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THE COMING(?) INFLATION AND THE INCOME TAX: LESSONS FROM THE PAST, LESSONS FOR THE FUTURE

by

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ABSTRACT

The concerns about inflation as a result of the current financial crisis and the U.S. budget deficit challenge the social order, including taxation. Based on the historical U.S. experience and discourse on this issue, the article focuses on the relationships between adjusting the tax system for inflation and the general attitude towards adjustment for inflation in the social order. The article offers a new insight which is very different from the current research. The nominalism/adjustism culture that dominates the social order is placed at the center of the analysis. There is "equilibrium" between the scope of adjustment in the social order and in the tax regime. Advancing adjustment of the tax regime requires that it also be promoted in the general social order. This cultural paradigm plays a significant role in the tax response to inflation, including the scope and character of that adjustment regime. This approach erodes the literature's conservative approach arguing that classical tax policy consideration like cost-benefit analysis is the most effective factor on the adjustment issue. The article argues that adopting an adjusted tax regime is largely dependent on the existence and extent of a general culture towards the concept of "money": Is the prevailing culture one of nominalism or adjustism?

This paradigm explains the reality in the U.S. in the past with regards to adjustment for inflation. The sophisticated American discourse on adjusting the income tax regime for inflation, which first took place in the late nineteen seventies and early nineteen eighties, was unproductive from

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the start, and was doomed to failure because the U.S. culture of adjustism was not sufficiently ripe for justifying or permitting a "legitimate" social decision on adjusting the tax regime. The lessons from the past are that advancing adjustment of the tax regime requires promoting adjustment of the general social order. Adjusting the income tax regime without adjusting the general social order would be, culturally, a tough mission and even impossible.

INTRODUCTION

The concerns of facing inflation under the current economic crisis and the tremendous U.S. budget deficit challenge the current social order, including taxation. Will the issue of adjusting the income tax regime to inflation be on the tax agenda?[1] Based on the historical U.S. experience and discourse on this issue, the article focuses on the relationships between adjusting the tax system for inflation and the general attitude towards adjustment for inflation in the social order. Tax adjustment for inflation must be examined in the framework of an integrative, cohesive and coherent review of nominalism (valorism)\adjustism present in the social order.[2] It attempts to establish the strategic boundaries of the various inflationary adjustment regimes and the means for choosing among them.

The issue of adjusting the tax regime to inflation is challenging due to its complexity, and that tends to create an imbalance between the attention given to the particulars of adjustment for inflation and the concern for broader issues such as the general attitude towards adjustment for inflation in the social order. A proper balance must be struck between those particulars and the broader issues. The tax discourse must therefore adopt a coherent approach that attaches proper weight to the role of tax law in society by emphasizing the reciprocity between tax law and other components of the social order. The fundamental underpinnings of the tax regime cannot be examined autonomously, but rather must be viewed as part of the general social order reflected in the legal system.

Most countries[3] either do not adjust for inflation (nominalist regimes), or do so only partially.[4] Such adjustment may be either explicit or

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1. The scholarly literature uses the terms 'adjustment' and 'indexation' in regard to converting nominal-value tax regimes to real-value tax regimes. See, e.g., Victor Thuronyi, Tax Law Design & Drafting 434 (Victor Thuronyi ed., Kluwar Law International 2000); Reed Shuldiner, Indexing the Tax Code, 48 Tax L. Rev. 537 (1993); Brookings Inst. Inflation and The Income Tax (Henry J. Aaron ed., 1976) [hereinafter Inflation and The Income Tax]. This article uses the term 'adjustment' rather than 'indexation,' inasmuch as several adjustment regimes do not employ indexation but use other means of adjustment.

2. For historical developments, see, e.g., Keith. S. Rosenn, Law and Inflation 57-59 (Univ. of Penn. Press 1982); Eliyahu Hirshberg, The Impact of Inflation Law and Inflation, (1982); Eliyahu Hirschberg, The Impact of Inflation and Devaluation on Private Legal Obligations (1976); Frederick A. Mann, The Legal Aspects of Money, 5th ed. (Oxford Univ. Press 1992); Shirley Renner, Inflation and The Enforcement of Contracts (Edward Elgar 1999); Aaron Yoran, The Effect of Inflation on Civil and Tax Liability (Springer 1983).

3. To the best of my knowledge, only nine countries have adopted a comprehensive adjustment model: Argentina, Brazil, Chile, Colombia, Israel, Mexico, Peru, Romania, and Venezuela. See Thuronyi, supra n. 1, at 447 n.37; Vito

implicit.[5] This article proceeds from the assumption that a tax regime should be adjusted for inflation, and the absence of such adjustment results in a distorted tax regime.[6] The classical approach[7] adopts the view that the issue of adjustment for inflation should be weighed in accordance with the normal tax-policy considerations, i.e., cost-benefit considerations.[8] The primary benefit is taxation of real income, thus preventing a distortion of distributive justice[9] and promoting economic efficiency. The cost is the compliance costs. The dominant view is that comprehensive adjustment for inflation, which is preferable to nominalism or partial adjustment,[10] is conceptually and technically complex and involves high compliance costs. Thus, in terms of a cost-benefit analysis, it should not be adopted despite the inflationary damage to the tax regime. As inflation rates rise, the benefit of adjustment increases, while compliance costs generally remain fixed. Thus, under the classical approach, the tendency toward adjustment will grow as the rate of inflation increases. Since the inflation rates in the democratic countries are not high, the classical tax discourse involves finding the optimal partial adjustment regime as the second best option, due to its relatively low cost compared to a comprehensive adjustment.

At the core of this article is the erosion or elimination of the literature's conservative approach arguing that classical tax policy consideration like cost-benefit analysis is the most effective factor on the

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Tanzi, Inflation and the Personal Income Tax: An International Perspective (Cambridge Univ. Press 1980); Keith S. Rosenn, Adjusting Taxation of Business Income for Inflation: Lesson from Brazil and Chile, 13 Texas Int'l L.J. 165 (1977-1978); Int'l Fiscal Ass'n, Adjustments for Tax Purposes in Highly Inflationary Economies (Kluwer Law International 1985); Yishai Beer, Taxation Under Conditions of Inflation: The Israeli Experience, 5 Tax Notes Int'l 299 (1992); Daniel Halperin & Eugene Steuerle, Indexing the Tax System for Inflation, *in* Uneasy Compromise: Problems of a Hybrid Income-Consumption Tax 347 (Aaron et al. eds., Brookings Inst. Press 1988).

4. See Part III C.

5. See Halperin & Steuerle, supra note 3, 353-57.

6. See text accompanying note 14 et seq.

7. See, e.g., the literature cited in notes 1 and 3; Richard A. Musgrave, *Comments*, *in* Uneasy Compromise: Problems of a Hybrid Income-Consumption Tax 376 (Aaron et al. eds., Brookings Inst. Press 1988).

8. In this article cost-benefit considerations include all social costs, unless otherwise stated.

9. See, e.g., Cong. Budget Office, Indexing the Individual Income Tax for Inflation, at 5-10 (1980); OECD Comm. on Fiscal Affairs, The Adjustment of Personal Income Tax Systems for Inflation, at 19-22 (OECD Publications Center 1976) [hereinafter The OECD Report]. For example, the effect of non-adjustment for capital gains is greater for the middle class than for the wealthy. See Bruce Bartlett, Inflation and Capital Gains, 75 Tax Note 1263 (1997).

10. Id.

adjustment issue. The article argues that adopting an adjusted tax regime is largely dependent on the existence and extent of a general social culture of adjustment, which I refer to as 'adjustism' (the opposite of nominalism). The more a society and its economy are characterized by adjustment for inflation in non-tax areas,[11] the more likely it is that the tax system will also adjust for inflation. Adjustisim derives from the way a society relates to the value of "money": is the society committed to nominalism or adjustism? Is the prevailing culture one of nominalism or adjustism?[12] According to the proposed paradigm, the integration of the tax system into the surrounding socio-economic culture includes the adjustment for inflation. In the face of substantial change in the socio-economic environment, the tax system will not be the first to react due to its complicated and conservative nature, but it is not to say that the tax system will be the last to adjust.

The general cultural paradigm of adjustment affects the decision of whether to adopt a partial adjustment regime or a comprehensive adjustment regime. This paradigm explains the reality in the United States with regards to adjustment for inflation in general and its tax regime in particular. The American discourse on adjusting the income tax regime for inflation, which first took place in the late nineteen seventies and early nineteen eighties, was unproductive from the start and was doomed to failure because the U.S. culture of adjustism was not sufficiently ripe for justifying or permitting a "legitimate" social decision on adjusting the tax system for inflation.

Part I will present the fundamental principles regarding the adjustment of the income tax regime, focusing on the two basic models of adjustment for inflation – comprehensive adjustment and partial adjustment – and the subcategories of partial adjustment: explicit partial adjustment and implicit partial adjustment. This part provides the necessary background for Part II, which will review the various considerations that influence the transition from a nominalistic model to a model that adjusts for inflation, and the scope of that adjustment. At the center of this discussion is the general culture paradigm of adjustment for inflation, and the relationship between the general culture paradigm and other policy considerations.

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11. For a legal analysis of inflation, see Rosenn, supra note 2; Hirschberg, supra note 2; Mann, supra note 2.

12. Only few areas of the social order are unaffected by inflation. See, e.g., Jim Chen, The Price of Macroeconomic Imprecision: How Should the Law Measure Inflation? 54 Hastings L.J. 1375, 1376 (2003).

I. FUNDAMENTAL PRINCIPLES OF ADJUSTING THE INCOME TAX REGIME FOR INFLATION

A. General

Inflation erodes the effectiveness of various normative regimes by distorting distributive justice[13] and economic efficiency.[14] This erosion continues as long as the legal system employs nominal values of money between points in time. When inflation occurs, this nominal nominal approach creates a variety of distortions, and many legal regimes are rendered ridiculous in the absence of adjustment for inflation.[15]

Inflation undermines the primary goal of the tax system: Collection of just and efficient taxes.[16] This distortion occurs even at relatively low rates of inflation.[17] Distributive justice suffers when inflation affects ability to pay,[18] both in terms of horizontal and vertical justice. It also causes substantial harm to the economic effectiveness of the tax system. Inflation gives preference to debt over equity due to the deduction of the inflationary

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13. For an analysis of the impact of inflation on distributive justice, see, e.g., Stanley Fischer, Indexing, Inflation, and Economic Policy 19-27 (MIT Press 1986). Fischer argues that inflation harms distributive justice because it introduces discrimination between creditors and debtors, risk takers and risk seekers, and between short-term and long-term contracts, while also exacerbating the inter-generation issue. Unlike the economic costs of inflation, the social costs of inflation have not been explored in depth. See, e.g., Stanley Fischer, Why are Central Banks Pursuing Long-Run Price Stability?, *in* Achieving Price Stability, Federal Reserve Bank of Kansas City Symposium Series (1996).

14. For the economic harm caused by inflation, see, e.g., Stanley Fischer, Modern Central Banking, *in* The Future of Central Banking (Forrest Capie et al. eds., 1994); Stanley Fischer, Towards an Understanding of the Costs of Inflation: II, *in* The Cost and Consequences of Inflation (Karl Brunner and Allen H. Meltzer eds., 1981).

15. Guido Calabresi, A Common Law for the Age of Statutes 66 (Lawbook Exchange 2000). Calabresi emphasizes that inflation often leads to serious results that prevent the achieving of legislative purpose. For example, legislation intended to benefit a particular group may end up harming that group.

16. See, e.g., Richard Goode, Government Finance in Developing Countries 128-29 (Brookings Inst. Press 1984).

17. Halperin & Steuerle, supra note 3, at 348.

18. See, e.g., Martin J. Baily, Inflationary Distortions and Taxes, *in* Inflation and The Income Tax, supra note 1, at 291, 296 et seq. On this principle and critique of it in the framework of the traditional view of tax justice, see, e.g., Liam Murphy & Thomas Nagel, The Myth of Ownership: Taxes and Justice 12-39 (Oxford Univ. Press 2002).

element of debt[19] and the choice among different assets will be affected by the inflationary effect caused by tax law. Failure to neutralize inflation effectively levies an additional tax burden. This burden can be positive or negative (constituting a subsidy) and its scope may be influenced by arbitrary variables (e.g., the inflation rate, equity v. debt, the length of asset possession) that are inappropriate or irrelevant to a desirable tax policy. Such arbitrariness harms both distributive justice and economic efficiency. Inflation not only adversely affects the accurate measurement of income, but also the collection of taxes after tax liability has been established.

What suffers from inflation can be analyzed from several perspectives. For our analysis, I will use the classic view of the effects of inflation on the tax system,[20] which identifies three primary normative levels that have to be adjusted. Each of the levels erodes the distributive justice and efficiency of the tax regime, since each has unjustifiable and inefficient tax consequences that change the effective tax burden, as compared to the effective tax burden that would apply in an inflation-free world.

The first level is the collection lag. Tax liability must be adjusted after the occurrence of a tax event. Even if the tax base is entirely adjusted for inflation, the tax liability must also be adjusted to the date of payment. In the absence of such adjustment the effective tax burden will not coincide with what is normatively required. The collection lag applies to two sub-periods: The period between the occurrence of the tax event and the date the taxpayer is required to pay the tax[21] and the period between the date the taxpayer is required to pay and the date of actual payment.[22] The second sub-period is not inherently connected to tax law. Hence, it must be treated the same way that society treats other debts' collection lag. In the absence of a general legal arrangement for adjusting debts for inflation, there is no justification for only adjusting tax debts.

The second level concerns the effect inflation has on nominal elements in the tax system. For example, in the case of income tax, the required adjustment comprises, first and foremost, personal exemption,

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19. For the difficulty in distinguishing equity capital and debt capital in the context of adjustment for inflation, see, e.g., Halperin & Steuerle, supra note 3, at 366.

20. See, e.g., Thuronyi, supra note 1, at 435.

21. The first sub-period is of particular relevance to income tax rather than to value added tax. See, e.g., Thuronyi, supra note 1, at 437.

22. For increasing the collection efficiency, see, e.g., Goode, supra note 16, at 132, 225. A substantive reaction to the erosion is the collection tools that operate over the course of the taxable period, such as withholding tax and tax advances. These vehicles were not originally intended to serve as adjustment mechanisms, but rather to increase the effectiveness of collection. These mechanisms thus serve a dual function: collection and adjustment. The latter is of greater importance during periods of high inflation.

standard deduction, earned income credit, and the tax brackets, in order to prevent the phenomenon of bracket creep.[23] These elements are essential, primarily from the distributive justice perspective. Addressing inflation in this level is relatively simple, and can be achieved by adjusting nominal values to inflation.[24]

The third level deals with the inflation effect on the tax base. This level is the one most 'infected' by inflationary distortions, and curing it is most difficult.[25] Inflation potentially affects the tax base of other tax regimes, as well, but the income tax regime is the most susceptible.[26] The simplest explanation of how inflation affects the tax regime is provided by the S.H.S. (Schanz-Haig-Simons) model,[27] according to which taxable income is composed of the addition to wealth between the two end points of the measurement period, with the addition of consumption over that period. These variables are measured at different times (beginning, end and inbetween of the period). Thus, the inflationary reality distorts the accuracy of the measurement.[28]

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23. In the United States, the adjustment of these elements began in 1984. See IRC §§ 1(f), 63(c)(4), and 151(d)(4); Joel Slemrod & Jon Bakja, Taxing Ourselves 238 (MIT Press 1996); Indexing the Individual Income Tax for Inflation, supra note 9, at 5; The OECD Report, supra note 9, at 9. For comparative aspects, see Goode, supra note 16, at 128, 140. For the political aspects of bracket creep, see S. Steinmo, Taxation and Democracy: Swedish, British and American Approaches to Financing the Modern State 19 (Yale Univ. Press 1993). It should be noted that not all the elements of the U.S. income tax regime were indexed, as for example, the Alternative Minimum Tax. See, e.g., Gabriel Aistebaomo, The Individual Alternative Minimum Tax and the Intersection of Bush Tax Cuts: A Proposal for Permanent Reform, 23 Akron Tax J. 109, 138 (2008); Joint Comm. on Tax'n, Present Law and Background Relating to the Individual Alternative Minimum Tax, at 110 (Comm. Print 2007).

24. Slemrod & Bakja, supra note 23, at 28, 237-38; Emil M. Sunley, Jr. & Joseph Pechman, Inflation Adjustment for the Individual Income Tax, *in* Inflation and The Income Tax, supra note 1, at 153-54; George Vukelich, The Effect of Inflation on Real Tax Rates, 20 Canad. Tax J. 243 (1972).

25. These three areas form a dynamic process of adjustment. For example, if adjustment is adopted in the second area, this adjustment influences the effective tax burden, and motivates adjustment of the entire tax system, including the third area, based on the argument that from the effective tax point of view, there is no substantive distinction between adjusting the second area and adjusting the third area.

26. See Thuronyi, supra note 1, at 440.

27. For attributing the Haig-Simons model to the German economist George von Schanz, see, e.g., Stanley. S. Surrey & Paul. R. McDaniel, Tax Expenditures 4 (Harvard Univ. Press 1985).

28. Robert M. Haig, The Concept of Income – Economic and Legal Aspects, *in* The Federal Income Tax 1, 7 (Robert M. Haig ed., 1921) (*reprinted in*

Five fundamental issues arise when adjusting the income tax base:[29] First, the capital gains tax regime imposes tax on nominal capital gain, including the inflationary component.[30] Such taxation represents the taxation of the capital itself,[31] rather than taxation of the capital gain.[32] Second, inflation distorts income and expense in relation to debt.[33] Conceptually, the inflationary component of nominal interest does not constitute real interest, but rather is part of the principal and this component does not create income or expense.[34] Incorporating the inflationary component distorts the income tax regime by erasing the distinction between capital and the return on

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The Am. Econ. Ass'n, Readings in the Economics of Taxation 54 (Richard A. Musgrave & Carl S. Shoup eds., Richard D. Irwin 1959); Henry C. Simons, Personal Income Taxation: The Definition of Income as a Problem of Fiscal Policy 50 (1938).

29. Dale Chua, Inflation Adjustment, *in* Tax Policy Handbook 142 (Parthasarathi Shome ed., Int'l Monetary Fund 1995).

30. Thus, for example, between the years 1946 and 1977, there was no real capital gain, yet capital gains were taxed. See Robert Eisner, Capital Gains and Income: Real Changes in the Value of Capital in the United States, 1946-1977, *in* The Measurement of Capital 447 (Dan Usher ed., Univ. of Chicago Press 1980). The proposal to index capital gains was first raised by the US Treasury in Department of Treasury, Blueprint for Basic Tax Reform (GPO, Washington D.C: 1977).

31. See Shuldiner, supra note 1, at 549; Halperin & Steuerle, supra note 3, at 352. It should be noted that the longer the asset is held, the smaller the effect of taxing the inflationary component of the capital gain, for two reasons: First, the longer the said period, the smaller the inflationary component in the overall capital gain. Second, the longer the period, the greater the benefit of the tax deferral. However, when we are concerned with losses, the longer the asset is held, the greater the need for adjustment, due to the same considerations. See Shuldiner, supra note 1, at 552-557; Halperin & Steuerle, supra note 3, at 3.

32. The adjustment of capital gains tax for inflation is strongly tied to the realization requirement and eliminating this requirement by building the tax regime on an accrual basis would substantially reduce the need to address adjustment. See Halperin & Steuerle, supra note 3, at 379; Shuldiner, supra note 1, at 550-57. This article proceeds from the premise of the realization requirement which stands at the core of the current income tax regime.

33. Yoram Margalioth, The Case for Tax Indexation of Debt, 15 Am. J. Tax Pol'y 205 (1998).

34. The same tax treatment that applies to the principal applies to the inflationary component of the nominal interest. For analyzing the proposal of an arbitrary distinction between the two components, see Halperin & Steuerle, supra note 3, at 353-54; Richard A. Musgrave, supra note 3, at 378; Eugene Steuerle, Tax arbitrage, Inflation, and the Taxation of Interest Payments and Receipts, 30 Wayne L. Rev. 991, 991-1013 (1984). For the effect of inflationary taxation on the interest rates, see, e.g., Int'l Monetary Fund, Taxation, Inflation, and Interest Rates (Vito Tanzi ed., 1984).

capital,[35] both conceptually and functionally. Such incorporation provides a wide space for creating arbitrages and under relatively high inflation rates, the nominal income tax regime collapses.[36] Third, the institution of depreciation is based upon the historical purchase cost of an asset. In a period of inflation, the historical cost is of little significance. Fourth, evaluating inventory according to its nominal value distorts the measure of income by including the inflationary profits.[37] Fifth, losses carried forward suffer a reduction in real value due to inflation.

The article will focus on the third level, i.e., adjustment of the tax base which is the most challenging.[38] In theory, the issue of adjustment for inflation could be rendered entirely superfluous if we were to exchange our local coinage for virtual currency that would reflect inflationary changes daily (or any other time period chosen), and tax liability would be calculated by that virtual currency. Such a system would not require adjustment for inflation. Effectively, a "virtual" currency could be "foreign currency," assuming that the change in its exchange rate at any given time (day, month, or year) would be identical to the inflationary change over that period.[39] This method would be equivalent to periodically adjusting the tax base. However, a cost-benefit analysis illustrates that this approach is very costly since it is based on a daily measurement of price variations.[40] Although selecting a longer period would lower the cost, benefits would also drop,[41] and a trade-

35. For negating the distinction between capital gain and interest in a broader context, see Joseph Stiglitz, The General Theory of Tax Avoidance, 38 Nat. Tax J. 325, 328-29 (1985).

36. The tax rates on the various categories of capital income are not necessarily identical. From distributive justice and efficiency perspectives, this lack of uniformity increases the distortion during an inflation period. See Halperin & Steuerle, supra note 3, at 352.

37. This issue can be mitigated to some extent by adopting the LIFO rather than the FIFO. For the arbitrary nature of LIFO, see, e.g., Strnad, supra note 15, at 257-58.

38. Therefore, when this article addresses an unadjusted income tax regime, it does not imply that the first two levels are not adjusted, but only that the tax base is unadjusted. Hence, an unadjusted regime can also refer to a regime that adjusts tax payments, tax brackets, fixed elements etc., (the first two areas), while the third area – the tax base – is unadjusted.

39. See, e.g., Thuronyi, supra note 1, at 454.

40. In terms of neutralizing the inflationary effect, the results of this approach are identical to those produced by comprehensive adjustment of net worth (which will be further examined). However, the latter is far cheaper than a daily, weekly or monthly adjustment. See also Thuronyi, supra note 1, at 454-55.

41. Thus, for example, in the case of income tax regime, the taxpayer would be required to file a semi-annual, quarterly or monthly return. The income tax regime does not carry out multi-period (multi-year) measurements in order to ascertain the

off would have to be reached.[42] The article proceeds from the classical view that the purpose of adjustment for inflation is neutralizing the effects of inflation so that the effective real tax rate will be unaffected by inflation. In other words, the effective tax rate during periods of inflation will be identical to the effective tax rates during periods that are inflation-free.[43]

There are two archetypical adjustment regimes: partial adjustment[44] and comprehensive adjustment. Academic literature on adjusting tax systems discusses a broad spectrum of adjustment regimes (hereinafter – the adjustment spectrum), beginning with non-adjustment – which effectively is an adjustment regime for zero inflation rate – through various forms of partial adjustment regimes and ending with comprehensive adjustment. The end points of the adjustment spectrum are clearly defined: non-adjustment and comprehensive adjustment. Between those two points, there are many varied models of partial adjustment. A non-adjustment regime is the simplest of the existing tax regimes along the spectrum, inasmuch as it ignores inflation, and the tax burden is levied in purely nominalistic terms. As we move along the adjustment spectrum from non-adjustment to comprehensive adjustment, the discussion becomes increasingly complex.

One of the basic structural decisions that must be addressed in the adjustment discourse is whether adjustment will be performed automatically[45] or whether an administrative authority will be required to exercise discretion. Eroding the automatic adjustment mechanism by subordinating it to administrative discretion provides, first and foremost, flexibility to react to changing circumstances. In addition, some have viewed automatic adjustment as a costly tool because it denies the government flexibility in times of inflation crisis.[46] On the other hand, discretion can

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average income. In general, income is measured over a period of a taxable year. Shortening the taxable period can increase the detrimental effects of a lack of multi-period measurement, due to the fluctuations among the various periods (which are shorter than a tax year). Thus, for example, replacing the classical taxable year with a taxable “half-year” will lessen the inflationary gap, but it will also increase the distortion derived from the lack of a multi-period measurement in regard to the year (which is composed of two semi-annual tax periods). The issue of adjusting Value Added Tax is of limited scope for few factors such as the shorter taxable period.

42. Shortening the periods for measuring the tax base provides an implicit partial adjustment. For this adjustment model see Part III C.

43. For the various objectives of adjusting tax regimes for inflation, see, e.g., Shuldiner, supra note 1, at 566-69.

44. Sometimes referred to as ad hoc adjustment. See Halperin & Steuerle, supra note 3, at 347; Thuronyi, supra note 1, at 443.

45. See, e.g., Edward M. Gramlich, The Economic and Budgetary Effects of Indexing the Tax System, *in* Inflation and the Income Tax, supra note 1, at 271, 279.

46. See, e.g., Musgrave, supra note 7, at 379.

serve improper political interests, and lacks the certainty and stability that automatic adjusting provides.[47] The less comprehensive and more partial the adjustment, the easier it may be to justify subjecting it to administrative discretion.

B. Comprehensive Adjustment

Comprehensive adjustment (CA) for inflation means adjusting all the relevant components of the tax regime in order to neutralize the inflationary element.[48] I will present the basic aspects of CA, inasmuch as it is important for the appraisal of the merits of the central argument against adopting a CA, according to which such a regime is overly complex and, therefore, unjustifiable.

The classical approach to CA is that of net worth,[49] which focuses on the opening and closing balance, including all assets and liabilities, the changes (increase/decrease) in equity capital over the course of the year, and income and expenses that are not recognized for income tax purposes. CA is comprised of many issues.[50] Accounting is of cardinal importance in a CA,[51] since it is entirely based on balance sheet values and general accounting principles as reflected in financial reports.[52] Thus this adjustment regime transfers the tax discourse on adjustment for inflation from a classical legal arena to an accounting arena, which bears significant consequences.[53]

47. Denying discretion in an adjustment regime is consistent with a general tax policy that views the exercise of discretion in the tax regime to be undesirable except in extraordinary circumstances.

48. See Thuronyi, supra note 1, at 446; Arnold C. Harberger, Comments, *in* Uneasy Compromise: Problems of a Hybrid Income-Consumption Tax 381, table 3 (Aaron et al. eds., Brookings Inst. Press 1988). Some countries have adopted significant adjustment regimes that are not CA regimes due to the argument of complexity. However, these achieve similar results, See, e.g., Francisco Gil-Dias & Wayne Thirsk, Mexico's Protracted Tax Reform, *in* Tax Reform in Developing Countries 287, 304-09 (Wayne Thirsk ed., Oxford Univ. Press 1998).

49. For a more detailed explanation of the net worth method, see Thuronyi, supra note 1, at 446.

50. For example, what is the status of foreign currency in the adjustment regime? See, e.g., Herberger, supra note 60, at 383; R.J. Vann & D.A. Dixon, Measuring Income under Inflation 70-71 (1990); Thuronyi, supra note 1, at 453, 460.

51. See, e.g., Thuronyi, supra note 1, at 453.

52. Double-entry bookkeeping is a basic precondition for introducing a CA regime that is based upon financial records.

53. Transferring a significant part of the tax discourse from the legal arena to the accounting arena bears substantial implications in three spheres: in legal education; in the participants in the tax discourse (particularly in practice); and in designing the development of the tax discourse. The tax law education must pay

Grounding tax adjustment in accounting theory requires a suitable foundation of appropriate enforceable accounting standards.[54] Adjustment in a CA regime, like the net-worth method, and an explicit partial adjustment regime,[55] are generally achieved through indexing to the CPI,[56] by measuring the change in CPI over the course of the current tax year.[57]

There are two alternatives for transitioning to a CA regime. The first is the "extreme" alternative, transitioning from a non-adjustment regime *directly* to a CA regime with no intermediate steps of implicit or explicit partial adjustment.[58] The second alternative is that of gradual transitioning; going step by step through the adjustment components without jumping *directly* from a non-adjustment regime to a CA regime. The NW method is not the product of a process by which an additional adjustment component is added to a pre-existing partial-adjustment regime in reaction to growing inflation, so that at the end of the process, the regime evolves into a CA regime. Rather, the NW method facilitates a direct transition from a non-adjustment regime to a CA regime without intermediate steps.[59]

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increased attention to the role of accounting. The participants in the tax discourse also change as a greater role is given to accountants as opposed to lawyers. Increasing accounting education and the role of accountants also affects the way tax law develops. One can expect erosion in the status of general legal insights, together with an increase in the importance of accounting insights. Moreover, one can expect a decrease in the scope of dialectic discourse in the tax law discourse, which stems from the substantial dialectical character of the legal education – and which is seen as one of the pinnacles of legal culture – in comparison to the relatively limited dialectic discourse in accounting thought.

54. A proper comparative study of adjustment regimes must also consider the level of the accounting infrastructure in the various countries, due to its importance in a CA regime.

55. For the explicit partial adjustment see Part III C.

56. For a discussion of the appropriate index for adjusting tax regimes to inflation, see Indexing the Individual Income Tax for Inflation, supra note 9, at 30-34; OECD Report, supra note 9, at 27-30. For a discussion of this issue in regard to the general law, see, e.g.*,* Rosenn, supra note 2, at 27-30; Chen, supra note 12, at 1403-29. For a comparative analysis, see supra note 3, at 30.

57. The method measures the change in CPI over the course of the current tax year and not over the course of the previous tax year, since there is no justification for indexing adjustment using the change in the previous year. An identical position must be taken in regard to the elements comprising the second level affected by inflation, i.e., tax brackets.

58. For implicit partial adjustment, see Part III C.

59. Following a decision to adopt CA, several issues, generally of secondary importance, arise. If the income tax regime operated on an accrual basis, switching to an indexing system is not particularly complex. However, since the current classic income tax regime uses the realization requirement, a decision has to be made as to the timing of indexation. Should it be continuous, or performed only

C. Explicit Partial Adjustment and Implicit Partial Adjustment

Partial adjustment can be achieved using one of two models: explicit partial adjustment (EPA) and implicit partial adjustment (IPA).[60] The difference is that EPA relies on indexation for the purpose of adjustment, but not comprehensively, whereas IPA uses other tools in order to neutralize the effects of inflation. The extent of EPA includes three types: The first type applies partial indexation of some of the elements of economic activity. For example, the partial indexation of some capital gains, so that capital gain tax will not be entirely applied to inflation, but only to part, in accordance with the scope of indexation. The second type includes full indexation of some of the elements of economic activity. For example, full indexation will apply only to capital assets so that no capital gain tax will be levied on its inflationary component. The last type applies partial indexing of all the elements of economic activity (e.g., adoption of the NW comprehensive adjustment regime and using only partial indexation instead of full indexation). These patterns of EPA include certain arbitrariness in the rate of indexation or scope of economic elements indexed. It is hard to determine whether the arbitrariness expressed by a partial rate of indexation is greater than that expressed in a partial scope of the indexed economic activities, or vice versa.[61] It should be noted that in terms of compliance costs, there is no difference, regarding the indexation of all components of economic activity between 100% indexation and partial indexation.

The inherent arbitrariness of the EPA, based on the scope of the adjustment's partialness creates infringing affects on distributive justice and economic efficiency.[62] However, there are additional aspects which make the analysis more complicated. For example, macro-economic considerations of an anti-inflation policy[63] argue for reducing the scope of adjustment for inflation as part of the battle against inflation. Granting significant weight to this policy leads to adjustment models that reduce adjustment to a minimum and diminish the use of indexation. Such a policy often prefers employing implicit adjustment methods in order to "hide" adjustment and remove it

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upon realization? The common approach is that capital assets are adjusted upon realization under a CA regime. See, e.g., Halperin & Steuerle, supra note 3, at 363.

60. See Halperin & Steuerle, supra note 3, at 347.

61. Sometimes it is justified to limit the scope of assets subject to indexation for a variety of reasons, primarily that of compliance costs.

62. See, e.g., Goode, supra note 16, at 133. Thus, for example, indexing only capital gains creates distortions. See, e.g., Slemrod & Bakja, supra note 23, at 328. The distortions in partial adjustment create new areas for tax planning and tax arbitrage. See, e.g., Charles E. McLure, Jr., Demographic Shark in the Fiscal Water, *in* Tax Policy in the Twentieth-First Century 33, 43 (Herbert Stein ed., Jon Wiley & Sons 1988).

63. See Part IV D.

from the public agenda. Granting significant weight to political considerations[64] that support a tax policy utilizing adjustment, as a means for granting tax benefits, will lead to the scope of indexation being dictated by the desirable scope of the benefit, and by the areas of economic activity that the tax policy seeks to promote.

IPA is an adjustment model that does not use indexation at all, but rather uses other tools as a proxy for indexation. IPA is also characterized by an element of arbitrariness, in the sense that its partial nature infringes distributive justice and economic efficiency.[65] The consequences of the arbitrariness of EPA are all the more applicable to IPA.[66] In terms of the desirable tax policy, even if there are considerations that support partial, rather than comprehensive adjustment, EPA is preferable to IPA. Like any implicit normative regime, an IPA regime lacks transparency, and is more susceptible to arbitrariness in comparison to an EPA regime. In terms of achieving the goal of neutralizing the inflationary element, IPA is inferior not only to CA, but also to EPA.[67]

IPA can be achieved by various, and at times odd, means including, for example, reduced capital gain tax burdens,[68] accelerated depreciation,[69] reduced tax on dividends,[70] adopting the LIFO method for inventory,[71] and indexation to the exchange rate of a foreign currency that is of particular importance for the local market. IPA can also be "hidden" in the tax treatment of the interest expense, by imposing arbitrary limitations on the deductibility of the expense, while completely ignoring the actual rate of

64. See Part IV F.

65. Thuronyi, supra note 1, at 443-45; Shuldiner, supra note 1, at 563-66.

66. On the distortions of a lower capital gains rate as a mean for IPA, see Martin Feldstein & Joel Slemrod, Inflation and the Excess Taxation of Capital Gains on Corporate Stock, 31 Nat. Tax J. 107 (1978).

67. See Halperin & Steuerle, supra note 3, at 348.

68. See Shuldiner, supra note 1, at 563-64; Halperin & Steuerle, supra note 3, at 353-55; Joint Comm. on Tax'n, General Explanation of the Revenue Act of 1978, at 252 (United States Printing Office, 1979). For a discussion of whether reduced capital gain tax burden constitutes partial adjustment, see Musgrave, supra note 7, at 379; Walter J. Blum, A Handy Summary of the Capital Gains Arguments, 35 Taxes 247 (1957); Noel B. Cunningham & Deborah H. Schenk, The Case for a Capital Gains Preference, 48 Tax L. Rev. 319 (1993); Alvin C. Warren, Jr., The Individual Income Tax, *in* The Promise of Tax Reform 37, 54-55 (Joseph A. Peachman ed., Prentice Hall 1985).

69. See Halperin & Steuerle, supra note 3, at 355; David F. Bradford, Untangling the Income Tax 52-53 (Harvard Univ. Press 1986).

70. See Halperin & Steuerle, supra note 3, at 356; Shuldiner, supra note 1, at 569-74.

71. See Shuldiner, supra note 1, at 613-617; Halperin & Steuerle, supra note 3, at 356; Strnad, supra note 15, at 258.

inflation.[72] The same is applying on interest income, e.g., by recognizing only part of interest income as taxable income, or by applying a reduced tax rate to a nominal interest income. The realization requirement may also constitute IPA, inasmuch as the effective tax liability that stems from nominal measurement, is set off, partially or fully, by the tax benefit inherent to tax deferrals.[73] It should be emphasized that there are tax arrangements that inherently create IPA, although it is not their original function or purpose, and, therefore, they do not require adjustment for inflation. Setting off financial expenses against financial income makes an adjustment of these tax items. This is also the case with tax-exempt income, such as capital gains[74] or interest income produced by tax-exempt organizations.[75] Shortening the taxable period of the tax base is also a technique for achieving IPA.[76]

II. General Tax Policy Considerations

A. General

What are the considerations in choosing among NA, EPA, IPA and CA? The cornerstone for this analysis discussion is that CA is preferable to EPA or IPA, or NA, inasmuch as CA completely neutralizes the inflationary component and therefore increases distributive justice and economic efficiency.[77] In other words, inflation's substantive effect on the central goal of the tax system – just and efficient collection of just and efficient taxes – lessens as adjustment increases, and adopting CA completely eliminates that effect.[78] Inflation rates and tax rates[79] also appear to exert an influence over the choice of adjustment regime. The higher the inflation rate, the greater the tendency to increase the adjustment component in the tax regime. Tax rates

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72. See Halperin & Steuerle, supra note 3, at 368. The partial method creates difficulties for financial institutions. See Halperin & Steuerle, supra note 3, at 369-70.

73. For a critique of this model of IPA, see, e.g., Strnad, supra note 15, at 252.

74. For example, the tax exemption of capital gains due to the "step-up in basis" doctrine applying on death.

75. See Halperin & Steuerle, supra note 3, at 353; See also note 11.

76. See also text accompanying note 25 et seq.

77. See Halperin & Steuerle, supra note 3, at 372.

78. When inflation is not steady but exists at a fluctuating rate, CA is particularly preferable in terms of the neutrality of the tax system. See Mark Perlis, *Comments*, *in* Uneasy Compromise: Problems of a Hybrid Income-Consumption Tax 373 (Aaron et al. eds., Brookings Inst. Press 1988).

79. See, e.g., Halperin & Steuerle, supra note 3, at 349.

operate in a similar manner. The higher the tax rates, the greater the tendency to increase the scope of adjustment (although this variable exerts less influence than the inflation rate variable). Nevertheless, I argue that the effect of these two variables must be considered in the broader context of the various tax policy considerations, analyzed below.

Under an extreme level of inflation, the inflation rate will have greater, if not decisive, influence. In an environment of triple-digit inflation, for example, we may expect the tax system to introduce a CA regime. In contrast, at a very low inflation rate we may reasonably expect the tax system to opt for non-adjustment or "soft" partial adjustment. However, we should bear in mind that the discussion of the appropriate adjustment regime does not, in general, address inflation rates at the extreme ends of the spectrum, but rather "moderate" inflation rates. The variables of inflation rate and tax rate are also built into the various tax policy considerations that will be addressed below.

B. Cost-Benefit Analysis

The cost-benefit analysis examines the cost of adopting an adjustment regime, of one model or another, compared to the benefit it provides. Among the social benefits sought are distributive justice and economic efficiency of the tax regime. The more comprehensive the adjustment regime, the more successful it will be at attaining these goals. The same is true for the choice between IPA and EPA. Generally speaking, the more explicit the adjustment, the more just and efficient it will be.[80]

Opposite the benefits stand the compliance costs,[81] which can be divided into two groups: First, the initial costs of introducing the comprehensive or partial adjustment to the tax administration and the taxpayers. These costs are fixed. The second group comprises the variable

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80. See the discussion regarding the weaknesses of an implicit adjustment regime which are reflected in the capital gain tax regime through reduced capital gain tax rates. Shuldiner, supra note 1, at 563-64.

81. See*,* e.g.*,* Indexing the Individual Income Tax for Inflation, supra note 9, at 43. This analysis considers the difficulties in adjusting fixed amounts (the second level). Of course, indexing the tax basis creates more complexity and compliance costs. See also The Adjustment of Personal Income Tax Systems for Inflation, supra note 9, at 12 (recommending retaining the nominal adjustment regime in the case of, for example, a low inflation rate or when revenue from income tax represents a small part of the budget. The reason for this is cost-benefit considerations). The compliance costs also include the difficulty in enforcement that derives from non-adjustment of criminal penalties in the tax law. For this issue see Report to the Comm. on Finance, Tax compliance: Inflation Has Significantly Decreased the Real Value of Some Penalties (United States Accountability Office 2007).

annual costs of operating and maintaining the adjustment regime. The costs of adopting and operating a comprehensive adjustment regime are higher than those of EPA,[82] and certainly higher than those of IPA.[83] The classical discourse on adjustment for inflation employs arguments regarding the complexity of adjustment regimes, reflected on the compliance costs side, in order to reject or adopt them; this is particularly so in regard to CA.[84]

C. The General Culture Paradigm: Nominalism or Adjustism

The most influential factor affecting adjustment for inflation of a tax system is the general cultural of adjustment, in which adjustment for inflation in the tax arena is but one element of a broader cultural phenomenon referred to in this article as "the general culture of adjustment for inflation." In other words: What is the cultural character of the social order: A culture of adjustism or a culture of nominalism?

Addressing adjustment of the tax regime divorced from the other elements of social order is mistaken and undesirable. Effort should be made to match the scope of adjustment of the tax regime to a society's general culture of adjustment for inflation. The phenomenon of inflation affect a substantial fraction of human activity and it greatly influences the entire social order, and not just taxes. The extent of a tax regime's adjustment, whether comprehensive or partial, should be set up in accordance with the general culture of adjustment as reflected in the social order. The tax system's approach to inflation must be consistent with the way that society contends with inflation in general. Focusing exclusively on the issue of adjusting the tax system for inflation, while ignoring or discounting the issue of adjustment in other branches of the social order, creates an internal imbalance in the social order. This imbalance is created because risk

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82. From the compliance cost perspective, it is irrational to support the introduction of explicit partial adjustment that includes the entire economic activity, but adopts partial indexation. There are generally no marginal compliance costs in transferring from less than 100% indexation to 100% indexation.

83. Implicit adjustment is generally of an arbitrary nature, so the compliance costs involved tend to be relatively low compared to the scope of such costs in an explicit adjustment regime.

84. See, e.g., Slemrod & Bakja, supra note 23, at 35. The complexity argument has also been employed to reject partial adjustment. Thus, for example, the rejection of the recommendation for partial-adjustment by full indexing of capital gains was based upon complexity, along with the argument of tax arbitrage, see, e.g., Bartlett, supra note 9, at 16-17. It should be emphasized that, often, among the costs of maintaining a nominal regime is the harm to the tax system as a result of the intensive preoccupation with the issue of whether or not to adjust for inflation. Focusing on this issue may deviate attention from other tax issues. Introducing adjustment into the tax regime "frees" the society to address the other tax issues.

management's policy towards the risks of inflation in the tax arena will differ from the risk management's policy towards inflation in other areas of the social order.[85] Introducing an adjustment regime only in the tax arena shows that society is unwilling to expose itself to inflationary risks in regard to tax, while it tolerates leaving other social components open to inflationary risk.

The proposed paradigm reflects a broader approach according to which the tax discourse should not be viewed as an autonomous cultural discipline that is separate from the general discourse of the social order as a whole, which captures society's dominant cultural attitudes.[86] The tax system should not be analyzed independently of the general social order regarding the cultural issue of nominalism or adjustism. Adjustment for inflation is social, legal, economic and political insight purposed to cope with the phenomenon of inflation. In general, every social institution must attain normative, legal or social recognition in the social order before it is recognized by the tax system, and this approach has to apply on the adjustment for inflation as a social institution as well. The tax regime, in general, is a normative system that "hovers above" human activity, gathers "select" elements ("tax events"), and taxes them. In fulfilling its role, the tax regime develops a dialogue with that human activity in terms of language (concepts, etc.) and discourse that derives from its legal institutions. This is the cornerstone of any analysis of desirable tax policy, and it changes only if there are weighty arguments that require deviation.

The social order conducts a broad and ongoing, sometimes painful, dialogue with the phenomenon of inflation. One of the important variables in this dialogue is the institution of adjustment for inflation. This institution is not unique to tax regimes, but is both relevant and necessary to every field of law. If a society has a culture of adjustism, that culture will be reflected across the entire spectrum of the social order. Normative recognition of the institution of adjusting for inflation must, first and foremost, find expression in the social order as a whole and not in its tax regimes alone. Tax regime recognition of the adjustment institution will not precede its general acceptance of the social order. Is it conceivable, for example, that changes in family structure – like the "new family" – will be recognized by the tax regime before first achieving recognition in the social order, i.e., in family law? I have chosen an example from the family arena in order to emphasize that the difference between a nominalistic perspective and an adjusted perspective is no different in our context than the said change in the context of family law. One cannot a priori discount the possibility of circumstances

85. See, e.g., Chen, supra note 12, at 1430.

86. Thus, for example, the issue of fairness in the tax arena should be addressed from a broader perspective, so that it focuses not merely on tax fairness, but on social fairness. See Liam Murphy & Thomas Nagel, supra note 18, at 173.

that might lead to incoherence between the social order and the tax regime, but such a situation would be exceptional. The adjustment for inflation cannot be categorized as such an exception.

Introducing a CA regime into a tax system requires the existence of a broad culture of adjustism, founded upon a valoristic perspective at the various levels of the social order, particularly the economic level. Thus, it would be unreasonable that the concept of "profit," in the income tax regime, will be based upon real values (adjustism), while, for example, the same concept will be based upon nominalistic values in the corporate law. It would not be undesirable to adjust the tax system for inflation, while accounting practice, for example, remains unadjusted. A culture of adjustment for inflation in the economic sphere means that the economic and commercial discourse – not just in the tax arena – be conducted in real terms. Hence, for example, a firm's profitability will be established in real terms, and investment strategies will be based upon a real analysis. The measurement of taxable income ("tax accounting") may differ from economic or financial accounting measurements. Such differences derive, primarily, from tax-policy aspects according to which income tax law must deviate from accounting or economic measurement practices in appropriate circumstances. But it would be difficult to present tax policy considerations that would justify a substantive difference among these disciplines in regard to adjusting for inflation. Moreover, inasmuch as CA regime is based upon accounting, it would be unreasonable to adjust the tax system for inflation while leaving accounting practices unadjusted.

To put it differently, the inflationary phenomenon presents a challenge to a broad cross section of the social order regarding the adjustment.[87] The general culture of adjusting to inflation is developed through the contending with this challenge, and an adjustment means thus enter into various areas of the social order. The adjustment culture contains a wide variety of adjustment mechanisms and the issue of adjusting the tax regime for inflation does not stray from the general discourse, in the sense that adopting a regime for adjusting the tax system for inflation cannot be described as audacious, extraordinary, too complex or "strange" to the general public discourse.

Adjustment for inflation is not an exclusively technical issue of computations, so that the discussion is limited to technical issues. It is not just an economic or accounting technique, as one might imagine from looking at the classical tax literature. Adjustment of the tax system is an inseparable component of an economic, social and political culture that adopted the fundamental insight regarding the meaning of money. The adjustment insight denies a nominalist approach to money based on nominal

87. See, e.g., OECD Report, supra note 9.

terms and prefers a valoristic system that focuses on the value of money in terms of purchasing power.

Converting nominalist values with valoristic values as a culture involves far-reaching consequences for the social order, of which the tax system is not the primary focus. When a society faces significant inflation and its democratic structure and social and economic institutions are preserved and continue to function, it is a reflection of the existence of the culture of adjustism.[88] In the absence of such a culture, the foundations of the economic and social structure will be damaged, perhaps beyond repair, as a result of inflation's effects on distributive justice and economic efficiency.[89] The proposed paradigm is not based solely on a coherent normative or doctrinal approach, but also and mainly on distributive justice and utilitarian considerations. Thus, for example, as the number of non-tax adjustment regimes increases, the compliance costs associated with adopting and maintaining adjustment regimes for tax will be decreased.

This paradigm does not argue that the tax regime must "wait" until *all* other components of the social order adjust for inflation. The tax regime requires the social order's substantive recognition of adjustment, and this usually comes about as a result of its absorption of a critical mass of non-tax adjustment arrangements in the social order. This critical mass provides the platform for the adoption of an adjustment arrangement in the tax arena. Generally speaking, the tax regime *reacts* to social and economic changes, but does not *initiate* them. It is an inseparable part of the legal system, which, as a rule, *responds* to social change. Not only will the tax regime not lead the way, it will usually lag behind other institutions, because it tends to be one of the more conservative branches of the social order.[90] Therefore, the tax discourse will not address the issue of adjustment immediately upon the onset of inflation, but will require an "introductory" period for the development of a public discourse on adopting strategies for adjustment for inflation in the various branches of social order. A similar process will take

88. On the constitutional implications of adjustment for inflation, see, e.g., Chen, supra note 12, at 1388-95; Fred Wertheimer & Susan Weiss Manes, Campaign Finance Reform: A key to Restoring the Health of Our Democracy, 94 Colum. L. Rev. 1126, 1142 (1994): Rosenn, supra note 1 (analyzing the effect of inflation on the various branches of law); United States v. Soderna, 82 F.3d 1370 (7th Cir. 1996).

89. On the political economics of inflation, see, e.g., The Political Economy of Inflation, (Fred Hirsh & John Goldthorpe eds., Harvard Univ. Press 1978).

90. There are several reasons for this. The tax system is technically complex, cumbersome and conservative in the sense that it does not take risks and demands a relatively high degree of certainty of success; The tax system often serves as an arena for political grappling in regard to political approaches of considerable economic and social importance that are ultimately decided through a long process. Lastly, there are often powerful elements of society that support preserving the status quo.

place when the rate of inflation decreases, and the social agenda addresses the issue of rescinding adjustment regimes. Here, too, the tax regime will respond only after the crystallization of a culture of nominalism in the primary levels of the social order. This characteristic of the tax system means that it will neither be the first to adopt nor the first to repeal adjustment mechanisms.

This approach clarifies the United States environment regarding adjustment for inflation, including the tax regime.[91] The American discourse on adjusting the income tax regime for inflation, which first took place in the late nineteen seventies and early nineteen eighties, was unproductive from the start, and was doomed to failure because the U.S. culture of adjustism was not sufficiently ripe for justifying or permitting a "legitimate" social decision on adjusting the tax system for inflation. It would have been entirely unreasonable to expect the tax system to adopt adjustment regime when the American social order did not comprise the requisite normative adjustment infrastructure within which tax adjustment could develop. There was little academic writing on adjusting the social order for inflation of its non-tax components, despite the impact of inflation on the American economy and society.[92] American legal discourse did not perceive the issue of adjustment for inflation to be the kind of fundamental cultural issue that would warrant in-depth theoretical research from a broad perspective. This discourse reflected a deeply rooted and pure nominalistic culture.

Although the American theoretical tax research laid the appropriate groundwork for adopting an adjustment regime,[93] that groundwork did not achieve statutory expression. Political discussions highlighted the complexity behind adjustism in order to reject its adoption.[94] The complexity argument

91. See, e.g., Advisory Comm. on Intergovernmental Relations, Inflation and Federal and State Income Taxes: A Commission Report (1976).

92. Chen, supra note 12, at 1378-79.

93. Differences in adjustment culture are also reflected in attitudes towards changes in the monetary currency itself. Thus, for example, in regard to replacing bills with coins, which reflects the diminished importance of the sum formerly represented by the bill now represented by the coin, a country with a pure culture of nominalism will be more resistant to changing its currency than a country with a culture of adjustism. Despite the aggregate inflation in the U.S. over the years, the currency has not been replaced, and, for a very long time, there was no substantial attempt to exchange bills for coins. The recent move of introducing a one-dollar coin alongside the dollar bill does not seem to have been met with success. In this issue, nominalism is reflected in symbolic and psychological manifestations that ascribe significant importance to the status quo.

94. In 1984, the U.S. Treasury recommended an adjustment regime based on indexing the tax system, but the recommendation failed to garner support, primarily due to the complexity argument. See Treasury Dep't, Tax Reform for Fairness Simplicity and Economic Growth, at 97 (1984); David A. Weisbach, The

was largely rhetorical, since the primary reason for rejecting adjustment for inflation was the pervasive nominalistic culture of the American society. While there are some isolated instances of adjustment for inflation, they are inconsequential compared to the overall nominalistic approach, and do not affect the general nominal character of the American culture.[95] Therefore, it is reasonable to predict that even if the rate of inflation were to rise, it is doubtful that the tax system will adopt CA or even EPA regime in the absence of parallel developments in other levels of the social order. The prevailing American culture of nominalism leaves little room for any kind of adjustment for inflation other than IPA.[96]

The foregoing leads to the conclusion that there must be general equilibrium in the overall culture of adjustism[97] between the social order as a whole and in the tax regime. This equilibrium is twofold. First, it would be hard to justify an economic, social and legal system characterized by adjustment regimes in the central levels of the social order, but lacking a parallel adjustment regime for its tax regime. Second, it would be hard to justify the opposite situation of adjustment of the tax regime when such adjustment is lacking in other central levels of the social order. This is true particularly in the case of CA regime. The upshot is that increasing the level of adjustment for inflation in the other levels of the social order is crucial for promoting the adjustment of the tax regime, especially in regard to CA

(Non) Taxation of Risk, 58 Tax L. Rev. 1, 13-14 (2004); Slemrod & Bakja, supra note 31, at 238; David F. Bradford and the U.S. Treasury Tax Policy Staff, Blueprints for Basic Tax Reform 75 (2nd Revised ed., 1984); Henry J. Aaron, Inflation and The Income Tax: An Introduction, *in* Inflation and The Income Tax, supra note 1, at 29**.**

95. See, e.g., David Leonhardt, Some Rain On the Parade On Wall St., N.Y. Times, July 18, 2007, Business Day, at C1; Calabresi, supra note 15, at 66-68, tried to explain America's nominalistic laws, but with only limited success. In my opinion, the answer lies in the general nominalistic culture that pervades the American experience as a whole, and that is reflected in the social order and legal discourse. For a detailed description of the depth of the nominalism in the American laws, see Chen, supra note 12.

96. For example, reduced capital gain tax rate, based on the perspective that it is an IPA regime.

97. Two types of equilibrium must be distinguished in regard to adjustment for inflation. The first is "external" equilibrium that characterizes the various elements of the social order – i.e., if and to what extent the social order has adopted a culture of adjustism/nominalism. The second is the "internal" tax equilibrium that treats of the equilibrium among the various elements of the tax regime itself. For example, adjustment for inflation only of capital assets without a parallel adjustment of liabilities creates an imbalance. There is a certain relationship between the two, in the sense that the greater the general external equilibrium, the greater the tax internal equilibrium.

regime. Only an increased culture of adjustism in the social order will enable the appropriate, parallel adjustment for inflation of the tax regime.

It appears that the deciding factor behind adjusting for inflation is the existence of a general culture of adjustment to inflation. This view differs from the classical approach that imputes far greater importance to cost-benefit considerations, in particular with CA regime. Complexity, which has served as a primary defense against the adoption of adjustment regimes, is a concept found in the cost-benefit lexicon. The classical approach[98] utterly disregards the general culture of adjustment for inflation. It does not address the relationship between the scope of the general adjustment culture and the extent to which the tax regime adjusts. Thus, the tax discourse on the issue of adjustment does not see itself as part of the general discourse on adjustment, whether in theory or in politics, and addresses adjustment from a technical perspective.

The compliance costs are relatively unimportant in the debate over adoption of adjustment for inflation in modern tax systems that operate in a developed and sophisticated technological environment. In such an operating environment, the introduction and the maintenance of even a CA regime do not involve substantial compliance costs that might deter its adoption. In the area of compliance, tax systems contending with substantive and technical issues are no less complex, and often considerably more complex, than adjusting for inflation. For example, the prevailing regime of international tax requires comprehensive treatment of international economic activity, or the complicated issue of taxation of financial instruments.[99] The complexity of these two issues is certainly no less than that of adjustment for inflation. It should be emphasized that this approach does not deny the influence of all of the other considerations mentioned in this chapter on the decision-making process regarding the introduction of an adjustment regime. However, their relative weight is not significant compared to the substantial importance of the paradigm of the general culture of adjustment.

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98. See the literature cited in notes 1, 3 and 9.

99. See, e.g., Alvin C. Warren, Jr., U.S. Income Taxation of New Financial Products, 88 J. of Public Econ. 899 (2004); Alvin C. Warren, Jr., Financial Contract Innovation and Income Tax Policy, 107 Harvard L. Rev. 460 (1993); David. P. Hariton, The Taxation of Complex Financial Instruments, 43 Tax L. Rev. 731 (1988); J. P. Simon, Selected Federal Income Tax Aspects of Securitizing Debt Obligations, 66 Taxes 897 (1988); Reed Shuldiner, A General Approach to the Taxation of Financial Instruments, 71 Tex. L. Rev. 243 (1992); Reed Shuldiner, Consistency and the Taxation of Financial Products, 70 Taxes 781 (1992); Jeff Strand, Choosing a Tax Treatment for New Financial Products, 46 Stan. L. Rev. (1994); George C. Howell, III & Cameron N. Cosby, Exotic Coupon Stripped: A Voyage to the Frontier Between Debt and Options, 12 Va. Tax Rev. 531 (1993). An analysis of these articles reveals a theoretical complexity greater than what is argued in regard to adjusting tax regime for inflation.

There are two arguments for the exclusive focus on cost-benefit considerations, which ignore the perspective of the general culture of adjustment. The first is that cost-benefit considerations exist in every decision-making process. The second is that when we address tax issues like the one before us, there is a tendency to adopt a utilitarian view that focuses on cost-benefit considerations to the exclusion of other factors such as cultural influences. This tendency is consistent with the broader tendency to view tax law as one of the most, if not the most, "utilitarian" areas of the social order in terms of excluding cultural arguments. In my view, in the tax law arena, as in every other normative sphere, the cost-benefit analysis is not the only player. The discourse has to adopt a broader and richer analysis based also on cultural infrastructure as well.[100] The general culture of adjustment for inflation provides a good example, as it provides a broader perspective on society's monetary culture, including its psychological and sociological aspects.[101]

There are powerful forces in society that are not interested in adjustism. For example, in certain circumstances, it is worthwhile for the financial sector to continue to communicate in nominal rather than real terms (as would be required by a general adjustment culture). This is primarily true in regards to the discourse between this sector and the common household. It prefers nominal discourse to real discourse since nominal measurements tend to show higher levels of profitability than real measurements.[102]

The choice between a CA regime and an IPA or EPA regime is also influenced by the general culture of adjustment. The level to which this culture has taken root in the social order will be expressed in the scope of adjustment chosen. When the adjustment culture is not pervasive, but there is an awareness of the substantial need for adjustment in tax law, a regime of IPA will be adopted. IPA is a device for bridging the gap between the tax discourse and the general discourse in the social order on the adjustment issue. EPA is premised on a limited general adjustment culture, and will be adopted when the social order is primarily nominalistic, with "adjustment islands." This is especially true when the cultural reality is one of a dynamic character, where nominalism is in the process of erosion due to an increasing public discourse on adopting an adjustment regime. From this perspective, it is reasonable to conclude that the general adjustment culture in the U.S. had not even reached the level that enables EPA of the tax regime. The American

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100. This issue requires a separate and more comprehensive analysis than can be provided in the confines of this article.

101. See, e.g., Nigel Dodd, The Sociology of Money: Economics, Reason & Contemporary Society (Continuum Int'l 1994) (especially Chapter 3: "Cultural Aspects of the Mature Money Economy," beginning on pg. 41).

102. Regarding deflation, see Strnad, supra note 15, at 247-50.

social order is characterized by a purely nominalistic culture,[103] and whatever adjustment islands exist are insufficient to justify the introduction of EPA into the tax regime.

As noted, the general adjustment cultural paradigm is of crucial importance in deciding between a nominalistic regime, a regime of partial adjustment or of comprehensive adjustment. It also influences the choice between IPA and EPA. However, it does not help in making the choice between various IPAs or various EPAs.[104] In this regard, the suggested paradigm is of little influence in relation to the relative weight of other considerations.

The general adjustment culture may be dynamic and can respond to the scope and challenges of inflation faced by society. The more nominalism is culturally ingrained, the greater the inflationary challenge needed to spur change. The tax regime may adopt IPA or EPA, but as the non-tax environment takes on an increasingly adjusting character over time, the partial adjustment regime will gradually fall out of step with the general adjustment culture. This will be the case, for example, with a tax system that adopts an IPA without any indexing component. If, over time, indexing becomes increasingly common in other areas of the social order, the absence of even partial indexing in the tax system will be perceived as unjustified.

The influence of the general culture paradigm on adjustment for inflation is not limited to such fundamental tax issues as the model and scope of adjustment of the tax regime. It is also manifested in areas of secondary importance, such as whether the adjustment regime will operate automatically or whether it will require the exercise of discretion of administrative agency.[105] The more pervasive the adjustment culture, the greater the tendency toward automatic adjustment without an exercise of discretion.

One can argue that the ultimate proof of the primacy of a cost-benefit analysis is that it can reasonably be assumed that at particularly high rates of inflation, tax regimes will adopt CA. This is because in a highly inflationary environment, the benefit to be gained from adjustment outweighs the cost. This argument is incorrect. In reality, at high rates of inflation we can expect to find a developed general adjustment culture that has introduced adjustment mechanisms across the social order, such that CA of the tax regime is consistent with the society's general adjustment culture.

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103. For a general description on the United States legal approach to adjustment to inflation, see, Chen, supra note 12.

104. Cost-benefit considerations are of particular importance in these decisions.

105. See text accompanying note 46.

There are countries, like the United States[106] and others,[107] in which tax brackets are adjusted, as are various fixed sums set by the tax system,[108] even though there is no general adjustment culture. This kind of adjustment represents the outer limit of the tax system's ability to include elements of adjustment in a social order dominated by nominalism. Such adjustment is possible only because it does not clash with other areas of the social order, inasmuch as these variables are unique to the tax system. This is different from the fundamental tax concepts of "profit" or "income," which stand at the center of the social order's economic activity (corporate law, accounting, etc.).

The proposed paradigm is tied to a broader issue. Two tax culture approaches can be distinguished in the tax discourse. The first is the isolationist approach, which views the tax culture as set apart from other areas of the social order. This approach is reflected in classical legal discourse, which does not always include tax law as its normative participant. Another approach is the coherent approach, according to which the tax discourse forms an integral part of the general social order. The proposed paradigm in this study is premised on the coherent, rather than the isolationist approach.

D. Nominalism as a Stabilizer

From an economics perspective, nominalism contributes to price level stability, and thus works against inflation. Under a macro-economic theory, according to which comprehensive adjustment of the social order to inflation may cause society to become "reconciled" to inflation, makes the marketplace indifferent to inflation. The "reconciliation" will perpetuate and even intensify inflation.[109] According to the Rational Expectations

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106. See text accompanying note 23.

107. For example, in Canada, France and the U.K., tax brackets are adjusted for inflation. See, e.g., Brian J. Arnold, Genaral Description: Canada, *in* Hugh J. Ault, Comparative Income Taxation, a Structural Analysis 25, 26 (Kluwer Law Int'l 1997); Guy Gest , Genaral Description: France, *in* Hugh J. Ault, Comparative Income Taxation, a Structural Analysis 39, 41 (Kluwer Law Int'l 1997); John Tiley, Genaral Description: United Kingdom, *in* Hugh J. Ault, Comparative Income Taxation, a Structural Analysis 109, 117 (Kluwer Law Int'l 1997); See also note 23.

108. For this component of adjustment regime, see text accompanying note 23.

109. Bannock et al., The Penguin Dictionary of Economics, 7th Ed. 183 (Penguin Books 2004) ("*'Indexation'*…While indexation reduces the cost of inflation, some economists believe it entrenches inflationary expectations and makes it harder to get inflation down…."); Fisher, supra note 14, at 193 ("The main reason governments are reluctant to adopt price indexation in their own transactions and

Theory,[110] the inflation includes fundamental psychological aspects, making it important to restrict the scope of economic regimes that introduce CA. Institutionalizing adjustment as part of the social order sends a clear message to the public that inflation will continue.[111] This argument has been the subject of criticism.[112] In addition, non-adjustment of the tax system can be

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encourage its use in the private sector is that indexing is thought to be inflationary. The argument is that an indexed economy inflates more, and more rapidly, in response to an inflationary shock than does a nonindexed economy, given the monetary and fiscal policies being followed. It is also argued that the will to fight inflation is weakened when the costs of inflation are reduced by indexing – equivalently, that the adoption of indexing affects the choice of policies.") See Shuldiner, supra note 1, at 546; The Implication for Economic Stability of Indexing the individual Income Tax, in Inflation and The Income Tax, supra note 1, at 173-74, 187-88 (1976); Hirschberg, supra note 2, at 151-52. For a discussion of this argument and the counterarguments, see Milton Friedman, Monetary Correction: A Proposal for Escalator Clauses to Reduce the Costs of Ending Inflation 29-32 (Inst. of Econ. Affairs 1974).

Tax regimes function as a stabilizer as well and the nominal character of the tax regime could be viewed as a stabilizer. For the stabilization function, see, e.g., Yair J. Listokin, Stabilizing the Economy Through the Income Tax Code, 123 Tax Notes 1575 (2009).

110. See, e.g., Thomas Sargent, The Ends of the Four Big Inflations, in Inflation: Causes and Effects 41 (Robert E. Hall, ed., Univ. of Chicago Press 1982). This study looks at inflation in Germany, Austria, Poland and Hungary between the two World Wars and the effects of Rational Expectations Theory on inflation rates.

111. OECD Report, supra note 9, at 17.

112. For criticism of these macro concerns, see, e.g., Fisher, supra note 14, at 215 ("The theoretical development of section . . . implied that indexation does put potential destabilizing mechanisms in place that will worsen the impact of an inflationary shock, given monetary and fiscal policies that link money growth to the budget deficit. But it was also emphasized that the link between inflation and indexation is not inevitable, and that appropriate policies can prevent the inflationary shock-cum-indexing effect on the budget deficit that is responsible for the result. The empirical evidence, presented in table…, is that the inflationary response to the oil shock in countries with indexation was not significantly larger than in other countries. This suggests that the indexed countries followed policies that mitigated the inflationary impact of the oil shock, or those other countries' policies permitted the oil shock to affect prices as much as it did in indexed countries. Evidence that money growth rates responded *more* to the oil price shock in nonindexed countries supports this view.").

seen as a tool for price stabilization.[113] This position is controversial as well.[114]

Under the above theories, even if a cost-benefit analysis supports CA of the tax regime, it should be rejected in order to attain the anti-inflationary goal of price stability. In the general fight against inflation, we must bear the cost of maintaining a non-adjusting tax system. However, there is an advantage to IPA since it "conceals" adjustment from the public. This explains why tax systems adopt IPA despite its inherent substantive distortions. This macro-economic consideration creates a hierarchy among adjustment regimes, giving high preference to a non-adjusting regime, followed by IPA, EPA, and finally, CA.[115]

E. Tax Collection Considerations

In general, tax collection is greater in a non-adjusting tax system as compared to a comprehensively adjusted tax system (hereafter: "the basic tax collection insight").[116] Thus, converting a non-adjustment regime to that of partial or comprehensive adjustment, or increasing the scope of adjustment, leads to a decline in tax collection.[117] These changes in the adjustment regime are, therefore, not characterized by tax collection neutrality, and may, therefore, be rejected or delayed due to budgetary constraints. In this regard, these changes are no different than any other structural reforms in the tax system whose adoption, scope and timing may be affected by concern over tax collection. These collection considerations are such that the decision to adopt an adjustment regime is not solely contingent upon the tax-inflation discourse, but is also affected by the general tax discourse, inasmuch as there may be other tax areas that require reform and that involve tax collection

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113. James L. Pierce & Jared J. Enzler. The Implication for Economic Stability of Indexing the Individual Income Tax, *in* Inflation and the Income Tax, supra note 1, at 141, 173; Indexing the Individual Income Tax for Inflation, supra note 9, at 21-22.

114. Shuldiner, supra note 1, at 546.

115. For a discussion of the issue whether the tax system should be employed to contend with macro-economic issues, see, e.g., Strnad, supra note 15, at 249-50.

116. See, e.g., Henry J. Aaron, Inflation and The Income Tax: An Introduction, *in* Inflation and The Income Tax, supra note 1, at 16-17; Indexing the Individual Income Tax for Inflation, supra note 9, at 10-11; Margalioth, supra note 41, at 209. See also W. Elliot Brownlee, Federal Taxation in America: A Short History, 135-36 (Cambridge Univ. Press 2004) (the historical public debate in the U.S. regarding the adjustment of tax brackets and fixed amounts, where collection considerations weighed against those adjustments).

117. Collection considerations can support making adjustment subject to discretion. See, e.g., OECD Report, supra note 9, at 30.

declines. Budgetary constraints thus impose trade-offs among the various tax issues, including that of adjustment for inflation. The existence of a nominalistic culture versus a culture of adjustism is of particular importance in this regard, because the greater the extent of the latter, the greater the tendency toward adjustment despite concerns over tax collection.[118]

F. Political and Social Considerations

Introducing the adjustment tax regime constitutes a change in the economic, social and political status quo and it may face considerable political opposition. During a period of inflation, a non-adjusting tax regime increases the tax burden. It allows an increase in the effective tax without increasing the tax rate,[119] and politicians are fond of hidden taxes.[120] Furthermore, there are taxpayers who benefit from non-adjustment,[121] and will join the politicians and supporting the nominalistic status quo by opposing the adjustment, based on a variety of arguments mentioned above.[122]

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118. It should be noted that sometimes part of the discussion devoted to tax collection decline in deciding the character of the adjustment regime focuses also on the difficulty that will be caused in regard to the budget, both in terms of planning and in terms of execution. This issue reflects, inter alia, a political argument according to which adjustment limits political maneuverability compared to its scope in an environment of nominalism (on the political aspects of the adjustment issue, see Part IV F below). Part of the debate on budgetary issues focuses on the lack of equilibrium in the budgetary process because some of the elements of the budget are adjusted for inflation, while others are not. It should be pointed out that this argument should be seen as part of the culture of adjustism/nominalism of the social order which comprises the budgetary process as well. For an analysis of the various arguments concerning the relationship between inflation, adjustment for inflation and the budgetary process in both its components, see, e.g., Indexing the Individual Income Tax for Inflation, supra note 9, at 14-25.

119. Indexing the Individual Income Tax for Inflation, supra note 9, at 15. See also W. Elliot Brownlee, supra note 116 at 126-28, 133) (historical analysis of this phenomenon in the United States in the course of various inflationary periods, particularly following the two World Wars, and in the course of the nineteen seventies (primarily in the second half of the decade)).

120. See, e.g., Sven Steinmo, Taxation and Democracy: Swedish, British and American Approaches to Financing the Modern State 19 (Yale Univ. Press 2004); Milton Friedman, supra note 119, at 13-15.

121. As a result of the nature of their economic activity or as a result of their tax arbitrage.

122. One of the central variables in the cost-benefit debate is the high operating cost of an adjusting regime. Thus, for example, supporters of the non-adjusting status quo have argued in the past that adjusting tax brackets and fixed

Political powers prefer arrangements that involve political decisions or administrative discretion[123] so they have the potential to be used or even abused in various alternatives, based on the political arena. One of the main arguments raised in the U.S. against adopting adjustment regimes is that a comprehensive and automatic adjustment regime would prevent the political echelon from annually reexamining the tax system in its entirety in order to uncover tax arrangements that should be redesigned. This argument is wrong for four reasons: First, it would be exceedingly difficult to produce tax cuts that could precisely offset excess taxes, both in terms of scope and entitled taxpayers, resulting from non-adjustment. Second, this practical difficulty infringes economic efficiency. Third, it is possible that the distortion created by non-adjustment is more substantive than the other distortions that may be discovered. Fourth, this argument undermines any possibility of tax reform intended to correct distortions. Moreover, such an argument[124] allows the political echelon to retain tremendous power to "correct" inflationary damage by means of tax reductions in other areas, while not addressing them in the primary area of adjustment for inflation.

Adopting a CA regime sets aside political considerations, since this regime comprises an all-inclusive, precise, automatic mechanism that, by its nature, neither requires nor is subject to purely political decisions. It is an independent normative regime that is not directly or indirectly dependent on the ongoing political discourse. In contrast, IPA and EPA regimes do involve the political discourse, which may explain their greater appeal,[125] as well as the continued widespread use of IPA, despite its general inferiority to

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amounts in the income tax regime presents a difficult and complex challenge; see, e.g., W. Elliot Brownlee, supra note 116, at 6-135.

123. The primary argument for adopting automatic mechanisms is that of distributive justice. For the issue of automatic adjustment and discretionary adjustment, see Richard Goode, Government Finance in Developing Countries 128 (The Brookings Inst. 1984); OECD Report, supra note 9, at 17-18, 30. For comparative aspects of this issue, see The Adjustment of Personal Income Tax Systems for Inflation, supra note 9, at 13-16.

124. The argument is not limited to adjustment of the tax regime, but also applies to other areas of the social order in which a political effort can be made to neutralize the effects of inflation by means of correcting other distortions, while leaving inflation itself unaffected.

125. A CA proposal put forward in the U.S. in 1984 failed, inter alia, because political interests eroded its pure adjustment objectives by introducing tax arrangements that contradicted the adjustive purpose of the proposal. For example, the proposal made it possible to deduct mortgage interest, including the inflationary element, even though the proposed adjustment regime ruled out deducting the inflationary component of interest expenses. See Slemrod & Bakja, supra note 23, at 238 n.9.

EPA.[126] Using IPA allows for political use, and abuse, of the adjustment regime. Partial adjustment arrangements, particularly implicit ones, can be used to accomplish unrelated political goals without a public debate. For example, consider the debate over the appropriate tax burden on capital gains.[127] One argument for the reduced tax rate for capital gains is the issue of taxing inflationary profits, even though those gains enjoy deferral.[128] From a political perspective, implicit adjustment has, in general, the dual function in the sense that it can be justified on the basis of inflationary function or on the basis of a non-inflationary function. This leads to political maneuvering that can maximize the advantages of this dualistic dimension.[129] This duality may facilitate the enactment of controversial tax arrangements by emphasizing the adjustment aspects while eroding contentious non-adjustment aspects. There can also be situations in which political considerations will operate in the opposite direction, emphasizing the non-adjustment feature while playing down adjustment.[130] The range of uses to which the duality of the tax arrangement can be used is a product of the general social order regarding adjustism/nominalism. In the discourse of a culture of nominalism, the debate over the appropriate capital gain tax rate will emphasize the non-adjusting function of the reduced tax rate, whereas in the discourse of a culture of adjustism, the adjusting function will be more prominent.

There are political advantages to an EPA regime as well. Creating tax regimes that adjust only certain economic components or activities can provide new areas for political maneuvering. Rather than apply CA to all taxpayers as part of the normative equality-based tax regime, the EPA regime would be seen as a medium for granting tax benefits. The basic requirements of the normative tax regime (e.g., taxing real income) would be

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126. For the political conceptions that influence the scope of adjustment for inflation in the tax arena, see Shuldiner, supra note 1, at 641. Shuldiner argued that American politics assigns greater importance to adjustment of capital assets than to liabilities, although he believes that the adjustment of liabilities is more important.

127. This represents a concealed partial adjustment regime. For this issue, see Part III C.

128. See, e.g., Shuldiner, supra note 1, at 552-57; Halperin & Steuerle, supra note 3, at 354.

129. Thuronyi, supra note 1, at 445, argues that IPA is explained on a non-adjustment function. In my opinion, IPA can *also* be explained on the adjustment function when the culture of nominalism is common and it reflects the "maximum" adjustment that can be introduced into this culture.

130. Imagine a CA tax regime in which there is also a reduced capital gain tax rate. In such circumstances, strong emphasis would be placed on the non-adjustment aspects of the reduced capital gain tax rate, while the adjustment aspect would be muted in order to preserve the reduced capital gain tax rate together with the comprehensively adjusted tax regime.

politically transformed into tax benefits (tax expenditures).[131] This transformation is of public importance because such EPA can divert the public discourse from a debate on the normative nature of the adjustment regime to a debate of tax expenditures. It enlarges the political involvement in the redesigning of the partial adjustment tax regime and, in turn, increases the potential for arbitrariness and abuse. Here the culture of adjustism/nominalism of the social order plays a very important role: The strength of political considerations wanes the more a society employs adjustism. The ability of political groups to adopt/prevent the CA or IPA/EPA regime diminishes as the culture of adjustism/nominalism increases in the social order.

The public debate on adjustment in the tax arena comprises of political tension among different groups of taxpayers. For the purpose of this discussion, I will refer to each of the concepts as follows:

ATC - the total tax collected under a CA regime (Adjusted Tax Collection).

NTC - the total tax collected under a non-adjusted tax regime (Nominal Tax Collection).

EUIT - the difference between the NTC and the ATC is the excess tax, positive or negative, caused by inflation (Excessive Unadjusted Inflationary Tax; NTC – ACT = EUIT).[132]

The taxpayer population is comprised of three groups when looked at from the perspective of the effect of non-adjustment/adjustment on tax

131. On the relationship between the adjustment regime and tax expenditures, see W. Elliot Brownlee, supra note 116, at 132-33.

132. Since EUIT is created as a result of inflation, it would seem appropriate to call it Inflation Tax, but that concept has a completely different meaning, according to which inflation itself constitutes a tax in the sense that it transfers real resources from the public to the government. It is the government that imposes the tax (inflation) due to its monopolistic power over money supply. A distinction should be drawn between Inflation Tax and Seigniorage. The state's revenue from issuing currency, in its sovereign and monopolistic role, unrelated to inflation, is referred to as "seigniorage." However, if the government wishes to increase its revenues, and induces inflation, its revenues in excess of seigniorage constitute "inflation tax." John Maynard Keynes, Tract on Monetary Reform 41 (1935) (Keynes referred to inflation (as a tax) as: "…the form of taxation which the public find hardest to evade and even the weakest government can enforce."); Milton Friedman, supra note 119, at 13 (From a political point of view, governments are particularly fond of taxation in the form of inflation: "Inflation has been irresistibly attractive to sovereigns because it is a hidden tax that at first appears painless or even pleasant, and above all, because it is a tax that can be imposed without specific legislation. It is truly taxation without representation.").

liabilities: The first group consists of the taxpayers whose tax liability decreases as a result of adjustment. This group is thus "fined" as a result of non-adjustment (hereafter: the fined taxpayer group). The second group comprises of taxpayers who are not affected by the adjustment/non-adjustment arrangements (hereafter: the indifferent taxpayer group).[133] There is a third group of taxpayers, who benefit from a decrease in the scope of adjustment, in the sense that as the scope of adjustment increases, their tax liability increases (hereafter: the benefited taxpayer group). The benefited taxpayer group exists as a result of the gap between theory and the effective tax reality, one which includes loopholes and enables tax planning and arbitrage. This reality occurs in a non-adjustment regime or in a partial adjustment regime, due to the absence of comprehensive adjustment.[134]

There are thus three possible scenarios: If the EUIT on the fined taxpayer group is greater than the (negative) EUIT of the benefited taxpayer group, then EUIT > 0. In this situation, a CA decreases the total collection revenue, which is in accordance with "the basic tax collection insight."[135] In contrast, if the EUIT imposed on the fined taxpayer group is less than the (negative) EUIT of the benefited taxpayer group, then EUIT < 0. In this situation, a CA will increase the total collection revenue. If the EUIT imposed on the fined taxpayer group is equal to the (negative) EUIT enjoyed by the benefited taxpayer group, then EUIT = 0. In this scenario, it is also important to carry out CA, because such adjustment increases the distributive justice and economic efficiency of the tax regime by eliminating the excess tax and the negative tax, leaving the taxpayers with tax burdens equal to the tax burdens in a tax regime in an inflation-free environment. These conclusions apply to an introduction of a CA, but only partially apply to EPA or IPA.

The conflict between the benefited taxpayer group and the fined taxpayer group creates political, economic and social tension in the public discourse about adjustment. The more realistic "the basic tax collection insight" – in the sense that it accurately reflects reality – the smaller the benefited taxpayer group, and the lesser the tension between the two groups. When "the basic tax collection insight" is accurate, the benefited taxpayer

133. Employees are generally members of this group.

134. Thus, for example, in terms of tax collection, the tax system may find itself in a position in which the total tax collection under a partial adjustment regime is lower than under a CA regime, due to inefficient introduction of partial adjustment components that enables tax arbitrage.

135. This is not to say that the benefited taxpayer group is empty, but rather that the extent of their benefit is smaller than the extent of tax imposed upon the fined taxpayer group.

group is empty and the only player left on the field is the fined taxpayer group that desires the elimination of the unjust tax imposed on it.[136]

The indifferent taxpayer group may take part in this public debate, and either support or resist adjustment, despite its indifference, as long as its relative portion of the tax collection changes as a result of increased adjustment. For example, when the benefited taxpayers are an empty group, then increasing the scope of adjustment reduces the tax burden on the fined taxpayer group, to which the indifferent taxpayer group may object in light of the increase in its relative contribution to overall tax revenues. Such an objection should be rejected because while the adjustment indeed increases the relative tax burden of the indifferent taxpayer group, the original tax burden imposed on the fined taxpayer group was unjust and therefore had to be changed. [137]

Assuming EUIT > 0, which is most likely, proceeding from a lesser adjustment to a greater adjustment will cause an erosion of the EUIT. Such a process has two tax consequences: First, transitions that increase adjustment create a "negative tax" that may be unjustly distributed. Thus, for example, if the partial adjustment regime chooses only to index capital gains, then the owners of capital assets will enjoy a negative tax while those who do not possess capital assets will continue to bear the burden of non-adjustment, i.e., the remainder of EUIT after its reduction through indexing capital gains. Second, partial adjustment may create new opportunities for tax arbitrage due to the fact that the adjustment mechanisms of the tax regime are not coherent. Such tax arbitrage causes the EUIT to decrease not only due to the increase of adjustment, but by a greater amount due to the tax arbitrage.[138]

Moving along the spectrum of adjustment regimes toward increased adjustment includes converting from one adjustment regime to another where the difference between them is in the content of the various adjustment components. Every partial adjustment regime changes the scope and composition of the benefited taxpayer group, the fined taxpayer group, and the indifferent taxpayer group, and the EUIT imposed. An adjustment

136. The third group of taxpayers unaffected by adjustment/non-adjustment is not relevant to this discussion.

137. For collective action's aspects regarding inflation, see Mancur Olson, The Logic of Collective Action 166 (Harvard Univ. Press 1971).

138. A single process of increasing adjustment can meet – although not entirely – the condition of distributive justice if the only variable related to adjustment is the extent of indexation, i.e., gradually increasing the percentage of indexation. Thus, for example, at the beginning of the adjustment process, all of the relevant elements of the tax system are linked to a certain percentage of the index, and progress along the spectrum of adjustment regimes is carried out by means of gradually increasing the level of linkage to the index up to 100% linkage, which constitutes CA. In general such an adjustment process would be atypical. See also text accompanying note 61.

component added to the adjustment regime changes the composition of the three groups and their EUIT burden. This conclusion will be correct even if EUIT < 0, because every increase in the extent of adjustment leads to changes in the relative tax burdens of the three groups. Even if EUIT = 0, the composition and tax burdens of the three taxpayer groups may change in either direction. A parallel issue concerns economic efficiency. Adopting a gradually adjusting approach leads to changes in modes of economic behavior, and causes changes in the composition of the three taxpayer groups and their share in the EUIT. The primary goal for economic efficiency is finding the optimal "imposition" of the EUIT during the adjustment process.

To summarize, when a tax system progresses along a spectrum of adjustment regimes, each step will encounter a political confrontation from the taxpayer groups due to the concrete components of adjustment. This will be the case because those components will influence the manner in which the positive and negative elements of the EUIT will be distributed among the different groups, as well as the scope and composition of the indifferent taxpayer group. The political discourse will focus both on distributive justice and economic efficiency. The wide range of considerations in this regard may result in a political decision that will create discontinuous and distorted movement along the spectrum not grounded in a tax policy appropriate for confronting inflation. Intense political involvement in the design of partial adjustment regimes can lead to distortions of distributive justice and economic efficiency and may serve as a strong incentive to adopt a CA regime.

The tension among the various taxpayer groups plays out against the background of society's culture of nominalism or adjustism. In a culture of adjustism, the fined taxpayer group is more likely to support further adjustment of the tax regime. If society is dominated by a culture of nominalism, then the benefited taxpayer group will find support for its desire to maintain the nominalistic status quo. Inasmuch as nominalism is the typically dominant culture, one may expect the fined taxpayer group to play the most active role in advocating the adjustment of the tax system for inflation, as well as for increasing the adjustment in other areas. Moreover, the same paradigm will lead the benefited taxpayer group to oppose not only the adjustment of the tax system, but any attempt to introduce adjustment for inflation in any part of the social order, due to the influence that adjustment of non-tax areas will have on adjustment of the tax system.[139]

139. See OECD Report, supra note 9, in regard to the influence of other areas of the social order.

G. Inflation Levels and Tax Rates

As noted,[140] the inflation levels and tax rates are built into the arguments and considerations discussed above. For example, a cost-benefit analysis demonstrates that the higher the inflation rate and tax rates, the greater the benefit of adjustment.[141] The same applies for the general culture paradigm of inflation.[142] The higher the inflation rate, the more likely it is that adjustment regimes are rooted in non-tax areas of the social order. However, it is possible that a society will have a culture of adjustism even when inflation rates are not high. This may result from past experience with high inflation[143] that engendered social and economic sensitivity. Under these circumstances the effect of the general culture paradigm will be opposite to the effect of cost-benefit analysis. Under the general culture paradigm, tax rates have relatively little influence over the scope of adjustment. This greatly contrasts the importance of tax rates to cost-benefit considerations. What about the macro-economic considerations combating inflation by means of nominalism?[144] The influence of the inflation rate on the weight of these considerations is the reverse: the higher the inflation rate, the more important it becomes to eliminate it by means of non-adjustment. Tax rates do not affect the macro-economic considerations favoring non-adjustment for inflation.

The inflation level and tax rates also influence tax collection considerations.[145] The higher the inflation level and the tax rates, the higher the budgetary cost of introducing adjustment mechanisms into the tax system. Therefore, tax collection considerations will lean in the opposite direction of cost- benefit considerations and the effect of the general culture paradigm. The political considerations follow the direction of collection considerations, in the sense that the higher the inflation level and tax rates, the more valuable the "political assets" that result from the absence of comprehensive or partial adjustment. Nevertheless, as inflation and tax rates rise, the relative importance of tax collection and of the political considerations lessen in comparison to that of general culture paradigm of inflation and the cost-benefit considerations. Under such circumstances, adjustment for inflation will increase.

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140. See text accompanying note 1 et seq.

141. However, the analysis becomes complicated when inflation is not high, since the compliance costs are not strongly affected by the inflation rate's increase.

142. See Part IV C.

143. On the expression of an inflationary culture in the context of the role of the central bank in stabilizing prices, see, e.g., Bernd Hayo, Inflation Culture, Central Bank Independence and Price Stability, 14 Eur. J. of Pol. Econ. 241 (1998).

144. See Part IV D.

145. See Part IV E.

CONCLUSIONS

This article analyzes fundamental aspects of adjusting the tax regime to inflation. The cultures of nominalism and adjustism are placed at the center of the analysis due to the reciprocal relationship between the tax adjustment debate and the unadjustment/adjustment culture that dominates the social order. In these relationships, there is "equilibrium" between the scope of adjustment in the social order and in the tax regime. Advancing adjustment of the tax regime requires that it also be promoted in the general social order. Adjustment to inflation demands the tax discourse to be integrated within the general social order. This cultural paradigm plays a central role in the tax response to inflation, both in terms of the adoption of an adjustment regime, and in regard to the scope and character of that regime. According to this approach, the academic orientation that sees the complexity of comprehensive and partial (implicit and explicit) adjustment as the primary cause for adopting nominalism is largely rhetorical in that it ignores the following: First, the current tax regime comprises elements that are far more complex than the alleged "complexity" of adjustment for inflation. Second, greater weight should be given to the cultural nature of adjustment to inflation, and less emphasis should be placed on its technical aspects. Adjustment for inflation is a cultural phenomenon and not a technical issue. This article takes the view that tax regimes should be analyzed and critiqued on the basis of an integrative-cultural approach which is reflected in the social order, rather than an isolated phenomenon not playing a major role in the social order.