ECONOMICS

Americans Pay a Hidden Tax. It's Called Sticky Inflation.

By Neal Templin Follow

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Consumers prices rose 3.3% in May on an annual basis. (SHELBY TAUBER/BLOOMBERG)

If inflation doesn't drop back to where it was before the pandemic, nearly every American—rich or poor—will see their spending power diminished, a new working paper finds.

"It's like a permanent tax hike," says Boston University economics professor Laurence Kotlikoff, who co-authored the paper.

For months, the prevailing economic view has been that high consumer prices were a temporary phenomenon, and that price increases would soon moderate. But while inflation has dropped sharply from a peak of 9.1% in June 2022, it has defied predictions for further declines. In recent months, it has been bouncing in a range of 3.1% to 3.5%—well above its 2.3% annual rate in 2019.

Most economists still say inflation will subside in the coming months as slowing rent increases eventually show up in the numbers. Indeed, the May inflation rate eased to 3.3% on an annual basis from 3.4% in April, raising expectations that the Federal Reserve will lower interest rates later this year.

But what if inflation were stuck at a higher rate—or, worse yet, rose from its current level—because of mounting federal debt, housing shortages, or others factors we don't understand yet? While that might not be the most likely scenario, the paper's analysis illustrates the erosive impact of persistent inflation on consumers' wallets.

The National Bureau of Economic Research working paper lays out the toll of lifelong high inflation on consumers. It estimates that permanent 5% inflation would lower household lifetime spending by a median 3.62%, compared with zero percent inflation. Permanent 10% inflation would lower lifetime household spending by a median 6.82%.

Even if inflation ran permanently at the Fed's 2% target, consumers would still feel a pinch, with a 1.5% reduction in lifetime household spending, Kotlikoff estimates. The last time inflation was at or below the central bank's goal was 2018, when prices rose at a 1.9% rate for the year.

This inflation-induced pain, however, isn't the same across tax brackets. The richer you are, the bigger the effect. The top 1% in lifetime resources would see a median decline in lifetime spending of 8.52% under permanent 5% inflation, and a decline of 15.9% under 10% inflation, the paper calculates. By contrast, the bottom 20% would see declines of 3.47% and 6.76%, respectively.

"We looked at effective inflation as it works through the tax system, and the imperfect adjustments in some of the structural elements of our tax system—that essentially increase the tax liability of the individual as inflation rises," says paper co-author David Altig, chief economic advisor for the Federal Reserve Bank of Atlanta. "It creates a world in which inflation, which ought to be relatively neutral, is not."

One of group especially affected by inflation is the 67 million Americans who are collecting Social Security. Their benefits are adjusted annually for inflation, but they still get hit hard because the benefit increase every January reflects the previous year's price changes. If inflation keeps rising briskly year after year, Social Security recipients never catch up.

Persistent 4% inflation is equivalent to about a 2% permanent drop in spending power for Social Security recipients, the paper found. If inflation were to surge to 10% and remain there, it would effectively lower Social Security benefits by about 5%, according to the analysis.

Just as with Social Security benefits, tax brackets are adjusted for inflation. But there is also a lag there, and that particularly hurts the middle- and upper-income filers in a period of permanently high inflation.

The wealthy and families that are accumulating wealth get hit even harder. That's largely because they get taxed on nominal capital gains in asset values—not on gains that are adjusted for inflation.

Suppose someone bought $100,000 worth of stock and it doubled in value over 10 years to $200,000. Now suppose that consumer prices also doubled during that period, effectively offsetting that $100,000 gain. At the end of the decade, that $200,000 would have exactly the same buying power as $100,000 did 10 years earlier. Yet if that person sold that stock, they would have a $100,000 capital gain on paper that they would have to pay taxes on—even though they actually gained nothing in real terms.

"The real issue is we're taxing nominal asset income, not real asset income," Kotlikoff says.

To be sure, the government throws some big tax breaks at homeowners. If a house rises in value, a single homeowner selling that house doesn't have to pay capital-gains taxes on the first $250,000 increase; a married couple escapes taxes on the first $500,000. But those numbers haven't changed since 1997, and consumer prices have nearly doubled since then, so these tax breaks aren't nearly as valuable as they once were.

And some income brackets for certain government benefits aren't adjusted. That top bracket for Medicare premiums is $500,000 for single filers and $750,000 for joint filers. Seniors who hit those income levels pay a monthly premium of $594, compared with a monthly premium of $174.70 for the majority of Medicare recipients. The $500,000 and $750,000 number haven't changed for several years. As incomes rise, more people are finding themselves in the top bracket — even though inflation has lessened the spending power of those earnings.

"If you're asking why people are so upset about inflation," Kotlikoff says, "it may be this hidden explanation—that everybody is being taxed at a higher level."

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