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WATERING DOWN TAX INDEXING IS BAD ECONOMICS

Washington is fixated on the budget deficit to the exclusion of good public policy and sound economics. Members of Congress who would never dream of voting for an across the board increase in average and marginal tax rates on workers and savers are rushing to embrace the same thing in the guise of "fixing" the consumer price index to help balance the budget by 2002. Those who support an ad hoc CPI change need to reflect on the economic and public policy consequences, and to find a better way to end the budget deficit.

Even if inflation were zero, tax rates would rise over time as per capita real incomes rise. If the graduated tax rate structure is not adjusted for real income changes, it will eventually choke off incentives for further economic growth.

Tax indexing increases the personal exemption, standard deduction, and the income levels that separate the marginal income tax rate brackets each year by the growth of the consumer price index. If these amounts were not adjusted, workers whose wages barely kept pace with inflation would find more and more of their income subject to tax each year at the tax rate imposed on additional income in their tax bracket. Their average tax burdens would rise faster than their incomes. Savers whose assets barely rise in line with prices would also find their returns taxed more heavily. Furthermore, each year, some taxpayers would find their incomes spilling over into the next highest tax bracket, raising their marginal tax rates as well. The marginal tax rates are what govern the incentives to work and save to earn additional income. As people rise through the tax brackets, they tend to work less and take more leisure, save less and use more income for consumption. Economic activity suffers when marginal tax rates creep upward, a lesson that became painfully obvious during the bouts of double digit inflation of the 1974-1981 period.

Some policy officials and economists have protested that the CPI overstates inflation, that the adjustments of the exempt amounts and tax brackets are too big, and that the government is losing tax revenue. Budget makers want the Bureau of Labor Statistics to improve its calculation of the CPI (which it is already doing) or, if BLS won't move far or fast enough, want an ad hoc cut in each annual adjustment to save money for the Treasury.

Inflation, however, is not the only source of rising nominal incomes and rising average and marginal tax rates under our graduated income tax. Real per capita income growth also boosts nominal income. Even if inflation were zero, tax rates would rise over time as per capita real incomes rise. If the graduated tax rate structure is not adjusted for real income changes, it will eventually choke off incentives for economic growth.

The growth in real incomes has many sources. These include, among others, wage hikes triggered by technological or productivity advances, increased education, and accumulation of income-earning assets on the part of savers. Whatever the source of the growth of incomes, the population faces higher tax rates unless the tax system is indexed to match the gains.

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Imposing rising tax rates on rising real incomes punishes the saving,investment, and research that makes the gains possible, and is bad tax policy.

Thanks to the slight overstatement of the CPI, however, tax indexing not only protects workers and savers from rising average and marginal tax rates as their incomes rise with inflation, it also counters some of the tax rate hikes that would otherwise occur as real incomes rise over time. This is a good thing.

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The extra bit of tax indexing has helped to keep taxes steady as a share of national income. The government still gets its share of the national income growth, but at a steady, not a rising tax rate. If the extra protection were lost, the government's tax take would rise steadily as a share of income over time, and marginal tax rates would creep up. Each year, labor costs would rise, work incentives and employment would fall, saving would be less attractive, and the economy would become weaker than under current procedures. A third or more of the projected revenue gains would never materialize.

There is no reason why government should take over more of the economy as the population's income expands. A more prosperous population has less need of public assistance or subsidies for education and health care. The tax system should not be rigged to transfer automatically an ever-increasing percent of national income to the government. If the public wants more government, it can support a tax increase openly voted by the Congress.

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Inflation drove the inclusion of tax indexing in the Economic Recovery Tax Act of 1981. Productivity had been slipping since the late 1970s, and real wages had been declining. Nominal wages, however, soared in a losing effort to keep pace with inflation. Without indexing, tax burdens jumped, cutting real takehome pay further. Marginal tax rate hikes also raised labor costs and cut incentives to work, retarding employment and contributing to the onset of the 1980 and 1981-1982 recessions. Savers saw the returns to incremental saving fall as taxes took more of each additional dollar of interest, dividends, or capital gains. Saving was discouraged, making it harder to finance private investment. Adjusting for the rapid inflation-related bracket creep was essential.

In the 1980s, however, productivity and real wages began to rise again in most occupations, while inflation eased. The rising real wages might have increased tax rates just as inflation had done. But, by chance, the overstatement of the CPI compensated for some of the tax impact on wage gains due to productivity as well as inflation. It has prevented a general rise in tax rates on workers, and has bolstered job creation. The extra bit of indexing also protects savers whose real incomes grow as they accumulate assets, and the lower tax rates on saving have helped baby boomers prepare for retirement. The CPI-related "error" in tax indexing may have been unintended, but it is good for the economy and the taxpayer.

Even if one favors a progressive tax, one should not confuse differences in income among taxpayers in a given year with changes in taxpayers' incomes over time. Imposing higher tax rates on the rich than on the poor in any given year does not mean that the total tax take should rise as a share of national income if everyone gets richer over time.

If tax brackets are not widened to offset real income growth, ultimately, everyone will be in the top bracket, sharply reducing progressivity, and sharply increasing taxes as a share of national income. If tax brackets are widened to offset real income gains for the population as a whole, the system would remain progressive, but taxes would not rise as a share of national income.

The CPI should be fixed, but not to balance the budget. Any tax revenues raised by CPI reform should be used to expand tax indexing to offset the rising tax rates or to otherwise lower taxes on labor and capital. The ultimate solution to bracket creep is to adopt a proportional tax system with one tax rate imposed above a reasonable exempt amount. Until then, the progressive tax system must be restrained from taking over more of our income each year.

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Note: Nothing written here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before Congress.