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Stealth Wealth Tax

By Richard W. Rahn

LOWER INTEREST RATES AND INFLATION ARE ERODING AMERICANS' SAVINGS

The stealth wealth tax may be the single-largest tax ever imposed on the American people, yet virtually no one knows about it. What is particularly unconscionable about this tax is that it has been imposed upon the most responsible citizens and the elderly in a most disproportionate way, and the real tax rate on American savers has soared to record levels.

The Federal Reserve has held down interest rates so that the average person receives less than 1 percent on money-market funds or certificates of deposit - that is, money used for precautionary and low-risk savings. At the same time, the Fed has allowed inflation to rise to an annual rate of more than 3.5 percent. As can be seen in the accompanying chart, when inflation rates are higher than interest rates, people suffer an effective real tax rate above 100 percent. At present rates of interest and inflation, this means that most Americans pay effective tax rates on their savings ranging from 360 percent for lower-income people to 390 percent for higher-income people.

Real Tax Rate on Savings
($100,000 CD, 3.5% inflation rate, 20% tax rate)

Interest Rate	Interest Income	Inflation Tax	Income Tax	Total Tax	Real Tax Rate
5.5%	$5,500	$3,500	$1,100	$4,600	83.6%
1.0%	$1,000	$3,500	$200	$3,700	370%

Inflation is a non-legislated wealth tax. If you had kept a $100 bill a year ago, today you would be able to buy just $96.20 worth of goods and services, given the current 3.8 percent inflation rate. The Fed, by its failure to preserve the value of the currency as it is charged to do, has imposed a stealth wealth tax on you.

The Internal Revenue Service (IRS) has made it worse by imposing a tax on nominal savings income, not just on inflation-adjusted income. The 16th Amendment to the Constitution gave the federal government the right to impose a tax on "incomes." A change in the price level caused by inflation is not income by any economic or sensible definition of the word. The IRS, in fact, recognizes that inflation is not income because it adjusts the individual income tax brackets each year to offset inflation. Yet it tries to impose a tax on the "imaginary income" of those who receive interest and capital gains. It cannot have it both ways. The Constitution does not grant the federal government the right to impose an individual wealth tax, which is what a tax on imaginary income is, nor has Congress legislated such a tax.

We have a situation in which tens of millions of American retirees are receiving real negative returns on their hard-earned savings yet the federal government, whose primary job is to ensure liberty and protect person and property, is, in essence, stealing from them. I ponder the question: Are the people at the IRS too dumb to understand what they are doing to their fellow Americans or do they just not care because they lack an ethical compass?

It is clear that hundreds of billions of dollars are being extorted from American taxpayers and savers without any legislated tax increase as required by the Constitution. So the question is: Who gains? The answer is those in the political class who spend other people's money on themselves or on their favorite contributors and supporters. Because the Fed is holding interest rates artificially low (and this can last only temporarily) the government is paying out less interest than free-market rates would allow, thus enabling the politicos to spend more because the deficit looks smaller than it is. But this is only a short-term illusion.

The economic consequences of this con game are grim. As people increasingly realize that the Fed and IRS are stealing their wealth, they will find ways to protect themselves by doing such things as buying gold and other nonproductive investments, choosing not to save or moving money to other countries. All of these reduce the amount of money for productive capital formation in the United States - that is, the money that would have been invested in new plants, equipment, and research and development - the money that would have been used to create real jobs.

The Fed and IRS are engaged in this wealth destruction with the very explicit support of the Obama administration and many in Congress. These are the very same people who are claiming that their most important goal is creating more jobs, yet they are doing the opposite of what is needed to create them. Confiscating and taxing away the wealth that is needed to boost demand and to provide cost- and time-saving tools for workers is no way to create jobs.

To mitigate the situation, Congress should explicitly require the Fed to keep inflation/deflation within 2 percent per year with the sanction that the Fed governors would be fired if they miss the targets. (New Zealand did a similar thing.) Congress also should explicitly prohibit the IRS from taxing imaginary interest or capital gains because of inflation and allow a taxpayer deduction for any real loss in principal of an investment caused by inflation.

Too many members of Congress have been more interested in protecting the IRS and the Fed than in protecting their own constituents. As voters become increasingly aware of the stealth wealth tax, will their representatives become more responsible?

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