CBO Budget Update Shows Higher Taxes Are Just Around the Corner

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The Congressional Budget Office (CBO) released their annual summer update to their budget projections, and as usual it has some interesting nuggets. Dan Mitchell of the Cato Institute has an useful take on how ridiculously easy it would be to balance the budget with very modest spending restraint.

There's a few items on taxes that should be of note to, well, taxpayers. These CBO reports are goldmines of intelligence if you read them closely enough. Here's what I dug up of interest in the tax area:

Taxes will dip in 2016 but rise quickly after that to historically high levels. CBO projects that federal tax revenues will fall to 17.8% of the economy in 2016 as a result of lower than expected estimated tax payments and because of companies taking full advantage of tax breaks which were made permanent in December 2015. After that, taxes rise even faster than economic growth, eventually hitting 18.5% of the economy, about a full percentage point higher than the historical average.

Taxes are rising primarily because of Obamacare and Baby Boomers. As I wrote earlier this year, the cause of higher taxes is four-fold, according to CBO:

1. "Real bracket creep," where families find themselves in higher tax brackets because their incomes outpace inflation (the tax brackets are indexed to inflation only, not income growth)
2. The 3.8 percent surtax on investment income and the 3.8 percent Medicare payroll tax bracket are not indexed for inflation (each starts at $200,000 of income or $250,000 for married couples). Over time, more and more income is captured by this Obamacare tax increase
3. Baby Boomers begin to make taxable withdrawals from their 401(k), IRA, and defined benefit pension plans as they enter retirement
4. Two tax increases which are temporarily delayed by Congress are scheduled to be implemeted. Namely, these are the "Cadillac plan" excise tax Obamacare imposes on

high income health insurance plans, and the phaseout of 50 percent “bonus depreciation” on new business investment.

There’s a good chance that Congress will indefinitely delay (4), the looming tax hikes on gold plated insurance plans and business equipment investment. Even if Congress were to delay these tax increases indefinitely, however, the revenue projections would only decline by several tenths of a percentage point of the economy–noticeable, for sure, but not trajectory-altering.

High corporate tax rates are reducing tax collections. The CBO report points out what should be an obvious fact: corporations are paying less in taxes than they otherwise would because of inversions and income-shifting outside the U.S. tax base and toward foreign subsidiaries. There is one answer to this: make the U.S. a more attractive home for capital. This can be done most easily by lowering the corporate income tax rate from nearly 40 percent today (when states are properly included) to something at or below the developed nation average 24 percent rate. We also need to stop double taxing income earned overseas, and it would help if business investment was closer to full expensing than to long depreciation schedules.

Tax reform is going to be difficult. The CBO report points out that the largest candidates for rate-lowering pay-fors are eerily familiar to Jane and Joe taxpayer. The “big five” include health insurance at work or from the government, contributions and deferrals to 401(k)s and IRAs, and the deductions for state and local income, sales, and property taxes. Throw in something that consumption base conservatives don’t consider a tax break at all (the lower rate on capital gains and dividends) and deferral of corporate taxes from overseas earnings (needed for international tax reform), and you have a very politically sensitive exercise on your hands.

Ending “bonus depreciation” hurts economic growth. If Congress were to follow through on the proposed phaseout of 50 percent “bonus depreciation” (whereby a company can write off half the cost of a new equipment purchase in year one and then subject the rest to multi-year depreciation deductions), business fixed investment would decline. That, in turn, lowers the economic growth forecast and makes us all poorer. It’s significant that CBO has acknowledged the connection here.