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Taxing Income Discourages Paid Employment and Taxing Consumption Promotes Savings

Dr. Chris Erickson, NMSU

Economists say you should ‘tax what you do not want’ and ‘not tax what you do want’. We want people to generate income. After all, income is the reward for ‘doing’ what fellow citizens value. If you earn a wage, it is because your work is valued. If you receive rent, it is because people benefit from using your property. If you receive interest, it is a reward for financing worthwhile projects with your savings.

Americans continue to overconsume, or more precisely, undersave. Part of the problem is large government deficits, although inadequate private savings contributes meaningfully. Sixty percent of baby boomers, for example, have less than $100,000 in savings.

By taxing income, we discourage what we want, yet we consume too much and save too little. Switching from an income tax to a consumption tax would be an improvement. There are a several proposals for this change.

An obvious way to tax consumption is by imposing a national sales tax to replace the income tax. The problem with this way: sales taxes fall disproportionately on the poor, who often have no choice but to consume all their income.

An alternative idea I favor is to allow unlimited contributions to IRAs. Currently, IRA contributions are limited to no more than $5000 for people less than 55 years old and $6500 for people more than 55 years old. Under a national sales tax, people who earned $150,000 and consumed $100,000 would be taxed on only the $100,000.

The tax code would remain intact except for the change in the maximum IRA contribution. The Internal Revenue Service (IRS) would continue to administer it. This is both a feature and a bug. Our tax system is immensely complicated, with enumerable built-in
incentives to promote worthwhile activities from childcare to old folks’ homes. All these incentives, for good or ill, would remain in place. So would the costly bureaucracy to administer them.

Another alternative is the FairTax plan, which would replace both the income tax and the payroll tax with a single national sales tax of 23%. The FairTax would include a monthly ‘prebate’ for each household on spending up to the poverty line; households below that line would pay no net taxes.

Although the FairTax would eliminate the need for an IRS, at least in its current form, it is less progressive than our current income tax (i.e., it disproportionately burdens lower-income households).

Turning from the economic to the political, such tax reform would encounter many challenges. Many taxpayers would resent the possibility someone earning $1 million annually but spending only $30,000 would pay less taxes than someone earning and spending $50,000 annually. Hence, my belief the unlimited IRA is a better prospect for passage, as it requires the least change to the current system and thus is least likely to offend vested interests.

Note: A previous version of this article appeared in the Las Cruces Bulletin.

About the Author

Dr. Chris Erickson is a professor of economics at NMSU, where he teaches money and banking to undergraduates and economic development to graduate students. His major area of academic research is the role of the financial system in economic development.