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The Hidden Tax: Inflation, Deficits, and the True Cost of Big Government

BY VERONIQUE DE RUGY, PH.D.,

George Gibbs Chair in Political Economy, Mercatus Center at George Mason University

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How Big Government Made Life Unaffordable and How to Fix It

INTRODUCTION

Ask most economists about American living standards since 2020, and they will point to recovery: the 2021–2022 inflation retreated, real wages rose, and unemployment stayed low. Yet in April 2026, more than half of Americans said their financial situation was getting worse, a level of pessimism not seen since the Great Recession, with nearly a third citing inflation and high prices as their single biggest problem.¹

The explanation is simple and politically inconvenient: inflation does not reverse itself when it slows. Inflation pushed prices up and kept them there: prices rose roughly 20% during the 2021–2022 surge alone, and, measured from 2019, the cumulative increase is closer to 28%. A family that needed \$60,000 in 2019 needs roughly \$77,000 today to buy the same things. For the large share of working- and middle-class households whose wages did not fully keep pace, that gap is the affordability crisis the aggregate statistics keep missing.

Some prices rise for reasons specific to their sector, such as zoning laws that strangle housing supply, pharmaceutical regulation that limits competition, and energy permitting that drags on for years. The other chapters in this volume take up those supply-side failures directly. But beneath every sector-specific price problem lies a common macroeconomic foundation: the purchasing power of money. No amount of sector-by-sector reform can deliver lasting affordability if the currency itself is losing value.

That is the disease this chapter addresses. Unfortunately, the conditions that produced the inflation surge in the first place have not disappeared.²

¹ Gallup, "Affordability Still Dominates Americans' Financial Worries," April 28, 2026, <https://news.gallup.com/poll/708905/affordability-dominates-americans-financial-worries.aspx>.

² Veronique de Rugy, "Expectations, Policy, and the Anatomy of Recent Inflation," *The Unseen and The Unsaid* (Substack), March 19, 2026, <https://www.theunseenandtheunsaid.com/p/expectations-policy-and-the-anatomy>.

What Actually Caused the Inflation Surge

Some accounts attribute the 2021–2022 inflation surge to supply-chain disruptions, the war in Ukraine, or corporate greed. The first two were minor contributing factors; the third is scapegoating. The principal cause was a fiscal decision: between 2020 and 2021, Congress committed roughly \$6 trillion in deficit-financed transfers to American households,³ with no credible plan to pay for it through higher future taxes (which would hurt economic growth) or lower future spending (which would wreak havoc among D.C. special interest groups).⁴

That last part is what matters. When people receive money from the government, the key question is whether they expect to be taxed back for it later. If they do, they save it. If they don't, they spend it. During the pandemic, Congress made no gesture toward future restraint. In fact, unlike President Obama, who promised he would cut the deficit in half within five years after the Great Recession, the Biden administration doubled down on deficit spending after a deluge of emergency spending in 2020 under President Trump and well after the COVID emergency was over.⁵ The Federal Reserve reinforced the message by holding interest rates near zero and absorbing roughly \$3.7 trillion in Treasury debt, confirming that no correction was coming. Households rationally concluded the transfers were permanent additions to their real wealth and spent them accordingly. The government had issued far more in promises than its fiscal trajectory could credibly back. Prices rose to close the gap, acting as the adjustment Congress refused to make through legislation.

By the time inflation peaked at 9.1% in June 2022, the real value of government debt had fallen by roughly 10 percentage points of GDP. The fiscal adjustment Congress refused to legislate was delivered instead through the destruction of household purchasing power. As a result, American consumers are still paying that price today.

Inflation Is a Regressive Tax

Inflation is not neutral. It falls hardest on people who are least equipped to fight back: those without assets, without bargaining power, and without the financial sophistication to protect themselves. As economist Arnold Kling puts it, “[Inflation] rewards the most alert and aggressive economic actors, and it punishes people who are passive and habitual; it interacts with the tax system to reduce productive investment; and it makes planning for the future difficult, particularly when it comes to buying a home.”⁶

Start with wages. When prices rise, employers adjust pay for new hires and for workers who push for raises. Passive workers, those who stay put and don't ask for a raise, get hurt the most. Those who look for a new job may find that other employers are willing to pay them more. The result is wage distortion that has nothing to do with merit or productivity.

The distributional damage goes deeper. A family spending nearly everything it earns on rent, food, and utilities has no buffer. A wealthier household with money in equities, real estate, and inflation-protected assets is at least partially shielded. The deficit spending that caused the inflation was sold

3 Committee for a Responsible Federal Budget, COVID Money Tracker, <https://www.covidmoneytracker.org/>.

4 Jack Salmon, “Important Lessons from the 2021–24 Inflation Surge: Demand, not supply, drove the post-pandemic price spike,” The Unseen and The Unsaid (Substack), July 7, 2025, <https://www.theunseenandtheunsaid.com/p/important-lessons-from-the-202124>.

5 Committee for a Responsible Federal Budget, “The Biden Administration Has Approved \$4.8 Trillion in New Borrowing,” CRFB.org, September 13, 2022, <https://www.crfb.org/blogs/biden-administration-has-approved-48-trillion-new-borrowing>.

6 Arnold Kling, “What’s Wrong with Inflation? The Media Try to Sensationalize It. Inflation Does Cause Serious Economic Damage, but in Subtle Ways,” Arnold Kling’s Substack, June 12, 2021, <https://arnoldkling.substack.com/p/whats-wrong-with-inflation>.

as helping working Americans. Its actual effect was to erode their purchasing power while inflating the balance sheets of people who could have withstood the economic turmoil without help.

People with fixed and slowly adjusting incomes bear the heaviest burden. Retirees on fixed annuities, workers with little bargaining power, and anyone holding savings in cash or low-yield instruments watched the real value of their assets shrink year after year. Social Security is inflation-indexed, but many of the other income streams that older Americans depend on are not. Further, even indexed adjustments typically lag actual prices long enough to cause lasting damage.

The tax code makes it worse. When wages rise nominally to keep pace with inflation, bracket creep pushes households into higher tax brackets even though their real purchasing power has not improved. The government collects a windfall from the very inflation it helped create. Savers are hit twice: inflation erodes the real value of their savings, and then the tax code taxes the full nominal return, including the portion that merely compensated for inflation. After taxes, many savers lose ground entirely.

Finally, when people sell assets, whether a home or an investment, they owe capital gains tax on the full nominal appreciation, including the portion that simply reflects currency depreciation, not real wealth creation. That is not a tax on gains, but a second penalty for the government's own fiscal irresponsibility.

The Debt-Inflation Feedback Loop

The inflation surge of 2021–2022 left American

households with a price level roughly 20% higher than before that surge. Groceries, rent, utilities, insurance: the bills that consume the largest share of a working family's income are permanently larger. The more urgent question is what comes next, because the fiscal conditions that produced the last inflation surge have not been resolved. They have worsened.

With the exception of Social Security payments, federal interest payments have now surpassed all other spending, including defense.⁷ The national debt is now larger than the economy. The CBO's long-run projections show this trajectory continuing without limit, driven not by defense budgets or discretionary programs but by the compounding cost of Social Security, Medicare, and Medicaid. These are the financial conditions that determine whether the dollars in your wallet hold their value or quietly lose it.

Short of another emergency in which Washington decides to respond with a rescue plan on the order of 25% of GDP, the next fiscal pressure point arrives in the early 2030s, when the Social Security and Medicare trust funds are projected to be exhausted.⁸

At that moment, Congress will face a choice it has spent decades avoiding. Current law requires automatic benefit cuts to match available payroll tax revenues. The alternatives are raising taxes sharply, borrowing the entire shortfall, which economist Jessica Riedl calculated would add roughly \$115 trillion to the deficit over thirty years (\$124 trillion in shortfall plus interest minus the surplus of the rest of the budget), or enacting genuine structural reform.⁹ Unfortunately, Washington's track record strongly suggests the path of least resistance will be borrowing, at least initially.

For ordinary Americans, this danger is neither abstract nor distant. The moment investors conclude

⁷ Visual Capitalist, "America Now Spends More on Interest Than Defense," <https://www.visualcapitalist.com/america-spends-more-on-interest-than-defense/>.

⁸ Veronique de Rugy, "When the Trust Funds Run Dry: The Price Level May Do the Adjusting If Congress Doesn't," The Unseen and The Unsaid (Substack), November 19, 2025, <https://veroderugy.substack.com/p/when-the-trust-funds-run-dry>.

⁹ Jessica Riedl, "A Comprehensive Federal Budget Plan to Avert a Debt Crisis," Manhattan Institute, June 2024, <https://media4.manhattan-institute.org/wp-content/uploads/a-comprehensive-federal-budget-plan-to-avert-a-debt-crisis-2024.pdf>.

that Congress has committed to borrowing its way through the entitlement shortfall with no credible plan to close the gap, the repricing begins immediately. Bond values will fall, the dollar will weaken, and inflation will return, potentially faster and harder than last time. The same families that absorbed a 20% increase in their cost of living during COVID would face another round before recovering from the first.

Unfortunately, when the Federal Reserve raises rates to fight inflation, government borrowing costs rise with them. As existing debt matures and rolls over at higher rates, the deficit widens further, intensifying the very fiscal pressure that caused the inflation. At current debt levels, aggressive rate increases become fiscally destabilizing rather than stabilizing, and the political pressure on the Fed to back off becomes overwhelming.

Economists call this fiscal dominance: the point at which monetary policy stops serving price stability and starts accommodating the government's fiscal position. The United States has not fully arrived there, but it is closer than at any point since 1951, when the Fed was legally required to peg Treasury yields and had no independent ability to fight inflation. Fed independence is not a permanent institutional feature. It is a function of fiscal conditions that Congress controls, and Congress is eroding those conditions year by year.

The bottom line is simple: the debt trajectory is the single most important determinant of whether the cost of living stabilizes or continues to climb. Every dollar of deficit spending without credible future repayment is a future price increase waiting to arrive.

Why the Intuitive Fixes Make Things Worse

Washington's response to the affordability crisis has been to propose more of what caused that crisis. The pattern is consistent: governments subsidize demand for goods whose supply they simultaneously restrict, thereby bidding prices higher, then propose additional subsidies to offset the prices they have raised, and finally consider price controls when the subsidies prove insufficient. Each step of this sequence makes the underlying problem worse.

Stimulus payments, billions of dollars in tax expenditures,¹⁰ and expanded transfer programs deliver purchasing power to households without expanding the supply of what those households wish to buy. In a well-functioning market with elastic supply, demand-side support can be absorbed without large price increases. But in an economy where supply has been systematically suppressed by regulation, the spending simply bids up prices. The people it is meant to help are frequently made worse off in real terms once the general equilibrium effects work through.

Price controls mark the terminal failure of this logic. When governments prohibit sellers from charging market-clearing prices, the predictable result is shortages: supply contracts, quality deteriorates, and black markets emerge to clear the transactions that the official price forbids. This is not a matter of ideological dispute. It is among the most thoroughly documented findings in the history of economics. Wage and price controls were tried in the 1970s and failed completely, ultimately abandoned in favor of the actual, durable solution of genuine monetary and fiscal adjustment.

¹⁰ Veronique de Rugy and Jack Salmon, "Introduction: A Principled Approach to Tax Expenditures: A Roadmap for a More Efficient, Fair, and Growth-Oriented Tax Code," Policy Brief, Mercatus Center at George Mason University, April 7, 2025, <https://www.mercatus.org/research/policy-briefs/introduction-principled-approach-tax-expenditures>.

The political appeal of price controls and other short-term apparent fixes is understandable. They offer the appearance of action without seeming to demand the genuine sacrifice that structural reform requires. But the appearance is just that: an appearance with no basis in reality. Each round of demand-side relief postpones the supply-side reckoning and adds to the fiscal pressure that drives long-run inflation risk.

Solutions: Fiscal Discipline and Credible Commitment

The path back to genuine affordability at the macro level is not complicated in logic, though it is difficult in politics. Price stability requires fiscal credibility. Fiscal credibility requires a government that spends within the limits of what it can plausibly collect and repay. The United States government does not currently meet that standard, and the gap widens every year. Closing it requires honest, hard choices about spending, not the fantasy that revenue increases alone can outrun a structural entitlement trajectory.

First and most urgently, Congress should reform Social Security and Medicare. This is not an optional item on the fiscal agenda; it is the fiscal agenda. No other spending category comes close to driving the long-run deficit path. Reforming Social Security should include adjusting eligibility ages to reflect longer lifespans and offering workers the option of private investment accounts. Unlike the current system, where payroll taxes are spent immediately, and the so-called trust fund holds nothing but IOUs from the Treasury to itself, private accounts would allow workers to own real assets that compound over time. The historical record is unambiguous: a

diversified portfolio of stocks and bonds, held over a working lifetime, generates returns that dwarf what Social Security's pay-as-you-go structure can ever promise. Workers would build actual wealth they could pass on to their children, rather than a political promise that the next generation may struggle to keep. For those who remain concerned about the most vulnerable, a modest flat benefit serving as a poverty-prevention backstop for the lowest earners could complement these reforms, ensuring a final safety net without eliminating meaningful benefits for the broad middle class.¹¹ Reining in federal Medicare spending requires more than trimming at the margins. Congress should cap spending growth and transform Medicare from an open-ended entitlement into a defined-contribution system, channeling risk- and income-adjusted payments directly to enrollees.¹² When paired with free-market reforms, as discussed by Chris Jacobs in the healthcare chapter of this handbook, Medicare reforms can enhance patient choice and competition, resulting in lower costs and higher-quality care.

Second, Congress should adopt binding fiscal rules with enforceable targets. A primary balanced budget requirement (meaning revenues covering non-interest spending) or a hard ceiling on the debt-to-GDP ratio, ideally anchored in statute or constitutional amendment, would force the discipline that discretionary appropriations processes have consistently failed to provide. The mechanism matters less than the credibility. Rules that are routinely waived through emergency designations or budget gimmicks do not anchor expectations; they erode them.

Third, Congress must bring emergency and supplemental spending designations to heel.¹³ For three decades, lawmakers have stretched the definition

11 Romina Boccia and Ivane Nachkebia, "Rethinking Social Security from a Global Perspective: What Congress Can Learn from the Experiences of Canada, Germany, New Zealand, and Sweden," Policy Analysis no. 998, Cato Institute, Washington, DC, June 23, 2025, <https://www.cato.org/policy-analysis/rethinking-social-security-global-perspective>.

12 Michael F. Cannon, "How to Eliminate Waste, Fraud, and Abuse in Medicare," Cato Institute, June 6, 2025, <https://www.cato.org/blog/how-eliminate-waste-fraud-abuse-medicare>.

13 Dominik Lett, "The \$15 Trillion Emergency Spending Loophole: Federal Emergency Spending: 1991–2025," Policy Analysis no. 1004, Cato Institute, September 16, 2025, <https://www.cato.org/policy-analysis/15-trillion-emergency-spending-loophole>.

of “crisis” to route spending off-budget and around their own fiscal rules. The fix is straightforward: properly define the term “emergency” and ensure that any new emergency spending is fully offset.

Fourth, Congress should establish a fiscal commission.

Entitlement reform is politically difficult, not because it lacks majority support in the abstract, but because no individual legislator wants to be the one who votes to change benefits. The 1983 Social Security Commission offers a precedent: facing imminent trust fund insolvency, Congress delegated the hard choices to the commission and then accepted its recommendations. That model could be repeated if Members of Congress lack the courage to take tough votes.

Fifth, Congress should restore the conditions for Federal Reserve independence by reducing the debt that makes independence structurally implausible.¹⁴

The Fed cannot be fully independent when the government’s interest costs are high enough that rate increases trigger immediate political crises. Monetary credibility ultimately rests on fiscal credibility. The way to protect the Fed from political interference is not to issue more strongly worded statements about central-bank autonomy; it is to put the federal balance sheet on a path that makes the Fed’s job manageable.

None of this requires overnight austerity or sharp immediate cuts to current beneficiaries. What it does require is a credible commitment to visibly shift our trajectory. Good news on the fiscal front can deliver real relief faster than most people assume, because confidence in future surpluses stabilizes the dollar’s real value today. The 1980s disinflation demonstrated this reality: once markets came to believe that the fiscal and monetary trajectory had genuinely improved, inflation expectations collapsed more quickly than the underlying data alone would have predicted.

The Bill Always Arrives

Americans are right to feel that something has gone fundamentally wrong with the cost of living.

The affordability crisis is not a mystery caused by impersonal economic forces or corporate greed. It is the predictable result of decisions made in Washington over decades to spend beyond what taxes can sustain, to suppress the supply of housing, medical care, and education through regulation while subsidizing their demand, and to meet the resulting fiscal gap with borrowing rather than reform.

Inflation is the steep bill for that set of choices. The macroeconomic solution is the same as the solution in every sector this book examines: the government should stop making the problem worse; it should get out of the way of the market forces that would solve it.

¹⁴ Veronique de Rugy, “The Illusion of Fed Independence: How Fiscal Pressures Will Continue to Shape Monetary Policies Even Absent Donald Trump,” The Unseen and The Unsaid (Substack), September 4, 2025, <https://veroderugy.substack.com/p/the-illusion-of-fed-independence>.



About the Author

Veronique de Rugy is the George Gibbs Chair in Political Economy and Senior Research Fellow at the Mercatus Center at George Mason University and a nationally syndicated columnist. Her primary research interests include the U.S. economy, the federal budget, taxation, tax competition, and cronyism. Her popular weekly columns address economic issues ranging from lessons on creating sustainable economic growth to the implications of government tax and fiscal policies. She has testified numerous times in front of Congress on the effects of fiscal stimulus, debt and deficits, and regulation on the economy.

Previously, de Rugy has been a resident fellow at the American Enterprise Institute, a policy analyst at the Cato Institute, and a research fellow at the Atlas Economic Research Foundation. Before moving to the United States, she oversaw academic programs in France for the Institute for Humane Studies Europe. She received her MA in economics from the Paris Dauphine University and her PhD in economics from the Panthéon-Sorbonne University.
