What if taxes go higher? (Part 1)

Blog

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The bad news for Americans is that taxes are probably going to be higher in the future. There aren't many other viable options for managing the country's debt and deficits, and while taxes aren't popular, they're more attractive than currency devaluation or a default on debt.

In addition, outright spending cuts are unlikely to make much of a dent without meaningful entitlement reform—a prospect seen as so dangerous to politicians' careers that it is often referred to as "the third rail" of American politics. Moreover, many politicians are in favor of policies that would require starkly higher government spending.

So this leaves higher taxes. On the positive side, the US taxpayer is starting from a relatively low tax burden versus international peers, at 29.6% of pretax income versus the 36.1% OECD average.

A higher US tax burden could come in a few different forms:

- **A less-accommodative estate tax policy.** This seems likely; without Congress's action, the lifetime gift tax exemption is poised to fall by half at the end of 2025.
- **A tax on wealth.** This is possible, but this approach could be politically difficult to accomplish, and is actually going out of style around the globe; according to this OECD report, just four countries applied a net wealth tax in 2017, versus 12 in 1990.
- **A federal value-added tax (VAT).** Many nations have a VAT, and this could raise a lot of revenue (a 5% VAT would raise over USD 6 trillion), but this concept is deeply unpopular among voters and would be regressive (more impactful on lower-income Americans' bottom lines), so it would likely be paired with other, more progressive taxes.
- **Higher capital gains or income tax rates.** This could raise a substantial amount of revenue, and seems to be the most politically feasible option.

Flexibility is, as always, key

That's the bad news. The good news is that investors have many strategies they can use to manage their tax liabilities. As we discuss in detail in our recent Modern Retirement Monthly report, it's important to view tax management through the lens of meeting your financial goals, and building your savings and retirement strategies around maximizing flexibility can be far more effective than strategies that rely on an accurate forecast of tax rates.

In fact, many investors are already building flexibility simply by saving across a mix of taxable, tax-deferred, and tax-exempt accounts. When this is paired with a dynamic "deccumulation" strategy in retirement, investors can effectively manage their tax liabilities without compromising on meeting their goals if tax-rate changes are different than expectations.

To be continued

When it comes to evaluating possible tax changes, there are a lot of facets to consider, and we'll be writing more about this in the future. In the meantime, please remember that, even if you're sure tax rates will go higher in the future, strategies like tax deferral can still add value, so you shouldn't stop contributing to your 401(k) or IRA, or take a break from loss-harvesting (which should be a year-round activity, in our view).

Appendix

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