

The Hidden Tax

Inflation's Effect on American Families and Small Businesses



Ranking Member Rand Paul, M.D.



Contents

Executive Summary	2
The Hidden Tax	5
The Current State of Inflation.....	5
The Cause of Inflation	10
Inflation’s Inequitable Effects	12
Inflation and Small Businesses	15
Conclusion: Government Spending and the Hidden Regressive Tax.....	16

Executive Summary

The Bureau of Labor Statistics (BLS) Consumer Price Index (CPI) release on January 12, 2021 found that prices had risen 7 percent in the 12 months prior to December.¹ This represents the largest increase in a 12-year period in the last four decades. Similarly, the Producer Price Index (PPI) final demand release on January 13, 2021 found that prices for businesses had jumped 9.7 percent in 2021, the largest calendar year increase in prices for businesses in the history of this index.²

As the Nobel Laureate, Milton Friedman, suggested in a speech amidst the period of rising prices in the 1980s, inflation can be thought of as a hidden tax for rampant government action. Though the U.S. government has not levied taxes to pay for the \$4.9 trillion spent on COVID relief,³ the American public must still pay a hidden tax. In an attempt to understand how this tax was levied and how it affects American workers, this report arrived at three key conclusions:

1.) COVID-19 stimulus is directly responsible for rising prices.

- The Federal Reserve Bank of San Francisco published a study in October 2021 looking at the effects of the American Rescue Plan on price increases. This study concluded that the \$1.9 trillion package, representing just a fraction of the total funds spent on COVID relief, pushed prices at least 0.3 percentage points higher.⁴ The Federal Reserve has indicated in its December 2021 meeting that they will end their period of COVID stimulus and focus on fighting inflation.⁵

2.) Inflation disproportionately harms low and middle-income families.

¹ <https://www.bls.gov/news.release/cpi.nr0.htm>

² <https://www.bls.gov/news.release/ppi.nr0.htm>

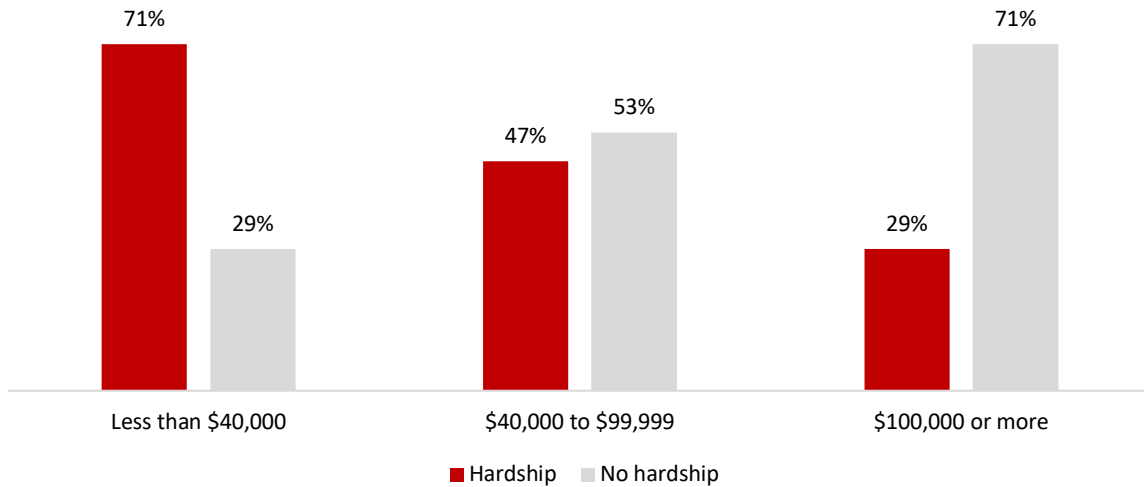
³ <https://www.covidmoneytracker.org/>

⁴ <https://www.frbsf.org/economic-research/publications/economic-letter/2021/october/is-american-rescue-plan-taking-us-back-to-1960s/>

⁵ <https://www.wsj.com/articles/fed-s-bullard-four-interest-rate-rises-in-2022-now-appear-likely-11642017785>

- 71 percent of households making under \$40,000 annually have indicated economic hardships from rising prices, as opposed to just 29 percent of households making \$100,000 or more.⁶

Inflation Burden by Household Income



- Low and middle-income families spend a larger portion of their income on high-inflation items, such as gasoline, used cars, and food. Families in the lowest income quartile spend nearly 40 percent of their annual income on these three categories. As a means of comparison, families in the top quartile spend only 10 percent of their annual income on these categories (see Chart 7).⁷
- The cost of an average tank of gas rose from \$25.32 in December 2020, to \$38.04 in December 2021.⁸ A used car that cost \$10,000 in December 2020, cost \$13,730 in December 2021. A grocery cart that cost \$100 in December 2020, cost \$106.30 in December 2021.⁹ While these price increases may seem trivial to wealthy families, this disproportionately burdens low and middle-income families that spend a much larger portion of their income on these items.

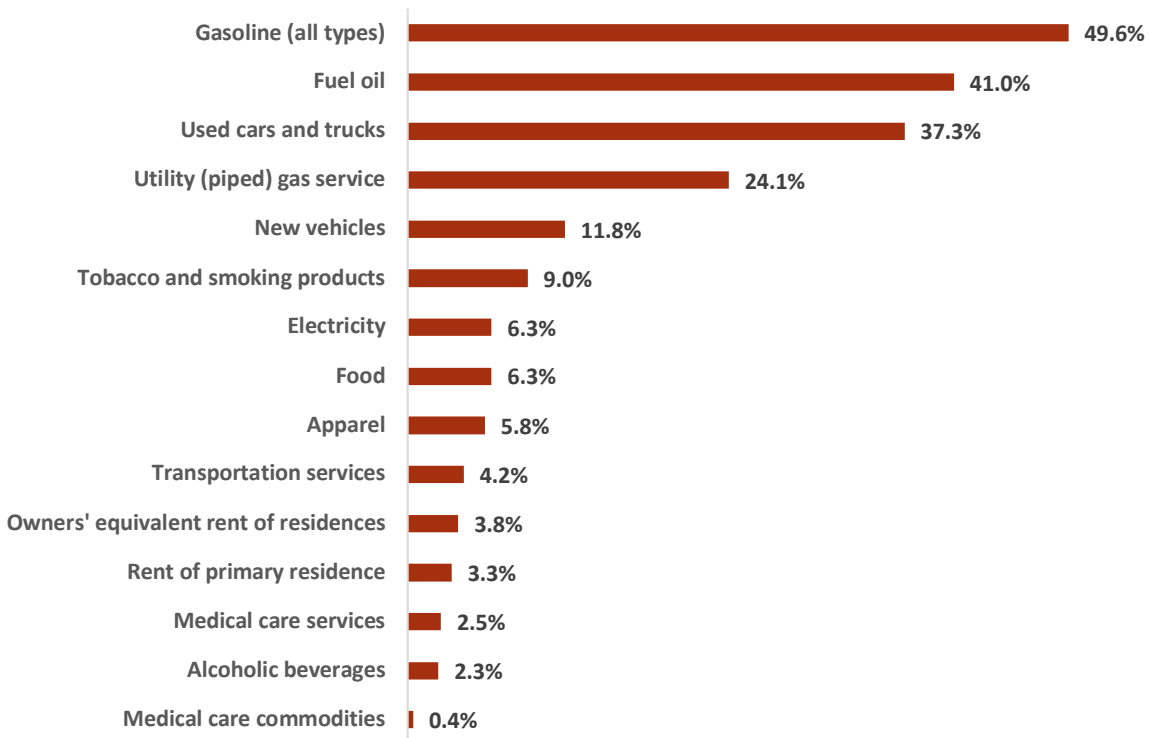
⁶ <https://news.gallup.com/poll/357731/inflation-causing-hardship-households.aspx>

⁷ <https://www.bls.gov/charts/consumer-price-index/consumer-price-index-by-category.htm#>

⁸ <https://www.eia.gov/petroleum/gasdiesel/>

⁹ <https://www.bls.gov/charts/consumer-price-index/consumer-price-index-by-category.htm#>

Inflation by Category (Percent change from Year ago)



3.) Inflation disproportionately harms small businesses.

- 82 percent of small businesses reported raising prices in the last several months, 42 percent reported raising prices by 20 percent or more.¹⁰
- 45 percent of small businesses reported taking out a loan to cope with the pressures of inflation in this last year.¹¹
- Large corporations have reported consistent profit margins.¹²

This report concludes that, though no formal tax has been levied to pay for the government’s recent spending trends, a hidden, regressive tax has been levied on the American public, charging more from low and middle-income families and small businesses and less from wealthy families and big businesses.

¹⁰ <https://www.business.org/finance/accounting/effects-of-inflation-on-small-businesses/>

¹¹ <https://fortune.com/2021/12/14/small-business-owners-loans-inflation/>

¹² <https://www.axios.com/profit-margins-record-high-rising-inflation-e48151ba-139b-475a-a611-b81a0ead39ba.html>

The Hidden Tax

The Nobel Laureate economist Milton Friedman once said,

*“Before every election our representatives would like to make us think we are getting a tax break, and they are able to do it while at the same time actually raising our taxes because of a bit of magic they have in their kit bags. That magic is inflation. They reduce the tax rates, but the taxes we have to pay go up, because we are automatically shoved into higher brackets by the effect of inflation. A neat trick. **Taxation without representation.**”¹³*

While elected officials did not promise tax breaks, they did spend \$4.9 trillion in COVID-19 stimulus since the beginning of the pandemic.¹⁴ These programs included popular programs geared towards families, workers, and business owners alike, such as the Paycheck Protection Program, the Economic Impact Payments (stimulus checks), and the Enhanced Unemployment Insurance. Though Congress passed these popular programs without raising taxes, Americans are now faced with the hidden tax that is a risk with any form government spending: inflation.

The Current State of Inflation

Just a day prior to the release of the Bureau of Labor Statistics (BLS) December Consumer Price Index release, the statistics that indicate the levels of inflation the nation is facing, President Biden stated in a press conference that the inflation findings the following day would “not reflect today’s reality.”¹⁵ While this phrase

¹³ <https://www.youtube.com/watch?v=0uyqBnkPoK0>

¹⁴ <https://www.covidmoneytracker.org/>

¹⁵ <https://www.barrons.com/news/upcoming-inflation-data-does-not-reflect-today-s-reality-biden-01639072808>

was intended to explain away what would become the largest price increase in four decades (7 percent rise in consumer prices and 9.7 percent rise in producer prices),¹⁶ this statement holds. A simple statistic does not reflect the reality of the struggle small business owners, workers, and consumers have faced in the last year. While Congress was able to unite in 2020 in spending \$4.9 trillion,¹⁷ unity does not always lead to virtuous outcomes, and this particular example of unity left Americans with the most difficult economic conditions in recent history.

BLS released the December CPI statistics on January 12, 2021. The release showed prices rising 7.0 percent for the 12 months prior to November of 2021. This marks the largest increase in prices since June of 1982.

Chart 1: Consumer Price Index (Percent change from year ago)

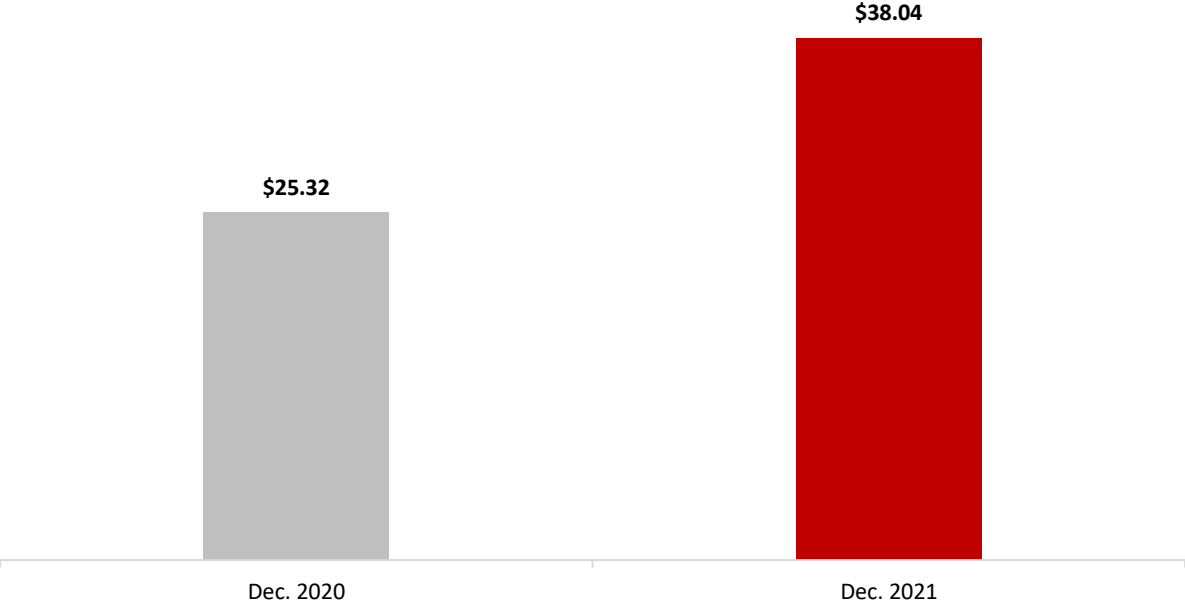


¹⁶ <https://www.bls.gov/news.release/cpi.nr0.htm>

¹⁷ <https://www.covidmoneytracker.org/>

These price increases were driven largely by energy prices and food prices. In 2021, energy prices as a whole, including electricity, propane, gasoline, and other energy sources, rose 29.3 percent. Gasoline on its own rose 49.6 percent.¹⁸ For perspective, a tank of gas for the average American in November of 2020 cost \$25.32. The same tank of gas in November of 2021 cost the average American \$38.04 (chart 2).¹⁹ This trend is even more shocking considering Americans drove considerably less in 2020 and 2021 than in previous years.²⁰ Aside from the jump in energy prices, used vehicle prices and food have also been key contributors to the price jumps, rising 37.3 percent and 6.3 percent respectively (See Chart 3).²¹

Chart 2: The Cost of a Tank of Gas to the Average American



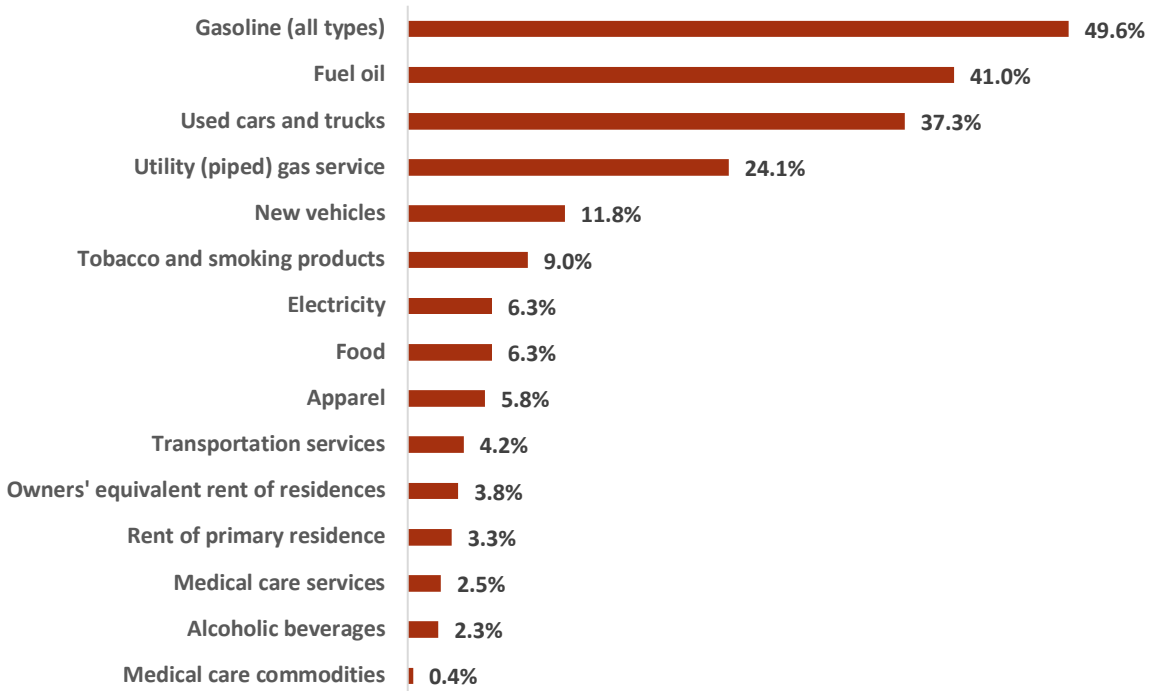
¹⁸ <https://www.bls.gov/news.release/cpi.nr0.htm>

¹⁹ <https://www.eia.gov/petroleum/gasdiesel/>

²⁰ <https://www.eia.gov/tools/faqs/faq.php?id=23&t=10>

²¹ <https://www.bls.gov/news.release/cpi.nr0.htm>

Chart 3: Inflation by Category (Percent change from Year ago)

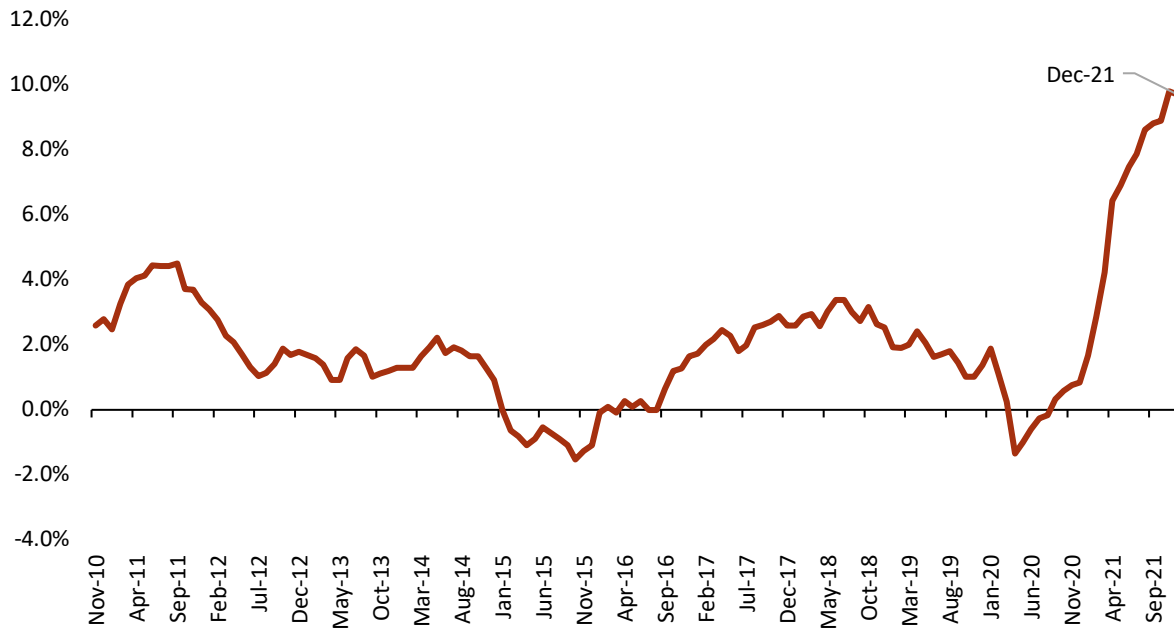


In addition to the jumps in CPI, the Producer Price Index (PPI) final demand found an increase of 9.7 percent in 2021.²² While CPI measures the cost for the average consumer for a basket of consumer goods and services, PPI measures the revenues for goods and services made by American producers and sold for: personal consumption, capital investment, government purchases, and exports. A 9.7 percent increase in producer prices represents the largest increase in a calendar year since the beginning of the measurement in 2010 (see chart 4). The largest increases driving this unprecedented jump were energy, food, and transportation.²³

²² <https://www.bls.gov/news.release/ppi.nr0.htm>

²³ <https://www.bls.gov/ppi/detailed-report/ppi-detailed-report-december-2021.pdf>

Chart 4: PPI Final Demand (Percent Change from Year Ago)



These trends are not just isolated to government statistics. A recent poll by Goldman Sachs' 10,000 Small Businesses project²⁴ found that:

- 86 percent of polled small business owners are concerned about inflation;
- 84 percent have seen an increase in operating costs;
- 81 percent indicate that inflationary pressures are still increasing; and
- 74 percent say inflation has negatively impacted their businesses financial health.

²⁴ <https://www.goldmansachs.com/citizenship/10000-small-businesses/US/infographics/the-covid-surge-is-slowing-the-road-to-recovery/index.html>

According to the Job Creator Network Small Business Intelligence Quotient November release,²⁵ the top five concerns for small business owners were:

1. Inflation;
2. Consumer spending;
3. General operating expenses;
4. Supply-chain disruptions; and
5. Taxes

Since the poll's creation in May of 2021, Inflation has been the top choice for small business owners. However, the magnitude of concern has risen from 32 percent of small business owners indicating inflation as their top business concern in June of 2021 to 40 percent in November of 2021.²⁶

The Cause of Inflation

While various groups and pundits have tried labeling the recent increases as transitory or temporary, Federal Reserve policymakers indicated in December that they would begin to combat rising prices, marking an end to their era of pandemic-related stimulus efforts. Interest rates, which are currently set near zero to encourage employment, are expected to rise three or four times throughout the course of this year in an effort to combat inflation.²⁷ In addition to signaling rising rates, Federal Reserve policymakers also put an abrupt end to the bond-buying program, which the Federal Reserve had been using to shovel money into the

²⁵ <https://monthlymonitor.icnf.org/monthly-monitor/november-2021/>

²⁶ Ibid.

²⁷ <https://www.wsj.com/articles/fed-s-bullard-four-interest-rate-rises-in-2022-now-appear-likely-11642017785>

economy to encourage spending. This program will come to a complete halt by March of 2022.²⁸

These actions signaled by the Federal Reserve’s December meeting seem to suggest the Federal Reserve’s skepticism of the transitory nature of rising prices. This skepticism could be informed by the preliminary research from the San Francisco Federal Reserve on the effects of stimulus spending on inflation. In October 2021, the Federal Reserve Bank in San Francisco (FRBSF) found that Biden’s American Rescue Plan (ARP), the \$1.9 trillion package and most recent of the stimulus packages passed in March of 2021, had a statistically significant relationship to rising core inflation.^{29, 30}

FRBSF found that the passage of Biden’s American Rescue Plan has likely pushed the inflation rate 0.3 percentage points higher. ARP, however, represents just a fraction of the dollars injected into the economy since the pandemic has started, including the Federal Reserve’s own stimulus efforts and the rest of the \$4.9 trillion that the United States government spent. As quoted in FRBSF’s report, former Treasury Secretary Larry Summers expressed his concern on government spending’s contribution to inflation,

“there is a chance that macroeconomic stimulus on a scale closer to World War II levels than normal recession levels will set off inflationary pressures of a kind we have not seen in a generation.”³¹

²⁸ <https://www.federalreserve.gov/newsevents/pressreleases/monetary20211215a.htm>

²⁹ “Core inflation” is CPI excluding the highly volatile categories, food and energy.

³⁰ <https://www.frbsf.org/economic-research/publications/economic-letter/2021/october/is-american-rescue-plan-taking-us-back-to-1960s/>

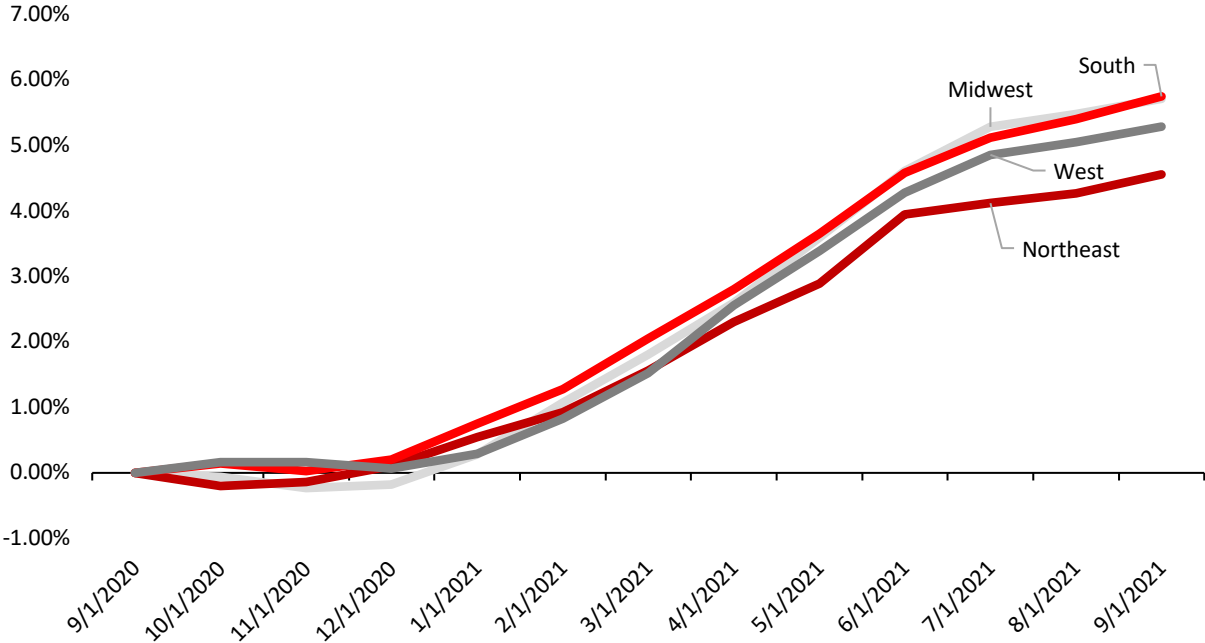
³¹ <https://www.washingtonpost.com/opinions/2021/02/04/larry-summers-biden-covid-stimulus/>

This quote comes from Summers’ Washington Post op-ed on February 4th, 2021, prior to the passage of both the American Rescue Plan and to the spurt of rising prices. In November of 2021, Summers’ prediction rang true and America reached the highest levels of inflation since 1982.

Inflation’s Inequitable Effects

These recent trends in rising prices, however, do not have uniform effects on the nation. While the inflation metrics lag and much is still left to be discovered, preliminary data from the BLS show that this round of inflation has hit the Midwest and the South harder than it has the East and West coasts (chart 5).³² This makes intuitive sense, insofar as the Midwest and the South have lower overall prices, making a change of the same magnitude in these regions proportionally larger than a change in areas with a higher starting point.

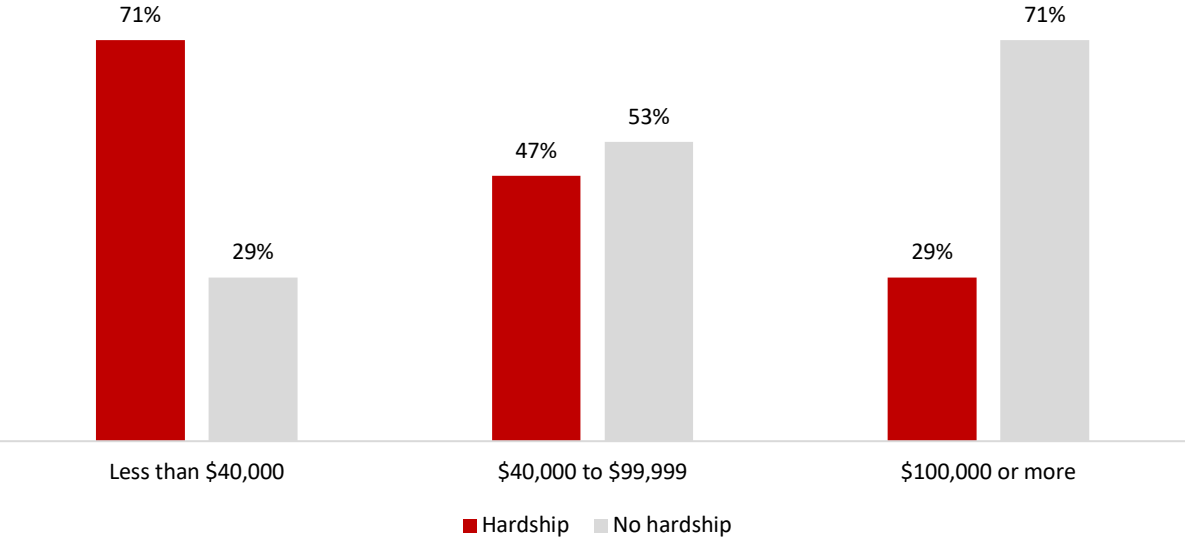
Chart 5: Regional CPI (Percent Change from Sept. 2020)



³² <https://www.bls.gov/cpi/regional-resources.htm>

Rising prices also disproportionately burden low and middle-income families. A recent poll by Gallup has shown disparities between both income and education level in the amount of hardship reported from recent inflation trends (chart 6). 70 percent of those earning under \$40,000 annually reported moderate or severe hardship as a result of inflated prices in the last year compared to 28 percent of those earning over \$100,000 annually.³³

Chart 6: Inflation Burden by Household Income



These disparities are likely to manifest from a number of different reasons, however, two direct examples of inflation’s harm on low and middle-income families are that these households typically possess less real assets to hedge against rising prices and a larger portion of their income represents items that are most susceptible to inflationary pressures.

³³ <https://news.gallup.com/poll/357731/inflation-causing-hardship-households.aspx>

1. Lack of Real Assets

One of the most effective hedges against rising prices are real assets, such as real estate, business equity, plant property and equipment, or other tangible assets. The prices of these items usually track with the overall levels of inflation. Low and middle-income individuals are more likely to lease these types of assets than to own. According to research from Oxford University, the top 20 percent of the income distribution holds nearly half of the total home mortgage debt; the top 50 percent holds 75 percent.³⁴ Research from University of Chicago shows that households in the top one percent of adjusted gross income account for the vast majority of income from business ownership.³⁵

2. Spending on High-Inflation Categories

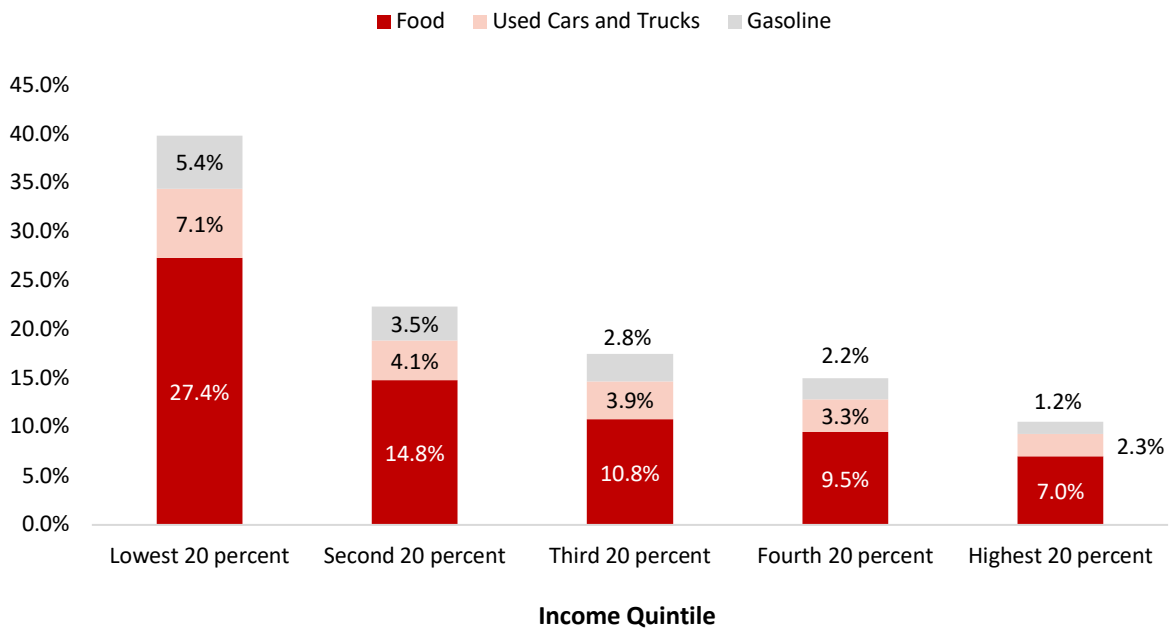
Low and middle-income individuals are more exposed to the items that are most affected by inflation. For example, three items that contributed significantly to rising prices in the November CPI release were gasoline, used vehicles, and food. While both high, low, and middle-income individuals spend money in each of these categories, these items represent a much larger percentage of low and middle-income household expenditures than high-income expenditures, creating more strain on low and middle-income households than their wealthy counterparts (chart 7).³⁶

³⁴ <https://academic.oup.com/restud/article-abstract/88/1/229/5889966?redirectedFrom=fulltext>

³⁵ <https://www.journals.uchicago.edu/doi/full/10.1086/685594#>

³⁶ <https://www.bls.gov/charts/consumer-price-index/consumer-price-index-by-category.htm#>

Chart 7: Percent of Income Spent on High-Inflation Items



Inflation and Small Businesses

Aside from the pressures imposed on consumers, small businesses have faced devastating blows to their already COVID-strained profit margin, creating a difficult decision of either passing on costs, downsizing, or closing.

A number of different studies have shown that small businesses have endured difficulties in this last year. A recent study³⁷ found that:

- 82 percent of small businesses reported raising prices;
 - 11 percent raised their prices by 10 percent;
 - 44 percent of businesses raised prices by 15 percent; and
 - 45 percent of small businesses raised prices by 20 percent.

³⁷ <https://www.business.org/finance/accounting/effects-of-inflation-on-small-businesses/>

The National Federation of Independent Business (NFIB) reported in their monthly survey that a 54 percent of surveyed businesses plan on increasing prices in the near future.³⁸ The U.S. Chamber of Commerce Small Business Index found that, in efforts to mitigate the effects of inflation, 45 percent of small business owners have reported taking a loan to cope with the effects of inflation, and 41 percent have reported decreasing the size of their labor force.^{39 40}

While larger businesses have the economies of scale necessary to adapt to changing conditions and access to inexpensive capital to help them do it, small businesses often operate with thin margins and are often financed with the personal assets of its owner. Sustained inflation is more likely a fatal blow to small businesses squeaking by than larger corporations entrenched in their economies of scale.

Conclusion: Government Spending and the Hidden Regressive Tax

\$4.9 trillion in COVID-19 stimulus spending has led to one of the highest and sustained levels of inflation in U.S. history. Though government stimulus spending was intended as a form of relief, and low and middle-income families as well as small business owners were promised that their taxes would not increase as a result of these packages, Americans are now paying a “hidden tax” for these policies. This price of these measures is high to all, but low and middle-income households and small business owners are responsible for a higher share than their

³⁸ <https://www.nfib.com/surveys/small-business-economic-trends/>

³⁹ <https://fortune.com/2021/12/14/small-business-owners-loans-inflation/>

⁴⁰ <https://www.uschamber.com/sbindex/summary/>

wealthy counterparts. Further spending in this time of rapidly rising prices is to impose an even higher tax on this nation's already vulnerable small business owners and low and middle-income families. In the words of Milton Freidman, there is no such thing as a free lunch.