Statement
To
The Subcommittee on Taxation and Debt Management
United States Senate
on
Indexing Tax Laws
by
Norman B. Ture, President
Norman B. Ture, Inc.
Washington, D.C.
April 24, 1978

SUMMARY

The objectives sought by proposals to index the tax system are certainly wholesome and deserving of widespread support. In evaluating these proposals, however, policy makers should be mindful of the limited potential of tax indexing for canceling the adverse economic consequences of inflation.

(1) Indexing cannot eliminate the basic cause of inflation --- excessively rapid growth in the stock of money --- nor can it offset the basic distortions of relative prices and in the use of production capability that results therefrom. Indeed, by somewhat easing the pain of inflation, indexing might be counterproductive if it were to reduce popular resistance to inflation.

(2) Indexing doesn't address the basic deficiencies in the tax system. It cannot reduce the economic distortions resulting from the present tax biases against effort and saving and investment. Dealing with these basic flaws in the tax system should not be shunted aside by indexing.

(3) Indexing can moderate the economic distortions resulting from interaction of inflation and the tax system. These third tier distortions certainly should be eliminated, but the Congress should not permit indexing to divert attention from far more fundamental concerns, viz., achieving a stable, noninflationary monetary policy and a more nearly neutral tax system.

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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 monetary 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 policy-makers 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 Distortions

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 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 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 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 rates 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.