The Invisible Tax Increase

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Let's face it, no politician wants to be seen as a tax raiser, especially in an election year. But that doesn't change the fact that many politicians, in their hearts of hearts, believe that taxes should be raised.

What to do? Well, according to Chris Edwards of the Cato Institute some tax-and-spenders have found a way they can raise taxes and still avoid the political consequences of doing so:

As we close in on congressional votes to increase the federal debt limit, negotiators are coming up with all kinds of ideas to hike taxes. (Suspiciously, they haven't revealed very many spending cut ideas so far).

One idea being discussed is to raise revenue by reducing the indexing of parameters in the income tax code. Currently, tax brackets and other features of the tax code are indexed to the Consumer Price Index (CPI). It is widely recognized that the CPI overestimates inflation for various reasons, as discussed here.

The Bureau of Labor Statistics has developed a more accurate (and lower) measure of inflation, called chained CPI. If the tax code was indexed to chained CPI instead of CPI, the government would receive an automatic tax increase relative to current law every year until the end of time.

Edwards does not approve:

Switching to chained CPI is a very bad idea for two reasons:

1. It would create a large tax increase over the long run. And it would be an invisible annual tax increase on families and voters because there would be no obvious changes in their tax forms.
2. It would be an anti-growth tax increase because it would push families into higher tax brackets more quickly over time, subjecting them to higher marginal tax rates. The chained CPI proposal is essentially a proposal to increase marginal tax rates slowly and steadily over time.

Some economists may argue that the chained CPI proposal is a good idea because the tax code would more accurately reflect inflation, and it would. However, the tax code already contains a bias that pushes families into higher tax brackets over time, which is called "real bracket creep." Real growth in the economy steadily moves taxpayers into higher rate brackets since the tax code is indexed for inflation but not real growth. The discussion in the Congressional Budget Office's new long-range budget outlook implies that this will be an important force in raising federal revenues as a share of GDP in coming decades.

And he proposes a better idea:

So I’ve got a better idea than indexing the tax code to chained CPI: indexing the tax code to nominal GDP growth. That would adjust for the effects of both inflation and real economic growth on tax code parameters, and it would prevent stealth tax rate increases under our graduated income tax system.