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The Return of the Inflation Tax

The Pelosi tax surcharge applies to capital gains and dividends.

All of those twentysomethings who voted for Barack Obama last year are about to experience the change they haven't been waiting for: the return of income tax bracket creep. Buried in Nancy Pelosi's health-care bill is a provision that will partially repeal tax indexing for inflation, meaning that as their earnings rise over a lifetime these youngsters can look forward to paying higher rates even if their income gains aren't real.

In order to raise enough money to make their plan look like it won't add to the deficit, House Democrats have deliberately not indexed two main tax features of their plan: the $500,000 threshold for the 5.4-percentage-point income tax surcharge; and the payroll level at which small businesses must pay a new 8% tax penalty for not offering health insurance.

This is a sneaky way for politicians to pry more money out of workers every year without having to legislate tax increases. The negative effects of failing to index compound over time, yielding a revenue windfall for government as the years go on. The House tax surcharge is estimated to raise $460.5 billion over 10 years, but only $30.9 billion in 2011, rising to $68.4 billion in 2019, according to the Joint Tax Committee.

Americans of a certain age have seen this movie before. In 1960, only 3% of tax filers paid a 30% or higher marginal tax rate. By 1980, after the inflation of the 1970s, the share was closer to 33%, according to a Heritage Foundation analysis of tax returns.

These stealth tax increases—forcing ever more Americans to pay higher tax rates on phantom gains in income—were widely seen to be unjust. And in 1981 as part of the Reagan tax cuts, a bipartisan coalition voted to index the tax brackets for inflation.

We also know what has happened with the Alternative Minimum Tax. Passed to hit only 1% of all Americans in 1969, the AMT wasn't indexed for inflation at the time and neither was Bill Clinton's AMT rate increase in 1993. The number of families hit by this shadow tax more than tripled over the next decade. Today, families with incomes as low as $75,000 a year can be hit by the AMT unless Congress passes an annual "patch."

The Pelosi-Obama health tax surcharge will have a similar effect. The tax would begin in 2011 on income above $500,000 for singles and $1 million for joint filers. Assuming a 4% annual inflation rate over the next decade, that $500,000 for an individual tax filer would hit families with the inflation-adjusted equivalent of an income of about $335,000 by 2020. After 20 years without indexing, the surcharge threshold would be roughly $250,000.

And by the way, this surcharge has also been sneakily written to apply to modified adjusted gross income, which means it applies to both capital gains and dividends that are taxed at lower rates. So the capital gains tax rate that is now 15% would increase in 2011 to 25.4% with the surcharge and repeal of the Bush tax rates. The tax rate on dividends would rise to 45% from 15% (5.4% plus the pre-Bush rate of 39.6%).

As for the business payroll penalty, it is imposed on a sliding scale beginning at a 2% rate for firms with payrolls of $500,000 and rising to 8% on firms with payrolls above $750,000. But those amounts are also not indexed for inflation, so again assuming a 4% average inflation rate in 10 years this range would hit payrolls between $335,000 and $510,000 in today's dollars. Note that in pitching this "pay or play" tax today, Democrats claim that most small businesses would be exempt. But because it isn't indexed, this tax will whack more and more businesses every year. The sales pitch is pure deception.

As for the Senate, instead of the 5.4% surcharge, the Finance Committee bill raises taxes on "high-cost" health care plans. But this too uses the inflation ruse. The Senate bill indexes its tax proposal for the inflation rate plus one percentage point. But that is only about half as high as the rate of overall health-care inflation, i.e., the rate of increase in health-care premiums. So the Joint Tax Committee has found that a Senate tax that starts in 2013 by hitting 13.8 million Americans will hit 39.1 million by 2019.

The return of the inflation tax demonstrates once again the stealth radicalism that animates ObamaCare. In the case of inflation indexing, Democrats would repeal a 30-year bipartisan consensus that it is unfair to tax unreal gains in income, thus hitting millions of middle-class Americans over time with tax rates advertised as only hitting "the rich." Oh, and the House vote on this exercise in dishonest government will come as early as Saturday.

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