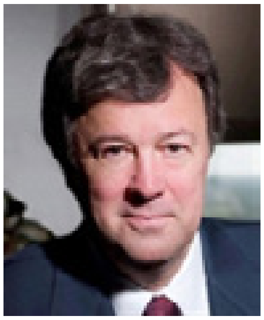
Goodman Institute
Turning Ideas Into Policy

What Congress can do to lower the cost of inflation

We should stop taxing inflationary gains.

Laurence J. Kotlikoff is a Boston University economist, president of MaxiFi.com and author of *Money Magic*



John C. Goodman, Ph.D. President of the Goodman Institute and author of *New Way to Care: Social Protections That Put Families First*

Inflation is the highest it's been in 40 years. There are many culprits — COVID-19, a 40 percent increase in the money supply, largely to finance COVID spending, the war in Ukraine, China supply-side disruptions and supply bottlenecks due to inappropriate shipping and trucking regulation.

Congress can't change these factors. But it can help us all weather inflation, be it short- or long-term.

Here's how.

Fully index the federal income tax to inflation.

Federal income tax brackets are already indexed, keeping workers out of higher brackets simply because their wages keep up with prices. But significant parts of the tax code aren't. Take capital gains. When inflation pushes up the price of stocks, bonds, real estate and other property, people get taxed on the "gains," even though they've experienced no increase in real income. The same is true for coupon clippers. Yields on standard (nominal) Treasury bonds, corporate bonds, savings accounts, etc. rise with inflation to compensate lenders for getting repaid in watered-down dollars. But the extra yield – due solely to inflation – is subject to taxation.

At least index the taxation of Social Security benefits.

Seniors are particularly vulnerable to inflation. Many live largely on fixed incomes. Others are, as indicated, getting taxed on illusionary capital gains or interest income. And the vast majority are at risk from inflation-induced higher Social Security benefit taxation.

In 1983, Congress started taxing Social Security benefits to improve the system's long-term financial health. Above a certain level of income, seniors get taxed on an extra 50 cents of benefits every time they earn an additional dollar of income. That means, when they earn one more $1, they get taxed on $1.50. Thus, when seniors sell a stock, receive interest or dividend income, or withdraw funds from an IRA, their tax rate can be 50 percent higher than young people with the same income. At a somewhat higher level of income, the Internal Revenue Service (IRS) begins taxing 85 percent of benefits. At that point, seniors are facing a marginal tax rate that is 85 percent higher than young people with the same income.

What Congress can do to lower the cost of inflation

Only a small percentage of the elderly were originally affected by this tax. But the politicians left unindexed the income thresholds beyond which the first 50 percent and then 85 percent of our Social Security benefits become taxable. This left inflation free, with no act of Congress, to raise more and more retirees' nominal incomes above the thresholds, making more and more of their benefits subject to income taxation.

Today, 56 percent of Social Security recipients are taxed on their benefits. Each percentage point of inflation raises this share. Without indexing the thresholds, all beneficiaries, rich, middle-class and poor alike, will eventually face income taxation on 85 percent of their benefits.

Some seniors are paying a tax on $1.50 every time they earn $1. Their tax rate is 50% higher than the rate for younger taxpayers.

Tax only the real return on inflation-indexed Treasuries.

Under current law, people of all ages can buy TIPS (Treasury Inflation Protected Securities) bonds — financial assets that protect them from inflation. Unfortunately, these securities do not shield investors from the tax law. To repeat, in periods of high inflation, the investors get higher returns but are forced to pay taxes on this phantom "income." That means investing in TIPS is a terrible tax move if inflation continues to run high — since every penny of inflation protection income will be taxed. This helps explain why TIPS real yields (the yield apart from any inflation protection) have risen, rather than fallen, as inflation has picked up — to compensate TIPS purchasers for facing a higher effective tax on the security's real yield.

Have the Treasury issue I-bonds that function as inflation-indexed annuities.

Cohort-Survivor I-Bonds would pay an inflation-indexed real return set by the Treasury. The amount that could be purchased annually would be up to, say, $25K per person. The return, which one would start receiving at 65, would be higher than on standard I-Bonds because you'd only get paid if you're alive. The return set on newly issued Cohort-Survivor I-Bonds would depend on your birth cohort's survival probabilities. Cohort-Survivor I-Bonds would establish a critically important missing financial market — one providing inflation-indexed annuities.

Eliminate Social Security's earnings test.

Over one-in-three 54-65 year-olds don't participate in the labor market. For those 62 to 67 (the ages when you can collect early retirement benefits) the fraction working is just 40 percent. When COVID hit, many older folks joined the "Great Retirement" and took Social Security early. Now, if they return to work and earn more than $19,660, they'll lose 50 cents in benefits for every dollar they earn. (The tax is 33 percent above $51,960 in the calendar year they attain full retirement age.) When this "earnings test" is combined with the Social

Security benefits tax and regular income and payroll taxes, senior workers can face astronomically high marginal tax rates — even exceeding 90 percent.

Ironically, Social Security eventually reimburses most seniors for the loss of benefits due to the earnings test via its arcane Adjustment of the Reduction Factor (ARF) provision. The reimbursement comes in the form of a permanently higher benefit level starting at full retirement age. In other words, the government taxes you today and then gradually returns the money after you hit full retirement age.

Seniors can lose 50 cents in Social Security benefits every time they earn a dollar of wage income.

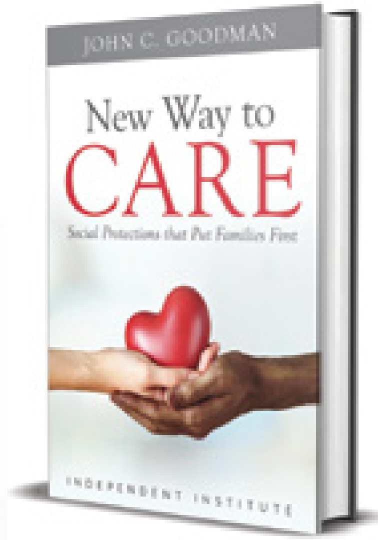
The earnings test is surely leading millions of early retirees to permanently retire because they think they are being taxed to death because they have no clue about the ARF adjustment. Eliminating the earnings test would clearly make the government money. The elderly's increased earnings would be subject to both federal income and FICA taxation.

Eliminate Social Security's (FICA) payroll tax for everyone over the full retirement age.

Why is the government collecting a 12.4 percent payroll tax from people who, in general, have little to gain in higher benefits from paying more Social Security FICA taxes? This reform would likely more than pay for itself in the form of higher federal income taxes.

These reforms are important even with moderate inflation. With today's very high inflation, they can be a life saver for many.

New Way to Care!



With the COVID-19 pandemic and shutdowns, federal debt has reached $22.8 trillion with a 2020 deficit of $3.3 trillion, more than triple the deficit for 2019. Not including Obamacare, the unfunded liability in Social Security and Medicare alone is $120 trillion, 6 times the entire U.S. economy. If such spending continues, average people will be paying two-thirds of their income to the federal government by mid-century, destroying families, businesses, and communities. And with entitlements the largest component of federal spending, politicians have failed at reining in one of the most troubling issues facing Americans.

Now, the path-breaking book ***New Way to Care: Social Protections that Put Families First***, by **John C. Goodman**, offers a bold strategy to end the spending and debt crisis by giving Americans the needed control over their own destiny, and at *far less cost*. ***New Way to Care*** shows how smartly-crafted, private, market-based social protections best serve families, harmonize individual and societal interests, foster personal responsibility and government accountability, bridge the partisan divide over spending, and end runaway spending that will drive the U.S. over a fiscal cliff. With ***New Way to Care***, social insurance and human well-being in America can finally be secured.

"***New Way to Care*** shows what's wrong with our antiquated system of social insurance."
—**Newt Gingrich**, former Majority Leader, U.S. House of Representatives

"***New Way to Care*** should be national policy. It is pragmatic, knowledgeable and accessible. Read it."
—**Regina E. Herzlinger**, Nancy R. McPherson Professor, Harvard Business School

"John Goodman is one of the most creative thinkers of our time in the complex world of health care policy. In ***New Way to Care***, he puts forth important, thought-provoking ideas about the role of government. Read it!"
—**Scott W. Atlas**, M.D., Member, White House Coronavirus Task Force

"In ***New Way to Care***, John Goodman is consistently ahead of his time. What he writes today will be policy in the coming years."
—**Bill Cassidy**, M.D., U. S. Senator

John C. Goodman is Senior Fellow at the Independent Institute, President of the Goodman Institute, and author of the acclaimed, Independent books, *A Better Choice: Healthcare Solutions for America,* and the award-winning, *Priceless: Curing the Healthcare Crisis*. *The Wall Street Journal* has called him the "Father of Health Savings Accounts."

Order Today at independent.org/NewWayToCare

INDEPENDENT INSTITUTE

100 Swan Way, Oakland, CA 94621
800-927-8733 • 510-632-1366 • orders@independent.org

Goodman Institute
FOR PUBLIC POLICY RESEARCH

6335 W Northwest Hwy - #2111 • Dallas, TX 75225 • email: info@goodmaninstitute.org • +1 214 302.0406