Source)						

POSITIONS

FULL TIME		1	1	1	1	1
PART TIME		2	2	2	2	2
TEMPORARY						

III. ANALYSIS (See Fiscal Note Preparation Instructions, Section III)

See attached memorandum to R. D. Stevenson dated 4/26/79.

IV. DATE April 26, 1979 PREPARED BY   
 AGENCY Department of Revenue, Audit Division  
 Original: Legislative Finance PHONE 465-2320  
 cc: Budget and Management  
Prime Sponsor (First Legislator Named)

STATE  
of ALASKA

## MEMORANDUM

TO:  R. D. Stevenson  
Special Assistant  
Department of Revenue

DATE: April 26, 1979

FILE NO:

TELEPHONE NO:

FROM: N. David Ziemer  
Acting Director  
Audit Division

SUBJECT: Senate Bill No. 266

This bill, which is identical to House Bill No. 464, provides for a method of indexing State income taxes by an inflation factor. The bill provides that the tax rates, standard deductions, personal exemptions and tax credits be adjusted annually by an inflation factor of either 110 percent or other amount as set by the Legislative Budget and Audit Committee. This bill will have a marked effect on both the revenue of the State and the operations of the Department of Revenue. Before discussing these effects, one technical clarification needs to be made.

Throughout, the bill calls for an inflation factor of either the amount set by the Budget and Audit Committee or 110 percent, and specifies that that factor should be applied to the rates, deductions and credits for the next tax year. Section 2 of the bill at AS 43.20.025(d) says, "If the Legislative Budget and Audit Committee has not determined an annual inflation factor before October 15 of a tax year, the annual inflation factor for that tax year is 110 percent". The word, "that" should be replaced with the words, the next. This will provide absolute clarity as to which years the bill is referring to.

We estimate, using the 110 percent inflation factor, that the loss of revenue will be approximately \$14,500,000 in the first year. This estimate is based on 1977 tax returns and is merely 10 percent of the total individual collections for that year. A more sophisticated estimate is being prepared by the Research section and should be available soon.

### Analysis

While this bill seems like a simple, straightforward act, there are many ramifications due mainly to the complexity of individual income tax administration.

The Department of Revenue is opposed to this bill and finds fault with it for the following reasons:

1. Assuming the default inflation factor of 110 percent, the State Treasury would suffer a loss of approximately \$14,500,000. This estimate is based on the tax statistics for 1977. We are, however, aware that this loss would be offset to some unknown extent by the general growth in the total tax base caused by inflation of wages, etc.

2. The bill provides for the annual inflation rate to be applied to three different levels in the determination of final tax due:
  - A. The minimum deduction and the personal exemption deduction, both of which are deductions from adjusted gross income.
  - B. The tax rate brackets, used to determine tax from taxable income.
  - C. Tax credits, which are offsets to tax determined from rate schedules and are nonrefundable.

It should be noted that by allowing the annual inflation factor to be applied concurrently to all three levels, that the total effect will in all cases be a tax benefit greater than the inflation factor determined by the Legislative Budget and Audit Committee. If the goal of this legislation is to offset the effect of inflation, as measured by the rate they determine, then the total tax benefit should be equivalent to the annual inflation factor. In connection with this, two things should be noted concerning the application to tax credits. First, the bill references the "tax credits" allowed in AS 43.20.036 - 43.20.039. This reference encompasses three sections.

AS 43.20.036 is basically a prohibition section. It lists the federal credits which either are not allowed in the calculation of Alaska income tax due, or which are limited in application.

AS 43.20.038 defines the Residential Fuel Credit as five percent of residential fuel expenses paid during the tax year. There is no maximum ceiling on this credit. Because the credit is based on current dollars spent, if the cost of fuel inflates during the year, the credit will already reflect this rise. To further increase the credit by an artificially determined factor would be needless and redundant.

AS 43.20.039 defines the Residential Fuel Conservation Credit as ten percent of the qualifying expenses subject to a maximum of \$200 or \$100 if married filing separately. Except for the ceiling imposed, the same reasoning applied to AS 43.20.038 applies.

3. Under the current statute construction, the personal exemption deduction allowed in computing Alaska taxable income is tied to the federal personal exemption deduction. For example, when the federal deduction went to \$1,000 in 1979, the Alaska

deduction rose also. The minimum deduction allowed by AS 43.20.031(a)(4) is to be "equivalent in amount to the zero bracket amount defined in Sec. 63(d) of the Internal Revenue Code". If the provisions of this act are adopted in their entirety, it is obvious that from the first year on, neither the personal exemption deduction nor the minimum deduction is going to remotely resemble its federal counterpart. In the case of the minimum deduction, I believe this would call for rewriting AS 43.20.031(a)(4) to incorporate the inflation factor.

4. Since the ultimate result of this act will be to establish a unique tax rate schedule, personal exemption deduction, minimum deduction, and tax credit level for each succeeding tax year, a desirable uniformity is going to be lost. In a time when we are striving to make it possible for the average taxpayer to prepare his/her own return, we would make it more complicated to do so. Especially in the instance of amended returns, multiple year filings, and income averaging schedules, it will be increasingly more difficult for the average taxpayer to prepare his own return. This aspect of the act will undoubtedly have an adverse affect on our Taxpayer Assistance Program.
5. Approximately 28 percent of all filings are from part-year/nonresidents. Since the annual inflation factor reflects the inflation experience of Alaska, it would give a perhaps undue additional tax benefit to this segment of the population, since they presumably spend a healthy portion of their incomes in some other state.
6. Assuming the rate adopted on October 15 applies to the next tax year, the Department of Revenue will need to calculate a new withholding rate for the coming year, to be effective January 1 of the next tax year.
7. In the somewhat unlikely event that the economy takes a turnaround and the inflationary spiral reverses, we would face a rising tax situation (e.g. an inflation factor of .85).
8. In addition to the above comments, there are a couple of technical errors/oversights in the bill, noted below.
  1. In Section 2 of the bill, AS 43.20.025(b) as proposed, provides for adjustment by multiplication by the annual inflation factor for the previous taxable years so the application of the annual inflation factor will be cumulative. First, it should be made clear that this is not retroactive in the first year, i.e., the factor for the first year of application becomes the base. Secondly,

April 26, 1979

it should be pointed out that by multiplying by previous years' factors (e.g. 110% x 108% = 118.80%), the factor becomes compounded, not cumulative. If it were to be cumulative, the above example would result in a second-year factor of 118%.

2. In Section 2 of the bill, AS 43.20.025(d) should read as follows:

"(d) If the Legislative Budget and Audit Committee has not determined an annual inflation factor before October 15 of a tax year, the annual inflation factor for the taxable year beginning after December 31 of that year is 110 percent."

Recommendations:

The goal of compensating taxpayers for inflation is admirable and, in fact, an increasing necessity. However, it could be accomplished much more easily. Let each legislative session adopt a new set of tax tables to be effective on January 1 of the following year. These could be adopted from Budget and Audit Committee recommendations and could compensate only for inflation rather than overcompensation as in the proposed bill. This would have the additional advantage of preserving unto the Legislature its previously sacred duty of setting tax rates.

Budget Impact

Forms costs and preparation would not be significantly impacted as long as the lead time specified in the bill was preserved. We would, however, anticipate that enough confusion about constantly changing rates, deductions and credits would exist to seriously impact our taxpayer assistance function. We expect that due to the added confusion caused by changing tax rates and deductions, our assistance requests will increase 25 to 30 percent over this year. This estimate is based on knowledge of the kinds of questions most frequently asked and the vast number of requests we received last year during the "zero bracket confusion". We estimate that one full time and two five month seasonal Tax Examiner positions will be required. These, together with requisite equipment commodities and travel funds, will cost \$38,300 the first year. See the attached Fiscal Note for details.

MEMORANDUM

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TO: Senate Finance Committee Members  
FROM: Jay Hogan  
DATE: April 16, 1979  
RE: SCR 30 and SB 266

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SCR 30 (Directing the Legislative Affairs Agency to study indexing the Alaska state personal income tax system) calls for a study on indexing the Alaska state income tax in order to protect the taxpayer against higher taxes caused by inflation. Three articles on indexing state and federal income taxes are enclosed. These articles and summaries are an example of the material currently available on indexing such taxes to neutralize the effect of inflation. Rather than having a full-blown study of indexing, the committee might prefer to direct Legislative Finance to perform an interim review of various state tax indexation laws with a summary to be presented to the next session of the legislature.

## 4.108 Indexation of the State Individual Income Tax<sup>1</sup>

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-

<sup>1</sup>Derived 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 immediacy  
16 preceding tax year.<sup>1</sup>

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

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

---

<sup>1</sup>The 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.

Tax Foundation's

Tax Review



MAY 1978  
Vol. XXXIX, No. 5

## Indexation of Canada's Individual Income Tax System

By C. F. Steiss

I have been asked to provide a few observations on Canada's reaction to what I might refer to as the "silent tax increase." Perhaps I should begin with a word about what I mean by this phraseology.

Generally speaking, inflation causes taxable income to increase more rapidly than total real income, since taxable income is a calculated amount after allowing for certain exclusions and deductions. While some exclusions and deductions may increase at a rate commensurate with inflation, others, and notably the basic personal exemptions which account for almost 80 percent of all exemptions and deductions in Canada from individual income, do not. Consequently, in a period of inflation, taxable incomes rise more rapidly than the inflation rate, because of the static nature of the quantum of those exemptions. Thus we have one element of the silent tax increase.

A second element is the progressive rate structure. An increase in the effective average rate with unchanged *real* taxable income yields higher real taxes. The only obvious way of avoiding this is to index the brackets. Assuming a taxpayer's various deductible expenses rise at an inflation rate, indexing of the brackets should generally mean that real tax liabilities will rise only when total income is rising more rapidly than the inflation rate. Where total income is rising less rapidly than that rate, real liabilities will actually fall.

On the evening of February 14, 1973, the then Minister of Finance, The Honourable John Turner,

proposed the introduction to the Canadian tax system of a "major innovation in tax philosophy and practice." In commenting on this proposal, the Minister expressed concern in respect of the rampant inflation phenomena in Canada and the impact such inflation has on a tax system based on a progressive rate schedule. The proposal, as presented, was subsequently implemented into law with effect from 1974. Many, myself included, regard this change to Canada's income tax laws as one of the two most important structural changes to the Canadian income tax system since World War II, the other being the taxation of capital gains and the many other

### *This Issue In Brief*

Since 1974, Canada has applied indexation to its individual income tax system, adjusting most kinds of exemptions and the marginal tax rate brackets by an annually computed inflation factor.

Mr. Steiss discusses the philosophy and circumstances leading to the introduction of the indexation system, and gives examples of its effects today. He sees problems ahead, especially for the provinces, unless inflationary rates subside, and questions whether logical extension of indexation to capital gains and various deductions would be feasible.

substantive changes implemented by the 1971 tax reform bill.

Implementation of the proposal introduced the following basic system of indexation of Canada's individual tax system:

- (a) The annual determination of a so-called "inflation factor" based upon the increase in Canada's Consumer Price Index in a defined immediately preceding 12-month period.
- (b) Application of this inflation factor to the various principal exemptions available to individual taxpayers in Canada. Such principal exemptions prior to indexing (in 1973) included a \$1,600 single status exemption, a \$3,000 marital status exemption and individual dependency exemptions of upwards to \$550 per dependent.
- (c) Application of the inflation factor to the marginal tax rate brackets of the Canadian individual taxpayer.

The technical definition of the cumulative inflation factor is: the ratio of the Consumer Price Index for the year ending September 30 of the relevant previous year divided by the Consumer Price Index for the year ending September 30, 1972. From a practical point of view, the Minister announces the increase annually, soon after the September CPI statistic is available. The inflation factor is pragmatically expressed in terms of an annual adjustment to the prevailing exemption levels and tax rate brackets of the prior year.

For example, the legislative adjustment in respect of the 1978 personal exemptions and rate brackets was announced in October of 1977, and was determined by dividing the average CPI for the 12



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This Review is based on Mr. Stelss's presentation at a Tax Foundation seminar on Integration and Indexation, held in Washington, D.C. on March 30, 1978.

months ended September 30, 1977 by the corresponding average for the preceding 12-month period ended September 30, 1976. Expressed in percentage terms, the major personal income tax exemptions and the tax bracket limits for 1978 were raised by 7.2 percent as compared with those that prevailed for 1977.

Why September 30? The selection of September as the extreme of each 12-month averaging period was based on the factual circumstance that the month of September was simply the last possible month in a year that could be reflected in the calculation while still allowing the government time to print and distribute the withholding tax tables on a timely basis for the following taxation year, the year for which the calculation is relevant.

Why a 12-month averaging period? The intent of the government was to extend the period so as to minimize the impact of unusual events or circumstances which might initiate an undue influence on the calculation of an inflation factor based on a shorter period.

### Some Effects of Indexation

Interestingly enough, the law itself does not contemplate a reduction in exemptions and/or a narrowing of the marginal tax rate brackets. Indeed, where the inflation factor for a particular year is less than that of the preceding year, the preceding year's factor will be deemed to be operative: In other words, the exemptions and tax rate brackets will not be reduced from that of the preceding year. I mention this point merely for your general interest since, with the rates of inflation to date in Canada, the matter has certainly not been in issue from the time the scheme was first introduced.

The inflation factor applied to the marginal rate brackets and exemptions has broadened the brackets and increased the exemptions on an annual basis by some 6.6 percent for 1974, 10.1 percent for 1975, 11.3 percent for 1976, 8.6 percent for 1977 and 7 percent for 1978. By 1978, the *compound* effect of indexing since its inception amounts to a hefty 52.1 percent. Introduction of indexing in 1974 meant the dropping of some 175,000 taxpayers from the tax rolls and another 225,000 in 1975, after which the government stopped counting. Estimated cumulative Federal government revenues lost through indexing through 1978 are some \$4 billion.

Let's take a look at the rates. In the absence of indexing, our top marginal rate would cut in at

taxable income of \$60,000. I hasten to add that that top rate is dependent upon the province of residence of the taxpayer and may vary from a low of approximately 60 percent to a high of around 68 percent. For 1978, and strictly as a result of indexing, the top marginal rate does not cut in until taxable income of some \$91,260 is reached.

What about the exemptions? The married taxpayer with a wholly dependent spouse and two dependent children would, in the absence of indexing, qualify for exemptions of some \$3,600. Application of indexing to these exemptions entitles him to deductions of some \$5,480 in 1978. A single pensioner would have about \$4,000 in 1978 exemptions versus \$2,600 without indexing.

Indexing represented a major shift in historical attitudes in Canada as to inflation and taxes. Perhaps one of the most extensive studies of any developed tax system was that of the Carter Royal Commission on Taxation. That Commission spent some four years of intensive study of all aspects of our then-existing tax structure and issued its massive 2,700-page, five-volume report, in 1966. The Commission considered the merits of indexing and concluded that "the tax structure should generally *not* be adjusted automatically to take into account changes in the general level of prices. To develop a tax system that taxed only increases in 'real' purchasing power would irreparably damage the built-in stability of the system".

#### Why the change in attitude?

Obviously, a part of the change must be explained by the tremendous rates of inflation we have experienced since the mid-1960's and the significant pressures this has placed on government and government thinking. Indeed, in introducing their remarks and negative conclusions with respect to indexing a tax system, the Carter Commission made the following statement: "Assuming that the Consumer Price Index continues to rise at an average rate of 1.5 percent to 2 percent a year, what could and should be done?"

The fact that the level of inflation from 1952 through 1965 averaged only about 1.4 percent a year and reached its highest level of 3.2 percent only in 1957 may have contributed to their conclusion that indexing was not of paramount importance. After 1965 the rate of inflation escalated significantly, reaching 4.8 percent in 1972 and 9.1 percent in 1973, when indexing was introduced. Furthermore, inflation has simply galloped along since that date.

Expressed in terms of 1971 equals 100, Canada's Consumer Price Index factor at the end of January, 1978, was 167.8.

Prior to the introduction of indexing to Canada's income tax laws in 1974, personal income taxes were taking a higher and higher proportion of the real incomes of Canadians. Each year, the real value of personal exemptions was becoming less and less, and more and more Canadians were finding themselves thrust into higher tax brackets without a compensating increase in their real income. The impact was there in the late 1960's, but I would think it fair to say that the majority of Canadian taxpayers were unaware of this "silent but annual tax increase." With the advent of rampant inflation in the early 1970's, there were signs in Canada that the silence of the increase was being disturbed, and that Canadian taxpayers were becoming more and more aware of the interaction of inflation and taxes. Indeed, many were clearly beginning to recognize that inflation itself was a form of taxation, that the government was obtaining a rising share of personal income coincident with inflation, and that such an increase was being achieved in the absence of distasteful overt increases in nominal tax rates.

#### Where Benefits Are Greatest

Anyone concerned with basic social policy has to be concerned about the impact of inflation. As you rise up the income scale, Canada's higher tax brackets widen considerably, and increasingly insulate taxpayers from ravages of inflation on real tax rates. In other words, the tax increases resulting from inflation are highest not at incomes where the marginal rates are highest, but rather at those income levels where marginal tax rates increase most rapidly, thereby placing the burden more squarely on middle and low income earners.

What taxpayer has benefited the greatest from indexing? Notwithstanding my comments a moment ago about the \$60,000 marginal rate taxpayer, this is not the taxpayer category which has benefited the most. A computer simulation model study recently conducted indicated that the taxpayer with assessed income in the \$15,000 range enjoys the most significant percentage savings from indexing. Indeed, about 27 percent of the total tax savings enjoyed from indexing belongs to this taxpayer category. The next greatest saving goes to income ranges of from \$15,000 to \$20,000. Taxpayers with assessed income from \$10,000 to \$25,000 account for close to 70 percent of

the total Federal tax savings enjoyed through indexing of the Canadian tax system.

What about revenue lost through indexing? There is no doubt that indexing "COSTS"! For the 1978 taxation year, Federal tax reductions for taxpayers at all income levels will total some \$850 million as a result of application of the inflation factor applicable for that year, or roughly 6 percent of budgetary revenues. All of the provinces of Canada other than Quebec have tax collection agreements with the Federal government in respect of individual income taxes. Those provinces also of course experience reduction in revenues through indexing. In very early estimates prepared by the Province of Ontario, it was estimated that by 1980 the indexing revenue loss to the Federal government would range from about 18 percent at sustained 5 percent inflation to about 24 percent at sustained 8 percent inflation. Reduction in Ontario revenues indicated the same pattern. There is no doubt that indexing significantly reduces the rate of growth of direct personal tax revenues over the long term unless such reductions are offset by explicit increases in tax rate. Some would say, and I would agree, that out of this observation flows a still further advantage of indexing: Namely, indexing increases parliamentary and/or taxpayer/voter control over tax rates.

### Outlook for the Future

Will indexing in Canada survive? Costs of government are rising rapidly while tax revenues and the real wealth of the nation on which they are based are somewhat stalled. To continue indexing may continue to increase an existing budgetary deficit, and to raise taxes in isolation is not only politically unpopular but is also inconceivable with the fragile Canadian economy of today. One thought is that the government may be tempted to ease its predicament by changing the method of calculation of the magic inflation factor to produce a smaller factor, but this itself would be unpopular and could become a matter of substantive controversy.

While the reduction in revenue growth potential of the personal income tax can perhaps be absorbed in

the case of the Federal government for some years because of its surplus financial capacity, in the case of the provinces a substantial deterioration takes place in their long-run financing position. Pressure signs are starting to show, and the matter could become a significant issue in the next while. Perhaps the chief hope of the government is that inflationary rates will abate and the impact of indexing diminish.

Has the government of Canada accepted indexing as a logical and indeed necessary part of the Canadian tax system? The answer must be a qualified no! Certainly extension of indexing to exemptions and the personal tax rate schedule was a major innovation. But, if one accepts the principle of indexing, is there not some logic to extension of its application to most statutory deductions and absolute dollar income inclusions under our Income Tax Act? For example, the Canadian Income Tax Act prescribes various deductions to retirement plans including, as an illustration, a maximum deduction to a pension plan. The quantum of this deduction has increased over the past several years but such increase has not been tied to indexing. In 1971 the government recognized that employees may have expenses and allowed an arbitrary maximum deduction of \$150 in recognition of employment expenses. In 1977 the Minister of Finance recognized that inflation had eroded the value of that deduction and arbitrarily increased it to \$250 for 1977 and subsequent years. While the increase was welcome, one wonders why in 1973 the indexing scheme was not applied to this and many other deductions under the Income Tax Act. Another outstanding example must be capital gains. The only response of the Canadian government to date with respect to the impact inflation has on people's savings has been arbitrary deductions of \$1,000 of investment income, and certain private pension income. Again, indexing has been ignored.

Accordingly, the equity argument in favour of inflation-proofing the personal tax rate structure has not been fully accepted or reflected. Only time will tell, but I advance my own cautious opinion that for the time being, "They've Gone About As Far As They Can Go!"

# The Tax Reform You May Need Most

Letting inflation push you into the 50% bracket is an honor you'd probably rather skip. Here's how to decline it.

by Jerry Edgerton

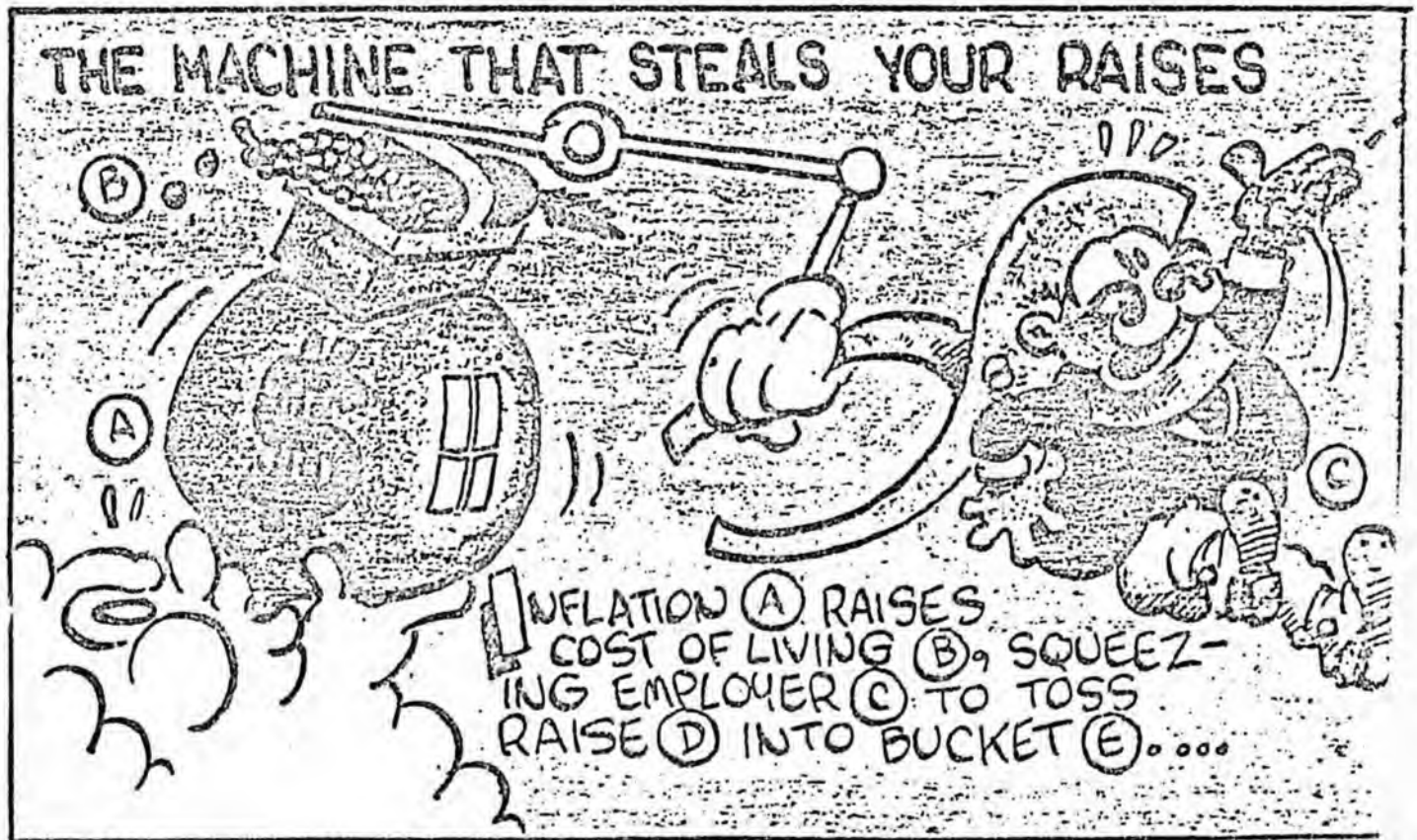
**D**ense and dank is the underbrush of the Internal Revenue Code, and hideous monsters lurk there. The one that Jimmy Carter particularly detests is the Loathsome Luncheon Loop-holer (of the three-martini species); Carter and others also shudder at the Exotic Shelter Digger. But the beast that preys most on middle-income taxpayers is the less fabled Stealthy Bracket Creeper.

The Creeper hides out in the fine print of tax schedules, and he's especially vicious because he feeds on in-

flation. In the years since 1965, while inflation has more than doubled prices, the brackets that determine what percentage tax you will pay have remained at the levels shown in the box on the opposite page. This means if you get pay raises intended to keep you even with inflation—which represent no increase at all in real buying power—your higher income continually raises your tax rate. In the end, your take-home income falls behind inflation. If Congress made no changes in the law, inflation at 6.5% would push a family making \$25,000 a

year now into the 50% bracket by the early 1990s.

The way to stop such tax increases on steady or even declining purchasing power is a system called indexing, already being used in Canada. As the cost of living goes up, indexing raises the dollar limits of the tax brackets and also the exemptions and standard deductions that a taxpayer gets to subtract from his gross income in computing his taxable income. With indexing, a citizen whose income keeps up with inflation still has a high-



er tax bill each year, but the percentage he pays to the government remains constant.

The consequences can be striking. Imagine two families of four whose incomes just kept up with the U.S. inflation rate by rising 36% from \$18,000 in 1973 to \$24,500 in 1977. During that period the income taxes of the first family jumped 54%, while those of the second climbed only 14%. Explanation: the first family lives in the U.S., the second in Canada. Hit by bracket creep, the Americans fell behind in buying power; coddled by indexing (plus some tax cuts), the Canadians increased their real income.

U.S. federal tax collections from individuals now rise about 16% for every 10% of increase in personal income. In states with progressive state income taxes, such as New York and California, inflation-increased income means a bigger state tax bite as well. The result, says Congressman Willis D. Gradison Jr., a Republican from Ohio, is that "government has a vested interest in maintaining inflation since present law permits a windfall tax bonus during an inflationary period."

Gradison has attracted more than

## Bracket creep

This table shows the tax brackets, effectively unchanged since 1965, that apply to middle-income married couples filing joint returns. Note that the percentage increases in tax rates apply not to the whole taxable salary but only to the marginal part of it contained within the bracket. Nevertheless, as inflation-fattened salaries creep up from one bracket to another, the ever-higher percentages raise taxes at a rate greater than the salary gain.

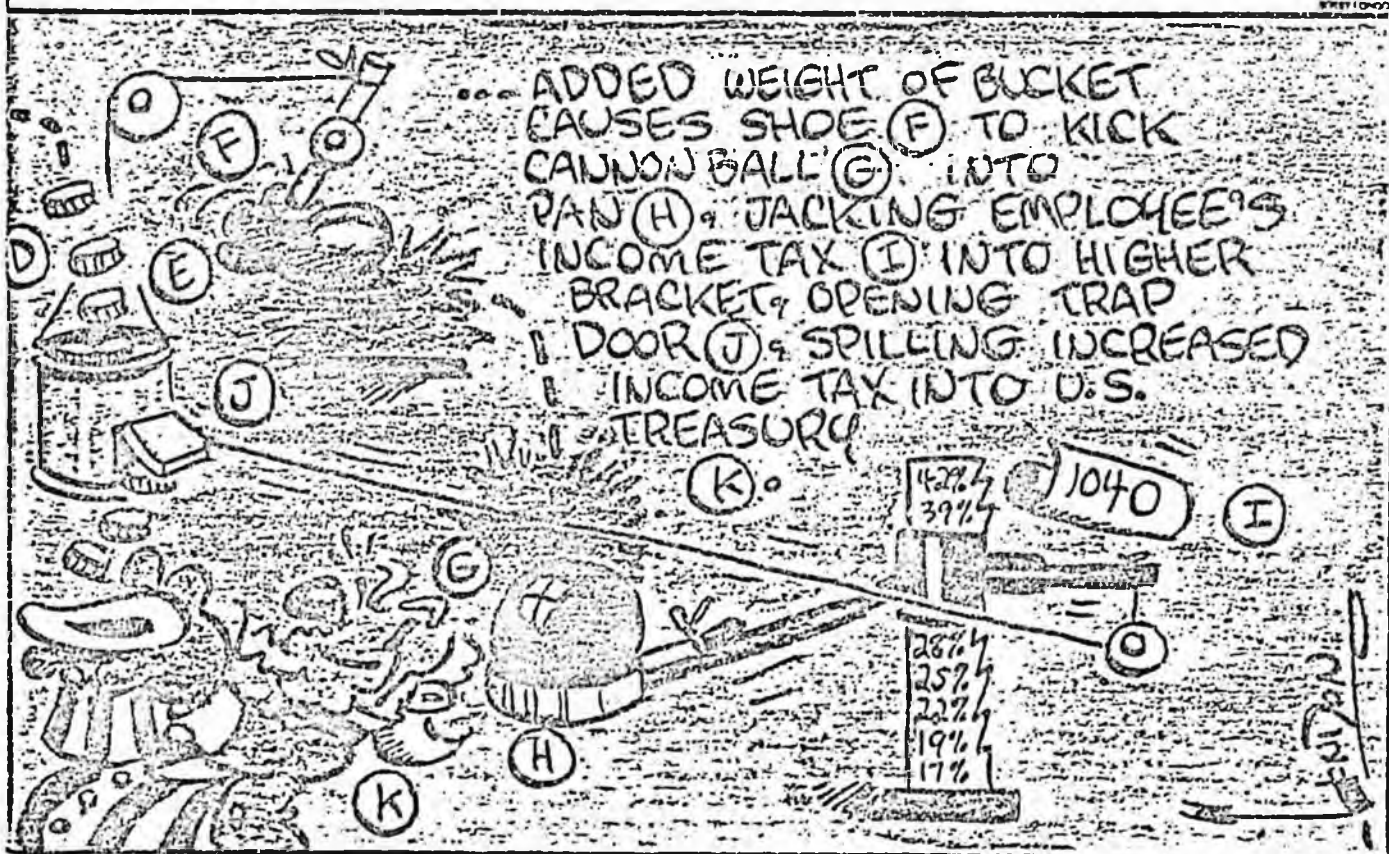
TAXABLE INCOME BRACKET	MARGINAL TAX RATE
\$11,201-\$15,200	22%
\$15,201-\$19,200	25%
\$19,201-\$23,200	28%
\$23,201-\$27,200	32%
\$27,201-\$31,200	36%
\$31,201-\$35,200	39%
\$35,201-\$39,200	42%
\$39,201-\$43,200	45%
\$43,201-\$47,200	48%
\$47,201-\$55,200	50%

80 co-sponsors for a bill that would index federal individual income taxes for inflation. Indexing proponents do not suggest that their bill will pass this year, but increasing complaints from constituents about taxes have generated more congressional interest in indexing than ever before. Past support has come largely from Republicans; this year there are some Democratic co-sponsors as well. "Indexing is an idea whose time is coming," says Gradison.

One reason is that taxpayers will begin to fall even further behind as higher Social Security taxes take effect. Economist Dennis Jacobe of the U.S. League of Savings Associations figures that middle-income families will need an annual wage increase of about 10% to keep pace, after taxes, with inflation of 6.5%.

Canada began indexing personal income taxes in 1974. Each October the Canadian Department of Finance determines the increase in consumer prices for the previous 12 months and then raises tax brackets, deductions and exemptions by the same percentage, in time to issue new tax tables in January. As a result, if your income rises in tandem with inflation, you stay in the

*continued*



## TAX REFORM *continued*

same bracket as the year before. Canadians on fixed incomes pay lower and lower taxes each year.

The past few years of tax indexing in Canada have come against a backdrop of hard times. Unemployment and inflation both have been around 9% recently. The Canadian dollar, traditionally worth slightly more than its American counterpart, dropped to a low of around 87 American cents early this year, though it has risen slightly since. "The government quite deliberately adopted an expansionary policy, but too much expansion was allowed," says economist John Bossons of the Institute for Policy Analysis at the University of Toronto. "That helped build in future inflation." But, adds Bossons: "You can't say the current large deficits are the fault of indexing. The government knew the effects of indexing before they cut taxes further."

Indexing proponents argue that Canadian spending might be even higher than it is—and the government deficit therefore even larger and more inflationary—if indexing hadn't disciplined the government to expect lower revenues because of indexing. Says John R. Allan, vice president of the University of Windsor and a former chief tax analyst of the Canadian Department of Finance: "Government officials now are saying, 'If we want to bring in a new program, we'll have to find something else that can be sacrificed.'"

### What the skeptics say

On balance Canada appears to have benefited from tax indexing, but some skeptics in Washington cite both economic and political arguments why indexing is not needed or would not work in the U.S. Here are three of the objections most often raised and responses from indexing proponents:

► Periodic tax cuts have kept taxpayers roughly abreast of inflation even without indexing. Tax brackets and tax rates have not been changed substantially since 1965. But, as Senator Russell Long points out in the interview in the box at right, Congress has reduced taxes by a variety of devices, including credits deducted from the taxes owed and increases in standard deductions and personal exemptions. Since 1965, however, only low-income taxpayers (making less than the inflation-adjusted equivalent of \$10,000 to \$12,000 in 1975) have had enough tax reductions to offset inflation.

► Congress has more control over the economy with the present system. In

practice, this means that inflation keeps boosting tax revenues and Congress then decides whether to give some of this money back in tax cuts.

Legislators who deal with tax bills, such as Senator Long, worry that without the inflation bonus in tax collections, Congress might face the politically dreadful prospect of voting to raise taxes. And some legislators contend that indexing would limit their ability to make changes in the substance of the tax law, such as cuts to stimulate the economy.

William Fellner, a member of the Council of Economic Advisers under Presidents Nixon and Ford, argues that indexing would simply prevent Congress from confusing fundamental tax law changes with adjustments for inflation. Says Fellner, "With indexing, Congress would at least have to be honest when it raised taxes," rather than let inflation sneak them up. A corollary economic argument for indexing is that it would help soften recessions. The senior economist of the congressional Joint Economic Committee has calculated that the U.S. recession of 1974-75 would have been less severe if indexing had been in effect to lower taxes and stimulate the economy.

► Indexing might make inflation worse. Large federal deficits encourage inflation, and indexing could increase the deficit by cutting back on revenues. Indexing proponents concede that deficits probably would go up at least temporarily. But they argue that growing deficits would provide a strong political incentive to cut federal spending, since without the inflation bonus the only alternative would be to raise taxes. Indexing might also help fight inflation, its backers argue. If unions knew that workers' tax rates would not go up with each pay increase, they might moderate wage demands.

The indexing proposals circulating in Washington don't apply to business taxes, because of the complexities of questions such as how to compute depreciation on equipment where inflation has greatly increased the cost of replacement. But one business tax issue, the treatment of capital gains, affects many individual taxpayers too. Capital gains could also be indexed, eliminating yet another source of tax unfairness caused by inflation.

Consider the plight of attorney John Sheffield, who bought a house in Los Angeles in 1949 for \$7,000. Though Sheffield recently was offered \$70,000 for the house, he contends that he can-



## Why Senator Long opposes indexing

not afford to sell it because of high capital-gains taxes. Even though most of that \$63,000 increase in value simply reflects inflation since 1949, Sheffield would still be taxed on half the gain. And since Sheffield already owns a second house that he now lives in, he couldn't defer the tax by investing in a new house.

With indexing, a capital asset's value would be increased each year by the rate of inflation; capital-gains taxes would take effect only after the inflation increase. Indexing capital gains is not being actively considered in Washington now. But Congressman William Steiger, a Wisconsin Republican, has persuaded a majority on the Ways and Means Committee to support an amendment to cut maximum capital-gains tax rates back to 25%—restoring the situation that existed in the 1960s.

Public fears about rising inflation have dominated the debate over tax legislation this year. Warnings that too large a cut and an increased federal deficit could push up inflation led President Carter last month to scale his proposed \$24.5 billion tax cut back to \$19.4 billion. A vexed issue has been whether to cut back the unpopular increases scheduled for Social Security taxes next year. But in mid-May the House Ways and Means Committee, reversing a previous vote, rejected any such reduction. Any tax cut therefore seems sure to come out of income taxes.

On taxation issues—whether this year's tax cuts or more basic changes such as indexing—the opinion that counts most in Washington is probably that of Democratic Senator Russell B. Long of Louisiana, chairman of the Senate Finance Committee. A senator for almost 30 years and veteran of many a legislative battle over taxes, Senator Long, 59, has been described as "the Baryshnikov of senatorial politics" because of his agility and control. He talked to Money recently about current tax issues. Excerpts:

Senator, you've opposed indexing the income tax for inflation. What is your basic objection?

Indexing the tax would mean that every year when you have inflation, government revenues would go up much less than they do now. Then, instead of reviewing the situation and voting for a tax cut, as we are doing, you'd find that the cost of government would

be going up with inflation and you'd be constantly under pressure to raise taxes. It's a lot easier to reduce taxes than it is to raise taxes.

So you prefer to let inflation push up people's tax bills?

In order to keep the government solvent, it's easier to do it with the existing system than it is with indexing. What we do each time inflation has occurred is to take a look at how each taxpayer finds himself after inflation and adjust taxes to take that into account. So we do reduce taxes, and we try to do it in a way that will be just and fair to all concerned.

One complaint is that people in the middle-income range have not kept up with inflation because tax cuts have been aimed chiefly at lower-income people.

I think that taxes are too high. For the upper-middle-income brackets and the upper brackets, they are far too high. But as long as the Congress is of a mood to put more taxes on the upper-middle- and high-bracket taxpayers in order to reduce the taxes of those who fall in the lower end of the scale, it won't matter what system you adopt, indexing or something else.

Some congressmen argue that a large tax cut would generate more revenue, as it did after the Kennedy tax cut of 1964. What's your view of that?

You can't be sure in advance just how any tax cut will work. You have to rely on someone's estimates. But I've

felt that in some areas, such as the investment tax credit, the stimulative effect was so good for the economy that it really cost us nothing, in fact made us money.

You apparently don't believe that a tax cut now might be inflationary?

If it results in more investment, particularly more production of energy, then it will not be inflationary. In my judgment, the result will be more investment.

Many members of Congress still want to cut back on the Social Security payroll tax. How do you feel about that?

It's sort of a distinction without a difference. We can reduce the income tax by as much as we want to reduce it in order to offset the increase in Social Security tax or to more than offset it.

The President has proposed a number of reforms that will eliminate deductions. Do you think any reforms will be coupled with the tax cut?

I think some of them will. But if we look at the history of tax reform bills, they also have to entail major tax reductions. This happens because there is far more resentment among those who pay more taxes as the result of a tax reform bill than there is appreciation among those who are going to pay less taxes. When you take up a major tax bill, first one item and then another stirs resentment. A tax reform bill which does not work out to be an overall tax reduction cannot become law.

Influential Democrats oppose Steiger's proposal, but he may win some compromise concessions—perhaps an increase in the amount of capital losses that can be used to reduce taxable income.

### Cut first, index later

Congressmen, especially Republicans, are tussling with the depressing effect of high taxes and bracket creep on economic growth and investment. Some proponents of indexing, such as Senator William Roth of Delaware and Buffalo-area Congressman Jack Kemp, believe that tax rates should be cut substantially first, then indexed to keep inflation from wiping out the cuts. Kemp and Roth are sponsoring a bill to cut personal tax rates within each bracket by nearly one-third, in addition to reducing corporate taxes. Kemp likes to

note that after a similar cut proposed by President John F. Kennedy and enacted in 1964, economic growth was so strong that federal tax collections increased rather than decreased in the next few years.

Taxes at the current rates discourage people from work and investment, Kemp and Roth contend. "People think on the margin," says Kemp, arguing that taxpayers are well aware how much of the earnings from an extra hour's or day's work will go to the government. An example is Charles R. Proseus, a telephone repairman from Baldwinsville, N.Y. Proseus says he and his fellow workers know that when they work more than 12 hours overtime, paycheck deductions from federal and state income taxes and Social Security will start to total 47%. "So I just cut it off at 12 hours," he says. "It

isn't worth it to work any more." The Kemp-Roth argument will be a major Republican plank this fall and in 1980.

"Support for indexing is going to be directly proportional to the rate of inflation," predicts Barber B. Conable Jr., ranking Republican on the House Ways and Means Committee, who backs the proposal. Possibly, Congress will come to see less political mileage in boasting of tax cuts to a skeptical population aware that inflation has already pushed up taxes. As former New York Senator James Buckley, a long-time supporter of indexing, told a recent Senate hearing: "There is no tax reform that is more important to achieve, easier to accomplish and fairer in its impact than income tax indexation." If Congress begins to think like that, the Stealthy Bracket Creeper could become an endangered species. END

# Inflation and the Individual Income Tax Introduction to the Issues—Findings and Recommendations

## INTRODUCTION

The United States is currently experiencing its most prolonged, severe inflation in the last quarter century. Indeed, since 1972, the Consumer Price Index (CPI) has risen by an average of 9.6 percent annually—a clear departure from the historically mild 2–3 percent for the U.S. since 1950. Moreover, rates of inflation well above the historical average are expected to continue, at least for the next five or six years. Both the Congressional Budget Office (CBO) and the President project an increase in the Gross National Product (GNP) implicit price deflator of somewhat over 6 percent in 1977 and an average annual increase of 5–6 percent over the period 1977–81.

There are several undesirable economic effects of such a sustained, high rate of increase in the general price level. One of the most important of these effects, and one which is gaining an increasing amount of attention from economists and policymakers at all levels of government, is the distorting effect on the personal tax burden which results from the interplay of inflation and any progressive individual income tax.<sup>1</sup>

When most of the current *U.S. Internal Revenue Code* provisions were enacted, inflation was not a serious problem. As a result, most major tax code provisions are specified in nominal dollar amounts—e.g., tax bracket boundaries, exclusions, exemptions, the standard deduction maximum, the low-income allowance, and various other deductions or credits, such as the child care expense deduction

and the per capita credit in 1975. Inflation, however, decreases the real value of these exemptions, deductions, and credits that are specified in fixed dollar amounts, causing taxable income to rise more rapidly than total income. In addition, since the tax rate brackets are stated in fixed dollar incomes, the increase in taxable income—regardless of whether there is an increase in real income—is subject to taxation at higher marginal rates.<sup>2</sup> It is the impact of inflation on individual income taxes because of these problems that is considered in this report.

## IMPACT OF INFLATION ON INCOME TAXES

Inflation interacts with a progressive individual income tax to distort real tax burdens in two ways. First, if a taxpayer's nominal (money) income increases, the share of income paid as tax rises even though there may be no increase—or even a decline—in real income or purchasing power. Second, the response of the tax structure to changing real income is asymmetric: if nominal income is constant so that real income falls by the inflation rate, income taxes do not fall to reflect this taxpayer's decline in purchasing power. In short, inflation causes individual income tax burdens for any given real income to increase.

The effects of an assumed 6 percent inflation on both Federal and state income taxes for families with differing money income changes are demonstrated in Table I-1. One sees that if a family's income increases sufficiently to just offset the increase in prices, income taxes claim a larger share of that constant real income—generating a decrease in disposable real income. Similarly, if this family receives no increase in money income, real income declines by 6 percent, but this family's income tax liability does not fall to reflect this fact. Finally, even if the family manages a gain in income more than enough to offset the inflation, income taxes rise in response to the growth of nominal income rather than real income and thus erode the real income gain.

## SCOPE OF THE STUDY

This study focuses on the increases in real individual income tax liabilities that result from the reduction in the real value of tax exemptions, deductions, credits, and rate brackets due to inflation. It is important to note that there are several other issues regarding the effects of inflation and income growth on individual income taxes that are *not* included in this report.

It is an inherent trait of any progressive tax, a trait which has been historically recognized and

**Table I-1**  
**INDIVIDUAL INCOME TAXES FOR VARIOUS CHANGES IN FAMILY INCOME,**  
**ACTUAL AND INDEXED 1975 TAX LAWS**

	Nominal Income	Percent Growth of Income	FEDERAL				STATE <sup>1</sup>			
			Actual 1975 Law		Indexed 1975 Law		Actual 1975 Law		Indexed 1975 Law	
			Income Tax <sup>2</sup>	Effective Rate	Income Tax <sup>2</sup>	Effective Rate	Income Tax <sup>2</sup>	Effective Rate	Income Tax <sup>2</sup>	Effective Rate
1975 Families A, B, and C	\$12,000	—	\$1089	9.08%	—	—	\$305	2.54%	—	—
1976—After 6 percent inflation										
Family A	12,000	0	1089	9.08	\$1018	8.48%	305	2.54	\$284	2.37%
Family B	12,720	6%	1201	9.44	1155	9.08	341	2.68	323	2.54
Family C	13,440	12	1321	9.83	1265	9.41	379	2.82	359	2.67

<sup>1</sup>New York

<sup>2</sup>Married couple with two dependents, all income is wages and salaries of one spouse, joint return claiming the standard deduction.

<sup>3</sup>Calculated as  $[1.06 \times 1975 \text{ tax on (nominal income)}]$ .

1.06

Source: ACIR staff.

applauded, that tax revenues will increase more than proportionately to increases in income. This concept of "revenue elasticity" has been supported both because it provides revenue to governments to meet rising demand for public services and because it enhances the built-in, macroeconomic, stabilizing influence of the tax. Any progressive individual income tax will provide greater percentage revenue increases than income increases regardless of whether the rise in incomes occurs as the result of real increases in output or from inflation.

### REAL VERSUS INFLATION GROWTH

There are several important reasons why the elasticity of income taxes with respect to real growth must be differentiated from the elastic response of revenue to inflation-induced increases in income.

First, real economic growth in the U.S. is a continuing, long-term feature that has been anticipated. Thus, income tax elasticity with respect to that real growth must also be an expected impact of the use of progressive income taxes. However, we have already noted that the inflation rates of the last several years have few parallels in U.S. economic history, leading to the plausible interpretation that substantial real income tax growth due to inflation was not explicitly intended.

Second, there is a fundamental difference between inflation-induced and real growth-induced income tax elasticity, at least from the viewpoint of taxpayers. With real increases in income, taxpayers have greater after-tax purchasing power—they are wealthier—and thus adjust their consumption demands, including the demand for public services. If the desire for public services also rises more than proportionately to an increase in real income, as is likely for at least some public services, then revenue elasticity provides the funds to satisfy these demands. However, when income changes occur simultaneously with general price-level increases, taxpayers are not necessarily made any "better" off—and, in fact, after-tax real income may decline. In short, income taxes and the growth of tax liabilities under an "ability-to-pay" concept must respond to real purchasing power and not nominal incomes.

Therefore, for any progressive individual income tax, the elasticity of revenue with respect to both real income growth and inflation is greater than one. The concern in this report—and the object of indexation—is the component of income tax growth that occurs because of inflation and is more than

proportionate to the increase in the price level. While it is possible to make a case for income taxes of unitary elasticity with respect to all income growth, the response of income taxes to inflation is in large measure a new issue due to the current, historically high rates of inflation. Accordingly, this study examines (1) the impact of inflation in increasing real income tax burdens irrespective of the amount of real economic growth and (2) indexation as a mechanism to set automatically the elasticity of income taxes with respect to inflation equal to one (without altering income tax elasticity with respect to real income growth).

### PROPERTY INCOME

The scope of this report is further limited to only a portion of the inflation impact on individual income taxes. Specifically, we exclude the issues of the proper definition of property income. Of particular importance are capital gains and interest income.

First, a capital gain (or loss) for income tax purposes is defined to be the difference between the purchase and sales price of an asset. If the general price level has increased during the period the asset is held, only a portion—if any—of the gain in value of the asset is real. Therefore, taxpayers incur an increase in taxable income from the capital gain greater than the increase in the real value of the asset.

Second, depending upon the degree to which an inflation is anticipated by lenders and borrowers of money, nominal interest rates adjust to correct for inflation. Thus, if the inflation is fully anticipated, lenders may receive and borrowers pay an interest rate that can be thought of in two parts: real interest representing the return or cost of the loan and an interest adjustment for inflation which serves to just maintain the real value of the loan (the principal).

This inflation response of interest rates would pose no problem if interest income were not taxable and interest payments were not tax deductible. However, since interest income is taxable, lenders must pay tax on the inflation adjustment component of interest which reduces the real after-tax rate of return. In fact, since the inflation component of an interest payment is designed to keep the real value of the principal intact, taxation of that interest income can be thought of as a tax on capital. For borrowers who can deduct interest payments, deduction of the inflation interest component means he or she pays a lower real rate of interest than intended (the real market rate). Deduction of the inflation component of interest can in fact reduce the borrower's repay-

ment below the original amount borrowed.

These problems arise irrespective of the degree of progressivity of the tax; in fact these problems exist even if the tax were proportional or regressive. Consequently, these issues are not solved by indexation of exemptions, credits, the standard deduction, and tax rate brackets. The inflation effect on the tax treatment of capital gains, interest, and debt arises not only because the tax structure may lead to an inflation-induced increase in tax, but also because the definition of income does not allow for the impact of inflation. Of course, even if the definition of these types of income were corrected, the structure effects with a progressive income tax remain.

This report is concerned only with the increase in effective income tax rates that occurs because of the interaction of inflation with the structure of the income tax and not with the definition of property income. This limitation can be made because of the very different and separate nature of these inflation-income tax issues. First, the property income issue exists not only for the individual income tax, but also for the corporate income tax. As such, it can better be examined as an integral part of broader discussions regarding revisions in accounting standards and practices. Second, from a policy standpoint, the adjustment of the tax structure for inflation can be properly viewed as a prerequisite to the issue of the definition of income since the tax structure problems impact on all income. Third, as a practical matter, the inflation impact and correction we are examining in this report relates to wages and salaries—a component which accounts for the bulk (83.5%) of the Federal tax base—Adjusted Gross Income (AGI). In contrast, interest income was 3.7 percent and sales of capital assets 2.3 percent of AGI.<sup>3</sup>

Accordingly, the remaining sections of this chapter highlight the implications of only the tax structure problems in an inflationary period and the advantages and disadvantages of indexing personal exemptions, major fixed-dollar deductions and the tax rate brackets of progressive individual income taxes.

## POLICY IMPLICATIONS

Clearly, one effect of the interaction of inflation and a progressive income tax is to increase the real income tax burdens of taxpayers. Moreover, since both inflation and its income tax effects do not impinge equally on all taxpayers, the legislated distribution of income tax burdens is altered. Because inflation generates increases in individual income tax liabilities, inflation also provides an automatic in-

crease in income tax revenue to any government using a progressive income tax.

Although these automatic, real revenue increases generated by inflation are only potential gains (i.e., they can be eliminated by enacting tax reductions), one school of thought argues that they bias the political process in favor of a larger public sector than otherwise would be legislated. This can occur for either or both of two reasons: (1) individuals may not perceive this automatic increase in taxes from inflation because it does not result from lengthy and detailed public debate of the type that surrounds legislated tax changes, and/or (2) individuals cannot easily pinpoint a particular public official who is a source of the tax increase upon whom they can impose a political penalty for the tax hike.

In addition, the inflation-personal income tax interaction will affect intergovernmental fiscal relations since it will impact differentially on the various levels of government. Thus, the level of government for which these automatic tax increases are larger can be favored by inflation. Alternatively, any move to force legislative action or accountability for these real tax increases might cause greater fiscal stress at one level of government than another. Each of these issues—the inflation and income tax effects on individual taxes, and the fairness of the system on public revenues, public sector growth, and intergovernmental fiscal relations—is considered in subsequent chapters of this report.

## POLICY ALTERNATIVES

### INDEXATION

Recognizing that inflation does have the effect of increasing real individual income tax burdens, many individuals have suggested, and some governments have implemented, a procedure to index progressive individual income taxes to eliminate automatic tax increases due to inflation. The procedure is to adjust rate brackets, personal exemptions, deductions, and credits for changes in the general price level.<sup>4</sup> These adjustments mitigate the effects of inflation that are generated through the income tax structure. While full indexation would thus maintain a constant real individual income tax burden on a constant real income, this type of indexing, while only partial, is a step in that direction. From the point of view of a government, "for an indexed (individual income tax) system, the elasticity of revenues with respect to price inflation is one."<sup>5</sup>

Again referring to Table I-1, one can see how

indexation of the individual income tax would affect tax liabilities. Under an indexed system, those families whose income gains just offset inflation would incur no change in effective tax rate. However, it is also important to note that the nominal amount of income tax paid by such families does increase; taxes increase by the inflation rate and thus continue as a constant share of income. Similarly, those families whose income gains outpace inflation would experience a smaller increase in income tax liabilities with indexation than under current law, although the effective income tax rate now would rise in response to the gain in real income. Finally, those families who experience no increase in nominal income would have both the tax liability and the effective rate reduced by indexation. In that way, the decline in real disposable income for such families would be reduced.

It should be recognized that some features of individual income taxes are already, in effect, indexed. All deductions, exemptions, and credits that are measured in current dollars (such as the itemized deductions) or as a percentage of income (such as the standard deduction below the maximum) are automatically adjusted for inflation by their definition.

A number of other countries have adopted income tax indexation, including France, the Netherlands, and Canada. Since indexation was introduced in Canada in 1974, the rate brackets and personal exemptions have been adjusted upward annually by the previous year's inflation rate. Because the Canadian experience is perhaps most relevant to the U.S., it is considered in detail in Chapter VI.

#### DISCLOSURE OF THE "INFLATION TAX"

While recognizing that inflation impacts on the individual income tax, some individuals would not go so far as to advocate indexation. Rather, viewing the problem as a misconception or lack of information about tax increases, they propose that the amount of the increase in real taxes due to inflation be calculated and be publicly disclosed annually. Whether this adjustment to the *status quo* would be sufficient to cause elimination of the inflation tax is not known.

One should recognize that either indexation or public disclosure—to the extent that they eliminate the inflation tax and that it is not restored by legislative action—would have effects on other economic variables. Specifically, one must determine the potential effects of indexation on the automatic stabilizing impact of the Federal personal income tax, on the

value of Federal deductibility of state-local taxes, and on the impact of state deductibility of Federal income tax liability. These issues, too, are examined in the course of our consideration of the process of indexing individual income taxes.

### A SUMMARY OF FINDINGS OF THE REPORT

Several findings relevant to public policy deliberations can be derived from this report. Before summarizing these, however, two important points must be emphasized. First, the issue of inflation-induced, progressive personal income tax increases deals with the rise in effective income tax rates due to a tax increase in nominal dollars. Personal income tax increases in nominal dollars which either are just proportionate to inflation and/or which result from real income growth are not of concern in this report. Second, the benefits and costs of personal income tax indexation are directly related to the rate of inflation. Thus, one's view of the desirability (or undesirability) of indexation depends in large part on the inflation rate.

The major findings of this report are as follows:

#### FISCAL ACCOUNTABILITY

- *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. Although progressive income taxes also exhibit elasticity with respect to real income growth, that property is inherent in a progressive tax and can be considered intended. Since recent inflation rates and those projected for the immediate future are well above the historical average, the automatic increase in aggregate, effective, personal income tax rates due to inflation is a significantly new and different issue.*

#### TAX EQUITY

- *Among the different taxpayers, the inflation induced increases in personal income taxes without legislated tax cuts are arbitrary. They depend on differences among taxpayers as to family size, level of gross income, type of income received, and the degree to which the various dollar limitations in the tax code affect tax liabilities.*

- *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. After one year of 7 percent inflation, the value (in constant dollars) of a \$750 personal exemption falls to \$701, the \$1,600 low income allowance falls to \$1,495, the \$2,600 maximum standard deduction for married persons falls to \$2,430. The income tax impact of the decline in the real value of personal exemptions increases with family size. The relative increase in tax liability because of the effect of inflation on all these variables will be greater for lower income taxpayers (with the exception that those with very low income may still owe no tax even after inflation erodes the value of these tax features).*
- *On the average, increases in tax liabilities due to the inflation erosion of income tax brackets will be greater for taxpayers in the upper income range where brackets are narrow and the rise in tax rates between brackets is fastest. For the Federal personal income tax, this occurs in the \$28,000 to \$200,000 income range.*
- *The middle-income taxpayers, those with income between \$10,000 and \$15,000, incur the smallest decline in real, after-tax purchasing power due to the inflation-income tax interplay. This occurs because the exemption-credit-deduction effect diminishes in importance faster than the bracket effect grows in importance.*
- *On balance, the four major tax cuts enacted since 1960 have introduced a greater element of progressivity into the income tax structure than would have been the case under an indexed system. This inference can be drawn from the fact that classes of taxpayers below \$25,000 generally have lower 1975 effective tax rates than they would have had if the 1960 law had been indexed and no other changes had been made. Taxpayers with incomes above \$200,000 also had lower 1975 effective tax rates than they would have had under an indexed system.*
- *Both the magnitude and the differential impacts of the inflation-induced individual tax*

*increases, in the absence of indexation and enacted tax cuts, can be substantial. For example, after five years of 7 percent inflation, the inflation-induced tax increase in the fifth year is \$352 for an average family with constant real income of \$6,000, \$602 for a real income of \$15,000, and \$1,743 for a real income of \$30,000. From another viewpoint, the decreases in real disposable income over this five-year period for families with these real incomes are: \$6,000 income—a \$449 or 7.4 percent decrease in disposal income, \$15,000 income—a \$420 or a 3.1 percent decrease, and \$30,000 income—a \$1,235 or 4.9 percent decline.*

#### PUBLIC SECTOR GROWTH

- *Assuming annual 6 percent inflation, annual 6 percent real income growth, and no discretionary tax code changes from 1976 on:*
- *The inflation-induced real increase (that is the increase which would be more than proportionate to inflation) in Federal personal income tax revenue would be about \$6 billion in 1977 (3.7% of income taxes) and about \$50 billion in 1980 (14.4% of income taxes). These are the amounts of the automatic increase in income taxes that would be eliminated by tax indexation.*
- *The inflation-induced real increase in personal income tax revenue for a hypothetical "average state" (under the above assumptions and assuming a state personal income tax elasticity equalling 1.65) would be about \$15 million or 3 percent of income tax after one year and about \$140 million or 14 percent of income tax after five years. Again, these are the amounts of the automatic increase in income tax that would be eliminated by tax indexation. Any given state's situation will vary from this projection depending on its income tax elasticity, the nominal amount of income tax revenue, and the state's reliance on the income tax in its total revenue picture.*
- *Since few local governments utilize progressive personal income taxes, the inflation impact is not significant at the local level. Important exceptions to this generality are: local jurisdictions in Maryland where the local individual income tax is a percent of the state in-*

come tax; New York City which has a progressive individual income tax and allows personal exemptions specified in fixed dollars; and the District of Columbia which has a progressive individual income tax.

- *In the past, at the Federal level, discretionary tax cuts have more than offset the automatic, inflation-induced real increase of personal income taxes.* Indeed, the four major Federal income tax cuts since 1960—justified largely for economic stabilization purposes—resulted in lower income taxes in 1975 than would have existed had indexation been adopted in 1960 with no subsequent tax changes. However, these Federal tax cuts have not fully eliminated the effects of inflation on aggregate income taxes since 1965.
- *Most states have not cut their income tax rates so as to reduce the inflation impact on their revenues.* From 1966 to 1973, state discretionary action in the aggregate served to increase income taxes beyond the impact of income growth and inflation. Since 1973, most states have not raised their rates but have relied on inflation's impact on their revenue to maintain their public service levels.
- *Using the economic projection of the Congressional Budget Office—average annual total income growth of 10 percent including about a 6 percent average annual inflation rate—the average annual increases in aggregate state income tax revenue will be about 13 percent from 1977 to 1980 with indexation; and about 16.5 percent without indexation.* In contrast, actual aggregate state individual income tax revenue increased at an average annual rate of about 15.5 percent from 1971 to 1975.

## INTERGOVERNMENTAL FISCAL EFFECTS

### Without Indexation

In the absence of indexation, the interaction of substantial inflation with progressive income taxes is likely to produce the following intergovernmental fiscal effects:

- *Of the revenue systems of the three levels of government, the Federal sector has the*

*greatest capacity to automatically realize the revenues which accrue as inflation generates nominal increases on various tax bases.* The Federal government makes relatively intensive use of the progressive personal income tax, Federal collections account for about 85 percent of all individual income taxes.

- *State governments have the second greatest ability to realize inflation-generated tax revenues.* States rely more heavily on progressive personal income taxation than do local jurisdictions.
- *On the expenditure side, local governments tend to be more "inflation prone" than the other sectors (Federal, state, private) of the economy.* Local government services are relatively most labor intensive (e.g., teaching, health).
- *The capability of the Federal government to continue its past (1960-75) record of returning the "inflation tax" revenues in the form of enacted tax reductions will continue for the foreseeable future unless Congress decides to underwrite a major new initiative such as a national health plan.* Although this capability is a function of national economic stability and the political alignment, both of which can be difficult to predict, CBO projections nevertheless indicate that during the next five years the Federal government will have the fiscal capacity to enact tax reductions and still reduce the size of its budget deficit in the absence of major new expenditure commitments.
- *The 16 states which permit their residents to deduct their Federal income tax liability in computing the state income tax will experience, during an inflation, a lower growth of revenues than would otherwise occur.* As inflation induces Federal personal income tax increases that are proportionately greater than inflation, these higher liabilities will erode these states' income tax base.
- *States which "piggyback" their state income tax on the Federal income tax (state tax liability is computed as a set percentage of Federal liability) are likely to find a roller-coaster effect on their income tax revenues.* Their tax collec-

tions will automatically rise with inflation due to the inflation responsiveness of the Federal income tax. If Congress follows past practice, however, (as is plausible) and enacts tax cuts to offset the inflation-generated, real income tax increases, the piggyback states will experience declines in their tax revenues (for a given tax rate). At the very least, the "piggyback" states will experience uncertainty of revenues with inflation.

- *Most state and local governments will be in too weak a fiscal position to enact tax reductions during the next few years.* State and local governments do not, in general, have highly inflation-responsive tax structures. Some state governments and many local governments have been forced to restrict or even reduce the quality and scope of their services in the last few years. Unlike the Federal government, they cannot engage in extended deficit financing to bridge their current expenditure-revenue gap. Accordingly, in the next two-three years, new state and local expenditures may be needed just to maintain past (e.g., 1972) program service levels.
- *The inflation-personal income tax interaction will slightly reduce the net resident burden of state and local taxes.* This interesting and beneficial twist for state-local jurisdictions results from the fact that the major state and local taxes are deductible when a taxpayer itemizes deductions on his or her Federal income tax. The reduced "cost" of state-local taxes thus occurs as inflation pushes taxpayers into higher Federal tax rate brackets and, as a result, increases the dollar value of the state-local tax deduction.

#### With Federal Indexation

With the indexation of the Federal individual income tax, the following intergovernmental effects are likely to occur:

- *The Federal government would experience reduced flexibility in the enactment of income tax cuts.* The "reduced flexibility" is likely to affect both the frequency and the amount of tax cuts during the next few years.
- *Depending on the requirements of stabilization policy, the Federal government might be*

*forced periodically to enact discretionary tax increases in the absence of the built-in, "inflation tax" increases which now occur.* This does not necessarily mean that, on net, Federal taxes will be higher over time—only that periodic tax increases which would be necessary would result from discretionary Congressional action.

- *State and local governments would find that their residents experience a rise in the net burden of state-local taxes relative to what otherwise would occur because of the reduction in the dollar value of the state-local tax deduction on the Federal income tax return.* Federal tax indexation would permit taxpayers with constant real incomes to avoid being moved into higher tax rate brackets where the dollar value of the state-local tax deduction on the Federal tax return is slightly increased.
- *States which permit the deductibility of Federal tax liability against their state income taxes would experience a slight increase in the revenue productivity of their taxes as Federal tax liabilities have the automatic "inflation tax" component eliminated.*
- *Piggyback income tax states would, just as the Federal government, lose the revenues once generated by the "inflation tax."* Federal indexation might reduce to some extent, the fiscal uncertainty these states now experience as a consequence of the possible periodic Congressional reductions in the Federal personal income tax.

#### State Indexation (In Addition to the Federal)

If the states as well as the Federal government index the individual income tax, the following fiscal effects are likely to occur:

- *In general, state income tax indexation could be expected to increase state-local fiscal tensions.* Because state governments have limited ability to incur deficits to finance current expenditure-revenue gaps and because their long-run budget situation is at best one of balance or slight surplus, indexation at the state level would mean either reduction in the rate of expenditure growth and/or the likelihood of

more tax increases than would be the case in the absence of indexation.

- *The degree of fiscal stress due to indexation would vary among states depending on the extent to which they rely on progressive personal income taxation. In general, jurisdictions which have a high reliance on the personal income tax would experience the most fiscal strain due to indexation. But some states which have rapidly growing economic bases (e.g., the "energy rich" states) may well be able to afford indexation and still be able to increase the scope and quality of their public services or cut taxes.*
- *To the extent that indexation would reduce the fiscal flexibility of certain states, local governments in these states would also experience financial strain if the states become more reluctant to increase state to local aid (e.g., for property tax relief) and/or take over certain local fiscal responsibilities (e.g., school financing). Over the last 20 years, state aid as a percent of local general revenue has risen from 42 to 60 percent.*

#### OTHER INDEXATION ISSUES

- *Indexation is not likely to alter the built-in, economic stabilizing influence of the Federal individual income tax. The response of income taxes to changes in real national income would remain under indexation. Any indexation impact on the built-in stabilizer would depend somewhat on how the index is determined.*
- *If unions or individuals bargain for wage levels high enough to maintain real after-tax purchasing power, then indexation would reduce pressure for wage increases. Indeed, the severe inflation (about 15% per year) in Australia has prompted the labor unions in that country to "bargain" for real wage increases by urging income tax indexation as a means to protect automatically at least part of wage gains negotiated at the bargaining table.*

#### FOREIGN EXPERIENCE

- *Several other countries have already adopted some form of indexing their individual income tax. These countries include Canada, the*

Netherlands, France, Luxembourg, Denmark, Israel, Brazil, and Chile.

- *Canada uses a partial tax indexation scheme similar to the type discussed in this report. Under the Canadian approach, which took effect in 1974, the personal exemptions and the tax rate brackets are adjusted upward annually by the rate of change in the Consumer Price Index for the year ending in the previous September. As a result, the Canadians have adjusted these two features by 6.6 percent for 1974, 10.1 percent for 1975, and by 11.3 percent for 1976.*

#### FEDERAL RECOMMENDATIONS

In the light of the foregoing findings, the Commission adopted recommendations for dealing with the impact of inflation on individual income tax structures at both the Federal and state government levels.

#### FULL DISCLOSURE AND ANNUAL INDEXATION OF THE FEDERAL INDIVIDUAL INCOME TAX

The Commission recognizes that inflation induces increases in real income tax revenue and introduces distortions in interpersonal tax equity. The Commission is persuaded that taxpayers may not readily perceive the automatic, real tax increase that occurs from the inflation-personal income tax interplay. Therefore, the Commission recommends, in the interest of complete public information, that the amount of the inflation-induced, Federal real personal income tax increase be calculated and publicized for each tax year.

While a full disclosure policy is a desirable first step, the Commission also believes that effective, personal income tax rates should only be increased by overt Congressional action and should not be an automatic consequence of inflation. Therefore, the Commission further recommends that the Congress 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 Federal individual income tax by the rate of increase in the general price level.\*

Five major considerations prompted the Advi-

\*Mr. Cannon abstained from the vote on this recommendation.

sory Commission to recommend that the Congress index the Federal individual income tax.\*

*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 *nominal* income.

*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.

*Fiscal Imbalance:* In the absence of indexation, inflation aggravates intergovernmental fiscal imbalance because the Federal government is the primary collector of the "inflation tax."

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

## STATE RECOMMENDATIONS

The policy implications of state income tax indexation differ from the Federal in two important respects. First, state governments face budgetary constraints and economic pressures which are fundamentally different from the national government (e.g., limits on deficit financing, special vulnerability of expenditures to inflation).

Second, statements about the effects of indexation on state income taxes are less subject to generalization due to the fact that there are 30 different broad-based, state income taxes with varying degrees of progressivity and relative quantitative importance.

### FULL DISCLOSURE AND ANNUAL INDEXATION OF STATE INDIVIDUAL INCOME TAX

The Commission recognizes that inflation induces increases in real income tax revenue and introduces distortions in interpersonal tax equity. The Commission is persuaded that taxpayers may not readily

perceive the automatic, real tax increase that occurs from the inflation-personal income tax interplay. Therefore, the Commission recommends, in the interest of complete public information, that governors have an estimate made of the amount of the inflation-induced state personal income tax increase and publicize the estimate for each tax year.

While a full disclosure policy is a desirable first step, the Commission also believes that effective personal income tax rates should be increased only by overt state legislative action and should not be an automatic consequence of inflation. The Commission recommends, therefore, that all states give early and favorable consideration to annual indexation of exemptions, deductions, per capita tax credits, and tax rate brackets. The Commission believes that the need for this remedial action is especially apparent for those states that combine a highly progressive, income tax rate structure with heavy reliance on the tax.

The same major considerations—fiscal accountability, tax equity, public sector growth—that prompted the Advisory Commission to recommend the indexation of the Federal income tax also support indexation of the state personal income tax.

Over the last 15 or 20 years, many states have moved strongly to make balanced use of various revenue sources including particularly the personal income tax. Thirty-nine states now use progressive individual income taxes that provide, on average, a substantial portion of own-source state revenue. As a result, state revenue systems now generally enjoy higher elasticity—that is stronger growth responsiveness—than ever before. There is little doubt that the inflation-induced real increases in income tax revenue encouraged the states to make greater use of income taxes. Now that these progressive, state personal income taxes are established, however, further automatic real increases *due to inflation* should not be tolerated.

With indexation, the distortions in interpersonal tax equity that are introduced by inflation interacting with progressive state income taxes would be largely eliminated. Furthermore, states would still enjoy substantial, income tax elasticity from the income tax response to real economic growth. Indeed the evidence suggests that, with indexation, aggregate state personal income tax collections can increase over the next four years at about 13 percent annually. This is only 2.5 percentage points less than the actual annual revenue growth between 1971 and 1975—a period of significant legislative action to raise taxes.

\*The pro and con argumentation for the Commission's policy recommendations on indexation is presented in detail in Appendix B.

Although state individual income tax collections approximate only 20 percent of Federal collections from this source, this average obscures the heavy reliance certain states make of this tax instrument. While Ohio and Louisiana income tax yields are only about 7 percent of the Federal, Minnesota and Wis-

consin income tax yields are 41 and 38 percent, respectively, of Federal collections. In states where a highly progressive rate structure is combined with heavy reliance on the income tax, the impact of inflation on the state's income tax collections can be substantial.

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### Footnotes

<sup>1</sup>Progressive here refers to the share of income paid as tax. An individual income tax may be progressive even if the rate structure is proportional; exemptions, deductions, and credits can cause the effective tax rate to increase with income.

<sup>2</sup>Even if a taxpayer is not forced into a higher bracket, a larger proportion of his income is subject to taxation at the highest marginal rate applicable.

<sup>3</sup>Internal Revenue Service, *Statistics of Income—1971*, Individual Income Tax Returns, Washington, D.C., 1973.

<sup>4</sup>The choice of the proper index to reflect changes in the general

price level for income tax adjustment purposes is not a trivial question. While many nations have opted to use their equivalent of the Consumer Price Index (CPI), this is not universal and may not be best. One desires to adjust for changes in the *general* price level and not for changes in the relative prices of different goods only. Some have argued that a better index for tax indexation is a national income deflator because national income comes close to the income tax base. For more on this issue, see Edward F. Denison, "Price Series for Indexation of the Income Tax System," paper presented at the Conference of Inflation and the Income Tax System, The Brookings Institution, October 1975.

<sup>5</sup>J. R. Allen, D. A. Dodge, S. N. Poddar, "Indexing the Personal Income Tax: A Federal Perspective," *Canadian Tax Journal*, July-August 1974, p. 363.

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## Acknowledgements

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**T**his report builds on a Commission policy adopted at its August 30, 1976, meeting recommending the indexation of federal and state personal income taxes for inflation. Preparation of this volume took place within the Commission's policy implementation division. Harley T. Duncan authored the report under the general supervision of Carl W. Stenberg, Assistant Director for Policy Implementation, and John Shannon, Assistant Director for Taxation and Finance. Assistance was provided by Commission staff members Will Myers, Robert Ebel, and Frank Tippet. Nalini Roy typed the several drafts of the manuscript.

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## Preface

**W**hen the Advisory Commission on Intergovernmental Relations first studied the effect of inflation on income tax burdens in 1976,<sup>1</sup> 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.<sup>2</sup> 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?

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#### FOOTNOTES

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

<sup>2</sup> 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

**M**ost 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.<sup>1</sup> 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).<sup>2</sup> 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."<sup>3</sup> 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
<b>\$10,000</b>											
<b>Indexed</b>	\$ 374	3.7%	\$ 400	7.0%	3.7%	\$ 458	22.5%	3.7%	\$ 525	40.3%	3.7%
<b>Unindexed</b>	374	3.7	485	28.0	4.5	747	99.7	6.1	1,067	185.3	7.6
<b>\$15,000</b>											
<b>Indexed</b>	1,242	8.3	1,328	7.0	8.3	1,521	22.5	8.3	1,742	40.3	8.3
<b>Unindexed</b>	1,242	8.3	1,435	15.5	8.9	1,923	54.8	10.5	2,516	102.3	12.0
<b>\$20,000</b>											
<b>Indexed</b>	2,012	10.1	2,153	7.0	10.1	2,466	22.5	10.1	2,822	40.3	10.1
<b>Unindexed</b>	2,012	10.1	2,239	11.3	10.5	2,808	39.6	11.5	3,499	73.9	12.5
<b>\$25,000</b>											
<b>Indexed</b>	2,901	11.6	3,104	7.0	11.6	3,553	22.5	11.6	4,069	40.3	11.6
<b>Unindexed</b>	2,901	11.6	3,224	11.1	12.1	4,051	39.6	13.2	5,083	75.2	14.5
<b>\$35,000</b>											
<b>Indexed</b>	5,064	14.5	5,419	7.0	14.5	6,204	22.5	14.5	7,103	40.3	14.5
<b>Unindexed</b>	5,064	14.5	5,668	11.9	15.1	7,131	40.8	16.6	9,027	78.3	18.4
<b>\$50,000</b>											
<b>Indexed</b>	9,323	18.6	9,975	7.0	18.6	11,421	22.5	18.6	13,076	40.3	18.6
<b>Unindexed</b>	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.<sup>4</sup>

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.<sup>5</sup> 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 1.

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.

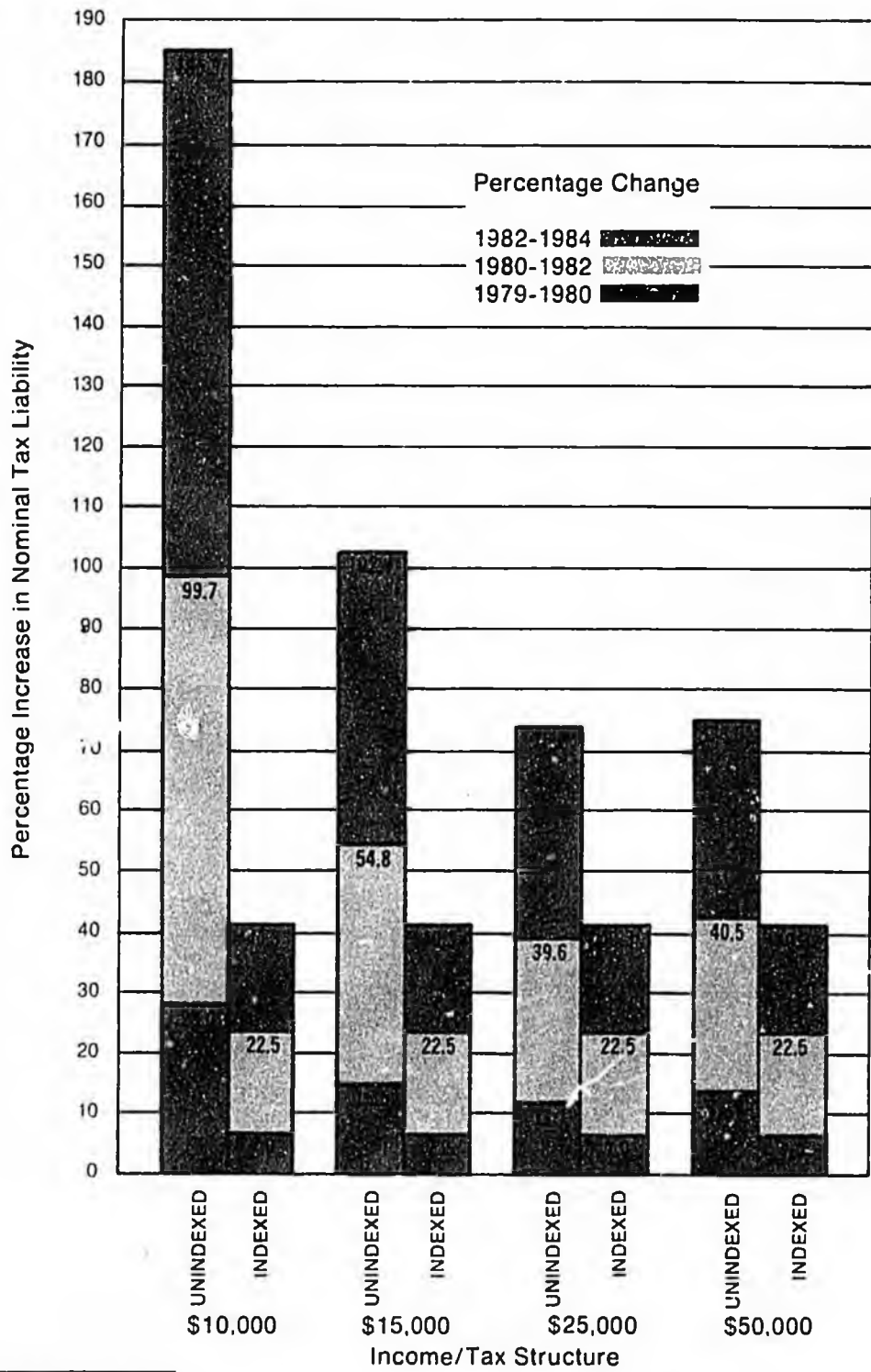
When tested by after-tax purchasing power, the disparity in the distribution of the inflation tax among family income groups is not as great as when the relative increase in tax liability is considered, and families at both the upper and lower ends of the income spectrum suffer the largest losses. The 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.<sup>6</sup>

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.<sup>7</sup> 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.<sup>8</sup>

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)<sup>9</sup> 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.<sup>10</sup>

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.<sup>11</sup>

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.<sup>12</sup>

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.)<sup>13</sup>

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 <sup>1</sup>	(4) 1979 Law Tax	(5) Tax Cut <sup>2</sup> (Col. 2 Minus Col. 4)	(6) Inflation Tax Increase <sup>3</sup> (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)

<sup>1</sup> 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.

<sup>2</sup> 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.

<sup>3</sup> 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.<sup>14</sup>

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

<sup>1</sup> 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.

<sup>2</sup> 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.

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

<sup>4</sup> 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.

<sup>5</sup> 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.

<sup>6</sup> 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.

<sup>7</sup> For further discussion of this issue, see pp. 27-28.

<sup>8</sup> 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.

<sup>9</sup> 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.

<sup>10</sup> 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.

<sup>11</sup> Roper Organization Study No. 648, op. cit.

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

<sup>13</sup> 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.

<sup>14</sup> *Ibid.*



# The States and the Inflation Tax

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**I**t 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



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.<sup>15</sup> 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 Levels<sup>1</sup>**

		High	Medium	Low
Progressivity at Higher Income Levels <sup>2</sup>	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		

<sup>1</sup>Progressivity 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.

<sup>2</sup>Progressivity 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
<b>\$10,000 - 14,025</b>											
<b>ALASKA</b>											
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
<b>VIRGINIA</b>											
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
<b>\$25,000 - 35,064</b>											
<b>ALASKA</b>											
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
<b>VIRGINIA</b>											
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
<b>\$50,000 - 70,127</b>											
<b>ALASKA</b>											
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
<b>VIRGINIA</b>											
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).

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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.<sup>16</sup> 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.<sup>17</sup>

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

<sup>15</sup> 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.

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

<sup>17</sup> 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

**T**he 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.

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## 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.<sup>18</sup>

## **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