

LEG. FINANCE - BILLS 1979 - 1980 1394

SR 27 thru SCP 30 1394



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

SR 27

Introduced: 5/22/80
Referred: Finance

1 IN THE SENATE BY THE RULES COMMITTEE BY REQUEST

2 SENATE RESOLUTION NO. 27

3 IN THE LEGISLATURE OF THE STATE OF ALASKA

4 ELEVENTH LEGISLATURE - SECOND SESSION

5 Relating to the construction of a
6 dike at approximately Mile 44 of the
7 Glenn Highway.

8 BE IT RESOLVED BY THE SENATE:

9 WHEREAS construction of a dike at approximately Mile 44 of the Glenn
10 Highway is necessary to protect the Butte area of the Matanuska-Susitna
11 Borough from potential flooding of the Matanuska River; and

12 WHEREAS it appears likely that funding in the amount of \$1,000,000 will
13 be made available to the State of Alaska for the purpose of constructing a
14 dike at approximately Mile 44 of the Glenn Highway; and

15 WHEREAS it appears that the United States Army Corps of Engineers must
16 issue a federal wetlands permit before construction on the dike may begin;

17 BE IT RESOLVED that the Alaska State Senate urges the United States Army
18 Corps of Engineers to process, review and issue a federal wetlands permit and
19 any other environmental permits required for construction of the dike at
20 approximately Mile 44 of the Glenn Highway which are consistent with the need
21 to provide protection from flooding to the Butte area and with the need to
22 protect, preserve and enhance the environment.

23 COPIES of this resolution shall be sent to Lt. General John W. Morris,
24 Chief of Engineers, U.S. Army Corps of Engineers; and to the Honorable Ted
25 Stevens and the Honorable Mike Gravel, U.S. Senators, and the Honorable Don
26 Young, U.S. Representative, members of the Alaska delegation in Congress.

29 COMMITTEE COPY

ALASKA STATE LEGISLATURE

ELEVENTH Legislature SECOND Session

SENATE RESOLUTION NO. 27
By THE RULES COMMITTEE BY REQUEST

Relating to the construction of the dike at approximately Mile 44 of the Glenn Highway.

Introduced in the Senate 5/22/80, 1980

HISTORY IN THE SENATE

19	80	Read first time and referred to Committee on Finance												
5	22	Reported back with recommendation that												
		Read second time and												
		Read third time and												
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SECRETARY OF THE SENATE														

HISTORY IN THE HOUSE

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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.

Introduced: 5/22/80
Referred: Finance

1 IN THE SENATE

BY THE RULES COMMITTEE BY REQUEST

2 SENATE RESOLUTION NO. 27

3 IN THE LEGISLATURE OF THE STATE OF ALASKA

4 ELEVENTH LEGISLATURE - SECOND SESSION

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6 dike at approximately Mile 44 of the
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8 BE IT RESOLVED BY THE SENATE:

9 WHEREAS construction of a dike at approximately Mile 44 of the Glenn
10 Highway is necessary to protect the Butte area of the Matanuska-Susitna
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13 be made available to the State of Alaska for the purpose of constructing a
14 dike at approximately Mile 44 of the Glenn Highway; and

15 WHEREAS it appears that the United States Army Corps of Engineers must
16 issue a federal wetlands permit before construction on the dike may begin;

17 BE IT RESOLVED that the Alaska State Senate urges the United States Army
18 Corps of Engineers to process, review and issue a federal wetlands permit and
19 any other environmental permits required for construction of the dike at
20 approximately Mile 44 of the Glenn Highway which are consistent with the need
21 to provide protection from flooding to the Butte area and with the need to
22 protect, preserve and enhance the environment.

23 COPIES of this resolution shall be sent to Lt. General John W. Morris,
24 Chief of Engineers, U.S. Army Corps of Engineers; and to the Honorable Ted
25 Stevens and the Honorable Mike Gravel, U.S. Senators, and the Honorable Don
26 Young, U.S. Representative, members of the Alaska delegation in Congress.



RECORDS CERTIFICATION



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James O. Smith
Signature of Camera Operator

3/23/90
Date

Introduced: 5/29/80
Referred: Finance

1 IN THE SENATE BY THE RULES COMMITTEE BY REQUEST
 2 SENATE RESOLUTION NO. 28
 3 IN THE LEGISLATURE OF THE STATE OF ALASKA
 4 ELEVENTH LEGISLATURE - SECOND SESSION
 5 Relating to the sale of agricultural
 6 land in the Point MacKenzie agricul-
 7 tural development project.

8 BE IT RESOLVED BY THE SENATE:

9 WHEREAS during the spring and summer of this year the division of lands,
 10 Department of Natural Resources, will begin preparation of state land within
 11 the Point MacKenzie agricultural development project for sale of agricultural
 12 rights to qualified individuals; and

13 WHEREAS state land within the Point MacKenzie agricultural development
 14 project is heavily forested with timber of commercial value; and

15 WHEREAS the current development plan for that project includes the cut-
 16 ting, removal, and sale of all commercially valuable timber on the land
 17 before the sale of agricultural rights; and

18 WHEREAS the removal of all timber from the land in the Point MacKenzie
 19 agricultural development project may not be the best agricultural practice
 20 because standing timber affords shade for livestock, prevents soil erosion,
 21 and provides a natural windbreak;

22 BE IT RESOLVED by the Senate that the governor is respectfully requested
 23 to direct the director of the division of lands, Department of Natural Re-
 24 sources, to appraise and dispose of the agricultural land in the Point
 25 MacKenzie agricultural development project with the timber intact to allow
 26 purchasers of the agricultural interest in the land to either leave or remove
 27 the timber in a manner that is consistent with sound agricultural land use
 28 practices.

COMMITTEE COPY

ALASKA STATE LEGISLATURE

ELEVENTH Legislature SECOND... Session

SENATE RESOLUTION... NO. ... 28...

By THE RULES COMMITTEE BY REQUEST

Relating to the sale of agricultural land in the Point MacKenzie agricultural development project.

Introduced in the Senate 5/29/19 80

HISTORY IN THE SENATE

19 80

Read first time and referred to Committee on

5 29

Finance

Reported back with recommendation that

Read second time and

Read third time and

PASS	Effective Date
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Reconsideration

PASS	Effective Date
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SECRETARY OF THE SENATE

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HISTORY IN THE SENATE

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Filed with Lt. Governor

Chapter No.

Introduced: 5/29/80
Referred: Finance

1 IN THE SENATE

BY THE RULES COMMITTEE BY REQUEST

2

SENATE RESOLUTION NO. 28

3

IN THE LEGISLATURE OF THE STATE OF ALASKA

4

ELEVENTH LEGISLATURE - SECOND SESSION

5

Relating to the sale of agricultural

6

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8

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10

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WHEREAS state land within the Point MacKenzie agricultural development project is heavily forested with timber of commercial value; and

14

15

WHEREAS the current development plan for that project includes the cutting, removal, and sale of all commercially valuable timber on the land before the sale of agricultural rights; and

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17

18

WHEREAS the removal of all timber from the land in the Point MacKenzie agricultural development project may not be the best agricultural practice because standing timber affords shade for livestock, prevents soil erosion, and provides a natural windbreak;

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22

BE IT RESOLVED by the Senate that the governor is respectfully requested to direct the director of the division of lands, Department of Natural Resources, to appraise and dispose of the agricultural land in the Point MacKenzie agricultural development project with the timber intact to allow purchasers of the agricultural interest in the land to either leave or remove the timber in a manner that is consistent with sound agricultural land use practices.

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James O. Smith
Signature of Camera Operator

3/23/90
Date

Introduced: 3/8/79
Referred: Finance

BY ZHAROFF, ANDERSON, BRANSON,
CARNEY, DUNCAN, ELIASON, FREEMAN,
FULLER, GUY, HAUGEN, HURLBERT, MALONE,
MARTIN, MILES, MOSS, OSTERBACK,
PARKER, SCHAEFFER AND GARDINER

1 IN THE HOUSE

2 HOUSE JOINT RESOLUTION NO. 30

3 IN THE LEGISLATURE OF THE STATE OF ALASKA

4 ELEVENTH LEGISLATURE - FIRST SESSION

5 Relating to the sale of revenue bonds
6 of the Alaska Power Authority for the
7 Terror Lake hydroelectric generating
8 project at Kodiak, Alaska.

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

10 WHEREAS the State of Alaska has funded a feasibility study for the
11 Terror Lake hydroelectric project in the Kodiak Island Borough through money
12 loaned from the Alaska Power Authority power project revolving fund and the
13 water resources revolving fund in the amount of \$520,000; and

14 WHEREAS the completed study shows that the hydroelectric project is
15 feasible; and

16 WHEREAS the Alaska Power Authority has submitted to the legislature and
17 to the governor a statement of its recommendations for financing the hydro-
18 electric project, as required in AS 44.56.180(b), and a statement outlining
19 the general design, demonstration of financial feasibility, and maximum
20 amount of revenue bonds necessary for the project; and

21 WHEREAS according to statements by the authority, it is to finance the
22 project only through the issuance of revenue bonds and may not construct,
23 acquire, or own the project; and

24 WHEREAS the statements by the authority provide that the project is to
25 be designed, acquired, and constructed by the Kodiak Electric Association
26 under an agreement with the authority which shall provide that the authority
27 have ownership rights in the project only as may be necessary to secure the
28 payment of the principal and interest on revenue bonds issued for the pro-
29 ject; and

Introduced: 3/8/79
Referred: Finance

BY ZHAROFF, ANDERSON, BRANSON,
CARNEY, DUNCAN, ELIASON, FREEMAN,
FULLER, GUY, HAUGEN, HURLBERT, MALONE,
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1 IN THE HOUSE

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20 amount of revenue bonds necessary for the project; and

21 WHEREAS according to statements by the authority, it is to finance the
22 project only through the issuance of revenue bonds and may not construct,
23 acquire, or own the project; and

24 WHEREAS the statements by the authority provide that the project is to
25 be designed, acquired, and constructed by the Kodiak Electric Association
26 under an agreement with the authority which shall provide that the authority
27 have ownership rights in the project only as may be necessary to secure the
28 payment of the principal and interest on revenue bonds issued for the pro-
29 ject; and

1 WHEREAS the statements submitted to the governor and to the legislature
2 fully satisfy the conditions set out in AS 44.56.180 which must be satisfied
3 before the adoption of this resolution; and

4 WHEREAS the cost to be incurred in financing the project will require
5 the issuance of revenue bonds of the authority in a presently estimated
6 amount not to exceed \$120,000,000; and

7 WHEREAS it is considered to be in the best interests of the state that
8 revenue bonds of the authority be issued to finance the cost of the project;

9 BE IT RESOLVED that the Alaska State Legislature approves the general
10 design of the Terror Lake hydroelectric project in the Kodiak Island Borough
11 and the sale of revenue bonds by the Alaska Power Authority in an amount not
12 to exceed \$120,000,000 to pay the costs of the project.

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Date

Original sponsors: Kelly, Dankworth,
Hackney, and Stimson

Offered: 4/27/79
Referred: Rules

1 IN THE SENATE BY THE FINANCE COMMITTEE

2 CS FOR SENATE CONCURRENT RESOLUTION NO. 30

3 IN THE LEGISLATURE OF THE STATE OF ALASKA

4 ELEVENTH LEGISLATURE - FIRST SESSION

5 Directing the Legislative Budget and
6 Audit Committee to study indexing the
7 Alaska state personal income tax
8 system.

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

10 WHEREAS inflation has caused the taxable income of Alaska taxpayers to
11 increase without actual gain in real income; and

12 WHEREAS this increase in taxable income places Alaska taxpayers in
13 higher percentage tax brackets without commensurate gains in real income; and

14 WHEREAS this situation results in ever lower real personal buying power
15 and constantly higher income taxes in real dollars for Alaskans; and

16 WHEREAS a system of indexing the personal income tax has been adopted by
17 the states of Colorado, California and Arizona; and

18 WHEREAS the experience of the Dominion of Canada with tax indexing has
19 been successful since its implementation in 1974; and

20 WHEREAS adopting a system of income tax indexing is recommended by the
21 National Conference of State Legislatures, the U. S. Advisory Commission on
22 Intergovernment Relations, and the Council of State Governments;

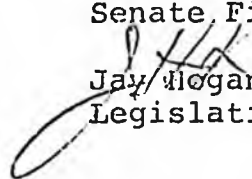
23 BE IT RESOLVED by the Alaska State Legislature that the Legislative
24 Budget and Audit Committee is directed to study the advantages and disadvan-
25 tages and fiscal impact of indexing personal income tax brackets, deductions,
26 exemptions and credits to the rate of inflation in Alaska; and be it

27 FURTHER RESOLVED that the Legislative Budget and Audit Committee is
28 requested to report its findings and recommendations to the Legislature not
29 later than the 10th day of the Second Session of the Eleventh Legislature.

April 25, 1979

M E M O R A N D U M

TO: Senator Sackett, Chairman
Senate Finance Committee

FROM:  Jay Hogan, Director
Legislative Finance Division

The study of indexing the Alaska State personal income tax directed in the Finance Committee Substitute for SCR 30 can be accomplished within the limits of funds budgeted for FY 80.

MEMORANDUM

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

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 Tax¹

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

Four major considerations prompted this recommendation:

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

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

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

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

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

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

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

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

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

Section 1 states the title of the act.

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

Section 3 defines key terms.

Section 4 requires the Governor to prepare and

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

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

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

Suggested Legislation

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

(Be it enacted, etc.)

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

2 SECTION 2. *Findings and Purpose.*

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

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

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

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

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

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

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

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

26 SECTION 5. *Adjustments for Inflation.*

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

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

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

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

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

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

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

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



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

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 exemption 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

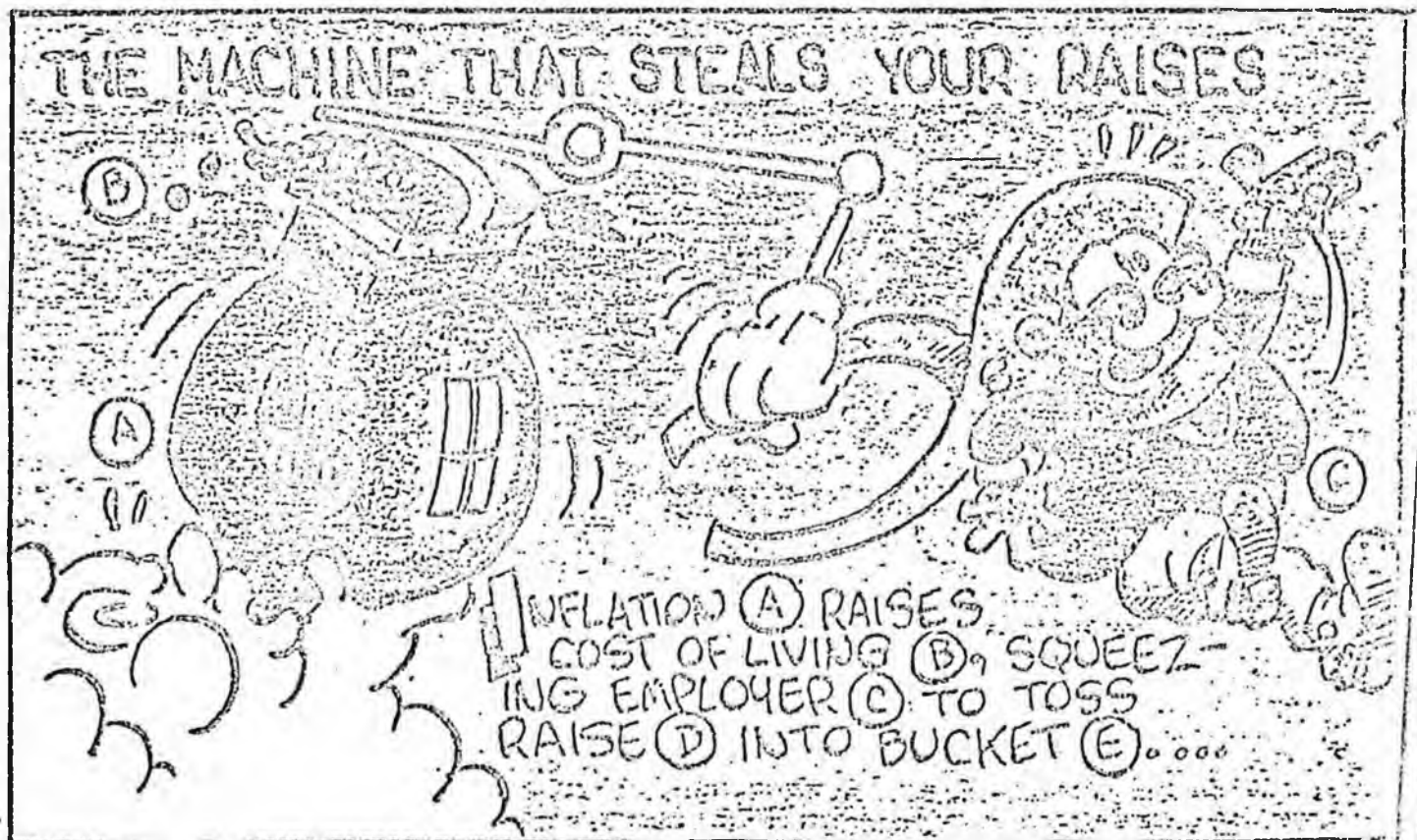
Dense and dark is the underbrush of the Internal Revenue Code, and hideous monsters lurk there. The one that Jimmy Carter particularly detests is the Loathsome Luncheon Loop-holer (of the three-martini species); Carter and others also shudder at the Exotic Shelter Digger. But the beast that preys most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

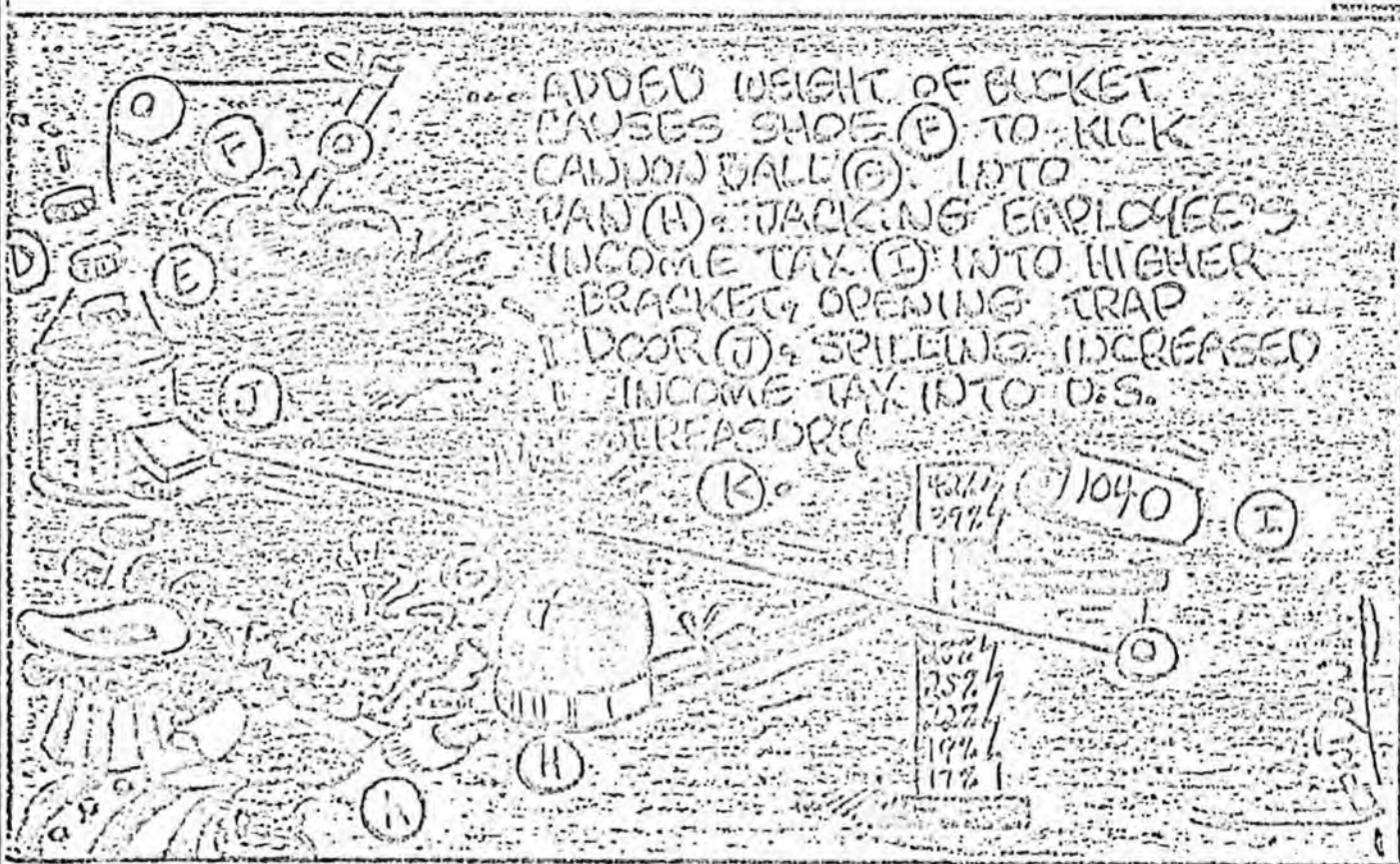
TAXABLE INCOME BRACKET	MARGINAL TAX RATE
\$11,201-\$15,200	22%
\$15,201-\$19,200	25%
\$19,201-\$23,200	28%
\$23,201-\$27,200	32%
\$27,201-\$31,200	36%
\$31,201-\$35,200	39%
\$35,201-\$39,200	42%
\$39,201-\$43,200	45%
\$43,201-\$47,200	48%
\$47,201-\$55,200	50%

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 Jacobs 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 recent 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 Borzikhov 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 hearing 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.¹

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.² 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 1-1. 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 1-1
INDIVIDUAL INCOME TAXES FOR VARIOUS CHANGES IN FAMILY INCOME,
ACTUAL AND INDEXED 1975 TAX LAWS

	Nominal Income	Percent Growth of Income	FEDERAL				STATE ¹			
			Actual 1975 Law		Indexed 1975 Law		Actual 1975 Law		Indexed 1975 Law	
			Income Tax ²	Effective Rate	Income Tax ²	Effective Rate	Income Tax ²	Effective Rate	Income Tax ²	Effective Rate
1975 Families A, B, and C	\$12,000	—	\$1039	9.08%	—	—	\$335	2.54%	—	—
1976—After 6 percent inflation										
Family A	12,000	0	1039	9.08	\$1010	8.48%	335	2.54	\$284	2.37%
Family B	12,720	6%	1201	9.44	1155	9.09	341	2.68	323	2.54
Family C	13,440	12	1321	9.83	1265	9.41	379	2.82	359	2.67

¹New York

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

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

1.06

Source: AGIR 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.⁹

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.¹⁰ 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."¹¹

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 \$120 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.²

Five major considerations prompted the Advi-

²Mr. 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 BUENEXATION 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.

Footnotes

¹Progressive 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.

²Even 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.

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

⁴The 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. Danison, "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. 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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Signature of Camera Operator

3/23/90
Date

Date passed to Senate _____

Bill # SCR 30

SENATE FINANCE COMMITTEE
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 - 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 _____

7069
Subini

Original sponsors: Kelly, Dankworth,
Hackney, and Stimson

1 IN THE SENATE BY THE FINANCE COMMITTEE
2 CS FOR SENATE CONCURRENT RESOLUTION NO. 30
3 IN THE LEGISLATURE OF THE STATE OF ALASKA
4 ELEVENTH LEGISLATURE - FIRST SESSION
5 Directing the Legislative Budget and
6 Audit Committee to study indexing the
7 Alaska state personal income tax
8 system.
9 BE IT RESOLVED BY THE LEGISLATURE OF THE STATE OF ALASKA:
10 WHEREAS inflation has caused the taxable income of Alaska taxpayers to
11 increase without actual gain in real income; and
12 WHEREAS this increase in taxable income places Alaska taxpayers in
13 higher percentage tax brackets without commensurate gains in real income; and
14 WHEREAS this situation results in ever lower real personal buying power
15 and constantly higher income taxes in real dollars for Alaskans; and
16 WHEREAS a system of indexing the personal income tax has been adopted by
17 the states of Colorado, California and Arizona; and
18 WHEREAS the experience of the Dominion of Canada with tax indexing has
19 been successful since its implementation in 1974; and
20 WHEREAS adopting a system of income tax indexing is recommended by the
21 National Conference of State Legislatures, the U. S. Advisory Commission on
22 Intergovernment Relations, and the Council of State Governments;
23 BE IT RESOLVED by the Alaska State Legislature that the Legislative
24 Budget and Audit Committee is directed to study the advantages and disadvan-
25 tages and fiscal impact of indexing personal income tax brackets, deductions,
26 exemptions and credits to the rate of inflation in Alaska; and be it
27 FURTHER RESOLVED that the Legislative Budget and Audit Committee is
28 requested to report its findings and recommendations to the Legislature not
29 later than the 10th day of the Second Session of the Eleventh Legislature.

STATE OF ALASKA



POUCH V
JUNEAU, ALASKA 99811
(907) 465-3822

SENATOR TIM KELLY

283 MULDOON ROAD
STATION BOX 76
ANCHORAGE, ALASKA 99504
(907) 333-1179

John. Put on agenda - 4-18-79
tell him to where I ask if he wants to testify

I'd appreciate this essentially minor Resolution passed out of finance. It calls for a study (no \$) by the Legislative Affairs Agency of indexing the Tax rate in Alaska to inflation.

Notified
4/19/79
JK

Thank,
Tim

Introduced: 4/16/79
Referred: Finance

BY KELLY, DANKWORTH, HACKENY
AND STIMSON

1 IN THE SENATE

2 SENATE CONCURRENT RESOLUTION NO. 30
3 IN THE LEGISLATURE OF THE STATE OF ALASKA
4 ELEVENTH LEGISLATURE - FIRST SESSION

5 Directing the Legislative Affairs
6 Agency to study indexing the Alaska
7 state personal income tax system.

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

9 WHEREAS inflation has caused the taxable income of Alaska taxpayers to
10 increase without actual gain in real income; and

11 WHEREAS this increase in taxable income places Alaska taxpayers in
12 higher percentage tax brackets without commensurate gains in real income; and

13 WHEREAS this situation results in ever lower real personal buying power
14 and constantly higher income taxes in real dollars for Alaskans; and

15 WHEREAS a system of indexing the personal income tax has been adopted by
16 the states of Colorado, California and Arizona; and

17 WHEREAS the experience of the Dominion of Canada with tax indexing has
18 been successful since its implementation in 1974; and

19 WHEREAS adopting a system of income tax indexing is recommended by the
20 National Conference of State Legislatures, the U. S. Advisory Commission on
21 Intergovernment Relations, and the Council of State Governments;

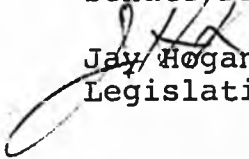
22 BE IT RESOLVED by the Alaska State Legislature that the Legislative
23 Affairs Agency is directed to study the advantages and disadvantages and
24 fiscal impact of indexing personal income tax brackets, deductions, exemp-
25 tions and credits to the rate of inflation in Alaska; and be it

26 FURTHER RESOLVED that the Legislative Affairs Agency is directed, in
27 cooperation with the Legislative Budget and Audit Committee, to report its
28 findings and recommendations to the Legislature not later than the 10th day
29 of the Second Session of the Eleventh Legislature.

April 25, 1979

M E M O R A N D U M

TO: Senator Sackett, Chairman
Senate Finance Committee

FROM:  Jay Hogan, Director
Legislative Finance Division

The study of indexing the Alaska State personal income tax directed in the Finance Committee Substitute for SCR 30 can be accomplished within the limits of funds budgeted for FY 80.

Kelly - You might consider
this instead - please
another study.

A stylized handwritten signature consisting of three large, overlapping loops, likely representing the initials 'J.S.G.'.

Time with me.

MEMORANDUM

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

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 Tax¹

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

Four major considerations prompted this recommendation:

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

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

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

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

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

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

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

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

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

Section 1 states the title of the act.

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

Section 3 defines key terms.

Section 4 requires the Governor to prepare and

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

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

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

Suggested Legislation

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

(Be it enacted, etc.)

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

2 SECTION 2. *Findings and Purpose.*

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

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

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

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

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

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

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

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

26 SECTION 5. *Adjustments for Inflation.*

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

8 (b) Sections [refer to sections of the state individual income tax law relating to tax rate brackets,
9 personal exemptions, per capita credits, and minimum and maximum standard deducti^ons] 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 immedi^aely
16 preceding tax year.¹

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

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

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

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



Carl F. Steiss is a partner in the firm of Price Waterhouse & Co., Toronto; a position to which he was appointed in 1973. He has been associated with the firm since 1963, and has served as a member of its tax division since 1967. Mr. Steiss is also a member of the faculty of the University of Toronto, and is a frequent lecturer at tax seminars and conferences. He is the author of numerous articles on taxation.

This Review is based on Mr. Steiss'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!"

CORRECTION

**THIS DOCUMENT
HAS BEEN REPHOTOGRAPHED
TO ASSURE LEGIBILITY**

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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

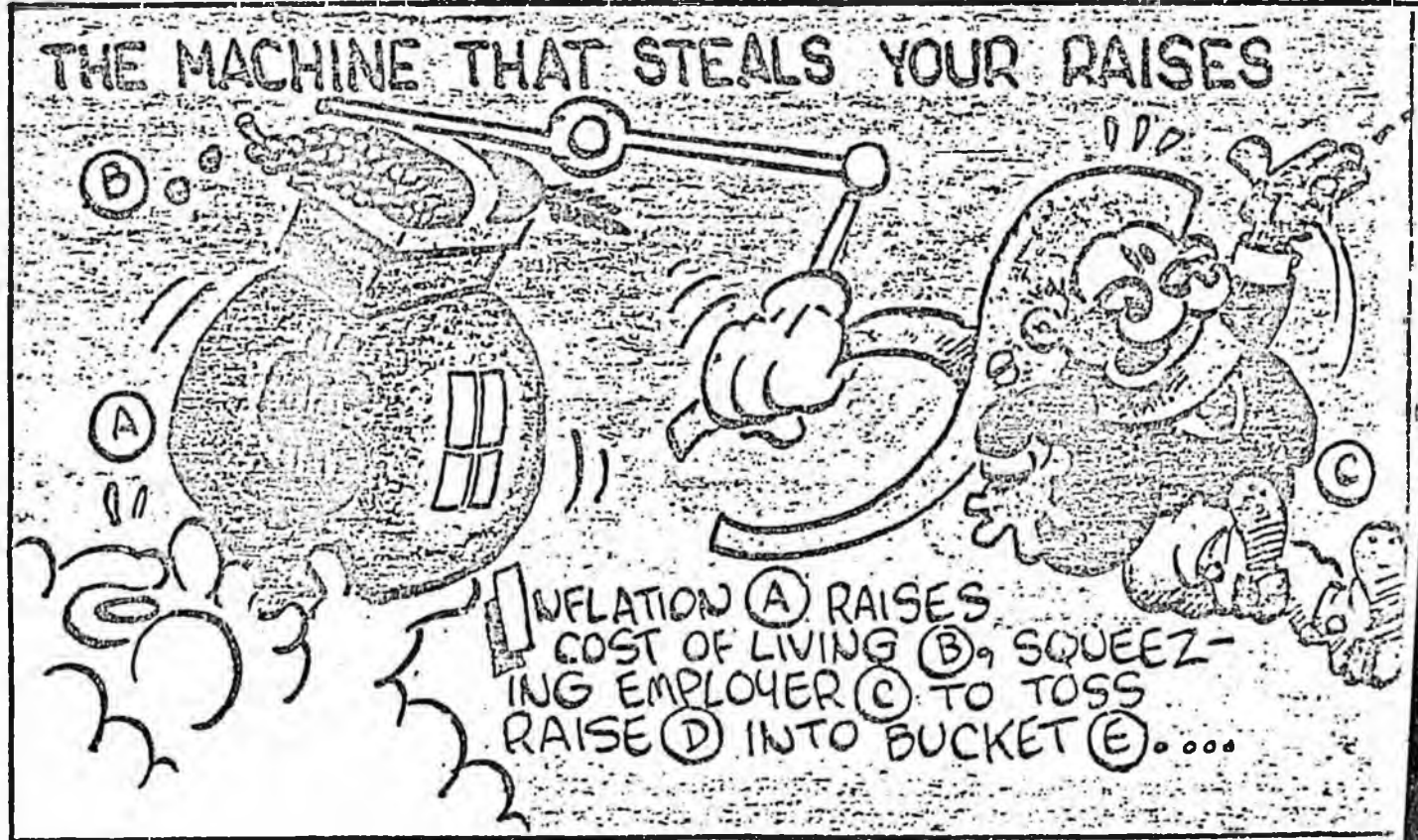
Dense and dank is the underbrush of the Internal Revenue Code, and hideous monsters lurk there. The one that Jimmy Carter particularly detests is the Loathsome Luncheon Loop-holer (of the three-martini species); Carter and others also shudder at the Exotic Shelter Digger. But the beast that preys most 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 1%. 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.

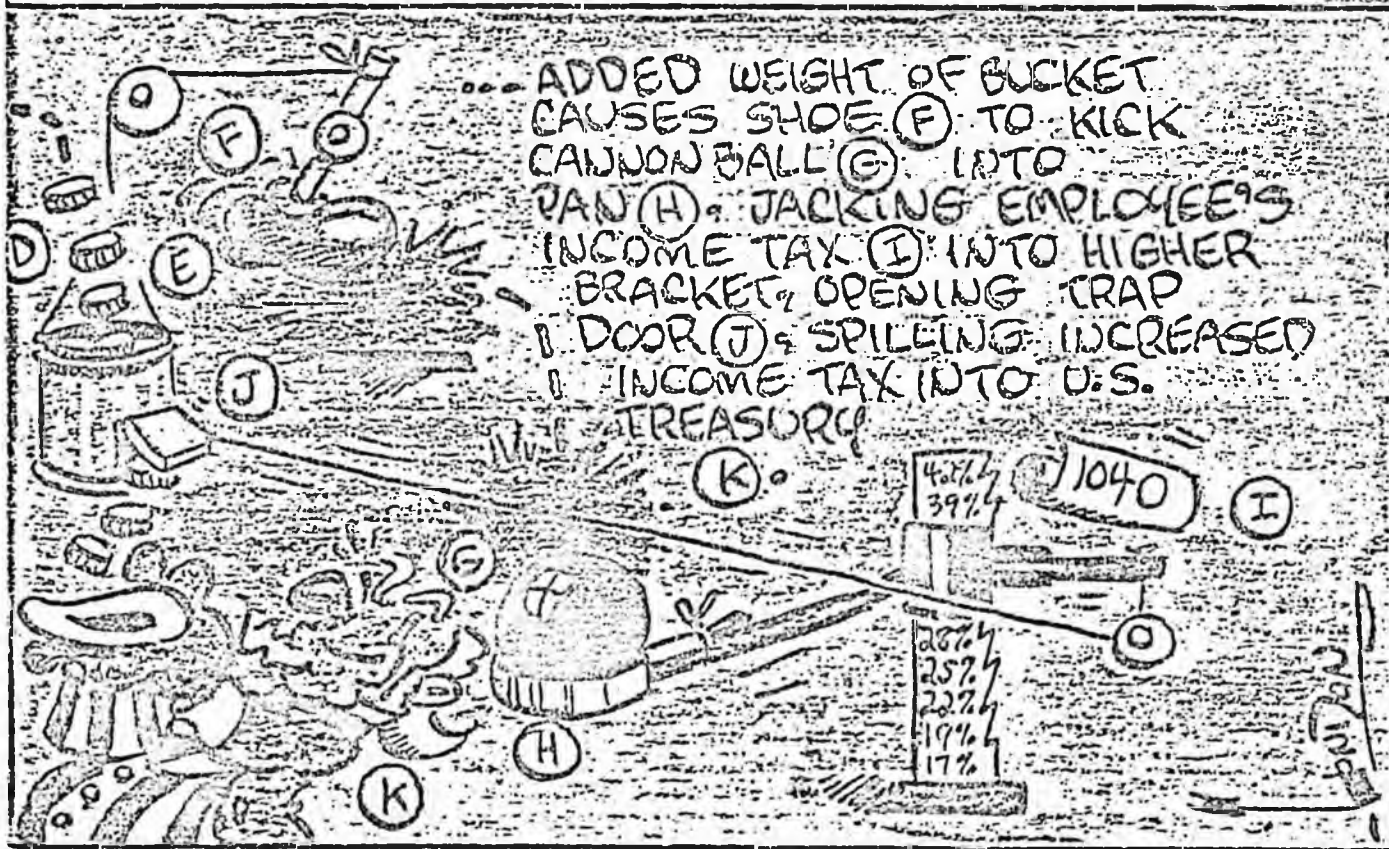
TAXABLE INCOME BRACKET	MARGINAL TAX RATE
\$11,201-\$15,200	22%
\$15,201-\$19,200	25%
\$19,201-\$23,200	28%
\$23,201-\$27,200	32%
\$27,201-\$31,200	38%
\$31,201-\$35,200	39%
\$35,201-\$39,200	42%
\$39,201-\$43,200	45%
\$43,201-\$47,200	48%
\$47,201-\$55,200	50%

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 Jacobs 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



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 Boryshnikov 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.¹

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.² 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 ¹			
			Actual 1975 Law		Indexed 1975 Law		Actual 1975 Law		Indexed 1975 Law	
			Income Tax ²	Effective Rate	Income Tax ²	Effective Rate	Income Tax ²	Effective Rate	Income Tax ²	Effective Rate
1975 Families A, B, and C	\$12,000	—	\$1089	9.08%	—	—	\$.05	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

¹New York

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

³Calculated 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.³

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.⁴ 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."⁵

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 local 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.

Footnotes

¹Progressive 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.

²Even 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.

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

⁴The 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.

⁵J. 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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BY KELLY, DANKWORTH, HACKENY
AND STIMSON

1 IN THE SENATE

2 SENATE CONCURRENT RESOLUTION NO. 30

3 IN THE LEGISLATURE OF THE STATE OF ALASKA

4 ELEVENTH LEGISLATURE - FIRST SESSION

5 Directing the Legislative Affairs
6 Agency to study indexing the Alaska
7 state personal income tax system.

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

9 WHEREAS inflation has caused the taxable income of Alaska taxpayers to
10 increase without actual gain in real income; and

11 WHEREAS this increase in taxable income places Alaska taxpayers in
12 higher percentage tax brackets without commensurate gains in real income; and

13 WHEREAS this situation results in ever lower real personal buying power
14 and constantly higher income taxes in real dollars for Alaskans; and

15 WHEREAS a system of indexing the personal income tax has been adopted by
16 the states of Colorado, California and Arizona; and

17 WHEREAS the experience of the Dominion of Canada with tax indexing has
18 been successful since its implementation in 1974; and

19 WHEREAS adopting a system of income tax indexing is recommended by the
20 National Conference of State Legislatures, the U. S. Advisory Commission on
21 Intergovernment Relations, and the Council of State Governments;

22 BE IT RESOLVED by the Alaska State Legislature that the Legislative
23 Affairs Agency is directed to study the advantages and disadvantages and
24 fiscal impact of indexing personal income tax brackets, deductions, exemp-
25 tions and credits to the rate of inflation in Alaska; and be it

26 FURTHER RESOLVED that the Legislative Affairs Agency is directed, in
27 cooperation with the Legislative Budget and Audit Committee, to report its
28 findings and recommendations to the Legislature not later than the 10th day
29 of the Second Session of the Eleventh Legislature.