INDEXATION OF CERTAIN PROVISIONS OF THE TAX LAWS

HEARING

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT GENERALLY

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-FIFTH CONGRESS

SECOND SESSION

ON

S. 2738

A BILL TO AMEND THE INTERNAL REVENUE CODE OF 1954 TO PROVIDE FOR THE INDEXATION OF CERTAIN PROVISIONS OF THE TAX LAWS

APRIL 24, 1978

Printed for the use of the Committee on Finance

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INDEXATION OF CERTAIN PROVISIONS OF THE TAX LAWS

MONDAY, APRIL 24, 1978

U.S. SENATE,
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
GENERALLY OF THE COMMITTEE ON FINANCE,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:05 a.m. in room 2221, Dirksen Senate Office Building, Hon. Harry F. Byrd, Jr., chairman of the subcommittee, presiding.

Present: Senators Byrd, Jr., of Virginia, Packwood, Dole, and Hansen.

[The committee press release and the text of the bill, S. 2738 follow:]

PRESS RELEASE

FOR IMMEDIATE RELEASE
MARCH 23, 1978
P.R. #23

COMMITTEE ON FINANCE
UNITED STATES SENATE
2227 Dirksen Senate Office Bldg.

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
ANNOUNCES HEARING ON S. 2738

Subcommittee Chairman Harry F. Byrd, Jr. (I-Va.), and Senator Bob Packwood (R.-Oreg.), ranking Republican member, today announced that a hearing will be held on April 24, 1978 on S. 2738, a bill to provide for the indexation of certain provisions of the Federal income tax laws. The Subcommittee may also consider other proposed legislation relating to tax indexing.

The hearing will be held Monday, April 24, 1978, at 10:00 A.M. in Room 2221 Dirksen Senate Office Building.

Senator Bob Dole is the sponsor of S. 2738, which is co-sponsored by Senators McClure and Griffin.

The provisions contained in S. 2738 are of general applicability and would result in a reduction in Federal revenues as follows:

(Billions of Dollars)

FY 1979	FY 1980	FY 1981	FY 1982	FY 1983
-5	-12	-21	-30	-41

Requests to Testify. -- Persons who desire to testify at the hearing should submit a written request to Michael Stern, Staff Director, Committee on Finance, Room 2227 Dirksen Senate Office Building, Washington, D. C. 20510 by no later than the close of business on Friday, April 14, 1978.

Legislative Reorganization Act. -- Senator Byrd stated that the Legislative Reorganization Act of 1946, as amended, requires all witnesses appearing before the Committees of Congress "to file in advance written statements of their proposed testimony, and to limit their oral presentations to brief summaries of their argument."

Witnesses scheduled to testify must comply with the following rules:

(1) A copy of the statement must be filed by the close of business two days before the day the witness is scheduled to testify.

(2) All witnesses must include with their written statement a summary of the principal points included in the statement.

(3) The written statements must be typed on letter-size paper (not legal size) and at least 75 copies must be submitted by the close of business the day before the witness is scheduled to testify.

(4) Witnesses are not to read their written statements to the Committee, but are to confine their ten-minute oral presentations to a summary of the points included in the statement.

(5) Not more than ten minutes will be allowed for oral presentation.

Written Testimony. Senator Byrd stated that the Subcommittee would be pleased to receive written testimony from those persons or organizations who wish to submit statements for the record. Statements submitted for inclusion in the record should be typewritten, not more than 25 double-spaced pages in length and mailed with five (5) copies by May 26, 1978, to Michael Stern, Staff Director, Committee on Finance, Room 2227, Dirksen Senate Office Building, Washington, D. C.

P.R. #23

95TH CONGRESS
2D SESSION

S. 2738

IN THE SENATE OF THE UNITED STATES

MARCH 13 (legislative day, FEBRUARY 6), 1978

Mr. DOLE (for himself, Mr. MCCLURE, and Mr. GRIFFIN) introduced the following bill; which was read twice and referred to the Committee on Finance

A BILL

To amend the Internal Revenue Code of 1954 to provide for the indexation of certain provisions of the tax laws.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 That this Act may be cited as the "Tax Indexation Act of
4 1978".
5 **SEC. 2. INDEXATION OF CERTAIN INCOME TAX PROVI-**
6 **SIONS.**
7 (a) Chapter 1 of the Internal Revenue Code of 1954 is
8 amended by adding at the end thereof the following new
9 subchapter:
10 **"Subchapter U—Indexation**

"Sec. 1391. Determination of indexation percent.
"Sec. 1392. Adjustment.

1 "SEC. 1391. DETERMINATION OF INDEXATION PERCENT.
2 "(a) IN GENERAL.—At the beginning of each calendar
3 year as soon as the necessary data become available from the
4 Bureau of Labor Statistics of the Department of Labor, the
5 Secretary of Labor shall report to the Secretary the percent
6 by which the price index for the preceding calendar year
7 exceeded the price index for the second preceding calendar
8 year.
9 "(b) PRICE INDEX.—For purposes of subsection (a),
10 the term 'price index' means the average over a calendar
11 year of the Consumer Price Index (all items—United States
12 city average) published monthly by the Bureau of Labor
13 Statistics.
14 "SEC. 1392. ADJUSTMENT.
15 "(a) IN GENERAL.—Upon receipt of a report under
16 section 1391 (a), the Secretary shall compute the increase
17 in each dollar amount in each of the following provisions
18 of this chapter by multiplying such dollar amount by a
19 percent equal to two-thirds of the percent reported to the
20 Secretary under such section:
21 "(1) the tables in subsections (a), (b), (c), (d),
22 and (e) of section 1 (relating to rates of tax);
23 "(2) paragraphs (1) and (2) of section 11 (d)
24 (relating to corporate surtax exemption);

1 "(3) subsections (b) (2) and (c) (1) of section
2 37 (relating to credit for the elderly);
3 "(4) paragraphs (1) and (2) of section 42(a)
4 (relating to general tax credit);
5 "(5) subsections (a) and (b) of section 43 (re-
6 lating to earned income credit);
7 "(6) subsections (d) (1), (d) (2), (e) (2) (A),
8 and (e) (2) (B) of section 44A (relating to credit for
9 expenses for household and dependent care services
10 necessary for gainful employment);
11 "(7) subparagraphs (A) and (B) of section 46
12 (a) (3) (relating to limitation on amount of investment
13 credit);
14 "(8) subsections (a) (1) and (b) (1) (B) of sec-
15 tion 56 (relating to imposition of minimum tax) and
16 subsections (a), (b), and (c) (2) of section 58 (re-
17 lating to rules for application of minimum tax);
18 "(9) subsection (d) of section 63 (relating to zero
19 bracket amounts);
20 "(10) subsection (b) (1) of section 121 (relating
21 to gain from sale or exchange of residence of individ-
22 ual who has attained age 65);
23 "(11) subsections (b), (c), (d), and (e) of sec-
24 tion 151 (relating to personal exemptions);

1 "(12) subsection (b) (1) of section 219 (relating
2 to deduction for retirement savings);
3 "(13) subsection (b) (1) (C) of section 220 (re-
4 lating to deduction for retirement savings for certain in-
5 dividuals); and
6 "(14) paragraphs (1), (2), and (4) of section
7 404 (e) (relating to special limitations for self-employed
8 individuals).
9 "(b) INCREASE.—Except as provided in section 4 of
10 the Tax Indexation Act of 1978, each dollar amount with
11 respect to which an increase has been computed under sub-
12 section (a) shall be increased by such amount, and as so
13 increased and rounded to the nearest $10, shall be the dollar
14 amount in effect under any such provision for taxable years
15 beginning in—
16 "(1) the calendar year following the calendar year
17 in which the report with respect to such increase was
18 made under section 1391 (a), and
19 "(2) any other calendar year prior to the calendar
20 year in which the next increase takes effect under this
21 section.".
22 (b) Section 1016(a) of the Internal Revenue Code of
23 1954 (relating to adjustments to basis) is amended—
24 (1) by striking out the period at the end of para-
25 graph 23 and inserting in lieu thereof a semicolon, and

1 (2) by adding at the end thereof the following new
2 paragraph:
3 "(24) with respect to any period after Decem-
4 ber 31, 1978, and before January 1, 1984, and before
5 making any other adjustments to basis under this sub-
6 section, for an amount equal to the basis of such property,
7 as determined under section 1011 before adjustment
8 under this section, multiplied by two-thirds of the percent
9 (excluding any percent attributable to a calendar year
10 with respect to which a suspension plan is in effect under
11 section 4 of the Tax Indexation Act of 1978) by which
12 the price index (the average over a calendar year of the
13 Consumer Price Index (all items—United States city
14 average) published monthly by the Bureau of Labor
15 Statistics) for the calendar year preceding the calendar
16 year in which the property is sold or otherwise disposed
17 of bears to the price index for the later of (A) the calen-
18 dar year in which the property was acquired or (B) the
19 calendar year 1978.".
20 (c) (1) Section 1 of such Code (relating to tax im-
21 posed) is amended by adding at the end thereof the following
22 new subsection:
23 "(f) ADJUSTMENT FOR CHANGES IN ZERO BRACKET
24 AMOUNTS.—Prior to the beginning of each calendar year,
25 the Secretary shall, after adjusting each dollar amount listed

1 in the tables under subsections (a), (b), (c), and (d) as
2 provided in section 1392, adjust each such dollar amount to
3 reflect any adjustment in any zero bracket amount which is
4 made under such section 1392 and which is to be in effect for
5 such calendar year.".

6 (2) Subparagraph (B) of section 3402 (m) (1) (relat-
7 ing to withholding allowances based on itemized deductions)
8 is amended—

9 (A) by striking out "$3,200" and inserting in lieu
10 thereof "the dollar amount in effect under section 63
11 (d) (1)"; and

12 (B) by striking out "$2,200" and inserting in lieu
13 thereof "the dollar amount in effect under section 63
14 (d) (2)".

15 (3) Subparagraph (C) of section 402 (e) (1) of such
16 Code (relating to imposition of a separate tax on lump-sum
17 distributions) is amended by striking out "$2,200" and in-
18 serting in lieu thereof "the dollar amount in effect under sec-
19 tion 63 (d) (2)".

20 (4) Section 6012 (a) (1) of such Code (relating to
21 persons required to make returns of income) is amended by
22 adding at the end thereof the following new subparagraph:

23 "(D) Each time a cost-of-living adjustment is
24 made under section 1392 with respect to any dollar

1 amount under section 63 or 151, the Secretary shall
2 adjust each dollar amount—
3 "(i) under subparagraph (A) to corre-
4 spond to such adjustments, and
5 "(ii) under subparagraph (B) or (C) to
6 correspond to the cost-of-living adjustment made
7 with respect to any dollar amount under sec-
8 151, and
9 such amount, as adjusted and rounded to the nearest
10 $10, shall be the amount in effect under such sub-
11 paragraph for taxable years beginning in any cal-
12 endar year with respect to which such adjustment is
13 in effect under sections 63 and 151.".
14 (5) Section 408(a)(1) of such Code (relating to in-
15 dividual retirement accounts) is amended by striking out
16 "$1,500" and inserting in lieu thereof "the amount in effect
17 under section 220(b)(1) for the calendar year in which
18 such taxable year begins".
19 (6) Section 408(b) of such Code (relating to individ-
20 ual retirement annuities) is amended by striking out
21 "$1,500" and inserting in lieu thereof "the amount in effect
22 under section 220(b)(1)(C) for the calendar year in
23 which the payment of such premium is made".
24 (7) Section 409(a)(4) of such Code (relating to re-

1 tirement bonds) is amended by striking out "for the pur-
2 chase of such bonds in excess of $1,500 for any taxable
3 year" and inserting in lieu thereof ", for any taxable year,
4 for the purchase of such bonds in excess of the amount in
5 effect under section 219 (b) (1) for the calendar year in
6 which such taxable year begins".

7 (8) Section 3 (b) of the Revenue Adjustment Act of
8 1975, as amended, is amended by striking out "Decem-
9 ber 31, 1978" and inserting in lieu thereof "December 31,
10 1983".

11 (9) Section 209 (b) of the Tax Reduction Act of 1975,
12 as amended, is amended by striking out "January 1, 1979"
13 and inserting in lieu thereof "January 1, 1984".

14 (10) Subsection (e) of section 401 of the Tax Re-
15 form Act of 1976 is amended by striking out "December 31,
16 1978" each place it appears and inserting in lieu thereof
17 "December 31, 1983".

18 (11) The table of subchapters of chapter 1 of such Code
19 is amended by adding at the end thereof the following new
20 item:

"SUBCHAPTER U. Indexation.".

21 **SEC. 3. INDEXATION OF ESTATE TAX AND GIFT TAX**
22 **PROVISIONS.**

23 (a) (1) Section 2503 of the Internal Revenue Code of
24 1954 (relating to taxable gifts) is amended by adding at
25 the end thereof the following new subsection:

1 "(d) COST-OF-LIVING ADJUSTMENT.—
2 "(1) IN GENERAL.—At the beginning of each
3 calendar year as soon as the necessary data become
4 available from the Bureau of Labor Statistics of the De-
5 partment of Labor, the Secretary of Labor shall report
6 to the Secretary the percent by which the price index for
7 the preceding calendar year exceeded the price index
8 for the second preceding calendar year. Except as pro-
9 vided in section 4 of the Tax Indexation Act of 1978,
10 the dollar amount in subsection (b) shall be increased
11 by an amount equal to such dollar amount multiplied by
12 two-thirds of such percentage and, as so increased and
13 rounded to the nearest $10, shall be the amount in effect
14 under such subsection for taxable years beginning in
15 the calendar year following the calendar year in which
16 such report is made.
17 "(2) PRICE INDEX.—For purposes of paragraph
18 (1), the term 'price index' means the average over a
19 calendar year of the Consumer Price Index (all items—
20 United States city average) published monthly by the
21 Bureau of Labor Statistics.".
22 (2) Section 2035(b)(2) (relating to exceptions for
23 adjustments for gifts made within 3 years of decedent's
24 death) is amended by striking out "$3,000".
25 (b) Section 2010 of the Internal Revenue Code of

1 1954 (relating to unified credit against estate tax) is amend-
2 ed by adding at the end thereof the following new subsection:
3 "(f) COST-OF-LIVING ADJUSTMENTS.—
4 "(1) IN GENERAL.—At the beginning of each cal-
5 endar year as soon as the necessary data become avail-
6 able from the Bureau of Labor Statistics of the Depart-
7 ment of Labor, the Secretary of Labor shall report to the
8 Secretary the percent by which the price index for the
9 preceding calendar year exceeded the price index for the
10 second preceding calendar year. Except as provided in
11 section 4 of the Tax Indexation Act of 1978, the dollar
12 amount in subsection (a) shall be increased by an
13 amount equal to such dollar amount multiplied by two-
14 thirds of such percent and, as so increased and rounded
15 to the nearest $10, shall be the amount in effect under
16 such subsection for the estates of decedents dying in
17 the calendar year following the calendar year in which
18 such report is made.
19 "(2) PRICE INDEX.—For purposes of paragraph
20 (1), the term 'price index' means the average over a
21 calendar year of the Consumer Price Index (all items—
22 United States city average) published monthly by the
23 Bureau of Labor Statistics.".
24 (c) Section 2505 of such Code (relating to unified cred-

1 it against gift tax) is amended by adding at the end thereof
2 the following new subsection:
3 "(e) COST-OF-LIVING ADJUSTMENT.—
4 "(1) IN GENERAL.—At the beginning of each cal-
5 endar year as soon as the necessary data become avail-
6 able from the Bureau of Labor Statistics of the Depart-
7 ment of Labor, the Secretary of Labor shall report to
8 the Secretary the percent by which the price index for
9 the preceding calendar year exceeded the price index for
10 the second preceding calendar year. Except as provided
11 in section 4 of the Tax Indexation Act of 1978, the
12 dollar amount in subsection (a) (1) shall be increased
13 by an amount equal to such dollar amount multiplied by
14 two-thirds of such percent and, as so increased and
15 rounded to the nearest $10, shall be the amount in effect
16 under such subsection for gifts made in the calendar
17 year following the calendar year in which such report
18 is made.
19 "(2) PRICE INDEX.—For purposes of paragraph
20 (1), the term 'price index' means the average over a
21 calendar year of the Consumer Price Index (all items—
22 United States city average) published monthly by the
23 Bureau of Labor Statistics.".
24 (d) Subsection (a) of section 6018 of such Code (relat-

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1 ing to estate tax returns by executor) is amended by adding
2 at the end thereof the following new paragraph:
3 "(4) ADJUSTMENTS FOR COST-OF-LIVING.—The
4 Secretary shall adjust each amount in paragraphs (1)
5 and (2) to reflect the adjustments made by section 2010
6 (f).".
7 **SEC. 4. PRESIDENTIAL AUTHORITY TO SUSPEND ADJUST-**
8 **MENTS.**
9 (a) (1) If, for any calendar year, the President deter-
10 mines that adjustments under sections 1016 (a) (24), 1392,
11 2010 (f), 2503 (d), and 2505 (e) will have a significant ad-
12 verse effect on the economy of the United States, he may sub-
13 mit to the Congress a suspension plan providing for the
14 suspension of all such adjustments for such calendar year.
15 (2) A suspension plan described in paragraph (1) shall
16 take effect only if—
17 (A) such plan is submitted to the Congress in ac-
18 cordance with the provisions of subsection (b), and
19 (B) before the close of the sixtieth day (as defined
20 in subsection (d) (5)) after the day on which such plan
21 is delivered to the Congress, neither the House of Repre-
22 sentatives nor the Senate disapproves such plan in ac-
23 cordance with the procedures set forth in subsection (c).
24 (b) Whenever the President submits a suspension plan

1 under subsection (a) to the Congress, a copy of such plan
2 shall—
3 (1) be delivered to each House of Congress on the
4 same day and shall be delivered to the Clerk of the
5 House of Representatives if the House is not in session
6 and to the Secretary of the Senate if the Senate is not in
7 session, and
8 (2) bear an identification number.
9 (c) (1) The House of Representatives or the Senate
10 may disapprove any suspension plan referred to in subsection
11 (a) if it adopts a resolution of disapproval—
12 (A) by an affirmative vote of a majority of those
13 present and voting in that House, and
14 (B) before the close of the sixtieth day after the
15 date on which such plan was delivered to the Congress
16 under subsection (b).
17 (2) For purposes of this section, the term "resolution
18 of disapproval" means only a resolution of either House
19 of Congress, the matter after the resolving clause of which is
20 as follows: "That the does not favor the taking
21 effect of the proposed suspension plan numbered , trans-
22 mitted to the Congress by the President on ", the
23 first blank space therein being filled with the name of the

1 resolving House and the other blank spaces being appropri-
2 ately filled.
3 (d) (1) A resolution of disapproval in the House of
4 Representatives shall be referred to the Committee on Ways
5 and Means. A resolution of disapproval in the Senate shall
6 be referred to the Committee on Finance.
7 (2) (A) If the committee to which a resolution of dis-
8 approval with respect to any suspension plan has been re-
9 ferred has not reported it before the close of 45 days after
10 its introduction, it is in order to move either to discharge
11 the committee from further consideration of the resolution or
12 to discharge the committee from further consideration of any
13 other resolution of disapproval with respect to such plan
14 which has been referred to the committee.
15 (B) A motion to discharge may be made only by an
16 individual favoring the resolution, is highly privileged (ex-
17 cept that it may not be made after the committee has re-
18 ported a resolution of disapproval) and debate thereon
19 shall be limited to not more than 1 hour, to be divided equal-
20 ly between those favoring and those opposing the resolution.
21 An amendment to the motion is not in order, and it is not
22 in order to move to reconsider the vote by which the motion
23 is agreed to or disagreed to.
24 (C) If the motion to discharge is agreed to or disagreed
25 to, the motion may not be removed, nor may another motion

1 to discharge the committee be made with respect to any
2 other resolution of disapproval with respect to the same
3 suspension plan.

4 (3) (A) When the committee has reported, or has been
5 discharged from further consideration of, a resolution of
6 disapproval, it is at any time thereafter in order (even
7 though a previous motion to the same effect has been dis-
8 agreed to) to move to proceed to the consideration of the
9 resolution. The motion is highly privileged and is not debat-
10 able. An amendment to the motion is not in order, and it is
11 not in order to move to reconsider the vote by which the
12 motion is agreed to or disagreed to.

13 (B) Debate on the resolution of disapproval shall be
14 limited to not more than 10 hours, which shall be divided
15 equally between those favoring and those opposing the reso-
16 lution. A motion further to limit debate is not debatable. An
17 amendment to, or motion to recommit, the resolution is not
18 in order, and it is not in order to move to reconsider the vote
19 by which the resolution is agreed to or disagreed to.

20 (4) (A) Motions to postpone, made with respect to the
21 discharge from committee or the consideration of a resolu-
22 tion of disapproval, and motions to proceed to the considera-
23 tion of other business, shall be decided without debate.

24 (B) Appeals from the decisions of the Chair relating
25 to the application of the Rules of the House of Representa-

1 tives or the Senate, as the case may be, to the procedure
2 relating to any resolution of disapproval shall be decided
3 without debate.

4 (5) (A) As used in subsection (a) (2) (B) and (c)
5 (1) (B), the term "day" means any calendar day other
6 than a day on which either House is not in session because
7 of a sine die adjournment or an adjournment of more than
8 3 days to a day certain.

9 (B) For purposes of this section, if any suspension plan
10 is delivered to the Congress on any day on which either
11 House is not in session, such plan shall be treated as delivered
12 on the first day thereafter on which both Houses are in
13 session.

14 (6) This subsection is enacted by the Congress—

15 (A) as an expense of the rulemaking power of
16 the House of Representatives and the Senate, respective-
17 ly, and as such it is deemed a part of the rules of each
18 House, respectively, but applicable only with respect to
19 the procedure to be followed in that House in the case
20 of resolutions of disapproval; and they supersede other
21 rules only to the extent that they are inconsistent there-
22 with; and

23 (B) with full recognition of the constitutional right
24 of either House to change the rules (so far as relating
25 to the procedures of that House) at any time, in the

1 same manner, and to the same extent as in the case of
2 any other rule of that House.

3 SEC. 5. EFFECTIVE DATES.

4 (a) (1) The amendments made by section 2 shall apply
5 with respect to taxable years beginning after December 31,
6 1978, and ending before January 1, 1984.

7 (2) The amendments made by section 3 (a) shall ap-
8 ply with respect to gifts made after December 31, 1978,
9 and before January 1, 1984.

10 (3) The amendments made by section 3 (b) and (d)
11 shall apply to the estates of decedents dying after Decem-
12 ber 31, 1980, and before January 1, 1984.

13 (4) The amendment made by section 3 (c) shall apply
14 with respect to gifts made after December 31, 1980, and
15 before January 1, 1984.

16 (b) (1) The first report required to be made under sec-
17 tions 1391 and 2503 of the Internal Revenue Code of 1954,
18 as amended by this Act, shall be made in calendar year 1978
19 and shall indicate the percent by which the price index for
20 calendar year 1977 exceeded the price index for 1976.

21 (2) The first report required to be made under sections
22 2010 and 2505 of such Code, as amended by this Act, shall
23 be made in calendar year 1980 and shall indicate the per-
24 cent by which the price index for calendar year 1979 ex-
25 ceeded the price index for 1978.

Senator BYRD. The committee will come to order.

Today, the Subcommittee on Taxation and Debt Management will hold hearings on S. 2738, a bill to provide for the indexing of certain provisions in the Federal income tax law.

This legislation was introduced by the distinguished Senator from Kansas, Mr. Dole. Previously, it had been introduced in other Congresses by the Senator from New York, Senator Buckley, who is here today.

The first witness this morning will be the Honorable Philip M. Crane, Congressman from Illinois. Congressman Crane, we are glad to have you here today, and you may proceed as you wish.

STATEMENT OF HON. PHILIP M. CRANE, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF ILLINOIS

Representative CRANE. Thank you, Mr. Chairman, and distinguished members of the Taxation and Debt Management Subcommittee of the Senate Finance Committee. I appreciate this opportunity to speak before you this morning. I am very glad to see the tax indexation, a much needed and very genuine tax reform, is finally getting the attention it deserves from both chambers in Congress and on both sides of the aisle.

I introduced the first tax indexation bill back in the House back in 1974 because I believed then, as I still do, that tax indexation is the only way to combat our rampant inflation. I am genuinely supportive of all our indexation efforts, though I believe that some do not extend as far as they should.

The need for indexation results from the inflation that eats away at the real income and all facets of our economy, and thus, the battle must be waged on all grounds in order to win.

H.R. 2406, a bill I have cosponsored in this Congress, addresses the issue at all levels.

As I have mentioned, this bill is the most recent of several I have introduced on this subject. On May 13, 1974, back in the 93d Congress, I introduced H.R. 14738, the cost-of-living adjustment act and it paralleled, item for item, those needs addressed in my most recent effort.

Dr. Milton Friedman, who has often cited tax indexation as the most efficacious weapon with which to battle inflation taxes, was in Washington at that time. In the past 4 years, Dr. Friedman has continued to be most supportive of my efforts.

In a recent statement on inflation, President Carter explained our spiralling cost of living to us. The official myth from 1600 Pennsylvania Avenue is due to, and I quote liberally, unpleasant facts about ourselves, especially a preoccupation with self that circumvents the willingness of our citizens to sacrifice for the common good.

This official tale continues with the information that the fall of the dollar is due to oil imports rather than to the excess in supply of

dollars. The declining dollar is blamed for the inflation that exists in our economy rather than in finding in inflation the cause of our worthless currency.

At no point did the President address the fundamental truth that an endless money supply creates this inflation. Indexing the whole tax structure would prevent this deterioration that is occurring in the standards of living of all Americans, and yet it is not included in the President's package of tax proposals.

Without indexation in a time of persistent inflation, Congress must pass a major tax program every few years to protect Americans from drastic cuts in our real income, and this is precisely what has been happening.

Assuming that some sort of tax bill emerges this year, Congress will have approved a major tax bill in 3 out of the past 4 years. As long as the current inflationary trend continues—and there is no reason to suspect otherwise—the consideration of tax reduction proposals promises to become an annual rite, but one in which I would rather not get involved.

Clearly, tax indexation is an idea whose time has come. Inflation is running at 6 and 7 percent with no relief in sight. Those of us here in Washington cannot seriously believe that we can erase the hidden tax in our economy, inflation, by cosmetic means when major surgery is what the doctor ordered.

We have to propose fundamental reform, not cuts that we will have to repeat next year that do nothing more than push a bit of the burden from one group to another.

Tax indexation responds to inflation percentage point by percentage point and assures us that we will be able to spend as much, or save as much, next year as we can now.

With this in mind, I hope you will review the current tax indexation proposals. Once again, I thank you for this opportunity to appear this morning.

Senator BYRD. Thank you very much, Congressman Crane.

Congressman Crane, if you could maintain your seat there if you had a few minutes and we could hear from Congressman Gradison and then the committee would have questions for both of you.

Do you have time?

Representative CRANE. Yes, indeed.

Senator BYRD. Good morning, Congressman.

Representative GRADISON. Good morning, Mr. Chairman.

Senator BYRD. You may proceed as you wish.

Representative GRADISON. I would, Mr. Chairman, ask that certain background documents be included in the record, with my statement.

Senator BYRD. Yes. It will be made a part of the record.

[The material referred to follows:]

CONGRESSMAN GRADISON, INDEX THE RATE BRACKETS AND THE ZERO BRACKET AMOUNT [FORMERLY THE STANDARD DEDUCTION] FOR INFLATION [1]

[In billions of dollars]

	Inflation rate (percent)	Calendar year	Fiscal year [2]
Year:			
1973	7.4	−$3.7	
1974	12.0	−6.7	
1975	7.8	−4.9	
1976	5.5	−3.8	
1977	6.6	−5.1	
1978	6.0	−5.2	
1979	6.0	−5.8	
1980	6.0	−6.5	−$4.5
1981	6.0	−7.2	−7.0
1982	6.0	−8.0	−7.8
1983	6.0	−9.0	−8.7

[1] The September over previous September unadjusted Consumer Price Index for urban wage earners.
[2] Starting January 1, 1980.

Source: Joint Committee on Taxation, March 28, 1978.

CONGRESS OF THE UNITED STATES,
HOUSE OF REPRESENTATIVES,
Washington, D.C., March 15, 1978.

DEAR COLLEAGUE: On March 9, 1978, we reintroduced a proposal, HR 11413, to index the personal income tax tables and the standard deduction for the rate of inflation. Effective January, 1980, this bill would automatically adjust the individual income tax rates to stop taxpayers from being pushed into higher brackets by inflation.

Our progressive personal income tax system was designed for a world of stable prices. We levy taxes on the dollar amounts of income with no regard to the purchasing power of those dollars. Whenever our economy experiences inflation, the Government reaps the benefit as incomes are pushed up into higher tax brackets. This unlegislated, unvoted, unsigned tax hike can be stopped once and for all by the adoption of indexing. The Federal Government has been taking advantage of this destructive economic phenomenon long enough, and it is time to leave in the pockets of the American taxpayer money he should never have had to pay in the first place. On the outgo side of the budget, we automatically adjust food stamps, social security, supplemental security income, and even civil service and congressional salaries for the loss of purchasing power; the time has come to treat taxpayers by the same standard.

Without indexing, any tax cuts passed by this Congress will be a sham. At best, they would just offset the tax increases caused by inflation. And a year after these so-called cuts go into effect, the taxpayers would once again fall behind due to the relentless impact of inflation. This has been happening for years. In the decade from 1965 to 1975, the cumulative effect of inflation and all the legislated tax cuts left taxpayers worse off than if we had not cut taxes but had merely indexed our system.

This Congress must never give in to inflation, but as we seek ways to stop inflation, we should do what we can to protect our citizens from its impact. Our Canadian neighbors have indexed their tax system since January, 1974, and their experience shows that indexing slows down the growth in Government spending and provides a strong incentive to fight inflation and promote real economic growth.

This reform legislation is permanent, fair and just.

In the weeks to come, we will be sending you further information and a sampling of the many articles that support this concept. We invite our colleagues from both sides of the aisle to join us in supporting this bill. If you wish to cosponsor, please call Doug Bates (53981) of Bill Gradison's staff.

Sincerely,

BILL GRADISON,
CLARENCE J. BROWN,
JIM GUY TUCKER,
WILLIAM S. MOORHEAD,
BILL FRENZEL,
BARBER B. CONABLE, Jr.,
ELLIOTT H. LEVITAS.

CONGRESS OF THE UNITED STATES,
HOUSE OF REPRESENTATIVES,
Washington, D.C., April 3, 1978.

"Bombarded from Washington with propaganda about the beneficence of tax cuts and confronted with a largely static tax bill, the average taxpayer sooner or later is bound to react in anger and disillusionment."—Robert J. Samuelson, National Journal, January 28, 1978.

DEAR COLLEAGUE: Indexing the tax system for the rate of inflation represents a fair and permanent tax cut for every taxpayer. Whether a taxpayer receives income tied to the cost of living or not (about half the families in America do), inflation penalizes all taxpayers in the present tax structure in one of several ways.

First, indexing ends the so-called bracket creep, which occurs as cost-of-living raises designed to maintain a worker's purchasing power in the face of inflation push him into a higher tax bracket. Bracket creep is most pernicious for taxpayers with low to middle incomes where the tax brackets are closer together. A worker's real purchasing power after taxes will be less than before, despite his cost-of-living raise.

Secondly, there exists an "intra-bracket creep." A cost-of-living raise need not push a worker into a higher tax bracket to increase his taxes unfairly. Even if his income remains in the same bracket, he must pay a greater proportion of his income at the marginal rate and therefore pays taxes at a higher average real rate.

Finally, consider the taxpayer who receives no raise at all during a year marked by inflation. By the end of the year, his purchasing power has declined, but he is taxed at the same average nominal rate. His average real rate will rise, and his purchasing power will be eroded even further.

American taxpayers are swimming against a tide of inflation, and each year they must wait for Congress to pass a tax cut so that they can catch up. We have introduced a bill, HR 11413, which would assure that taxpayers pay only their fair share. If you would like to join this bipartisan effort to index the tax brackets for the rate of inflation, please call Doug Bates (53981) of Bill Gradison's staff.

Sincerely,

BILL GRADISON,
CLARENCE J. BROWN,
JIM GUY TUCKER,
WILLIAM S. MOORHEAD,
BILL FRENZEL,
BARBER B. CONABLE, Jr.,
ELLIOTT H. LEVITAS.

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THE FUTURE IS NOW

Tax indexation is an idea whose time has come—and this year is going to prove it.

Though indexation sounds complicated, it actually is simple. It means that the government automatically corrects the income tax system to prevent inflation from kicking taxpayers into higher and higher brackets. Assume, for example, that inflation raises a family's income 10 per cent. It goes into a higher tax bracket, and its tax rate increases even though its "real" income hasn't. Without indexation. Congress must pass a major tax "cut" every few years simply to prevent this invisible tax increase.

That's precisely what has been happening. Assuming a tax package passes in 1978, Congress will have approved major tax reduction bills in three of the past four years. As long as inflation persists at a 5 per cent to 6 per cent annual rate, the cycle will continue. (*See this issue, p. 133, for details of the proposed tax cut.*)

The defects of this system are now becoming increasingly clear.

Most important, it's fundamentally dishonest. It confuses the average citizen and, indeed, possibly the average Member of Congress. It puts the nation's highest officials, starting with the President, in the foolish and ultimately self-defeating position of pushing half-truths on the public. They promise tax reductions, but in the main, all they are doing is repealing automatic tax increases.

Average taxes, as a percentage of personal income, are declining largely against what they would have been, not what they were. Even if President Carter's program passes as proposed, the average income tax level is estimated to be higher in 1979 than in seven out of the past 10 years, as the following table indicates. It shows federal income taxes as a percentage of personal income since 1969:

	Percent		Percent
1969	11.6	1975	9.9
1970	10.5	1976	10.2
1971	9.9	1977	10.1
1972	9.9	1978	[1] 10.3
1973	10.3	1979	[1] 10.5
1974	10.7		

[1] Estimated.

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

A second flaw of the current system is that it hampers economic policy and increases the likelihood of an economic downturn or recession. In the days when inflation crept along at an annual rate of 1 per cent to 3 per cent, the dynamics of the income tax system were thought to represent a helpful "automatic stabilizer." If inflation increased, incomes would rise and, consequently, so would the tax bite. That would reduce consumer spending, the economy would slow, and inflationary pressures would abate. This was a comforting notion.

Unfortunately, it does not sit well with reality. As the past few years have demonstrated vividly, inflation has an independent momentum. Through powerful unions, oligopolistic companies, government fiat and social custom—the idea that everybody should stay "even"—inflation gets perpetuated, checked only feebly by weak constraints.

In this climate, the "automatic stabilizer" simply puts the economy on its backside—or threatens to do so—with a mild impact on inflation. There is then a rush to pass a tax "cut" to revive the economy.

The uotlook for 1978 illustrates the risks. Many economists worry that the economy may slow down in the second half of the year, in part because the rising tax bite will curb consumer spending. But the Administration doesn't think it can possibly get its tax cut passed before Oct. 1. So Carter's economists are forced to bite their nails and hope that the timing turns out right.

A final defect of the existing anarchic approach is that it constitutes a cruel and unusual punishment of Members of Congress. This, of course, contradicts the conventional wisdom that politicians like nothing better than approving tax cuts and then basking in the ensuing public approval. Many Members may have once embraced this simple logic, but, by now, a more complicated reality is forcefully asserting itself.

That reality is that Congress stirs up as much grief as gratitude when it acts on a major tax bill. Every interest group that feels entitled to some new tax break, or simply wants to protect an existing benefit makes a pilgrimage to Capitol Hill. Almost any Member is bound to disappoint some of these petitioners. And the more big tax bills there are, the greater the opportunity for offense.

Moreover, on the other side of the political ledger, public gratitude for tax reductions is increasingly tempered by the realization that they largely represent a holding action against inflation. The political arithmetic of this process is not especially favorable, and the more the cycle of phantom tax cuts occurs, the worse the arithmetic will become. Ultimately, Members of Congress are bound to search for an exit.

Indexation would minimize their problems. Although adjusting corporate and business taxes for inflation is difficult, the necessary alterations for the personal tax present no insuperable technical problems. Tax rates, deductions, exemptions and credits can automatically be changed to reflect inflation.

Indexation wouldn't and shouldn't—exempt Congress from the necessity of changing the tax laws. There are fundamental political and social problems that will not conveniently vanish. As social security taxes rise (reflecting the program's higher costs), should Congress let the total federal tax bite increase, or should it cut some existing spending? Should the tax system be used more aggressively to promote income redistribution or, on the other hand, investment?

Regardless of what it does, Congress will have a difficult time permanently evading these issues. But, already overburdened by complicated problems that it only dimly understands, it does not need to create added uncertainties by having to fiddle with tax rates every 18 months.

ADDITIONAL COSPONSORS TO DATE

James J. Blanchard
Clair W. Burgener
Elford A. Cederberg
James C. Cleveland
Tom Corcoran
Robert K. Dornan
John J. Duncan
Mickey Edwards
Joshua Eilberg
Louis Frey, Jr.
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Floyd Spence
Dave Stockman
Guy Vander Jagt
G. William Whitehurst
Don Young

CONGRESS OF THE UNITED STATES,
HOUSE OF REPRESENTATIVES,
Washington, D.C., April 10, 1978.

"I believe that this proposal for indexing the personal income tax puts Canada in the vanguard of countries with advanced tax systems. I suggest that this new system will be recognized everywhere as a bold and sensitive response to a rather fundamental tax problem."—The Honorable John N. Turner, Minister of Finance and Member of Parliament, February 19, 1973.

DEAR COLLEAGUE: In January, 1974, the Canadian government began indexing the tax rates and exemptions of their personal income tax systems for the rate of inflation. Their experience with indexing provides an excellent background on which to consider indexing our own tax system.

The Canadian Parliament enacted indexing on the rationale of fairness. When faced with high rates of inflation and unemployment, they saw that their unindexed tax code was automatically withdrawing extra tax dollars that should have been left in their citizens' paychecks. Since that time, they have found that indexing has two other major effects.

First, contrary to some speculation, indexing has not removed Parliamentary discretion in changing or cutting taxes. The Parliament has cut taxes twice since 1974. These cuts are in addition to the automatic inflation adjustment. They are real cuts that more directly and more effectively stimulate the sectors of the economy they were designed to reach. They are not watered down and dissipated by inflation. They are not mere "catch up" tax cuts.

Equally important, indexing has had a major role in reducing the rate of growth of government spending. The rate of real growth in spending in Canada declined from 15.9 percent in 1974 to 10.24 percent in 1975 and all the way to 2.7 percent in 1976. This is remarkable testimony of indexing's value in stimulating fiscal responsibility.

On March 9, we introduced a bill, HR 11413, that would index the personal income tax brackets and the standard deduction for the rate of inflation. If you would like to join this bipartisan effort, please call Doug Bates (53981) of Bill Gradison's staff.

Sincerely,

BILL GRADISON,
CLARENCE J. BROWN,
JIM GUY TUCKER,
WILLIAM S. MOORHEAD,
BILL FRENZEL,
BARBER B. CONABLE, Jr.,
ELLIOTT H. LEVITAS.

JOHN N. TURNER, MINISTER OF FINANCE AND MEMBER OF PARLIAMENT, EXTRACT FROM HIS BUDGET SPEECH BEFORE THE CANADIAN PARLIAMENT, FEBRUARY 19, 1973

Mr. Speaker, I come now to an income tax measure of fundamental importance. I am deeply concerned about inflation and the effect that inflation has on a tax system which is based on a progressive rate schedule. I therefore propose to take steps now to provide a lasting solution to this problem should inflation continue.

First, let me explain more clearly how the problem arises.

Our tax system is based on a progressive rate schedule. This means that as a person's income increases, he pays a greater percentage of his income in taxes. For example, under our present system, in 1973 a person pays 15 per cent of his first $500 of taxable income, but 18 per cent on the next $500. In other words, as his income increases from one bracket to the next, the rate of tax on this additional income increases. Basically, this is a sound and fair approach and most advanced countries have adopted this progressive tax system.

But an increase in a person's income may be real or simply the result of inflation. Put another way, if a man gets a 5 per cent raise in salary, but the cost of living has also increased 5 per cent, he has the same real purchasing power he had before, and nothing more. Yet, the progressive tax system can leave him worse off than he was before because he has entered a higher tax bracket. What I want to do is eliminate that unfair and unintended result from our tax system.

Beginning in 1974, I propose to introduce the following system. First, in each year an inflation factor would be determined based upon the increase in the Consumer Price Index in an immediately preceding period. Second, in each year the principal exemptions would be increased by this inflation factor. This would include the basic exemption, the marital exemption, the two exemptions for dependents, and the exemptions for the aged and the blind and the disabled. Third, every year each of the brackets of taxable income would be adjusted by the inflation factor.

For example, if in a particular year, the inflation factor was determined to be 4 per cent, then the principal exemptions would each be increased by 4 per cent. Similarly, each bracket of taxable income would be adjusted upwards by the same percentage. Thus, the first bracket of taxable income, which is taxed this year at 15 per cent, would be raised from $500 to $250. The next bracket, which would be subject to an 18 per cent rate, would commence at $520 and would extend to $1,040, and so on right through the tax schedule.

The indexing of rates and exemptions will produce a tax liability which will no longer erode a person's purchasing power as a result of inflation interacting with the progressive tax system. A person will no longer pay tax at a higher marginal rate simply because inflation swept him up into a higher tax bracket. For a person on a fixed income, the result of indexing would be to reduce his taxes each year if prices rise.

Members may ask why delay implementation of this indexing proposal until next year? There are two reasons. First, the income tax reductions and increased exemptions I have already announced for this year are far larger in magnitude than would be the effect of this indexing system if applied in 1973. Second, and more important, this proposal is a major innovation in tax philosophy and practice. It is not complex, but it will take some time for people and governments to adjust to it. For these reasons, I have concluded that it should come into effect only next year.

Mr. Speaker, a final comment on income taxes. I believe that this proposal for indexing the personal income tax puts Canada in the vanguard of countries with advanced tax systems. I suggest that this new system will be recognized everywhere as a bold and sensitive response to a rather fundamental tax problem. With the introduction of this change, Canada will join a very select group of countries which have eliminated the hidden revenues accruing to governments through the effect of inflation on a progressive tax system.

CONGRESS OF THE UNITED STATES,
HOUSE OF REPRESENTATIVES,
Washington, D.C., April 17, 1978.

"We have been going through these rinkydinks for a long time now. We have an income tax system in which the rates and exemptions are not indexed for inflation, so the rates automatically rise with rising money income. This lets politicians blow their horns about how they are cutting our taxes . . . Baloney!"—Gerard Brannon, Tax Notes, January 30, 1978.

DEAR COLLEAGUE: In the decade spanning the years 1965 to 1975, the Congress legislated several reductions in personal income taxes. The purpose of these cuts was to stimulate the economy by leaving more disposable income to taxpayers to spend or save, as each saw fit.

How much of these tax cuts went merely to offset the increased tax take resulting from inflation? The answer is every dime, and still the cuts did not offset inflation. If there had been no tax cuts and no indexing over this decade, the 1975 tax liability would have been $143.7 billion. The cumulative effect of the tax cuts reduced the actual liability to $119.7 billion. But if there had been no tax cuts and our entire personal income tax system had been indexed, the tax liability in 1975 would have been $115.4 billion. In reality, taxes were not "cut" over this period; real taxes increased by $4.3 billion.

Congress has already protected social security recipients, supplemental security income recipients, and federal and congressional salaries from the erosion of inflation. Surely if these forms of indexing make sense we should apply the same principle to the taxpayers who foot the bill for Government spending programs.

As Canada's experience with indexing has shown, we would lose none of our discretionary power to change or lower the tax structure if we index, and such reductions would provide real stimulation in the sector where the cut was intended.

If you would like to cosponsor this bipartisan legislation, HR 11413, which indexes the personal income tax brackets for the rate of inflation, please call Doug Bates (53981) of Bill Gradison's staff.

Sincerely,

BILL GRADISON,
CLARENCE J. BROWN,
JIM GUY TUCKER,
WILLIAM S. MOORHEAD,
BILL FRENZEL,
BARBER B. CONABLE, Jr.,
ELLIOTT H. LEVITAS.

[From Tax Notes, January 30, 1978.]

TAX REFORM, AT LAST! OR TAX REFORM, AT LAST?

(By Gerard M. Brannon)

After nearly a year filled with trial balloons that self destructed, we have finally received a real Carter tax reform proposal. The waiting was more exciting.

TAX REDUCTION?

Quantitatively the big thing is the rate reduction. On this the message is less than candid. There is a big negative that needs to be put alongside this tax cut, before we swallow the President's claim that "the tax reductions will more than offset the recent increase in social security taxes and will provide the consumer purchasing power and business investment strength we need to keep our economy growing strongly and unemployment moving down." The big negative is the inflation tax.

There is a revealing discussion of the inflation problem buried back in Fact Sheet Number 3 which says that the ratio of individual federal income tax to total personal income of Americans is now (1977) 10.7 percent, and that with no change in the law it will rise to 11.4 percent in 1979! The "generous" Carter program will slash the tax burden in 1979 from the present 10.7 percent to 10.5 percent. The fact sheet doesn't carry out the arithmetic for 1980, which is obvious from the attached chart.[1] By 1980 the tax burden *with* the Carter relief will be higher than it is now!

We have been going through these rinkydinks for a long time now. We have an income tax system in which rates and exemptions are not indexed for inflation, so the rates automatically rise with rising money income. This lets the politicians blow their horns about how they are cutting our taxes. "Thankee, Massa." Baloney!

NEEDED: AUTOMATIC INFLATION ADJUSTMENTS

We will really have a more coherent tax system when we move to making automatic inflation-adjustments in the exemption levels and the bracket widths. Then we will have a basically stable tax burden, and we can have some coherent dialog on whether this should be higher or lower. As it stands now, it is just too hard for the public to know what's going on.

For example: If the so-called tax reductions barely offset the inflation increase, then it's simply wrong to say that they also offset the social security tax increases. Incidentally, most of the public finance textbooks say that the social security tax on employers is shifted to employees so Treasury tables understate the social security tax increases by 50 percent.)

Further, for example: It is well known that there is very little of the inflation updrift in the corporation tax. Is the present package simply a cancelling of the inflation tax increase for individuals and a net tax reduction for corporations? If this so, would we not do better to use the corporate reduction money to make a start on corporate tax integration?

So much for the rate reductions.

Source: Reprinted by permission of Tax Analysts and Advocates.

ADDITIONAL COSPONSORS TO DATE

Glenn M. Anderson
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James T. Broyhill
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Albert H. Quie
Ralph S. Regula
John H. Rousselot
Floyd Spence
Dave Stockman
Guy Vander Jagt
William F. Walsh
G. William Whitehurst
Don Young

[1] Chart omitted.

CONGRESS OF THE UNITED STATES,
HOUSE OF REPRESENTATIVES,
Washington, D.C., April 24, 1978.

Fair, sensible, practical and economically wise—the case for indexing seems overwhelming. Which leaves us with the obvious question: why hasn't anything been done about it?"—Michael Nelson, Washington Post Magazine, March 5, 1978.

DEAR COLLEAGUE: It has been said that indexing the tax system for the rate of inflation would be an acceptance of defeat at the hands of inflation. On the contrary, although the government is the one sector of the economy with the ability to reduce inflation, under present law the government has a vested interest in maintaining inflation. The Treasury gets a windfall bonus in real tax dollars whenever inflation occurs. Indexing would force the Congress to meet the challenge of inflation head on.

Because of the progressive rate structure, the Treasury gains as much in real terms for every percent of inflation as it does for every percent of real economic growth. Indexing removes the "fiscal dividend" provided by inflation and introduces an incentive for Congress to promote real economic growth to pay for expanded services and new programs.

The American taxpayer is no longer fooled by money illusion either in his wages or in his tax liability. To make use of this hidden tax on the rationale that it is an "automatic stabilizer" is no longer reasonable when confronted simultaneously with high levels of inflation and unemployment. The last thing we want to do during periods of high unemployment is to remove from people's pockets any extra money that they might use for investment or consumption. Indeed, the failure to index made the sharp recession of 1974–1975 far more severe than it otherwise would have been.

We would welcome your support of this bipartisan effort to index the personal income tax brackets for the rate of inflation. If you would like to cosponsor HR 11413, please call Doug Bates (53981) of Bill Gradison's staff.

Sincerely,

BILL GRADISON,
CLARENCE J. BROWN,
JIM GUY TUCKER,
WILLIAM S. MOORHEAD,
BILL FRENZEL,
BARBER B. CONABLE, Jr.,
ELLIOTT H. LEVITAS.

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WHERE DO ALL THE TAX CUTS GO?

(By Michael Nelson)

A friend of mine used to tell me about a trick he would play on a rather absentminded high school teacher of his. It seems that sometimes the teacher would leave a pen on his desk and when he turned his back to write on the blackboard, my friend would take it. A little later the teacher would look around frantically until finally my friend would say: "That's all right—I've got one just like it that you can borrow," and the grateful teacher would thank him profusely.

I used to laugh at that story, until one day someone pointed out that the federal government was doing the same thing to me that my friend used to do to his teacher. I asked him what he meant.

"Look," he said, "the government has cut taxes for three years in a row and it will probably cut them again this year. You probably think you've been getting something, right?"

"Sure," I replied. "After all, that's what a tax cut does—it gives you something."

"Now think a little harder. Has your tax rate actually gone down?"

I thought a little harder. He was right; it had not. And then I found out why.

The reason my tax rate and the tax rates of tens of millions of other people have not gone down, despite the tax cuts, is something called "taxflation." Though officials in Congress, the Treasury Department and the White House would just as soon not hear about it, taxflation may be the most expensive political time bomb in the entire tax code.

Taxflation is what happens when inflation blindsides a progressive income tax system, driving people up the tax ladder even as their real income—their actual spending power—stays the same or goes down. The most frustrating thing about inflation, of course, is that its eats up—or more than eats up—what seem at first glance to be substantial pay raises. But to add insult to injury, these illusory raises boost workers into higher and higher tax brackets just as if they were real ones. The reason is that the tax brackets and all the basic deductions—the personal exemption, standard deduction, and low-income allowance—are expressed in the tax law in simple dollar amounts, as if there were no inflation at all.

To appreciate how big a problem taxflation is, imagine reading this fictitious lead, concocted by former Office of Management and Budget director James Lynn, to an article in The Post one morning:

"To pay for its current and newly proposed spending, the federal government has programmed a series of regular tax increases that, each year, will add from $350 to $450 to the average family's income-tax bill. These increases will continue indefinitely."

Here is what Lynn means. The "average" husband-wife-and-two-kids American family made around $15,000 last year. That will work out to an effective tax rate of about nine percent, or $1,400, when they fill out their 1040 form this spring.

Now let's assume that inflation runs at seven percent this year—the average annual rate since 1970—and that this family's income just barely keeps up. That would give them $16,050 in dollar income in 1978, but, of course, no more actual spending power than last year's $15,000. Yet not only would their income tax go up to almost $1,600, but the rate at which they are taxed would go up to eleven percent. And if this were to continue through 1987, the family—still no better off than they were last year—would be paying at a rate of eighteen percent.

The average Washington area family, which makes around $25,000 a year, would be hit even harder. Presently paying fifteen percent in income tax, they would be assessed at a rate of twenty-seven percent ten years from now—again, with no increase in their spending power. Similarly, singles now paying around twelve percent on a $10,000 income would be up to twenty percent in 1987. (This would change if a tax cut were passed this year, but as we will see later, even that would not solve the problem.)

Perhaps the worst case is that of the poor working mother. A woman with one child who earned $7,500 in 1976 actually got $50 from the government in "earned income credit," which lowered her tax rate to 6.6 percent. But if her income simply kept pace with inflation that year—lifting her to $8,010—she will have to pay $635 in taxes—a rate of eight percent.

Of course, you won't see many leads this year of the kind James Lynn proposes; instead, you will be reading "Congress, Carter Slash Taxes"-style stories with sidebars on "Low and Middle-Income Taxpayers to Benefit Most." That is the nature of news—a tax cut is a finite event that ultimately takes place in one day; taxflation is a slow, continuing leak in your income that takes place every day. As a result, it strikes most news editors as about as newsworthy as "Sun Rises in East" or "Gravity Holds Pie on Baltimore Woman's Windowsill."

What is worse, the power of taxflation matches the size of the problem it poses. For example, Jimmy Carter's proposal for a $17 billion net cut in personal income taxes next year is designed both to offset the effects of the new social security and energy taxes (an estimated $12.4 billion by the time fiscal year 1979 ends on October 1, 1979) and to provide a little stimulus to the economy with the remaining $4.6 billion.

Yet according to figures released by Congress' Joint Committee on Taxation, taxflation will cost us an additional $13.4 billion during this period. The bottom line: a net loss to the taxpayer of $8.8 billion, even after the tax cut. And if House Ways and Means Committee Chairman Al Ullman has his way, the entire taxflation burden will remain on the public.

The direct effect of taxflation is obvious: it costs us more money. That may seem bad enough in itself, especially since it takes the form of what economist Milton Friedman describes as "taxation without representation—higher taxes imposed on the citizenry year after year without legislation." But there are side-effects on the economy that are also harmful.

One side-effect is a now familiar economic phenomenon called "fiscal drag," a malady the United States seems likely to suffer from between now and—at the earliest—October 1, the day the proposed tax cut would take effect. Fiscal drag is anything that keeps the economy from performing as well as it otherwise would, and though taxflation will have some help this year from the sluggishness of foreign economies and other factors, it is the most constant source. After all, that $13.4 billion in revenue from taxflation in fiscal years 1978 and 1979 represents money that consumers otherwise would be spending and banks would be lending, fueling economic growth.

It used to be that taxflation had a good side-effect too, namely that it contributed to economic stability during inflationary periods. The reasoning was that since inflation was caused by excess demand—too much money chasing too few goods—the removal of a few billion dollars from an overheated economy via taxflation would help cool it off.

But that no longer appears to be true. In fact, Professor Thomas Dernberg of American University showed in a study commissioned by the Joint Economic Committee of Congress that in 1974, our worst economic year in recent history, taxflation just added to the problem. The source of inflation then was not excess demand, but severe shortages in supply born of the Arab oil embargo and the poor grain harvest. As the Brookings Institution's Joseph Pechman points out, nowadays "inflation seems to occur at least as often when the economy is in trouble, when unemployment is high. The increased tax receipts (due to taxflation) during such periods are really counterproductive."

Not surprisingly, other nations that are burdened with inflation have been looking for a way to eliminate its effects from their tax system. Several—Canada, France, West Germany, Brazil and Denmark, among them—seem to have succeeded in a way that is instructive for the United States. Starting in 1974, for example, Canada had been "indexing" its personal income tax by adjusting individual tax brackets, credits, and deductions to take account of changes in the cost of living.

In the United States, indexing would mean that all the dollar amounts specified in the tax code—for the personal exemptions, standard deduction, low income allowance, and the brackets themselves—would be automatically reset every time the Consumer Price Index went up. Under an indexed system, our $15,000-a-year family would continue to pay around nine percent as long as its real spending power stayed the same, the $25,000-a-year family would still pay fifteen percent, the poor family would get its earned income credit, and so on. Thus, no one would be worse off on tax day just because inflation had kept them from being better off on payday.

Indexing advocates say that the advantages of such a plan—in addition to the economic ones already discussed—are obvious: it is fair, and it conforms with simple common sense. Fair because it is just not right for the government to take a multi-billion dollar "windfall profit" out of the hides of its citizens every time we go through an inflationary period. Sensible because it acknowledges modern economic realities that the present tax law is blind to.

To understand how much those realities have changed, recall that when the present tax brackets were set in 1964, the inflation rate was *one* percent. Economists did not even think to adjust the brackets for inflation—it just wasn't a problem. Since then, of course, prices have almost doubled. And if inflation continues to average seven percent a year, prices will keep on doubling every ten years from here on in.

Clearly, nobody ever meant for taxflation to happen. But now that inflation seems with us to stay, argue indexing supporters, there is no reason to glorify the earlier lack of foresight by not taxflation-proofing the personal income tax now. After all, the federal government is no stranger to the idea of indexing—it does not index the taxes that citizens pay in, but it does index most of the money it pays out. According to the Congressional Budget Office, $5 of every $8 of federal spending is already "adjusted automatically for increases in the price level."

Fair, sensible, practical, and economically wise—the case for indexing seems overwhelming. Which leaves us with the obvious question: why hasn't anything been done about it? Inevitably, the answer lies not in the realm of economics, but of politics.

"Let's fact it," says Eastern Shore Representative Robert Bauman, a supporter of indexing. "Many of my colleagues see the present system as a goose, hidden away from the public eye, laying golden eggs."

A Senate budget expert who opposes indexing adds: "We need the revenue, and practically speaking, there's no other way to get it. So the attitude [in Congress] is let's leave well enough alone."

There is a grim, public-be-damned quality to these theories. But they gained credence on August 3, 1976, when a proposal by Senator Robert Taft of Ohio to index the personal income tax came before the Senate.

It was an unusual scene, to say the least. There was Taft, figurative hardhat on head, bemoaning the fate of construction and steel workers bruised by taxflation. Then James Buckley, another conservative Republican, stood up to rail against its "cruel, hidden, deceitful" nature. And as if that weren't enough, Robert Dole, Pete Domenici and William Roth chimed in with expressions of their own unsurpassed concern for the "elderly and poor," the "workers," and the "low and middle-income taxpayer."

Holier than thou they may have been, but the conservatives clearly had the edge in this one. Not surprisingly, liberals of both parties took a walk, leaving only Russell Long—who, as chairman of the Finance Committee, had to be there—to articulate a case in favor of taxflation.

Perhaps rattled by the spectre of all this rhetorical Democratic wine being poured from Republican bottles, Long let slip a hanging curveball, which his tormenters handily parked in the back row of the bleachers. We never had trouble with social security until we indexed it, he said, and was promptly reminded that the reason social security was indexed in the first place was to keep congressmen from really driving it into the poorhouse with their annual ad hoc benefits boosts.

But, Long rallied, "this amendment would mean that every time we have a six percent inflation, we will lose $5 billion in revenue . . . when we already have an absolutely uncontrollable government deficit." To onlookers, that probably sounded as strange as compassion for the poor, the elderly and the working man did coming from the Republicans. Besides, he was lectured, it was tainted money, born of an inequitable, unjust, sneaky, and regressive tax.

Then, surely weary of hearing the Bible quoted at him by all these devils, Long told the truth. Not the whole truth, of course, but a better part of it than usually finds its way to the Senate floor.

The real problem with ending taxflation, he conceded, is that sooner or later Congress would have to make up the difference by openly voting for higher taxes.

"It is difficult—goodness knows, we have learned in writing this tax bill (of 1976) how difficult it is—to get senators to vote for tax increases. I have proposed all sorts of tax increases and voted for tax increases that we cannot persuade a majority of senators to vote for. Even when we call it reform we cannot get them to vote for it . . . Many times, when we ask people to vote for a tax increase, they will not vote for it, *for very understandable reasons*. Inflation is one thing that does tend, somewhat automatically, to help bring the budget into balance." (Emphasis added). Better to slip the people's money out of their pockets when they're not looking, in other words, than to run the risk of rousing them.

In case anybody is still wondering, those "very understandable reasons" Long was talking about are these: senators like being senators, and suspect that they would not be for very long if they openly raised taxes. The other side of the coin is that as much as they hate to vote tax hikes, that is how much they love to vote tax cuts. The great thing about taxflation, of course, is that it lets them have their cake and eat it too. Thus, over the past fourteen years, Congress has passed six tax cuts while at the same time it has doubled the federal budget, redoubling it, and almost redoubled it again.

"It is quite obvious," says economist Herbert Stein, that congressmen "are quite happy to have the real yield of the tax system increase automatically without their having to take any responsibility for it . . . [Congress] appears to all the people to be reducing taxes. In fact, however, it is mostly return-

ing to the people the additional tax revenue it has extorted from the population."

In light of all this, the following prediction may seem surprising: tax indexing is inevitable. It is inevitable for two very fundamental reasons, one economic and the other political. The economic reason is that inflation is here to stay and that means that the idea of leaving the tax brackets expressed in simple dollar amounts will soon become not just unfair, but absurd. Think about a fact noted earlier: at a seven percent rate of inflation, prices double every ten years. That means that a 25-year-old worker who takes a job at $15,000 a year in 1980 will have to be up to $30,000 in 1990, $60,000 in the year 2000, and $240,000 a year by the time he reaches retirement age in 2020—just to stay even. Obviously something has to give, and since it probably won't be inflation, it will have to be the brackets.

The political imperative is equally powerful, if not quite as mind-boggling. As political scientist Everett Ladd points out, taxflation has helped to place more and more of the tax burden on the middle and lower-middle class, while easing it for the rich. "Those earning four times the national median income in 1953—about $20,000—paid 20.2 percent of their incomes in taxes, while those at the median paid 11.8 percent," he writes. "Twenty-two years later, median-income families were taxed 22.7 percent of their income, while the rate of those earning four times as much had climbed more slowly to 29.5 percent . . . The burden of paying for the vast expansion of the role of the state has in a real sense been borne disproportionately by the middle and lower-middle tax brackets." If Congress—especially the Democrats—does not index the income tax soon, predicts Ladd, they will be running a very severe risk of inviting a full-scale middle-class revolt.

When will indexing come? The day that senators and representatives realize that they will have to pass it if they want to keep on being senators and representatives. And that should happen about one day after the light bulbs go on over taxpayers' heads, as they realize that the pen Congress keeps "giving" them is the same one it slipped off their desk when they had their backs turned.

ADDITIONAL COSPONSORS TO DATE

Glenn M. Anderson
Mark Andrews
Les AuCoin
James J. Blanchard
James Broyhill
Clair W. Burgener
Elford A. Cederberg
James C. Cleveland
William Cohen
Tom Corcoran
Robert K. Dornan
John J. Duncan
Mickey Edwards
Joshua Eilberg
Allen E. Ertel
Billy Lee Evans
Millicent Fenwick
Louis Frey, Jr.
Benjamin Gilman
Dan Glickman
Charles Grassley
S. William Green
Tennyson Guyer
Herbert E. Harris, II
Elwood Hillis
Marjorie Holt
Frank Horton
William J. Hughes
Henry Hyde
Andy Ireland
James M. Jeffords
Robert Kasten
Richard Kelly
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Thomas N. Kindness
John L. LaFalce
Robert J. Lagomarsino
Jim Leach
Norman F. Lent
Trent Lott
Thomas A. Luken
Joseph M. McDade
Robert C. McEwen
James G. Martin
Robert Michel
Barbara A. Mikulski
Henson Moore
Austin J. Murphy
Stephen L. Neal
Jerry Patterson
Dan Quayle
Albert H. Quie
Tom Railsback
Ralph S. Regula
John H. Rousselot
Floyd Spence
Dave Stockman
David Treen
Guy Vander Jagt
Doug Walgren
William Walsh
C. William Whitehurst
Don Young

STATEMENT OF HON. BILL GRADISON, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF OHIO

Representative GRADISON. Mr. Chairman, thank you for this opportunity to appear with my colleague on the Ways and Means Committee, Phil Crane, and speak before your subcommittee on automatic adjustment of the personal income tax brackets for changes in the value of the dollar.

Our system of progressive rates was designed for a world of stable prices and in a period of rising prices, there is a steady bracket creep as inflated nominal incomes move taxpayers into higher brackets, increasing their real average tax rates, even in situations where their income grows with the cost of living.

The Senate Finance Committee is, of course, familiar with indexing, since you have within your jurisdiction major spending programs which are indexed—social security and supplemental security income. My thesis is that American taxpayers deserve the same treatment as those who benefit from Government expenditures.

I am aware of the objections to indexing raised by the distinguished Chairman of the Senate Finance Committee on the Floor of the Senate on August 3, 1976.

Senator Long stated, and I quote:

> One of the few things we have going for us to give us the chance to balance the budget is that inflation does tend to bring in more revenues for the Government.

The Senator is quite right, of course, but let me point out that revenues would continue to rise, even with indexing. Such increases would result, however, from real economic growth, from more people working and paying taxes, not from the unvoted inflation tax.

For example, in fiscal year 1980 the administration estimates a revenue increase of $37 billion for the individual income tax over the previous year if the present tax structure were extended.

Indexing the brackets for inflation would reduce this revenue gain in that year by about $4.5 billion, thus a real economic growth would still provide a 1-year increase of over $32 billion in Federal revenues.

The Government is the only sector of the economy with the resources to reverse the upward spiral, yet the Treasury has a vested interest in maintaining inflation, since present law permits a windfall tax bonus during an inflationary period. Indexing would remove this convenience.

Indeed, the experience of Canada which has indexed rates and exemptions since January 1974, suggests that indexing can actually slow down the growth of Federal spending. Their Federal outgo increased about 16 percent in 1974, dropped to about 10 percent in 1975 and then down to less than 3 percent in 1976. Thus, a reduction in tax revenue may result in a reduction in expenditures.

In addition, inflationary pressure finds a source not only in the growth of Federal spending but also in the rate of growth of wage demands. If higher nominal salaries did not result in higher real tax liabilities, the pressure for further wage increases might be, at least, partially alleviated.

Another, I think unwarranted, fear of indexing is that it will remove our discretion to make changes in this tax structure. And, being a member of Ways and Means, I am concerned about that, as I am sure you are on your committee.

Frankly, I believe it actually would enhance our ability to make wise and targeted changes in the tax code. Instead of putting the Congress in a position of having to reopen the Code almost every year, as my colleague from Illinois has mentioned, indexing would add an element of stability and permit less frequent, perhaps more carefully considered, tax reductions.

Our usual purposes in making tax cuts include offsetting inflation-based tax increases, stimulating the economy, and making the structure more equitable.

A review of our past actions shows that in the decade from 1965 to 1975, the cumulative effect of inflation and all the legislated tax cuts left the taxpayers worse off than if we had not cut taxes, but had merely indexed the system.

The only group which gained, on balance, over that decade from legislated tax cuts were those with less than $10,000 of income in 1975 dollars. This fact, I think, helps to explain the outrage of middle income taxpayers about the burden on them of the present tax system which results in pressures for things like tuition tax credits.

In addition, the lack of indexing aggravated the 1973–1974 recession by increasing Government revenues very substantially during the period of an extremely sharp downturn in the economy and we scored no better on equity grounds for the marginal tax brackets are closer together at lower income levels.

Along with the bipartisan group of cosponsors, now numbering more than 70, I, with Mr. Crane, have introduced a tax indexing bill which I hope the Ways and Means Committee will be able to take up at the appropriate time in our markup. It would provide an annual adjustment similar to the Canadian adjustment of rates.

I am aware that Senator Dole has introduced S. 2728 which also provides an inflation adjustment mechanism. While my proposal does not extend indexing as far as Senator Dole's, my real intent is to establish in our tax laws the principle that only real income, not nominal income, should be taxed.

Once that first step is taken, it should be possible, and somewhat easier, to extend indexing to other relevant provisions of our tax laws. The specific mechanism is not nearly as important, in my view, as the fact that, out of fairness to the American taxpayer, as Mr. Crane has said, indexing is an idea whose time has come.

Mr. Chairman, I thank the subcommittee for this opportunity to speak before you today and congratulate you on holding hearings on this very important issue.

Senator BYRD. We are glad to have you, Congressman.

May I ask my two colleagues from the House if you would have time for the committee to hear Senator Griffin and Senator Buckley, and then the committee could put whatever questions they might have to the four of you. You could just stay there, if you like.

The Chair recognizes the able Senator from Michigan, Senator Griffin, as the next witness.

STATEMENT OF HON. ROBERT GRIFFIN, A UNITED STATES SENATOR FROM THE STATE OF MICHIGAN

Senator GRIFFIN. Thank you, Mr. Chairman.

I mainly want to commend the chairman and the members of the Finance Committee for holding these hearings. I am a cosponsor, with Senator Dole and others, of S. 2738. As the members of the commitee may recall, when we had the Tax Reduction and Simplification Act before us a year ago, I offered an amendment at that time to provide for tax indexation.

The amendment was defeated by a vote of 64 to 24. But during the debate, I engaged in a colloquy with the distinguished chairman of the committee, Senator Long, who promised—or at least indicated—that this committee would follow through and would take a careful look at the concept.

So I am glad that is being done.

I must say that the people are very, very upset about inflation, which is no news to bring to the committee. But as I go amongst my constituents, I find that they are beginning more and more to realize the relationship between inflation and their taxes; that they are being pushed into higher and higher income tax brackets; and that they are the victims of nonlegislative tax increases—which, as others have pointed out, really builds into the system a certain windfall profit for the Government in pursuing inflationary policies.

When it is explained to taxpayers that their taxes and the "take" of the Federal Government in revenue goes up 1.6 percent when the cost of living goes up 1 percent (or even if it just goes up any percentage more than the increase in the cost of living), this is a kind of a situation that really irritates taxpayers and makes them very, very unhappy.

While I think the time is long past due for tax indexation, I will not go into all of the economic arguments. I, like the members of the committee, look forward to hearing from the economists and the experts who will testify. But I think the time is long past due for us to take the windfoll profit out of inflation, as far as the Government is concerned.

Tax indexation would only be one step toward dealing with the impact of inflation upon the average citizen, but it certainly would be a very, very important step that this committee and the Congress might take. With that, Mr. Chairman, I would ask unanimous consent that I might have a more complete statement submitted and made a part of the record.

Senator BYRD. Without objection, your complete statement will be made a part of the record.

Senator GRIFFIN. Thank you, sir.

[The prepared statement of Hon. Robert Griffin follows:]

STATEMENT OF U.S. SENATOR ROBERT P. GRIFFIN

Mr. Chairman, I wish to commend the subcommittee for holding hearings on the tax indexation bill (S. 2738) that Senators Dole, McClure and I are sponsoring. I appreciate this opportunity to testify in support of one of the most helpful steps Congress could take to ease the staggering tax burden on American workers.

I long have been a strong supporter of the tax indexation concept. As the subcommittee may recall, almost exactly a year ago—on April 28, 1977—I offered a tax indexation amendment during Senate consideration of the Tax Reduction and Simplification Act. I called it an "inflation neutralizer" because it would have helped to buffer wage earners from the harsh, hidden tax impact of inflation by automatically adjusting personal income rates, the personal exemption, and the standard deduction to reflect increases in the cost of living.

Unfortunately, the Senate defeated my amendment by a vote of 24 to 64—although it did have the support of all the Minority members of the Senate Finance Committee. The next day, I introduced the amendment as a bill—S. 1431—and it is pending before your Committee along with the bill we are considering today.

I support tax indexation because I believe it would be an effective antidote to one of the most serious ailments affecting the American economy—I refer to that curious condition that economists are now calling "taxflation."

We all know the symptoms. Relentless inflation forces wages to rise, supposedly to keep pace—but then comes the rude awakening as wage earners find that their bigger paychecks not only buy no more, but also are subjected to heavier income taxes.

That's the "double whammy" of taxflation. For millions of Americans, particularly those of low and middle income, it means paying more real taxes on less real income.

That's because their added earnings, even though eroded by inflation, are taxed at ever-higher rates since our tax laws are blind to the shrinking value of the dollar.

As Senator Buckley has so ably pointed out, if a taxpayer doubles his nominal income from $10,000 to $20,000 between now and 1988 just to keep up with an average 7 per cent inflation rate, he would have no more real money to spend. And yet his federal tax bill—from being bumped into higher brackets—would more than double!

Obviously, the only beneficiary of this situation is the Federal government—which, at current inflation rates, rakes in about $6 billion every year in added revenues from taxes on these inflated wages.

This "windfall profit" to the government amounts to a non-legislated tax hike every year, and in effect represents a direct reward to Washington for the inflation it is at least partially responsible for producing in the first place through excessive and unnecessary spending.

Frankly, I find it unconscionable for the government—in addition to promoting policies that fuel inflation—to profiteer from its impact at the expense of American taxpayers. Tax indexation would be an essential first step toward helping the government kick the inflation habit.

By automatically adjusting tax rates to reflect cost of living increases, indexation would remove the government's profit incentive for pursuing inflationary policies. And, equally as important, the extra earnings American workers receive just to keep up with inflation would stay in their pockets rather than swelling IRS coffers.

That's why I call tax indexation an "inflation neutralizer." It simply would offset the impact of inflation on American wage earners by insuring that—unless their income grows faster than the cost of living—their federal income tax rate will stay constant.

Increasingly, American workers find themselves mired in financial quicksand. Like a man trying to climb a ladder in a bog, the average wage earner finds that every step he tries to take up the economic ladder only settles it deeper into the ground—so that every rung he thinks he climbs up is really a step down.

Taxpayers too often find that the pay increases they receive turn out to be and larger portions of his income become taxable; then, a larger chunk becomes illusionary. For, as the worker's pay goes up, three things occur: First, larger and larger portions of his income become taxable; then, a larger chunk becomes taxable at the highest marginal rate in his current tax bracket; and finally, he gets bumped into the next tax bracket.

It's no wonder that American taxpayers are as baffled as Alice must have been in Wonderland when the Red Queen said to her: "Here, you see, it takes all the running you can do to keep in the same place. If you want to go somewhere else, you must run twice as fast as that."

Just how serious this situation is was underscored by Senator Dole in introducing S. 2738, when he pointed out that the number of taxpayers in the 30 percent-plus brackets has increased six-fold in the last 15 years!

Mr. Chairman, it's no coincidence that the cost of living has doubled in that time. As I pointed out earlier, inflation pushes up wages, which pushes wage earners into high tax brackets.

And unless we break that cycle now, the situation will only get worse. We need to remember that with an average inflation rate of 7 percent, prices double in 10 years—and with inflation now above 8 percent and still climbing, the CPI may well redouble within the decade.

Let me offer some examples of what's in store without tax indexation.

A taxpayer who earned $15,000 in 1977 will have to earn $16,200 in 1978 just to break even at 8 percent inflation. But that's before the IRS tax bite. If he does earn $16,200 in 1978, his real tax liability will be increased by about $260—so, in reality, although his purchasing power in 1978 is only *equal* to that of 1977, he has in fact sustained an actual loss of $260!

The situation becomes more pronounced as workers move higher up the income ladder. A family with a $30,000 yearly income in 1977 will have to earn $32,400 in 1978 to keep pace with our projected inflation rate. However, at $32,400, the family's tax bill—and their real income loss—will rise by about $850.

This is pretty grim news for taxpayers trying to balance their family budgets. But it is not only personal income that inflation ratchets into higher tax brackets. The taxflation impact is felt across the tax spectrum—in capital gains taxes, corporate taxes, pension contribution limitations, the earned income tax credit, the tax credit for the elderly, and the child care tax credit.

If we enact a tax indexation bill, we can save taxpayers from these very real losses, and at least allow them to keep up with the cost of living. Our hypothetical $15,0000-a-year taxpayer would be able to keep his $260, and the $30,000-a-year family would be $850 better off.

When examples such as those I mentioned are cited, I must say that it is no surprise to me to see media reports of a pending American "tax revolt." The anger, frustration and disillusionment taxpayers justifiably feel—and that I hear about all the time from my constituents—is certainly understandable. It is up to those of us in government to provide a measure of tax relief that is meaningful and predictable.

While tax cuts are certainly desirable—and I support efforts here in Congress to cut taxes—they are not the whole answer. Too often, tax cuts are determined by the prevailing political winds. That is why, despite five legislated tax cuts in the past decade, the actual tax bill of many Americans—as a percentage of personal income—has increased rather than decreased.

The reason for this is that inflation has eroded the impact of those five tax cuts. Because of inflation—and the sporadic, patchwork approach to tax cuts taken by Congress in the past—a tax cut isn't really a tax cut at all. It may help for the year it's enacted, but when the inflationary spiral starts again, the benefits are lost.

To emphasize this point, I would cite a study conducted by the Joint Committee on Taxation, which showed that government tax reevnues rise at 1.65 times the rate of the cost of living. Translated to individual taxpayers, that means that for roughly every 10 percent rise in income, their taxes—on the average—go up by 16½ percent! The difference represents the windfall profit government receives from the inflation it helps to generate.

Indexing tax rates to inflation would remedy this by providing taxpayers with the assurance that the pay raises they receive just to keep up with the cost of living will not be taken away by the government in higher taxes. In addition, indexing would insure that any tax cuts we enact this year—or in future years—will be tax cuts that really mean something, not mere illusions.

I realize, Mr. Chairman, that there are differences of opinion as to the specific form that tax indexation should take—and that there are differences as well as to whether it should be attempted at all.

I am sure that there will be vigorous arguments made—as there have been in the past—that the government "can't afford" the loss in revenue that would result which, as I indicated earlier, would be about $6 billion or more every year.

But these revenues are artificial revenues that the government has no business collecting. They are, in effect, hidden tax hikes on which Congress has never voted.

If we are serious about wanting to fight inflation, we can—and must—start by getting serious about reducing Federal expenditures. And I can think of no better way to start than by ending the government's inflation profit through tax indexation.

By continuing our indulgence in this form of hidden taxation, we are draining money out of the economy, causing the Gross National Product to grow less than it should, and thus actually reducing Federal revenues.

Indexing would help stabilize not only the tax system but the economy as well, and in the long run save the government billions of dollars more than it costs.

I do not pretend, Mr. Chairman, that tax indexation is the sole solution to ridding ourselves of the inflationary demons that beset us. But, it is a major first step that we ought to take.

I would add that tax indexation, like so many other issues, is a case where the people are ahead of their elected representatives. When I introduced my indexing bill last year, I was gratified to see the responsive chord it struck. Newspapers all over Michigan editorialized on it favorably, and I have received countless expressions of support for the concept.

In closing, I would only say that this Congress must provide tax relief to the American people. Another tax cut my help in the short run—and I beleive it is needed—but we must also take action now to insure that wage earners do not continue to be hit with the "double whammy" of inflation and higher taxes in the future.

We should take action now to take American taxpayers off the taxflation treadmill once and for all.

I urge the members of this Committee and all of my colleagues in both Houses of Congress to work hard in the closing months of this session to enact a tax indexation bill.

Senator BYRD. Our next witness will be the former Senator from New York, Senator James Buckley, who, as I recall, introduced similar legislation some 2 or 3 years ago.

Senator Buckley, we are very glad to have you before the committee today.

Mr. BUCKLEY. Thank you, Mr. Chairman. I just regret that I cannot take a more active role in pursuing this particular matter.

Senator BYRD. You may proceed as you wish.

STATEMENT OF JAMES L. BUCKLEY, FORMER UNITED STATES SENATOR FROM THE STATE OF NEW YORK

Mr. BUCKLEY. I very much appreciate this opportunity to testify in support of tax indexation in general and Senator Dole's tax indexation bill in particular. To my mind, it is the most important structural tax reform on the agenda and I want to compliment Senator Dole, and also Senator Roth who has been active in this area before for their leadership in urging its adoption by this committee.

At the outset, I think it important to recognize that indexation does not attempt a radical departure from traditional concepts of income taxation. Rather, its purpose is simply to protect our tax system against the unanticipated distortions and inequities caused by inflation. What it does is to insure that the real income of taxpayers will be taxed at the rates Congress originally intended, and no more, and it accomplishes this, as you know, by the simple expedient of tying key provisions of the tax code to the consumer price index.

It should be remembered that during most of our experience since the adoption of the income tax amendment, we have enjoyed a remarkable degree of price stability. Until just the past dozen years,

in fact, the phrase "sound as the dollar" expressed an internationally accepted fact. It therefore never occurred to those who drafted our basic tax laws that high rates of inflation would have the effect of doubling and trebling the effect of taxation on lower income individuals or that capital gains taxes could, in practice, be converted into capital levies.

As a matter of fact, as recently as 1974 when I first introduced legislation to index our Tax Code, many members of the Senate still found it difficult to fully understand the mechanics by which inflation ratcheted taxpayers into higher rates of taxation, even though their real income, as measured by purchasing power, remained the same.

Today, however, it is hard to find an article on taxation or tax reform that does not recognize the major inequities that result from what is now sometimes referred to as taxflation.

Mr. Chairman, I then go on to provide a couple of examples of illustrations of this fact in my prepared testimony.

There are similar distortions and inequities which occur in the case of capital gains where the impact of inflation on nominal profits can be especially harsh. Let's take a typical example of a young couple who bought a home in 1952 for $25,000 in order to accommodate a growing family. Twenty-five years later, their children having grown, the couple sell their home for $60,000 and move into a small apartment.

Even though the real value of their house declined somewhat over the intervening years, they were, nevertheless, required to pay a tax on a nominal gain of $35,000; assuming a rate of 20 percent, this represents a $7,000 capital levy that, surely, the Congress never intended.

This is a situation which faces tens of millions of Americans as the time comes for them to dispose of what is likely to be, by far, their most important investment, namely their homes.

I would call the committee's attention to a recent study detailing the extent to which excessive taxes are collected on often fictitious gains realized on the sale of common stock. It was prepared by Martin Feldstein and Joel Slemrod, of Harvard University, on behalf of the National Bureau of Economic Research. Based on an analysis of 1973 individual income tax returns, the authors conclude that "in 1973, individuals paid nearly $500 million in excess tax on capital stocks, capital gains because of the distorting effect of inflation." This finding understates the full amount of the excess taxes actually collected that year, because the study did not include partnership or fiduciary returns.

The Feldstein-Slemrod study is particularly illuminating in what it tells us of the uneven impact of taxflation on different income groups and between individuals reporting the same real gains. Whereas taxpayers with adjusted gross incomes below $50,000 suffered a real loss of about $3 billion, they were, nevertheless, required to pay Uncle Sam an additional $99 million for the privilege of liquidating their shares. Those having adjusted gross incomes of $50,000 and more, on the other hand, realized a $2.1 billion in real gains, on which they paid about $1 billion in taxes for an effective tax rate of 48 percent.

The authors also point to a very widespread effect of taxation on the same amount of real capital gains. Quite obviously, the longer the shares were held, the greater the purely nominal gain attributable to inflation and the greater the tax.

The impact of inflation on capital gains taxation goes beyond the inequities and distortions I have described. It amplifies the disincentives to the sale of, and reinvestment in, corporate securities that have now reached very serious proportions.

The adoption of this feature of the Dole bill, the indexation of the tax base for capital assets, would be a major step in reversing the alarming decline in investment in the newer, innovative companies which hold the greatest promise for job creation and the preservation of American technological preeminence.

There is no tax reform that is more important to achieve, easier to accomplish and fairer in its impact than income tax indexation. Government must not be allowed to profit by the inflation it creates. Government revenues rise at 1.65 times the rate of inflation. That 65 percent spread, as Senator Griffin has pointed out, and others here today, is what Federal spenders like to refer to as the "inflation bonus" a euphenism for a windfall profit that Government extracts from the hides of the taxpayers least able to afford it.

Tax indexation would require the Congress to show the political courage to vote for the tax increases required to finance the new programs and expanded budgets that it authorizes which, no doubt, is one of the unspoken reasons why the idea of indexation has met with such resistance.

Some opponents argue that indexing is itself inflationary. This is nonsense. Indexing does not, in any way, affect inflation, nor does it imply a willingness to live with inflation. On the contrary, because it eliminates the so-called inflation bonus, it removes a major temptation for excessive Federal spending, which is the root source of inflation.

Inflation should be fought, not by increasing the tax bite on lower income Americans, but by adopting the appropriate fiscal and monetary policies. President Carter's tax proposals underscore the need for indexation. Enactment of his recommendations will result in tax cuts for lower income citizens, but only temporarily, because, all too soon, inflation will be ratcheting their nominal incomes into tax brackets that will leave them worse off than before.

Yes, indexation is what is needed and S. 2738 points the way. The bill goes far beyond indexing the tax rate tables. It will protect the integrity of the most important sections of the tax code, such as the personal exemption, the corporate surtax exemption, the gift exclusion, the child care tax credit, and a host of others, all of which would be automatically adjusted annually to offset the effect of inflation.

Many of these sections have substantial impacts on that group of our society that is the most vulnerable to inflation, namely the elderly. Pensions paid under private plans cannot provide for pensions paid under cost of living increases. Therefore, indexing such items as the tax credit for the elderly and the exempt amount on homes sales are particularly important in restoring some measure of tax equity for this group.

The Dole bill also recognizes the importance of protecting the business community against inflation-induced changes that distort or nullify the tax rates and incentives intended by Congress. Thus, this bill will index the corporate surtax, the investment tax credit, and the tax basis of assets for capital gains purposes.

I would urge the committee to also index inventory costs and depreciation allowances. Information provided by the Commerce Department's Bureau of Economic Analysis reveals that real corporate profits, adjusted to reflect replacement costs, were taxed at effective rates of 56 percent in 1972, 102 percent in 1974 and 78 percent in 1976.

The rates of inflation in those years were 3.4, 12.2 and 4.8 percent respectively.

Where I must respectfully part company with Senator Dole is on some of the limitations which he would place on his otherwise exemplary bill. S. 2728, for example, would limit the inflation tax adjustment to two-thirds of the increase in the consumer price index which is to say, it would do away with only two-thirds of the extra burden that taxflation now places on taxpayers; two-thirds of the capital levies now exacted on individuals who sell homes or securities whose value has increased in nominal, but not in real terms; two-thirds of the windfall inflation profits that Government now enjoys at the expense of the governed.

To my mind, the case for indexation is so clear so compelling, so just that I would urge this committee to exercise true leadership and report a bill that would go-three-thirds of the way in offsetting the distortions that inflation now imposes on our tax system.

I also question the 5-year limitation that the Dole bill would place on this important reform. Five years hence, a cowardly Congress could impose a significant tax increase by stealth through the simple expedient of doing nothing. And if the Congress wants to grant the President a limited power to increase taxes subject to a one-House veto as in effect is provided by S. 2738, let the Congress provide him with the explicit authority to do so.

I would hope, however, that the Congress would come up with a formula that would spread the burden of a tax increase more equitably than would be the case if indexation were to be suspended.

This is not new ground, Mr. Chairman. Indexation, as has been pointed out this morning, is in effect in Canada and it works. Since tax indexing was first proposed, the principle has gained increasing support in all sections of our country. Indexation is an idea whose time has clearly come and the Dole bill, S. 2738, is the place to start.

Thank you.

Senator BYRD. Thank you, Senator Buckley.

Mr. BUCKLEY. Mr. Chairman, I skipped a few portions of my text. I wonder if I could have unanimous consent to have the full text printed in the record.

Senator BYRD. Without objection, the full text of Senator Buckley's remarks will be printed in the record.

The committee has heard four excellent presentations. I might say that I am in full agreement as to the emphasis that has been placed on inflation. It is the No. 1 problem facing our country today. I think I should say, however, that I am perhaps the only legislator in the

room who is not totally convinced as to the wisdom of this legislation, but I have an open mind. I am flexible.

I have listened, and will continue to listen, to the testimony with a great deal of interest and try to reach a decision in due course.

I would like to read into the record the cosponsors of the legislation, along with Senator Dole: the Senator from Michigan, Mr. Griffin; the Senator from Idaho, Mr. McClure; the Senator from Alabama, Mr. Allen; the Senator from New Mexico, Mr. Schmidt; and the Senator from Indiana, Mr. Lugar.

I would like to ask just one or two questions and then yield to Senator Packwood.

Senator Buckley, you mentioned Presidential authority to increase taxes as being part of this legislation. Would you elaborate on that?

Mr. BUCKLEY. Well, my understanding is that the legislation would allow the President to suspend indexation. If you allow him to suspend indexation, you allow him to increase the real tax burden on the American people by the amount of the windfall profit we have spoken of.

Senator BYRD. Well, efforts have been made in past Congresses and under previous Presidents to give to a President the power to increase taxes. I have always been very strongly opposed to permitting a President to make a decision as to whether the American people would be subject to additional taxation. I think that is a prerogative, and a responsibility, that the Congress must maintain.

Senator Packwood?

Senator PACKWOOD. I have no questions.

Senator BYRD. Senator Dole?

Senator DOLE. I do not have any questions. I have a statement which I will present later as an outline of how indexing applies under the bill I have proposed and how, what it would affect income tax rates, exemptions, deductions and credits. I first focused on this issue several years ago at a breakfast that Senator Buckley initiated with Milton Friedman. Dr. Friedman explained the advantages of indexing. I know the interest that Phil Crane and Bill Gradison have in indexing. Of course, Bob Griffin has taken his efforts on the Senate floor. Former Senator Bob Taft also had a great deal of interest in indexing.

I offered an amendment to the last tax bill that received 20-some votes, so we still have a great deal of work to do. I think the panel—if I can refer to these four gentlemen as a panel—have set the stage so we can have testimony from the administration and the other witnesses.

Indexing takes the profit out of inflation for the Government. I know the committee is going to hear later from the Government witnesses that indexing might even add to inflation. I do not understand that myself, but I hope to learn from Mr. Sunley how that would happen.

I would ask a general question of the panel. Do you look upon tax indexing as a political argument or an economic argument, or both?

Representative GRADISON. Senator, if I may just start on that, I think that while it is both, there is a political argument, and it cuts

two ways. I spent 3 days in Ottawa talking with the Government people about this during this winter, and I found the group least enthusiastic about indexing were the members of Parliament, because they felt they were not getting the credit from the people that they thought they deserved.

They thought they got it the first time when indexing went into effect, but that they were not getting it in the future in the same way that would happen if there was an annual adjustment in taxes.

My own sense of what is happening is that it is not as difficult as it once was to explain this problem to the people because they know about it. I think people really sense that they are getting pushed into higher brackets and, while they might not call it indexing, they know it is happening to them. And we are finding more and more articles coming out, just in the general press, which make it clear that, from a political point of view, the public may be ahead of all of us on this issue.

I do not think it is going to get put into effect as a practical matter as a result of decisions made here unless there is relatively broad public support, because I think it flies in the face of the desire of those on the tax-writing committees to cut taxes every year. You know, that is considered historically, especially by those of us who came up through State or local office, the royal road to political success.

To me, that is the old politics, and I really believe that the public is going to suggest that there is a better approach.

Senator DOLE. We have had six tax cuts since 1964. It would seem that if we eliminate this inflation windfall. It is going to make it tough for those in politics, because we are going to have to do something to take care of that lost revenue, even maybe cut Federal spending which we talk about a lot. There is a certain amount of politics involved, not partisan politics, but political judgment.

Representative CRANE. If I may add one thing to what my colleague has just said, it seems to me that there are three particularly dangerous and unwholesome consequences of inflation's impact on tax brackets. The first of these is that it is, as some have already commented, undemocratic, in that sense, it is taxation without representation. I think the people of this country have a right to know when we are imposing taxes on them and, ideally, in the most direct and forceful way, so no one is confused as to the amount of taxes that Congress has voted to levy.

Second, as Senator Buckley observed, it is a regressive tax because its most severe impact is on people in the lowest income brackets. In that sense, then, it runs contrary to all of the stated positions of Congress with respect to imposing taxes on those who are best able to pay.

Third, particularly at this time, when we have talked about capital shortfalls and the ability of our economy to grow and to produce jobs, that to increase taxes through this manner is counterproductive. What should be the objective of this Congress, is, devising ways and means of reducing taxes and, of course, this is one starting point.

Senator DOLE. Either Jim or Bob, do you have any comments on the general question of whether we are going——

Mr. BUCKLEY. One of the things that worries me is the political aspects, in that taxflation creates pressures on the Congress to enact very hurried legislation now on an annual basis the net effect which has been, when all of the dust blows away, to increase the progressivity of the real tax burden. This provides an invitation for all of those add-ons which then become enacted late, late, late in the session without being digested because of the compelling need to lower the burden at the lowest level of the American working population.

So I think that to adopt indexation would remove the tax structure one notch from politics in the worst sense, and liberate time for really thoughtful tax reform legislation.

Senator GRIFFIN. I suppose I would only add that since we have tied social security benefits to cost of living—which generates some different problems, perhaps—the possibility that Congress would adopt this, it seems to me, is real. Particularly (as my colleagues have already indicated) since the understanding among the people is increasing, the level of consciousness is going up, of what is actually going on.

It is a very, very interesting experience now to talk about this and see all the heads nodding in the audience. People really understand what you are talking about when you talk about taxation now. A year or so ago, that was not the case.

I think that you, Senator Byrd, ought to keep in mind here that no one is trying to deny the Government a proportionate increase in revenue on the basis of inflation. In other words, if the cost of living goes up 10 percent, the revenues of the Government ought to go up 10 percent. But the question here is, should they go up 16 percent. That is what is going on now.

It does not seem to me that an administration should devise a budget that actually forecasts inflation and builds in larger and larger projections of revenue on the greater amount of inflation that can be generated—which is the situation today. A windfall profit, a bonus, all of these things, create if not a conscious, at least a subconscious incentive, for Government in all steps to actually promote inflation, which is the last thing that we ought to be doing at the present time.

Mr. BUCKLEY. Mr. Chairman, if I might add to my earlier comment, I would hope that in considering this area the committee would focus not only on the plight of the individual but also on the corporate level, both in terms of corporate finance and the current distortions in capital gains taxation when you are taxing nominal gains only. The present system immobilizes capital at a time when we desperately need to increase the amount of money available to finance the small, innovative companies that are the cutting edge of American technological supremacy.

Also, I urge the committee to recognize the impact that this has on real corporate earnings. Too many companies now do not find themselves generating the kind of cash they need to modernize their plant and to keep producing jobs and to keep American goods competitive. And this is an economic effect, not a political effect. People do not worry about corporations.

But really there is a lot of statistical data available to this committee that could demonstrate the extent to which indexing could

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provide equity in an area on which American jobs and economic prosperity depend.

Incidentally, Senator Byrd, I would say this, that I agree with you that I would not give a President the right to increase taxes. Our present system delegates that right to the Federal Reserve System.

Senator DOLE. I might just say finally that in the bill itself it does not give the President that authority. It just says that he can prevent the indexing from going into effect based on certain economic factors, and that his decision can be overriden by a one-House veto.

But, according to the Congressional Budget Office, in 1975, approximately 63 percent of all Federal expenditures were completely indexed or quasi-indexed, so this is not something that is totally new. I agree with someone who suggested that the American people are beginning to understand tax inflation and indexing.

I made a speech to a group on Friday where I talked about indexing. I had been somewhat apprehensive, thinking that the audience would not understand what I was talking about. I think they understand it probably better than I did, because they not only nod, but they indicate in other ways their approval of the concept.

Indexing has been an issue as far back as an article in Newsweek in 1969 by Milton Friedman, "No Taxation Without Representation," and it was probably around long before that. It seems that we can make some progress by conducting this hearing this morning. We appreciate very much having this forum, Mr. Chairman, and appreciate your interest and willingness to hear more about indexing.

I know that there are going to be some who do not agree with indexing. Some people think we ought to have more basic reforms before we worry about indexing. I appreciate very much the chance to hear from those who have been out on the hustings to discuss their views. I would like to put in the record at this point, Mr. Chairman, a series of articles by Milton Friedman explaining his views on indexing.

Senator BYRD. Yes. Without objection, that will be done.

Senator DOLE. And also a statement of mine, along with a summary of indexing, how it would apply and what provisions it would apply to.

Senator BYRD. That will be inserted into the record.

[The materials referred to follow. Oral testimony continues on p. 59.]

STATEMENT OF SENATOR BOB DOLE

TAX INDEXING

I would like to thank the distinguished chairman, Senator Byrd, for commencing these very important hearings on tax inflation. I believe that S. 2837, the Tax Indexation Act introduced by myself and Senators McClure, Griffin, Allen, Lugar, and Schmitt is a bold and much needed step in the right direction.

AUTOMATIC TAX INCREASE

Inflation creates a cruel paradox for the American taxpayer. As prices and income rise, a person is pushed into a higher tax bracket. The result is a larger Federal tax bite out of the taxpayer's pocketbook. When the increases become too large, the Congress "rescues" the taxpayer by modestly reducing taxes and usually enacting a host of unwanted reforms. Congress

receives credit for such enlightened action: However the taxpayer is in no better condition than if you eliminate the tax inflation. In effect, tax reduction enacted by Congress is nothing more than repealing the automatic tax increases caused by inflation.

INCREASED REVENUES

The Joint Tax Committee in a 1976 report states that a 10-percent inflation rate increases Federal revenues by 12.5 percent so that the net real tax burden is 2.5 percent.

The Congressional Budget Office predicts tax inflation will generate $6 billion for the Federal Government in 1979 and $14 billion in 1980. The figures sharply rise from that point to $22 billion in 1981, $33 billion in 1982, and a whopping $45 billion for 1983. During the last 15 years the number of taxpayer forced into the 30 percent or greater tax bracket has increased 6 times.

The President in unveiling his tax proposals led the American people to believe that they could expect a generous tax cut. He stated that the cuts will "more than offset the recent increases in social security taxes."

However, what the President did not explain was that his tax cut will only keep many Americans even and only for a very short time. The President's tax plan is designed to perpetuate the seesaw syndrome of inflation tax increases followed by tax cuts. Even if the President's cuts are enacted, millions of Americans will be paying more taxes than they are now within less than 2 years.

The Tax Indexation Act of 1978 is simple. It would partially index income, estate, and gift taxes for inflation. The adjustment would be for two-thirds of the increase in the consumer price index. The President would have the authority to suspend those automatic inflation adjustments, subject to an either house congressional veto, if he finds that the adjustments will have a substantial adverse effect on the economy.

The adjustments I proposed present no insurmountable technicals problems. S. 2738 will return honesty and stability to the process of Federal tax collection.

I believe it is time to take some positive action for the American taxpayer. I am anxious to hear the comments of the witnesses and hope tax indexing will replace the worn-out policies of the past.

[From Newsweek, March 3, 1969.]

NO TAXATION WITHOUT REPRESENTATION

(By Milton Friedman)

Congress has not legislated a reduction in the personal exemption under the income tax since 1942. Yet the exemption today is only about half of what it was then. How come? In dollars, the exemption was reduced to $500 per person in 1942. It is now $600. But a dollar is not a dollar is not a dollar. Today, a dollar will buy less than half as much as a dollar would buy in 1942. Rising prices have cut nearly in half the real value of the income-tax exemption.

Inflation is not ordinarily considered to be a tax. And yet that is what it is. It is a tax twice over. It is, first, a tax on income because it lowers the real value of personal exemptions, and raises the rate applied to our incomes by pushing us into higher tax brackets. As a result, taxes go up faster than prices, which means that the government collects more in real terms.

Second, inflation is a tax on cash balances. When prices rise, all of us must add to the number of dollars we hold in order to keep the purchasing power of our cash balances constant. To get these extra dollars, we must give up some real resources, in the form of labor or of the goods we could have purchased instead—just as we must in order to get the dollars that we pay in explicit taxes. To whom do we give up the real resources? To the government from whom we get the extra dollars it prints or makes available indirectly through deposits at the Federal Reserve System; and to the banks that create book entries labeled "deposits" over and above the amount they hold as currency or as deposits at the Federal Reserve. The total of these extra dollars is the revenue from the tax on cash balances, a revenue that, under our system, is shared between government and the banks.

WHY INFLATION?

The special feature of inflation as a tax is that it is the only tax that can be levied without specific Congressional authorization. It can be and is levied by the U.S. Treasury and the Federal Reserve System on their own say-so, without announcement and without public hearings. That is what has made inflation such a tempting recourse to governments in need of funds. That is why countries that have had their ability to levy and collect explicit taxes destroyed or seriously impaired by defeat in war or by domestic disruption—and only such countries—have experienced hyperinflation that essentially wiped out the value of their money.

What can we do to end such taxation without representation?

We can end taxation of cash balances without representation by adopting a Congressional rule to limit the power of the monetary authorities. That is one reason why I have long favored a Congressional rule specifying that the money supply should be increased by a fixed percentage year in and year out. However, the main reason I favor this rule is different—to promote economic stability.

A SIMPLE REFORM

We can end the taxation of income without representation by legislating in advance that the exemptions, the maximum standard deductions, and the tax brackets under the personal income tax shall be adjusted each year for the change in the price level.

For example, start with the 1968 dollar exemptions, maximum deductions and tax brackets. As a measure of price change, the BLS cost-of-living index number. Suppose that, by this index, prices turn out to average 4 per cent higher in 1969 than in 1968. The personal exemption for 1969 would then be 104 per cent of the personal exemption for 1968 or $624 per person instead of $600. The maximum standard deduction for a single person would be $312 instead of $300. The first bracket rate of 14 per cent would apply to the first $520 for a single person instead of to the first $500, and so on down the line.

This simple and thoroughly practicable reform will not begin to solve all the defects of the income tax. But it will prevent a creeping and automatic increase in the rate of taxation as a result of inflation. It will not prevent Congress from raising or lowering income-tax rates but it will require Congress to do so openly and by explicit action.

The hearings on tax reform that are now being held will be lengthy, complex, and to judge from experience, unproductive. Here is a simple reform that requires no lengthy hearings, no extensive consideration of technical tax provisions, no attack on long-established vested interests.

Will anyone who can find any objection to enacting it at once please step forth?

[From Newsweek, April 12, 1971]

PURCHASING-POWER BONDS

(By Milton Friedman)

High-quality bonds—corporate or governmental—were long regarded as just the thing for pension funds and university endowments, as well as the cautious individual setting aside a nest egg to cushion his retirement. The past few years have shaken that image.

Suppose our cautious individual had purchased in August 1966 a $1,000 newly issued U.S. Treasury Note yielding 5¼ per cent, maturing in May 1971. In the nearly five years since, he received $250 in interest and he will shortly cash in his note for $1,000. How has he done? Since he bought the note, consumer prices have risen about 23 per cent, so it now takes about $1,250 to buy as much as $1,000 bought five years ago. The investor is back where he started from—except for interest on the interest and that would be more than balanced by income taxes on the "interest" he received. In truth, the investor had to pay for the privilege of lending money to the U.S.

That is why long-term interest rates rose so sharply in the past few years as inflation accelerated and why they have been so stubborn in coming down as inflation has been tapering off. Barnum had a point.

IF GOVERNMENT DOES NOT . . .

The government, and the government alone, is responsible for inflation. By inflation, it has expropriated the capital of persons who bought government securities—often at the urging of high officials who eloquently proclaimed that patriotism and self-interest went hand in hand.

The right way to avoid this disgraceful shell game is for the government to borrow in the form of purchasing-power securities. Let the Treasury promise to pay out $1,000 but a sum that will have the same purchasing power as $1,000 had when the security was issued. Let it pay as interest each year not a fixed number of dollars but that number adjusted for any rise in prices. This would be the precise counterpart of the escalator clauses that have become so popular in wage contracts.

Unfortunately, the Treasury has shown little interest in issuing purchasing-power securities, and Congress has brought no pressure on it do so.

Another way to achieve the same result would be for private enterprises to issue such securities. Investors would then have an effective hedge against inflation. Government could sell its securities only if it made them equally attractive.

Such securities have been issued by private enterprises in other countries but, so far as I know, not in the U.S. It is too bad we have departed from a pattern of relative price stability (major wars aside) that made such devices unnecessary. But now that we seem to have done so, market forces here too will lead private enterprises to issue purchasing-power bonds.

. . . WHY NOT PRIVATE BUSINESS

Consider a major enterprise selling a wide range of goods. If today it were to issue a twenty-year bond of the traditional kind, it would have to pay something between 7 and 8 percent, even if its credit rating is high. By committing itself to such a rate, it is gambling on the pace of inflation. If prices in general rise rapidly, so will the prices of the goods it sells. In that case, even 8 per cent will raise no problem. However, if prices in general rise slowly or not at all, its income will also rise slowly, and even 7 per cent will prove a heavy burden.

Suppose instead it were to offer a purchasing-power bond. Given the present uncertainty about inflation, such a bond would be in great demand. Very likely, the corporation could sell the bond at a 3 per cent *real* rate (i.e., for a promise to pay $3 per $100 adjusted for the rate of inflation) instead of a 7 to 8 per cent *nominal* rate.

Both the corporation and the investor would be hedged against inflation. If prices rise rapidly, the corporation will indeed have to pay back a higher dollar total when the bonds mature—but it will be able to do so because its sales and its capital value will also be higher in dollar terms. If prices rise slowly, it will have lower dollar sales and capital values—but also a smaller debt to repay.

Corporations that issued such securities would benefit themselves—by borrowing at a lower average rate and by eliminating uncertainty. Purchasers of the securities would benefit—they would be protected against unanticipated inflation or deflation. We could all benefit—the reduced uncertainty about interest costs would encourage a steadier stream of capital expenditures by business, thereby contributing to a stabler economy.

[From Newsweek, January 21, 1974.]

ECONOMIC MIRACLES

(By Milton Friedman)

I have just returned from a brief visit to Brazil, the third major nation in recent history to take off on a period of growth so rapid as to justify the term "economic miracle." The explosion is obvious even to the casual visitor. The cars that jam the streets of Sao Paulo and Rio are almost all new; multistory buildings, both new and still under construction, crowd the sky; cranes are almost as numerous as TV antennas, and the air of bustle and hustle is

unmistakably different from the pre-Christmas shopping rush. Many of the men in responsible positions are surprisingly young; clearly a new generation is taking charge. Their confidence, pride and high expectations are seasoned with just a tinge of uneasiness about the future. "Will it really last?" is a question that no one asks yet that all seem to have at the back of their minds.

The Brazilian miracle dates from 1967, when output started growing at an average rate of approximately 10 per cent a year. The other miracles, in Germany and Japan, started nearly two decades earlier, shortly after the end of World War II. Though the three countries differ greatly in history, culture, resources and technological sophistication, there are striking similarities among the three miracles.

THE SIMILARITIES

1. All three miracles were preceded by a period of economic disorganization that was produced or intensified by price and wage controls imposed to suppress inflation.

In Germany and Japan, a productive capacity diminished by war and defeat faced a money supply swollen by war-time spending and postwar fiscal collapse. Wartime price and wage controls were continued by the occupation authorities who enforced them far more rigorously than a native police force could ever have done. The result was economic collapse.

In Brazil, political instability in the late '50s and early '60s produced large government deficits financed by a rapid increase in the quantity of money. Inflation reached a rate of more than 100 per cent a year by early 1964. The government attempted to suppress the inflation by measures such as fixing prices and wages, controlling foreign-exchange transactions and introducing multiple exchange rates. As in Germany and Japan, the controls produced widespread waste, inefficiency and black markets.

2. All three miracles were made possible by monetary reforms that ended most government controls over prices and wages and thereby permitted a market-price system to operate.

In Germany and Japan, the prior economic collapse had been so extreme that the reforms, drastic though they were, were followed almost immediately by recovery and expansion.

In Brazil, where the prior collapse was much less extreme, a "tight" money policy that reduced the rate of inflation from more than 100 per cent to about 30 per cent in three years was accompanied by recession and increased unemployment. However, after the initial shock was absorbed, the freeing of markets plus political stability unleashed unsuspected dynamic forces.

MONETARY CORRECTION

3. All three miracles relied primarily on private enterprise for their motive power.

In all three countries, government intervened extensively—subsidizing here, taxing there, building roads, ports and similar facilities, taking over part or all of selected industries. Yet these measures, though highly visible, were the trimming on the cake, not the cake itself. I believe that most of them did more harm than good. The government served best when it interfered least with the driving force of private enterprise coordinated by market prices.

The one major difference among the policies that fostered the three miracles is the tactic adopted to permit the price system to operate.

Germany and Japan followed a monetary policy that, until very recently, all but eliminated inflation. They were therefore under no pressure to control prices and wages and could let the price system operate freely.

Brazil followed a different course. After reducing inflation to about 30 per cent per year by 1967, it eased off. Simultaneously, however, it introduced purchasing-power escalator clauses into a wide range of contracts. The term used in Brazil is "monetary correction." If a Brazilian deposits money in a savings bank, the bank not only will pay him a stated interest rate, say 5 per cent, but also will periodically credit his account with a monetary correction equal to the rate of inflation over the period. Longer-term business loans, government securities, mortgages, and so on are handled the same way: the borrower pays the lender a stated rate plus a monetary correction.

All wage rates are subject to mandatory adjustment by a similar monetary correction—though in fact most wages have been rising much faster than that.

The personal exemptions under the income tax and the tax brackets are adjusted by a monetary correction. So also is the value of fixed business assets for purposes of calculating depreciation allowed under the tax laws. The exchange rate is adjusted frequently to allow for inflation. And so on and on.

The use of the monetary correction in some of these ways is mandated by law; in others, it is voluntary. In practice, its use is sufficiently widespread to remove most of the pressure for price and wage controls.

The monetary correction is an accounting nuisance and it cannot be truly universal. A world of zero inflation would obviously be better. Yet, given the inevitable, if temporary, costs of reducing inflation rapidly without such a measure, the Brazilians have been extremely wise to adopt it. I believe that their miracle would have been impossible without the monetary correction. With it, they have been able to reduce inflation gradually from about 30 per cent in 1967 to about 15 per cent now without inhibiting rapid growth, and they may be able to succeed in gradually bringing inflation down to near zero. With it, they currently experience less economic distortion from a 15 per cent inflation than the U.S., without it, experiences from a 9 per cent inflation.

A TRUE "SECOND BEST"

Even the most ardent defenders of price and wage controls regard them as at most a "second best," as an expedient to avoid still worse problems. The three major economic miracles—as well as many less dramatic episodes—teach that they are rather a "first worst," a cancer that can destroy an economic system's capacity to function.

The widespread use of purchasing-power escalator clauses as a remedy "for fluctuations of general prices" was proposed by the great British economist Alfred Marshall as long ago as 1887. The Brazilian experience parallels Marshall's proposal with amazing fidelity—by the force of necessity, not design. Theory and practice coincide in demonstrating that a true second best for living with inflation is the widespread use of purchasing-power escalator clauses. It is past time that the U.S. applied the lesson.

[From Fortune Magazine, July 1974.]

USING ESCALATORS TO HELP FIGHT INFLATION

(By Milton Friedman)

The season's most misunderstood economist is Milton Friedman of the University of Chicago. The leading American economist generally identified as a conservative, he has stirred considerable puzzlement by coming out for "indexation." To some observers, it seems that Professor Friedman is advocating acceptance of perpetual inflation. In this article, he argues that, on the contrary, indexation would strengthen *the ability of government to deal with inflation.*

The real obstacles to ending inflation are political, not economic. Ending inflation would deprive government of revenue that it now obtains without legislation. Ending inflation would also produce a temporary, though perhaps fairly protracted, period of recession or slowdown and relatively high unemployment.

These obstacles to ending inflation can be substantially reduced through what has come to be called "indexation"—the widespread use of price-escalator clauses in private and governmental contracts. Such arrangements are not a good thing in and of themselves. They are simply a lesser evil than a badly managed money. The widespread use of escalator clauses would not by itself either increase or decrease the rate of inflation. But it would reduce the revenue—which means that government would have less incentive to inflate. More important, it would reduce the adverse side effects that effective measures to end inflation would have on output and employment.

From time immemorial, the major source of inflation has been the sovereign's attempt to acquire resources to wage war, to construct monuments, or for other purposes. Inflation has been irresistably attractive to sovereigns because it is a hidden tax that at first appears painless or even pleasant, and above all because it is a tax that can be imposed without specific legislation. It is truly taxation without representation.

The revenue yield from inflation takes three major forms:

Additional fiat money. Since ancient times, sovereigns have debased coinage by replacing silver or gold with base metals. (Current examples include U.S. dimes and quarters, formerly silver but now copper coated with a nickel alloy.) Later, paper currency supplemented token coins. More recently still, book entries at central banks (misleadingly called deposits) have been added to the repertory. Governments use the fiat money they issue to finance expenditures or repay debts. In addition, the fiat money serves as a base on which the banking system creates additional money in the form of bank deposits. In calendar 1973, the U.S. government realized around $8 billion from these sources.

Windfall tax yield. Inflation increases the yield of the personal and corporate income tax by pushing individuals into higher income brackets; generating paper capital gains on which taxes must be paid; and rendering depreciation allowances inadequate to replace capital, so that a return of capital is taxed as if it were a return on capital. Estimates by the economist George Terborgh of the effect of inflation on the reported profits of nonfinancial corporations imply that the inflation yield from the corporate tax alone amounted to nearly $13 billion in 1973.

Reduction in the real amount of outstanding debt. Much of the federal government's debt was issued at yields that did not allow for current rates of inflation. On a conservative estimate, the government must have realized in 1973 something like $5 billion from this source.

All told, then, the government's revenue from inflation came to more than $25 billion in 1973. Ending inflation would end these sources of revenue. Government would have to reduce expenditures, increase explicit taxes, or borrow additional funds from the public at whatever interest rate would clear the market. None of these courses is politically attractive.

An even more serious political obstacle to ending inflation is the reluctance of the public to tolerate the transitory rise in unemployment that ending inflation would currently entail. To avoid misunderstanding, let me stress that I am not saying an increase in unemployment is a cure for inflation. It is not. There are many ways to increase unemployment that would exacerbate rather than cure inflation. I am saying something very different: that unemployment is today an inevitable *side effect* of cuing inflation—just as the need to stay in bed is a side effect of a successful operation for appendicitis but is not itself a cure.

Ending inflation requires a slowing down in the growth rate of total dollar spending. In my opinion, a reduction in the growth rate of the quantity of money is the only reliable instrument available to government for slowing down the growth rate of total dollar spending. But what follows is independent of that proposition. If there is some other way to slow spending growth, the side effects will be essenitally the same. Hence this analysis of side effects of ending inflation is relevant even if you do not accept my monetarist view.

THE LONG LAG IN EXPECTATIONS

When total spending slows down, each producer separately tends to regard the reduction in the demand for his product as special to him, and to hope that it is temporary. He is inclined to meet it primarily by reducing output or accumulating inventory, not by shading prices. Only after a time lag will he start to shade prices. Similarly, any of his workers who are laid off are likely to react by waiting to be recalled or by seeking jobs elsewhere, not by moderating wage demands or expectations.

A slowdown in total spending will therefore tend to be reflected initially in a widespread slowdown in output and employment and an increase in inventories. It will take some time before these lead in turn to widespread reductions in the rate of increase in prices and the rate of increase in wages. It will take still more time before *expectations* about inflation are revised and the revised expectations encourage a resumption of employment and output.

Different activities, moreover, have different speeds of adjustment. Some prices, wages, and production schedules are fixed a long time in advance; others can be adjusted promptly. Accordingly, a slowdown of total spending produces substantial shifts in *relative* prices, which will sooner or later have to be corrected. The corrections, in turn, cause economic disturbances.

For the U.S. the time delay between a change in the rate of monetary growth and a corresponding change in the rate of growth of total spending and total output has averaged six to nine months. The further delay until a braking effect on prices is evident has averaged twelve to eighteen months. Accordingly, the total delay between a change in monetary growth and a change in the rate of inflation comes to about two years.

AN OPPORTUNITY CAST ASIDE

After inflation has continued for a time, inflationary expectations are reflected in interest rates, union contracts, and other long-term arrangements. Then a drop in the inflation rate imposes severe strains and hardships. The employer who granted very large wage increases in the expectation of continued inflation finds his real wage costs higher than he bargained for. The borrower who agreed to pay a very high interest rate finds his real borrowing cost higher than he expected. For example, a home-owner who took out a mortgage at 10 percent would be in a bad fix if the prevailing rate dropped to 5 percent, while the lender on that 10 percent mortgage would have received a bonanza.

Such side effects constitute, I believe, the most important political obstacle to ending inflation, given the commitment on the part of most modern governments to "full employment," the failure of the public at large to recognize the inevitable if temporary side effects of ending inflation, and the unwillingness or inability of political leaders to persuade the public to accept these side effects.

Some years back, when the rate of inflation was much lower than now, I believed that the readjustment required was sufficiently mild and brief to be politically feasible. But, unfortunately, the opportunity was cast aside on August 15, 1971, when President Nixon reversed economic policy by imposing a price and wage freeze and encouraging expansive monetary and fiscal policy.

A MASOCHISTIC EXERCISE

At the time, we were well on our way to ending inflation without severe side effects. At the cost of the mild 1970 recession, the annual rate of inflation had been reduced from over 6 percent to 4.5 percent and was still declining. The economy was slowly recovering from that recession. Had the nation had the will—for President Nixon was reflecting a widespread national consensus when he reversed policy—another year of continued monetary restraint and of slow expansion would probably have turned the trick. As it was, the 1970 recession was a masochistic exercise rather than a side effect of a successful cure.

As everyone certainly knows, inflation is now far worse than in August, 1971. The very high rate in the first half of 1974 was doubtless a temporary bubble, but even on the most optimistic view, inflation is not likely to fall below 6 percent during the next twelve months. Starting from that level, and with inflationary expectations ever more deeply entrenched, an effective policy to end inflation would entail as a side effect a considerably more severe and protracted recession than we experienced in 1970. The political will to accept such a recession, without reversing policy and restimulating inflation, is simply not present.

What then? If we do nothing, we shall suffer ever higher rates of inflation—not continuously, but in spurts as we over-react to temporary recessions. Sooner or later, the public will get fed up, will demand effective action, and we shall then have a really severe recession.

How can we make it politically feasible to end inflation much sooner? As I see it, only by adopting measures that will reduce the side effects from ending inflation. These side effects fundamentally reflect distortions introduced into *relative* prices by *unanticipated* inflation or deflation, distortions that arise because contracts are entered into under mistaken perceptions about the likely course of inflation. The way to reduce these side effects is to make contracts with prices, wages, or interest rates stipulated in *real* terms, not nominal terms. This can be done through the widespread use of escalator clauses.

Indexation is not a panacea. It is impossible to escalate all contracts (consider, for example, currency in circulation), and widespread escalation would be cumbersome. A great advantage of using money is precisely the ability to

carry on transactions cheaply and efficiently, and universal escalator clauses reduce this advantage. Far better to have no inflation and no escalator clauses. But that alternative is not now available.

AN IDEA WITH ANCESTORS

Let me note also that the use of escalator clauses is not a new idea or an untried idea. It dates back to at least 1707, when a Cambridge don, William Fleetwood, estimated the change in prices over a six-hundred-year period in order to get comparable limits on outside income that holders of fellowships should be permitted to receive. The use of escalator clauses was explicitly suggested a hundred years later by an English writer on money, John Wheatley. In 1886 the concept was spelled out in considerable detail, and enthusiastically recommended, by the great English economist Alfred Marshall.

The great American economist Irving Fisher not only favored the "tabular standard"—as the proposal for indexation was labeled nearly two centuries ago—but also persuaded a manufacturing company that he had helped to found to issue a purchasing-power security as long ago as 1925. Interest in the tabular standard was the major factor accounting for the development of index numbers of prices. In recent years, indexation, as the tabular standard is now called, has been adopted by Brazil on a wider scale than I would recommend for the U.S. It has been adopted on a lesser scale by Canada, Israel, and several other countries.

ABOLISHING HIDDEN TAX INCREASES

For the U.S., my specific proposal has two parts, one for the federal government, one for the rest of the economy. For the federal government, I propose that escalator clauses be legislated; for the rest of the economy, that they be voluntary, but that any legal obstacles be removed. The question of which index number to use in escalator clauses is important but not critical. As Alfred Marshall said in 1886, "A perfectly exact measure of purchasing power is not only unattainable, but even unthinkable." For convenience, I would use the cost-of-living index number calculated by the Bureau of Labor

The U.S. government has already adopted escalation for social-security payments, retirement benefits to federal employees, wages of post-office employees, and perhaps some other items. Taxes that are expressed as fixed percentages of price or other value base are automatically escalated. The government should now proceed to adopt escalator clauses in the personal and corporate income tax and in government securities. (The following proposed revisions in the federal government's taxing and borrowing arrangements are contained in a pending bill introduced by U.S. Senator James Buckley of New York.)

The personal income tax

Minor details aside, four changes are called for:

The personal exemption, the standard deduction, and the low-income allowance should be expressed not as a given number of dollars, but as a given number of dollars multiplied by the ratio of a price index for the year in question to the index for the base year in which indexation starts. For example, if in the first year prices rise by 10 percent, the base amounts should be multiplied by 1.10.

The brackets in the tax tables should be adjusted similarly, so that, in the example given, $0–500 would become $0–550, and so on.

The base for calculating capital gains should be multiplied by the ratio of the price index in the year of sale to the price index in the year of purchase. This would prevent the taxing of purely paper capital gains.

The base for calculating depreciation on fixed capital assets should be adjusted in the same way.

The corporate tax

The present $25.000 dividing line between normal tax and surtax should be replaced by that sum multiplied by a price index number.

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

The bases for calculating capital gains and depreciation of fixed capital assets should be adjusted as for the individual income tax.

Government securities

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

THE ETHICAL ASPECT

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

As a result largely of inflation produced by government, personal income taxes are today heavier than during the peak of World War II financing, despite several legislated "reductions" in tax rates. Personal exemptions in real terms are at an all-time low. The taxes levied on persons in different economic circumstances deviate widely from the taxes Congress explicitly intended to levy on them. Congress has been in the enviable position of actually imposing higher taxes while appearing to reduce taxes.

As for government borrowing, the savings-bond campaigns of the Treasury have been the largest bucket-shop operation ever engaged in. This is not a recent development. In 1951, in responding to a questionnaire of the Joint Economic Committee of Congress, I wrote:

"I strongly favor the issuance of a purchasing-power bond on two grounds: (*a*) It would provide a means of lower- and middle-income groups to protect their capital against the ravages of inflation. These groups have almost no effective means of doing so now. It seems to me equitable and socially desirable that they should. (*b*) It would permit the Treasury to sell bonds without engaging in advertising and promotion that at best is highly misleading, at worst, close to being downright immoral. The Treasury urges people to buy bonds as a means of securing their future. Is the implicit promise one that it can make in good faith, in light of past experience of purchasers of such bonds who have seen their purchasing power eaten away by price rises? If it can be, there is no cost involved in making the promise explicit by adding a purchasing-power guaranty. If it cannot be, it seems to me intolerable that an agency of the public deliberately mislead the public."

Surely the experience of the nearly quarter century since these words were written reinforces their pertinence. Essentially every purchaser of savings bonds (or, indeed, almost any other long-term Treasury security) during that period has paid for the privilege of lending to the government. The supposed "interest" he has received has not compensated for the decline in the purchasing power of the principal, and, too add insult to injury, he has had to pay tax on the paper interest. And the inflation that has sheared the innocent lambs has been produced by the government that benefits from the shearing!

It is a mystery to me, and a depressing commentary on either the understanding or the sense of social responsibility of businessmen (note that I say of *businessmen*, not of business), that year after year eminent and honorable business leaders have been willing to participate in this bucket-shop operation by joining committees to promote the sale of U.S. savings bonds, or by providing facilities for payroll deductions for that purpose.

Private use of escalator clauses is an expedient that has no permanent role if government manages money responsibly. Hence I favor keeping such private use voluntary in order to promote its self-destruction if that happy time arrives.

No legislation is needed for the private adoption of escalator clauses, and such clauses are now widespread. More than five million workers are covered by union contracts with automatic escalator clauses, and there must be many non-union workers who have similar implicit or explicit agreements with their employers. Many contracts for future delivery of products contain provisions for adjustment of the final selling price either for specific changes in costs or for general price changes. A great many rental contracts for business premises

are expressed as a percentage of gross or net receipts, which means that they have an implicit escalator clause. This is equally true for percentage royalty payments and for automobile-insurance policies that pay the cost of repairing actual damage. Some insurance companies issue fire-insurance policies under which the face value is automatically adjusted for inflation. No doubt there are many more examples of which I am ignorant.

It is highly desirable that the practice of incorporating escalator clauses be extended to a far wider range of wage agreements, contracts for future delivery of products, and financial transactions involving borrowing and lending. The first two are entirely straightforward extensions of existing practices. The third is more novel.

HEDGED BOTH WAYS

The arrangements suggested for government borrowing could apply equally to long-term borrowing by private enterprises. Instead of issuing a security promising to pay, say, interest of 9 percent per year and to repay $1,000 at the end of ten year, XYZ Corp. could promise to pay 3 percent plus the rate of inflation each year, and to repay $1,000 at the end of ten years. Alternatively, it could promise to pay each year 3 percent times the ratio of the price index in that year to the price index in the year the security was issued, and to repay at the end of ten years $1,000 times the corresponding price ratio for the tenth year.

One question has invariably been raised when I have discussed this kind of arrangement with corporate executives: "Is it not too risky for us to undertake an open-ended commitment? At least with fixed nominal rates we know what our obligations are." This is a natural query from businessmen reared in an environment in which a roughly stable price level was taken for granted. But in a world of varying rates of inflation, the fixed-rate agreement is the riskier agreement. The dollar reecipts of most businesses vary with inflation. If inflation is high, dollar receipts are high, and business can afford to pay the escalated rate of interest. If inflation is low, dollar receipts are low, and they will find it easier to pay the low rate with the adjustment for inflation than a fixed but high rate. And similarly at the time of redemption.

What is crucial is the relation between assets and liabilities. For many enterprises, their assets, including goodwill, are real in the sense that the dollar value will rise or fall with the general price level. But their liabilities tend to be nominal, i.e., fixed in dollar terms. Accordingly, these enterprises benefit from inflation at a higher rate than was anticipated when the nominal liabilities were acquired, and they are harmed by inflation at a lower rate than was anticipated. Match assets and liabilities, and such enterprises would be hedged against either event.

A related yet somewhat different case is provided by financial intermediaries. Consider savings-and-loan associations and mutual-savings banks. Both their assets (primarily home mortgages) and their liabilities (due to shareholders or depositors) are expressed in nominal terms. But they differ in time duration. The liabilities are in practice due on demand; the assets are long term. The mortgages now in the portfolios were mostly issued when inflation and therefore interest rates were much lower. If the mortgages were revalued at current yields—i.e., at the market prices they could be sold for in a free secondary market—every savings-and-loan association would be technically insolvent.

THE DISINTERMEDIATION MENACE

So long as the thrift institutions can maintain their level of deposits, no problem arises because they do not have to liquidate their assets. But if inflation speeds up, interest rates on market instruments will rise further. Unless the thrift institutions offer competitive interest rates, their shareholders or depositors will withdraw funds to get a better yield (the process inelegantly termed disintermediation). But with their income fixed, the thrift institutions will find it difficult or impossible to pay competitive rates. (This situation is concealed but not altered by the legal limits on the rates they are permitted to pay.)

Further acceleration of inflation threatens a major crisis for this group of financial institutions. And the crisis is no minor matter. Total assets of these institutions approach $400 billion. As it happens, they would be greatly helped

by a deceleration of inflation, but some of their recent borrowers who are locked into high rates on mortgages would be seriously hurt.

Consider how different the situation of the thrift institutions would be with widespread escalator clauses. The mortgages on their books would be yielding, say, 5 percent plus the rate of inflation; they could afford to pay their shareholders or depositors 3 or 4 percent plus the rate of inflation (assuming that legal limits were removed or modified). They, their borrowers, and their shareholders or depositors would be fully protected against changes in the rate of inflation.

Similarly, an insurance company could afford to offer an inflation-protected policy if its assets were in inflation-protected loans to business or mortgages or government securities. A pension fund could offer inflation-protected pensions if it held inflation-protected assets.

A TEMPERING OF HARDSHIPS

To repeat, none of these arrangements is without cost. It would be far better if stable prices made them unnecessary. But they seem to me far less costly than continuing on the road to periodic acceleration of inflation, ending in a real bust.

Note that the suggested governmental arrangements will stimulate the private arrangements. Today one deterrent to issuance of private purchasing-power securities is that the inflation adjustment would be taxable to the recipient along with the real interest paid. The proposed tax changes would in effect exempt such adjustments from taxation, and so make purchasing-power securities more attractive to lenders. In addition, government issuance of purchasing-power securities would offer effective competition to private borrowers, inducing them to follow suit.

How would widespread adoption of the escalator principle affect economic policy? Some critics say that indexation would condemn us to perpetual inflation. I believe that, on the contrary, indexation would enhance the government's ability to act against inflation.

To begin with, indexation will temper some of the hardships and distortions that now follow from a drop in the rate of inflation. Employers will not be stuck with excessively high wage increases under existing union contracts, for wage increases will moderate as inflation recedes. Borrowers will not be stuck with excessively high interest costs, for the rates on outstanding loans will moderate as inflation recedes. Indexation will also partly counteract the tendency of businesses to defer capital investment once total spending begins to decline—there will be less reason to wait in expectation of lower prices and lower interest rates. Businesses will be able to borrow funds or enter into construction contracts knowing that interest rates and contract prices can be adjusted later on in accord with indexes of prices.

STEELING THE POLITICAL WILL

Most important, indexation will shorten the time it takes for a reduction in the rate of growth of total spending to have its full effect in reducing the rate of inflation. As the deceleration of demand pinches at various points in the economy, any effects on prices will be promptly transmitted to wage contracts, to contracts for future delivery, and to interest rates on outstanding long-term loans. Accordingly, producers' wage costs and other costs will go up less rapidly than they would without indexation. This tempering of costs, in turn, will encourage employers to keep more people on the payroll, and produce more goods, than they would without indexation. The encouragement of supply, in turn, will work against price increases, with additional moderating feedback on wages and other costs.

With widespread indexation, in sum, firm monetary restraint by the Federal Reserve System would be reflected in a much more even reduction in the pace of inflation and a much smaller transitory rise in unemployment. The success in slowing inflation would steel the political will to suffer the smaller withdrawal pains, and so might make it possible for the Fed to persist in a firm policy. As it became credible that the Fed would persist, private reactions could reinforce the effects of its policy. The economy would move to noninflationary growth or high levels of employment much more rapidly than now seems possible.

The major objection to indexation is the allegation that escalators have an inflationary impact on the economy. In this form, the statement is simply false. An escalator goes into effect only as the result of a prior price increase. Whence came that? An escalator can go down as well as up. If inflation slows, and hence so do wage increases, do escalators have a deflationary impact?

Escalators have no direct effect on the rate of inflation. They simply assure that inflation affects different prices and wages alike, and thus they moderate distortions in relative prices and wages. With widespread use of escalators, inflation will be *transmitted* more quickly and evenly, and hence the harm done by inflation will be less. But why should that raise or lower the rate of inflation?

On a more sophisticated level, it has been argued that by reducing the revenue yield from any given rate of inflation, indexation would induct the government to speed up the rate of inflation in order to recoup the lost revenue. Furthermore, it has been suggested that the general public would interpret the adoption of escalator clauses to mean the government has given up the fight against inflation, and is seeking only to live with it—which in turn would reinforce inflationary expectations. To me, these objections do not seem weighty. If the public does not wish to stop inflation, but is content to have the government use inflation as a regular source of revenue, the sooner we adapt our institutions to that fact the better.

A BENEFICIAL TRADE-OFF

On a still more sophisticated level, it can be argued that, by removing distortions in relative prices, indexation will make it easier for the public to recognize changes in the rate of inflation, will thereby reduce the time lag in adapting to such changes, and so will make the nominal price level more sensitive and variable. It is certainly possible that indexation would have this effect, though it is by no means demonstrated. But if so, the *real variables* would be less sensitive and more stable—a highly beneficial trade-off. Moreover, it is also possible that by making accurate estimates of the rate of inflation less important, indexation will reduce the attention devoted to such estimates, and thereby provide greater stability.

An objection of a very different kind is that inflation serves the critical social purpose of resolving incompatible demands by different groups. In this view, the participants in the economy, to put it crudely, have "non-negotiable demands" for more than the entire output. These demands are reconciled because inflation fools people into believing that their demands have been met when in fact they have not been. Escalator clauses, it is argued, would bring the inconsistent demands into the open. Workers who would accept a lower real wage produced by unanticipated inflation will not be willing to accept the same real wage in explicit negotiations. If this view is correct on a wide enough scale to be important, I see no other ultimate outcome than either runaway inflation or an authoritarian society ruled by force. Perhaps it is only wishful thinking that makes me reluctant to accept this vision of our fate.

A MAJOR SOURCE OF UNREST

The conventional political wisdom holds that the citizenry may utter about inflation but votes on the basis of the level of unemployment. Nobody, it is said, has ever lost an election because of inflation; Hoover in 1932 and Nixon in 1960 lost because of unemployment. But as we leave the Depression decade further and further behind, and as we experience more and more inflation, this conventional wisdom becomes increasingly questionable. Edward Heath surely lost an election because of inflation. Prime Minister Tanaka's popularity is at an all-time low because of inflation. Throughout the world, inflation is a major source of political unrest.

Perhaps indexation is not the best expedient in this time of trouble. But I know of no other that holds out as much promise of both reducing the harm done by inflation and facilitating the ending of inflation. If inflation continues to accelerate, the conventional political wisdom will be reversed. The insistence on ending inflation at whatever cost will lead to a severe depression. Now, before that has occurred, is the time to take measures that will make it politically feasible to end inflation before inflation ends not only the conventional wisdom but perhaps also a free society.

Senator BYRD. Before you leave, could I ask the two Congressmen and Senator Griffin, in regards to section 4 which grants Presidential authority to suspend the indexing adjustment, do you have any feeling either way on that? Senator Buckley has expressed his views.

Representative GRADISON. I concur, Mr. Chairman, in the views of Senator Buckley on that point.

Representative CRANE. I share that same position. I think that there is a concession of power to the President, because of this phenomenon of the increased revenues deriving from inflation. This is a grant of power that is, in fact, unconstitutional.

Senator GRIFFIN. I do not have strong feelings on it at the moment, Mr. Chairman. I think it is an aspect of this bill which you ought to take a very close look at.

Senator BYRD. I think the emphasis which has been placed this morning on inflation and the effect that it is having on the American people is most worthwhile. I think the public, the grassroots are far ahead of Washington in recognizing this problem. I think the administration is taking an awful long time in recognizing it.

In recognizing it, I could not find that there was a great deal in the President's speech that would do much about inflation, if anything. No mention was made of a 10-percent increase in the cost of Government. That is double-digit inflation right there.

The Federal funds budget and the current budget that the Congress is working on now will be the highest in the history of the country and the Federal funds deficit for 1978 and 1979 combined will be greater than the total cost of Government in 1965. So I do not see that this administration is doing very much to get inflation under control, and yet the Gallup Poll today reiterated that it reported some time ago, that the public, by a 9 to 1 ratio, would favor controlling inflation to a reduction in taxes.

And, in a sense, I guess that is what the concept of this bill, at least, would attempt to do, to focus upon inflation and give the taxpayer some break if inflation is to continue.

Thank you, gentlemen, very much.

Senator GRIFFIN. The only thing I would say, Mr. Chairman, instead of giving him a tax reduction, this does not do that. It merely keeps him at the same place, so that he does not have his taxes increased by the effective tax rate. The purpose of this would be just to keep him in the same tax position that he is.

Senator BYRD. Thank you, sir.

[The prepared statement of Mr. Buckley follows:]

STATEMENT BY JAMES L. BUCKLEY

Mr. Chairman, I very much appreciate this opportunity to testify in support of tax indexation in general, and Senator Dole's Tax Indexation Act of 1978 (S. 2738) in particular. To my mind this is the most important structural tax reform on the agenda, and I want to compliment Senators Dole and Roth for their leadership in urging its adoption by this Committee.

At the outset, I think it important to recognize that indexation does not attempt a radical departure from traditional concepts of income taxation. Rather, its purpose is simply to protect our tax system against the unanticipated distortions and inequities caused by inflation. What it does to insure that the real income of taxpayers will be taxed at the rates Congress originally intended, and no more; and it accomplishes this automatically through the

simple expedient of typing key provisions of the income tax code to the Consumer Price Index.

It should be remembered that during most of our experience since the adoption of the 16th Amendment, we have enjoyed a remarkable degree of price stability. Until just the past dozen years, the dollar could still be called "as good as gold"; and the phrase, "sound as the dollar", expressed an internationaly accepted fact. It therefore never occurred to those who drafted our basic tax laws that high rates of inflation could have the effect of doubling and tripling the effective rate of taxation on individuals in the lower tax brackets, or that capital gains taxes could in practice be converted into capital levies.

As a matter of fact, as recently as 1974, when I first introduced legislation to index our tax code, many members of the Senate found it difficult to fully understand the mechanics by which inflation ratcheted taxpayers in higher rates of taxation even though their real income, as measured by purchasing power, remained the same. Today, however, it is hard to find an article on taxation and tax reform that doesn't recognize the major inequities that result from what is now sometimes referred to as "taxflation."

By way of example to illustrate the impact of inflation on the real rate of taxation, let us take the case of an individual earning $10,000 per year in 1978, and assume that inflation will average 7 percent per year over the next ten years. If that taxpayer receives cost-of-living pay increases which keep pace with inflation, his income would be $20,000 in 1988. Yet, that $10,000 increase in income would not enable him to buy any more than he could today. In fact, his income would have less purchasing power because he would have to pay over a higher percentage of his earnings to Uncle Sam.

Assuming our taxpayer is the head of a typical family of four, he would be required to pay approximately 6 percent of his 1978 earnings in federal income tax. However, because inflation would have the effect of lifting him into ever higher tax brackets, by 1988 he would be required to pay over 13 percent of his earnings to the Federal Government. Thus, although his real income in terms of purchasing power remained unchanged, his increase in "money" income would cause him to pay more than twice as much in taxes.

By way of contrast, to demonstrate that tax inflation has its harshest impact on those in low to middle income brackets, an individual whose $100,000 income is doubled to $200,000 over the next ten years would have his taxes increased by less than one-fourth—from 43 percent to 54 percent.

Similar distortions and inequities occur in the case of capital gains, where the impact of inflation on nominal profits can be especially harsh.

Let's take a typical example of a young couple who bought a home in 1952 for $25,000 in order to accommodate a growing family. Twenty-five years later, their children having grown, the couple sell their home for $60,000 and move into a small apartment. Even though the real value of their house declined somewhat during the intervening years, they were nevertheless required to pay a tax on a nominal gain of $35,000. Assuming a rate of 20 percent, this represents a $7,000 capital levy that surely the Congress never intended. This is a situation that faces tens of millions of Americans as the time comes for them to dispose of what is likely to be by far their most important investment, their homes.

I would call the Committee's attention to a recent study detailing the extent to which excessive taxes are collected on often fictitious gains realized on the sale of common stocks. It was prepared by Martin Feldstein and Joel Slemrod, of Harvard University, on behalf of the National Bureau of Economic Research. Based on an analysis of information on 1973 individual income tax returns recently released by the Treasury Department, the authors conclude that "in 1973 individuals paid nearly $500 million in excess tax on capital stock capital gains because of the distorting effect of inflation." This finding understates the full amount of the excess taxes actually collected that year because the study did not include partnership or fiduciary returns.

The Feldstein-Slemrod study is particularly illuminating in what it tells us of the uneven impact of taxflation on different income groups, and between individuals reporting the same real gains. Whereas taxpayers with adjusted gross incomes below $50,000 suffered a real loss of $3.056 billion, they were nevertheless required to pay Uncle Sam an additional $99 million for the

privilege of selling their shares. Those having adjusted gross incomes of $50,000 and more, on the other hand, realized $2.146 billion in real gains on which they paid $1.039 billion in taxes, which represented an effective tax rate of 48 percent. The authors also point to a very wide spread of taxation on the same amount of real capital gains. Quite obviously, the longer the shares were held, the greater the purely nominal gain attributable to inflation and the greater the tax.

The impact of inflation on capital gains taxation goes beyond the inequities and distortions I have described. It amplifies the disincentives to the sale of and reinvestment in corporate securities that have now reached very serious proportions. The adoption of this feature of the Dole bill—the indexation of the tax base for capital assets—would be a major step in reversing the alarming decline of investment in the newer, innovative companies which hold the greatest promise for job creation and the preservation of American technological preeminence.

There is no tax reform that is more important to achieve, easier to accomplish, and fairer in its impact than income tax indexation. Government must not be allowed to profit by the inflation it creates. According to a recent article in Harper's Magazine,[1] government revenues rise at 1.65 times the rate of inflation. That 65 percent spread is what federal spenders like to refer to as "the inflation bonus"—a euphemism for a windfall profit that government extracts from the hides of the taxpayers least able to afford it.

Tax indexation would require the Congress to show the political courage to vote for the tax increases required to finance the new programs and expanded budgets that it authorizes, which no doubt is one of the unspoken reasons why the idea of indexation has met with such resistance.

Some opponents argue that indexing is itself inflationary. This is nonsense. Nor does it imply a willingness to live with inflation. On the contrary, because it eliminates the so-called inflation bonus, it removes a major temptation for excessive federal spending, which is the root source of inflation. Inflation should be fought not by increasing the tax bite on lower income Americans, but by adopting the appropriate fiscal and monetary policies. In the meantime, Congress has the duty to protect citizens against such of the consequences of inflation as it reasonably can. Indexing the tax system is the most obvious, the fairest way to accomplish this.

President Carter's tax proposals—that is to say, the most recent of them—underscores the need for indexation. Enactment of the President's recommendations will result in tax cuts for lower income citizens, but only temporarily; because all too soon, inflation will be ratcheting their nominal incomes into tax brackets that will lease them worse off than before. The Congressional Budget Office estimates that the government's inflation windfall will reach $45 billion by 1983. The President's tax proposals would barely make a dent in that figure.

Yes, indexation is what is needed; and S. 2738 points the way. The bill goes far beyond indexing the tax rate tables. It will protect the integrity of the most important sections of the tax code, such as the personal exemption, the corporate surtax, the gift exclusion, the child care tax credit, and a host of others, all of which would be automatically adjusted to offset the effects of inflation.

Many of these sections have substantial impacts on that group of our society that is the most vulnerable to inflation, namely the elderly. Pensions paid under private plans cannot provide for cost-of-living increases. Therefore, indexing such items as the tax credit for the elderly and the exempt amount on home sales are particularly important in restoring tax equity for this group.

The bill provides for increases in allowable contributions to Individual Retirement Accounts and Keogh Plans. It recognizes the importance of protecting existing tax incentives for individuals to plan for their own retirements. If inflation continues at present rates, the current limit on IRA contributions will soon prove grossly inadequate.

The Dole bill also recognizes the importance of protecting the business community against inflation-induced changes that distort or nullify the tax rates and incentives intended by Congress. Thus this bill will index the corporate

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[1] "Disguising the Tax Burden," by Paul Craig Roberts. Harper's/March, 1978.

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surtax, the investment tax credit, and the tax basis of assets for capital gains purposes. I would urge the Committee to index inventory costs and depreciation allowances as well. Information provided by the Commerce Department's Bureau of Economic Analysis reveals that real corporate profits (adjusted to reflect replacement costs) were based at an effective rate of 56 percent in 1972, 102 percent in 1974, and 78 percent in 1976. The rates of inflation in those years were 3.4 percent, 12.2 percent, and 4.8 percent respectively.

Where I must respectfully part company with Senator Dole is on some of the limitations that he would place on his otherwise exemplary bill—limitations that are designed, I know, to gain support, and which may therefore be prudent.

S. 2738, for example, would limit the inflation tax adjustment to two-thirds of the increase in the Consumer Price Index; which is to say, it would do away with only two-thirds of the extra burden that taxflation now places on taxpayers, two-thirds of the capital levies now exacted on individuals who sell homes or securities whose value have increased in nominal but not in real terms, two-thirds of the windfall inflation profits that government now enjoys at the expense of the governed. To my mind, the case for indexation is so clear, so compelling, so just, that I would urge this Committee to exercise true leadership and report out a bill that would go three-thirds of the way in offsetting the distortions that inflation imposes on our existing tax system.

I also question the five year limitation that the Dole bill could place on this important reform. Five years hence, a cowardly Congress could impose a significant tax increase by stealth through the simple expedient of doing nothing. And if the Congress wants to grant the President a limited power to increase taxes subject to a one-house veto (as is provided for in S. 2738), let the Congress provide him with the explicit authority to do so. I would hope, however, that the Congress would come up with a formula that would spread the burden of such a tax increase more equitably than would be the case if indexation were to be suspended.

This is not new ground, Mr. Chairman. Indexation has been in effect in Canada for several years now, and it works. Since tax indexing was first proposed, the principle has gained increasing support in all segments of our country. Indexation is an idea whose time has clearly come; and the Dole bill, S. 2738, is the place to start.

Senator BYRD. The next witness will be Mr. Emil Sunley, Deputy Assistant Secretary for Tax Policy, Department of the Treasury.

Welcome, Mr. Secretary.

STATEMENT OF EMIL SUNLEY, DEPUTY ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY

Mr. SUNLEY. I appreciate this opportunity to appear before you and to discuss the subject of indexation of the tax system. The recent surge of interest in inflation adjustment of the tax system—that is, in indexation—obviously stems from the high rate of inflation that we have experienced in the last several years.

If inflation were proceeding only at 1 or 1.5 percent a year as it did in the early 1960's, there would be much less concern for as complex an alteration of the tax law as indexation.

There are two separate issues in indexing the tax system: The definition of income and the proper tax treatment of income, once defined. I will begin by discussing the second issue—the tax treatment of nominal dollar amounts—because in this area, proposals and recommendations have been most fully developed.

As inflation occurs, the real value of fixed dollar amounts declines and thus, since income taxes are computed from tax brackets and exemptions which are denominated in fixed dollars, tax liabilities, and the effective tax rate rise.

To illustrate this result, consider a family consisting of a husband and wife and two children with an income of $15,000.

Their income tax based on 1977 rates would be $1,385 or about 9.2 percent of income. Now, let's assume that inflation runs at a rate of 7 percent this year, a bit higher than our current estimate, but the average that we have experienced for the last several years, and assume further that this family's income increases by this same percentage.

That would mean that their dollar income in 1978 would be $16,050, but, of course, their real income—that is, their actual spending—would not have increased at all above last year's level of $15,000. Yet their income tax would rise to $1,613 and, more importantly, their effective tax rate, which had been 9.2 percent in 1977, would rise to 10 percent in 1978.

If this high rate of inflation were to continue for 10 years, this family, even though it had experienced no increases in real income, would see its effective rate climb to 17.8 percent, almost double what it had been in 1977—if, and this is a big if, Congress did not make any income tax changes during the intervening period.

In this instance, what is true for an individual family is true for taxpayers as a whole. If we experience 10 percent inflation, individual income tax receipts rise not by 10 percent, but by something closer to 15 percent. Put another way, tax receipts rise one and a half times as fast as the rate of inflation.

Senator BYRD. If I could interrupt you there, then you concur with the proponents of this legislation? I think they have been saying that it rises at a rate of 1.6 and you say 1.5, so as a practical matter, both of you agree that the Government benefits to the extent of 50 to 60 percent?

Mr. SUNLEY. That is, of course, Mr. Chairman, with respect to individual income taxes.

Senator BYRD. Yes.

Mr. SUNLEY. Yes, that is right. There is a general agreement that the figure is around 1.5 or 1.6.

Senator BYRD. So both the proponents and the opponents, so far as Treasury is concerned, agree with that figure.

Mr. SUNLEY. That is correct.

Senator BYRD. Thank you.

Mr. SUNLEY. Since World War II, the rate of inflation has ebbed and flowed, but the trend of prices has always been upward. Does this mean that the effective tax rate on individual income has been constantly rising over time?

Not at all, because Congress has, in fact, taken frequent action to reduce individual taxes so that the individual income tax as a percentage of personal income has actually fluctuated in a rather narrow band. Since 1951, it has ranged from a low of 9.2 percent in 1965, following the tax cuts enacted in 1964, to a high of 11.6 percent in 1969 when the 10 percent surcharge was in effect.

It is not just inflation which pushes taxpayers up into higher tax brackets. Because the real productivity of the American economy has been rising, in the absence of offsetting legislation, our tax bills would also have risen, given our progressive rate structure.

This would have been true even if there had been no inflation. Thus, the fact that income taxes, as a percent of personal income, have not risen means that Congress, with its periodic tax cuts, has been offsetting not only the impact of inflation on tax rates, but also the impact of the growth of real per capita income.

Senator BYRD. If I could interrupt you there, your previous statement is true of only part of the taxpayers. It is not an across-the-board tax reduction.

Mr. SUNLEY. It is true of all taxpayers as a whole. When you look at particular groups of taxpayers, the story you tell depends on what year you choose as your base year. Your first panel of witnesses chose as the base year 1965, which was the low point following the tax cuts enacted in 1964. Using that as a base year, it turned out that only the lowest income classes had a reduction in their effective tax rates, once you take into account the impact of inflation.

However, if you would take, as your base year, 1961 or 1963, then you would find that the tax reductions which Congress has enacted periodically have offset the impact of inflation, not only at the low end of the income scale, but also at the very highest income level. Because Congress, in 1964, as you will recall, reduced the top marginal rate on individuals from 91 percent to 70 percent, and made other substantial——

Senator BYRD. You are going back 14 years. There has been nothing done since that time and inflation has occurred since then.

Mr. SUNLEY. There have been significant tax reductions in 1969, 1971, 1975, 1976, and a small tax reduction in 1977.

Senator BYRD. Of course, we are talking about two different things. I am talking about an across-the-board reduction, which has not occurred, and you are talking about specialized, or what I call, politically motivated tax reduction.

Is it not a fact that, at the present time, those taxpayers in the upper median group, upper half, pay 94 percent of all the taxes?

Mr. SUNLEY. In 1975, the latest year for which we have statistics, 94 percent of all individual taxes were paid by taxpayers above the median income. Now, that is not families——

Senator BYRD. That is right.

Mr. SUNLEY. That includes singles, retired people, college students working in the summer all taxpayers with adjusted gross incomes of over $10,000 a year. They also had 80 percent of the income that year.

Senator BYRD. But for those earning more than $10,000 a year, they pay 94 percent of the taxes.

Mr. SUNLEY. That is correct.

Senator BYRD. And those earning more than $17,000 a year pay 72 percent of all the taxes.

Mr. SUNLEY. That is correct.

Senator BYRD. Thank you.

Mr. SUNLEY. I think that the question we should ask is not, should we adjust the tax system for inflation, but rather, how should we adjust the tax system for inflation: By an automatic process called indexation or by periodic legislative readjustments?

Automatic indexing would have an adverse impact on overall fiscal policy. Traditional demand-push inflation represents an excess of purchasing power relative to the amount of goods and services available, and therefore tax increases are called for. Automatic indexation of the tax system, whatever its appeal on equity grounds, moves in the opposite direction. That is, under indexation, inflation would give rise, not to tax increases, but rather to tax cuts, or at least in real terms, no change in effective tax rates.

Rather than give up its control over this aspect of fiscal policy, I believe that the country would be better off if Congress continued with its existing ad hoc approach to tax increases and decreases.

There have been occasions when we would have been better off with an automatic tax reduction—1974 or 1975 might have been such occasions, given the increasing rate of unemployment in those years. But, in general, if all we know about the economy is that it has been experiencing inflation, economists would generally prefer to have taxes going up rather than going down.

If the appropriate fiscal policy calls for a tax reduction, Congress can, and has, provided that reduction.

Let me now turn to the second and much more difficult issue concerning indexation; that is, the definition of income and specifically, the measurement of real income from capital.

Ideally, the base of the tax system should be real income, because that is the best measure of ability to pay. With reasonable price stability, nominal income provides a satisfactory approximation of real income, but under inflationary conditions, this is no longer the case. Particularly severe problems arise in four areas: Depreciation of fixed assets, inventory accounting, capital gains, and financial instruments.

Generally, fixed assets are depreciated on the basis of their historical cost. It is easy to see that this is inappropriate in a period of inflation, because the dollar value of depreciation allowances will be worth less, as time goes on, then the real value of the assets being used up. Unfortunately, while the problem is clear, the solution is not. There has been much controversy in recent years, both here and abroad, concerning the appropriate accounting for depreciation of fixed assets in a period of inflation.

One possible approach would be to adjust depreciation for each asset based on replacement costs, which would involve calculating a separate price index for every kind of asset. Even aside from the great difficulty in adjusting for quality changes and technological innovations over time, it is clear that the sheer numbers and recordkeeping involved here would lead to a very cumbersome system.

Moreover, such practice would allow real changes in relative values to escape taxation.

Another possibility would be to index on the basis of some measure of the general price level. Such a measure would refer not just to the prices of capital assets, but would be a reflection of the value of the dollar in broader terms.

Although current law does not contain an explicit depreciation adjustment to account for the effect of inflation, accelerated depreciation methods provide some offset for inflation. In fact, until the high

inflation rates experienced in the last few years, the use of accelerated depreciation on an historical cost basis has generally meant higher depreciation deductions and hence, lower income taxes, than if the law permitted straight-line depreciation on a replacement cost basis.

The Commerce Department has estimated that the net effect of these adjustments—accelerated depreciation and replacement cost accounting—on capital consumption allowances, which is the national income and product account concept analogous to depreciation and amortization. For corporations, the net effect was positive—that is, lower taxes—for the years 1962 through 1973, while for the years since 1974, it has been negative. That is, for the last few years of high inflation, replacement cost depreciation on a straight-line basis would have meant lower taxes, whereas for earlier years, historic cost depreciation on an accelerated basis meant lower taxes. For sole proprietorships and partnerships, the net effect has been lower taxes for every year since 1946.

In the area of inventories——

Senator BYRD. Do you have much more of your prepared statement?

Mr. SUNLEY. No, I am going to be skipping much of the remaining portions.

Senator BYRD. The entire statement can be put into the record.

Mr. SUNLEY. Well, why do I not, then, skip for you to the very end of my summary here.

What we conclude from this review of indexation is that at rates of inflation above a certain level, almost everyone would feel that indexation is desirable. I feel that our present and prospective inflation rates are not above that level.

To introduce indexation into the tax system would mean substantially increasing the complexity of the present system, greatly increasing the recordkeeping requirements of the individuals concerned, and making fairly arbitrary decisions in many areas of income measurement in which no consensus has emerged, to date, from economists, accountants and businessmen.

Until there exists a greater consensus of the best manner of adjusting financial and operating statements for inflation, it would be inappropriate for the Treasury Department to attempt to impose any particular "correct" method. Until the accounting profession has worked out the technical details of how to index income, until the business community is prepared to use an indexed financial statement in reporting to their stockholders and creditors, Congress should not permit the business community to report to the Internal Revenue Service on an indexed basis.

Thank you, Mr. Chairman.

Senator BYRD. Thank you, Mr. Secretary.

I was just reviewing "Inflation and the Income Tax", a book published by the Brookings Institution in which you contributed a chapter on inflation adjustment proposals, you seem to make a pretty strong case for Senator Dole's legislation. In one sentence, on page 153, you state: "The result is that tax liabilities increase faster than inflation and take away an increasing percentage of the family's real

income" which is, as I understand it, the real thrust of what Senator Dole is trying to get at.

Now, the second thing is, a little while ago I made an assertion in regard to discretionary tax reductions and you took issue with that. I want to read from the same book, where you say on page 165:

In general, the discretionary cuts have been larger for the lower income classes, while those in the higher income classes just below the top of the income scale—say between $25,000 and $200,000, where the rate of progression is steep—have not been compensated for inflation.

That is exactly the point that I was making a few moments ago that you took issue with me on. You expressed it much better than I did.

Mr. SUNLEY. Thank you, Mr. Chairman, but I think I pointed out that for those above $200,000, discretionary cuts have in fact, offset the impact of inflation.

Senator BYRD. A great portion of our taxpayers are in the range beginning at $25,000, and, in your paper, you went up to $200,000. Those people above $25,000 are those who received the least consideration through the years in regard to the handling of our tax program.

But I was interested in all of your testimony this morning, nowhere do you mention the most important thing that needs to be done, namely, getting inflation under control. You just assume that we are going to continue to have this inflation, and perhaps you are right, but I think it is important that we get inflation under control. The problem, as I see it, is not so much tax indexing, but halting inflation, and then we would not have to worry about tax indexing.

Now, if you can enlighten us as to what the administration that you represent is doing in this regard, I am sure the committee would be glad to hear it.

Mr. SUNLEY. Mr. Chairman, the administration is committed to getting inflation under control. We are particularly concerned about the unfavorable price news for the first couple of months of this year.

Considerable progress has been made in reducing inflation since the very high double-digit inflation level in 1974. But we are not satisfied with where we are today and we want to continue to move, both in reducing the level of unemployment in this economy, and also reducing what we consider to be an unacceptably high level of inflation.

If I may also comment on your first comment, saying that on the first page of my testimony that we made the case for Senator Dole's proposal, we agree on what the problem is and what the effect of inflation on individual income taxes is, but what we disagree on is whether the adjustment should be made automatically, every year, regardless of the level of the deficit, or regardless of the level of inflation in the economy; or whether the adjustment should be done periodically.

Senator BYRD. So you are against the concept?

Mr. SUNLEY. Well, no. We do not deny that if you do not provide tax reductions, either periodically or automatically, income taxes rise more rapidly than income in an inflationary world. But what we disagree on is whether the best way to proceed in this situation is to

provide tax reductions automatically at the beginning of each year, as is done in Canada, or whether tax reductions should be provided periodically by Congress depending on the overall economic situation.

Under the type of proposal that we are discussing today, the size of the tax cut each year will depend on the level of inflation last year. The higher the rate of inflation, the greater the tax cut, and therefore, the greater the stimulus being provided to the economy.

It would seem to us that we could better manage the overall fiscal policy if the tax cuts were discretionary. But we have no disagreement that, over time, we want taxes to go down. We do not want taxes to go up with inflation. In fact, the President is committed to holding down Federal expenditures as a percent of GNP and therefore holding down——

Senator BYRD. I am glad you mentioned holding down Federal expenditures. I restrained myself and did not bring it up.

There has been no holding down of Federal expenditures at all. Federal expenditures have gone up at an unbelievably high rate. There has been a 10 percent increase in the cost of Government in this new budget, but the administration has not been satisfied with that.

Since submitting the budget, it has now submitted a new program for $2.4 billion for urban aid in addition to what is already being done. It is advocating a new welfare program that will greatly increase the number of people on welfare and tremendously increase the cost of welfare.

So I do not buy that argument that the administration is holding down the cost of Government, for the simple reason that the facts do not justify any such assertion. There has been a tremendous increase in the budget deficit. The budget deficit in the Federal funds area, and that is what we really need to examine, is the highest in history.

You were talking about holding down the costs of Government and holding down the deficit. You are going in exactly the opposite direction. You are not going to be able to balance your budget going in the direction that you are going in now.

Now, to get back to this proposal that is before the committee, I will yield to Senator Dole.

Senator DOLE. I only have a few questions. I appreciate the questions posed by the chairman and the statement, Mr. Sunley.

I think, as you recognize, the idea is not new. Maybe it is not the right solution, maybe it is not the best solution, maybe it should be modified, maybe we should stick to the present system and leave it up to the Congress to make adjustments. I would assume in the article, "Inflation Adjustment and the Individual Income Tax," was an effort by you and Mr. Peckham to address the problem and not to indicate what you propose, is that correct?

Mr. SUNLEY. If I recall, in that article we did not conclude whether you should or should not do it. We were mainly laying out the facts.

Senator DOLE. I seem to see that there appears to be some measure of support for the concept.

But under the present law, there are only a few provisions of the Internal Revenue Code which are adjusted for inflation. Certain pension law provisions which impose limitations on the amount of contributions which can be made on behalf of the employee under a qualified plan and limits on annual retirement benefits for which any employee may qualify are presently adjusted. These limits are indexed to the rise in the rate of inflation.

The increase in social security wage base, which is, itself, indexed to the average increase in wage rates, and as a result, the limits on annual contribution has risen from $25,000 to $30,500 and the amount of annual benefits has risen from $75,000 to $90,000.

There has been some indication in your testimony that adjustment for indexing is a complicated matter, that it would impose many burdens on the Treasury. I would like to know if the adjustments currently made impose any great and insurmountable technical problems for the Treasury.

Mr. SUNLEY. The kind of adjustments that you are talking about, the fixed dollar amounts, involve considerably less complexity than the kind of adjustments needed to correct measurement of income.

The complexity argument that I used referred specifically to the complexity involved in adjusting depreciation for replacement costs. Just widening brackets or pushing up the personal exemption each year to reflect inflation would impose some costs, but they would not be great.

We would have to put out each year new withholding tables, and this is some burden on small businesses to have to make an adjustment each year. But I do not think that the complexity here is really the deciding factor on whether you want to go down this route or not.

Senator DOLE. I think you mentioned depreciation, which is very complicated. As far as fixed dollar adjustments are concerned, it does not seem to be too complicated.

I have introduced legislation which would increase the $1,500 and the $1,750 contribution limits on individual retirement accounts by the rate of inflation. Would you oppose any extension of indexing in the pension law area?

Mr. SUNLEY. I think, at the present time, where we come out is that we should not go down this road unless we are going to do it for all of the major fixed dollar amounts.

The big ticket items are, of course, the personal exemption, the brackets and the rate schedule. If we adjusted those for inflation, then I think it is just a question of whether you want to adjust some of the other fixed dollar amounts that appear throughout the Internal Revenue Code. Many of them are relatively minor provisions that affect only a few taxpayers.

But I think we would not want to start by extending indexation to these lesser provisions until we have made our decision, really, on whether we want to index the big ticket items, the personal exemption, the brackets, the general tax credit.

Senator DOLE. Well, I think you have indicated when something is expressed in a fixed dollar amount inflation causes real values to decline. Inflation causes many Federal excise taxes, like the 4-cent-

per-gallon gas tax and the alcohol and cigarette taxes to decline in real terms during periods of inflation.

Would it be appropriate to index taxes which rise automatically in real terms because of inflation, without also indexing the taxes which fall in real terms because of inflation?

Mr. SUNLEY. These raise, of course, Mr. Dole, very similar issues. That is right——

Senator DOLE. There are gainers and losers.

Mr. SUNLEY. The real, effective rate of excise taxes, which are denominated in fixed dollar amounts, so much per pack of cigarettes or so much per gallon of liquor, do decline in value.

Now, if you had ad valorem excise taxes, they would keep up with inflation. I think if you are moving towards indexation on the income tax side, there is a strong case for making a similar adjustment on the excise tax side. At this time the administration is recommending neither change.

Senator DOLE. But it would be another source of revenue that might offset some of the losses on the other side.

About the energy tax bill, in section 2041 of the House bill and in section 1065 of the Senate bill contains an excise tax on business use of oil and natural gas and the tax which is to be imposed would be indexed in 1981, using 1979 as a base year. Does this mean the administration will accept the indexing of excise taxes.

I do not know if you are familiar with those two sections or not.

Mr. SUNLEY. Yes. The energy bill raises somewhat different issues, I believe. What we are trying to do there is to push up the price of energy for consumers that will be equal to the replacement cost of importing foreign oil, and so that you want, in a sense, taxes to continue to rise as the price of replacement oil rises, and that is sort of the general argument for tying these tax rates into either a general price index or into a world price of oil, as has been done in different parts of the energy bill.

So I think it is the overriding energy policy considerations that have led us to, perhaps, some form of indexation here but these considerations are not present when we look at the indexation involved in the bill before this committee today.

Senator DOLE. Finally, just a general question, it occurs to me that the uncertainty created by inflation distorts and clouds future business and market decisions. There was a recent article in the Washington Post by Hobart Rowan which gave an example to show how inflation taxes can be levied at higher marginal rates as income rises with inflation.

Based on the assumption that a family of four earning is $15,000 in 1955, and that increases in income match inflation. That family would be earning $32,900 in 1976, or a gain of 120 percent. Yet, this same family would have been moved from the tax bracket of 22 percent to 36 percent, increasing its tax bill from $1,540 to $6,600 for an increase of 330 percent.

And, if you look at the entire situation, the family, in terms of real income, was 11 percent worse off in 1976 than it was in 1955. My question is, how does the administration's tax program compensate for these deficiencies and, under the President's program, which is

now on the House side, what do we have in that program which insures that individuals are not going to be damaged by tax inflation 1 or 2 years down the road?

Mr. SUNLEY. The President's program provides approximately $17 billion of net individual income tax reductions for individuals. Now, this $17 billion offsets first the impact of higher social security rates that were enacted by Congress last year. It also offsets the impact of inflation.

If the President's program is enacted, taxes as a percent of personal income, including social security taxes, will be lower in 1979 than they are in 1977.

Now, it is clear that it does not offset the impact of inflation through 1985 or 1990. If we continue to make our adjustments on an ad hoc basis, there would be need for additional tax reductions in future years. But we are committed to offsetting the impact of both the increase in social security taxes and the impact of inflation for the next 2 years.

Now, the numbers I gave you, Mr. Dole, relate to the total tax reductions being proposed for individuals. You can also look, as Hobart Rowan did, and look at typical families in different income levels and here you will see that up through the median family income level, the President's program offsets fully the impact of social security and inflation.

It does not fully offset that at higher income levels, mainly because last year Congress enacted such very steep social security increases by raising the maximum wage base for families with incomes over approximately $17,000.

Senator DOLE. Well, if you had to pick out, in your view the biggest single flaw in the indexing concept, how would you pinpoint it? Is it complexity, or is it interfering with the right of Congress on an ad hoc basis to make adjustments?

Is there some underlying reason that it does not deserve consideration?

Mr. SUNLEY. I hope I did not imply that it does not deserve consideration. I think it is an important issue. The impact of inflation on the tax system has been of concern to us. I think if I had to pick one reason, I would pick a different reason for the two different kinds of indexation that the committee is considering. When we are talking about the automatic adjustment of fixed dollar amounts, it is not complexity that is the problem. The issue here is, do you want to have taxes going up or going down in an economy which is experiencing inflation?

All other things equal, we would prefer, from a macroeconomic point of view, not to be interjecting any additional stimulus into an economy heating up with inflation. And we think that Congress has, in fact, periodically adjusted taxes so that taxes as a percent of personal income have not tended to rise.

Senator DOLE. If we had had indexing in 1974, we might have avoided the recession in 1975.

Mr. SUNLEY. As I pointed out in my testimony, there are some years when you would prefer automatic tax cuts. I can remember in the fall of 1975 at a time when we had double-digit inflation and

unemployment beginning to rise, the administration at that time sought a surcharge, then in January and February of the next year, they were back seeking a tax reduction.

So maybe the administration would have been better off if there had been an automatic tax reduction in the beginning of 1975, in contrast to what the administration had actually proposed in the fall of '74, and which Congress rejected.

Now, with respect to the other kind of indexation, measurement of real income, here complexity is really the problem. If we go down this route, there are considerable problems. If you only do it for certain items on the income and balance sheet and not for all items, there are some very serious problems of equity raised.

I am concerned about making adjustment only for one type of asset, let's say capital gains, and doing nothing for the individual who has interest from a savings account. I am not sure that we improve equity by making adjustment for only one kind of income and making none of the other adjustments, and we incur an incredible amount of complexity if we go down that route.

Senator BYRD. Thank you, Mr. Secretary. I have a few questions which I will submit if you would answer them for the record, to save time.

Mr. SUNLEY. Mr. Chairman, I would be most pleased to.

Senator BYRD. Thank you very much.

[The following was subsequently supplied for the record:]

DEPARTMENT'S ANSWERS TO QUESTIONS SUBMITTED BY SENATOR BYRD

Question 1. The Bureau of the Census in the 1977 Statistical Abstract, page 450, Table No. 726, shows median income for United States households. The median income for 1976 is set at $12,686.

(a). How is household defined?

Answer. The source document, Current Population Reports, defines a household as "* * * consisting of all the persons who occupy a housing unit. A house, an apartment or other group of rooms, or a single room, is regarded as a housing unit when it is occupied or intended for occupancy as separate living quarters; that is, when the occupants do not live and eat with any other persons in the structure and there is either (1) direct access from the outside or through a common hall or (2) a kitchen or cooking equipment for the exclusive use of the occupants.

"A household includes the related family members and all the unrelated persons, if any, such as lodgers, foster children, wards, or employees who share the housing unit. A person living alone in a housing unit, or a group of unrelated persons sharing a housing unit as partners, is also counted as a household. The count of households excludes group quarters."

"Household income is different from family income in that household income includes not only the income of all related persons in the household but also the income of any unrelated persons in the household. Household income also covers the income of one-person households. Family income is limited to the income of related persons in the household only."

Question 1(b). What is the actual dollar individual tax liability for households at the median income level?

Answer. If we take the median household as a husband, wife, and two dependents filing a joint return and utilizing the standard deduction, their actual individual tax liability for 1977 if their adjusted gross income was $12,868 would be $950. Under the President's proposed tax program for 1978, their tax liability would be $630.

Questions 1(c) through 1(f). These questions cannot be answered in terms of household with data currently available. (See below for answers in terms of taxpayers.)

Question 2. Does government data measure income in terms of family income?
(a) If so, what is the definition of family income and in what context is it used?

Answer. The Census Bureau in Current Population Reports uses the term "family" to refer to a group of two or more persons related by blood, marriage, or adoption and residing together; all such persons are considered as members of the same family. Thus, if the son of the head of the household and the son's wife are in the household, they are treated as part of the head's family. On the other hand, a lodger and his wife not related to the head of the household or an unrelated servant and his wife are considered as additional families, and not a part of the household head's family.

The Census Bureau also uses the term "unrelated individuals" to refer to persons 14 years old and over (other than inmates of institutions) who are not living with any relatives. An unrelated individual may constitute a one-person household by himself, or he may be part of a household including one or more other families or unrelated individuals, or he may reside in group quarters such as a rooming house. Thus, a widow living by herself or with one or more other persons not related to her, a lodger not related to the head of the household or to anyone else in the household, and a servant living in an employer's household with no relatives are examples of unrelated individuals.

Question 2(b). Please provide information for family income comparable to information provided in question 1. (b) through 1. (f) above.

Answer. The Current Population Reports show median family income for 1976 to be $14,958, and income of unrelated individuals to be $5,375. Under current law, the tax liability for a four-person family filing a joint return and claiming the standard deduction with an adjusted gross income of $14,958 would be $1,375, while under the President's proposed program it would be $1,067. An individual taxpayer with no other exemptions and an adjusted gross income of $5,375 would have a tax liability of $342 under current law and $248 under the President's program.

Question 3. Does government data measure per capita income?
(a). If so, what is the definition of per capita income and in what context is it used?

Answer. The Bureau of Economic Analysis of the U.S. Department of Commerce makes an estimate of personal income monthly. Although this concept of income is slightly different from either that used in the Current Population Reports or adjusted gross income as defined in the tax laws, this figure is frequently published (e.g. in the Council of Economic Advisers' Economic Indicators) as a measure of current income. After subtracting taxes (on a National Income definition), disposable personal income is calculated, and this is published on a per capita basis. The latest period for which this is available is the fourth quarter of 1977 in which per capita disposable personal income was estimated to be $6,290 in current dollars or $4,394 in 1972 dollars. This consists of total disposable personal income as measured in the National Income and Product Accounts divided by the total non-institutional population of the U.S.

Question 3(b). Please provide information for per capita income comparable to that above.

Answer. There is no comparable tax liability for the per capita income published by the Bureau of Economic Analysis.

Question 4. Does government data measure average household and family income?
(a). If so, please provide information for average income as requested above.

Answer. The Census Bureau, in Current Population Reports, estimates average or mean income for both families and households. For calendar year 1976, the estimate of average income for household was $14,922 and for families was $16,870.

The tax liability for a husband and wife filing a joint return and claiming two dependents and the standard deduction with an adjusted gross income of $14,922 would be $1,365 under current law and $1,058 under the President's program. If their adjusted gross income were $16,870, their tax liability would be $1,789 under current law and $1,445 under the President's program.

Question 5. Does the Treasury measure income in terms of taxpayers rather than families or households?

(a). If so, please define taxpayer. How does the term "taxpayer" relate to the definitions of family and household?

Answer. The Treasury Department publishes tables on the basis of tax returns. Such returns may reflect one of five marital status classifications: (1) Joint returns of husbands and wives, (2) Separate returns of husbands and wives. (3) Returns of heads of households, (4) Returns of surviving spouses, and (5) Returns of single persons, not heads of households or surviving spouses.

Marital status is usually determined as of the last day of the tax year. If one spouse dies during the tax year, the other is considered married for the entire year. If a taxpayer is divorced during the tax year and does not remarry, the taxpayer is considered to be unmarried for the entire year. Thus, the term "taxpayer" is defined quite independently from "family" or "household." A "family" or "household" may include zero taxpayers or many taxpayers.

Question 5 (b). Please define the terms adjusted gross income, taxable income, income after credit, and expanded income. Which one of these terms is the most appropriate measurement of income in determining tax burden?

Answer. Adjusted Gross Income: This amount is the result of reducing gross income from all sources subject to tax by adjustments such as the following:

1. Ordinary and necessary expenses of operating a trade or business,
2. Employee business and moving expenses,
3. Expense deductions attributable to rents and royalties,
4. Expenses of outside salesmen attributable to earning a salary, commission, or other compensation,
5. Depreciation and depletion allowed life tenants and income beneficiaries of property held in trust,
6. Exclusion of allowable sick pay if the sick pay was included in gross salary,
7. Deductible losses from sales of capital assets and other property,
8. Deductible half of the excess of net long-term capital gains over net short-term capital loss,
9. Business net operating loss carryover,
10. Contributions to a retirement fund by the self-employed,
11. Deductions for the ordinary income portion of a lump-sum distribution, and
12. Deductions for interest forfeited because of premature withdrawals from time savings accounts or deposits.

TAXABLE INCOME OR INCOME SUBJECT TO TAX

In general, income subject to tax is the base for the assessment of income tax before credits. For returns with the regular or maximum tax computations, the income subject to tax is "taxable income," that is, adjusted gross income less personal deductions and exemptions. For returns with alternative tax computation, the income subject to tax is the larger of taxable income or one-half excess net long-term capital gain over net short-term capital loss.

For income average returns, income subject to tax is a reduced amount of taxable income which must be specially calculated.

INCOME TAX AFTER CREDITS

Income tax after credits is equal to "income tax before credits" minus the following statutory credits: retirement income credit, investment credit, foreign tax credit, Work Incentive (WIN) credit, and credit for contributions to candidates for public office. It did not include tax from recomputing prior-year investment credit, tax from recomputing prior-year Work Incentive (WIN) credit, self-employment tax, social security tax on tip income, or additional tax for tax preferences ("minimum tax").

EXPANDED INCOME

Tax experts have long been aware that Adjusted Gross Income is deficient as a measure of a taxpayer's net, or economic, income. AGI excludes such items as interest from tax-exempt state and local bonds, the excluded portion

of realized long-term capital gains (and all accrued but unrealized capital gains), and imputed rent on owner-occupied housing. Also, income from certain activities may be understated due to allowable deductions which exceed actual economic costs. Other income may not be "strictly" excluded from AGI, but it may be deferred to a later year for income tax purposes.

On the other hand, AGI may overstate economic income because some types of expenses incurred in the generation of income are not deductible in the computation of AGI; they are only deductible from AGI if the taxpayer itemizes his personal deductions. Two types of deduction which fall into this category are expenses attributable to a taxpayer's investments (as opposed to his active peration of a trade or business), including but not limited to investment interest, and employee expenses.[1] Also net realized capital losses may only be deducted in the computation of AGI to the extent of $1,000; any excess must be carried forward to future years.

Although, in economic terms, investment expenses ought to be deductible in the computation of AGI, the maximum amount which ought to be deductible is open to question. If all investment income were taxed currently, it would be appropriate to deduct all investment expenses without limit. Excess deductions would represent a net economic loss to taxpayers, roughly akin to a net operating loss from a trade or business. However, because money is fungible, because not all investment income is taxable, and because that which is taxable may not be taxable currently (for example, accrued but unrealized capital gains), it may be appropriate to limit investment expense deductions to the amount of investment income actually received in the given year.

The Congress has asked for high income data to be tabulated on the basis of a concept closely approximating economic income but only using data which are available on tax returns. Accordingly, data such as interest on tax-exempt state and local bonds cannot be included in the broader income concept. In order to distinguish the approximated income concept from economic income, it is called Expanded Income.

Expanded Income is Adjusted Gross Income plus items of tax preference less investment interest to the extent that it does not exceed investment income.[2] Congress has also mandated that these two adjustments be made separately for high income data. Thus, there are two additional income concepts AGI plus Preferences; and AGI less Investment Interest.[3]

When ranked according to size, AGI plus Preference is largest, AGI less Investment Interest is smallest, and AGI and Expanded Income fall in the middle. However, for any individual taxpayer, AGI can be larger or smaller than Expanded Income depending on whether Preferences are larger or smaller than Investment Interest.

Expanded Income most closely approximates a measure of economic income. The two intermediate concepts, AGI plus Preferences and AGI less Investment Interest, represent only partial corrections to recognized problems and are biased. The deficiencies of AGI have already been explained, but because of its long use and the wide availability of consistent data based on AGI, it remains a useful concept. The only available published data on income and taxes are contained in the Statistics of Income, Individual Income Tax Returns, which presents distributions only by AGI.

Question 5 (c). Please develop a table showing households, taxpayers, and families, at various income levels under the terms listed in 5. (b) and the tax liability at these various income levels. Please also demonstrate the distribution of the tax burden at these income levels.

1 (b). What is the actual dollar individual tax liability for taxpayers at the median income level?

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[1] In 1974 and 1975, alimony payments were also treated as an itemized deduction even though alimony income is includable in the AGI of the recipient. Beginning in 1977, alimony was deductible in computing AGI.

[2] Normally, investment interest to the extent that it does not exceed investment income is called "investment interest." Investment interest in excess of investment income is called "excess investment interest."

[3] The four income concepts are related in the following manner:

Expanded Income = Adjusted Gross Income + Preferences − Investment Interest.

Adjusted Gross Income = Expanded Income − Preferences + Investment Interest.

Adjusted Gross Income plus Preferences = Adjusted Gross Income + Preferences; or = Expanded Income + Investment Interest.

Adjusted Gross Income plus Investment Interest = Adjusted Gross Income − Investment Interest; of = Expanded Income − Preferences.

Answer. IRS does not publish a figure for median taxpayer AGI, but it is possible to interpolate such a figure from published tables. For calendar year 1975, the most recent period available, median taxpayer AGI was $9,109. This, of course, refers to all 82,229,332 returns, including joint returns, head of household returns, etc., so it probably does not make sense to calculate a tax liability for such a median AGI.

Question 1 (c). What percent of the individual income tax do taxpayers below the median income level pay?

Answer. Taxpayers (or, more precisely, tax returns) below the median AGI have 18.7 percent of total AGI, 10.7 percent of total taxable income, and 7.5 percent of total tax.

Question 1 (d). What percent of the individual income tax do taxpayers above the median income level pay?

Answer. Tax returns with AGI above the median pay 92.5 percent of the individual income tax.

Question 1 (e). Looking at taxpayers above the median income level, what percent of the taxpayers earn above 75 percent of income? What percent of taxpayers earn above 90 percent of income? What is the actual dollar amount of income earned at the 75 percent and 90 percent levels?

Answer. In 1975, 7.9 percent of all returns had AGI over $26,052, and these returns accounted for 25 percent of all AGI. Only 2.5 percent of all returns had AGI over $46,619, and these returns accounted for 10 percent of all AGI.

Question 1 (f). What is the actual tax liability for taxpayers at the 75 and 90 percent level? What percent of the individual income tax is paid by taxpayers at the 75 percent and 90 percent level?

Answer. In 1975, the returns with the top 25 percent of the AGI paid $52.8 billion or 42 percent of all individual income taxes. The returns with the top 10 percent of the AGI paid $28.7 billion or 23 percent of all individual income taxes.

Senator BYRD. Just one general question. Do you think that we can get inflation under control if we do not get Government spending under control?

Mr. SUNLEY. As I said, Mr. Chairman, the President is committed to getting Government spending under control. That does not mean that we are going to reduce the total amount of Government spending denominated in nominal dollars. If the role of Government remains the same and inflation is 10 percent, you would expect that Government spending would go up by 10 percent.

What the President is committed to, is reducing the share of GNP represented by Federal expenditures. That means that, as the economy grows, Government expenditures would grow less rapidly, and he is committed to getting that share down to 21 percent.

The budget that he submitted to Congress last January, is the first budget in a number of years which would reduce the share of GNP going to the Federal Government.

Senator BYRD. Well, without debating the point of whether the administration is, or is not, getting Government spending under control—you have one view and I have another view, but leaving out that—I take it from your answer that you do agree with my assertion that we are not going to get inflation under control until we get Government spending under control.

Mr. SUNLEY. Getting Government expenditures under control is an important part of that. The President's program that he announced in his recent inflation message, you know, would hold down the increase in Federal salaries as an important step in that direction.

Senator BYRD. Thank you very much.

Mr. SUNLEY. Thank you, Mr. Chairman.

[The prepared statement of Mr. Sunley follows:]

Statement of Emil M. Sunley, Deputy Assistant Secretary for Tax Analysis

Mr. Chairman and Members of this Distinguished Committee: I appreciate this opportunity to appear before you and discuss the subject of indexation of the tax system. The recent surge of interest in indexation, or inflation adjustment of the tax system, obviously stems from the high rate of inflation we have experienced for the last several years. If inflation were proceeding at a rate of only 1 or 1½ percent as it did in the early 1960's, there would be much less concern with as complex an alteration of the tax law as indexation. On the other hand, if the rate of inflation were to accelerate and reach a level of 20 or 25 percent as in some other countries, I believe almost everyone would favor indexation. Thus, one factor in deciding whether we want to index the tax system is the projection of likely future inflation rates. If we expect a moderate rate of inflation, say 6 to 7 percent, we must then decide whether the complexities involved in going to an indexed system are worth the gains, or whether there are other forms of ad hoc adjustments which could achieve the same ends of automatic indexation, but which would involve much less tax complexity.

There are two separate issues in indexing the tax system: the definition of income and the proper tax treatment of income, once defined. I will begin by discussing the second issue, the tax treatment of nominal dollar amounts, because in this area proposals and recommendations have been most fully developed.

FIXED DOLLAR AMOUNTS

As inflation occurs, the real value of fixed dollar amounts declines; and thus, since income taxes are computed from tax brackets and exemptions which are denominated in fixed dollars, tax liabilities and effective tax rates rise. To illustrate this result, consider a family consisting of a husband, wife, and two children, with an income of $15,000. Their income tax based on 1977 rates would be $1,385 or about 9.2 percent of income. Now, let's assume that inflation runs at a rate of 7 percent this year, a bit higher than our current estimate but the average that we have experienced for the last several years, and assume further that this family's income increases by this same percentage. That would mean that their dollar income in 1978 would be $16,050, but, of course, their real income, that is, their actual spending power, would not have increased at all above last year's level of $15,000. Yet their income tax would rise to $1,613 and more importantly, their effective tax rate, which had been 9.2 percent in 1977, would rise to 10.0 percent in 1978. If this high rate of inflation were to continue for 10 years, this family, even though it had experienced no increases in real income, would see its effective tax rate climb to 17.8 percent, almost double what it had been in 1977—if, and this is a big if, Congress did not make any income tax changes during the intervening period.

In this instance, what is true for an individual family is true for taxpayers as a whole. If we experience 10 percent inflation, individual income tax receipts rise not by 10 percent, but by something closer to 15 percent. In the technical jargon of economics, the elasticity of the income tax with respect to inflation is about 1.5; that is, tax receipts rise one and a half times as fast as the rate of inflation.

Since World War II, the rate of inflation has ebbed and flowed but the trend of prices has always been upward. Does this mean that the effective tax rate on individual income has been constantly rising over time? Not at all, because Congress has in fact taken frequent action to reduce individual taxes so that the individual income tax as a percentage of personal income has actually fluctuated in a rather narrow band. Since 1951, it has ranged from a low of 9.2 percent (in 1965), to a high of 11.6 percent (in 1969 when the 10 percent surcharge was in effect).

It is not just inflation which pushes taxpayers up into higher tax brackets. Because the real productivity of the American economy has been rising, in the absence of offsetting legislation, our tax bills would also have risen, given our progressive rate structure. This would have been true even if there had been no inflation. Thus, the fact that income taxes as a percent of personal income have not risen, means that Congress, with its periodic tax cuts, has been offsetting not only the impact of inflation on tax rates, but also the impact of the growth of real per capita income. In fact, if Congress had not cut taxes

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periodically but instead had indexed the individual income tax for inflation on the basis of the Consumer Price Index in 1960, taxes would in fact have been higher in 1975 than they were under the actual 1975 law.

Thus, I think the question we should ask is not: should we adjust the tax system for inflation? But rather, how should we adjust the tax system for inflation: by an automatic process called indexation or by periodic legislative readjustments?

AUTOMATIC INDEXATION

I would like to discuss three issues concerning automatic indexation: the impact of inflation on the government's share in the economy, the necessity of congressional overview, and the impact of indexation on economic stability.

Many people favor automatic indexation because they believe that the government will automatically increase its share of the total economy as inflation generates additional taxes. Thus, they believe the government "benefits" from inflation. This view is mistaken. The historical record mentioned above, shows that the response of the Federal Government to an upward trend in effective tax rates has not been to launch new expenditure programs, but rather to reduce taxes. The present proposed tax cuts illustrate this. Taxes are raised to pay for government programs; government programs are not expanded just to spend increased tax revenues. Automatic indexation by itself would lead to neither a smaller nor a larger government sector.

Next, the argument is sometimes made that automatic indexing is desirable because Congress should not have to "be bothered with" an inflation adjustment every year. It is true that the automatic nature of indexation systems removes the need for frequent oversight by Congress, but this argument works both ways. The argument could be made equally well, that encouraging the Congress to take a more frequent look at what is happening to the tax system may in itself be desirable. Also, even with indexation, Congress would have to adjust taxes downward periodically to offset the impact of rising real per capita incomes.

The final argument, and one which I find very important, concerns the impact of automatic indexing on overall fiscal policy. Inflation represents an excess of purchasing power relative to the amount of goods and services available, and therefore tax increases are called for. Automatic indexation of the tax system, whatever its appeal on equity grounds, moves in the opposite direction. That is, under indexation, inflation would give rise not to tax increases but rather to tax cuts or at least, in real terms, no change in effective tax rates. Rather than give up its control over this aspect of fiscal policy, I feel the country would be better off if Congress continued with its existing ad hoc approach to tax increases and decreases.

There have been occasions when we would have been better off with an automatic tax reduction—1974 or 1975 might have been such occasions, given the increasing rate of unemployment. But in general, if all we know about the economy is that it has been experiencing inflation, economist would generally prefer to have taxes going up rather than going down. If the appropriate fiscal policy calls for a tax reduction, Congress can provide that reduction.

INCOME MEASUREMENT

Let me now turn to the second and much more difficult issue concerning indexation, that is, the definition of income and specifically the measurement of real income from capital. Ideally, the base of the tax system should be real income because that is the best measure of ability to pay. With reasonable price stability, nominal income provides a satisfactory approximation of real income, but under inflationary conditions, this is no longer the case. Particularly severe problems arise in four areas: depreciation of fixed assets, inventory accounting, capital gains, and financial instruments.

DEPRECIATION

Generally, fixed assets are depreciated on the basis of their historical cost. It is easy to see that this is inappropriate in a period of inflation because the dollar value of depreciation allowances will be worth less, as time goes on, than the "real" value of the assets being used up. Unfortunately, while the problem is clear, the solution is not: there has been much controversy in

recent years, both here and abroad, concerning the appropriate accounting for depreciation of fixed assets in a period of inflation. One possible approach would be to adjust depreciation for each asset based on replacement cost, which would involve calculating a separate price index for every kind of asset. Even aside from the great difficulties in adjusting for quality changes and technological innovations over time, it is clear that the sheer numbers and record-keeping involved here would lead to a very cumbersome system. Moreover, such practice would allow real changes in relative values to escape taxation. Another possibility would be to index on the basis of some measure of the general price level. Such a measure would refer not just to the prices of capital assets, but would be a reflection of the value of the dollar in broader terms.

Although current law does not contain an explicit depreciation adjustment to account for the effect of inflation, accelerated depreciation methods provide some offset for inflation. In fact, until the high inflation rates experienced in the last few years, the use of accelerated depreciation on an historical cost basis has generally meant higher depreciation deductions (and hence lower income taxes) than if the law permitted straight-line depreciation on a replacement cost basis. The Commerce Department has estimated the net effect of these adjustments (accelerated depreciation and replacement cost accounting) on Capital Consumption Allowances, which is the National Income and Product Account concept analogous to depreciation and amortization. For corporations, the net effect was positive (i.e. lower taxes) for the years 1962–1973, while for the years since 1974, it has been negative. That is, for the last few years of high inflation, replacement cost depreciation on a straight-line basis would have meant lower taxes, whereas for earlier years historic cost depreciation on an accelerated basis meant lower taxes. (For sole proprietorship and partnerships, the net effect has been lower taxes ever since 1946.)

INVENTORY ACCOUNTING

In the area of inventories, the current LIFO (Last In, First Out) system of accounting is in fact a form of inflation adjustment similar to replacement cost depreciation. However, some have argued that it would be more appropriate to require FIFO (First In, First Out) inventory accounting but to permit adjustment to reflect the change in the general price level from the time the item was put in inventory until the time it was removed from inventory and sold. Such a system would be much more complex than the LIFO method.

CAPITAL GAINS

One of the clearest areas in which inflation has an impact is capital gains. If an asset's market value increases due solely to inflation, the holder of that asset has really experienced no increase in wealth, yet he is required to pay a capital gains tax on the difference between the original purchase price and the sales price. In fact, this impact of inflation has been one of the key arguments in defending the present favorable treatment which capital gains receive in our tax system. The present 50 percent exclusion feature does indeed provide an offset for inflationary gains. However, in any given case it is usually either too much or too little; only rarely would inflationary gains amount to exactly 50 percent of the total gain. The proper taxation of capital gains under inflation depends on the way financial instruments are handled, as we shall see below.

FINANCIAL INSTRUMENTS

If an individual earns an interest rate of five percent on a $1,000 savings account, at the end of the year he would have $1,050. Suppose, however, the rate of inflation has been 7 percent over the course of the year. This means that at the end of the year the individual has not gained from his investment, but is actually worse off, for he has less purchasing power than he did at the beginning of the year. His $1,050 is actually worth only $981 in terms of beginning-year prices, and even though he is experiencing this $19 decline in real purchasing power, he must still include $50 in his taxable income, and when he withdraws his deposit, he will not be allowed a tax deduction for his loss of purchasing power.

On the other hand, consider a debtor who is able to pay off his debt in deflated dollars: he actually benefits from inflation. Moreover, for tax purposes

he may deduct all of his interest payments—even those which merely reflect inflation. Thus, inflation produces both gainers and losers in terms of real income, and this asymmetry poses real problems for any practical system of indexation. Suppose for example, I purchased an asset for $1,000 and financed it entirely by debt. Would I be helped or hurt by inflation? The answer is that if the holding period of the asset and the debt are the same, I have completely protected myself from the effects of inflation; any inflationary loss on the asset is exactly offset by a gain on the debt.

MARKET ADJUSTMENTS

We generally speak of the changes in value resulting from inflation as if they were always unanticipated, but this is not really the case. No one, for example, thinks that the price level 12 months from now will be precisely where it is today—while we may not agree on an exact number, everyone anticipates some rise in prices, and lenders, as well as borrowers, take this into account in deciding the terms of a loan.

If the real rate of interest, that is, the rate for stable prices, is three percent, lenders will not continue lending money at three percent when the rate of inflation is five percent—they will demand a higher rate of interest. How much higher, depends on the lender's tax rate, for he will try to maintain his after-tax rate of return. Suppose a lender's marginal tax rate is 50 percent; that means that under stable prices, his after-tax rate of return was 1½ percent. If inflation now rises to five percent, he will seek to raise the before-tax rate not just to eight percent (i.e. three percent + five percent), but to 13 percent, because after he pays taxes on 13 percent he will have 6½ percent left, which in real terms (subtracting five percent for inflation) is the same as the 1½ percent he was earning before inflation.

Thus, in this case the market rate of interest would adjust so that no inflation adjustment would be necessary for the lender. What about the borrower? If he is in the same tax bracket, no adjustment is necessary for him, either. In the absence of inflation, he had to pay three percent, but this was a deductible expense on his tax return, so his after-tax, real cost was 1½ percent. Now he has to pay 13 percent interest, but this, too, is deductible, so after-taxes he pays only 6½ percent, and he is repaying the loan in depreciated dollars, so his real cost is again 1½ percent.

To the extent that market rates of interest adjust for anticipated inflation, then, it would appear that no tax adjustment for debt instruments is necessary. There are three qualifications to this, however. First, creditors and debtors may not be in the same tax bracket, so any rise in the rate of interest will have certain redistributive effects between them. Second, many people feel that the market does not fully adjust, that there are always lags and other discrepancies among nominal rates of interest, real rates of interest, and the rate of inflation. Finally, for many creditors there are institutional barriers which prevent them from adjusting their rate of return in response to inflation. Specifically, we have laws setting limits on the rate of interest which may be paid on savings in banks and other financial institutions. In some recent years, these limits have been less than the rate of inflation, which means that savings account holders have been unable to adjust the rate of interest they earn, and therefore have suffered an actual loss in the value of their assets while at the same time they have been forced to pay income tax on their nominal interest receipts.

In brief, there is currently no agreement among economists, accountants, or businessmen on just how an adjustment for financial instruments should be made. This uncertainty reflects both differences of opinion concerning how well the market adjusts rates of return to take account of inflation, and concern with the equity and practicality of handling inflation premiums. Some economists have argued that the interest deduction should be reduced by the amount of interest that is caused by inflation, i.e. the "inflation premium." This of course would require an estimate of how much of the current nominal rate of interest is "real" and how much is just an inflation premium. Others have suggested that the full interest deduction should be permitted and the full amount of interest income taxed, but at the time debt is paid off, a gain or loss should be recognized to the extent that the debt is paid off with deflated dollars.

FINANCIAL ACCOUNTING

Similarly, no consensus has yet emerged concerning the appropriate way of adjusting depreciation for inflation. The Securities and Exchange Commission has required on certain large companies to provide supplemental accounting information concerning the cost of replacing productive capacity. The approximate amount of depreciation, depletion, and amortization which would have been recorded under such a scheme provides a measure of replacement cost depreciation.

Another proposal for adjusting accounting data for inflation was made, somewhat tentatively, by the Financial Accounting Standards Board. The aspect of that proposal which drew the most attention was the inclusion in net income of changes in the purchasing power of net holdings of monetary assets. This turned out to be quite controversial, and the FASB subsequently withdrew its proposals for further study.

A study of the impact of indexed accounting for two groups of corporations was undertaken by Sidney Davidson of the University of Chicago and Roman Weil of the Georgia Institute of Technology. They recalculated the financial statements of the 30 firms included in the Dow Jones Industrial Average and the 24 utilities included in the Dow Jones Utility Average. All of the utilities would have had higher income and hence presumably higher taxes under the FASB proposed accounting rules, mainly because of the large amount of debt they owed. In the case of the industrial firms, 21 would have had lower taxes and nine would have had higher taxes. Thus indexation is not an unmixed blessing from the point of view of corporate taxpayers.

It seems to us that until there exists a greater consensus within both the accounting profession and the business community concerning the best manner of adjusting financial and operating statements for inflation, it would be inappropriate for the Treasury Department to attempt to impose any particular "correct" method. Until the accounting profession has worked out the technical details of how to index income, and until the business community is prepared to use an indexed financial statement in reporting to their stockholders and creditors, Congress should not permit the business community to report to the Internal Revenue Service on an indexed basis.

CONCLUSION

What we can conclude from this review of indexation? As I stated at the outset, at rates of inflation above a certain level almost everyone would feel that indexation is desirable. I feel that our present and prospective inflation rates are not at that level. To introduce indexation into the tax system would mean substantially increasing the complexity of the present system, greatly increasing the recordkeeping requirements of individuals and firms, and making fairly arbitrary decisions in many areas of income measurement in which no consensus has emerged to date from economists, accountants, or businessmen. Until we know more, it would be a mistake to proceed too rapidly.

COMMENTS ON S. 2738

I have been asked to comment on bill S. 2738 which provides for indexation of certain provisions of the tax laws. This bill essentially calls for indexing the fixed dollar amounts defined in the tax code by adjusting them upwards at two-thirds of the percentage change in the Consumer Price Index. As I indicated in the first part of my testimony, this is a fairly straightforward form of adjustment, and while it does mean the recalculating of a number of factors, it requires no action on the part of Congress or the executive each year in response to inflation. It does mean, however, that the amount of fiscal stimulus (in the form of tax cuts) provided each year will be determined by the rate of inflation in the previous year: the more inflation last year, the more stimulus this year. Moreover, it would make it more difficult for taxpayers to make accurate estimates of their tax liability and therefore make appropriate adjustments in their withholding rates.

The bill goes well beyond this simple form of indexation, however, and provides for a basis increase for capital gains. This basis increase would apply only to capital assets; no provision is made for adjusting financial instruments. Thus, the proposal encounters the difficulty which I mentioned of dis-

criminating between leveraged and unleveraged investors, and between those investors capable of converting income into a capital asset and those unable to.

While a heavily-leveraged taxpayer would receive a significant windfall from such a provision, many persons relying on fixed incomes would be relatively disadvantaged. The savings account depositor is a prime example. Because his savings account interest rate is limited by law, he is not in a position to obtain a real interest rate sufficient to compensate for his inflationary losses. Moreover, a fixed security like a savings account cannot increase in market value the way an equity can. Thus, while the equity holder might experience a rise in market value for his equity, only a portion of which would be taxed away, the holder of a bank deposit would see no rise in the value of his account. He would still be required to pay taxes annually on the full amount of his nominal interest income while the owner of a capital asset could adjust his gain for inflation as well as postponing the tax on that adjusted gain until the asset is sold. Further, under S. 2738, only half of that real capital gain would be taxed at all! There is a patent inequity in a tax system that would insulate holders of real estate and stock from the impact of inflation while ignoring the plight of low income taxpayers who tend to hold savings accounts.

Current law with respect to capital gains has demonstrated that taxpayers will strive to change an ordinary income transaction into a form qualifying for preferential tax treatment. An inflation adjustment for capital gains would place an even greater premium on such manipulative practices and open new avenues for tax gamesmanship. A clear example of this is the collapsible corporation, a device used for the conversion of ordinary business profits into capital gains. If an inflation adjustment is permitted with respect to stock, such collapsible corporations would retain substantial tax advantages unless a significant holding period were required before the inflation adjustment would go into effect.

If we attempt to restrict the categories of assets eligible for inflation adjustments, we would exacerbate problems involving corporate tax shelters. In the event corporate stock is eligible for an inflation adjustment which is denied most other assets, there will be pressure to incorporate scores of nonpreferred investments. For example, taxpayers might be motivated to incorporate savings accounts, jewelry, and antiques if the basis of those investments could not be adjusted independently. Another area of complexity in the tax law would have to be developed in order to prevent such abuses.

Finally, providing an inflation adjustment for capital gains as proposed in S. 2738 would add to the complexity of computing taxable gains. Currently, the amount of gain in a transaction is generally determined without regard to the length of time an asset has been held, once the holding period is such as to qualify as "long-term." With an inflation adjustment mechanism such as S. 2738, however, the date of any change in basis becomes all important. Even in the simplest of transactions, a taxpayer will have to account for the date an asset was purchased as well as the amount paid for that asset, and this determination could create significant administrative problems in those instances where basis is carried over from one taxpayer to another or from one asset to another by transfer where no gain is recognized. Further, an investor adding to or withdrawing from his investment over time would have to calculate a separate inflation correction for each such action.

In brief, without the introduction of a comprehensive scheme of indexation throughout the tax law, a basis adjustment for capital gains might violate the neutrality standard and add new economic distortions to the tax laws. During periods of high inflation, the savings of individuals and businesses would tend to flow increasingly into those investments eligible for an inflation adjustment and away from "non-adjustable" investments. Once an inflation adjustable asset had been selected as an investment, there would also be a tendency for the investor to maintain that investment longer than would be desirable in the absence of the inflation adjustment.

There are many difficult conceptual as well as practical problems involved in correcting the measurement of income for the effects of inflation. Until we have made much more progress in this area, it would be a mistake to proceed in piecemeal fashion to provide an adjustment for only one form of income, namely, capital gains, while denying any adjustment for other, equally deserving, types of income which do not enjoy the preferential treatment already accorded capital gains.

Senator BYRD. The next witness will be Dr. Norman B. Ture of Norman B. Ture, Inc.

Thank you. Doctor, we are glad to have you.

Mr. TURE. Thank you, Mr. Chairman.

If I may, I will read an abbreviated version of my prepared statement and request to have my entire statement in the record.

Senator BYRD. The entire statement will be published in the record.

STATEMENT OF NORMAN B. TURE, PRESIDENT, NORMAN B. TURE, INC.

Mr. TURE. The objectives sought in S. 2738 surely must be supported by the vast majority of Americans. I have reservations about the proposed legislation, but they do not address its objectives, which I heartily endorse.

Rather, these reservations are concerned with possible collateral consequences of the proposed indexing of the Federal tax system.

In brief, I fear that indexing might erode resistance to inflation, reduce the perceived urgency of adopting the basic anti-inflation policies which are required, and misdirect tax policy from what should be its principal concerns.

Policymakers must be concerned with the interaction of inflation and the tax system on the performance of the economy and on individual's economic well-being. But legislative energy, I believe, should first be directed toward correcting the principal structural deficiencies of the tax system. Progress toward a basically revised tax structure does not itself insure a lower rate of inflation, but it would significantly reduce compounding inflation's adverse consequences by tax inflation.

The adverse economic effects of inflation stem from its distortion of relative prices. If the price of goods and services were to increase at exactly the same rate, inflation would be a matter of little consequence. But the inflation phenomenon, in fact, involves different rates of change among prices, and the resulting relationship among prices differ from those that would prevail in the absence of inflation.

The inflation-produced changes in relative prices and the responses of households and businesses to them results in the economy's using its production capability less effectively than it would in the absence of inflation.

You can use this same line of reasoning when you turn your attention to the effects of inflation-induced changes in taxes on economic activity.

If the tax system were perfectly proportional, so that if there were a perfectly proportional inflation, every element of every tax base would increase in exactly the same proportion, and if there were only a single tax rate, then the percentage change in every tax liability would be identical to the inflation rate.

The relationships among the net-of-tax prices of all goods and services would be the same as in the absence of inflation. The inflation would have no effect on real, relative prices.

But the tax system is far from perfectly proportional. It is, on the contrary, appropriately characterized as an extensive system of

selective excises imposed at widely differing marginal rates, some of which are flat, while others are graduated.

In itself, then, the present tax system distorts relative prices, hence the allocation of resources, even in the absence of inflation. This second tier of distortions would exist even if the inflation were perfectly proportional. In the real world of inflation which distorts price relationships, these are further distorted by our existing tax system. The interaction of uneven inflation and of the present tax system results in a third tier of distortions.

Tax-indexing proposals are aimed at moderating, if not eliminating, the latter set of inflation-produced distortions. Not even the most nearly ideal tax indexing could eliminate the primary distortion of relative prices resulting from inflation itself. Nor would perfect tax indexing eliminate the distortions which result, even in a noninflationary context, from the existing tax system.

The objective of tax indexing, properly perceived, is far more limited. It can aim only at moderating what I have designated as the third-tier of distortions.

Tax indexing is not a cure for the inflation disease, nor is it likely to eliminate its major symptom. The most we may expect of it is that it will avert or moderate its tertiary effects.

Some medication, by alleviating symptomatic distress, allows an ailing individual to live more comfortably with his illness. This is, of course, desirable provided that the patient's being more comfortable does not interfere with his undertaking the therapy required to cure the disease itself or provided the disease is not curable.

I hope we still believe that inflation is curable. A proper reading of our experience over the last decade or so does not lead one to the conclusion that inflation has resisted the best medicine there is available, but rather to the conclusion that we have not actually taken that medicine.

We can still entertain the hope, with considerable confidence, that if we will curb the rate of growth in Government expenditures and in the money stock and stay with that prescription, we will soon make progress in reducing the inflation rate.

The hazard in symptomatic therapy such as tax indexing is that, by easing the pain of inflation, it will make us increasingly reluctant to insist on the basic cure and sustain its brief, transitory discomforts.

The usual response to such expressions of concern—and this is a response which is often advanced as one of the basic arguments for tax indexing—is that by significantly constraining the inflation-induced expansion of tax revenues, tax indexing will also curb the growth in Government spending. This alleged slowdown in Government spending will both release production capability to the private sector, resulting in a faster growth in real output, and reduce pressures on the monetary authorities to expand the money stock more rapidly in support of the Treasury's management of the Government's deficits.

Indexing, according to this argument, not only would be effective in dealing with the third-level distortions I have described, it would contribute materially to curing the inflation disease per se.

I wish there were empirical evidence or a convincing abstract analysis to support this argument. The historical record urges that revenues no longer constrain expenditures. The contemporary style in fiscal policy is to increase Government outlays irrespective of the increase in revenues, indeed, even while reducing Government revenues. It seems to me unlikely, therefore, that the revenue effects of tax indexing will reduce the rate of Government expenditure growth.

If tax indexing were not to slow Government spending, it would not make any more real resources available to the private sector, it would exacerbate rather than ease the pressure on the Federal Reserve to accelerate monetary expansion to assist in financing the deficit; and it would, if the Fed were to accede to such pressure, result in accelerating inflation.

To be sure, the Fed does not need to succumb to these pressures. By the same token, it need not have done so in the past, nor need it do so now, given the huge deficit in prospect of the coming year. The fact is, however, that it did do so in the past and there is no plausible reason that I can see to believe that tax indexing itself would impel a change in the Federal Reserve's basic stance on monetary policy.

On the contrary, if the level of inflation pain were to be eased by tax indexing, it is plausible that future Fed policy would be more, rather than less, expansionary and more, rather than less, inflationary.

The real objective of tax indexing, to repeat, is to mitigate the effects of inflation in accentuating the distorting features of the present tax system.

Now, surely, there is much to be said for tax indexing in this connection, if we must be resigned to the indefinite perpetuation of these tax unneutralities. But surely there is a choice between (1) Accepting the present tax unneutralities and seeking by tax indexing to moderate their accentuation of inflation's distortions; and (2) seeking to make the present tax system far more nearly neutral, thereby reducing the tertiary distortions from inflation, hence the occasion for tax indexing. Surely the latter is, at least potentially, a far more productive course.

The basic deficiencies of the present tax system operate to distort the uses of income and of production capability irrespective of the inflation rate. The losses to the economy would be substantial even if the inflation rate were zero. Of course, these losses are increased by inflation, but the incremental losses resulting from inflation are small compared to those which are sustained without regard to inflation. If public policy is to be addressed to cutting losses, surely it should focus on reducing, if not eliminating, the secondary distortions rather than accepting them while concentrating on the tertiary distortions.

Senator DOLE. I wonder if we might be able to summarize it. Senator Byrd is going to try to get back. If you could summarize the balance of your statement.

Mr. TURE. I will, if I might.

One of the major sources of unneutrality in the present tax system is the graduation of marginal tax rates. It is the marginal tax

rate, not the effective tax rate, I think it is widely agreed, which enters into decisions regarding economic behavior, because it is the marginal tax rate which affects prices at the margin.

If we had a single tax rate, inflation would certainly differentially affect the aftertax real incomes of differently situated taxpayers, but it would leave unaffected the marginal tax rate applicable to an additional dollar of income or of deductible expense.

If tax indexing is to be effective in averting what I have referred to as the third-tier distortions of inflation, it must somehow or other cancel the effects of inflation on marginal tax rates. It is the effects of inflation on the marginal rates of tax rather on the taxpayers liability which really is the essence of the problem produced by inflation.

Senator DOLE. I just had a couple of questions because we have some additional witnesses. We first of all appreciate your taking the time to enlighten the committee and the staff on your views on indexing. I, of course, know of your interest in the Kemp-Roth tax reduction bill. As I understand it, that bill would reduce Federal taxes a total of 30 percent over a period of 3 years.

Is that, in effect, a type of indexing itself?

Mr. TURE. I have observed in my statement, Senator, that the effects of indexing can be more or less accomplished by discretionary tax reduction. I would say in that regard, a tax reduction in the form of a rebate or any other form which does not directly reduce marginal tax rates is of very little assistance in offsetting the adverse effects of inflation through the tax system.

If you really want to use discretionary tax changes for that purpose, you should be sure they are reductions in marginal tax rates. That is one of the great virtues of the Roth-Kemp bill.

Senator DOLE. Do you think there is more flexibility through tax indexing the Roth-Kemp approach?

Mr. TURE. Let me make it perfectly clear, sir, that if you could, in fact, implement the sort of tax-indexing proposal that you have in your bill and make sure that there were no Presidential interruptions, that would certainly be far more flexible in the sense that it would impose many fewer demands on the attention of the Congress to do the right kind of thing with respect to the problem to which indexing is appropriately directed.

It would still leave all the basic deficiencies of the tax system unchanged, and I think those are very severe and really require primary attention.

Senator DOLE. I appreciate very much—and with your permission, we will probably be in contact with you.

[The prepared statement of Mr. Ture follows:]

STATEMENT OF NORMAN B. TURE, PRESIDENT, NORMAN B. TURE, INC.

INTRODUCTION

The objectives sought in S. 2738 surely must be supported by the vast majority of Americans. My reservations about the proposed legislation do not address its objectives which I heartily endorse. Rather, these reservations are concerned with possible collateral consequences of the proposed indexing of the Federal tax system. In brief, I fear that indexing might erode resistance to inflation, reduce the urgency of changing the basic mone-

tary policy stance to provide a steadier and slower rate of increase in the stock of money, and misdirect tax policy from what should be its principal concerns.

In expressing these reservations, I do not intend to suggest that policymakers should be indifferent to the interaction of inflation and the tax system on the performance of the economy and on individuals' economic well being. Rather, I would urge that legislative energies should be directed toward correcting the principal structural deficiencies of the tax system. Progress toward a basically revised tax structure does not itself ensure a lower rate of inflation, but it would significantly reduce compounding inflation's adverse consequences by tax inflation.

In the discussion that follows, I shall focus only on the economic issues with which indexing proposals are concerned. This focus reflects my assessment of my comparative advantage, not a dismissal of equity issues as unimportant.

THE BASIC ECONOMIC COST OF INFLATION : FIRST TIER DISTORTIONS

The adverse economic effects of inflation stem from its distortion of relative prices. If each and every price of every good and service were to increase at exactly the same rate, inflation would be a matter of little consequence. For example, if the nominal—current dollar—wage rate for every kind of labor service, the nominal interest rate for every debt contract, the market or shadow price of every kind of capital, the nominal amount of every annuity, insurance benefit, retirement income, the price of every intermediate and final product, domestic and international, etc., were to increase by identical percentages, nothing in real terms would be changed. But the inflation phenomenon is in fact quite different—it does involve differing rates of change among prices and the resulting relationships among prices differ from those that would prevail in the absence of inflation. On the assumption of reasonably efficient markets, the inflation-produced changes in relative prices and the responses of households and business to them imply efficiency losses—an economy using its production capability less effectively than it would in the absence of inflation.

INFLATION AND THE TAX SYSTEM : SECOND AND THIRD TIER BISTORTIONS

This same line of reasoning is appropriate when we turn our attention to the effects of inflation on taxes and the effects of inflation-induced changes in taxes on economic activity. If the tax system were perfectly proportional so that, if there were a perfectly proportional inflation, every element of every tax base were to increase in exactly the same proportion and if thre were only a single tax rate, then the percentage change in every tax liability would be identical to the inflation rate. The relationships among the net-of-tax prices of all goods and services would be the same as in the absence of the inflation; the inflation would have no effect on real relative prices. But the tax system is far from perfectly proportional. It is, on the contrary, appropriately characterized as an extensive system of selective excises imposed at widely differing marginal rates, some of which are flat while others are graduated. In itself, then, the present tax system distorts relative prices, hence the allocation of resources, even in the absence of inflation. This second tier of distortions would exist even if the inflation were perfectly proportional. In the real world of inflation which distorts price relation-ships, these are further distorted by the tax system. The interaction of uneven inflation and of the present tax system results in a third tier of distortions.

THE LIMITED OBJECTIVE OF TAX INDEXING

Tax indexing proposals are aimed at moderating, if not eliminating, the latter set of inflation-produced distortions. Obviously, not even the most nearly ideal tax indexing could eliminate the primary distortion of relative prices resulting from inflation itself. Nor would perfect tax indexing eliminate the distortions which result, even in a noninflationary context, from the existing tax system. The objective of tax indexing is far more limited; it can aim only at moderating what I have designated as the third tier of distortions.

In so describing its objective, I do not mean to deprecate the virtue of tax indexing. My purpose is only to provide a cautionary reminder, which may be unneeded, that tax indexing is not a cure for the inflation disease nor is it likely to eliminate its major symptoms. The most we should expect of it is that it will avert or moderate its tertiary effects.

TAX INDEXING AND BASIC ANTI-INFLATION POLICIES

Some medication, by alleviating symptomatic distress, allow an ailing individual to live more comfortably with his illness. This is, of course, a desirable result provided that his being more comfortable does not interfere with his undertaking the therapy required to cure the disease itself or provided the disease is not curable. Certainly we are not yet prepared to believe that inflation is incurable. A proper reading of our experience over the last decade or so doesn't lead one to the conclusion that inflation has resisted the best medicine there is available, but rather to the conclusion that we haven't actually taken that medicine. We can still entertain the hope, with considerable confidence, that if we will curb the rate of growth in the money stock and stay with that prescription, we will soon make progress in reducing the inflation rate. The hazard in symptomatic therapy, such as tax indexing, is that by easing the pain of inflation, it will make us increasingly reluctant to insist on the basic cure and to sustain its brief, transitory discomforts.

The members of this Committee are far better equipped than I to weigh this hazard. From where I sit, it seems that public policy in many fields has more often than not taken the easy rather than the most effective course. I respectfully urge careful consideration to the question whether tax indexing, though not so intended, might prove to be more a placebo than the rigorous therapy that is required.

The usual response to such expressions of concern—a response often advanced as one of the basic arguments for tax indexing—is that by significantly constraining the inflation-induced expansion of tax revenues, tax indexing will also curb the growth in government expenditures. This alleged slowdown in government spending will both release production capability to the private sector, resulting in a faster growth in real output, and reduce pressure on the monetary authorities to expand the money stock more rapidly in support of the Treasury's management of the government's deficits. Indexing, according to this argument, not only would be effective in dealing with the third-level distortions I've described, it would contribute materially to curing the inflation disease *per se*.

I wish there were empirical evidence or a convincing abstract analysis to support this argument. The historical record urges that fiscal policy long past lost the disciplining effect of revenues on expenditures. The contemporary style in fiscal policy, thanks largely to the influence of John Maynard Keynes and his intellectual heirs, is to increase government outlays, irrespective of the increase in revenues, indeed even while reducing government revenues. It seems to me unlikely, therefore, that the revenue effects of tax indexing, whether measured in terms of initial impact or net of feedback, will influence the course of government expenditure growth; it is wishful thinking, I suspect, to assert that tax indexing will result in a lower level of government outlays than otherwise at any time in the foreseeable future.

TAX INDEXING MIGHT ACCELERATE INFLATION

If the asserted connection between tax indexing and government expenditures were not to materialize, tax indexing would not reduce the government's claim on the economy's real income, it would not make any more real resources available to the private sector, it would exacerbate rather than ease the pressure on the Federal Reserve to accelerate monetary expansion to assist in financing the deficit, and it would, if the Fed were to accede to such pressure, result in accelerating inflation. To be sure, the Fed need not succumb to these pressures. By the same token, it needn't have done so in the past nor need it to do so now, given the huge deficit in prospect for the coming year. The fact is, however, that it did so in the past and there is no plausible reason to believe that tax indexing itself would impel a change in its policy. On the contrary, if the level of inflation pain were to be eased by tax indexing,

surely it's as plausible to believe that future Fed policy would be less constrained than at present by the perception of the inflationary consequences of an accomodating monetary policy. If tax indexing were to result in higher rate of inflation, surely this cure would be counterindicated.

TAX INDEXING VS. FUNDAMENTAL TAX REFORM

Adverting to the first part of my discussion, the real objective of tax indexing is to mitigate the effect of inflation in accentuating the distorting features of the present tax system. Putting aside the reservations so far expressed, there surely is much to be said for tax indexing in this connection if we must be resigned to the indefinite perpetuation of these tax unneutralities. But this presents a choice between (1) accepting the present tax unneutralities and seeking by tax indexing to moderate their accentuation of inflation's distortions and (2) seeking to make the present tax system far more nearly neutral, thereby reducing the tertiary distortions from inflation, hence the occasion for tax indexing. Surely the latter is, at least potentially, a far more productive course.

The basic deficiencies of the present tax system operate to distort the uses of-income and of production capability irrespective of the inflation rate. The losses to the economy would be substantial even if the inflation rate were zero. Of course these losses are increased by inflation, but the incremental losses resulting from inflation are small compared to those which are sustained without regard to inflation. If public policy is to be addressed to cutting losses, surely it should focus on reducing, if not eliminating, the secondary distortions, rather than accepting them while concentrating on the tertiary distortions.

This is not the occasion for discussion of the basic deficiencies of the existing tax system or of the agenda of prescriptions for constructive tax reform. Perhaps a couple of examples will illustrate the point at issue.

An income tax which does not permit immediate expensing of capital outlays increases the cost of saving and capital formation relative to that of consumption, compared with their relative costs in the absence of the tax. To be sure, if the depreciation deductions are based on the historic rather than the current replacement cost of the capital, inflation will accentuate this anti-saving-investment tax bias, but generally this incremental bias is substantially less severe than that which inheres in our sort of income tax.

Similarly, any tax on capital gains is an incremental levy on the returns to a given amount of capital. It represents a differential excise on saving and capital formation from which consumption uses of income are exempt. This element of the present tax bias against saving and investment is substantial even when measured capital gains are real, not inflationary in source. Of course, it is accentuated by inflation; in the extreme, the nominal gains may be real losses so that any tax on gains is in fact an additional tax on the original saving, not only an incremental tax on the returns thereto.

The fundamental reform called for in these cases is to allow expensing or immediate deductions for the saving or investment, while fully taxing the gross returns to the saving. Insofar as these returns are saved—invested—the immediate expensing provides an automatic rollover and deferral of tax. This clearly would afford a complete insulation of the saving and the returns thereto from any inflation, but this protection against inflation would be a collateral benefit to the basic gain in neutrality in the tax treatment of saving compared with consumption uses of income. In contrast, indexing depreciation deductions and capital gains leaves the basic anti-saving bias in place.

One of the major sources of unneutrality in the present tax system is the graduation of marginal tax rates. This is the most politically sensitive issue confronting tax policy. The ethical concerns upon which graduation is based are ancient; the appropriate weight to be given them has been the subject of a long-standing and continuing philosophic debate. Regarding the economic considerations there is, I believe, a far wider agreement that graduation imposes an increasing bias against productive effort and against saving the more productively one uses one's currently available resources and that it penalizes increasing the productivity and intensity of use of one's resources. To be sure, there are widely divergent views as to the quantitative significance of these effects, but a broad consensus exists regarding the thrust of graduation.

Graduation is also an important source of the third-tier distortions produced by inflation, which was discussed earlier. It is a nearly universally accepted principle that it is the marginal—not the effective—rate of tax which enters into decisions pertaining to economic behavior. It is the marginal tax rate which affects the price at the margin—where choices are made—of effort vs. leisure, of saving vs. consumption, of one saving outlet vs. another, etc. With a single tax rate, inflation would certainly differentially affect the after-tax real income of differently situated taxpayers but it would leave unaffected the marginal tax rate applicable to an additional dollar of income or of deductible expense. With a graduated structure of marginal tax rates, however, inflation exposes taxpayers to higher marginal rates than would be applicable if their real rather than their nominal incomes were subject to tax. The magnitude of the inflation-induced increase in marginal rates probably tends to increase the higher the applicable marginal rate absent inflation. Moreover, the increase in applicable marginal tax rates generated by inflation varies among taxpayers depending on the sources of their incomes and the nature of their deductible expenses, since inflation does not equally affect the price of each productive service and of each intermediate and final good and service.

If tax indexing is to be effective in averting the third-tier distortions of inflation, it must cancel the effects of inflation on marginal tax rates. However successful it might be in offsetting third-tier distortions, tax indexing would not affect the fundamental distortions produced by graduation of marginal tax rates.

CONCLUSION

In considering tax indexing, it should be kept in mind that this is not a cure for inflation. The benefits which would be afforded by indexing are not to be casually dismissed, but neither should they be permitted to disguise the far more serious and basic deficiencies of the existing tax system. Certainly tax indexing is vastly preferable to devices such as tax rebates as a means of offsetting the tertiary distortions of inflation described above. Much the same effect as indexing could, of course, be achieved by discretionary tax reductions in the form of marginal rate cuts. Whatever the approach, it should be emphasized that tax adjustments for inflation are likely to contribute far less to the long-term progress of the economy than constructive, basic tax revisions to reduce the existing tax biases against effort and saving.

Senator DOLE. I think we will call the remaining three witnesses, Dr. Fellner, Dr. Jacobe, and Mr. Koch. If you could all come forward and Dr. Fellner, you could proceed.

STATEMENT OF WILLIAM FELLNER, AMERICAN ENTERPRISE INSTITUTE, STERLING PROFESSOR OF ECONOMICS EMERITUS, YALE UNIVERSITY

Mr. FELLNER. Gentlemen, I do indeed consider it a requirement of honest and efficient decisionmaking in matters of fiscal policy to index the tax structure. Indexation does not, of course, imply that Congress could not subsequently change the properly adjusted tax structure whenever it wished to do so. What indexation would mean is that whenever the tax system is changed or "reformed" such measures would relate to a structure that is not distorted by the effects of inflation. Hence the changes or reforms would not get merged confusingly with occasional and partial rectifications of a distorted structure.

As concerns the individual income tax, the inflationary distortions result mainly from the fact that individuals and families obtaining a rise in their current-dollar incomes in proportion to the inflation

rate, thus remaining at the same level of real income, pay over a higher proportion of their incomes to the tax collector, because the additions to current dollar incomes fall in a higher tax bracket than the average dollar of which the incomes are made up.

This means that if Congress puts into effect a tax structure in year 1, then the proportion of each income taxed away in year 2 will be different, depending on the rate of price increase from year 1 to year 2. The proportion taxed away in year 2 will be larger the higher the rate of price increase is. The distortion cumulates over the years. I consider it very difficult to call the procedure anything but indefensible.

In defense of the nonindexation the unconvincing argument has occasionally been used that from time to time Congress has reduced the statutory tax rates and has increased the exemptions and the standard deduction. Whether Congress has, in fact, offset the inflationary excess taxation of individuals and families in the aggregate depends on the time span we choose for exploration. That is not true of all time spans that tend to be reasonably selected for such an investigation.

But let us consider some span for which the excess taxation was offset in the aggregate by measures that were misleadingly described as tax cuts. Even for such spans, it is true not only that the tax burden was redistributed in the process, but also that this redistribution involvedan actual increase of the tax burden relative to incomes for a very major part of the population.

For instance, the tax package proposed by the administration for fiscal year 1979 is said to involve tax cuts for almost all taxpayers and to impose some amount of tax increases merely on the recipients of very high incomes. But the presentation of these figures by the administration disregards the fact that, meanwhile, inflation is pushing taxpayers into higher brackets. Any realistic calculation would demonstrate that the proposed package—the package proposed by the administration—raises taxes for a family of four from around $20,000 upwards—as a matter of fact, from somewhat below this figure by some ways of looking at the matter, or from just about this figure upward, depending on the specific assumptions made.

Now, Congress is obviously free to raise taxes for a very large number of taxpayers while reducing them for others but if on the initiative of the administration it truly wishes to do so, then it needs to be made clear and explicit that this is what is being done.

After indexation it will be possible to raise taxes for part of the population and to reduce them for another part, but it is questionable, to say the least, whether with the break-even point at or below $20,000 for a family of four, such a combination of cuts and raises would receive serious consideration.

At any rate, a combination of this sort that raises taxes from about that level upward and reduces them only below that level, a combination of this sort could not be described as representing a general tax reduction.

As a result of failure to index the tax structure, the measure is described as tax reduction, and high-standing officials are illustrating the effect of proposed changes for taxpayers without taking account the rise of the tax burden due to inflation. All the official illustrations of what will result for the various tax brackets just leaves this out of the account.

As I said, from a rather moderate-income level upward the rise in the tax burden due to inflation is not offset by the so-called tax cuts. It is possible to present the matter in a highly misleading fashion because it is presented under the smokescreen created by a nonindexed tax structure.

The main provisions required for the indexation of the individual income tax include stepping up, in proportion to the inflation rate, the tax credit, the exemptions, the standard deduction and the lower and the upper limit of each bracket interval. Stepping up in proportion to the inflation rate the cost of acquisition of assets on which capital gains taxes are levied belong in the same category of measures.

I am not in favor of limiting the automatic inflation adjustments to two-thirds of the inflation rate, as bill S. 2738 would. In years in which other considerations should call for what in the spirit of the bill would be described as partial correction, there should, in my view, nevertheless be full correction of the tax structure and it should then be made explicit that other considerations lead Congress to raising the tax rates in the framework of the fully indexed system.

Hiding any part of the bracket push is highly confusing and I think that we should abstain from hiding any part of the excess taxation brought about by inflation.

I limited myself to the question of indexing the individual income tax. Rising prices result also in purely nominal, inflationary, additions of substantial size to taxable corporate profits. This leads to the taxation of merely nominal value increments of physically unchanging quantities of inventories and of fixed capita.

Correcting taxable profits for this inflationary distortion gives rise to problems of greater complexity than does the correction of the individual income tax. But the somewhat more complex problems encountered in the area of business taxes are also manageable.

These problems do not, however, belong among those to which the present hearings relate.

Thank you, Senator.

Senator DOLE. Thank you very much, Dr. Fellner. I know you have a time problem.

Mr. FELLNER. I have a time problem, but not——

Senator DOLE. Could you wait a few minutes while we hear from the other witnesses?

Mr. FELLNER. Yes.

Senator DOLE. The next witness is Dr. Jacobe.

Mr. JACOBE. Yes, Senator. I would like to read, in an abbreviated version, my paper.

STATEMENT OF DENNIS JACOBE, ECONOMIST, U.S. LEAGUE OF SAVINGS ASSOCIATIONS

Mr. JACOBE. In my few minutes here this morning I will discuss the process of the interaction between inflation and our tax system, the way it creates an inflation-tax wedge, and its implication for the economic well-being of the middle-income taxpayer. In this way, I hope to make the point that inflation produces an arbitrary and unfair increase in the real tax burden of the middle-income taxpayer, a situation which, in my opinion, must be corrected.

Inflation significantly increases the real tax burden of middle-income Americans. Generally this process occurs as follows: Inflation reduces the purchasing power of the middle-income family. As a result, the family receives a dollar income increase, just to maintain its real purchasing power and thus, its standard of living. Such a money income increase, however, will increase the family's tax burden.

In fact, since our tax system is progressive and based upon money income rather than real income, the dollar wage increase produces not only a dollar tax increase but also a real tax increase.

As a result, our current tax system creates an inflation tax wedge between the dollar income a family receives and its real purchasing power. This wedge makes it more difficult for the middle-income family to maintain its purchasing power in the face of rampant inflation, while providing the Government with an inflation tax bonus.

For discussion purposes, I have provided the subcommittee with a few exhibits which illustrates how the inflation-tax wedge works.

Table No. 1 deals with a 10-percent wage increase for middle-income Americans earning between $15,000 and $30,000 and encountering a 10-percent inflation rate. For example purposes, let's consider a family earning $20,000 in 1977.

The 10-percent wage increase would thus total $2,000, thus increasing this family's income level to $22,000 in 1978.

Table No. 1 shows that in 1977, this family paid Federal taxes of $2,536 for an effective tax rate of 12.7 percent. Although this family received a $2,000 income increase in 1978, it did not receive a real income increase, due to inflation. As a result, equity would imply that this family's relative tax burden should not increase. That is, a wage increase which enables a middle-income taxpayer to maintain his before-tax purchasing power should, if equitable, permit him to maintain his after-tax purchasing power.

In order to keep this consumer taxpayer's after-tax purchasing power constant, the equitable tax increase on this $2,000 new money income should keep his effective tax rate constant at 12.7 percent.

Column No. 5 of table No. 1 shows that an increase in this family's taxes of $253.60, at 10 percent, would be equitable in this context. Our current tax structure, however, does not produce such an equitable tax increase. Since our tax system is progressive and measures dollar income rather than real income, this family's dollar wage increase is taxed at a rate of 25 percent rather than its effective rate of 12.7 percent.

As a result, this middle-income family would find itself with a tax burden totaling $3,036, or a tax increase of $500.

The bottom line of this simple illustration, however, is shown in column 9 of table 1. The middle-income consumer taxpayer incurs an added tax burden of about $246 as a result of the interaction of inflation and our current tax system. This amount represents the inflation-tax wedge.

This wedge provides the Treasury with an inflation bonus, a gain of $246 from this one taxpayer. Further, it reduces this middle-income family's real purchasing power by about the same amount. That is, while the 10 percent wage increase compensates for inflation on a pretax basis, the consumer taxpayer still loses ground on an after-tax basis.

Table No. 2 illustrates how the inflation-tax wedge works if the same conditions were repeated in 1979. Suffice it to say that it would provide the Treasury with another inflation tax bonus of $307.

Table No. 3 illustrates the combined effects of the 2-year impact of the inflation-tax wedge. As a result of 2 years of 10-percent inflation, the Treasury receives an inflation-tax bonus of about $550.

Due to time limitations I cannot go into further detail on the way the middle-income inflation-tax wedge works. Suffice it to say that it gets bigger as the inflation rate increases, it gets bigger as income increases, it permits the Treasury to profit from inflation, and it adds to the inflation burden of the middle-income American.

Obviously, the existence of the inflation-tax wedge holds dire consequences for the economic well-being of middle-income Americans, as well as for the economy as a whole. I would like to briefly discuss two of these: First, its impact on real wages during the next 2 years and its implications for the Federal budget.

Table No. 4 illustrates an example of how middle-income Americans might fare this year and next, assuming a 6.5-percent inflation rate and a 10-percent wage increase. It shows that a middle-income family earning $20,000 in 1977 and receiving a 10-percent wage increase in 1978 of $2,000 would receive a real wage increase of only about 1.2 percent or $231, while a similar increase in 1979 would provide a negligible real increase of about $11.

While these numbers only illustrate what every middle-income family already knows about the real value of its wage increases, I find them dismaying for another reason. They illustrate the danger that continued high rates of inflation without substantial tax reform will produce real purchasing power losses for middle-income Americans. These losses, in turn, may bring about a return to the stagflation of 1973–74 or something even worse.

With respect to the Federal budget, these figures imply that it is very important that we keep middle-income families in mind as we try to achieve budget balance. In this respect, I feel an effort toward adjusting our tax system is necessary. Such an effort should reduce, or eliminate, the unfair impact of the inflation-tax wedge on middle-income taxpayers. Further, it should reduce or eliminate the inflation-tax bonus currently received by the Treasury.

As I understand it, S. 2738, the purpose of this proposal is twofold, having a direct and indirect objective. First, it directly attacks

the problems of most of America's individual taxpayers who now pay inflationary dividends to the very Government that creates the inflation.

Second, and somewhat indirectly, I believe that this proposal is designed to force on the Congress and the administration greater spending discipline as a result of the elimination of the Treasury's inflation dividends. These two objectives are worthy and should be subjected to careful consideration by the Congress.

The proposal, however, is not a solution to our inflation problem. It does not directly attack the primary cause of inflation and monetary instability; namely, excessive Federal spending and record deficits. In this regard, the question that must be asked is: Will the elimination of the Treasury's inflation dividend result in spending discipline?

Frankly, I do not know the answer to that question.

I have appreciated this opportunity to discuss with the subcommittee this issue of such vital importance to the Nation's future economic health. I look forward to your questions.

Senator DOLE. Dr. Fellner, before you have to leave, I would just like to ask one question. As a former member of the President's Economic Advisory Council you have a good grasp of what we are trying to come to grips with.

You said in 1975, the only systematic way to gradually remove these distortions would be to use an index tax system as a point of departure for any tax rate adjustments we may wish to make in the future.

Mr. FELLNER. Yes, sir.

Senator DOLE. I just wondered if you could elaborate what provision in the Tax Code should be indexed and what formula you might use, whether it by the GNP deflator or the Consumer Price Index or what you might suggest?

Mr. FELLNER. Well, I think that there is a lot of room for judgment on which of these one would select. I personally would select the GNP price deflator, but I would not be unhappy about selecting the Consumer Price Index and in most other countries—I do not know for sure whether it is really in most other countries, but in several countries about which I know—it is the CPI which is being used.

I do not think there is very much difference there and, in fact, those two move pretty much parallel to one another.

The philosophy behind these two things is a little different because the GNP deflator expresses prices other than consumer prices as well, and what one wants to mean by the purchasing power of the dollar is somewhat indeterminate as to which index one wants to use to measure it.

I would take the broader measure which is the deflator. I would not be unhappy at all about the CPI.

Senator DOLE. Would you extend indexing for the basis for calculating depreciation on fixed assets?

Mr. FELLNER. Senator Dole, I think yes, I would, but it needs to be admitted that there are some complications there which are greater than the complications, arising for personal taxes. There are very

few complications which would arise in connection with the individual income tax.

As a matter of fact, I think I am correct in saying that there are no serious complications whatever in connection with the individual income tax. It is a simple procedure.

Now, of course, it needs to be somehow taken into account that if you go to business taxes, then there is a difference between the self-financed or equity-financed part of these investments and the debt-financed part of these investments. Some sort of allowance has to be made for that, because to the extent that an investment is debt-financed, the merely inflationary and thus fictitious part of the taxable income shows in the tax returns of the creditor, and there is a complication there so that some sort of adjustment would have to be made, in my opinion, if you go to business taxes.

I do not think that that is an insurmountable difficulty. I think that satisfactory ways of dealing with that problem are available and, hence, I would indeed be in favor of extending indexation also to business taxes, including corporate taxes.

However, I think that the logical sequence may be to start with the individual income tax, but I would include there the capital gains tax. The logical sequence, I think, is to start that way, and to reduce the rates of the corporate income tax which, in my view, is not a good tax anyway.

And then gradually, we should work out some arrangement that would make that reduction also more systematic tied in with the inflationary swelling up of taxes.

Senator DOLE. Thank you very much.

Dr. Fellner, if you do have to leave, I understand.

Mr. Koch, you may proceed.

Mr. FELLNER. Thank you, Senator Dole.

Mr. KOCH. Thank you, Senator.

STATEMENT OF ALBERT A. KOCH, ERNST & ERNST

Mr. KOCH. My name is Albert Koch. I am a partner of the executive office of Ernst & Ernst in Cleveland. I am accompanied today by Joel M. Foster who is here in our Washington, D.C., office.

I will be offering only a brief summary of our comments and would request that the full statement be included in the record of these hearings.

Ernst & Ernst does appreciate the privilege of submitting some views on improving our tax system and making it fairer, by strengthening the economic base upon which we depend to raise Government moneys which are needed to serve and protect all of us.

Inflation is a cruel tax because it falls most heavily on those who are least able to afford its impact. Pensioners and others on fixed incomes are particularly affected. So, too, are those taxpayers with significant investments in capital assets.

We commend Senators Dole, McClure, Griffin and others on their effort both to explicitly recognize the impact of inflation in our system of taxation and to mitigate its impact so that the burden of inflation is shared equitably.

We believe that the system of indexing outlined in the proposed Tax Indexation Act of 1978 has merit and is worthy of careful study and consideration.

One facet of that bill is of particular interest to our firm—that of indexing the basis of property for computing gain or loss. We urge that this basis adjustment extend also to the cost of capital assets so that depreciation capital consumption allowances appropriately recognize the impact of inflation.

Our firm is very concerned about the impact that inflation has had in capital intensive industries. Here, because of inflation, capital consumption allowances computed on the basis of historical costs are totally inadequate to replace capital assets as they wear out and need to be replaced.

Thus, internally generated funds are inadequate to maintain existing productive capacity. Expansion in real economic terms is out of the question. Inflation-adjusted profits for most capital-intensive industries show little, if any, retained profits expressed in real economic terms.

Further, capital markets today penalize these same capital-intensive industries by favoring service and other industries that do not require relatively large investments in capital assets. Accordingly, while accelerated depreciation might be viewed as a partial solution to the problem of inflation, this is a macroeconomic view which overlooks those capital-intensive industries whose annual asset additions are insufficient to provide depreciation deductions that will keep pace with the real costs of capital consumed.

As a result of inadequate internally-generated cash flows to maintain and expand productive capacity, and because of unfavorable capital markets, American industry is experiencing extreme difficulty in remaining competitive in world markets. Unless corrective action is soon taken, this competitive deficiency will become chronic in some industries, and terminal in those others that will be absolutely unable to compete. Hundreds of thousands of jobs may be affected.

Certainly, some of the problems of the American steel industry can be directly traced to this inflation-based problem. Other industries are similarly affected. Our firm believes that something needs to be done quickly if our country is to remain the greatest economic power in the world.

About 1½ years ago our firm issued a proposal that depreciation for both tax and financial reporting purposes be computed on the basis of current cost depreciation. The concept of indexing is very similar to that expressed in the proposed Tax Indexation Act of 1978.

The Ernst & Ernst proposal for current cost depreciation has the advantages of more clearly reflecting income by a better matching of revenues and related costs, preventing misleading distortions in financial statements caused by high rates of inflation, and avoiding computational complexities that might be introduced by attempting to determine fair market values of capital assets based on subjective estimates and appraisals.

We believe that current cost depreciation is a practical and appropriately flexible method of accounting for inflation. It would enable capital recovery and retention commensurate with economic conditions and advancing technology. To determine the economic effect of this suggested change in tax and financial accounting procedure, our firm engaged Chase Econometrics to study its macroeconomic impact. The results of this very recent study are summarized in our statement.

It shows that if our suggested changes had been adopted prospectively effective January 1, 1977, it would have produced these results: Purchases of production equipment would be $1.6 billion higher this year; nonresidential construction would increase $2.2 billion this year; GNP would rise $4.6 billion this year; and unemployment would be .15 percent lower this year.

The Chase study also shows that our proposal would have a positive impact on the economy. It would create 400,000 new jobs by 1980 without increasing inflation. Increase in the Federal budget deficit would be minimal so capital markets would not be upset and interest rates would not be materially affected.

Investment in production equipment would rise an additional 2 percent by 1980 and nonresidential construction would be 5.1 percent greater at that time.

Thank you for your kind attention. We appreciate this opportunity to have shared our views with you this morning.

Senator DOLE. That proposal is set forth in more detail, as I understand, in your full statement.

Mr. KOCH. Yes, sir, it is.

Senator DOLE. Inflation in our tax system has been generally hard on capital formation and the net effect of this combination is that real capital losses are either minimized or converted into taxable capital gains.

I assume that you agree that is somewhat of a disincentive for economic growth.

Mr. KOCH. Indeed it is.

Senator DOLE. Do you think that your proposal might address that particular problem?

Mr. KOCH. We think, Senator, that it would in the sense that those who commit funds now to capital investments are not assured of obtaining a tax allowance plus a profit. In fact, they can generally look forward to receiving a capital consumption allowance that is inadequate for its replacement and therefore, in real economic terms, they may suffer a loss.

Senator DOLE. Now, with reference to the indexing proposal, I assume that you are for the concept but have some reservations about how it might apply insofar as depreciation or replacement costs?

Mr. KOCH. Senator, we have heard this morning from people addressing the complexity. Indeed, there would be some difficulties in implementing the concept but, at the same time, we do not think they are any more difficult than some other areas of our tax code which themselves are very complex.

Senator DOLE. I think, Dr. Jacobe, you asked the best question—will the elimination of the Treasury's inflation dividend result in spending discipline. You proceeded to say you did not know the answer: we do not either.

You did not address the specifics of any indexing proposal, but I assume you favor the concept?

Mr. JACOBE. That is right, Senator, the qualification being that we do not worsen our inflation problem as a result of it increasing the deficit.

Senator DOLE. The American people are beginning to understand indexing and they are beginning to question us why there is not something built into the tax structure that prevents this on again, off again, tax reduction battle. They are not so interested in whether the tax reduction comes right before the election as is generally proposed by any administration. They are more concerned about whether it really means anything.

I think many are convinced, as Dr. Fellner pointed out, that incomes up to about $25,000 there is not a tax cut, it is probably going to be an increase.

Mr. FELLNER. Surely it is going to be an increase, Senator, and it would be well below $20,000.

Senator DOLE. Below $20,000?

Mr. FELLNER. Yes. Well, it depends on how you compute the social security tax in this regard and on what you assume with respect to conditions that family lives influences this.

Senator DOLE. It has been stated earlier this morning that maybe indexing would cause us to accept inflation, that it would destroy any discipline and that Congress would be even less disciplined than we are now. There is not much evidence of any discipline now.

Mr. FELLNER. If I may venture an opinion on that, I think it would add to discipline rather than to the contrary of it. I think that it would then become clear that the deficit would run very, very high—unacceptably high—if some fiscal discipline were not imposed on the expenditure side of the budget, some reasonable degree of that.

Senator DOLE. We would lose that windfall, too. We would have to make it up somewhere.

Mr. FELLNER. Yes, and I think it is very difficult to stand openly for a tax bill that raises taxes from about $20,000 upwards for a family of four. to do that openly and explicitly. That, I think, would be very, very difficult to do.

Senator DOLE. Well, we are telling people now that they are getting a tax reduction and in effect—and I do not say it because it is the administration's proposal, but under most tax cut proposals, whether it is Republican or Democrat, we always say you are getting a tax cut. However, I understand that is not the case. For many taxpayers it is not a tax cut. There is going to be an increase.

Mr. FELLNER. For a very, very large number of taxpayers it is a tax increase. I think it would be difficult to stand for that openly and explicitly and we see that the administration refused to do that. All illustrations disregard the question to which we are now address-

ing ourselves in figuring out or submitting to the public where the breakeven point comes it comes very, very high up somewhere and not where it really comes in view of the inflation.

So it is difficult to do that.

Now, Congress would then be faced, if the tax structure were indexed, with a choice between openly admitting that it is raising taxes, on the one hand, at least to a very large part of the population, or letting the deficit rise to levels which, I think, would generally be considered very objectionable.

So I think that also, from the point of view of fiscal discipline, it would be a step in the right direction and this is, I think, why it is opposed by many people.

Senator DOLE. Would you like to add to that?

Mr. JACOBE. Yes, Senator. In the Gallup Poll that was quoted earlier, the question was asked would you rather have a tax cut or inflation? It is really the reverse. It is a question of a tax increase or inflation. And if you took a poll and you asked people, giving them three alternatives; inflation, a tax increase or neither, you know what the answer would obviously be.

I think this question is a distortion, particularly the way it is presented. But I think that is more a political than economic problem.

Senator DOLE. I think Senator Hansen may have some questions. We all run around the country talking about tax cuts. We think it is politically appealing. However, what we are really talking about is increasing taxes for some Americans if we endorse a particular proposal.

The only other question I would have, if we did index, that would not prevent basic changes, reforms, in the Tax Code, would it?

Mr. FELLNER. It would certainly not do that, Senator, and the countries that have developed the tax indexation have demonstrated that it does not mean that. They have changed the indexed system, only they had to admit what they were doing.

Senator HANSEN. I do not have any questions, Mr. Chairman. I would like to observe that I am keenly interested in legislation that affects this vitally important field. I think the need for capital formation and its relationship with jobs is a very real one and I am delighted that we have had the witnesses who have appeared here this morning.

I have a couple of bills to explore different approaches, any one of which may be helpful. I think there could be no question but what, given the parameters under which we have been operating, as adjustments are made in wages or salaries to compensate for the erosive effects of inflation, taxpayers are placed in higher brackets. When they get through meeting the April 15 deadline, they have not held even, they have actually lost ground.

That point, I understand, was brought out here.

I am going to be keenly interested in reading the testimony each of you gentlemen has given here today. I would hope that we would be able to persuade our colleagues in the Senate that some of the ideas that have been advanced which you support will indeed represent long overdue changes in the law.

Thank you, Mr. Chairman.

Senator DOLE. Thank you.

Your statements will be included in full in the record. I would just say this, that there is more and more interest in this concept. Maybe it is 1 year away or 2 years or 10 years, but once the American public fully understands what indexing is there is going to be a change. Right now, there is not a lot of political appeal.

We talk about indexing but there are not enough people who fully understand it. Maybe it should be changed, or modified. But I would just predict that, in a year from now, if we are still talking about indexing, you will have nine colleagues here and one TV camera, that is the way you can judge how things are going. When you get one camera, you are almost in business; two cameras, you are over the hill.

But the interest is growing and we appreciate your taking the time to pioneer the effort. Whatever bill may emerge, even though there is some fear by some Members of Congress that that would take away a politically popular issue every 2 years right before election, it seems to me that it might be in our interests to do so.

[The prepared statements of Dr. Jacobe and Mr. Koch follow. Oral testimony continues on p. 129.]

STATEMENT OF DR. DENNIS JACOBE, ON BEHALF OF THE U.S. LEAGUE OF SAVINGS ASSOCIATIONS, TO THE SENATE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT, APRIL 24, 1978

Mr. Chairman: My name is Dennis Jacobe, of Chicago, Illinois. I am an Economist for the Unied States League of Savings Associations.[1]

The savings and loan business is concerned primarily with the business of mortgage finance and the ability of our country to adequately house its citizens—a subject somewhat removed from issues before this Subcommittee this morning.

Still, inflation is of great concern to the savings and loan business. As long-term lenders and short-term borrowers, we are severely exposed to, and damaged by, price instability. Further, we realize that inflation impacts all Americans by reducing both their ability to save and their ability to buy homes. Both areas are of vital concern to our business.

In our opinion, the only real solution to our current inflation problem is a return to a balanced Federal Budget. Our business has maintained for years that, "There is no living with inflation."

Still, it does not appear that our current inflation problem will soon be solved. Thus, I appear before you this morning to discuss the current plight of middle-income Americans. In this context, I believe I represent the concerns of all Americans, and not just those of the savings and loan business.

In my few minutes this morning, I will discuss the process of interaction between inflation and our tax system; the way it creates an "inflation tax wedge" and its implications for the economic well-being of the middle-income taxpayer. In this way, I hope to make the point that inflation produces an arbitrary and unfair increase in the real tax burden of middle-income taxpayers; a situation which must be corrected. As I see it, this is the major objective of Senator Dole's bill, S. 2738.

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[1] The United States League of Savings Associations (formerly the United States Savings and Loan League) has a membership of 4,400 savings and loan associations, representing over 98 percent of the assets of the savings and loan business. League membership includes all types of associations—Federal and state-chartered, insured and uninsured, stock and mutual. The principal officers are: Stuart Davis, President, Beverly Hills, Calif.; Joseph Benedict, Vice President, Worcester, Mass.; Lloyd Bowles, Legislative Chairman, Dallas, Tex.; Norman Strunk, Exec. Vice Pres., Chicago, Ill.; Arthur Edgeworth, Director-Washington Operations; and Glen Troop, Legislative Director. League headquarters are at 111 E. Wacker Drive, Chicago, Illinois 60601; and the Washington Office is located at 1709 New York Ave., N.W., Wash., D.C. 20006; Phone: (202) 785-9150.

Inflation significantly increases the real tax burden of middle-income Americans. Generally, this process occurs as follows. Inflation reduces the purchasing power of the middle-income family. As a result, this family must receive a dollar income increase just to maintain its real purchasing power and thus, its standard of living.

Such money income (dollar) increases however will increase this family's tax burden. In fact, since our tax system is progressive and based upon money income rather than real income, a dollar wage increase produces not only a dollar tax increase but also a real tax increase. This results from two factors:

(1) higher dollar earnings push middle-income families into tax brackets where they pay higher tax rates; and

(2) the fixed-dollar deductions, exemptions, and credits available to the taxpayer eliminate a lesser fraction of the middle-income wage earner's income subject to tax.

As a result, our current tax system creates an "inflation tax wedge" between the dollar income a family receives and its real purchasing power. This wedge makes it more difficult for the middle-income family to maintain its purchasing power in the face of rampant inflation while providing the Federal Government with an inflation bonus.

For discussion purposes, I have provided the Subcommittee with a few exhibits which illustrate the way this "inflation tax wedge" works. Table No. 1 deals with a 10 percent wage increase for middle-income Americans earning between $16,000 and $30,000 and encountering a 10 percent inflation rate. (I chose 10 percent simply because this is an easy figure with which to work).

For example purposes let's consider a family earning $20,000 in 1977. A 10 percent wage increase would thus total $2,000, increasing this family's income level to $22,000 in 1978. Assuming a 10 percent inflation rate, this family does not receive a real income increase.

Column No. 3 of Table No. 1 shows that in 1977 this family paid Federal taxes of $2,536 for an effective tax rate of 12.7 percent (column No. 4). Although this family received a $2,000 income increase in 1978, it did not receive a real income increase due to inflation. As a result, equity would imply that this family's relative tax burden should not increase; that is, a wage increase which enables these middle-income taxpayers to maintain their before-tax purchasing power. In order to keep this consumer/taxpayer's after-tax purchasing power constant, the "equitable" tax increase on this $2,000 of new money income should keep his effective tax rate constant at 12.7 percent. Column No. 5 shows that an increase in this family's taxes of $253.60 or 10 percent would be equitable in this context.

Our current tax structure however, does not produce such an equitable tax increase. Since our tax system is progressive and measures dollar income rather than real income, this family's dollar wage increase is taxed at a 25 percent tax rate rather than its effective tax rate of 12.7 percent. As a result, this middle-income family would find itself with a tax burden totalling $3,036 (column No. 6) or with a tax increase of $500 (column No. 7). This would increase this family's effective tax rate of 13.8 percent (column No. 8).

The bottom line of this simple illustration however, is shown in column No. 9. The middle income consumer/taxpayer incurs an added tax burden of about $246 as a result of the interaction between inflation and our current tax structure. This amount represents what I like to call the "inflation tax wedge".

This wedge provides the Treasury with an inflation bonus of $246 from this one taxpayer. Further, it reduces this middle-income family's real purchasing power by the same amount. That is, although this 10 percent wage increase compensates for inflation on a pre-tax basis, the consumer/taxpayer still loses ground on an after-tax basis.

Table No. 2 illustrates how the inflation tax wedge would work if these same conditions were repeated in 1979. The consumer/taxpayer would receive another 10 percent wage increase giving him earnings of $24,200 on which he would pay taxes totalling $3,647 (column No. 6). This would increase his effective tax rate to 15.1 percent (column No. 8). It would also provide the Treasury with another inflation tax bonus of $307 (column No. 9).

Table No. 3 illustrates the combined two year impact of the inflation tax wedge. As a result of two years of 10 percent inflation, the Treasury receives an inflation revenue bonus of $553 from this one middle-income family. Sim-

ilarly, even though this consumer/taxpayer stays even with inflation on a before-tax basis, his real after-tax purchasing power does not keep pace as a result of the "inflation tax wedge."

Due to time limitations I cannot go into further detail on the way the middle-income "inflation tax wedge" works. Suffice it to say that: (1) it gets bigger as the inflation rate increases; (2) it gets bigger as income increases; (3) it permits the Treasury to profit from inflation; and (4) it adds to the inflation burden of middle-income Americans.

Obviously, the existence of this inflation tax wedge holds dire consequences for the economic well-being of middle-income Americans, as well as for the economy as a whole. I would like to briefly discuss two of these: (1) its impact on real wages during the next two years; and (2) its implications for the Federal Budget.

Table No. 4 illustrates an example of how middle-income Americans might fare this year and next assuming a 6.5 percent inflation rate and a 10 percent wage increase. This table is derived from an article I have attached which was published in the U.S. League's Savings and Loan News of March, 1978. It shows that a middle-income family earning $20,000 in 1977 and receiving a 10 percent wage increase in 1978 of $2,000 would receive a real wage increase of only about 1.2 percent or $231, while a similar increase in 1979 would provide a negligible increase of $11.

While these numbers only illustrate what every middle-income family knows about the real value of its wage increases, I find them disturbing for another reason. They illustrate the danger of continued inflation and our failure to adjust our tax system. Continued high rates of inflation without substantial tax reform will produce real purchasing power losses for middle-income Americans. These losses could in turn bring about a return of the "stagflation" of 1973–74 of something even worse.

With respect to the Federal Budget, these figures imply that it is very important that we keep middle-income families in mind as we try to achieve budget balance. I feel very strongly that we must balance the Federal Budget if we are to achieve price stability. In my opinion, however, I think it would be a great mistake to do this by increasing the tax burden of middle-income Americans.

In this respect, I feel an effort toward adjusting our tax system is necessary. Such an effort should reduce or eliminate the unfair impact of the "inflation tax wedge" on middle-income taxpayers. Further, it should reduce or eliminate the inflation tax bonus currently received by the Treasury.

As I understand S. 2738, the purpose of this proposal is twofold, having a direct and indirect objective. First, it directly attacks the problem of most of America's individual taxpayers who now pay inflationary dividends to the very government that creates the inflation. Secondly, and somewhat indirectly, I believe that this proposal is designed to force on the Congress and the Administration greater spending discipline as a result of the elimination of the Treasury's inflation dividends.

These two objectives are worthy ones and should be subjected to thoughtful consideration by the Congress. The proposal, however, is not a solution to our inflation problem. It does not directly attack the primary cause of inflation and monetary instability, namely excessive spending and record deficits. The question which must be asked is "Will the elimination of the Treasury's inflation dividend result in spending discipline?" I don't know the answer to that question.

I have appreciated this opportunity to discuss with your Subcommittee this issue of such vital importance to our nation's future economic health. I look forward to your questions.

[From Savings & Loan News, March 1978.]

Outlook: Budget Deficits Reveal Strong Inflationary Bias

It's Time to Cut Federal Spending

In his final public appearance as chairman of the Federal Reserve Board, Arthur Burns talked to the Washington Press Club about the will of the American people to fight inflation.

"The need to fight inflation is widely recognized in our country, but the will to do so is not yet strong enough."

Recent events support this observation. The replacement of Dr. Burns is a primary example. Few have voiced the dangers of inflation as often or as eloquently as the former Fed chairman.

Another example is President Carter's new federal budget proposal. For almost three years, our country has been operating at a level far above its long-term stable growth rate. Still, federal deficits are projected to increase, not decline.

The federal budget will show a deficit of more than $60 billion in both fiscal 1978 and 1979. If we cannot reduce our deficit spending during good times, when can we reduce it?

The proposed tax reduction for later this year fits this same mold. At year-end 1977, Congress voted to substantially increase social security taxes. Now, the administration argues that a tax cut is needed to head off the dangers of fiscal drag in 1979. That is, it must offset the combined impact of inflation and taxes on real wages (see "Commentary" next page).

One might ask why taxes were raised in the first place? Better yet, if a "good" tax cut offsets a "bad" tax increase, why must the cut increase the federal deficit?

Finally, the whole situation is made worse by enormous election year spending pressures in Congress. Much unhappiness has been expressed with the President's spending restrictions. In all probability, the deficit will exceed the administration's projections.

In sum, although everyone generally acknowledges the dangers of inflation, few of our leaders seem to be willing to combat it. Actions are needed to win the inflation battle, not just words.

When will our nation's will to fight inflation be strong enough? Only when the average American voter-taxpayer makes inflation his congressman's overriding concern.

Fiscal illusion

Early this year, the President issued his long-awaited tax reform proposals. A major feature of this tax package is a $25 billion tax cut. Recent discussions surrounding this proposal epitomize the inflationary bias of our national leaders.

Late last year, when the tax cut was proposed in terms of stimulating a somewhat sluggish economy, the congressional response was overwhelmingly favorable. A congressman likes nothing more than cutting taxes in an election year.

With the unemployment rate at a 30-month low, however, we hear somewhat different comments. Some leaders now suggest no tax cut. They argue that the funds are needed instead to provide badly needed social programs.

The administration no longer argues that the tax cut is needed to help current economic conditions. Instead it suggests that inflation and taxes—particularly the recently passed social security tax increase—will produce a fiscal drag. These factors will so impact real wages that they will lead to curtailed consumer spending and a much slower economy.

What has not been discussed by the administration and Congress is the interrelationship of a tax cut, the federal budget deficit and inflation. Dr. Burns made this point when he noted that a tax cut should be accommodated by limiting federal expenditures so that the budget deficit can be significantly reduced.

The sequence of events preceding the tax cut proposal seems to represent an obvious attempt at fiscal illusion. At this stage of the economic recovery, we should be attempting to balance the federal budget. At least we should be reducing federal deficit spending. This should not be impossible since economic growth and inflation-induced tax increases will raise federal revenues substantially during the next few years.

In this context, a social security tax increase may make some sense. That is, it would represent a move toward fiscal stability—a strong action to counter inflation.

Such a tax increase does not make sense, however, when the nation is running a $60 billion deficit. The combined impact of inflation, the federal tax effect and social security tax increase represents a danger to our general economic well-being.

Even more disturbing, however, is the current attempt to compensate for the impact on real wages by means of a tax cut. The argument that a tax reduction is needed is very strong. In fact, the interaction between inflation and federal taxes implies that our tax system should be adjusted downward for inflation.

Economic danger

Such a tax cut does not relieve us of the responsibility to reduce the federal deficit. Nor does it justify the social security tax increase of late last year.

The only explanation for these events is that our nation's leaders want to give us a tax cut during an election year. In order to do so, they had to pass a tax increase. A tax cut also acts as an excuse for increasing the budget deficit.

Fiscal illusion is not the answer to fighting inflation. What we need is a national resolve to make the tough decisions required to reduce federal spending when the economy can grow without this stimulus.

To quote Dr. Burns: "I only hope [the will to combat inflation] will come through a growth of understanding—not from a demonstration—that inflation is the mortal enemy of economic progress and our political freedom."

TABLE 1.—REAL WAGE INCREASES, 1978

1977 gross wages	1978 wage increase	Federal tax increase	Social security tax increase	Inflation cost	Real wage increase	Percent wage increase
$10,000	$1,000	$178	$81	$630	$102	1.02
$15,000	1,500	327	120	896	157	1.05
$20,000	2,000	500	106	1,163	231	1.16
$25,000	2,500	753	106	1,417	224	.90
$30,000	3,000	1,073	106	1,653	168	.56
$50,000	5,000	2,496	106	2,477	−79	−.16
$100,000	10,000	5,000	106	4,235	659	.66

COMMENTARY: FOR EMPLOYERS AND EMPLOYEES, THERE'S NO LIVING WITH INFLATION

When you filled out your tax form this year, did you feel like you were paying relatively more taxes? When you received your first paycheck, did you feel like your raise didn't mean much in take home pay? If so, you weren't imagining anything. Nor were you alone.

During the 1970s, the U.S. has experienced an unprecedented degree of inflation. Unfortunately, we have little reason to expect conditions to differ substantially in the foreseeable future (see "Outlook," preceding page).

One of the most dangerous aspects of high inflation rates is their impact on real wage income. Of course, everyone realizes that inflation reduces purchasing power. They know that when they get a raise, a part of it simply makes up for the cost of inflation. In fact, this concept is so well understood that it has become institutionalized.

When a union bargains for a wage increase, it also demands an escalator clause to make up for inflation costs. Similarly, many savings and loan associations compute their pay increases based upon a cost-of-iving increase and a merit increase.

The basic idea is simple. Hard working, competent employees should be able to maintain their present living standards. This requires that they be compensated for inflation.

Those employees who excel deserve to improve their current living standards. This requires that they receive a wage increase in excess of the cost of inflation.

INTERACTION OF TAXES

The current cost-of-living approach to salary administration, however, neglects one very important aspect of inflation: its interaction with the federal tax system. As a result, a 6.5 percent wage increase does not compensate an employee for a 6.5 percent inflation rate as is popularly believed. The actual pay increase required to permit wage earners to maintain their current living standard is more like 10 percent.

Further, inflation may injure low-income workers relatively more in the way it affects the cost of basic commodities. But this is not the case when the cost of government is taken into account. The fact that the living standard of middle- and upper-middle income Americans is most severely damaged by inflation.

This is important to associations from an institutional perspective since it is closely related to the general well-being of our nation's economy, the supply of savings and the cost of employee compensation.

Also, it is of personal significance to every American wage earner. Everyone in as association from the newest teller to the managing officer will have his real

purchasing power and, thus, his living standard affected by the combined impact of inflation and taxes.

Of all the goods and services Americans buy, government services are experiencing perhaps the most rapid price acceleration. This is a direct result of the interaction between inflation and our tax system.

Wage earners pay taxes based upon the dollars they earn, not on the real purchasing power of those dollars. As a result, when an individual taxpayer receives a wage increase which simply keeps his purchasing power constant, his taxes increase.

Further, the U.S. tax system is progressive. Those who earn more bear a relatively higher tax burden. Thus, dollar wage increases not only increase the wage earner's taxes, they also increase the tax rate he pays—the so-called bracket effect.

TABLE 2.—REAL WAGE INCREASES, 1979

1978 gross wages	1979 wage increase	Federal tax increase	Social security tax increase	Inflation cost	Real wage increase	Percent wage increase
$11,000	$1,100	$209	$76	$683	$132	1.20
$16,500	1,650	363	115	973	199	1.21
$22,000	2,200	611	333	1,245	11	.05
$27,500	2,750	865	333	1,518	34	.12
$33,000	3,300	1,252	333	1,765	−50	−.15
$55,000	5,500	2,750	333	2,604	−187	−.34
$110,000	11,000	5,500	333	4,571	596	.54

TABLE 3.—TAX AND INFLATION EFFECT ON WAGES

Gross wages			Federal income taxes[1]		
1977	1978	1979	1977	1978	1979
$10,000	$11,000	$12,100	$450	$637	$846
15,000	15,500	18,150	1,385	1,712	2,075
20,000	22,000	24,200	2,536	3,036	3,647
25,000	27,500	30,250	3,871	4,624	5,489
30,000	33,000	36,300	5,424	6,497	7,749
50,000	55,000	60,500	13,784	16,280	19,030
100,000	110,000	121,000	38,780	43,780	49,280

[1] 4-person family, filing jointly using standard deduction.

This situation becomes even more onerous when government passes on the inflationary costs it incurs by increasing tax rates. The recently passed social security tax increase is a prime example.

Associations, as long-term lenders and short-term borrowers, are one of the groups most injured by inflation. Another group which incurs great costs from inflation are those persons living on fixed incomes.

Recognizing this latter fact, Congress instituted a cost-of-living escalator into social security benefits. This escalator, combined with population trends, has required increased funding of the social security system.

Of course, these tax increases act to increase federal revenues. That's one reason some observers say the federal government benefits from inflation.

One way to gain insight into the combined impact of taxes and inflation on real wage incomes is provided by the accompanying tables. These illustrate the tax and inflation costs the wage earner will incur if her receives a 10 percent wage increase in 1978 and 1979.

Tables 3 and 4 show the federal income tax, social security tax and cost-of-living increases various wage earners encounter as their dollar incomes increase. The full impact of these cost increases are then compared to the worker's dollar wage increase (10 percent each year) to ascertain his real benefit (Tables 1 and 2).

Table 1, for example, shows that those earning between $10,000 and $20,000 in 1977 would get a real income increase of about 1 percent as a result of a 10 percent wage increase in 1978.

Social security taxes			Inflation costs [1]	
1977	1978	1979	1978	1979
$585	$666	$742	$630	$683
878	998	1,113	896	973
965	1,071	1,404	1,163	1,245
965	1,071	1,404	1,417	1,518
965	1,071	1,404	1,653	1,765
965	1,071	1,404	2,447	2,604
955	1,071	1,404	4,235	4,571

[1] Assumes 6.5 pct. cost of living increase.

This net benefit actually declines as wage income increases. Those earning $50,000 actually lose ground in real terms. Even those earning $100,000 get less than three-fourths of 1 percent real benefit from a 10 percent—$10,000—wage increase.

A similar pattern is shown in Table 2 for 1979. In this case, however, the average American needs a 10 percent wage increase just to stay close to even.

Of course, other taxes have not been taken into account. Both state income and sales taxes increase as the wage earner's dollar income, not necessarily his purchasing power, increases. These will further reduce the net benefits shown in Table 1 and Table 2.

Similarly, inflation increases the property assessments of home owners and eventually their property taxes. This is another inflation-tax effect which reduces the net well-being of the wage earner.

IMPACT ON MANAGEMENT

These numbers are shocking. Most Americans did not receive a 10 percent wage increase in 1978, nor will they in 1979 if inflation stays at 6.5 percent as these calculations assume. Of course, if the inflation rate were to accelerate, even larger wage increases would be required just so middle-income Americans could maintain their current living standard.

From another perspective however, these findings simply illustrate common knowledge. We all know we are paying higher taxes and higher prices. We also know that the raises we receive seem of modest benefit. The real significance of these numbers involves the way inflation and our tax system are combining to reduce the living standard of the American middle class.

Savings and loan management can ease the impact of these cost increases upon themselves and their employees by including taxes in their compensation planning. Management will have to if associations are going to keep good people.

Similarly, government could initiate real tax reform by acknowledging that middle- and upper-income Americans are being taxed more onerously every day. Our tax system could be adjusted, or indexed, for inflation.

In the long run, however, our nation's leaders must recognize the validity of what our business has been saying for many years: "There's no living with inflation."

TABLE 1.—CHANGE IN MIDDLE INCOME TAX BURDENS (1977-78) [1]

Wage income 1977	Wage income 1978	Federal [2] taxes 1977	Effective tax rate 1977 (percent) (col. No. 3/No. 1)	Equitable [3] tax increases 1977-78	Federal taxes 1978	Federal tax increases 1978 (col. No. 6/No. 3)	Effective tax rate 1978 (percent) (col. No. 6/No. 2)	Treasury inflation revenue bonuses (col. No. 7/No. 5)	Marginal tax rate 1977-78 (percent)
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
$15,000	$16,500	$1,385	9.2	$138.50	$1,712	$327	10.4	$188.50	21.8
20,000	22,000	2,536	12.7	253.60	3,036	500	13.8	246.40	25.0
25,000	27,500	3,871	15.5	387.10	4,624	753	16.8	365.90	30.1
30,000	33,000	5,424	18.1	542.40	6,497	1,073	19.7	530.60	35.8

[1] Assumes 10 pct wage increase and 10 pct inflation which nets out constant purchasing power.
[2] 4-person family, filing jointly using standard deduction.
[3] Tax increase which keeps the wage earners, effective tax rate constant. For $20,000 income this equals the effective rate (12.68 pct) times the income increases ($2,000) which equals $138.50.

TABLE 2.—CHANGE IN MIDDLE INCOME TAX BURDENS 1977-78[1]

Wage income 1978	Wage income 1979	Federal[2] taxes 1978	Effective tax rate 1978 (percent) (col. no. 3/no. 1)	Equitable[3] tax increases 1978-79	Federal taxes 1979	Federal tax increases 1978-79 (col. no. 6/no. 3)	Effective tax rate 1979 (percent) (col. no. 6/no. 2)	Treasury inflation revenue bonuses (col. no. 7/no. 5)	Marginal tax rate 1979 (percent)
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
$16,500	$18,150	$1,712	11.4	$171.20	$2,075	$363	11.4	$191.80	22.0
22,000	24,200	3,036	13.8	303.60	3,647	611	15.1	307.40	27.8
27,500	30,250	4,624	16.8	462.40	5,489	865	18.1	402.60	31.5
33,000	36,300	6,497	19.7	649.70	7,749	1,252	21.3	602.30	37.9

[1] Assumes 10 pct. wage increase and 10 pct. inflation which nets out constant purchasing power.
[2] 4-person family, filing jointly using standard deduction.
[3] Tax increase which keeps the wage earners, effective tax rate constant. For $20,000 income this equals the effective rate (12.68 pct) times the income increase ($2,000) which equals $138.50.

TABLE 3.—CHANGE IN MIDDLE INCOME TAX BURDENS, 1977-78 AND 1978-79[1]

Wage income 1977	Wage income 1979	Equitable tax increase 1978 and1979	Federal tax increases 1978 and 1979	Treasury inflation revenue bonuses 1978 and 1979 (col. No. 4—col. No. 3)
(1)	(2)	(3)	(4)	(5)
$15,000	$18,150	$309.70	$690.00	$380.30
20,000	24,200	557.20	1,111.03	553.80
25,000	30,250	849.50	1,618.00	768.50
30,000	36,300	1,192.10	2,325.00	1,132.90

[1] Derived from table 1 and table 2.

TABLE 4.—REAL WAGE INCREASES 1978-1979[1]

Wage income 1977	Dollar wage income 1978	Real wage increase 1978	Dollar wage increase 1979	Real wage increase 1979
$15,000	$1,500	$157	$1,650	$199
$20,000	2,000	232	2,200	11
$25,000	2,500	224	2,750	34
$30,000	3,000	168	3,300	−50

[1] Assumes 10 pct wage increase; 6.5 pct inflation rate; 1977 tax rates; new social security law; and 4-person family, filing jointly using standard deduction.

STATEMENT OF ERNST & ERNST

SUMMARY

We appreciate this opportunity to comment for the record on the Tax Indexation Act of 1978 (S. 2738) and to participate in these public hearings.

Ernst & Ernst is an international firm of Certified Public Accountants with 113 offices in the United States and 160 offices in 59 other countries of the world. We provide accounting, auditing, tax and management consulting services to corporate, individual and other clients engaged in a wide range of business activities.

Our comments at these hearings are directed toward one specific proposal which we believe would provide incentives for greater productivity, capital investment and employment. None of our comments are made on behalf of any clients of our firm.

S. 2738 is intended to adjust our tax system to provide relief from the hardships, inequities and tax burdens that are caused by inflation. Inflation causes two types of changes in our tax system. With respect to progressive income tax rates that are applicable to noncorporate taxpayers, it can change the tax rates imposed on the same real tax base; and it also can artificially enlarge the income tax base (taxable income) as a result of inadequate provisions for capital recovery. To some extent these problems can be corrected by indexing tax rates and by indexing the income tax base.

A short-run alternative to indexing tax rates for individuals is to periodically enact tax cuts when artificial tax increases cause individual income taxes to rise beyond their accustomed range of 10 to 11 percent of personal income. To date this is the route we have chosen in this country and in the years since 1964 we have enacted 6 tax reduction acts in furtherance of this approach.

While tax rate reductions for individuals can provide a substitute for indexing tax rates they do not provide an appropriate solution to the capital formation problems of corporate and individual taxpayers caused by an artificially enlarged tax base which could be alleviated by a system of indexation for capital recovery.

In the past few years there has been a great deal of discussion about accounting under inflationary conditions. Since we believe that the problems of "accounting for inflation" are closely akin to the problems of indexing the income tax base, we advocate a practical new approach for computing depreciation for tax and financial accounting purposes that we think will achieve many of the objectives to aid capital formation that are encompassed in S. 2738.

Under our proposal, businesses would base their annual depreciation allowances for both tax and financial reporting purposes on the current cost (based on an objective index) of replacing the underlying assets. In times of inflation, the increased costs of the assets would be measured by the increase in the implicit deflator for capital goods as reported in the National Income and Products Accounts (or such other convenient measure as Congress might consider appropriate).

The Ernst & Ernst proposal, called Current Cost Depreciation (CCD) has the advantages of more clearly reflecting income by a better matching of revenues and related costs, preventing misleading distortions in financial statements caused by high rates of inflation, and avoiding computational complexities that might be introduced by attempting to determine fair market values of capital assets based on subjective estimates and appraisals. This proposal is described in detail in Appendix A, with an illustration of its application and discussions of the relative merits of historical costs and current values as bases for financial reporting.

In order to determine the economic impact of the introduction of this change in tax and financial accounting procedure, Ernst & Ernst engaged Chase Econometrics Associates, Inc. (CEAI) to study the macroeconomic impact of CCD. The CEAI study shows that if CCD had been adopted effective January 1, 1977 applicable only to new investments after that date:

The initial impact of the change in 1977 would have been modest, primarily as a result of the lagged effect of changes in the tax laws on investment.

1978 purchases of producers' equipment would be $1.1 billion higher in terms of 1972 prices, or $1.6 billion higher in terms of current prices, while nonresidential construction would increase an additional $1.3 and $2.2 billion in constant and current dollars, respectively. Accordingly, fixed business investment would be 1.8 percent higher than would otherwise be the case.

Unemployment would be 0.15 percent lower for 1978.

Real Gross National Product (GNP) for 1978 would rise $4.6 billion, or 0.3 percent.

The primary revenue loss to the Federal government from higher depreciation allowances in 1978 would be $5.2 billion, higher interest payments would cost an additional $0.5 billion and higher cost of Federal government purchases would be $0.1 billion. Transfer payments would be $0.3 billion lower because of the increased level of economic activity. Additional tax revenues induced by higher growth in 1978 would be $2.2 billion, leaving a total increase in the Federal budget deficit of $3.8 billion.

In addition, the CEAI study shows that the application of CCD on new equipment would have a significant positive effect on the economy. It would

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create 400,000 new jobs by 1980 without increasing the rate of inflation, since the higher level of demand would be offset by an improved level of productivity. The increase in the Federal budget deficit would be minimal; as a result, capital markets would not be upset, and interest would not be materially affected. Investment in producers' durable equipment would rise by an additional 2 percent by 1980, while nonresidential construction would be 5½ percent greater. On balance, CCD would strengthen capital formation, growth and employment without the negative side effect of higher inflation which usually accompanies fiscal stimulus.

The complete summary on the "Macroeconomic Impact of Current Cost Depreciation" prepared for Ernst & Ernst by Dr. Michael K. Evans, the President of Chase Econometric Associates, Inc., is set forth in Appendix B.

If the members of this Subcommittee or your staff would like to discuss our statement or require any additional information with respect to it, we would be pleased to respond.

[APPENDIX A]

ACCOUNTING UNDER INFLATIONARY CONDITIONS

OVERVIEW

Continual high rates of inflation invite criticisms of the usefulness and credibility of corporate financial reporting. Critics of conventional accounting contend that reported net income is not a fair measure of managerial accomplishment because the cost of replacing inventories and depreciable assets, for example, is greater than the historical costs charged against revenue under conventional cost-based financial reporting.

Two-fold Influence of Inflation on Accounting. But income measurement is not the only accounting related problem resulting from inflation; it also causes a cash flow penalty in the federal income taxes are levied at legislated rates against corporate taxable income, also calculated on a historical cost basis. If, during inflation, conventional cost-based accounting understates the cost of goods sold and the cost of using long-lived depreciable or depletable assets, application of the federal income tax results in taxing the resulting "overstated" net income. In the plainest terms, real corporate income is then taxed in excess of statutory rates. If a substantial portion of reported profits is distributed as dividends to shareholders, corporate capital may not be maintained.

Proposals to "account for inflation" tend to emphasize income measurement and to ignore the other effects of inflation. The theory that the primary, if not the only, purpose of accounting is to inform investors and creditors leads to a narrow conception of the role of accounting. As we see it, accounting measures of corporate net income have other uses as well. They influence the health of our economy in many ways, all of which merit attention. Certainly we believe in a well informed investing public and we participate in efforts to bring this about. But we would find little comfort if that well informed investing public faced a deteriorating economy, especially if the deterioration resulted from inadequate capital maintenance and excessive taxation based on accounting measures of income.

Components of an Adequate Solution. Accordingly, our view of the total effect of inflation on corporate reporting and accounting leads us to the following components of an adequate solution to the problem of corporate reporting under inflationary conditions. Such a solution should:

Recognize the effect of inflation on conventional corporate income measurement.

Recognize the negative impact of inflation on corporate cash flow because effective rates of taxation exceed statutory rates.

Cover the major costs affected by inflation yet be understandable to financial statement readers.

Disrupt customary reporting practices as little as possible.

Be objectively verifiable.

Strengthen the credibility of corporate financial reporting.

The major impact of inflation on income determination occurs when costs incurred in one period are not matched with revenue until prices have changed significantly. Depreciation, depletion, and amortization, and the

inventory effect on cost of goods sold are the most important costs affected. A net income amount that results from matching current revenue dollars with costs stated in old dollars is not as informative and useful to financial statement readers as it should be.

LIFO as a Partial Answer to Inflation. Accounting has long had an answer to the influence of inflation on cost of goods sold. Last-in, first out (LIFO) inventory accounting charges the most recent inventory costs incurred to cost of goods sold, thereby matching current costs with current revenues. Thus LIFO offsets much of the effect of inflation on cost of goods sold.

In addition, LIFO is accepted for income tax purposes. This means that companies adopting LIFO for tax purposes get a larger deduction for cost of sales, pay less tax, and are better able to replace the goods sold, even when prices are rising. In addition, if LIFO is used for both financial reporting and tax purposes, the company has no need to explain why it uses different income figures for different purposes.

A Depreciation Equivalent to LIFO. As yet, accounting has no technique that does for the depreciation of tangible, long-lived, exhaustible assets what LIFO does for cost of goods sold.[1] We think one can and should be established. We propose that, for income determination purposes only, the historical cost of depreciable assets be updated to a current cost basis by application of appropriate, officially authorized indices, and that depreciation be calculated at the company's usual rates applied to current cost. This would result in a depreciation amount based on the current cost of the company's assets to be charged against revenue in determining net income.

But this meets only part of the problem, that part concerned with income measurement. If corporations are to pay income taxes at effective rates no higher than statutory rates, the same depreciation should be accepted for tax purposes. If corporations are to report net income sufficient to obtain the capital required to meet the expanding needs of our economy, and if they are to have sufficient cash flow to replace present assets as these wear out, effective tax rates must recognize current costs. We therefore propose that "current cost depreciation" be accepted for both corporate reporting and income tax purposes.

Our recommendation for "accounting for inflation" is that both LIFO and current cost depreciation be used for both corporate financial reporting and federal income taxation. With minimum disruption of customary reporting practices, this will provide an objectively verifiable updating of the major costs affected by inflation. It will also strengthen the credibility of corporate financial reporting by removing important differences between reporting for tax and shareholder purposes. Most important, it recognizes the two-fold influence of inflation on accounting, both on income measurement and on income taxation.

AN ERNST & ERNST PROPOSAL FOR ACCOUNTING UNDER INFLATIONARY CONDITIONS

Inflation is a disruptive and burdensome force in any economy. It falls on individuals as well as companies. Its effects are anything but equitable, punishing those with fixed incomes and large investments in depreciable assets, and often rewarding debtors at the expense of creditors. Its impact has been described as similar in effect to regressive taxation.

For both financial statement preparers and users, inflation magnifies the problems of effective financial reporting. In addition, we must not neglect the fact that inflation imposes an additional financial burden on industry through effective tax rates higher than those legislated. We believe that these are two facets of the same problem and should be resolved together. Halfway measures that appear to solve the financial reporting problem without meeting the tax impact of inflation on a business enterprise are inadequate. None of the many proposals on "accounting for inflation" which we have reviewed meet both aspects of the inflation issue satisfactorily.

In a number of other countries, sustained inflation has reached levels that far exceed anything ever experienced in the United States. Faced with conditions that we believe would be near disastrous to business activity as con-

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[1] Hereafter, in this paper, "depreciation" should be read to include depreciation, depletion, and amortization of long-lived, tangible assets.

ducted here, authorities in those countries have imposed or proposed major accounting changes. Nothing has yet occurred in the United States that would justify similar action in this country.

We counsel against precipitate major changes in financial reporting. Hasty action either to meet an assumed emergency or to keep up with others, whose problems are much different than ours, is unlikely to provide satisfactory long-run results. We need a carefully considered method that fits the needs of our economy, not one borrowed from a different set of economic circumstances.

Practical Usage of Financial Statements. In seeking an acceptable solution to the problem of accounting and inflation, we felt it important to note that the income statement is understood by most people to be the principal measure of a company's past success and future prospects. The balance sheet is important and useful in presenting certain aspects of liquidity but as a measure of success is generally of less importance to users than the income statement.

As a result, we felt that our search for an acceptable method of responding to inflationary influences on accounting should be guided by the following:

The proposed response should not be so complex as to negate any reasonable chance of acceptance by diverse groups of financial statement users such as institutional investors, small shareholders, creditors, and the management and employees of the enterprise.

Net income should continue to receive the highest priority and should be adjusted to recognize the most material effects of inflation of a company's costs (cost of sales and depreciation).

Proposed changes in income determination are unlikely to be accepted by taxing authorities unless the changes are administratively feasible.

Balance sheet valuation can reasonably continue to be based substantially on historical cost which effectively presents current assets and liabilities as elements of a conservatively portrayed financial position.

Our approach has been a practical one. Given that one of our objectives was to identify an economic as well as an accounting solution to the effects of inflation, we recognize that the difficulty of mobilizing necessary support for change in our nation's income tax laws might well be directly proportionate to the complexity of a proposed solution. We feel that what follows is, for all users of financial statements, an equitable, understandable, and readily implementable solution to the problem.

Advantages of LIFO Under Inflationary Conditions. We have long recommended LIFO accounting for inventories as a partial solution to the problem of inflation. LIFO has a twofold effect. By bringing the most recent costs incurred into cost of goods sold, to be matched with current revenue dollars, a more understandable net income figure results than would otherwise be obtained during a period of inflation. In addition, because LIFO is accepted for tax purposes, it has positive financial benefits to the companies which adopt it. The immediate cash flow advantages of LIFO through reduced income taxes help a company bear the financial burden of inflation.

Needed: A LIFO-Type Result for Depreciation Accounting. During periods of inflation, depreciation on a historical cost basis understates, in terms of current dollars, the cost of replacing depreciable property consumed through operations. To compensate for this, and to prevent capital erosion, proposals have been made to "restate" assets and depreciation on a replacement cost or some other basis.

None of the present proposals, in our judgment, has a realistic expectation of the dual benefits of LIFO adoption—both income statement and positive cash flow effects. Proposed accounting adjustments for depreciation tend to reduce reported income, thereby decreasing the company's relative ability to obtain capital and credit, without any compensating improvement in cash flow. Rather than helping affected companies bear the burden of inflation, such restatement levies an additional burden. Something more than this is needed.

Briefly stated, we urge acceptance of increased depreciation for both income tax and financial reporting purposes so that affected companies retain more cash to permit acquisition of replacement assets at higher prices.

We believe that the most common understanding of corporate net income would describe it as the increase in net assets which a company has obtained

through operations and which it can distribute to its shareholders without reducing the company's ability to continue as a going concern at approximately the same scale of activity. During an inflationary period, historical cost depreciation does not measure asset use in current cost terms so historical cost net income overstates the amount that could be distributed to shareholders if the company is to replace its assets at current prices. Yet the reduction in net income that would result from charging depreciation on a current cost basis would also make it more difficult for a company to raise funds in the capital market.

The solution to this problem is to charge depreciation on a current cost basis for both book and tax purposes. In this way, a net income amount more closely approximating the common concept of net income is obtained and, at the same time, the increased depreciation results in reduced income taxes and a cash flow advantage to assist in replacing tangible capital assets at increasing costs.

Is this equitable and socially desirable? We think it is. Upward restatement of depreciation and downward restatement of net income with no cash flow accompaniment penalizes a company and discourages capital formation at a time when it is sorely needed. Positive cash flow through reduced federal income taxes for those companies whose income is affected by inflation will assist them to retain their viability in the capital market. It also results in an effective rate of taxation closer to the statutory rate.

Is it administratively feasible? We think it is. Alternative proposals, such as complete current value models, are so new, so indefinite, so subject to varying interpretation in specific situations, and so lacking in standards for implementation that they would present intolerable problems of administration if applied for income tax purposes. Accordingly, their adoption for that purpose is highly improbable in time to help counter present inflation. But the restatement of depreciation alone, using approved indices, would be sufficiently objective to cause no significant problems of Treasury Department interpretation and administration.

Essentials of Proposed Depreciation Accounting. We think our depreciation proposal, when combined with LIFO, provides both a better measure of corporate net income under inflationary conditions and more equitable income taxation. It is also practical and feasible. The close tie-in of financial reporting and income tax results is important. Neither is adequate without the other.

We propose that the Treasury Department and Internal Revenue Service accept restated depreciation for tax purposes. If they find it necessary, the depreciation deduction could be related to capital asset acquisitions on some appropriate basis. Insofar as accounting technique is concerned, the procedure is uncomplicated and readily understood. It provides that:

1. The property and associated accrued depreciation accounts would be maintained on a historical cost basis with no necessary change in method of computation or estimate of life.
2. Depreciation charged against income for both book and tax purposes would be computed on historical cost restated to current dollars by application of selected indices acceptable to the Treasury Department.
3. Accrued depreciation in excess of historical cost depreciation would be credited to a special account in the shareholders' equity section of the balance sheet which would accumulate during inflation and decrease during deflation.
4. As long as reinvestment occurs, there would be no attempt to recapture the restated depreciation for either book or tax purposes. Gain or loss on retirement or sale of a capital asset would be calculated on the basis of historical cost amounts.
5. The amount and method of determining restated depreciation would be disclosed by footnote.

Note the rather unusual combination of effects if this depreciation methodology is accepted for both book and tax purposes. Assuming that a company already uses LIFO for inventory purposes, the following would result:

Net income would be reduced by the amount of the increased depreciation less the resulting tax saving.

Although net income is reduced, equity would be enlarged because the credit for the increased depreciation, not reduced for any tax effect, would be carried directly to a special equity account.

Net cash flow would be increased by the amount of the tax saving resulting from acceptance of the increased depreciation for tax purposes.

The following simplified illustration presents the essentials of current cost depreciation. Assume a company with the following balance sheet on December 31, 1976. Its accounts are kept in accordance with generally accepted accounting principles.

Other assets	$400, 000
Properties and equipment	500, 000
Less depreciation	200, 000
Subtotal	300, 000
Total	700, 000
Other liabilities	285, 000
Taxes payable	15, 000
Shareholders' equity:	
Capital stock	200, 000
Retained earnings	200, 000
Subtotal	400, 000
Total	700, 000

The company's income statement for 1976 includes the following:

Revenues	$1, 000, 000
Other costs	850, 000
Depreciation	50, 000
Subtotal	900, 000
	100, 000
Federal income tax	50, 000
Net income	50, 000

To apply current cost depreciation in this situation, assume that the properties and equipment are being depreciated over 10 years, and that the cost indices appropriate to those assets have gone up an average of 40 percent since the assets were acquired. The current cost of the assets, therefore, is $700,000, and depreciation at a 10 percent rate for the current year is $70,000. An income statement for 1976 using current cost depreciation would appear as follows:

Revenues	$1, 000, 000
Other costs	850, 000
Depreciation	70, 000
Subtotal	920, 000
	80, 000
Federal income tax	40, 000
Net income	40, 000

This company's year-end balance sheet for 1976 under current cost depreciation would appear as follows:

Other assets	$400,000
Properties and equipment	500,000
Less depreciation on a historical cost basis	200,000
Subtotal	300,000
Total	700,000
Other liabilities	285,000
Taxes payable	5,000
Shareholders' equity:	
Capital stock	200,000
Retained earnings	190,000
Accumulated current cost depreciation	20,000
Subtotal	410,000
Total	700,000

Use of Indices. Our recommendation for the establishment of authorized indices contemplates procedures which are substantially identical to those which are now used by many retail companies. LIFO inventories determined using the retail pricing method, the Treasury Department has published regulations which provide that indices prepared by the United States Bureau of Labor Statistics are acceptable. We envision development of authorized indices for adjustment of depreciation expense following the precedent which has already been established in gaining acceptance for LIFO inventories. Not only have these procedures proven acceptable to both government and industry, but many of the implementation details, which are often quite troublesome in adapting to change, have already been carefully established.

Why an Ernst & Ernst Proposal? A number of proposals for accounting for inflation have been put forward, some of them in considerable detail. Why then does Ernst & Ernst recommend still another? The proposals we have seen each do well at serving the desires of one or more of the several interests in financial reporting but give little consideration to the concerns of other interests. We offer a proposal that favors no one group yet effectively serves the interests of all.

For readers of financial statements, it provides a restated net income that largely avoids inventory profits and deducts depreciation in terms of current dollars.

For companies and their investors, it provides cash flow benefits to ease the difficulties of capital formation.

For the Treasury Department, it is not only administratively practical but taxes income at real rates much closer to statutory rates and provides an opportunity to tie the tax benefits to maintenance or expansion of productive capacity, thereby creating jobs and related economic benefits.

For all concerned, it provides a readily understood procedure, one that is objectively verifiable and that causes minimum interference with present generally accepted accounting principles and practices.

We propose it as a sensible, sound, equitable, and feasible solution to the problem of accounting for inflation.

THE CASE FOR HISTORICAL COST

We are firmly in favor of retaining historical cost as the basis for corporate financial reporting. As the succeeding section will show, we have examined the major alternatives to historical cost and find them greatly lacking in objectivity and usefulness. But this does not mean that we fail to recognize the limitations of historical cost. We have examined historical cost with equal thoroughness and are familiar with the arguments of its critics. They fail to persuade us.

The Purpose of Accounting. The thought that comes through to us after reading what has been argued by the critics of historical cost accounting is that they apparently misunderstand its purpose. They criticize historical cost on the grounds of its alleged failure to do a number of things that it was never designed to do.

Conventional accounting was never intended to provide shareholders with a precise measure of the value of their shares. That is a function of the stock market.

Conventional accounting does not purport to show economic values, either of a company or of its individual assets. Indeed, economic concepts of value vary so much that to attempt to state "economic value" will almost certainly mislead someone whose interpretation of the term differs from that of the one making the statement.

Conventional accounting does not purport to report the economic income of a company. Economic income is essentially a personal income concept that can be adapted to business corporations only after severe modification of the basic concept.

What conventional accounting was intended to do—and what it still does well—is to provide a reliable record on an objective basis of the actual transactions and events to which the reporting company was a party during the period of the report.

Accounting does so under the theory that a reliable record of the immediate past, together with trends over a period of years, provides information useful for predicting future transactions and events. Although this is a less dramatic role than some of its critics would attribute to accounting, its usefulness is clear. Accounting has no need to make exaggerated claims about that information because a great variety of interests in business have found such objective reports of acrual transactions to be of great usefulness, if not indispensable, in the performance of their functions. A danger is that, in trying to make accounting something different, the practical usefulness of a reliable record of actual events will be lost.

Balancing Objectivity and Relevance. Once one departs from a factual report of past events, reliability decreases even if relevance to the needs of some specific interest may increase. If accounting were to be completely objective, it might restrict its reporting to purchases, sales, and cash transactions, and be much less useful. On the other hand, if it had no concern with objectivity, it could engage in forecasts and all forms of "what if" accounting. Generally accepted accrual accounting principles represent what management, accountants, and the various users of accounting information have agreed is a reasonable balance between objectivity and relevance.

Over the years of its development, accounting has seen a continuing effort to balance objectivity and relevance. Early theorists, eager to inject some discipline into financial reporting practices which they felt were almost completely dominated by the immediate wishes of corporate management, urged the acceptance of historical cost established in arms-length transactions to which the reporting company was a party as a means of curbing the reporting of assets and income having little real substance.

To support this concept, they proposed that accounting be viewed as a process of cost allocation rather than one of asset valuation. The history of accounting over the last several decades is largely a record of attempts to improve accounting as a process of cost allocation.

At the same time that strenuous efforts were made to improve cost allocation practices, critics of historical cost as a basis for accounting were calling for the introduction of "current value" which they contended came closer than historical cost to approaching "economic reality" in an economy with a

continuing inflationary tendency. Cited as examples of the irrelevance of historical cost were substantial changes in the values of certain securities and land.

Practical Modifications of Historical Cost. While the theorists argued with one another at length, corporate management and accounting practitioners adopted a far more pragmatic attitude. Accepting historical cost as the appropriate basis for the preparation of financial statements did not prevent them from modifying historical cost in those circumstances where they felt its strict application was not the most useful practice. Very early, provision was made for the anticipated uncollectibility of accounts receivable on an experience basis. Inventories were priced at the lower of cost or market as a practical way of measuring loss of utility and salability. Anticipated permanent declines below cost in the values of investments were recorded as writedowns. At the same time, experience convinced these practical businessmen that unless alleged increased values of assets were corroborated by the judgment of another entity expressed in an arms-length purchase transaction, those values might prove to be illusory and the familiar realization test of a completed transaction was adopted.

Consequently, traditional or conventional accounting practice continued to be based on historical cost, but it gradually adopted a number of modifications which were inconsistent with the strictest interpretation of the historical cost concept. This encouraged the critics of accounting, some of whom saw every such adaptation as evidence that historical cost was inappropriate, to argue for a valuation or economic approach which they believe would provide a logical and internally consistent theory on which to report the results of operations and financial condition of business corporations.

We have examined both sides of this controversy with care. We recognize that conventional accounting has both conceptual and implementation problems. Our examination of current value concepts leads us to the conclusion that these present even greater conceptual and implementation problems. Furthermore, traditional accounting is in place and working. The possibility of trying to make a major shift in our basis of accounting presents untold problems. Contracts and agreements of all kinds, business practices, and legal requirements and precedents are all based on conventional accounting practice. We have been accounting on a cost basis for the corporate entities which constitute the most important components of this nation's economy for a long time. Those who manage these entities, those who share in the proceeds of their activities, those who invest in them or advance credit to them, members of regulatory bodies—indeed, everyone concerned with corporate business relies on present accounting practice in one way or another. Traditional accounting is an important part of our economic culture.

Traditional Accounting and Managerial Decision Making. Our attachment to traditional accounting is both theoretical and practical. We accept the role for accounting on which historical cost is based, yet we accept the desirability of periodic modification and adaptation to meet the needs of changing circumstances.

Consider some of the advantages of present accounting. It provides a readily understood income concept that fits the corporate executive's decision processes in the great majority of business situations. The accounting calculation of income is a reflection of the way corporate executives think about their work and about meeting the needs and desires of their customers. It provides some major information on which they make operating decisions. For most companies, buying and selling, rather than mere holding, are essential parts of business activity. The pursuit of profit requires that a company add sufficient utility of time, place, or form to the materials, product, or services it buys so they can be sold above cost. The most common, the best understood, the simplest, the most versatile concept of profit is the excess of selling price over cost.

A decision to continue or to discontinue a product, a division, a department, or a plant hinges to a considerable extent upon whether continuation of the operation is expected to show a favorable spread between projected revenue and cost. This concept of profit can be applied to a few or to many transactions, to a simple or a complex operation, to the results of the activities of the entire business or to any part of it, to past activities of future expectations.

The matching principle grows directly out of this concept of profit. Costs and revenues are matched on a basis of their relationship to one another so that management and others can judge whether those costs should continue to be incurred. Have they been successful in producing adequate revenue or have they not? Any shift to an asset valuation basis for income determination will depart directly from the kinds of decisions that must be made to operate most business enterprises.

Traditional accounting provides an appropriate and recognized basis for evaluating operating results. Present historical cost financial statements report those transactions which have actually taken place, not those which might have taken place under some other assumed conditions. The income statement brings together a record of management's efforts in the form of costs incurred with management's accomplishments in the form of revenues. And both of these are measured in terms of actual transactions entered into by the company, not in terms of subjective estimates of asset values. We can think of no more rational or equitable basis for evaluating performance, whether for the total company or for any one of its parts.

"Holding," an activity emphasized in some analyses of business income, and much emphasized by current value advocates, is no more than an incidental aspect of most corporations' productive operations. Where it is of sufficient independent importance to warrant attention, that attention can be given by supplementary disclosure without revolutionizing all financial reporting.

Thus traditional accounting holds firmly to objectively determined facts—actual transaction data, the most reliable information available. Plans, intentions, and expectations may be disclosed in the annual report if desired, but one of the great advantages of generally accepted accounting principles is that such interpretive material is clearly distinguished from factual transaction data. A clear separation between completed and possible events is maintained.

Finally, traditional accounting is the result of decades of effort to strengthen and improve financial reporting practice. From the time companies first began to report their results of operations to outsiders, professional accountants both in industry and in public accounting, have worked together to develop standards adequate to distinguish acceptable from unacceptable financial reporting. The AJCPA Committee on Accounting Procedure, the Accounting Principles Board, the Financial Accounting Standards Board, the Financial Executives Institute, the American Accounting Association, the National Association of Accountants, the stock exchanges, the Securities and Exchange Commission, and other regulatory agencies—all aided by scores of committees and great individual efforts—have improved corporate financial reporting by narrowing the range of acceptable practice and by requiring essential disclosures.

The Role of Accounting Theory. We wholeheartedly support the idea that accounting must have a conceptual base. No art applied by so many people under such varying circumstances and relied on for such important decisions as accounting can serve satisfactorily without some core of established concepts and principles.

But it is not always clear just what those concepts should be. The current controversy between those who support traditional accounting and those who favor current value as the basis for financial reporting can best serve all those who use the financial information it produces. Under such conditions, we rely on a cost/benefit test. In the specific circumstances, what works best for the majority of those concerned? What are the costs of change? Who will bear them? What are the established—not merely claimed—benefits? Unless persuasive evidence exists that the total economic benefit exceeds the total cost, change is unwise.

In applying that approach, we would deny our professional responsibility if we are so bound by any theory that we permit it to override our professional judgment. As yet, we have not met any general accounting theory which we believe satisfies all needs and all occasions so well that it can be applied without thoughtful consideration of its appropriateness in the specific circumstances. We feel obliged to recommend departures from prevailing theory when our best judgment tells us this is necessary to meet the needs of the situation. Such departures are and should be relatively rare, otherwise the value of a conceptual basis is negated.

Our reasons for this judgmental attitude toward accounting grow out of our perception of business as a dynamic process presenting an endless number and variety of actions and effects. Accounting must have flexibility to meet the innovations and adaptations of business activity. It should respond to business activity, not dominate or restrict it. Accounting is an appropriate tool for use by those charged with responsibility to direct, control, or regulate business, but accounting should seek to report facts fairly and objectively, uncolored by the accountant's subjective approval or disapproval of the actions reported.

The difficulty of doing this is apparent. If only those facts that are completely and objectively measurable were accounted for, accounting would be much less useful. Accounting would also be much less useful if it lost its emphasis on objectivity. One of the responsibilities of accountants—and a factor in the usefulness of both—is a continuing effort to obtain the best mixture of faithfulness to basic concepts and adaptability to new circumstances, an emphasis on traditional objectivity balanced by a recognition of changing needs.

PROBLEMS WITH CURRENT VALUE ACCOUNTING

Two general types of current value proposals have been made: (1) internally consistent theoretical models which give little attention to the problems of application in a wide variety of companies and situations, and (2) somewhat more realistic models directed almost completely to the details of implementation with little concern for theoretical consistency as long as the specific valuation techniques employed fit within the general category of current value.

Although we expect that the more realistic models will be proposed for actual implementation purposes, we feel obligated to consider the theoretical models also because our criticisms run to the basic concepts as well as to the very serious problems of implementation.

Conceptual difficulties with current value accounting

Theoretical models fall into three types on the basis of the way they value a company's assets: (1) the present value of discounted future cash flows, (2) current realizable value, and (3) replacement cost.

Change in Present Value of Future Cash Flow. Most current value proposals are urged as a reasonable approximation of an economic income concept based on the present value of future cash flows which is often cited as the basic economic concept of value. The theory is that if the amount and timing of the future cash flows from a given asset, whether that asset be a security, a machine, or a company, were known, these could be discounted to the present at an appropriate rate of interest and the result would be the value of that asset in the most realistic economic terms.

There is an interesting result in this approach. If a company could be recorded at the present value of its future receipts, the company's net income in any period would then become nothing more than a rate of interest applied to its value. The most revealing information about the differences among companies would be found, not in such a statement of income for each company, but in the calculation of the future cash flows necessary to determine present values. All the differences between companies would be worked out in determining the future cash flows from their anticipated activities. Once the future cash flows were determined and a rate of interest selected, income determination would consist of applying the interest rate to accumulate the present values back up to the amounts of the cash flows.

This approach works ideally with a federal government bond which comes as close to certainty of cash flow as we have in our uncertain world. It would also work for some rental properties under lease for the duration of their lives. But it is quite another matter to apply it to a variety of assets, such as the components of a production line, which must be associated with one another in order to produce an income stream. And, of course, a company is far more difficult to value based on the present value of future cash flows because it includes a variety of assets, not all of which are a matter of record.

For example, how does one determine anticipated cash flows from such intangibles as created goodwill, from a successful marketing program, from a research and development department? Included in the idea of income as the change in the present value of future cash flows is the frequently overlooked

idea that if we can approximate the present value of each of the company's individual assets, these can be added to reveal the current value of the company. We have difficulty in accepting the idea, even on a conceptual basis, that all the assets which contribute to a company's cash flows can be identified and valued on any basis that provides dependable information.

Most people concede that, with rare exceptions, the implementation difficulties in applying discounted cash flow concepts of value and net income to the operating assets of many companies on a realistic basis are overwhelming. For the assets of most companies, future productivity is so uncertain that we just do not know and cannot estimate with any degree of objectivity what future cash flows will be. Neither can we find sufficiently reliable evidence of the appropriate interest rate at which they should be discounted. Hence, change in the present value of future cash flows is held by some to constitute an ideal which cannot be attained in practice but should at least be sought.

We do not argue with the idea of present value of future cash flows as a useful economic concept of value. We do disagree strongly with the contention that such a concept has any valid application to the financial statements of a modern corporation. An income concept that presumes (a) to identify as assets all the factors that contribute to a company's future cash flows, (b) to measure the specific cash flows resulting from such factors, (c) to effectively equalize such flows with a discount rate, and (d) then to total the results to obtain the value of the company and to determine its income is so far removed from real world uses and problems of corporate income data as to have little, if any, perceivable relevance to corporate financial reporting.

Current Realizable Value. Another group of theorists argues that the major economic decision facing management is whether to continue in its present line of activity or to convert the capital under its control to some other course of action. For example, if the rate of return on government bonds is greater than the return from making steel, the company's assets used for making steel should be disposed of and the amount realized should be invested in government bonds or whatever other available activity promises the highest rate of return commensurate with the risk the company is willing to accept.

But to make such a decision, the argument runs, management must know what the current realizable value of its assets actually is. It does no good to sell the steel mill and find the amount realized is so small that less will be earned on the government bonds than would have been earned if the company still made steel. Therefore, at the end of each period, the current realizable value of the company's assets should be determined. Under this theory, the change in the current realizable value of the company's assets from the beginning of the period to its end, taking into account additional investments and withdrawals, represents its income.

The implementation problems in ascertaining current realizable values are similar to those faced in attempting to discover future cash flows. As a matter of fact, in concept they are much the same. If markets were "perfect," every asset could always be priced at the present value of its future cash flows. In this uncertain world with limited and imperfect markets, a variety of questions arise. What is the current realizable value for a steel mill? Do we plan on selling the assets on a piece by piece basis or seek bids on the plant as a whole? Does one assume forced sale liquidation or disposition on a going concern basis? What value is to be used if no sales of plants of this kind or size have taken place recently?

We have great difficulty in finding any usefulness in such information even if it could be obtained. Certainly management must be alert to the possibility that other opportunities exist for employment of its capital. But going out of business is not a decision that needs to be made at every balance sheet date, nor should possible liquidation dominate financial reporting when the normal expectation is that the company will continue.

Replacement Cost. Replacement cost, a term that seems to mean many things to many people, is often advocated as the closest practical approximation of discounted future cash flows. Conceptually, except for market imperfections, replacement cost, current realizable values, and the present values of future cash flows should be the same. The assumption is that the market is willing to pay for any asset no more than the present value of what that asset will produce in the future in the way of cash flows. Thus, the present replacement cost

of any asset is the market's estimate of the future cash flows of such an asset discounted at what the market considers to be a reasonable rate of interest.

We have already noted what we consider to be the fundamental flow in that approach to asset valuation and income determination. Equally serious implementation issues require resolution.

The difficulty with replacement cost arises when we consider the nature and circumstances of the asset to be replaced. A simple staple like a ten-pound bag of sugar will likely be replaced by a ten-pound bag of sugar so similar that telling them apart might be nearly impossible. But replacing a complex piece of production machinery presents another problem entirely. If it were to be replaced at all, it might be by a greatly improved machine designed to perform the same function, or by a substantially different machine designed to use new technology for attaining the same results, or by equipment that produces a different product to perform the same function as the old product. A conceptual question concerns the extent to which replacement cost of property and equipment should recognize technological change.

In general, the following versions of replacement cost are all possibilities:

Reproduction Cost of Existing Assets. The cost to replace existing assets without considering technological improvement. Reproduction cost is frequently approximated through price-level adjustment of historical cost amounts using specific price indexes.

Replacement Cost of Existing Assets. The cost to replace a single asset or groupings of congruous assets with other assets of equivalent productive capability. Replacement cost is equivalent to reproduction cost only in those relatively rare instances when there has been no technological change.

Replacement Cost of Existing Capacity. The cost to replace productive capacity without regard to existing assets or their physical distribution. This approach represents a forecast of how the company might proceed if it were to establish a competing business with identical productive capacity. For this purpose, a technological change, economies of scale, and other anticipated savings are all considered. Variations in the way these influence replacement cost seem unavoidable.

In addition to the possibility of confusing these, some pose significant implementation shortcomings. The lack of an adequate and accepted technology to develop replacement cost data, absence of a reasonably identifiable set of standards to reduce subjectivity to a satisfactory minimum, and a widespread failure to understand either the purpose or limitations of replacement cost data represent important deficiencies. We believe that adoption of replacement cost for financial statement purposes would introduce problems of measurement and interpretation that would far exceed those now faced in conventional financial reporting.

The SEC has introduced yet another application of replacement cost, one that tends to emphasize implementation over theory.

SEC Requirement for Supplementary Replacement Cost Data. A modification of replacement cost accounting was adopted by the Securities and Exchange Commission on March 23, 1976, in its Accounting Series Release No. 190.[3] The new SEC rule calls for the disclosure on a supplementary basis, by certain large companies of the following items of information:

The current replacement cost of inventories at each fiscal year end for which a balance sheet is required.

For the two most recent fiscal years, the approximate amount which cost of sales would have been if it had been calculated by estimating the current replacement cost of goods and services sold at the times when the sales were made.

The estimated current cost of replacing (new) the productive capacity together with the current depreciated replacement cost of the productive capacity on hand at the end of each fiscal year for which a balance sheet is required.

For the two most recent fiscal years, the approximate amount of depreciation, depletion, and amortization which would have been recorded if it were estimated on the basis of average current replacement cost of productive capacity.

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[3] Ernst & Ernst Financial Reporting Developments, SEC Requires Replacement Cost Disclosures for Large Companies. April 1976, Retrieval No. 38450.

The requirement differs from the typical proposal for replacement cost accounting in both purpose and detail. It does not call for determination of a net income amount based on replacement cost, although an invitation to make such a calculation seems implicit in provision of the replacement cost data. The SEC Release states that the information is offered as supplementary data intended to provide information to investors which will assist them in obtaining an understanding of the current costs of operating the business which cannot be obtained from historical financial statements taken alone. A secondary purpose is stated to be to provide information which will enable investors to determine the current cost of inventories and productive capacity as a measure of the current economic investment in these assets existing at the balance sheet date.

A distinguishing feature of the SEC's replacement cost rule appears in its definition of replacement cost as the current cost to obtain an asset of equivalent productive capability in accordance with management's normal or most likely replacement policy. Thus if a given item of equipment which cost $1,000 dollars and is still profitable could be replaced either by a similar piece of equipment at a current cost of $1,200 or by a technologically improved machine at $1,500, the replacement cost to be used would depend on management's policy. If it is assumed that management's policy would be to acquire the technologically improved machine at time of replacement, the replacement cost of the machine would be reported at $1,500 under the SEC rule.

In this illustration, SEC replacement cost results in an asset valuation greater than that which could result under other definitions of replacement cost. The difference exists because the SEC calls for replacement cost to be determined using management's normal approach to replacement.

SEC replacement cost and "ordinary" replacement cost will approximate one another when any technological advance is reflected in the asset cost. If that technological advance appears instead in the use of less material because spoilage is reduced, or in lower labor costs, or in energy consumption, replacement cost under the two approaches may be significantly different.

Companies are currently seeking to apply the SEC replacement cost concepts. We expect that most companies will be able to do so, although at some cost and management effort. But to what end? Will the resulting information have any practical use? Nothing in the SEC Release answers the kinds of conceptual and implementation objections we have to replacement cost accounting but we strive to keep an open mind until the considerable experience to be acquired during the next year or two will provide a better basis for evaluating the usefulness of the required information and the implementability of the rule as it stands.

Implementation problems in current value accounting

As mentioned previously, models advanced by practitioners tend to adopt current value as a general goal of financial reporting, a goal to be reached in specific circumstances by whatever valuation technique seems both available and appropriate. For example, current market quotations would be used for marketable securities; inventories would be valued at the lesser of current replacement cost or current realizable value; income producing property at exit or discounted value; plant and equipment at replacement cost or exit value with replacement cost selected from (1) reproduction cost, (2) the replacement cost of existing assets, (3) the lower of replacement cost or reproduction cost, or (4) the lower of replacement or reproduction cost provided the resulting amount does not exceed the present value of future cash flows.

Although general agreement might be reached among current value advocates on the appropriate valuation procedure for many assets and liabilities, a number of items present special problems. Included among these are intangible assets such as goodwill, patents and copyrights; land in use under productive facilities, natural resources such as oil reserves; and even long-term receivables and payables when interest rates are changing.

Consider the determination of financial statement amounts for long-term receivables and payables. Some current value proponents would have companies revalue all such long-term items at every balance sheet date. Fluctuations in interest rates would then influence reported income. To the extent that a company has entered into a long-term financing transaction at a current

market rate, we feel that rate should govern the accounting for the receivable or payable until settled or until another transaction is consummated.

Neither the lender nor the borrower can control prevailing interest rates, and it is economically impracticable to refinance obligations or dispose of assets at every rate change. Of course interest rates influence the profits of companies engaged in financial activities but we believe financial statement readers are interested in the results of actual transactions, not in every change that would have influenced other transactions if they had been entered into.

Net Income in Current Value Models. In reporting net income, current value models exhibit differences similar to those found in their valuation methods. Most models try to subdivide the present net income figure into a variety of components including, for example, operating income, realized value changes, and unrealized value changes. Some would include a provision for capital maintenance based on the decline in the general purchasing power of the dollar. Others would adjust reported income for general purchasing power gains or losses on net monetary items.

Segregation of holding gains (generally defined as the increase in value of an asset during the time it is held by a company) is a relatively common characteristic of current value reporting proposals. This is apparently done on the theory that such gains are so different from operating income that they should not be combined with it. In some cases, the contention seems to be that they are not actually enterprise income at all. The purpose in separating them from other income items is so that financial statement readers will identify holding gains as something they cannot count on to be repeated in future years.

As a practical matter, holding and operations are often inseparable. Manufacturing and sales operations cannot be conducted without holding inventories and other assets for a period of time, and to report these activities as if they were separable can be misleading. In other cases, holding gains are the result of wise management planning and purchasing and are as much a result of management action as are operating gains. We concur that extraordinary market changes may result in holding gains that are not indicative of a company's ability to sustain reported earning power but we feel that such changes can be disclosed without major modifications to the conventional income concept.

Because we believe the present concept of corporate net income has demonstrated great usefulness, we are opposed to the idea that what is now reported as net income should be subdivided into a number of separate elements with new designations and descriptions. The present concept of net income is so much a part of the way investors, management, credit grantors, labor, regulatory authorities, and others think about business success and failure that proposals to change it in major ways impress us as unreasonable. Such a proposal would place a significant burden on financial statement readers who would then be left to their own devices to formulate and apply some concept of enterprise net income. The failure to identify and determine net income is not likely to be received by financial statement readers who would then be left to their own devices to formulate and apply some concept of enterprise net income. The failure to identify and determine net income is not likely to be received by financial statement users as progress.

Loss of Discipline Under Current Value Proposals. It seems curious that some of those who now complain that present financial reporting already includes far too wide a range of acceptable practices should advocate abandonment of historical cost. One can only conjecture about the total range of asset valuation practices that would be proposed as acceptable if current value amounts were injected into financial statements. Certainly the discipline now incorporated in conventional accounting, the hard-earned results of decades of work by many individuals and organizations, is likely to be sacrificed if a new basis of accounting is adopted, and the long, tedious, and painful process of developing authoritative standards will have to commence anew.

Financial Statements Adjusted for Changes in General Purchasing Power. An entirely different method of adjusting accounting data for the impact of inflation was proposed by the Financial Accounting Standards Board in an exposure draft entitled "Financial Reporting in Units of General Purchasing

Power." Ernst & Ernst opposed the issuance of that proposal as a financial accounting standard.[5]

Our primary opposition focused on the recommendation that the purchasing power gain or loss from holding net monetary items be included in net income although it is an item that will never constitute realized net income in the sense that most readers of financial statements understand that term. It represents a "gain" that will never be received by the reporting company in cash and as such cannot be reinvested or distributed to shareholders. We commented further:

"On this point, GPP net income for conservatively capitalized companies will compare unfavorably to that of highly leveraged companies, because the latter will include larger purchasing power gains as part of their net income. Users may not understand that income in leveraged companies is influenced by the amount of debt and could erroneously conclude that prospects for leveraged companies are unrealistically better than future cash flows will ever justify. The opposite conclusion may be reached for conservatively capitalized companies. Should this occur, reported net income would be misleading as a measure of past success and future prospects."

We also objected to the proposal on the grounds of its general lack of understandability, the questionable usefulness of price level adjustments for economic predictive purposes involving specific companies based on a single general index, the cost of not only implementing the proposal but of educating financial statement users to an understanding of its meanings and limitations, and the widespread lack of enthusiasm for a procedure which has been available for years.

We did take that occasion to advocate the reporting on a supplementary basis of depreciation expense adjusted for price level changes, a position included in the recommendations of this present paper.

In June, 1976, the FASB announced that it had decided to defer further consideration of a statement on Financial Reporting in Units of General Purchasing Power.

Conclusions about current value accounting

Our approach to resolving accounting issues is essentially an application of a cost/benefit test. What are the net advantages or disadvantages of historical cost? What are the net advantages or disadvantages of current value? How do they compare? Such an evaluation, of course, should be made keeping in mind the varying interests in and uses of accounting data. We recognize that others may place different evaluations on some of these factors but, given our experience and practical orientation, we find the decision an easy one.

In favor of historical cost we find its demonstrated usefulness over time and under a variety of circumstances. It has wide acceptance and understanding, and is supported by a body of well established standards and practices. Literally innumerable decisions are made every day on the basis of conventional accounting data and those who make them are not the ones calling for a change to current value. On the negative side we recognize its limitations during times of inflation or deflation and the desirability of supplementing it with specific value information under some conditions. Both of these deficiencies can be remedied, the first by the proposals in this paper, the other by supplementary disclosures.

We also support continuing efforts to narrow the range of acceptable practices insofar as this is possible without unduly restricting application of the judgment necessary to recognize the influence of circumstances and conditions on transactions.

Current value advocates claim great usefulness for financial statements prepared on that basis but such claims are as yet completely unsupported by any significant amount of experience. They also claim conceptual conformity with economic concepts, but this claim is subject to challenge. On the negative side are anticipated but as yet unknown problems of implementation. We consider these of great importance. There is also an absence of experience, of acceptance, and of discipline in the form of established standards or accepted practices. An additional negative is the cost of change if current value is substituted for historical cost, a change that can result in great confusion and distress to those who fail to understand the results.

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[5] Ernst & Ernst Financial Reporting Developments, *Price Level Accounting*, Aug. 1975, Retrieval No. 38350.

Given such a summary, we can come to no other conclusion than that the clear balance of usefulness at this time remains with the modest departure from historical cost we have recommended. If we put ourselves in the position of corporate managers, investors, analysts, regulators, taxing authorities, creditors, or whatever interest you choose, and consider whether we would prefer to have traditional financial statements, modified as proposed in this paper, or some version of current value with all the disadvantages we envisage in the implementation of that method of accounting, we find historical cost to be the better choice by far. On any cost/benefit test we can apply, society would be ill served by the adoption of current value accounting as the basis for corporate financial reporting.

[APPENDIX B]

MACROECONOMIC IMPACT OF CURRENT COST DEPRECIATION

SUMMARY

Introduction

Under conditions of inflation, the replacement cost of capital goods will in general exceed original purchase price of these items. When this occurs, depreciation allowances based on historical costs will be insufficient to provide the reserves necessary to purchase replacement goods at the time of obsolescense. If depreciation expenses are not adjusted to reflect the fact that more expensive equipment is being utilized by the firm, the costs of using this equipment in subsequent years will be understated and hence operating profits will be overstated. Thus, during inflationary times both income statements and balance sheets will fail in many respects to reflect the underlying economic and operating results of the firm. The problem becomes even more serious when we consider the effects of corporate and personal income taxes, since firms and individuals will have to pay taxes based upon a level of operating income which is overstated by the amount by which depreciation expenses have been understated. Hence under present legal and accounting conventions, inflation imposes a heavy tax burden upon corporations and individuals alike.

This situation is somewhat analogous to that which exists when the FIFO (first in-first out) inventory convention is used. Firms overstate their operating income by an amount equal to the difference between the current market value of the input and its historical cost.

In order to make the financial documents which reflect business operations more indicative of the actual cost of these operations under inflationary conditions, and to help to reduce the disincentives to investment which result from the taxation of the portion of profits which results solely from the understatement of depreciation expenses, Ernst & Ernst has suggested a procedure which would allow firms to value their assets for depreciation purposes on a basis which is approximately equivalent to the current cost of acquisition. Under this procedure, firms would value each asset by an amount equal to the undepreciated portion of that asset times the ratio of the cost of the asset at the time of the financial statement to the original cost of the asset. The increase in the cost of the asset would be measured by the increase in the implicit deflator for capital goods as reported in the National Income and Product Accounts. This proposal, called Current Cost Depreciation (CCD), has the twin merits of preventing the distortion in financial statements which is caused by high rates of inflation while avoiding the computational complexities which would be introduced by attempting to determine a fair market value for each capital good which a firm holds.

In order to determine the economic impact of the introduction of this change in accounting and legal procedures and definitions, Ernst & Ernst has commissioned Chase Econometric Associates, Inc. (CEAI) to investigate the macroeconomic impact of CCD. The results of this study are summarized below.

The inflation penalty

Recently the Department of Commerce has started to estimate the difference between depreciation based upon the current-year prices of capital and depreciation using historical costs as a basis.[4] This difference is called the Capital

[4] Although this latter concept is a close approximation of depreciation as used by the IRS, several differences exist, the most important of which are the exclusion of farm sector depreciation, owner-occupied housing and landlords who file individual tax returns.

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Consumption Adjustment (CCA) in the National Income and Product Accounts. The 1976 value of CCA was approximately $15 billion. However, CCA is calculated based upon the assumption that it represents "economic" depreciation, and in addition to assuming current price accounting, it also assumes that all capital goods are depreciated on a straight line basis using 85 percent of the Bulletin F tax lives. The latter two assumptions are clearly inappropriate to a study of the impact of CCD under the conditions specified by Ernst & Ernst which assumes in general that all other tax laws would remain unchanged. Therefore, it was necessary for CEAI to calculate the increase in depreciation expense which would occur should CCD be adopted along the lines suggested by Ernst & Ernst.

These increases were calculated on an annual basis for the ten-year period 1976–1986 for each of 24 industry classifications. In each case, it was assumed that the average tax life and proportion of assets depreciated by accelerated methods for industries would be equal to the average values which occurred during the 1972–1976 period. The rate of inflation used to calculate the CCD adjustment was the rate of inflation for all capital goods taken from the standard CEAI Long-Term Macroeconomic Forecasts.[6] These calculations show that the additional depreciation which would be attributable to CCD both for assets on hand at January 1, 1977 and those acquired after that date would be $60 billion in 1977 and would rise gradually to $96 billion in 1986.

A $60 billion increase in depreciation allowances would imply a $26 billion decline in Federal income taxes, $20 billion of which would be corporate income taxes. This would likely encounter political roadblocks inasmuch as the idea of such a significant and sudden tax reduction would undoubtedly create a difficult environment for adoption of CCD—without regard to its merits. Thus Ernst & Ernst has suggested that this problem be handled by phasing in the tax reduction over a number of years. The most logical way to proceed would be to have CCD apply only to all new investment and not make the adjustment retroactive. This proposal would have several advantages.

It would not require a massive increase in the Federal budget deficit in the first year.

It would be similar to other tax reforms which have affected investment incentives. For example, when accelerated depreciation was introduced, it was not applied retroactively but instead could be used only for future investment.

Since the added incentive would give firms an additional reason to purchase new plant and equipment instead of continuing to utilize their existing capital stock.

It would meet the criticism of historical cost depreciation without causing a massive disruption in existing financial statements.

In view of these factors, CEAI has calculated the economic impact of CCD under the assumption that it applies only to new investment.

Model adjustments required by CCD

Since the CEAI standard forecasts are used as a baseline, we calculated the difference in the economic inputs which would result from CCD and then entered these into the CEAI Macroeconomic Model as changes in assumptions. The model was then simulated over the 1977–1986 period. The difference in the results between the new simulation and the CEAI standard forecast is then the impact resulting from the adoption of CCD.

Several changes in assumptions had to be entered into the model. First, corporate and non-corporate depreciation expenses were increased, as noted

[6] The standard CEAI long-run macroeconomic forecast is relatively pessimistic in the short-run with a major pause in economic growth forecast for 1978. However, beginning in 1979, growth will resume and the economy will gradually reach a full-employment equilibrium by 1986. The forecast average annual rate of increase in real Gross National Product is 3.0 percent, while the forecast average annual rate of inflation for capital goods is 5.3 percent. These forecasts are based upon the standard CEAI forecasts of fiscal and monetary policy. Briefly stated, Federal government expenditures are forecast to grow at an average annual rate of 8.6 percent, while receipts are forecast to grow at a 9.2 percent average annual rate. Thus, the deficit is expected to fall somewhat both in real terms and as a percent of real Gross National Product. Monetary policy is expected to be formulated in a way such that the nonborrowed monetary base grows at a 7.4 percent average annual rate during the decade. For a further discussion of the assumptions and conclusions of the CEAI standard forecasts, see the Long-Term Macroeconomic Forecast, June, 1977.

above. The amounts of the increase for each year are listed on line 2 of Table 1. Second, tax revenues declined because of the increase in depreciation expenses. The amount of the reduction in revenues was based on the average of present marginal tax rates for corporations and for upper income individuals. The loss in personal and corporate income taxes was estimated to be approximately $2.8 billion in 1977 and $16.3 billion in 1986; estimates for each year are given on lines 5a and 5b of Table 1. These revenue and depreciation estimates are "primary" in the sense that changes in depreciation, income, and tax revenues resulting from changed levels of economic activity have not yet been considered. The "secondary" impacts are then calculated from the model solution. In addition, the present value of the depreciation deduction for both equipment and structures must be changed. The amount of change was calculated based upon the increase in deductions which corporations and individuals could expect from the adoption of CCD. For the purpose of these calculations, it was assumed that the expectations of businessmen and individuals with respect to the rate of inflation conformed to the inflation rates forecast by CEAI. Finally, Federal purchases of goods and services were adjusted in current dollars such that constant-dollar purchases remained unchanged.

Once these changes were entered into the CEAI Macroeconomic Model, the model was simulated and the economic impact—including secondary effects upon approximately 400 economic variables including the Federal budget, employment, and inflation—was calculated. A summary of the results is given in Table 2.

TABLE 1.—CHANGES IN FEDERAL GOVERNMENT REVENUES—SUMMARY

[In billions of dollars]

	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986
(1) Depreciation allowances, baseline case	200.3	224.5	251.9	282.9	315.6	350.4	388.8	431.5	477.8	528.5
(2) Additional depreciation attributable to CCD	7.0	13.4	17.7	20.9	23.9	27.4	31.8	36.6	39.4	42.8
(3) Additional depreciation attributable to incremental induced investment	.0	.2	.6	1.2	1.9	2.9	3.8	4.7	5.8	7.1
(4) Depreciation allowances with CCD	207.3	238.1	270.2	305.0	341.4	380.7	424.4	472.8	523.0	578.4
(5a) Primary revenue loss to Federal Government from personal income taxes	.7	1.3	1.7	1.9	2.2	2.6	3.1	3.6	4.0	4.4
(5b) Primary revenue loss to Federal Government from corporate income taxes	2.1	3.9	5.2	6.2	7.1	8.1	9.3	10.6	11.3	12.1
(6) Higher interest payments by Federal Government	.2	.5	.9	1.5	2.1	2.6	3.3	4.1	5.0	5.8
(7) Higher cost of Federal Government purchases	.0	.1	.1	.1	.1	.5	.5	.7	1.1	1.2
Less:										
(8) Lower Federal transfer payments	.1	.3	.5	.5	.6	.4	.5	.4	.4	.3
Less:										
(9) Additional tax revenue induced by growth stemming from CCD	.7	2.2	3.5	4.3	5.2	6.0	7.5	9.2	11.0	12.8
(10) Total increase in Federal budget deficit	2.2	3.3	3.9	4.9	5.7	7.4	8.2	9.4	10.0	10.4

Note: (1) to (10) are: (4)=(1)+(2)+(3); (10)=(5)+(6)+(7)−(8)−(9).

Macroeconomic impact

The initial impact of the change in 1977 is rather modest, but that is primarily because of the lagged effect of changes in the tax laws on investment. In 1978 purchases of producers durable equipment is $1.1 billion higher in 1972 prices or $1.6 billion higher in current prices, while nonresidential construction has increased an additional $1.3 and $2.2 billion in constant and current dollars respectively. Hence fixed business investment is 1.8 percent higher than would otherwise be the case. Unemployment is 0.15 percent lower, while real GNP has risen $4.6 billion or 0.3 percent.

The primary revenue loss to the Federal government from higher depreciation allowances in 1978 is $5.2 billion; higher interest payments cost an additional $0.5 billion, while transfer payments are $9.3 billion lower because of the in-

creased level of economic activity. Additional tax revenues induced by higher growth are $2.2 billion, leaving a total increase in the Federal budget deficit of $3.3 billion.

By 1980 the economic effects are considerably more important. The size of the depreciation adjustment has increased from $13 to $21 billion but the increase in the Federal budget deficit has risen only from $3.3 to $5 billion, largely because the size of the private sector has been enlarged. Disposable income is some $6.4 billion higher in 1972 prices, while real GNP has risen an additional 0.6 percent.

Investment in equipment is $1.8 billion higher in 1972 dollars, while nonresidential construction is $2.7 billion higher. In current (1980) dollars these figures translate into $3.1 and $4.9 billion respectively. Equipment purchases are 2 percent higher, while nonresidential construction is 5½ percent higher. The increase in equipment is smaller because the CCD adjustment is not as important for equipment, since tax lives are much shorter and hence the distortion caused by inflation is not as severe.

TABLE 2.—CHANGES IN KEY ECONOMIC VARIABLES—SUMMARY

	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986
(1) Increase in labor force	0.0	0.1	0.1	0.1	0.1	0.1	0.0	0.0	0.1	0.1
(2) Increase in employment	.0	.2	.3	.4	.4	.3	.3	.3	.3	.3
(3) Decrease in unemployment	−.0	−.1	−.2	−.3	−.3	−.2	−.3	−.3	−.2	−.2
(4) GNP, constant prices	1.5	4.6	7.2	8.3	8.8	8.0	8.3	8.0	7.6	6.6
(5) GNP, constant prices, percent change	.1	.3	.5	.6	.6	.5	.5	.5	.5	.4
(6) Investment, Equipment (billions of 1972 dollars)	.5	1.1	1.6	1.8	1.8	1.7	1.6	1.6	1.5	1.4
(7) Investment, Nonresidential Structures (billions of 1972 dollars)	.1	1.3	2.3	2.7	2.8	2.8	2.8	2.8	2.8	2.8
(8) Profits after tax	−2.6	−5.1	−6.5	−7.4	−8.6	−9.6	−10.9	−12.5	−13.1	−14.0
(9) Depreciation, corporate	5.0	9.7	13.3	16.2	19.1	22.4	26.2	30.3	33.1	36.4
(10) Corporate cash flow	2.4	4.6	6.8	8.8	10.5	12.8	15.3	17.8	20.0	22.4
(11) Disposable income (billions of 1972 dollars)	1.3	3.3	5.3	6.4	7.4	7.1	7.8	8.0	8.0	7.7
(12) Consumer price index, percent change	.0	.0	.0	.1	.2	.3	.4	.5	.7	.9
(13) Wholesale price index, percent change	.0	.0	.0	−.1	−.1	−.1	−.1	.0	.0	.0

Note: (1) to (3) in millions; ((4), (6), (7), and (11) are in billions of 1972 dollars; (5), (12), and (13) are percent changes.

We find that the incremental investment and the associated increase in aggregate demand produces 0.4 million new jobs by 1980, and reduces the rate of unemployment by 0.3 percent; it also increases the labor force by 0.1 million. Depreciation allowances have risen $21 billion, but the Federal governmen deficit is only $5 billion larger and current-dollar GNP has increased $15 billion. In constant (1972) dollars depreciation allowances have risen $44 billion and the government deficit has increased by $15 billion, but real GNP has risen only $20 billion. This implies an ex post multiplier of about 3, which is at the upper range of fiscal stimulus multipliers.

We do not find much further incremental improvement in the economy beyond 1980, since further additional stimulus would be necessary to keep the economy advancing at a higher rate. However, the increase in inflation is very modest so that the initial gains are not eroded, as would be the case with a sharply higher government deficit. Hence by 1986 real GNP is approximately 0.5 percent higher, 0.3 million new jobs have been created, and business fixed investment is $4.2 billion higher in 1972 prices and $10 billion higher in current prices. The Federal budget deficit has increased by $10 billion, half of which is due to higher interest payments. Federal government receipts are only $4 billion lower, as the $16 billion *ex ante* loss due to the effect of higher depreciation allowances is almost entirely offset by the gain in revenues stemming from a stronger economy.

Conclusion

This study has shown that the adoption of a CCD method of accounting which applies to new plant and equipment spending would have a significant

positive effect on the economy. It would create 400,000 new jobs by 1980 without increasing the rate of inflation at all, since the higher level of demand would be offset by an improved level of productivity. The increase in the Federal budget deficit would be minimal; as a result capital markets would not be upset and interest rates would not be materially affected. Investment in producers durable equipment would rise by an additional 2 percent by 1980, while nonresidential construction would be 5½ percent greater. On balance this method would strengthen capital formation, growth and employment without the negative side effect of higher inflation which usually accompanies fiscal stimulus.

Senator DOLE. We will stand in recess, subject to the call of the Chair, and thank you very much.

[Thereupon, at 12:30 p.m., the subcommittee was recessed to reconvene at the call of the Chair.]

[By direction of the chairman the following communications were made a part of the record:]

DENVER, COLO., *April 21, 1978.*

Mr. MICHAEL STERN,
Staff Director, Committee on Finance, Room 2227, Dirksen Senate Office Building, Washington, D.C.

DEAR MR. STERN: As a member of the silent majority, a company accountant by profession, I appreciate this opportunity to finally say something about my Federal taxes by making the following comments in regard to S. 2738:

(1) It appears that this bill is finally an attempt to do something about the increasing federal tax bite caused mainly by inflation.

(2) However, it also looks like a perhaps unwitting attempt to complicate further the already complex tax reporting methods (This would help me—I plan to start a tax return business next year.).

I would like to suggest that the inflation adjustment be applied to reduce current tax rates rather than to each of the several credits, deductions, and exemptions mentioned. This would require a reprinting of tax tables and rate tables each year (assuming inflation continues), but that would cost the individual taxpayer much less than his time or money involved in having more complicated forms completed.

Even if the change I recommend cannot be made I commend the sponsors of this bill in making the first attempt to conquer the primary source of erosion of personal income. Thank you.

Very truly yours.

PHIL PANNABECKER.

STATEMENT OF THE FEDERAL TAX DIVISION, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

The American Institute of Certified Public Accountants is the sole national organization of CPAs and currently has in excess of 135,000 members. The Federal Tax Division of the AICPA endeavors to provide public service in the field of federal taxation for the mutual benefit of taxpayers and government.

We are pleased to have the opportunity to comment on the subject of indexation. Although the Tax Division has not formally studied the entire concept of indexation, we applaud the initiative taken by Senator Dole and this subcommittee on this important subject. All of us have personally experienced greatly increased prices in our daily lives. Inflation affects all segments of our economy. With respect to federal income tax policy, inflation erodes the relevance of historical cost as a yardstick for measurement of depreciation on fixed assets held for substantial periods of time as well as the relevance of historical cost for measuring cost of goods sold by manufacturers, processors and sellers of goods. Any legislation in this regard should be designed to achieve simplification of the tax laws, and to provide relief for the reporting and recordkeeping problems encountered by all businesses, but with particular reference to small businesses.

Biannually, the Federal Tax Division publishes a booklet entitled "Recommended Tax Law Changes" which is distributed to all members of Congress, Treasury and Internal Revenue Service officials. The booklet is intended to define areas in which legislation is needed to provide greater equity and simplification of the tax system. Copies of the booklet are enclosed with our statement and additional copies are available upon request from our Washington office.

The latest edition of "Recommended Tax Law Changes" was issued in 1977, and includes (on page 48, under Section 472), the following recommendation concerning the general use of published indexes.

All taxpayers should be permitted to use published indexes to compute the last-in, first-out values of their dollar-value pools, and the IRS should be directed to publish acceptable indexes.

Under regulations section 1.472-1(k) and 1.472-8(e)(1), only taxpayers using the retail method of pricing LIFO inventories may use retail price indexes prepared by the United States Bureau of Labor Statistics (BLS). In practice, TIR-1342 and Revenue Ruling 75-181 (1975-1 CB 150) have further limited the use of published BLS indexes to department stores. Other taxpayers engaged in the business of selling merchandise at wholesale and retail who intend to adopt the LIFO inventory method must develop their own retail price indexes based upon sound statistical methods, using their own specific data on prices and inventory quantities unless they can independently demonstrate accuracy, reliability, and suitability of use of BLS indexes to the satisfaction of the district director.

Under regulations section 1.472-8(e)(1), taxpayers not entitled to use the retail method of pricing inventories may ordinarily use only the double-extension method for computing the base-year and current-year cost of a dollar-value inventory pool. Where the use of the double-extension method is impractical because of technological changes, the extensive variety of items, or extensive fluctuations in the variety of the items, in a dollar-value pool, a taxpayer may use an index method for computing all or part of the LIFO value of the pool. The index is computed by the taxpayer by double-extending a representative portion of the inventory in a pool or by the use of other sound and consistent statistical methods.

A statutory provision allowing all taxpayers to use published indexes, and requiring the IRS in cooperation with the applicable government agency to select and issue acceptable indexes applicable either on a general or specific industry basis at the option of the taxpayer, would greatly simplify the computation of LIFO inventories under the dollar-value method. It would, therefore, make the LIFO method much more practical and usable for smaller businesses upon which the present computations may be considered an inordinate burden, and thus simplify the administration of the tax law.

The Tax Division strongly recommends that this recommendation be enacted into law and we are prepared to work with the Congress and the Administration to implement it.

We might add that within the past year the Tax Division has created a task force on Indices for LIFO Purposes to study the development and use of indices for LIFO reporting. The task force was formed after a meeting with Internal Revenue Service officials in July 1977. Some of the questions being studied are:

1. Is there broad interest in the use of indexes outside of retail businesses? How many indexes would be needed?

2. In view of the substantial revenue involved, how would the IRS monitor the indexes and be satisfied as to their reasonable accuracy?

3. If the cost of indexes are subsidized by industries, would industry pay for updating an index in situations in which the updating might be contrary to the industry's self interest?

4. Could third party-non-government statistical organizations be used? Could they be relied upon and are they acceptable?

5. How could small and large businesses be combined for determining and categorizing the type of indexes that might be needed?

6. How should the BLS proceed to produce figures that would be applicable to different industries?

While it is believed that administrative remedies should be available in this area, there has been an apparent reluctance on the part of the Internal Revenue Service to simplify LIFO procedures, expand the availability and use of gov-

ernment prepared indexes, and develop a realistic LIFO system that would make the LIFO concept available to a greater number of taxpayers. The group most adversely affected by this posture is small business.

We are making every effort to obtain the administrative remedies discussed, but if legislative effort is required, we want to make you aware of our efforts and of the direction we are headed.

Again, we appreciate the opportunity to comment and we urge you to call on us if we can be of help in the future.

LODI, CALIF., *May 2, 1978.*

Mr. MICHAEL STERN,
Staff Director, Committee on Finance, Room 2227, Dirksen Senate Office Building, Washington, D.C.

DEAR MR. STERN: This letter is being sent, along with the five copies requested, for the record on the hearing on S. 2738, a bill to provide indexation of various income tax provisions.

I cannot comment on all aspects of the bill because I do not yet know just what adjustments to such items as credit for the elderly, the earned income credit, child and dependent care, etc. will be. But there is at least one area of gross unfairness that should be remedied before other areas are considered. This is when a taxpayer sells his/her personal residence for a gain.

If a home was purchased in 1950 for $15,000 when the price index was around 80 and sold in 1976 for $30,000 when the index was around 165, there is an actual loss of $938 in 1950 dollars instead of profit of $15,000 under present calculations. The taxpayer has to either rent quarters at greatly inflated prices or reinvest the proceeds in a house costing as much or more than the $30,000 realized. Income tax is based on the ability to pay and in this case the taxpayer has not only less money than in 1950 but has to pay a tax based on inflationary effects rather than a true increase in worth.

The same arguments could apply to stock transactions. If an investor makes a 9 percent gain in a year when inflation is 10 percent (such as this one) then he has indeed suffered a loss. Yet he is required to pay tax as if he truly made a 10 percent profit.

The government will lose revenue by adjusting this inequity in the tax laws, but only the government can control inflation in any meaningful way and should not reap rewards for its inability to control an inflationary economy. If it is impossible to reduce expenditures to make up for lost revenues, then additional taxes could be raised by either:

1. Taxing actual gains at a higher rate. When investors understand that they are not paying on inflationary gains they will not object to a higher tax on real gains.
2. Increasing taxes on higher bracket taxpayers. At least such an increase would be based on the ability to pay.

There is no perfect way to equalize tax, but when taxpayers are required to pay taxes on non-existent gains we are not only far from basing taxes on the ability to pay, we are imposing a tax based on the results of inflation rather than any true increase in worth.

Increasingly, taxpayers are in revolt against high and unfair taxes or are at least expressing sentiments in that direction. When taxes are fair, taxpayers are willing to pay their share. But when taxes are not only unfair but also irrational, we are increasingly encouraging the revolt of the American taxpayer.

Most sincerely,

MARY ANNE POORE,
Certified Public Accountant.

PLANO, TEX., *February 27, 1978.*

Mr. MICHAEL STERN,
Staff Director, Committee on Finance, Dirksen Senate Office Building, room 2227, Washington, D.C.

DEAR MR. STERN: Everybody is clamoring for tax reform based upon changing and/or simplifying the provisions of the Internal Revenue Code. While I fully

recognize the need for attention in this area, I am much more concerned with the urgent need to make the simple adjustment which is necessary to protect the income of the lower income groups.

Due to inflation, the cost of living is continually rising. If a worker succeeds in obtaining raises large enough to offset the yearly increases in the cost of living, his income will naturally be pushed into higher and higher tax brackets, with the income tax taking a greater and greater percentage of his income. This worker has no more real income in one year than the next, and yet the Internal Revenue Code treats him as though he were financially better off in each succeeding year.

The tragic reality of this unfortunate situation is clearly evident in the example presented below. For purposes of illustration, I shall use as an example a subsistance level worker who makes a gross salary (before FICA) of $12,000 a year in year No. 1. Assuming that the rate of inflation in each year is 6 percent and that the worker obtains an offsetting 6 percent raise in each year, the following situation results:

	Gross wages	Taxable income[1]	Income tax	Income tax as a percent of gross income
Year No.:				
1	12,000	5,800	967	8
25	51,502	45,302	14,711	29
30	68,922	62,722	23,421	34
35	92,233	86,033	35,077	38
40	123,429	117,229	50,674	41

[1] Assuming 4 exemptions and standard deduction.

As you can clearly see, due merely to the inflexibility of the income tax rate schedules, the worker who was barely making a living in year No. 1 with a tax bite of 8 percent must somehow find a way to pay more than 40 percent of his income to the government in year No. 40, even though his real income has not increased at all. This is insane and grossly unjust.

I suggest that if nothing else is done in the area of tax reform that at least the income bracket levels should be raised annually to take into account the rise in the cost of living and/or the rate of inflation for the preceding year. To illustrate—the bottom bracket for married persons filing jointly should be raised from its current level of $3,200 to approximately $3,400 for 1978, and the top income bracket for such persons should be raised from $203,200 to approximately $215,400. Such an adjustment would provide for a 6 percent cost of living increase and thus protect the individual's real dollar income from an increasing tax bite.

In order to illustrate the adjustment that I am proposing, I have prepared an adjusted Schedule Y—"Married Taxpayers Filing Jointly". (See schedule on following page.)

Using this schedule, a person making $11,200 in 1977 would pay taxes of $1,380. An increase in that individual's salary to adjust for a 6 percent cost of living increase results in a salary of $11,900 and a tax of $1,465 (using the adjusted rate schedule for 1978). The tax in both years is the same percentage of the individual's gross income (12.3 percent).

Thus, by using rate schedules which are adjusted for inflation, an individual who continues to receive raises which are equal to the rate of inflation will remain in the same tax bracket and pay the same proportion of his income in taxes.

The rate schedule adjustment I have proposed is extremely easy to make, and should be made each year. I believe that an objective evaluation of the effect of inflation on individual taxes makes the necessity for such an adjustment obvious, and its implementation imperative. I would appreciate your informing me of any possibility that such an equitable provision would be incorporated into our federal income tax system. Thank you very much.

Yours very truly,

FREDERICK A. ROCKWELL.

ILLUSTRATION OF PROPOSED ADJUSTMENT

	Current (1977) tax brackets		Proposed (1978) tax brackets adjusted for a 6 pct cost of living increase and rounded to the nearest $100		
Income	Tax on column 1	Percent on excess	Income	Tax on column 1	Percent on excess
$3,200	0	14	$3,400	0	14
$4,200	$140	15	$4,500	$154	15
$5,200	290	16	$5,500	304	16
$6,200	450	17	$6,600	480	17
$7,200	620	19	$7,700	667	19
$11,200	1,380	22	$11,900	1,465	22
$15,200	2,260	25	$16,100	2,389	25
$19,200	3,260	28	$20,400	3,464	28
$23,200	4,380	32	$24,600	4,640	32
$27,200	5,660	36	$28,900	6,016	36
$31,200	7,100	39	$33,100	7,528	39
$35,200	8,660	42	$37,300	9,166	42
$39,200	10,340	45	$41,600	10,972	45
$43,200	12,140	48	$45,800	12,862	48
$47,200	14,060	50	$50,000	14,878	50
$55,200	18,060	53	$58,500	19,128	53
$67,200	24,420	55	$71,200	25,859	55
$79,200	31,020	58	$84,000	32,899	58
$91,200	37,980	60	$96,700	40,265	60
$103,200	45,180	62	$109,400	47,885	62
$123,200	57,580	64	$130,600	61,029	64
$143,200	70,380	66	$151,800	74,597	66
$163,200	83,580	68	$173,000	88,589	68
$183,200	97,180	69	$194,200	103,005	69
$203,200	110,980	70	$215,400	117,633	70

Statement of Andrew J. Biemiller, Director, Department of Legislation, American Federation of Labor and Congress of Industrial Organizations

The AFL–CIO is opposed to the proposed Tax Indexing Act of 1978. Under the terms of this legislation, a number of provisions affecting the taxation of individuals, corporations and estates would be adjusted each year for the next five years by an amount equal to two-thirds of the increase in the Consumer Price Index.

It is our view that this legislation represents a built-in automatic and continuing erosion of the tax base heavily weighted in favor of business, higher income individuals and wealthy estates. Enactment of such a measure would hopelessly confuse the majority of the nation's taxpayers and would severely limit the Federal government's powers to use fiscal measures as a means to stabilize the economy, promote balanced economic growth and full employment. The measure would also blunt the "automatic" stabilizing effect of the tax structure during periods of economic overheating and thereby contribute to inflationary pressures. And, in our view, such a measure would seriously undermine any efforts to achieve tax justice.

Under the terms of the bill, annual indexing would apply to:

1. The rate schedule.
2. The standard deduction.
3. The $750 personal exemption and $35 credit.
4. The lower tax rate corporations now pay on their first $50,000 of taxable income.
5. The ceilings on contributions to Keogh (H.R. 10) and Individual Retirement Plans.
6. The ceiling on the amounts that are exempt from gift taxation.
7. The ceilings on exemptions from estate tax.
8. The earned income tax credit.
9. The tax credit for the elderly.
10. The child care tax credit.

11. The maximum limitation on the amounts that can be credited under the Investment Tax Credit.

12. The amounts that can be exempted from the Minimum Tax on Tax Preference.

13. The basis upon which business depreciation deductions and capital gains are determined.

A few of these provisions could, in and of themselves, help low and middle income people—such as indexing the standard deduction and the $35 general tax credit. However, the benefits received by these groups would be far overshadowed by the absolute and relative reductions in the taxes owed by higher income individuals, corporations and large estates and the huge and continuing revenue losses to the Treasury.

One of the most serious inequitable aspects of the legislation is found in Section 1392(b)(1) which by "indexing" the adjusted basis of assets would have the effect of speeding up depreciation write-offs and completely destroying the concept of determining business profits on the basis of actual costs. The measure would also widen even further the present law capital gains loophole. This provision is the most unfair and costly provisions in the Federal Tax Code and by "indexing" the base upon which profits from the sale of capital assets are determined, such profits which are currently only half taxed would be taxed even less.

There are many other weaknesses. For example, it makes absolutely no sense to use the Consumer Price Index (let alone two-thirds of it) as a means to "adjust many features of the tax code. Technically, the $750 personal exemption could be adjusted, but there is no rational basis for applying the Consumer Price Index—which measures the changes in a market basket of consumer goods over time—to the rate schedule, the value of the vast array of business plant, machinery or equipment that is depreciated or the profit on the sale of an investment. The proposal also ignores the fact that during inflationary periods there are winners and losers. The bill, for example, makes no effort to recognize that inflation reduces the real value of debt and at least for consistency, any proposal to index and reduce taxes because of the effects of inflation on asset values should also recognize the effects of inflation on reducing the "real" cost of holding debt. A major fundamental evil of inflation is that it redistributes wealth and income with the general result that poor and middle income individuals lose the most. This measure would merely institutionalize and ensure such a result.

Finally, over the past several years, most of the more significant loophole closing measures that have been enacted took place within the context of an overall tax reduction bill. And, tax cuts have been enacted by Congress to stimulate the economy and prevent purchasing power losses due to inflation. In addition to making up for inflation's impact, these measures have, at the same time, generally improved the overall fairness of the tax structure—something that could not be done if there were a built-in system of automatic tax cuts through indexation. Indexing presumes that the current system is fair—and it is not. Indexation would undermine efforts to enact major changes needed to promote tax justice.

The AFL–CIO is concerned with the impact of inflation on increasing effective tax rates and as a result, reducing real after tax income and purchasing power.

In fact, one key reason for our support of the Administration's current proposal of a $240 tax credit in lieu of the present $750 personal exemption and rate reductions was the need to take account of the impact of inflation on taxes and purchasing power.

We cannot, however, support measures which, under the guise of protecting workers would in actuality erode the fairness of the nation's tax structure, complicate it even more and further hamstring the Federal government's ability to fund the programs needed to promote the national interest.

STATEMENT OF ARTHUR ANDERSEN & CO.

INTRODUCTION

Inflation has been called the greatest hidden tax, and one of the most regressive taxes, in our economic system. It affects both individual and business taxpayers in many ways.

Because of our graduated individual income tax structure with fixed-dollar exemption and bracket levels, inflation imposes on individuals higher effective taxes even thought there is no increase in their real earnings. The following simple example illustrates this point.

Assume that a married couple with two children, claiming the standard deduction (zero bracket amount), has income before exemptions of $30,000. Using tax rates in effect for 1977, the total tax on that amount of income would be $5,408, or 18 percent of income. Assume further a 7 percent annual inflation rate for the next five years, and that the couple's income will keep pace exactly with inflation. At the end of five years, income before exemptions will be $42,076, but the tax on that amount will be $10,108, or 24 percent of income. Furthermore, taxes on the increase in income over the five year period of slightly over $12,000, caused purely by inflation, would be $4,684, or effectively nearly 39 percent of the inflation induced income.

The pattern of Congressional action on tax rates, allowances and exemptions over the last few years indicates fairly regular reductions in rates or increases in exemptions and allowances that roughly approximate the inflationary increase in taxes. Reducing taxes every two years or so is popular politically, but it is misleading and tends to obscure other basic issues in taxation.

With respect to business taxation, the tax rate structure is simpler and less progressive than it is for individual taxpayers. Still, the taxation of business profits that reflect inflationary effects rather than real earnings is a serious matter. The primary effects of inflation on business taxation are in the areas of inventory profits and depreciation allowances. The LIFO method of inventory valuation provides some relief from taxation of inflated inventory profits. However ,the complexities of the LIFO systems, including the requirements for financial statement conformity, have deterred many business entities, particularly smaller companies, from electing that method. Accordingly, the taxation of inventory profits remains a significant problem.

In determining depreciation allowances, our present tax rules limit total deductions to the original cost of depreciable assets, even though inflation greatly increases the cost of replacting obsolete or worn out productive assets.

Based on our experience in working with many clients on major capital expansion projects, both equipment costs and construction costs have increased dramatically over the last few years. Recent studies by appraisal companies indicate that the replacement cost of machinery and equipment roughly doubled between 1966 and 1977. In the last five years, the rate of increase in machinery and equipment costs has been even greater, and machinery-type assets acquired in 1973 would cost over 50 percent more today than when originally acquired.

For industrial buildings, the same pattern emerges. A building constructed ten years ago for $1 million would cost well over $2 million today. In the last five years alone, the replacement cost of industrial buildings has increased nearly 40 percent.

Since our present tax policies limit depreciation allowances to original cost, it is important that taxpayers be able to recover their investment in such assets as quickly as possible, so these funds can be used to finance current operations or to replace or expand other productive facilities. Provisions such as accelerated depreciation, the Asset Depreciation Range class-life system and the investment tax credit do permit quicker recovery of capital investments, and help reduce the impact of inflation on the taxation of business profits.

IMPACT OF INFLATION AND TAXES ON INDIVIDUALS

In its analysis of the President's budget proposals for the fiscal year 1979, the Congressional Budget Office estimated that individual tax burdens would increase from 1978 levels by approximately $6 billion purely because of inflation. By 1981, this inflation-induced revenue increase will rise to $22 billion and, by 1983, to $45 billion. These projections are based on the Congressional Budget Office's estimated rate of inflation of 6.3 percent to 7.3 percent annually and, based on current economic data, it may be difficult to hold our rate of inflation to those levels.

IMPACT OF INFLATION AND TAXES ON THE BUSINESS SECTOR

Several studies have been made to illustrate the impact of inflation on reported business profits. The Machinery and Allied Products Institute (MAPI)

has published studies in this area for a number of years. In its April 1977 memorandum on "Inflation and Profits". MAPI analyzed the reported profits of non-financial corporations for the years 1965 to 1976. Following is an extract from one of the tables included in that memorandum:

[In billions of dollars]

Year	Profits as reported	Income tax thereon	After tax profits	Inflation adjustments[1]	Pretax profits as adjusted	After tax profits as adjusted
1965	64	27	37		64	37
1970	55	27	28	7	48	21
1972	76	34	42	7	69	35
1974	102	42	60	47	55	13
1976	126	54	72	31	95	41

[1] Inventory and depreciation costs. 9

This analysis shows that the understatement of charges against current earnings, due to the underdepreciation of asset costs and the understatement of inventory costs, was relatively minor through 1972, ranging from no significant adjustment in 1965, to about $7 billion in 1972. However, commencing in 1973, the understatement became much more significant, and this obviously was caused by the substantial increase in our rate of inflation starting in 1973. The understatement peaked in 1974 at more than $47 billion. For 1976, this amount dropped significantly, but still exceeded $30 billion.

Several conclusions can be drawn from this analysis. First, earnings reported to the public were considerably overstated since charges for depreciation and inventory costs were based on historical data. Even though this method of financial reporting was, and remains, consistent with generally accepted accounting principles, reported earnings do not reflect true economic results in periods of high inflation.

Second, the effective tax rates on reported earnings of these corporations did not state the true impact of taxation on their economic income. The following table extracted from the MAPI memorandum compares the effective tax rates on profits as reported with the rates on profits as adjusted for the increased inflationary costs:

Year	Effective rates on—Profits as reported	Effective rates on—Profits as adjusted
1965	42	42
1970	49	57
1072	44	49
1974	42	77
1976	43	57

In the 1965–76 period, the effective tax rate on earnings as reported ranged from about 42 percent to 49 percent. However, the effective taxes on profits as adjusted has in recent years greatly exceeded the rate on earnings as reported. In 1974, that rate exceeded 77 percent and, for 1976, it was nearly 57 percent.

Perhaps the most significant conclusion one can draw from this analysis is the amount of taxes being paid on inflated profits, which in turn decreases the capital generated or retained in the corporate sector. For example, if the effective tax rate on profits as reported for 1974 (42 percent) had been applied to such profits as adjusted ($55 billion), total taxes on the earnings of these corporations would have been approximately $23 billion rather than the liability reflected in financial statements of $42 billion. This means that nearly $20 billion of capital was taken from these corporations—and out of the overall pool of available investment capital—by the taxation of inflated business profits.

For the most recent year, 1976, a similar calculation indicates that more than $13 billion was extracted from the pool of capital available to these corporations.

PROPOSED SOLUTIONS

Indexation of individual tax system

To achieve greater equity in our tax system, and to separate the tax burden that should apply to a given level of income from other tax policy issues, a system of indexing the personal income tax brackets and fixed-dollar amounts that are so much a part of our tax system seems to make sense. Proposals like that presented by Senator Dole and others (S. 2738) would go part way toward an indexing system, and they merit serious consideration by the Congress. Other countries (e.g., Canada) have done this, and in our view it represents sound tax policy.

Some have suggested that indexing the individual tax structure would add complexity to our tax system. We do not agree with this view. Since the vast majority of individual taxpayers calculate their tax simply by referring to rate tables that are included with tax forms and instructions, it matters little whether those brackets are changed from one year to another.

The benefits achieved through indexing the individual rate structure, by eliminating the taxation of inflated earnings, more than offsets the slight additional complexity that might be created.

Adjusting for inflation in determining business taxable income

In an inflationary period, both financial and tax profits based on original cost concepts are overstated by the phantom profits caused by inflation. Various techniques for reducing or eliminating these phantom profits have been suggested. They range from adjusting the original cost of assets by changes in various indices to restating the cost of such assets based on current value or replacement costs.

Aside from recognizing changes in price levels or values of specific assets, another problem arises with respect to long-term debt which, when paid off in "cheaper dollars" than originally borrowed, may create an economic gain to the borrower. Whether or not recognition should be given to this so called "gain" realized by the borrower is a controversial issue in itself.

In recent years, when our rate of inflation has become more significant, an inflation element has been recognized in the interest rate structure and in the negotiations between borrowers and lenders as to that rate. Some analysts estimate that, of the current long-term corporate bond rate (approximately 8½ percent for AAA-rated bonds), over 5 percent represents an inflation premium. Gain realized by a borrower on the repayment of long-term debt is in effect offset by a loss to the lender. Therefore, looking at the economy as a whole, overall determination of income is approximately correct.

In considering the impact of inflation on a business entity, it is helpful to view corporations in a long-term perspective. Corporations are generally viewed as on-going entities with an indefinite life. This is one cornerstone upon which many aspets of corporate law, financial accounting, business decisionmaking, and the taxation of corporations are based.

Financial accounting and tax laws are founded on cost concept that, in periods of little or no inflation, results in a profit determination that approximates real economic earnings or profits. Under the on-going entity assumptions, as a corporation's assets are converted to cash, they will be replaced. If there has been no inflation, the cash recovered through operations should be adequate to purchase replacement assets. A firm that has revenues equal to costs will have the same equity at the beginning and the end of an asset's life cycle and will be able to purchase the replacement assets needed to continue the next cycle. In an inflationary period, however, the replacement asset will cost more than the asset consumed. In this circumstance, the break-even company will not have sufficient capital from its own resources to purchase the replacement asset and will soon find itself unable to function.

Deduction for capital maintenance

In an attempt to eliminate the inflationary element from business taxable income without a complex series of calculations involving both assets and liabilities, we suggest that consideration be given to allowing a tax deduction for capital maintenance in periods of inflation. The theory behind this suggestion is that every business entity has a pool of capital invested in it, generally represented by its net worth or shareholders equity. In periods of inflation, the decrease in

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the value of currency in which that equity is stated is a real economic cost. Accordingly, a reduction of the entity's profits should be allowed for the erosion of that capital caused by inflation during a particular year.

To use a simple example, assume that a company had a beginning equity of $2,000,000, pre-tax income of $1,000,000, Federal and state income taxes on that income of $300,000, and dividends paid of another $300,000. Ignoring the interdependent relationship of taxes and after-tax profits, the ending shareholders equity would be about $2,400,000, or average equity for the year of $2,200,000. Assuming the rate of inflation for the year is 7 percent, a deduction for capital maintenance of $154,000 (7 percent of $2,200,000) would seem appropriate.

For unincorporated business entities, a similar calculation could be made, based on the excess of assets over liabilities relating to the business activity.

RECOGNITION OF INFLATION IN TAX SYSTEMS OF OTHER COUNTRIES

Other industrial countries have recognized the impact of inflation in their tax systems. In accounting for inventories, for example, the United Kingdom permits a tax deduction for increases in the value of inventory for a taxable year, whether caused by inflation or not. France permits a reduction in taxable income through an inventory reserve to the extent that price increases for certain types of goods exceed 10 percent over a two year period. A reserve for price variation is also permitted when increases in the price of base inventory are determined by world market price fluctuations. Canada follows a relatively simple approach of allowing a tax deduction equal to a certain percentage (current 3 percent) of the opening inventory. Australia provides inventory relief by permitting a price level change adjustment, deductible for tax purposes, to the beginning inventory each year. All of these are attempts by other major countries to eliminate from business taxable income an element of profit caused by inflation.

Attached as Appendix A is a summary of some of the programs for adjusting income taxes for inflation adopted by selected other countries, along with a brief description of some of the steps adopted.

COMMENTS ON TAX INDEXATION ACT OF 1978 (S.2738)

The bill introduced by Senator Robert Dole, which was the subject of the hearing of the Subcommittee on Taxation and Debt Management on April 24, 1978, contains a number of provisions that would partially offset the impact of inflation on our tax system. In particular, the bill would adjust for inflation many of the fixed-dollar amounts and the tax rate brackets that are applicable to indivdual taxpayers. However, in determining the amount of the adjustment each year, only two-thirds of the increase in the consumer price index would be used.

If the objective of an indexing system of this type is to eliminate the inflation element in taxing individuals, we do not agree with reducing the inflation adjustment factor, as measured by changes in the consumer price index, to two-thirds. The full amount of the increase in the index would seem more appropriate.

With respect to corporate taxes, the bill would adjust the rate brackets in the same manner as is recommended for individual taxes. Furthermore, the $25,000 limit on the amount of tax which can be offset by the investment tax credit and the $10,000 exemption from the minimum tax would be adjusted. While these steps in themselves are desirable, they do not attempt to solve the most important problem in taxing the inflationary element in business earnings, that is the determination of the amount of business profits that will be subject to tax.

We recommend that serious consideration be given to providing a tax deduction for the erosion of the capital invested in a business entity. This step would go part way toward eliminating from taxable income the artificial profit element caused by inflation, and would avoid some of the complexities of complete indexation or price level adjustment procedures, involving both the assets and liabilities of a business entity.

In the event that the capital maintenance deduction is considered too radical a change in our business taxation structure at the present time, we urge changes in the present rules under the LIFO inventory evaluation method. As noted earlier, the LIFO method does provide some relief for the inflationary element in inventory profits, by matching current costs against current revenues. However, because of the complexities of that method and in particular the financial statement conformity requirement, it is not as effective as it should be.

The conformity requirements of Code Section 472 (c) and (e) should be repealed. Because of significant differences between tax reporting and current accounting and financial reporting practices, many of which are subject to government regulation, particularly by the Securities and Exchange Commission, present law has created many administrative problems in reconciling the conflicting rules of two or more government agencies for business taxpayers. The simple solution to these problems is to repeal Sections 472 (c) and (e), and we urge that step.

Furthermore, the accounting and record keeping requirements for the LIFO system are much too burdensome for many taxpayers, particularly smaller companies. We urge that this subject be studied carefully so that a more workable system can be developed and the use of the LIFO method can be extended to the majority of business taxpayers.

CONCLUSION

The impact of inflation on our economy is of great concern to all of us. The combined impact of inflation and taxation is a matter of increasing significance to U.S. taxpayers, both individual and corporate. When our rate of inflation was somewhat nominal, consistently below five percent, the impact was not as apparent, but in recent years where our inflation is consistently above six percent and for 1974 exceeded ten percent, the problem is alarming.

The subject deserves careful attention by Congress, and we are pleased to support proposals like that introduced by Senator Dole as a partial solution to the problems created by inflation.

APPENDIX A

COUNTRIES WITH SPECIFIC PROGRAMS FOR ADJUSTING INCOME TAXES IN RECOGNITION OF INFLATION

	Argentina	Australia	Brazil	Canada	Israel	The Netherlands	Switzerland [1]
Unpaid income taxes adjusted	X		X		X		
Individual taxes:							
Automatic adjustment of rates		X [2]	X	X	X	X	X
Regular adjustment of certain allowances	X	X	X	X	X	X	
Individual capital gains:							
Special tax treatment applies [3]		X	X	X	X	X	X
Special inflation allowance	X		X		X		X
Business taxes:							
Fixed assets adjusted [4]	X						
Inventory adjusted	X [5]	X		X		X [5]	X
Receivables/payables adjusted	X						
Capital maintenance deduction allowed			X				

[1] The Swiss constitution requires individual tax rates to be adjusted for inflation by the Federal Government. Some, but not all Swiss cantons, make similar adjustments.
[2] Australia has adjusted rates annually (not automatically) since its program was adopted.
[3] Most countries have special capital gain taxation rules.
[4] Virtually every country allows accelerated depreciation which is not shown here.
[5] The country allows LIFO.
Note: Key details regarding the specifics of each country's program appear in the following pages of this appendix.
Source: "Studies on International Fiscal Law," vol. LXIIa, International Fiscal Association.

KEY DETAILS IN TAX PROGRAM REGARDING INFLATION

ARGENTINA

A. Unpaid income taxes—1. Past-due and prepaid income taxes are automatically indexed.

B. Individual taxes—1. Annually there is an automatic revision based on cost-of-living changes of various allowances and deductions.

C. Individual capital gains—1. A special inflation adjustment is allowed of 6 percent to 12 percent per each year of ownership.

D. Business taxes—

1. Depreciation deductions are adjusted through indexing.
2. Inventory can be adjusted for "LIFO within a year" allowing closing inventory to be valued based on purchases in the first month of the year.

3. Indexing of receivables agreed upon by the debtor and creditor is not taxed.

AUSTRALIA

A. Unpaid income tax—1. None.

B. Individual taxes—1. Income tax brackets and certain allowances have been adjusted for inflation in 1976 and 1977 as a result of a program commenced in 1976.

C. Individiual capital gains—1. Gains from the sale of property held for twelve months and not acquired for resale are not taxed.

D. Business taxes—1. Inventory at the beginning of the year is adjusted for inflation. One-half of the percentage increase in the goods component of the consumer price index for one year is applied to the inventory to revalue it.

BRAZIL

A. Unpaid income taxes—1. Unpaid income taxes are adjusted for inflation including the annual liability not covered by withholding.

B. Individual taxes—

1. Individual tax brackets and exemptions are adjusted annually for inflation.

2. Income taxes withheld at source are adjusted for inflation when credited by the taxpayer.

C. Individual captial gains—

1. Investment in shares is adjusted through the issuance of nontaxable stock dividends reflecting inflation adjustments made by the company (see D below). Real estate gains which are taxable are adjused for inflation. The indexing of income on fixed-value assets (e.g., bonds) is not taxable.

2. Gains on the sale of shares are taxed at a low rate or totally non-taxable. Gains on isolated real estate sales are nontaxable.

D. Business taxes—1. All significant assets and liabilities of a business are adjusted for inflation with certain restrictions being applicable to the taxability of the gain or loss. Basically the impact is recognized as an adjustment of the shareholder's capital invested in the business.

CANADA

A. Unpaid income taxes—1. None.

B. Individual taxes—

1. Graduated tax rates are indexed on the basis of the consumer price index.

2. Indexation of various fixed monetary allowances and deductions is made the basis of the consumer price index.

C. Individual capital gains.—1. One-half of capital gains is includable in taxable income.

D. Business taxes—1. Taxpayers may claim a deduction equal to 3% of the opening inventory.

ISRAEL

A. Unpaid income taxes—1. Inflation is mitigated by linking tax liabilities and prepayments to the cost-of-living index.

B. Individual taxes—1. Provisions are made for automatic changes in accordance with the cost-of-living index. The tax brackets and the tax credits and deductions in respect of personal allowances and social benefits are indexed on the basis of cost of living.

C. Individual capital gains—

1. Cost basis is adjusted for general price-level changes between date of purchase and date of sale.

2. Capital gains are accorded preferential tax treatment in terms of both the tax rates and the tax base. Capital gains on assets held over one year are split into inflationary gain, taxed at 10 percent, and real gain, taxed at ordinary rates.

THE NETHERLANDS

A. Unpaid income taxes—1. None.

B. Individual taxes—

1. An automatic annual adjustment of the rate of income tax and wage tax and income deductions is made to neutralize the increases due to inflation.

2. Adjustments are made on the basis of fluctuations in cost-of-living index.

C. Individual capital gains—1. Capital gains on nonbusiness assets are as a general rule not taxed.

D. Business taxes—1. LIFO is accepted in determining inventory.

SWITZERLAND

A. Unpaid income taxes—1. None.

B. Individual taxes—1. The constitution requres the Federal government to adjust rates in respect of inflation. Many of the cantons, but not all, also make such adjustments.

C. Individual capital gains—1. Capital gains on personal (nonbusiness assets) are not taxed at the Federal level. Some cantons tax capital gains. All cantons tax capital gains on real estate sales. Some cantons adjust real estate gains for inflation.

D. Business taxes—1. Inventories may be undervalued by one-third.

LOS ANGELES, CALIF., *May 17, 1978.*

Re Tax Indexation Bill of 1978.

MICHAEL STERN,
Staff Director, Committee on Finance, Dirksen Senate Office Building, Washington, D.C.

GENTLEMEN: I urgently request your passage of S. 2738 to the Senate floor. Of the many inequities that exist in the U.S. Income Tax System, the most serious is the effect of inflation on the graduated income tax rate schedules. While the individual taxpayer is struggling to merely hold his purchasing power against inflation, the U.S. government is increasing his income tax rate by neglecting to provide automatic price level adjustments.

Very truly yours,

ANNE BERNSTEIN.

SIERRA MADRE, CALIF., *May 22, 1978.*

Re tax indexation bill of 1978.

MICHAEL STERN,
Staff Director, Committee on Finance, Dirksen Senate Office Building, Washington, D.C.

GENTLEMEN: I urgently request your passage of S. 2738 to the Senate floor. Of the many inequities that exist in the U.S. income tax system, the most serious is the effect of inflation on the graduated income tax rate schedules. While the individual taxpayer is struggling to merely hold his/her purchasing power against inflation, the U.S. government is increasing his income tax rate by neglecting to provide automatic price level adjustments. The passage of S. 2738 would be more positive and beneficial than any of the tax "relief" bills currently charading in California.

Respectfully,

CONNIE H. LUDER.

FROST, WOODY & DURGIN, INC., PS,
CERTIFIED PUBLIC ACCOUNTANTS,
Olympia, Wash., May 23, 1978.

Re: S. 2738—Indexation.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance, Dirksen Senate Office Building, Washington, D.C.

DEAR MR. STERN: As a CPA firm in a relatively small town, we represent many middle and low income taxpayers who, in the past several years, have had their income pushed into prohibitively high income tax brackets by inflation.

We, and many of our clients, feel that this has been a windfall for the government, creating opportunities for starting and continuing a vast number of wasteful jobs and programs.

Our feeling is that it would be more desirable for Congress and the bureaucracy to voluntarily limit spending. Since it does not appear that this is likely to happen, the next best thing appears to be the indexation of various income

tax provisions to effectively cut the government's 30 percent share of the gross national product.

If Congress and the bureaucracy are going to continue to foster inflation, then they should also have to suffer some of the hardships that inflation brings, particularly the fact that yesterday's dollar won't buy much in tomorrow's market.

Very truly yours,

JAMES M. FROST, *CPA.*

STATEMENT OF B. R. EMMONS, WALNUT CREEK, CALIF.

In 1913 the Sixteenth Amendment to the United States Constitution was adopted. It provides as follows:

> "The Congress shall have power to lay and collect taxes on income, from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration."

At that time the measuring instrument for determining whether income had been realized, the dollar, was backed by gold and silver and was relatively stable in value. Since then, however, the removal of the backing of gold and silver and numerous other changes have resulted in inflation or, in other words, a decline in the purchasing power, or value, of the dollar. In "good" years this decline is held to about 6 percent per year. In "bad" years the decline is greater.

Since the dollar is used as the measuring instrument for determining whether there is taxable income or loss, the loss in value of the measuring instrument itself presents the fundamental question of how gain or loss is to be computed.

For example if a taxpayer purchases an asset for $100 on the first day of the year and sells it for $106 on the last day of the year after the dollar has lost 6 percent of its value, has income been realized? While the taxpayer received a greater number of dollars, the amount received has no more purchasing power than the amount paid for the asset at the beginning of the year.

The attached Exhibit "A" shows how the income tax now applies to a taxpayer who purchases an asset for $10,000 and sells it 10 years later for an amount representing the exact purchasing power after constant 6 percent inflation. This Exhibit shows that a sales price of $17,909 is then required to return to the taxpayer the economic equivalent of the amount paid for the asset 10 years earlier. At the present time however, the income tax would require that the taxpayer to consider that he had realized a gain of $7,909 when in fact there is no economic gain. Since there is a taxable gain, it appears that the income tax in effect taxes the return of capital and not just income.

Attached Exhibit "B" concerns the case of the family breadwinner who is employed at an annual salary of $10,000 which pursuant to the employment contract is adjusted to compensate for inflation. This exhibit also assumes the following:

(1) 4 members of family,
(2) No other source of income,
(3) Joint return filed and zero bracket amount deducted each year,
(4) No changes in the income tax law during the period, and
(5) Constant inflation at the rate of 6 percent per year.

For interest, I have carried the computation here as far as possible using Tax Table B. As will be noted, the family income tax liability increases by a rate of about twice the rate of inflation (or greater) even though the before-tax salary is only increased by the actual inflation rate. Therefore in economic purchasing power, the family is losing economic purchasing power because of the effect of the income tax in inflation.

Based upon the information presented, it appears that in the interest of fairness something should be done to correct the effect of inflation upon the income tax. Since inflation appears to be a permanent part of American life, I believe that the tax should be indexed to insure that revenues of the government do not increase faster than revenues of taxpayers as a result of inflation.

Because the Social Security tax and benefits are already indexed for inflation, I can see *no* reason why the same adjustments for inflation cannot and should not be made to the income tax.

EXHIBIT "A"

Tax effect of a $10,000 investment sold for an amount representing the exact purchasing power after 10 years of constant 6% inflation?

	Value at beginning of period	Inflation rate (percent)	Value at end of period
Year:			
1	$10,000	6	$10,600
2	10,600	6	11,236
3	11,236	6	11,910
4	11,910	6	12,625
5	12,625	6	13,383
6	13,383	6	14,186
7	14,186	6	15,037
8	15,037	6	15,939
9	15,939	6	16,895
10	16,895	6	17,909

Note: To compute taxable gain:	
Sales price	$17,909
Less basis	(10,000)
Gain	7,909

EXHIBIT "B"

Tax effect of salary adjustments for inflation during 24 years of constant 6 percent inflation.

Assumptions:

(1) Beginning salary of $10,000,
(2) 4 Members of family,
(3) No other source of income,
(4) Joint return filed with zero bracket amount deducted,
(5) No changes in income tax laws during the period, and
(6) The inflation adjustment is the same as in Exhibit "A".

	Salary	Income tax	Tax increase over prior year	Tax increase (percent)
Year:				
1	$10,000	$450		
2	10,600	551	$101	22
3	11,236	675	124	23
4	11,910	808	133	20
5	12,625	941	133	16
6	13,383	1,080	139	15
7	14,186	1,216	136	13
8	15,037	1,385	169	14
9	15,939	1,580	195	14
10	16,895	1,789	209	13
11	17,909	2,020	231	13
12	18,984	2,274	254	13
13	20,123	2,561	287	13
14	21,330	2,861	300	12
15	22,610	3,199	338	12
16	23,967	3,577	378	12
17	25,405	3,983	406	11
18	26,929	4,432	449	11
19	28,545	4,944	512	12
20	30,258	5,507	563	11
21	32,073	6,155	648	12
22	33,997	6,839	684	11
23	36,037	7,632	793	12
24	38,199	8,470	838	11

ENCINO, CALIF., *May 15, 1978.*

Re: Tax Indexation Bill of 1978

MICHAEL STERN,
Staff Director, Committee on Finance, Dirksen Senate Office Building, Washington, D.C.

GENTLEMEN: I urgently request your passage of S. 2738 to the Senate floor. Of the many inequities that exist in the U.S. income tax system, the most serious is the effect of inflation on the graduated income tax rate schedules. While the individual taxpayer is struggling to merely hold his purchasing power against

inflation, the U.S. government is increasing his income tax rate by neglecting to provide automatic price level adjustments.

Yours very truly,

DANIEL L. BERNSTEIN.
Certified Public Accountant.

LOS ANGELES, CALIF., *May 17, 1978.*

Re: Tax Indexation Bill of 1978

MICHAEL STERN,
Staff Director, Committee on Finance, Dirksen Senate Office Building, Washington, D.C.

GENTLEMEN: I urgently request your passage of S. 2738 to the Senate floor. Of the many inequities that exist in the U.S. Income Tax System, the most serious is the effect of inflation on the graduated income tax rate schedules. While the individual taxpayer is struggling to merely hold his purchasing power against inflation, the U.S. government is increasing his income tax rate by neglecting to provide automatic price level adjustments.

Yours, truly,

GEORGE E. BERNSTEIN.

STATEMENT OF DR. DONALD J. SENESE

I am Dr. Donald J. Senese, a former associate professor of history at Radford College, (Radford, Virginia) and am presently employed as a Senior Research Associate for the House Republican Study Committee, U.S. House of Representatives. It is my pleasure to have the opportunity to submit testimony on behalf of proposals to index our tax system to compensae for inflation-induced tax increases.

The subject of tax indexing first interested me a few years ago and I began researching the issue. I completed a study entitled Indexing the Inflationary Impact of Taxes: The Necessary Economic Reform,* which was published this year by The Heritage Foundation of Washington, D.C. This work discusses the major arguments for indexing especially for personal income and for capital gains. I comment on the advantages of tax indexing, how and what to index in our economy, and attempt to answer the leading objections to tax indexing.

Despite the claims of opponents that periodic tax cuts by Congress help resolve the additional burden placed on the taxpayer, this has not been the case. Congress provides certain tax adjustments, not real tax cus. And these tax adjustments have not provided the equity or relief needed for all of our taxpayers.

We need to recognize the political problem of tax indexing. If the "bonus" for the federal government resulting from inflation is eliminated, members of Congress are going to be faced with the choice of reducing expenditures or increasing explicit taxes or borrowing additional funds from the public at the interest rate of the market at the time. None of these choices is an attractive one for the politician. The politician prefers the credit from a periodic (though not real) tax cut than the one time credit for indexing the tax rates to shield the public from inflation's penalty. It is time that we consider what is most beneficial to the public raher than a safe political course.

Despite many years of talk and discussion by politicians, we still have a serious problem with inflation. This problem is with us and may be even more serious in future years.

Inflation is a factor which every family must take into consideration when planning its budget. Prices on items from food to automobiles continue to increase. There is a great "catch up" game played with inflation in our economy. The average taxpayer seeks a raise to allow him to keep up with inflation or move slightly ahead. Wage increases are negotiated with the inflation factor in mind. The increases in prices because of inflation help to hide any increase due to additional productivity. Inflation inflates dollar amounts but only in nominal terms; the inflated income figures do not reflect increases in real income.

There is a side effect of inflation which more and more taxpayers are becoming painfully aware. The taxpayer, gaining a wage increase in nominal dollars to keep pace with inflation, is pushed into a higher tax bracket and pays a larger

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*The study was made a part of the committee file.

proportion of his income in taxes. The cost of living increase has actually reduced real income and the person's standard of living because of the higher level of taxation. This is why such a tax increase has been labeled a "hidden tax increase" or a "silent tax increase."

It is a tax increase which has not been legislated by Congress.

It is a tax increase which has resulted from the government's activity in promoting and encouraging inflation by excessive spending.

It is a process by which government gains a "profit" from inflation.

We still need to encourage efforts to reduce federal government spending and to adopt meaningful tax reform designed to encourage the development of capital and the creation of new jobs in the private sector. However, we should not and must not ignore the harmful effect inflation is having on the citizens of our country. Inflation—especially double digit inflation—distorts our entire economy. We need to take action to alleviate the extra burden—"the silent tax increase"—that inflation imposes on the American taxpayer.

I strongly endorse the concept of indexing our tax system to compensate for inflation-induced tax increases.

Senator Robert Dole's bill, the "Tax Indexation Act of 1978" (S. 2561), would be a start in that direction. Although indexing the economy at a rate of two-thirds of the Consumer Price Index for five years would be more desirable than our present system, we are still giving the federal government a one-third bonus for inflation and the limitation to five years could make it easy for a Congress to go back to a non-indexed economy after the expiration of this period.

Representative Willis D. Gradison, Jr. has proposed the "Anti-Inflation Tax Reduction and Reform Act of 1977" (H.R. 10286) to provide for automatic cost-of-living adjustments in the income tax and withholding rates in the full amount of the inflation increase at an annual basis according to the Consumer Price Index. This proposal is similar to the system in Canada. It is a system in effect since 1974 which is working well and has been a source of relief to Canadian taxpayers. It has isolated Canadian taxpayers from automatic tax increases because of inflation and has helped to limit increases in government spending. This bill has created much attention and has attracted a wide range of co-sponsors in the House of Representatives.

It is my conviction that we should seriously consider indexing our entire economy to make the necessary cost-of-living adjustment. We should index not only income tax rates, but also the amount of the standard deduction, personal exemptions, depreciation, and U.S. savings bonds and certificates. We should make the adjustment in accord with the inflation increase on an annual basis according to the Consumer Price Index.

Let me cite one example of how inflation hits the homeowner. A homeowner purchased a home for $30,000 in 1975 and sold it for $50,000 in 1978. We can assume that the inflation rate during this period totaled twenty percent. Our tax system would consider the capital gain to be $20,000. This is only a nominal gain not a real gain. If our economy was indexed, the taxpayer would be allowed to deduct the inflation rate from the "nominal" gain and pay capital gains only on the "real" gains. The taxpayer pays a tax not on $20,000 ($50,000–$30,000) of the nominal gains but on the real capital gain of $14,000. Thus, $6,000 is recognized as the inflation factor and therefore no real gain.

Indexing is not inflationary but merely helps the taxpayer to cope with inflation.

A proposal to index our economy according to the CPI on an annual basis is contained in the "Cost of Living Adjustment Act." A number of Members of the U.S. House of Representatives have introduced such a proposal including Representatives Jack Kemp of New York (H.R. 426) and George O'Brien of Illinois (H.R. 1690). Former Senator James L. Buckley and Representative Phil Crane first introduced this concept as a legislative measure back in 1974.

Passage of the "Cost of Living Adjustment Act" or the "Anti-Inflation Tax Reduction and Reform Act of 1977" or the "Tax Indexation Act of 1978" would provide relief for the overburdened American taxpayer, take away the "profit" the government gains from inflation, and help bring a reduction in some government spending by encouraging a reduction in government revenues.

It has been encouraging to read that leading economists like Dr. Milton Friedman are receiving more and more attention for advocating indexing. It has been a hopeful sign to see a number of newspapers throughout the United States editorializing in favor of indexing and I would like to include a few of these newspaper editorials in my testimony.

I would like to emphasize a point made in the conclusion of my book, Indexing the Inflationary Impact of Taxes: The Necessary Economic Reform (p. 52) that "only a concerned citizenry and a more concerned Congress will be able to enact this measure to aid the taxpayer to bear the burden of inflation in the tax system and remove, or at least mitigate, the distorting effect of inflation on the American economy."

I commend the Subcommittee on Taxation and Debt Management of the Senate Finance Committee for holding this hearing on tax indexing and I am hopeful that we will see some action toward indexing our economy to mitigate the effects of inflation during the 95th Congress.

[From the New York Daily News, Sunday, Feb. 26, 1978]

HOW ABOUT THIS REFORM?

Along with the schemes for tax reduction and tax reform already before it, Congress should give deep and serious consideration to eliminating the windfall tax profit the government realizes from inflation.

Indexing the tax system is an idea long advocated by such learned economists as Nobelist Milton Friedman.

Friedman has calculated that inflation, in a variety of ways, boosted federal revenues by $25 billion in 1973 alone.

A comprehensive new study by the Heritage Foundation cites expert evidence that "inflation-induced tax increases alone could bring the U.S. government an estimated $6 billion in 1977 and $50 billion more by 1980." The projection is based upon the realistic assumption of a 6 percent annual rise in the cost of living.

Indexing—revising the tax structure so that levies apply only to real income—would eliminate that extra gouge.

Under the present system, a person who gets a pay hike is bumped into a higher bracket. Uncle Sam takes a bigger bite of the total earnings, ignoring the fact that part of the raise already had been eaten away by inflation.

It is little wonder that millions of Americans are finding it harder to make ends meet even as their nominal salaries climb. It is—

NO GREAT MYSTERY

—why indexing proposals have not enjoyed much popularity on Capitol Hill. As the Heritage Foundation study pointed out:

"Government officials, politicians and special-interest groups who advocate larger and larger programs are not enthusiastic about indexation since it would take the 'profit' out of inflation for the government and provide a reduction of government revenues and, thus, less government funds to cover their particular programs."

In short, the "people's representatives" can pose as hold-the-line tax watchdogs while letting inflation do the dirty work of sandbagging the taxpayers.

Even when Congress does try to make belated adjustments, it acts so clumsily that the benefits are distributed unevenly. The 1974 rebate and the 1975 reduction were cut up in such a way that persons making less than $20,000 got more than their share. Those with incomes over $20,000 were cheated.

This distortion of the tax structure would continue—indeed, it would be magnified—by President Carter's tax program. It is a very bad trend.

It is bad enough that the government is driving up living costs with its huge deficits. The least it can do is see that the Treasury does not profit—at the taxpayers' expense—from inflation.

[From The Dallas Morning News, Tuesday, Feb. 28, 1978]

SHARING THE "PROFIT"

[By William Murchison]

As the dreaded 15th of April bears down on us, there is no better subject to talk of than taxes—taxes and why they are not only awful but getting still more awful.

So talks the Heritage Foundation, newest and in many ways best of the Washington think tanks, in a just-published study entitled, rather unglamorously, "Indexing the Inflationary Impact of Taxes." The study is written by Dr. Donald J. Senese, senior research associate for the U.S. House's Republican Study Committee.

Dr. Senese examines inflation; he peers closely at taxation. Looking up, he shakes his head glumly. The blockbuster combination, he makes known, is killing us.

What is afoot is easy enough to understand. As inflation drives up living costs, workers seek, and receive, sizable pay increases. Such increases should make them more comfortable, but unless the increase is a major one, no such thing happens. For higher pay means higher taxes. Out of the employer's pocket the money goes and into the tax man's. Our worker is left with a numb feeling. Wha' hoppen?

Economists differ somewhat as to how great a tax increase is produced by inflation. Given 10 percent inflation, says one, the tax increase is 16 percent; two others calculate the increase at slightly less than 15 percent. Either figure is formidable enough.

A chart in Senese's study indicates that a low-income family whose income rises in five years from $5,000 to $7,013—a 40 percent increase—will have an extra 35 percent in nominal after-tax income. Ah, but if we assume a 7 percent annual inflation rate, after-tax income drops to minus 4 percent for the period Two thousand dollars in extra income, and yet a net financial loss! It is stupefying to think upon. Needless to say, the effects upon higher-income families are comparable.

The effects on business are not attractive either. "When inflation," Senese writes, "raises the effective tax rate, the profitability of business is reduced. The result is felt throughout the economy since more business activity cannot be generated by making it less profitable. It is only with the decline of the inflation rate that economic activity picks up." Quoting Sen. Orrin Hatch of Utah, Senese says that the 12.2 percent inflation of 1974 hiked business' effective tax rate to 62 percent. A year later, inflation abated to 7 percent, and the effective tax rate fell to 54 percent: high but plainly more bearable.

So what is to be done? For the proposed solution, Senese takes no pride of authorship. The ground he treads, others have trod before him. There are to be discerned here, among others, the mammoth footprints of Milton Friedman.

Of course the fundamental goal is a slowdown in the inflation rate—a goal that will be achieved only when federal spending is curtailed. This Senese naturally advocates. But he advocates more: Compensating the taxpayer for inflation by a rejiggering of the tax formulas. The matter is a complex one, meet for economists and tax lawyers but hard for the layman to deal with.

At all events, the idea is to index the tax system, so that inflation will not drive taxes up. The tax scale would specifically take the cost of living into account, much as do the "escalator clauses" built into numerous union wage contracts. Friedman has provided formulas for adjusting both personal and corporate taxes, and these Senese offers for our perusal.

It will be said that if the idea of indexation contains so much of simple justice, it will surely be borne in triumph through the halls of Congress. This does not follow, and the reason is not far to seek.

As Senese explains, "Government . . . makes a 'profit' from inflation." The higher the inflation rate, the more taxes government collects, hence the more money there is to dole out from Washington. A measure that would cost the government precious resources is not likely to be viewed with favor in Bureaucracyville. "Government," writes Friedman, "would have to reduce expenditures, increase explicit taxes or borrow additional funds from the public at whatever interest rate would clear the market." These are horrible prospects to contemplate.

Nevertheless, the cause of indexation has its friends in Congress. Indexation bills were introduced into the 94th Congress during the days of double-digit inflation, and a dozen such bills lie before the 95th. They are there to be acted upon whenever Congress achieves the political gumption to render unto the taxpayers that which is the taxpayers'.

The day could yet come; for inflation is nowhere near subdued, and apace with its growth there grows resentment of taxation. California's Proposition 13 to cut back and limit the property tax rate—an idea made hugely popular by inflation-generated increases in homeowners' property taxes—is given a first-rate chance of passing when it comes before the voters this June. It is always risky to talk of "ideas whose time has come." But here is one—relief for the inflation-plagued taxpayer—whose time may not at that be far away.

[From the Joplin, Mo. Globe, Feb. 27, 1978]

THE 'PROFIT' MOTIVE

The wage earner who gets a cost-of-living raise from his boss may find himself actually losing ground in "real" or spendable income because of a tax system

that fails to weigh the impact of inflation on his paycheck. The more the worker gets, the more Uncle Sam takes in income taxes. An insidious treadmill.

The logical solution, according to Dr. Donald J. Senese, writing for the Heritage Foundation, a non-partisan public policy research organization, is an "indexing" of taxes. Government would compute the rate of inflation and then correct the income tax system to prevent taxpayers from being thrown undeservedly into higher brackets. The U.S. Advisory Commission on Intergovernmental Relations supports such a plan, noting that tax increases should be the result of overt action by Congress and not the consequence of inflation.

Unfortunately, government is motivated in this instance by the "profit" incentive—inflation could increase revenues by an estimated $6 billion this year and $50 billion by 1980—and political expediency. Certainly, no politicos, bureaucrats or special interest groups would welcome a change that might upset their pet spending scheme. "Ending inflation would end this source of revenue," Nobel Prize winning economist Milton Friedman says. "Government would have to reduce expenditures, increase explicit taxes, or borrow additional funds from the public at whatever interest rate would clear the market. None of these sources is politically attractive."

Where does that leave Mr. Taxpayer? Without tax indexing, in the same cruel boat as before. Only he'll have to row twice as hard to keep from being swept away.

[From the Burlington, Vt., Free Press, Mar. 16, 1978]

THE CASE FOR TAX INDEXING

Many Vermonters, who may be agonizing over their income tax forms to meet the fast-approaching April deadline, will pay a higher percentage of their incomes to the federal and state government this year simply because their wages and salaries have increased.

That means that the Internal Revenue Service will take a larger bite of their income, making it perhaps the biggest beneficiary of all from their good fortune.

In a study for The Heritage Foundation, Dr. Donald J. Sense, a senior research associate with the Republican Study Committee of the U.S. House of Representatives, has pointed out that there has been little net gain for the wage-earner, even though wages have been rising steadily to keep up with inflation. Higher earnings push them into higher tax brackets.

He has proposed a tax indexing plan that calls for the government to automatically correct the income tax system to prevent inflation from boosting taxpayers into higher brackets.

Under it, the personal exemption, standard deduction and low-income allowance would not be calculated at a set figure. To arrive at each amount, the taxpayer would multiply a given number of dollars by the ratio of the price index for the taxable year to the index for the year in which the process begins. If, for instance, prices rise by 10 percent in the first year, the amounts would be multiplied by 110/100 or 1.10.

Tax tables would be adjusted to the rate of inflation.

New standards also would be applied for corporate taxes.

Senese has claimed the tax system would be more equitable and would deal more effectively with inflation through the use of indexing.

"Government . . . makes a 'profit' from inflation as the rising cost of living forces the individual taxpayer into a higher tax bracket (with no real change in real income) and produces a greater amount of revenue for the government," he said. "Economically, the individual taxpayer suffers a loss and the government realizes a gain."

Since several attempts by Congress at tax reform have largely been futile in the face of inflation, the indexing system is appealing because it guarantees that the individual will benefit as much from wage increases as does the government.

THE LAWMAKERS

INCENTIVES AGAINST INFLATION

(M. Stanton Evans)

Despite the stated enthusiasm of the Carter government for federal tax reform, there is one species of correction in the national taxing system that seldom gets official mention: the idea of indexing federal tax rates to relieve the constant ravages of inflation.

That such a reform is urgently needed is apparent from the recent economic record. Inflation by itself, or progressive taxation by itself, would each be bad enough. But put the two together, and the combined potential for public mayhem is appalling. As cost-of-living adjustments push money wages constantly upward (while actual purchasing power increases little, if any), the taxpayer is bumped into higher income brackets—and that means ever-higher tax rates.

The exact amount of increased revenue accruing to the Feds from this procedure is uncertain, but a number of plausible estimates have been attempted. One academic study tells us, for example, that federal tax receipts were increased by $16 billion between 1973 and 1974, simply through the impact of inflation. Casting our economic horoscope for 1979–83, the Joint Committee on Taxation surmises that added taxes imposed by way of inflationary bumping will total $58.7 billion.

Round it off, as Donald J. Senese has done in a recent study for the Heritage Foundation, and it appears that every 10 percentage points of inflation may be expected to trigger a 14 or 15 percent increase in taxes. This unlegislated boost of rates and revenues means, among other things, that the much-publicized tax cuts of the past decade haven't really been cuts at all, but simply a method of keeping taxpayers even—if, indeed, they have accomplished that. ". . . Despite several supposed cuts in personal income taxes in the past decade," notes Professor Milton Friedman, "taxes paid were the same percentage of total personal income in 1976 as in 1966." The legislated cuts had been completely offset by the inflationary increases.

"The fact is," says Representative Jack Kemp (R., N.Y.), "that despite large tax cuts in 1971, 1975, 1976, and 1977, the steeply progressive tax rates went unchanged. In the meantime, inflation pushed all workers and investors up into higher and higher brackets and resulted in tax increases, not lower taxes. . . . Taxes have tripled for a typical family, [increasing] from $2,276 in 1967 to an estimated $6,333 in 1978. A median family will pay an estimated 37.3 percent of the annual family income in taxes this year, compared with 28.9 percent a decade ago, all as a result of the steeply graduated, or progressive, tax rates. . . ."

The inflationary lagniappe that flows to Washington through this quirk in the law explains sufficiently the lack of interest in reforming it. The reforms that get official favor are almost always those that will increase the revenues available to the government, not decrease them. If the Feds needed any further inducement to debauch the currency (which they obviously don't), this revenue bonus feature of the existing law provides it.

All the more reason, of course, that a true reform should be adopted. Fortunately there are numerous congressmen who are acutely conscious of this inequity, and have introduced appropriate legislation. So-called "indexing" bills have been presented in the current session by Kemp, Representative Willis Gradison of Ohio, Representative Lawrence Coughlin of Pennsylvania, Representative Philip Ruppe of Michigan, Representative J. Kenneth Robinson of Virginia, Representative George O'Brien of Illinois, Representative Robert Roe of New Jersey, and more than thirty other members of the House.

To give the numbers of all these bills would be a bit unwieldy; suffice it to say that nearly all of them are called the "cost of living adjustment act" or something of the sort, and that nearly all of them contain identical provisions. The major common feature is a requirement that federal tax brackets be adjusted upward to account for the annual increase in the Consumer Price Index (CPI), so that taxpayers aren't forced to pay a higher rate simply because of nominal increases in their income.

Most of the bills also require that the rise in the CPI be factored into computation of the standard deduction and personal exemptions, that capital gains taxes be computed only on real increases in values, and that depreciation schedules make realistic allowance for augmented replacement costs resulting from inflation.

Ohio's Representative Gradison, who has been pushing especially hard for indexation, illustrates the value of such a reform to a hypothetical wage-earner with a 1977 taxable income of $10,000. "By the year 1986," Gradison says, "assuming a 6 percent yearly inflation rate, he will have paid an additional $1,166 merely because rising prices have forced him into higher tax brackets." Indexing will deprive the Feds of that amount of money, and keep it in the hands of the average taxpayer.

"In the decade from 1965 to 1975," Gradison adds, "the cumulative effect of inflation and all the legislated tax cuts left taxpayers worse off than if we had

not cut taxes but had merely indexed our system . . . Our Canadian neighbors have indexed their system since January 1974, and their experience shows that indexing slows down the growth in government spending and provides a strong incentive to fight inflation and promote real economic growth."

One possible objection to indexing from a conservative standpoint is that it accepts and institutionalizes inflation as a permanent process. If the notion were applied across the board to everything in our society, this might be a valid objection. But applied specifically to taxes, indexing would have, I think, the opposite effect. Since it would remove one powerful incentive toward inflation, it should in the long run help curtail it.

FIORELLO RANCH,
San Juan Capistrano, Calif., May 15, 1978.

Re tax indexation bill of 1978.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance, Dirksen Senate Office Building, Washington, D.C.

GENTLEMEN: I urgently request your passage of S. 2738 to the Senate floor. Of the many inequities that exist in the U.S. income tax system, the most serious is the effect of inflation on the graduated income tax rate schedules. While the individual taxpayer is struggling to merely hold his purchasing power against inflation, the U.S. government is increasing his income tax rate by neglecting to provide automatic price level adjustments.

Yours very truly,

FRANK G. FIORELLO.

APPENDIX

[COMMITTEE PRINT]

DESCRIPTION OF S. 2738

RELATING TO

ADJUSTING THE INCOME, ESTATE, AND GIFT TAXES FOR INFLATION

LISTED FOR A HEARING

BY THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

OF THE

COMMITTEE ON FINANCE

ON APRIL 24, 1978

PREPARED FOR THE USE OF THE

COMMITTEE ON FINANCE

BY THE STAFF OF THE

JOINT COMMITTEE ON TAXATION

APRIL 21, 1978

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I. INTRODUCTION

The bill described in this pamphlet, S. 2738, has been scheduled for a hearing on April 24, 1978 by the Subcommittee on Taxation and Debt Management of the Committee on Finance. The bill relates to indexing the income, estate and gift taxes for inflation.

In connection with this hearing, the staff of the Joint Committee on Taxation has prepared a description of the bill. The description indicates the present law treatment, the issues involved, an explanation of what the bill would do, its revenue effect, and the Treasury Department position.

II. PRESENT LAW

Under present law, the income, estate and gift taxes are based on fixed dollar amounts and do not take into account changes in the value of the dollar resulting from inflation. For example, the personal exemption in the individual income tax equals $750; and, as inflation occurs, the amount of the exemption becomes relatively smaller in real terms (that is, in terms of purchasing power for goods and services).

Only a few provisions of the Internal Revenue Code are adjusted (or "indexed") for inflation. The pension provisions impose limits on the amount of contributions which can be made on behalf of any employee under a qualified plan and limits on annual retirement benefits for which any employee may qualify. These limits are indexed to rise at the rate of inflation. As a result, the limit on annual contributions has risen from $25,000 to $30,500; and the limit on annual benefits has risen from $75,000 to $90,150.[1]

A second relevant feature of present income tax law is that the definition of income does not take inflation into account. Thus, capital gains are included in income even to the extent that the appreciation merely reflects inflation and, therefore, does not represent any increase in real income or purchasing power for the owner of the asset. Similarly, interest on bonds or savings accounts is included in income, but no adjustment is made for the effect of inflation in reducing the purchasing power represented by the bond or the savings account.

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[1] The indexing of these pension provisions was enacted in the Employee Retirement Income Security Act of 1974 (ERISA).

The energy tax bill, now pending in conference, contains a tax on business use of oil and gas, the rates of which would be indexed for inflation.

III. DESCRIPTION OF S. 2738

S. 2738 would partially index the income, estate and gift taxes for inflation. The adjustment would be for two-thirds of the increase in the consumer price index. The President would have the authority to suspend these automatic inflation adjustments, subject to an either-house congressional veto, if he finds that they will have a substantial adverse effect on the U.S. economy.

Individual income tax

S. 2738 would adjust for inflation many of the significant fixed dollar amounts used in deremining individual income tax rates, exemptions, deductions and credits. These would be the following:

(1) the tax rate brackets;

(2) the $750 personal exemption;

(3) the general tax credit (both the $35 per capita credit and the $180 limit on the 2-percent-of-taxable-income alternative credit);

(4) the floors under itemized deductions and corresponding zero rate brackets, which have replaced what used to be the standard deduction ($2,200 for single persons and $3,200 for married couples);

(5) the $4,000 limit on the amount of earned income eligible for the earned income credit and the income phaseout range (generally $4,000 to $8,000);

(6) the limits on the amount of income eligible for the tax credit for the elderly ($2,500 for single persons and $3,750 for married couples) and the income phaseout of the credit;

(7) the limits on the amount of child care expenditures eligible for the child care credit ($2,000 for one child and $4,000 for two or more children);

(8) the $25,000 limit on the amount of tax which can be offset by the investment tax credit without regard to the 50-percent limitation;

(9) The $10,000 exemption from the minimum tax;

(10) the $35,000 limit on the sales price of a home, the gain on the sale of which by a person age 65 or over is exempt from tax,

(11) the $1,500 and $1,750 limits on annual contributions to an individual retirement account; and

(12) the $7,500 limit on the annual contribution to a self-employed person's pension plan.

In each case, the fixed dollar amount for a given year would be increased by two-thirds of the increase in the level of consumer prices during the preceding year over the level of the second preceding year. Thus, in 1979 there would be an adjustment for two-thirds of the extent to which the average price level in 1978 exceeded the average for 1977. The dollar amounts so determined would then be rounded to the nearest $10.

Other fixed dollar amounts in the Code would not be adjusted for inflation under S. 2738. These include the limits on the credit and deduction for political contributions, the $1 checkoff for public financing of presidential campaigns, the $3,000 limit on the amount of ordinary income against which capital losses may be deducted, and the $10,000 limit on deduction of excess investment interest.

In addition, S. 2738 provides that the basis of property for purposes of computing gain or loss is to be adjusted upward for two-thirds of the inflation occurring between the time the asset is purchased and the time it is sold. (However, there is to be no adjustment for inflation occurring before 1979.)

S. 2738 would also extend the general tax credit and the earned income credit, scheduled to expire at the end of 1978, through the end of 1983.

Corporate income tax

The bill would make inflation adjustments to the graduated corporate rate schedule similar to those made for individuals. Currently, there is a 20-percent tax rate bracket for the first $25,000 of corporate taxable income and a 22-percent bracket on taxable income between $25,000 and $50,000. These bracket amounts would go up by two-thirds the rate of inflation in the same manner that the individual rate brackets would be indexed.

The inflation adjustments relating to the investment tax credit and the minimum tax, described above under the individual income tax, would also apply to corporations.

While the bill itself does not do this, the staff understands that the sponsors intend to extend through 1983 the increase in the corporate surtax exemption to $50,000 and the cut in the corporate tax rate on the first $25,000 of corporate income from 22 percent to 20 percent, which expire at the end of 1978.

Estate and gift taxes

The following provisions of the estate and gift taxes would be adjusted for two-thirds the rate of inflation:

(1) the $3,000 per donee gift tax exclusion, and

(2) the credit against the unified estate and gift tax (which under present law will be $38,000 in 1979, $42,500 in 1980, and $47,000 in 1981 and subsequent years).

The bill does not index the rate schedule of the estate and gift tax.

Effective Date

The income tax amendments apply to taxable years beginning after December 31, 1978, and before January 1, 1984. The indexation of the per donee exclusion applies to gifts made after December 31, 1978, and before January 1, 1984. The indexing of the estate and gift tax credit applies to gifts made or decedents dying after December 31, 1980, and before January 1, 1984.

Revenue Effect

It is estimated that the indexing provisions of S. 2738 would decrease tax receipts by about $5 billion in fiscal year 1979 and about $12 billion in 1980. The revenue impact of the bill, of course, cannot be forecast precisely because the future rate of inflation is uncertain. This tax cut would be more than offset by the automatic tax increases resulting from inflation.

Departmental Position

The Treasury Department opposes the bill.

IV. DISCUSSION OF ISSUES

Indexing the U.S. tax system raises several very important issues, and this section will only summarize the principal ones. A more comprehensive study of indexing is being conducted by the Joint Committee staff pursuant to the Tax Reform Act of 1976.

General effects of inflation on taxes

Inflation affects taxes in two ways. First, whenever something in the tax system is expressed as a fixed dollar amount, inflation causes its real value (its value in relation to purchasing power over goods and services) to decline. This impact could occur with any type of tax provided that the tax rate or the size of deductions, exemptions or credits depends on fixed dollar amounts. For example, inflation causes the 4-cent-per-gallon gasoline tax to decline in real terms; and it raises the real burden of the income and estate and gift taxes.

The second impact of inflation is idiosyncratic to an income tax—individual or corporate—and relates to the way inflation distorts the measurement of income from capital. This distortion occurs because, in measuring capital income, the tax system does not take into account the declining value of the dollar. If the price of an asset rises by 10 percent during a period in which the overall price level has also risen by 10 percent, the owner has experienced no increase in his purchasing power; however, under present law the 10-percent price increase must be reported as a capital gain. The owner of a bond or a savings account must pay tax on his interest income but does not get any offsetting deduction for the decline in the real value of the bond or savings account resulting from inflation. Conversely, a debtor may deduct his interest payments but need not include in income his gain which results from the inflation-induced erosion in the real burden of the debt he owes. Finally, businesses now claim depreciation deductions based on the historical cost of an asset, not based on prices prevailing in the year in which the depreciation deduction is taken, even though the dollar may be worth less when the depreciation deduction is claimed than it was when the asset was purchased.

The net result of the way income is defined under current law is that inflation acts as a personal wealth tax in which each person's wealth tax rate equals his effective marginal income tax rate multiplied by the rate of inflation. (A direct wealth tax would be unconstitutional because the Constitution prohibits direct Federal taxes, except for an income tax, unless the tax revenues derived from each State are proportional to that State's population.)

Different inflation adjustments would be needed to offset each of these two impacts of inflation on the tax system. So-called "type 1" indexing would adjust the fixed dollar amounts in the tax rates, exemptions, deductions and credits by the rate of inflation. "Type 2" indexing would adjust the definition of income from capital to take account of inflation. (Inflation causes no distortion in the measurement of wages, salaries and other forms of noncapital income so there would be no "type 2" indexing for these kinds of income.) The arguments for and against each type of indexing are quite different, and

the two are logically separate issues. The argument for doing either type of indexing does not depend at all on whether one has done the other type of indexing.

S. 2738 deals mainly with type-1 indexing for the income, estate and gift taxes, although not all fixed dollar amounts in those taxes would be indexed under the bill. The bill would adjust the definition of income (type-2 indexing) only for one type of capital income—gain or loss upon sale of an asset.

Many foreign countries engage in some form of indexing. Canada employes type 1 indexing for the individual income tax for all inflation. Other countries index for a fraction of the inflation rate or only when inflation exceeds a certain percentage.

Type 1 indexing—Adjusting fixed dollar amounts

The debate about the desirability of automatic adjustments of fixed dollar amounts in the tax system for inflation depends in part upon one's view of the ability of Congress to make the appropriate discretionary adjustments in the absence of indexing. Someone who believes that Congress is likely to make discretionary adjustments for inflation on a current basis, and that the necessity of making these adjustments is not unduly burdensome for Congress, will usually not think that type-1 indexing is necessary. A person is likely to favor type-1 indexing, however, if he thinks that Congress is not likely to make the right *ad hoc* adjustments or that making these adjustments takes too much of Congress' time and effort.

Under a fully indexed system in the type-1 sense, real tax burdens would stay the same for a given real tax base, so that if the real tax base (real income in the income tax, gasoline consumption in the gasoline tax, and so forth) stayed constant during a period of 10-percentinflation, tax liability would rise by exactly 10 percent so that the real tax burden would notc hange. Thus, Congress would have to make a conscious decision to change real tax burdens and could not count on inflation to change them automatically. Without indexing, inflation changes real tax burdens, raising some and lowering others, and Congress must make a conscious decision to keep them unchanged.

Most Federal revenue comes from taxes whose yields tend to increase in real terms in response to inflation, particularly the graduated individual income tax and the estate and gift taxes. There is a mild tendency for the corporate income tax to increase with inflation because there is some graduation in the rate schedule. Many Federal excise taxes, however, decline in real terms during periods of inflation, including the 4-cent-per-gallon gasoline tax and the alcohol and cigarette taxes. A question may be raised about whether it would be appropriate to index the taxes which rise automatically in real terms because of inflation without also indexing those taxes which fall in real terms because of inflation.

In the past Congress has paid little attention to the effect of inflation on the real rates of Federal excise, estate and gift taxes. Estate and gift tax rates did not change at all between 1948 and 1976 despite more than a doubling of consumer prices. The rate of the 4-cent gasoline tax rate has not changed since 1959.

In contrast, Congress has made frequent changes in the individual income tax which have kept the overall income tax burden at approxi-

mately the same percentage of personal income. However, some taxpayers have been overcompensated for inflation and others undercompensated. If 1960 is used as the base year, taxpayers with incomes below $20,000 and above $200,000 have generally done better with the discretionary adjustments actually enacted than they would have done had the 1960 tax law been indexed and no discretionary changes made. Taxpayers with income between $20,000 and $200,000 have done worse under the actual discretionary adjustments than they would have under automatic indexing.[3] Of course, the pattern of discretionary adjustments by the Congress in the future may be different than it has been in the past.

The overall Federal tax structure is such that the real level of Federal taxation will rise as a result of inflation because the excise taxes that fall in real terms with inflation represent a small fraction of total Federal revenues. This feature of the tax system now gives Congress an opportunity to lower taxes periodically and, in effect, biases the system towards "fiscal responsibility." However, the current unindexed system may also make it easier to increase government spending because higher spending can be financed from the inflation-induced increases in revenues without new tax legislation. In an indexed system, except for temporary tax cuts during recessions, Congress could generally only cut taxes in a fiscally responsible manner if it also cut spending, and some feel this pressure would lead to less spending. Others feel it would only lead to larger government deficits.

Some argue that the current pattern of automatic inflation-induced tax increases and occasional, discretionary tax cuts creates instability in people's expectations about future tax rates, which may be detrimental to the economy.

Type 2 Indexing—Definition of Income

The failure to have a proper definition of income (type 2 indexing) clearly has significant economic effects. The overstatement of taxable income from capital tends to reduce saving and investment. It also makes the income tax less equitable in the sense that certain kinds of income from capital are taxed more heavily than income from labor.

A full program of redefining taxable income to take proper account of inflation, however, would result in a significant complication of the tax system. The complexity would be especially severe for the changes needed to adjust for the decline in the real value of bonds, savings accounts, and checking accounts which results from inflation and those needed to tax the real gain which debtors receive during periods of inflation.

Some economists have argued, however, that a simpler partial program of type 2 indexing would achieve essentially the same economic effects as the complete program. If borrowers and leaders have the same tax rates, if all inflation is anticipated and in interest rates are free to rise without legislated ceilings, then it will suffice to make only one inflation adjustment: indexing for inflation the basis of assets for purposes of computing gain or loss and depreciation. If this adjust-

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[3] See Emil M. Sunley, Jr., and Joseph A. Pechman, "Inflation Adjustment of the Individual Income Tax," in Henry J. Aaron, ed., *Inflation and the Income Tax*, Brookings, 1976.

ment were made and the other assumptions are correct, interest rates on debt would rise in response to expected inflation as much as is needed to compensate lenders for their additional tax burden and to offset fully the tax benefit now received by debtors. Unfortunately, the assumptions are not entirely valid, so that some inequities and inefficiencies would result from a program to make inflation adjustments for some kinds of capital income (like capital gains) and not for others (like savings accounts) or to adjust for income and not for debt. It is not clear, then, whether only a partial program of type 2 indexing for certain kinds of capital income would represent a gain or a loss in terms of economic efficiency and tax equity.

The income tax now contains some provisions which might be considered *ad hoc* adjustments for inflation. Under present law, one-half of long-term capital gains are excluded from income (but subject to the minimum tax), there is a maximum rate of 25 percent on the first $50,000 of long-term capital gains, and the tax on a gain is deferred from the time it occurs until the time the asset is sold. These provisions, however, do not relate very closely to the adjustment to basis which would be needed to compensate for inflation. For depreciable assets, accelerated depreciation can be viewed as a compensation for the failure to have an inflation adjustment, although at current inflation rates the adjustment may not be large enough for equipment. Consideration of inflation adjustments for capital gains and depreciation could be done in conjunction with a review of the existing provisions relating to these items.

Technical issues

There are a number of technical issues which would have to be dealt with under a program of indexing. These include the choice of an appropriate price index and establishment of a procedure which allows enough time for withholding schedules to be adjusted by January 1 of each year so that they would match the new tax rates for that year.

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