

Inflation and the resulting tax bracket creep has not been a major policy issue since the early 1980s. In the 1970s, it was a big issue, and it will become a very big issue again in a few years. Inflation and tax rates were so high in the 1970s that taxpayers suffered a loss of real wealth on passive income such as interest. Interest income minus taxes was substantially less than inflation. This problem was a major reason for the rise of Ronald Reagan and supply side economics. Since that time, inflation has been subdued. However, inflation does go on albeit at reduced rates.

Bracket creep is a major benefit to politicians. It permits tax increases without new legislation. How does it work? We have a progressive taxation system. If prices and wages are increased by inflation, then the PERCENT of GDP taken by taxation increases. This tax increase will occur with no change in legislated rates. The inflation of the 1970s was ignited by deficit spending to support Lyndon Johnson's Great Society and financing of the Viet Nam war. Many fear that there will be greater inflation than in the 1970s because of the very large current deficits.

How big was the inflation of the past 35 years? There are lots of ways to endlessly argue the level of cumulative inflation...but let us settle for a few anecdotes.

	1972	2007	% Change
Median Household Income	\$9,697	\$48,207	397%
First Class Stamp	8 cents	42 cents	425%
Gallon of Gas	36 cents	\$3.08	750%
Fuel/electricity index	24.5	145	491%

Probably Gas and fuel/electricity inflation is overstated using 2007 prices because of the unusual energy prices that year. But it seems safe to state that we experienced 400-450% inflation over those 35 years.

Next, let us look at incomes for each quintile of tax payers. The only handy data I found was for 2005, but it illustrates the point.

Minimum household income:

Lowest Quintile \$0
 Second Quintile \$17,900
 Middle Quintile \$30,500
 Fourth Quintile \$45,200
 Highest Quintile \$67,400
 Top 1% \$307,500

If the lowest household income in the middle quintile is \$30,500, then it only takes 120% wage inflation to put everyone in the middle and fourth quintile into the highest quintile of applicable tax rates.

What are those tax rates? The right column of the following table lists the effective federal tax rates for each quintile. If you move from the Middle Quintile to the Top Quintile your effective tax rate goes from 14.4% to 25.9%...and increase of 79%.

Average Effective Tax Rates Under Current Law by Type of Tax and Cash Income Percentile, 2007 ^a					
Cash Income Percentile ^b	Individual Income Tax ^c	Payroll Taxes ^d	Corporate Income Tax	Estate Tax	All Federal Taxes ^e
Lowest Quintile	-5.0	7.3	1.2	0.0	3.4
Second Quintile	-2.8	8.9	1.1	0.0	7.3
Middle Quintile	2.8	10.7	0.9	0.0	14.4
Fourth Quintile	6.8	10.8	1.2	0.0	18.8
Top Quintile	14.5	6.9	4.2	0.3	25.9
All	10.2	8.3	3.0	0.2	21.7
Addendum					
Top 10 Percent	16.3	5.6	5.1	0.4	27.4
Top 5 Percent	17.7	4.1	6.2	0.5	28.5
Top 1 Percent	19.2	2.0	8.6	0.6	30.4
Top 0.1 Percent	19.3	0.9	11.9	0.7	32.8

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 1006-1).
^aCalendar year.
^bTax units with negative cash income are excluded from the lowest quintile but are included in the totals. Includes both filing and nonfiling units but excludes those that are dependents of other tax units.
^cAfter tax credits (including refundable portion of earned income and child tax credits).
^dIncludes both the employee and employer portion of Social Security and Medicare tax.
^eExcludes excise taxes and customs duties.

Before you rush out and set your hair on fire, take a look at the following chart. This chart says that the federal government share of GDP was relatively stable from 1950 on at 18-20%. How is this possible will the gyrations in top marginal rates? Most of the time from 1941-1979 the top marginal tax rate was 70% and capital gain rates were 40%. The answer is that deductions, credits, depreciation etc blunted the effect of tax rates. This is more good news for politicians. Each new line of tax code (there were 1000s of new pages generated over those 35 years) generated generous campaign contributions. The only sure thing that will happen as a result of the current tax proposals is a lot more pages in the tax code. However, if you cannot afford your own politician – too bad. Support the Hedge Tax.

