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BEWARE RETURN OF BRACKET CREEP IN HEALTH REFORM

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INTRODUCTION

As the true cost of the Clinton health care proposal becomes clearer to Congress, key lawmakers supporting the central themes of the plan have felt impelled to call for new ways to fund the plan's mandated health package. House Ways and Means Committee chairman Dan Rostenkowski (D-IL) has proposed unspecified broad taxes. More specifically, Representative Pete Stark (D-CA), who chairs the health subcommittee of Ways and Means, proposes to finance part of the plan by eliminating the indexation of federal income tax rates—which would mean costly new taxes for millions of middle-class Americans.[1]

Indexing was one of the most important tax reforms of the 1980s. With indexing, the levels of taxable income at which higher tax rates take effect are adjusted each year to keep pace with inflation. As a result of this reform, taxpayers are no longer subjected to "bracket creep," being forced into higher tax brackets simply because their income keeps pace with inflation. Indexing also protects the value of the personal exemption and standard deduction, a particularly important feature for families and low-income workers. It also increases, in line with inflation, the amount of income subject to the lower rates of taxation for taxpayers in higher brackets. Since going into effect in 1985, indexing has saved taxpayers more than $100 billion. It has also forced pro-tax increase politicians to be more honest about their efforts to bring more money to Washington.

According to the Congressional Budget Office, eliminating indexing would enrich federal coffers by $132.2 billion over the next five years through the return of the inflation tax. But this estimate is based on the assumption that inflation will average only 3.0 per-

1 "Stark Floats Repeal of Indexing Tax Brackets to Fund Health Bill," *BNA Daily Report for Executives*, May 3, 1994.

cent. Since many experts believe that prices will increase at a faster rate, the actual tax increase imposed by a return to bracket creep could be considerably higher.

Repealing indexing would have serious adverse consequences for the American economy. Even by itself, the restoration of bracket creep would result in one of the largest tax increases in American history. Combined with the other taxes being considered as part of the health care debate—such as employer payroll taxes, taxation of employee fringe benefits, and tobacco taxes—the economic damage and job losses would be immense. This is particularly true since bracket creep subjects taxpayers to higher marginal rates, thus reducing the after-tax reward for working, saving, and investing.

THE IMPACT ON HOUSEHOLD FINANCES

While bracket creep would undermine the economy's long-term performance by subjecting increasing amounts of personal income to higher tax rates, the effect on household finances would be immediate and more dramatic. Even if inflation stays low, restoring the inflation tax would have a major impact on lower - and middle-income taxpayers. As the accompanying tables illustrate, a middle-income family whose income rises at the rate of inflation could see its taxes climb by as much as $4,444 over the next five years. Single taxpayers with middle-class incomes could see their tax bills climb by as much as $2,214 in the same time period.[2]

Lower-income taxpayers would be hit almost as hard. A married couple with two children and earning $16,150 does not pay any income taxes and would not pay any taxes under current law assuming their income rose at the rate of inflation. But if bracket creep is restored, as Representative Stark desires, their tax liability will go from zero to more than $1,138 over five years.[3] A single taxpayer with an income of only $6,250 in 1994 pays no income taxes. But if indexing is repealed and his income rises at the rate of inflation, he will be subjected to a five-year tax hike of more than $440 compared with current law.

HIGHER INFLATION MEANS EVEN HIGHER TAXES

What happens if inflation rises faster than government forecasters believe? Consider the impact on taxpayers if indexing is repealed and the rate of inflation increases by just one-half of one percentage point more each year than assumed in the CBO forecast.[4] The middle-class family cited earlier would see its tax bill climb by almost $6,290, or a 42

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2 These 1994 figures are calculated based on a personal exemption of $2,450 and standard deduction of $3,800 for individual returns and $6,350 for joint returns.

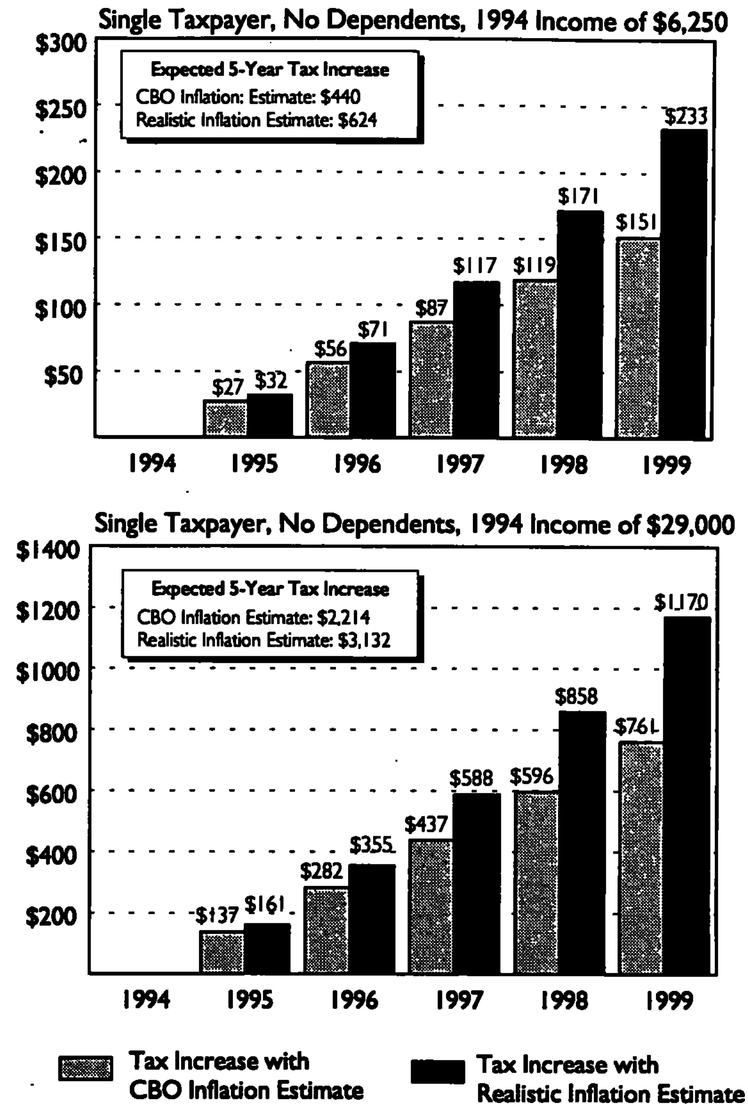
3 Assuming their income came from wages, this couple would be eligible for the Earned Income Tax Credit. Depending on how one counts the check received from this program, it could be argued that this couple would not pay any net taxes. Nonetheless, they would still be worse off because their check from the government would be reduced by the amount of taxes they would have paid.

4 This example assumes inflation would gradually rise, up to 5.6 percent in 1999. Given the monetary policy views of President Clinton's first two appointees to the Federal Reserve Board, many financial experts worry inflation will rise even faster.

percent jump from the $4,444 tax hike under CBO's more sanguine inflation estimate. And as the accompanying tables indicate, lower-income families would see their tax burden rise to more than $1,610 using more realistic inflation numbers.

The tax penalty on single taxpayers also would climb dramatically with more reasonable inflation assumptions. The tax increase on a single middle-income taxpayer would be nearly $3,132, up from the $2,214 using CBO's inflation estimate. For a lower-income single taxpayer, repeal of indexing would push their tax bill up by $623, compared with the $440 tax hike using CBO's numbers.

Removing Indexing from Federal Taxes: Expected Tax Increases by Income Level



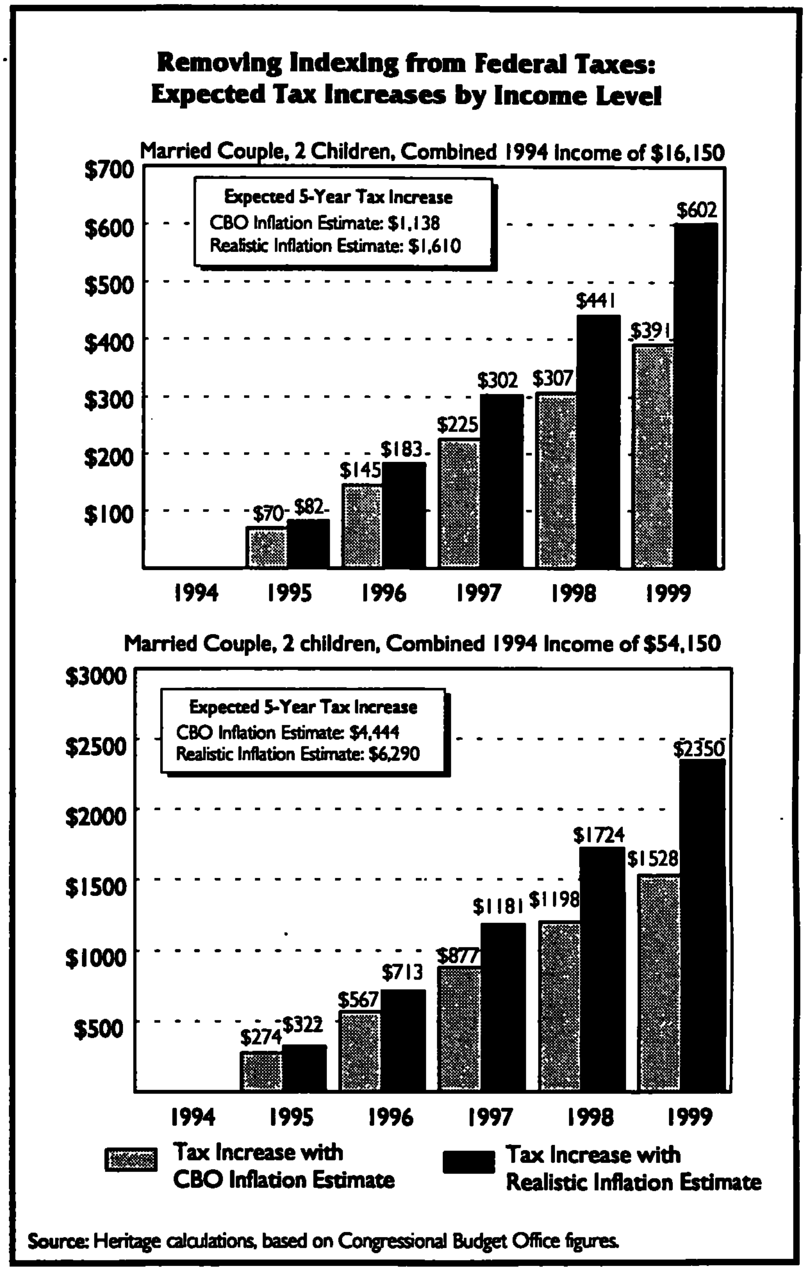
Note: Totals may not add up due to rounding.
Source: Heritage calculations, based on Congressional Budget Office figures.

AVERAGE TAX INCREASE HIGH

These examples show how badly bracket creep could affect selected taxpayers. To be sure, some taxpayers, particularly those with incomes just above the thresholds where higher tax rates take effect, would face smaller tax increases. It is possible, though, to measure the expected impact on the average taxpayer. CBO projects that restoration of bracket creep would result in a tax hike of $132.2 billion. Dividing that amount by 115 million personal income tax returns shows that the average tax increase over the five year period would be $1,150.[5] This figure, of course, is based on CBO's low inflation estimate. Using more realistic assumptions about future inflation, showing the inflation rate climbing to 5.6 percent by 1999, the average new tax burden would be more than $1,600 per taxpayer.

DISPARATE IMPACT

It is important to note that bracket creep affects all taxpayers, not just those forced into higher tax brackets. A taxpayer in the 15 percent bracket may not be pushed into the 28 percent bracket for many years, but he will still be harmed since inflation erodes the value of the personal exemption and standard deduction. As a result, even though his marginal tax rate remains temporarily stable, some income which was in the zero percent tax bracket will now be taxed at 15 percent. This is also why bracket creep hurts even those already in the highest tax bracket. Well-to-do taxpayers would see their average tax rate increase as greater portions of their incomes were subjected to higher tax rates, even though their marginal tax rate was unchanged.



Source: Heritage calculations, based on Congressional Budget Office figures.

The middle class and the working poor, however, are the ones who would be hurt the most if indexing were eliminated. Insult is added to injury because not only do taxpayers in these income ranges turn over more of their incomes to government under bracket creep, they also see their marginal tax rates increase. The dollar impact of bracket creep would vary widely depending on whether a taxpayer's income is just below or just above the point where a higher tax bracket takes effect.

THE MORAL PROBLEM

There is also a moral aspect to the indexing debate, quite separate from the financial impact on individual households. Bracket creep is a hidden tax which allows politicians to effectively impose higher taxes year after year without casting recorded votes. Indeed, some suspect this is one reason why Congress is considering the proposal. As Representative Stark, who first floated the bracket creep proposal, freely admits, "[Repealing indexing] might be an easy tax for members of Congress to vote for. Nobody quite knows what it is and their constituents would have a hard time ginning up doubts."[5]

But bracket creep violates elementary notions of fairness and justice. When government fails to protect and maintain the value of the currency, taxpayers should not be the ones who are punished. Furthermore, politicians who want to subject the economy to more taxes should be prepared to make a public case for new revenues and then cast a recorded vote—not rely on inflation surreptitiously to do the job of raising taxes for them.

Perhaps most troubling of all is that Representative Stark and others have referred to the indexing provision as a "loophole." In the minds of most Americans, tax experts and laymen alike, a loophole is a provision of law which grants a special privilege or favor to certain taxpayers. Indexing, by contrast, protects the entire population from losing a greater portion of their incomes to government as a result of inflation.[6]

CONCLUSION

Indexing was added to the tax code in 1985 as a result of the 1981 Economic Recovery Tax Act and may be the most important surviving legacy of the Reagan years. Since it went into effect, it has saved taxpayers more than $100 billion. Perhaps even more critical, however, it has restored a level of honesty to fiscal policy. Repealing this provision and allowing politicians to return to the days of stealth tax increases would damage not only the economy, but contribute to a further decline in the public's confidence in political institutions.

5 "Stark Floats Repeal of Indexing Tax Brackets to Fund Health Bill," *BNA Daily Report for Executives*, May 3, 1994.

6 Indeed, much of the tax code remains vulnerable to bracket creep. While personal income tax rates, the personal exemption, and the standard deduction are indexed, the capital gains tax is not. As a result, many Americans are forced to send money to Washington following the sale of an asset even though the taxpayer may have lost money after adjusting for inflation. To make matters worse, the corporate tax code is completely unprotected against inflation, thus hindering the ability of American companies to compete.