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INFLATION AND THE CONSUMER IN 1974

A STUDY

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CONGRESS OF THE UNITED STATES

(Pursuant to S. Con. Res. 93)

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LETTER OF TRANSMITTAL

FEBRUARY 6, 1975.

To Members of the Joint Economic Committee:

Transmitted herewith for the use of the Members of the Joint Economic Committee and other Members of Congress is a staff study entitled "Inflation and the Consumer in 1974." This study was undertaken as part of the Committee's Inflation Study (S. Con. Res. 93, 93rd Congress, Second Session) by the Subcommittee on Consumer Economics to provide Members of Congress and the general public with a better understanding of the impact of inflation on different income groups and on real purchasing power during 1974.

This study is an analytical review of the impact of inflation and does not attempt to make any recommendations on how to reduce the rate of price increase or on how to alleviate the burden of inflation on different groups. However, the study can provide the basis for hearings and the development of policy recommendations. Nothing in the study should be interpreted as representing the views or recommendations of the Joint Economic Committee or any of its individual members.

The study was prepared by Lucy Falcone, with the administrative assistance of Jeanine Drysdale, of the Joint Economic Committee staff. Additional assistance was received from other members of the Joint Economic Committee staff and from the Bureau of Labor Statistics. I would like to express my own appreciation to the Committee staff who prepared the study.

HUBERT H. HUMPHREY,
Chairman, Joint Economic Committee.

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INFLATION AND THE CONSUMER IN 1974

By LUCY A. FALCONE

CHAPTER I. INTRODUCTION AND FINDINGS

The U.S. has experienced during the last year the worst possible combination of circumstances—inflation coupled with recession. Rates of inflation during 1973 of 8.8 percent as measured by the Consumer Price Index were the highest since the end of World War II. In 1974, not only did the rate of inflation accelerate to 12 percent, but a rapidly spiraling downturn led to sharp increases in unemployment. While the rise in unemployment has had and will continue to have a particularly deleterious impact on income, this study focuses primarily on inflation—on how inflation affects different income groups and particularly on the perverse impact which inflation has on consumer purchasing power as a result of rising tax payments. Of course it is impossible to entirely separate the effects of inflation and recession. One of the consequences of declining real output is that incomes rise by less than the rate of inflation.

The principal findings of our study on the impact of inflation on consumers in 1974 are:

Consumer prices rose rapidly in 1974, by 12 percent, on top of an 8.8 percent increase in 1973. Contrary to the 1973 experience, when food prices rose fastest, the 1974 inflation was broadly based. Prices of all major components of consumption, food, housing, transportation, medical care, rose by more than 10 percent.

The cost of living, which includes not only purchases of goods and services but also taxes, rose dramatically in 1974. It cost the average family with an income of $12,626 in 1973 an additional $1,840 in 1974 simply to maintain its 1973 living standards. This average family's budget had to rise by 14.6 percent to $14,466 in order to maintain its modest standard of living. This family had to spend $379 more for food, $393 more for housing and $145 more for transportation to purchase the same amount of goods it purchased in 1973.

Higher tax payments outstripped all other price increases in the consumer's budget in 1974. While food prices rose 11.9 percent, housing 13.5 percent and transportation 14.3 percent, personal income and social security taxes rose twice as fast. For the family at an intermediate income level of $14,466, social security taxes rose 21.6 percent in 1974, from $647 in 1973 to $787 in 1974. Personal income taxes rose even more—by 26.5 percent. The family at the intermediate budget level would pay $2033 in

Federal, State and local income taxes in 1974 compared to only \$1607 in 1973—an increase of \$426—even though its real standard of living remained the same.

Food prices increased faster for low-income consumers than for others. The price of food for a family on a low-cost diet rose 12.7 percent in 1974, while food prices for families on a liberal food plan rose 10.5 percent, 2.2 percentage points less. This differential reflects the fact that foods consumed in greater quantities by poor families rose most in price during 1974.

Purchasing power did not keep pace with inflation during 1974. All measures of real income declined during the year. Some measures of earnings dropped at more than twice the 1973 rate of decline. Real weekly earnings declined 4.6 percent during the year. Real spendable weekly earnings fell 5.3 percent from the fourth quarter of 1973 to the fourth quarter of 1974.

Total real disposable income, the broadest measure of purchasing power in the economy, declined 4.3 percent in 1974. This measure of income fell much more sharply than it has in any other post-war recession. This sharp decline in purchasing power is creating a greater drag on the economy than in past recessions and may well dampen a recovery now expected to begin in the second half of 1975.

As a result of inflation-swollen tax collections, this is the first recession during which the overall tax burden on individuals and families has increased. In previous recessions the tax burden declined, thereby stimulating consumer demand. An increase in the tax burden of one percentage point in 1974 has actually reinforced the decline in economic activity.

Tax revenues rise more sharply than money incomes during a period of rapid price increases. Recent studies estimate that a 10-percent inflation rate increases tax revenues by 14.7 percent in one year alone.

Inflation has increased the income tax burden on low and middle-income taxpayers more than on wealthy individuals because it has reduced the value of the standard deduction and exemptions and because tax brackets are much narrower at low and middle-income levels. At lower income levels taxpayers are likely to use the standard deduction. While dollar incomes rise, the deduction remains the same, and thus taxable income rises faster than dollar income. At higher income levels, the value of itemized deductions is likely to keep better pace with dollar incomes so that taxable income doesn't rise faster than dollar incomes. Furthermore, families at middle and upper-middle-income levels move into higher brackets faster than upper income families during inflationary periods. A family with a joint income of \$32,000 in 1973 would have paid taxes at a 42-percent marginal rate; if this family's dollar income rose by 12 percent in 1974, it would have moved into the 45-percent bracket. On the other hand, a family with income above \$50,000 in 1973 could experience an income gain of 12 percent or more in 1974 and still remain in the same tax bracket. Thus, inflation makes the tax system less progressive.

During 1974 prices increased by roughly the same amount for all consumers. The broad-based nature of the inflation resulted in price rises of 12 percent for lower and higher income consumers. In the past three years, however, from 1971 to 1974, prices increased on the whole faster for the poor. During that period prices paid by low-income consumers rose 27.7 percent, while prices paid by higher income consumers rose 24.4 percent, a difference of 3.3 percentage points.

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Chapter II. Higher Consumer Prices and the Cost of Living

Although the Consumer Price Index published by the Bureau of Labor Statistics (BLS) is the broadest measure of price changes affecting the consumer, it is not a comprehensive yardstick of the cost of living. The CPI measures a typical marketbasket of goods and services purchased by urban wage earners. It does not include personal income taxes at Federal, State, and local levels.

In an effort to measure the consumer's total expenditures, BLS has developed a set of hypothetical budgets. These budgets were constructed for a family of four at three standards of living, low, intermediate and high.[1] The budgets do not purport to measure the actual cost of living for families, but they do provide an estimate of how much it would cost to maintain a standard of living judged to be typical by BLS. Better estimates of actual consumer expenditures for food, housing, transportation, etc., and how these vary among income groups will be available when BLS publishes the results of its 1972–73 Consumer Expenditure Survey in 1977 or 1978. Until then the Family Budget series provides the best data on living costs.

The most recent official BLS Family Budget estimates were issued in June 1974 and covered living costs in 1973. Because additional information has become available since June, the Committee staff has estimated 1974 living costs, based as closely as possible on the BLS methodology. Table I illustrates how living costs for the three budget levels changed in 1974. At each level, not only did budget costs rise sharply over 1973, but they increased at a faster rate than in 1973. In 1973 the cost of maintaining the lower standard of living rose 10.8 percent; in 1974 it rose 13.9 percent. In the last 2 years alone the cost of this very modest standard of living has risen by 25 percent. The same 25-percent increase was experienced for the intermediate and higher budgets. These two budgets showed increases slightly smaller than the lower budget in 1973 and slightly larger than the lower budget in 1974. The intermediate budget, which most closely approximates a hypothetical average family budget, rose 10.3 percent in 1973 but jumped an additional 14.6 percent in 1974.

The composition of inflation in 1974 was quite different from 1973. In 1973, food costs rose sharply, by almost 20 percent, while most other consumer items rose less than 5 percent. In other words, food price increases dominated the changes in the CPI. On the other hand, the 1974 inflation was broadly based. Virtually every major expenditure group experienced price increases above 10 percent.[2] The price of food, while rising 11.9 percent on top of an 18.6 percent increase in 1973, actually increased less in 1974 than other consumption items. The sharpest increases were registered by housing and transportation.

[1] For a detailed description of these budgets, see "Three Standards of Living for An Urban Family of Four Persons, Spring 1967," BLS Bulletin 1570–5.

[2] All 1974 price increases are measured by the change in the Consumer Price Index from October 1973 to October 1974, the period which corresponds to the BLS Autumn Family Budget series.

Costs of transportation rose 14.3 percent from October 1973 to October 1974. This was concentrated primarily in private transportation. Public transportation prices rose only 3.4 percent. All of the costs associated with private transportation jumped sharply: gasoline and motor oil prices were up 31 percent over the year, new car prices were up 10.5 percent after adjustment for quality changes, and used car prices rose 17.6 percent.

Housing costs increased 13.5 percent compared to a 4.7 percent increase in 1973. Rents increased relatively little during 1974, rising 5 percent. The sharpest increases occurred in fuel and utilities, which rose 20.7 percent and housefurnishings and household operations which rose 17.6 percent. The costs of homeownership, which reflect both higher purchase prices and mortgage interest rates, rose 12.3 percent.[3]

Outstripping all consumption items in the rate of increase were personal income and social security taxes. For each budget level, the increases in taxes overshadowed the rise in food, housing and transportation costs. At the lower budget level, social security taxes rose 13.8 percent and personal income taxes (Federal, State and local) rose 31 percent. Although the social security tax rate remained at 5.85 percent of income in 1974, the almost 14-percent increase in payroll tax payments reflects higher dollar incomes. (The impact of inflation on tax collections and on tax bracket changes by income level is discussed in Chapter III). The 31-percent increase in income taxes for the lower budget occurred because the higher income needed to maintain a lower living standard pushed taxable income into a higher tax bracket. The cost of maintaining the lower budget standard rose from $8,181 in 1973 to $9,320 in 1974.

At the intermediate budget level, social security taxes rose 21.6 percent reflecting not only the higher income level but also the increase in the payroll tax base from $10,800 to $13,200 on January 1, 1974.[4] Personal income taxes rose 26.5 percent at the intermediate level. Since these taxes rose more sharply than any other item in this average budget, they now constitute a larger share of total family expenditures than in 1973. During 1973, payroll and income taxes made up 17.8 percent of the intermediate budget budget while in 1974 the share which went to taxes rose to 19.5 percent. For many families whose income rose by less than the 14.6 percent required to maintain the average living standard, the sharp increases in taxes forced them to adopt a lower standard of living. The costs of maintaining an average budget rose from $12,626 in 1973 to $14,466 in 1974, with income and payroll taxes rising from $2,254 to $2,820.

Living costs at the higher budget level rose from $18,201 to $20,883 in 1974 with total payroll and income taxes rising from $3,727 in 1973 to $4,629 in 1974. Taxes at the higher budget level rose by roughly the same percentage points as for the average budget.

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[3] BLS constructs the homeownership component of the Family Budgets assuming a 6-year old home. Therefore the jump in the cost of homeownership from 1973 to 1974 reflects increases in the purchase price of home and in mortgage interest rates from 1967 to 1968. It does not reflect changes in costs for homes purchased more recently.

[4] The taxable base rose to $14,100 on January 1, 1975.

Although all three budgets rose by approximately 25 percent in the last 2 years, the lower budget rose more in 1973 than the other two budgets. This was due primarily to the fact that food, which constitutes a large share of the lower budget (29 percent) rose most sharply among consumption items in 1973. As we have seen, in 1974 food prices rose at about the average inflation rate, while housing and transportation costs, which constitute a large share of the intermediate and higher budgets, rose by 13.5 and 14.3 percent respectively. Housing and transportation have a weight of 26.7 percent in the lower 1974 budget, but a weight of 30.8 and 31.0 percent in the intermediate and higher budgets. Furthermore, while taxes rose sharply for families at all budget levels, these higher tax payments had a larger impact on the two higher budgets first because taxes constitute a larger share of these budgets; and second because the increase in the social security tax base from $10,800 to $13,200 affected only the intermediate and higher budgets.

In sum, living costs rose slightly more for the two higher budgets in 1974 because the items which constitute a relatively larger share of these budgets, housing, transportation and taxes, rose faster than other items. The cost of living rose about 14 percent for the lower budget budget family and 14.5 percent for the intermediate and higher budget family.

Major economic forecasts suggest some slowdown in the rate of inflation. Recent estimates predict that the rate of increase in the Consumer Price Index in 1975 may be closer to 9–10 percent than to the 12-percent rate the U.S. experienced in 1974.[5] However, forecasters are almost unanimous in anticipating the sharpest increases to occur in food costs, suggesting that budget increases in 1975 may closely approximate our 1973 experience. In other words, lower income families are more likely to face budget cost increases higher than those faced by families at higher income levels in 1975 since food, which constitutes a large share of their budget, is expected to rise faster than other items.

It should be noted that the preceding budget analysis measures only the increase in living costs and not the ability of families to cope with these budget increases. The family at the lower budget level is less likely to have savings on which to draw during periods when prices are rising faster than income and this family is more likely to suffer a real decline in its already modest standard of living during a period like 1974 when recession kept incomes from rising fast enough to keep up with price rises. Data on income distribution confirms that in a recession, the share of income going to the lower income quintiles drops. Traditionally, inflation has usually accompanied periods of strong economic growth. As a result, lower income workers usually increased their share of income as job opportunities increased. However, in 1973–74 as in the 1969–70 recession, inflation was accompanied by declining real output. In such a climate the share of income received by the lower quintiles declines.

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[5] These forecasts were made prior to the President's recommendations for increased fuel taxes contained in the State of the Union message, and do not include the roughly 2-to-4-percent increase in the Consumer Price Index during 1975 which would result entirely from the fuel tax increases, if they were adopted.

TABLE I.—ANNUAL BUDGET COSTS AT 3 LEVELS OF LIVING FOR A 4-PERSON FAMILY: AUTUMNS 1973-74

Family and item	Autumn budget, 1973	Budget dollar increase, 1972-73	Percent budget dollar increase, 1972-73	Percent share of budget, 1973	Autumn budget, 1974	Budget dollar increase, 1973-74 [1]	Percent budget dollar increase, 1973-74	Percent share of budget, 1974
Lower budget:								
Food	2,440	382	18.6	29.8	2,730	290	11.9	29.3
Housing	1,627	73	4.7	19.9	1,847	220	13.5	19.8
Transportation	563	17	3.1	6.9	644	81	14.3	6.9
Clothing and personal care	901	37	4.3	11.0	988	87	9.7	10.6
Medical care	660	31	4.9	8.1	734	74	11.2	7.9
Other consumption	389	11	2.9	4.8	436	47	12.0	4.7
Total consumption	6,580	551	9.1	80.4	7,379	809	12.3	79.2
Other items	385	20	5.5	4.7	431	46	12.0	4.6
Social security	492	95	23.9	6.0	560	68	13.8	6.0
Personal income taxes	724	129	21.7	8.8	950	226	31.2	10.2
Total budget	8,181	795	10.8	100.0	9,320	1,139	13.9	100.0
Intermediate budget:								
Food	3,183	510	19.1	25.2	3,562	379	11.9	24.6
Housing	2,908	98	3.5	23.0	3,301	393	13.5	22.8
Transportation	1,014	35	3.6	8.0	1,159	145	14.3	8.0
Clothing and personal care	1,270	53	4.4	10.1	1,393	123	9.7	9.6
Medical care	664	32	5.1	5.3	738	74	11.2	5.1
Other consumption	722	20	2.8	5.7	809	87	12.0	5.6
Total consumption	9,761	748	8.3	77.3	10,962	1,220	12.5	75.8
Other items	611	35	6.1	4.8	684	73	12.0	4.7
Social security	647	165	34.2	5.1	787	140	21.6	5.4
Personal income taxes	1,607	232	16.9	12.7	2,033	426	26.5	14.1
Total budget	12,626	1,180	10.3	100.0	14,466	1,840	14.6	100.0
Higher budget:								
Food	4,020	650	19.3	22.1	4,498	478	11.9	21.5
Housing	4,386	152	3.6	24.1	4,978	592	13.5	23.8
Transportation	1,315	45	3.5	7.2	1,503	188	14.3	7.2
Clothing and personal care	1,846	76	4.3	10.1	2,024	178	9.6	9.7
Medical care	692	33	5.0	3.8	770	78	11.2	3.7
Other consumption	1,191	32	2.8	6.5	1,334	143	12.0	6.4
Total consumption	13,450	988	7.9	73.9	15,107	1,683	12.5	72.3
Other items	1,024	57	5.9	5.6	1,147	123	12.0	5.5
Social security	647	165	34.2	3.6	787	140	21.6	3.8
Personal income taxes	3,080	433	16.4	16.9	3,842	762	24.7	18.4
Total budget	18,201	1,643	9.9	100.0	20,883	2,682	14.7	100.0

[1] Autumn 1974 budget dollar increases are calculated on the basis of Consumer Price Index percent changes from October 1973 to October 1974.

Source: Bureau of Labor Statistics, Department of Labor, and Joint Economic Committee.

Food Costs

While food prices as measured by BLS rose an average of 11.9 percent from October 1973 to October 1974, there are alternative measures prepared by the Department of Agriculture which break down food budgets by standard of living and by age. The Consumer and Food Economics Institute of the Department of Agriculture has developed food plans which families and individuals at different income and age levels might buy to provide a nutritious, balanced diet. These food plans take into account the higher consumption of meats, fruits and vegetables at higher income levels and a significant consumption of beans, bread, flour-based products and lower cost foods within each group—ground beef rather than steak—at lower income levels.[6]

A tabulation of the changes in food costs for three different food plans by family size and age yields interesting results. Table II shows that food costs escalated very sharply at all levels during 1973. For a four-person family at the low and moderate level, prices rose 20.9 percent, while prices increased 20.2 percent at the higher level. During 1974, by contrast, food prices still increased significantly, but less than during 1973. However, food price rises impacted more heavily on the lower income family. A four-person family at the low cost level saw its food bill rise 12.7 percent. The family on a liberal food plan experienced price increases of 10.5 percent, 2.2 percentage points less than the low-cost plan family. These data reflect the fact that food items consumed in greater quantities by lower income families have increased most in 1974.

Price trends for older and elderly couples followed roughly the same pattern. In 1973, prices at all three levels—low, moderate and liberal cost—rose more than 20 percent, with the greatest increases experienced by the moderate level couples. In 1974, price increases moderated somewhat at all levels but the cost of a lower food plan increased 11.5 percent for the older couple (age 55–75) while the liberal food plan rose only 9.2 percent. For an elderly couple over 75 years of age, the disparity between the low-cost and liberal food plans was even greater—2.5 percentage points. While the elderly couple on a low-cost plan suffered price increases of 11.3 percent, the couple on a more liberal plan experienced food price rises of 8.8 percent.

It should be noted that the Department of Agriculture food plans assume that the family at each level maintains a nutritious diet with the same composition of meats, cereals, milk, fruits and vegetables. However, during periods of rapidly rising prices many families may be unable to maintain this diet. In a year such as 1974, when taxes, transportation and housing costs rose more rapidly than food, families whose incomes did not keep up with inflation had to substitute down to less expensive foods. Families who were consuming the low-cost plan in 1972 may now be in the position of not being able to substitute down further. Many of these families and elderly couples have simply had to reduce their consumption and in some cases go without some meals. For illustrative purposes, in October 1974 the low, moderate and liberal food plans for a four-person family cost $45.00, $56.90, $69.30 per week respectively. Many families on a moderate budget of $10,000 or $12,000 simply are unable to afford the $56.90 a week necessary to maintain their diet at the moderate food plan level.

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[6] For a more detailed discussion of the composition of the different food plans, see "Family Food Plans, Revised 1964", CA62-19, Consumer and Food Economics Research Division, Agricultural Research Service, U.S. Department of Agriculture.

The Department of Agriculture has recently revised the content of their food plans to reflect changes in taste, nutritional content and relative prices of different foods. However, the new plans published in January 1975 will not be used to revise the 1974 data, but will form the basis for food cost estimates in the future.

TABLE II.—PERCENT INCREASE IN FOOD COSTS AT 3 LEVELS[1]

Families	1971–72	1972–73	1973–74
4-person family:[2]			
Low cost	4.3	20.9	12.7
Moderate	4.8	20.9	11.1
Liberal	4.6	20.2	10.5
Older couple (55 to 75):			
Low cost	4.6	20.8	11.5
Moderate	5.2	21.4	9.3
Liberal	4.9	20.5	9.2
Elderly couple (75 plus):			
Low cost	4.7	20.9	11.3
Moderate	5.2	21.3	9.1
Liberal	4.8	20.6	8.8

[1] Based on 1-month food costs, using October of each year. For 1971, data for September were used since October statistics were not available.
[2] Assumes husband and wife aged 20 to 35 years with 2 school-aged children.

Source: Consumer and Food Economics Institute, Department of Agriculture; and Joint Economic Committee.

Chapter III. The Effects of Inflation and Recession on Real Incomes

Last year in the Committee's staff study on *Inflation and the Consumer in 1973*, we found that most measures of real earnings had declined during 1973, anywhere between one and 3.5 percent. These real earnings declines were in most cases the first the U.S. had experienced in the last ten years. In 1974, as a result of a deepening recession coupled with higher inflation rates, all measures of real income and earnings declined. Table III compares income and earnings changes in 1974 with changes in previous years. In many cases, earnings measures fell at more than twice the 1973 rate of decline. For example, real hourly earnings fell 1.1 percent in 1973, and an additional 3.4 percent in 1974. Even larger declines were registered in the real weekly earnings series, which declined 2 percent in 1973 and a further 4.6 percent in 1974. The larger decline in the weekly earnings series is attributable to the drop in average hours worked per week. Average overtime hours worked in manufacturing, for example, declined from 3.9 to 2.9 hours in the past year.

The real spendable earnings series, which attempts to measure weekly earnings in real terms after taxes, dropped 5.3 percent in 1974 following a 3.4 percent decline in 1973.[1] Finally, real compensation per manhour, which fell only 0.2 percent in 1973, dropped 2.0 percent in 1974. This series provides perhaps the broadest measure of earnings decline among workers in private industry since it covers both production and supervisory personnel and it reflects changes in wages, overtime hours and fringe benefits.[2]

On the whole, these four earnings series have declined each quarter for the last six quarters, with the largest declines occurring in the first and last quarters of 1974. Real weekly earnings, for example, declined at an annual rate of 8.1 percent in the first quarter. This quarterly pattern was due to two major factors: first, real Gross National Product declined sharply in the first quarter, adversely affecting earnings and income; secondly, during the first quarter, Phase IV of wage and price controls was still in effect. After the program expired on April 30, 1974, wages rose more rapidly. However, continued declines in measures of real earnings in the second and third quarters provide evidence that, however large wage increases have been, they have not kept pace with price increases.

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[1] For an evaluation of the real spendable earnings series, see George Perry, "Real Spendable Weekly Earnings," *Brookings Papers on Economic Activity*, Vol. 3, 1972.

[2] For a more detailed explanation of the differences among the earnings series, see "Inflation and the Consumer in 1973," Joint Economic Committee, January 14, 1974, pp. 16–20.

TABLE III.—ANNUAL RATES OF CHANGE FOR SELECTED MEASURES OF INCOME AND EARNINGS [1]

	1965–69	1970	1971	1972	1973	1974	1973 (4th quarter)	1974			
								1st quarter	2d quarter	3d quarter	4th quarter
Real disposable income	4.0	3.1	4.5	6.9	3.8	−4.3	0.7	−7.9	−4.4	−0.4	−4.4
Real per capita disposable income	2.8	2.0	3.5	6.0	3.1	−6.0	1.0	−8.5	−5.0	−1.1	−5.2
Real adjusted hourly earnings (private nonfarm)	2.9	0	3.2	3.1	−1.1	−3.4	−2.7	−6.6	−1.4	−2.8	−2.8
Real adjusted weekly earnings (private nonfarm)	.7	−1.6	3.7	3.7	−2.0	−4.6	−4.0	−8.1	−2.7	−1.1	−6.3
Real spendable weekly earnings [2]	−.4	−1.2	4.4	4.4	−3.4	−5.3	−4.6	−8.4	−3.6	−2.2	−6.9
Real compensation per man-hour (total private)	2.9	1.1	2.8	3.5	−.2	−2.0	−1.3	−4.5	1.6	−2.5	−2.8

[1] Percent changes for annual data are based on 4 quarter changes, from 4th quarter to 4th quarter; percent changes for quarterly data are based on quarterly averages expressed at compound annual rates.

[2] Earnings expressed in 1967 dollars for a worker with 3 dependents.

Source: Bureau of Labor Statistics, Department of Labor, and Bureau of Economic Analysis, Department of Commerce.

Real disposable income, which is the broadest measure of earnings and other types of income for the entire economy, exhibited the sharpest change. In 1973 real disposable income increased 3.8 percent, a rate of increase somewhat below the rises in 1971 and 1972. In 1974, on the other hand, real disposable income declined 4.3 percent. Most forecasts are predicting a decline in real GNP for the first two quarters of 1975. In the absence of any tax cut measures, real disposable income will decline at least until mid-1975. Given the rapidly deteriorating economic outlook, income could continue to decline or show no improvement throughout 1975.

The Impact of Inflation on Tax Burdens

The combination of recession and inflation in the last year has meant that dollar incomes continued to rise, and that as a result taxpayers were pushed into higher and higher tax brackets. However, after adjusting these inflated incomes for rising prices and for higher tax burdens, disposable income fell sharply. As Table III shows, the decline in real disposable income during the current recession is larger, in fact more than twice as large, as in any other post-war recession. This sharp decline in purchasing power is creating a greater drag on the economy than in past recessions, and may well dampen a recovery now expected to begin in the second half of 1975.

Why has real disposable income, income after inflation and taxes, fallen so severely in the last year, compared to other recession years? A large part of the answer is attributable to the fact that taxes as a percent of total personal income have risen during this recession, while in every other recession, the tax burden was reduced, either through tax cuts or because taxpayers moved down into lower tax brackets. In three of the past five post-war recessions, the tax burden fell by almost a full percentage point (taxes as a percent of personal income excluding government transfers), thereby providing stimulus to the economy as it reached a low point in the recession.

TABLE IV.—CHANGES IN INCOME AND TAX BURDENS DURING POSTWAR RECESSIONS [1]

Recession years	Percent decline in real disposable income [1]	Taxes as a percent of personal income: Including Government transfer payments — Peak	Including Government transfer payments — Trough	Excluding Government transfer payments — Peak	Excluding Government transfer payments — Trough
1948–49	−1.8	10.4	9.5	11.0	10.1
1953–54	−.7	14.1	13.2	14.8	13.9
1957–58	−1.3	13.8	13.4	14.7	14.4
1960–61	−.7	14.6	14.5	15.7	15.8
1969–70	−.8	18.1	16.9	19.8	18.8
1973–74	−4.3	17.8	18.3	19.9	20.9

[1] Percent changes based on those quarters during which peak and trough months occurred, as defined by the National Bureau of Economic Research.

Source: Bureau of Economic Analysis, Department of Commerce and Joint Economic Committee.

In 1948–49, for example, the U.S. economy was in a period of relative price stability after rather sharp price increases immediately following the end of World War II. The fact that prices were stable, or declined in some cases, allowed the built-in stabilizer aspect of the tax system to function. In other words, as real output and real income fell so did dollar income. This allowed taxpayers to move into lower tax brackets. The personal tax system thus served to buoy up real disposable income and provided stimulus to aggregate demand.

During the 1953–54 recession, prices again were relatively stable and, in addition, personal income taxes were cut by 10 percent on January 1, 1954. As Table IV illustrates, the tax burden (excluding government transfers) declined from 14.8 to 13.9 percent during this recession, thereby countering the decline in income.

The 1957–58 recession occurred during a period of relatively stable prices and this again allowed the tax system's countercyclical features to operate. In the 1969–70 recession, even though inflationary pressures were strong, the 1969 personal tax cut reduced the tax burden from 19.8 to 18.8 percent.

The 1960–61 recession was the only one during which the tax burden remained the same and therefore it most closely approximates the current recession. The recovery from the 1960–61 downturn was the most sluggish in the post-war period, and tax cuts in 1962 and 1964 were needed to restore the economy to a growth path consistent with a substantial reduction in unemployment.

During the current recession, the tax burden is increasing rather than declining. In the fourth quarter of 1974, the tax burden was a percentage point higher than it was at the economy's peak, a year ago. This particular phenomenon tends to reinforce the decline in real output which we are now experiencing, rather than to counteract it. Critics of this argument might suggest that although the tax burden is increasing on some persons, government transfer payments, including AFDC, food stamps, Supplemental Security Income, are increasing sharply enough to offset higher tax rates. Table IV shows, however, that this is not true. Even when taxes are taken as a percent of personal income including transfers, the tax burden is increasing. Again, it is only during this current recession that the personal tax and income transfer system has had a restrictive impact on the economy. In other words, in spite of the increases in transfer programs during the past year, the tax burden is rising even faster.

Why is inflation having such a sharp impact on tax burdens? There are several reasons: first, inflation reduces the real value of the personal exemption and the standard deduction. A simple example illustrates this point. An average 4-person family with an income of $13,000 in 1973 took the standard deduction and paid $1391 in Federal income taxes. Its disposable, after-tax income was $11,609. Let us assume that this family's income rose 8 percent in 1974 (per capita personal income rose 8.3 percent from third quarter 1973 to third quarter 1974) to $14,040. This family would be liable for $1609 in Federal income taxes and its after-tax income would be $12,431. This means that family's after-tax income in dollar terms has risen by 7 percent. The higher taxes which resulted from the diminished value of the standard deduction and the exemption actually increased the tax burden on this family from 10.7 percent of income to 11.5 percent.

In real terms, of course, this family's real after-tax income has fallen as a result of higher taxes and inflation. Measured in 1973 dollars, its 1974 disposable income of $12,431 is actually worth only

$10,939. Therefore, even though the family's income rose by 8 percent during 1974, its purchasing power has dropped 6 percent.

Even if this family's income had risen by the rate of inflation, 12 percent, its after-tax purchasing power would have declined 3 percent from 1973 to 1974. This 3-percent decline would be entirely due to the diminished value of exemptions and deductions in a period of inflation.

Another reason for the rise in tax burdens during inflationary periods is that tax brackets are fixed in dollar terms rather than real terms. Therefore, many taxpayers are moving into higher tax brackets even though their real income remains the same. Furthermore, families at middle and upper-middle-income levels move into higher brackets faster than upper income families during inflationary periods. A family with a joint income of $32,000 in 1973 would have paid taxes at a 42-percent marginal rate; if this family's dollar income rose by 12 percent in 1974, it would have moved into the 45-percent bracket. On the other hand, a family with income above $50,000 in 1973 could experience an income gain of 12 percent or more in 1974 and still remain in the same tax bracket. Thus, inflation makes the tax system less progressive.

For the economy as a whole, it has been estimated that tax revenues rise much more sharply than money income during a period of rapid price increases. Recent studies estimate that a 10-percent inflation rate would increase tax revenues by 14.7 percent in one year alone. [3] In sum, it appears that inflation worsens rather than improves the income redistribution function of the tax system. Inflation actually results in a more unequal distribution of after-tax income. The reasons for this perverse shift in the progressive nature of the tax system were recently summarized in a paper by Alan Murray:

> The percentage increases in tax associated with inflationary rises in income will be greatest for taxpayers with very low tax liabilities in the base period because exemptions and fixed amount deductions total such a large proportion of their income. Percentage increases in tax liability will also be high for taxpayers whose taxable incomes rise through ranges where the rate brackets are relatively narrow and the increases in tax rates from one bracket to the next are relatively large. These would be taxpayers with middle incomes. At the highest income levels, tax brackets are wide, changes in bracket rates are small, and taxable income is a very high percentage of adjusted gross income. So inflation has less of an impact on the effective rate of tax at these levels.[4]

To summarize, not only does the overall tax burden increase during periods of rapid inflation, thereby reducing real disposable income, but inflation also perversely affects the distribution of income because the tax burdens on lower and middle-income taxpayers increase faster than they do on high-income taxpayers.

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[3] J. M. Buchanan and J. M. Dean, "Inflation and Real Rates of Income Tax," a paper presented at the Sixty-Seventh Annual Conference on Taxation, The National Tax Association-Tax Institute, October, 1974.

[4] Alan Murray, "Income Tax Progression and Inflation," a paper presented to the 26th National Conference of the Tax Foundation, December 1974.

Chapter IV. The Impact of Inflation on Different Income Groups

The Consumer Price Index, while providing a measure of price changes for a broad segment of the population (urban wage earners), does not cover consumers at the lower and upper ends of the income scale. The mix of goods purchased by very low-income consumers will emphasize food and housing while the marketbasket of high-income consumers will contain more luxuries. Marketbaskets for these consumers were developed by R. G. Hollister and J. L. Palmer in a study, "The Impact of Inflation on the Poor." These marketbaskets were then used to construct a Poor Person's Index (PPI) and a Rich Person's Index (RPI). These indices have been updated by Professor Thad Mirer, State University of New York at Albany.[1]

It is generally recognized that during most inflationary periods, prices rise by the same amount for all income groups. In other words, when all prices are rising by roughly the same amount, the composition of each income group's marketbasket is unimportant. After studying the U.S. post-World War II inflation, Hollister and Palmer confirmed this pattern.

During the past 3 years, however, prices have increased unevenly with a resulting differential impact on income groups. As Table V demonstrates, prices increased faster in 1972 and 1973 for the low-income consumer (PPI). In 1972, the PPI rose 3.8 percent while the RPI rose 3.3 percent. In 1973, as a result primarily of the rapid rise in food prices, the disparity between the two indices widened—the PPI rose 9.8 percent while the RPI rose 7.6 percent. During 1974, prices increased by roughly the same amount for both groups, by 12.1 percent for the PPI and 11.9 percent for the RPI. This result was to be expected as inflation became more widespread among consumption items. As we saw earlier, all major components of the consumer's marketbasket rose by more than 10 percent in 1974.

On balance, however, prices have risen more for the low-income consumer in the last three years than for the high-income individual. From October 1971 to October 1974, the PPI rose 27.7 percent while the RPI increased 24.4 percent, a difference of more than 3 percentage points. The spiraling inflation of the past three years has had an adverse impact on all consumers, but the poor have clearly borne a greater burden. Not only are they less able to cope with inflation because of their limited discretionary income, but low-income families and individuals have also suffered price increases significantly greater than those experienced by upper income consumers.

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[1] For a more thorough discussion of these indices and of their limitations, see "Inflation and the Consumer 1973," pp. 22-3.

TABLE V.—COMPARATIVE PRICE INDEXES

[August 1971=100]

	PPI	RPI
1971: October	100.13	100.31
1972:		
April	102.04	101.76
October	103.91	103.62
1973:		
April	108.36	106.93
October	114.07	111.49
1974:		
April	120.49	117.40
October	127.85	124.74
Percent changes:		
1972	3.8	3.3
1973	9.8	7.6
1974	12.1	11.9
1971–74	27.7	24.4

Source: Consumer Price Index and Prof. Thad Mirer.

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