BACKGROUND

What should determine the taxes that an individual pays? Specifically, what potentially taxable attributes should be included in the government’s calculus of the tax an individual must pay and the transfers (that is, tax reductions) she is entitled to receive? The question is among the most elemental and perennially controversial in tax law and policy.

Under the current U.S. tax and transfer system, an individual’s taxes and transfers are based on a long and varied list of personal attributes: the taxpayer’s income from various sources, expenses of various kinds, assets, liabilities, age, and family structure.

But despite the eclectic nature of the current system, the dominant view among tax scholars is that the tax base should not be so eclectic – that achieving the optimal balance of revenue, efficiency, and equity requires basing taxes and transfers on a single taxable attribute, namely labor earnings, and not also on other potentially taxable attributes such as capital gains. The optimality of such labor-earnings-only taxation is regarded as “the plain vanilla case” or the “natural model.” Circumstances in which a more eclectic tax base is warranted are described as “exotic” or as “theoretical curiosities.”

In a recent paper, however, University of Pennsylvania Law School Professor Chris William Sanchirico asserts that – with regard to balancing revenue, efficiency, and equity – tax eclecticism is in fact the optimal model, and labor-earnings-only taxation, the exotic exception. Sanchirico’s paper, Tax Eclecticism, does not defend the often frustrating complexity of the current U.S. tax system, but rather argues for the general principle of tax eclecticism based on his mathematical analysis.
Sanchirico’s argument has two parts. The primary objective of the paper concerns the three criteria of revenue collection, economic efficiency, and the mitigation of economic inequality. Sanchirico asserts that basing monetary flows between individuals and the government on a more inclusive set of taxable attributes makes it possible to achieve a better balance of these three competing criteria.

The second objective of the paper concerns a fourth criteria: the administrability of the tax and transfer system. Sanchirico argues that an eclectic tax base need not make the tax substantially more difficult to administer.1

Although Sanchirico’s argument for an eclectic tax base is somewhat consistent with the U.S. tax system as it actually is, it swims against a powerful tide of thought among many tax scholars regarding how the tax system ought to be.

Capital Gains Tax?
The paper has important implications for the long-running debate over whether capital gains should be taxed in addition to labor earnings. Accordingly, it casts doubt on the consensus view that the income tax, which taxes both capital and labor income, ought to be replaced with a consumption tax, which (under certain special conditions) is equivalent to a tax on labor earnings only.

The paper also contributes to the debate over whether non-tax-and-transfer legal and administrative policies – such as those concerning environmental regulation, public goods provision, immigration, and private law rules in tort or contract – should be set in part to reflect society’s redistributational goals, or rather be determined solely on the basis of efficiency.

1 A companion paper, *A Critical Look at the Economic Argument for Taxing Only Labor Income*, critiques the predominant optimal tax argument for taxing only labor income, the “tax substitution argument.”

METHODOLOGY

Sanchirico focuses on the taxation of capital gains to demonstrate the argument for tax eclecticism. He uses the mathematical tool of directional analysis to describe the conditions under which adding capital gains to a labor-earnings-only tax base enables the government to improve the tax system according to the criteria of revenue, efficiency, and equity.

The paper sets up the problem as follows: given an optimal labor-earnings-only tax system, the task is to locate a tax reform that adds capital gains to the tax base and increases at least one of the three criteria of equity, efficiency, or revenue without reducing the other two. The question is when such a tax reform can be found.

Notably, although his argument for tax eclecticism is inherently mathematical, Sanchirico devotes much of the paper to extended verbal discussions of mathematical concepts. As Sanchirico explains, the discussions represent an attempt to present the argument for tax eclecticism in a way that is intuitive and transparent.

FINDINGS & CONCLUSIONS

Sanchirico’s directional analysis calls into question the dominant view that including taxable attributes other than labor earnings in the tax base is optimal, in terms of revenue and welfare, only in the exceptional case.

He writes that his conclusion has weak, moderate, and strong forms, and invites the reader to take her pick. The weakest form is the conclusion that the circumstances under which a more eclectic base is optimal cannot be considered exceptional.
The moderate form is the conclusion that it is labor-earnings-only taxation that is the exception for optimality. The strongest form – which implies the other two forms and is the claim that Sanchirico makes – is the conclusion that the optimality of labor-earnings-only taxation is so exceptional as to be wholly ignorable.

According to Sanchirico, the directional analysis indicates that the optimal tax system is not one that is based solely on labor earnings. It is essentially always optimal, in terms of revenue and welfare, to add capital gains to a labor-earnings-only tax base.

Consequently, Sanchirico writes that optimal labor-earnings-only taxation is hardly the plain vanilla case – that, in fact, it is not even really on the flavor board.

Addressing the fourth criteria of administrability, Sanchirico finds that an eclectic tax base does not necessarily generate substantial amounts of additional complexity and administrative cost.

Indeed, his analysis shows that the improvement in a labor-earnings-only tax system is almost always accomplished with the simplest of tax adjustments. There is no reason to resort to complex formulae, he writes, and no reason to substantially complicate the tax code.