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Abstract

This paper responds to claims made by Chris Sanchirico in his paper, A Critical Look at the Economic Argument for Taxing only Labor Income. His paper, in part, criticizes the claims we made in "The Superiority of an Ideal Consumption Tax Over an Ideal Income Tax, 58 Stan. L. Rev. 1413 (2006). We show that he makes at least three critical mistakes. First, he systematically confuses a Haig-Simons tax with tax systems that have small positive or negative taxes on capital. Arguments for taxes on capital are not the same as arguments for a Haig-Simons income tax. Second, he argues that our examples are erroneous. While we disagree with his claimed errors, Sanchirico, more importantly, confuses errors in the examples with errors in our arguments which are based on established public finance theorems. He agrees these theorems are correct, which is all that matters. Third, his most striking claim, that our arguments for a consumption tax equally support a tax solely on income from savings, is false. It only works when there is a single type of taxpayer and does not apply to the central case where taxpayers vary by ability. Once we correct these errors, Sanchirico's only remaining claim is that the underlying public finance theorems have strong assumptions. We agree and spent a substantial portion of our prior paper examining those assumptions to see whether relaxing them restores support for an income tax. It does not. Sanchirico does not provide any arguments to the contrary.

I. Introduction

Chris Sanchirico has recently published an article in this journal, *A Critical Look at the Economic Argument for Taxing Only Labor Income*,[1] devoted to examining and rejecting the case for a pure labor income tax. In that article, he attributes the support for a pure labor income tax in part to an article we wrote in the *Stanford Law Review*,[2] and in particular, to what he refers to as our "tax substitution" argument.[3] The editor of this journal has graciously allowed us a few pages to respond to Sanchirico's piece.

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1 Chris William Sanchirico, A Critical Look at the Economic Argument for Taxing Only Labor Income, 63 Tax L. Rev. 867 (2010).

2 Joseph Bankman & David A. Weisbach, The Superiority of an Ideal Consumption Tax over an Ideal Income Tax, 58 Stan. L. Rev. 1413 (2006).

3 Sanchirico, note 1, at 867-68.

We do not believe Sanchirico's article adds much to the literature and in many ways obscures well-established ideas. His central claim is that a pure labor tax is not optimal; it can be dominated in theory by a mix of taxes.[4] We agree with Sanchirico on this point and said so in our introduction.[5] To our knowledge, everyone writing in the area agrees on this point.

We were not examining the optimality of a pure labor income tax, however. Rather than compare a pure labor income tax to an as yet unspecified mix of taxes and subsidies, we compared a labor tax to an idealized version of the current income tax. We wanted to examine the most commonly discussed tax bases, bases that have been the subject of a literature dating back more than 100 years. We concluded that a pure labor income tax (administered as a progressive cash-flow consumption tax) is superior to a pure Haig-Simons income tax.[6] The two issues--the optimality of a pure labor income tax and a comparison of a Haig-Simons tax to a labor income tax--are not the same and unfortunately, Sanchirico confuses them throughout.

Our claims were based on established public finance theorems.[7] As far as we can tell, Sanchirico does not dispute the validity of these theorems.[8] Our goal was to use relatively simple examples to illustrate the ideas behind the theorems and then examine how these ideas apply to the income tax/consumption tax debate. Most of Sanchirico's article is devoted to arguing that the examples are incorrect.[9] He notes, for example, that depending on the

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4 Id. at 954-56.

5 Bankman & Weisbach, note 2, at 1416 ("Newer models show that a complete, optimal tax analysis could produce exotic taxes that look like neither a pure consumption tax nor a pure income tax."). One of us, in fact, has recently published an article suggesting modifications to a pure labor income tax to take disabilities into account. David A. Weisbach, Toward a New Approach to Disability Law, 2009 Univ. Chi. Legal F. 47.

6 Bankman & Weisbach, note 2. There is an important difference between a pure labor income tax and a consumption tax, namely that a consumption tax will capture excess returns to capital. We support using a consumption tax to capture this return. Because this issue is not relevant to the present discussion, we use the terms interchangeably here.

7 These include A.B. Atkinson & J.E. Stiglitz, The Design of Tax Structure: Direct Versus Indirect Taxation, 6 J. Pub. Econ. 55 (1976); Louis Kaplow, On the Undesirability of Commodity Taxation Even When Income Taxation Is Not Optimal, 90 J. Pub. Econ. 1235 (2006).

8 If in fact he believes these theorems to be wrong, we would expect he would state so explicitly and submit his argument to public finance journals for peer review.

9 Sanchirico, note 1, 903-51.

taxpayers' utility function that tax receipts could differ under our hypothesized income and consumption tax systems. We used simple numbers that had an implied utility function. Under alternative assumptions about the utility function, the numbers might change but the core ideas would remain. Nothing depends on the particular choice. Regardless, if one is worried about unstated assumptions in the examples (or believes that they are incorrect), it is clear that the underlying theorems remain valid, and readers can always refer to the underlying literature.[10]

One may, of course, object to the theorems because the assumptions are not realistic. The second half of our article is devoted to the task of examining the assumptions behind the theorems.[11] In fact, we view this as the major contribution of our article as the first half simply explains what existing theorems say. Sanchirico also engages in this exercise, but we fail to see how he adds to the existing discussion. We want to know which assumptions are realistic and when relaxing the assumptions is likely to lead to a preference for a traditional income tax instead of a consumption or labor income tax. Rather than examining, say, empirical literature about the extent to which the real world deviates from the world of the model, Sanchirico simply repeats that the assumptions are unrealistic.

Sanchirico's article is long and complex. It is impossible in a few pages to address all of his claims. Instead, we briefly review the intuition behind our argument and then discuss four of his central claims.

II. The Superiority of a Pure Consumption Tax over a Pure Income Tax

Our article starts with a simple model in which a relatively high-wage taxpayer works, saves some of her labor income, and then consumes in a future year.[12] We describe the income tax as a tax on labor and a tax on savings, and show that the tax on savings has the same effect as a sales tax on deferred (but not current) consumption.[13] The sales tax reduces the amount of goods or services a worker can purchase through labor. The sales tax also causes the worker to

10 The precise construct, with utility functions specified, can be found in Kaplow, note 7, at 1239-45.

11 Bankman & Weisbach, note 2, at 1431-54.

12 Id. at 1419.

13 Id.

substitute current consumption for deferred consumption. To the extent this occurs, the worker is worse off, and the government gains no revenue. The sales tax on deferred consumption is thus an inefficient tax on labor. It reduces the return to labor by the amount of the tax and induces the worker to substitute away from the desired deferred consumption. We can increase the worker's welfare by eliminating the sales tax and substituting in its place an additional tax on labor. The total return to labor actually increases; explicit tax payments remain the same, but the worker can now purchase as much deferred consumption as she wishes.

We can perform the same substitution for taxpayers in other wage brackets. A middle-wage worker is apt to save less than a higher-wage worker. The sales tax on deferred consumption, however, is still distortive. We can eliminate that sales tax and substitute in its place an additional labor tax. Because a middle-wage worker saves less than the higher-wage worker, her sales tax eliminated is less, and the additional labor tax is less. In this manner, we can transform the income tax into a labor tax, increasing efficiency without redistributing the tax burden from one wage cohort to another.

The model we present is based on a 1976 article by Anthony Atkinson and Joseph Stiglitz.[14] That model has been widely accepted in economics as specifying a default condition of optimality[15] and usefully extended by Louis Kaplow and others.[16] The first part of our article merely provides an informal, intuitive explanation of the model;[17] the second part applies the model to the income tax/consumption tax debate.[18] We show that the advantage of a pure labor tax can be realized through a more easily administered cash-flow consumption tax. We then discuss the difficulty of translating the simple model into the real world. Issues discussed here include savings heterogeneity, the argument that a consumption tax ignores imputed income from wealth, the possibility that savings may be a proxy for ability or some other measure we wish to tax, distributive justice, and transition concerns. If, as Sanchirico states, the view we

14 Atkinson & Stiglitz, note 7.

15 See Bankman & Weisbach, note 2, at 1414.

16 See, e.g., Louis Kaplow, The Theory of Taxation and Public Economics ch. 9 (2008).

17 Bankman & Weisbach, note 2, at 1422-30.

18 Id. at 1431-55.

express has become the dominant view,[19] we suspect that is because it has a common-sense core. All sales taxes reduce the return to labor; and partial sales taxes, such as those levied only on deferred consumption, add an additional, unnecessary level of distortion.

III. Sanchirico's Arguments

As noted, Sanchirico's article is long and complex. There are far too many claims and sub-claims to deal with them all. Instead, we divide his discussion into four broad groups. First, Sanchirico claims we make arguments about the optimality of labor income taxes as opposed to comparing Haig-Simons income taxes to labor income taxes.[20] Second, he argues that our examples are insufficiently specified.[21] Third, he claims that our argument can be used to support a tax solely on capital income rather than on labor income.[22] Finally, he argues that the assumptions behind our argument are too strong.[23] We go through these in turn.

A. Confusion Between the Income/Consumption Tax Debate and the Optimality of a Labor Income Tax

Our article was on the choice between a Haig-Simons income tax and a consumption or labor income tax. As noted, we did not argue that a pure labor income tax is optimal as compared to some other complex mix of taxes or subsidies and, in fact, explicitly stated otherwise.[24] Sanchirico's failure to distinguish these two claims frustrates the reader trying to disentangle his arguments.

Sanchirico's lack of clarity on this point may stem from his unorthodox definition of an income tax. On the first page of his article, Sanchirico frames the question posed by our and others' works as whether the tax "base should include--in addition to labor income--income from

19 Sanchirico, note 1, at 867.

20 Id. at 924.

21 Id. at 905, 911.

22 Id. at 927-28.

23 Id. at 912-15.

24 In fact, our article is entitled "The Superiority of an Ideal Consumption Tax Over an Ideal Income Tax," not the optimality of a pure consumption tax.

savings and investment."[25] In the relevant footnote he states that this is the same as the choice between an income tax and a consumption tax.[26] If by this he means to state that any tax on capital makes a tax an income tax, he is using that term in a manner inconsistent with common usage. As readers well know, a pure Haig-Simons income tax imposes a nominal tax on capital income at the same rate as on labor income. Showing that the optimal system may have a tax on capital (which could be positive or negative or both) is not the same as, or even close to, showing that the tax should be at the same nominal rate as on labor income. Leaving aside implementation costs, it is likely that the optimal system would have a mixture of taxes and subsidies on many goods or activities, including capital. The tax on capital could be positive or negative, and in the dynamic context, might vary with the taxpayer's particular history of earnings and consumption. It might vary with the type of capital, the timing of its use, its location, or its ownership.[27] To our knowledge, there is nothing anywhere in the existing literature and nothing in Sanchirico's article that suggests that it would be optimal to impose a tax on capital income at the rate imposed on labor income. As Alan Auerbach recently noted, "one can scour the optimal taxation literature without finding a result suggesting that labor income and capital income should be treated equally by the tax system."[28]

The same confusion--between claims of superiority and optimality--is found later in the introduction. Sanchirico notes that several proponents of the tax substitution argument have

25 Sanchirico, note 1, at 867.

26 Id. at 867 n.l.

27 It might be desirable to have small subsidies or taxes on capital income. For example, Emmanuel Saez claims that it might be desirable to have an infinitely small tax on capital if certain assumptions are met (and if the assumptions go the other way, it would be desirable to have a small subsidy on capital). Emmanuel Saez, The Desirability of Commodity Taxation under Non-Linear Income Taxation and Heterogeneous Tastes, 83 J. Pub. Econ. 217 (2002). In the dynamic context, the net tax on capital is, in central cases, zero but includes both positive and negative components. Mikhail Golosov, Aleh Tsyvinski & Iván Werning, New Dynamic Public Finance: A User's Guide, 21 Nat'l Bureau Econ. Macroeconomics Ann. 317, 334 (2006). In fact, Sanchirico's own example does not impose a tax on capital equal to the tax rate on labor income--the marginal rate on capital income in his Table 7 goes to zero. Sanchirico, note 1, at 938-39.

28 Alan J. Auerbach, Tax Reform in the Twenty-First Century, in Fundamental Tax Reform: Issues, Choices, and Implications 27, 32 (John W. Diamond & George R. Zodrow eds., 2008).

published papers arguing that a pure labor income tax is not optimal.[29] He speculates that these articles are inconsistent with their prior work.[30] But they are not, of course.

This unfortunate confusion permeates his article. In many places where Sanchirico purports to be addressing our claims, he in fact is not. Indeed, although one would never guess from his rhetoric, very little of his article addresses our claim that a consumption or labor income tax is superior to a Haig-Simons income tax.[31]

B. Criticisms of our Model and Examples

Sanchirico raises a large number of complaints about our examples. In some cases, Sanchirico both makes an objection and then answers his own objection.[32] The examples were meant to illustrate established theorems in public finance. He does not object to the theorems and does not argue that our examples fail to illustrate the core ideas in the theorems. It is unclear what the point of this exercise is.

One of the key claims he makes is that tax revenues will not be the same under our hypothesized labor income tax replacement for a Haig-Simons tax.[33] We illustrate our model with a taxpayer who desires to save a portion of his income; the tax on savings leads him to save

29 Louis Kaplow, Optimal Policy with Heterogeneous Preferences 19 (Harvard Law & Econ. Paper No. 617, 2008), available at http://ssrn.com/abstract=1170048; Weisbach, note 5, cited in Sanchirico, note 1, at 870 n.10.

30 Sanchirico, note 1, at 870 n.10.

31 Sanchirico, in his Counter-Reply, argues that if the tax substitution argument does support a pure labor income tax it cannot be used to decide whether a consumption tax is preferable to a Haig-Simons income tax. Chris William Sanchirico, A Counter-Reply to Professors Bankman and Weisbach, 64 Tax L. Rev. __, __ (2011). This does not follow. Models can support weaker conclusions but not stronger conclusions. Sanchirico's criticisms of the assumptions behind the Atkinson-Stiglitz theorem say nothing about whether relaxing the assumptions would restore support for a Haig-Simons income tax.

32 For example, Sanchirico points out that a pure labor tax might reduce revenues becauseit might have a wealth effect. It might increase the effective return to labor and workers might respond by working less. That problem can be solved by increasing labor tax rates, and, a page or so after raising the problem, Sanchirico gives that solution. See Sanchirico, note 1, at 914-15 (raising issue of reduced labor), 917-18 (solving problem through increased labor rates).

33 Id. at 889-95.

less than he otherwise desires. Replacing that tax with an additional labor tax leaves the government equally well off and allows the worker to save as much as he desires. Sanchirico takes us to task for not presenting the taxpayer's utility function and, in particular, for not specifying that the taxpayer desires to save any portion of additional income.[34] Our assumption was that the savings rate on the marginal dollar was the same as the existing savings rate (for a given taxpayer). Suppose, Sanchirico hypothesizes, our worker instead wishes to spend every additional dollar he earns. Now, our substitute labor income tax would increase the marginal tax rate and increase the distortion on labor, potentially reducing tax revenue.

Sanchirico does not suggest that in the real world the demand for savings is apt to disappear at the margin. His purpose here is (or at least appears to be) simply to show this is an issue we have not considered. In fact, our example clearly implies the condition Sanchirico finds missing: that the taxpayer's demand for savings extends to the additional dollar earned.[35] We later explicitly discuss the possibility that taxpayers may differ in their propensities to save, a term that obviously implies behavior at the margin.[36] We did not specifically discuss the issue of marginal demand in the example, or provide a utility function, because we wanted to keep the article short and accessible.

Moreover, as Sanchirico notes,[37] if one is concerned about this issue, it is easily remedied by specifying the utility function. For example, even if the demand for savings were to disappear at the margin under a given utility function, our construct works (with the numbers properly modified to take into account the implied behavior). One may rework the example using any number of alternative utility functions. The idea is the same, and nothing about the core argument follows from the choice.

34 Id. at 913.

35 Bankman & Weisbach, note 2, at 1421-27.

36 Id. at 1439.

37 Sanchirico, note 1, at 913 n.94.

A related complaint against our model (and the well-accepted economic model that it presents) is that it is incomplete.[38] In fact, the model, like any other model, is incomplete. We acknowledge its "assumptions and simplifications" in our introduction and spend most of the article discussing the fit between the model and real world.[39] We state that "the economics literature examining and extending AS 1976 [Atkinson-Stiglitz, 1976] is large and complex" and limit our goal to exploring "core arguments . . . and their practical implications."[40]

Given the admittedly incomplete nature of the model, and the length of his article, one might expect Sanchirico to have found new and troubling problems applying the model to the real world. In fact, many of the problems he comes up with are based on a crabbed reading of our article. They all can be resolved without threatening our basic analysis.

An example is Sanchirico's argument that the substitution of an additional tax on labor for a tax on savings might cost the fisc money because of a labor-income subsidy.[41] In particular, Sanchirico envisions a scenario in which the labor tax increases work effort (and utility) but reduces revenues because an unrelated provision subsidizes work effort.[42] The more work effort, the more expensive this subsidy. Sanchirico gives the earned income tax credit as an example of such a subsidy.[43]

We did not discuss labor-income subsidies--negative taxes--in our piece but extending the analysis to this case is simple. Suppose that there is a negative tax on labor income but a positive tax on savings, and we want to eliminate the tax on savings while making a corresponding adjustment to the labor tax. As in our base case, the positive tax on savings acts as an implicit tax on labor, reducing the labor income subsidy. If we eliminate the tax on savings, we then make a corresponding reduction in the subsidy for labor. The results are exactly the same as in the positive-tax case, and our conclusions follow directly.

38 See, e.g., Sanchirico, note 1, at 875 ("I argue that the informal version of the tax substitution argument [that Bankman and Weisbach present] leaves open a number of decisive questions....").

39 Bankman & Weisbach, note 2, at 1415.

40 Id. at 1416 (citing Atkinson & Stiglitz, note 7).

41 Sanchirico, note 1, at 900-01.

42 Id. at 901.

43 Id.

Sanchirico, however, seems to be considering a case where no adjustment is made to the labor-income subsidy. Without such an adjustment, our model does not apply, but that is obvious. Moreover, even without such an adjustment, there are likely few effects. If Sanchirico means to suggest that a pure labor tax might actually increase costs to the fisc due to EITC payouts, he is plainly wrong. Low-wage individuals do not save very much and do not pay much tax on their savings. They would not benefit from the elimination of tax on savings, and so would not increase labor supply in the way Sanchirico hypotheses.[44] Moreover, if they did somehow benefit, presumably some would move into the EITC, increasing costs to the fisc, while others would work so much they would move out of the EITC, reducing costs to the fisc. Even if low-wage workers did somehow increase labor supply in a way that increased costs to the fisc, so long as other workers behaved in the manner Sanchirico hypothesizes, the fisc would come out ahead. Non-low-wage workers, who comprise the bulk of the tax base, would work more and produce greater tax revenues.

Suppose, though, that the labor tax did somehow lead to increased employment by the very lowest wage workers. That would be an unambiguously favorable development. If the EITC is justified only as a means to stimulate work, it would no longer be as necessary. The future of the EITC would be a matter of debate that takes place against the backdrop of a positive development (greater labor earnings of the poor) we would not want to lose.

It is possible that Sanchirico doesn't believe a labor tax would increase the costs of the EITC--he worries about the possibility that some other labor subsidy would become more expensive because of increased work effort. Sanchirico does not name the subsidy; presumably it does not now exist. If, however, it did exist, the analysis would be the same. The increased work effort would be a positive development. We could respond to increased costs by reducing the subsidy, which presumably would be needed less.

44 Our article reflects this by assuming the "poor" individual pays no tax on savings; she is unaffected by the switch to a labor tax. Bankman & Weisbach, note 2, at 1429.

C. A Pure Savings Tax Is as Desirable as a Pure Labor Tax

In only one part of his article does Sanchirico directly address our claims.[45] Recall that in our model, people were assumed to vary by their earnings ability. Bill Gates can earn more than a lawyer who can earn more than a janitor. At each earnings level, we replaced a distortive tax on savings with an equivalent tax on labor. The result was a progressive tax on labor or consumption. We then go on to examine what happens if people vary in other ways and how that might require further changes to the tax system.[46]

Sanchirico makes a surprising claim about the implications of the ability to replace a distortive tax on savings with a tax on labor or consumption. He argues that our model can be used to support placing the entire tax burden on savings. He writes that "there is no sense in which taxing only labor earnings is more (or less) efficient than taxing both labor earnings and savings earnings, or taxing only savings earnings."[47] At its core, the argument is that one can take the model and just switch the meaning of variables. What in the model stood for labor earnings is now savings earnings and what was one of many consumption choices--consumption at some future date--becomes labor earnings. Using the same construction, instead of replacing the distortive tax on savings with a tax on labor, one can replace the distortive tax on labor with a tax on savings. It is, to use his analogy, as if a consumer were purchasing shirts and pants--we can alternatively tax shirts, pants, or both. The meanings of variables in the mathematical equations can simply be reversed.

Said another way, we characterized a tax on future consumption as an implicit tax on labor income. We removed the tax on future consumption and replaced it with the equivalent explicit tax on labor income. We could alternatively describe a tax on labor income as an implicit tax on future consumption and remove the labor tax, replacing it with an explicit tax on future consumption. Under this logic, one can impose the entire tax on any good. For example,

45 See Sanchirico, note 1, at pt. V.

46 Id. at 1428-48; see also Weisbach, note 3, at 81-82.

47 Sanchirico, note 1, at 929.

we could impose the entire tax burden on the purchase of dill pickles or fluffy towels.[48] A tax on dill pickles or fluffy towels acts as an implicit tax on labor income, so the substitution, in theory, works.

Moreover, suppose that we replace the distortive tax on savings with an equivalent tax on labor earnings, and that as we suggest, this would improve the efficiency of the tax while leaving distribution constant. Sanchirico claims we could, using the same logic, then replace the tax on labor earnings with an equivalent tax on some other item, say dill pickles, once again improving efficiency. And we could then replace the tax on dill pickles with a tax on fluffy towels, replace that with a tax on savings, and so on and so forth. Sanchirico concludes that our logic does not support any particular tax base. We can always replace any given tax base with another one and improve efficiency.

This argument, however, is not correct. We cannot simply switch the meaning of the variables in the model. Recall that the model assumes that people vary by labor earnings ability. If we interpret the term representing labor earnings as the return to savings or dill pickle consumption, then the model is of a world where people vary only with respect to their ability to achieve a higher return to savings or to consuming dill pickles. Sanchirico's world is one where Bill Gates, the lawyer, and the janitor can all equally earn labor income but Gates differs from the rest in his stock picking ability. The model is valid in the sense that the math works, but it is not a plausible model of the world.[49]

The problem in Sanchirico's analysis arises because he is focusing on the single taxpayer case, where, by construction, taxpayers do not vary by earnings ability, savings ability, or in any other way. In this setting, a head tax would indeed be desirable and we could equivalently tax

48 West v. Prudential, 282 F.3d 935, 939 (7th Cir. 2002) (using dill pickles and fluffy towels as quintessential physical products).

49 Note that in his Web Appendix Sanchirico restricts his construction of a savings-only tax to the case where there is a single individual, although this is not clear in his article. See Chris William Sanchirico, Web Appendix for A Critical Look at the Economic Argument for Taxing Only Labor Income 64 (2009), http://ssrn.com/abstract=1680494. In this case, the substitution works but is trivial.

just about any attribute so long as it does not entirely disappear when taxed. But these conclusions do not carry over to the more realistic case where taxpayers vary by ability.

Sanchirico apparently focuses on this case because we start with the single taxpayer case as a simple setting in which to illustrate our argument. We intended our use of the single taxpayer case to be illustrative only, were always concerned with the case where taxpayers varied by ability, and said this explicitly.[50] If we took an Exacto knife and eliminated all discussions of the single taxpayer case from our article, all of our arguments would remain the same. Sanchirico's savings-only tax (and other undifferentiated taxes including head taxes), however, would no longer be appropriate.

Moreover, it is not even clear how a savings-only tax is supposed to work. As a general matter, we cannot have future consumption without work while we can work without saving for future consumption. For example, if people worked in each period and spent all of their earnings, saving nothing, there would be nothing to tax in a savings-only tax. The reverse is not true. As a general matter, people will not have savings unless they work.[51] The problem with the argument can be seen if we imagine replacing the labor income tax with a tax on some random item of consumption, such as dill pickles, fluffy towels, red sports cars, or for that matter consumption in some future period.

For the same reasons, Sanchirico's stair-step argument, replacing each tax with a better one, does not work. It is neither feasible nor would it allow us to produce the desired

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50 See Bankman & Weisbach, note 2, 1422 n.14.

Looking only at efficiency is, in an important sense, contrary to one of the key points of AS 1976 [Atkinson-Stiglitz, 1976]. The authors in AS 1976 argue that Ramsey-type efficiency analysis is wrong because if we eliminate redistribution from the analysis, the most efficient tax is a head tax. Once redistribution is added back in, a wage tax best distinguishes among individuals on the basis of their abilities. AS 1976 never considers the pure efficiency argument. The discussion in the text treats efficiency separately merely to give the spirit of the argument before moving on to the more complex case with redistribution.

51 There is a current stock of savings that can be spent (and therefore taxed) without labor. We discuss the treatment of this in id. at 1436-38.

distributional consequences. We cannot replace a labor-income tax with a savings-income tax, and we cannot replace that with a tax on pickle consumption or the use of fluffy towels.

D. Strong Assumptions: The Nonoptimality of a Pure Labor Tax

Sanchirico spends much of his article pointing out conditions that might make a pure labor tax suboptimal. The fact that our basic model has only a single representative taxpayer in each wage cohort offers much grist for his mill.[52] In the real world, taxpayers with similar wages will differ in their savings and pay different taxes on those savings. This means that it will be impossible to benefit all taxpayers. The replacement labor tax will be higher than the implicit labor income tax for some, lower for others. Sanchirico notes this, and writes that "The tax change thus will have distributional consequences. These consequences will not be positive if those who benefit most from the removal of the tax on savings earnings--those who earn more from savings--have lower social welfare weight."[53]

Once again, Sanchirico writes without referencing the existing literature. In fact, the point is a common one and acknowledged in our article:

> When there is heterogeneity in savings, the replicating wage tax will only be able to replicate the tax on average savings for each wage class. Within each class, switching tax systems will redistribute from spenders to savers. The merits of this type of redistribution (or the reverse) are precisely the focus of some of the literature on consumption taxation....[54]

We spend roughly one-quarter of our article discussing the implications of the change.[55] We conclude that while some spenders may be overtaxed relative to utility under a consumption

52 Sanchirico, note 1, at 903-29.

53 Id. at 935.

54 Bankman & Weisbach, note 2, at 1439.

55 Id. at 1439-48.

tax, these spenders nonetheless may benefit under a consumption tax. We characterize the welfarist case for retaining the income tax as "extremely tenuous."[56]

More generally, though, we agree with Sanchirico that a pure labor tax is not optimal. We say that explicitly in our Stanford article, and restate that in a companion piece.[57] We agree that, in theory, some mix of positive or negative income, consumption and other taxes is apt to dominate a pure labor tax. No one has yet specified just what that mix might be, however, or how it would be administered. In part for that reason, our article did not compare a pure labor tax with such an (unspecified) optimal tax mix. Instead, we compared the two leading tax bases: a pure labor tax (administered in the form of a cash-flow consumption tax) and a Haig-Simons income tax. We concluded that a pure labor income tax is superior to a pure income tax. On that issue, Sanchirico offers no plausible argument to the contrary.

56 Id. at 1448.

57 See id. at 1416; see also Joseph Bankman & David Weisbach, Reply, Consumption Taxation Is Still Superior to Income Taxation, 60 Stan. L. Rev. 789, 790 (2007).

Readers with comments should address them to:

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