The Estate Tax and the Laffer Curve

By RICHARD H. THALER

Richard H. Thaler is a professor of economics and behavioral science at the Booth School of Business at the University of Chicago.

My Economic View column last Sunday was about the estate tax, a treacherous topic on two counts.

First, it is hard to get all the details right, especially since some of them are not yet known. Second, lots of people have strong opinions about this subject, and many of them write to you. After digesting all the e-mails — except for those written in ALL CAPS, which I have learned to delete without reading — I have a few thoughts to add to my column.

First, let’s (try to) get the facts straight. An estate tax expert, Vince Lackner, wrote a nice note on some points I made about the estate tax that are open to interpretation:

“1) 2011 Exemption. The sixth paragraph in your article refers to the 2001 exemption (“applicable exclusion amount”) of $1,350,000 [$675,000 for each spouse]. Several paragraphs later, you refer to the first of three courses that Congress might take (“Do nothing and go back to the 2001 exemption and rates”). This reference implies that the applicable exclusion amount in 2011 would be $1,350,000. In fact, it is generally believed that this amount will be $2,000,000 ($1,000,000 for each spouse). This is the level that the applicable exclusion amount would have reached in 2006 if EGTTRA had never been enacted.

(footnote 2 here)

2) Carryover Basis in 2010: Your article states that “[t]here are new filing provisions in 2010 for any estate with more than $1.3 million in unrealized capital gains.” In fact, as we understand it, a new form will be required for any estate whose date-of-death value for all property previously reportable on a 706 exceeds $1.3 million. Thus, you could have an estate worth $1,300,001 at death, with a carryover basis of $1,300,000 (thus, an unrealized capital gain of only $1), and still be subject to the filing requirement.”

Did I mention that the estate tax is complicated? And note that even experts are tempering their opinions with phrases like “as we understand it”.

I also got some e-mails on the substance of my piece and on two blog posts of interest.
David Friedman notes that the capital gains tax should really be indexed to inflation, and that part of those unrealized capital gains are just attributable to the falling value of the dollar. This is a fair point, and I completely agree that as a matter of principle, the capital gains tax should take account of inflation. But it doesn’t, and no one in Congress is proposing to fix that.

Then on this site my University of Chicago colleague Casey Mulligan complains that I have things backwards.

Professor Mulligan thinks that the combination of a high exemption and a high tax rate is especially distortionary. He notes that: “Taxes affect behavior, because taxpayers take steps to pay less tax. As a result, every tax dollar brought into the public treasuries harms the private sector more than a dollar, and the amount of extra harm depends on the marginal tax rate.”

It seems to me that this analysis is incomplete. Suppose that we are considering two versions of the estate tax. Version 1 is the Obama proposal: A 45 percent tax with a $7 million exemption. Version 2 has no exemption but a much lower tax rate that is estimated to bring in the same revenues. Which causes more distortions?

I would argue that Version 2 is worse because every estate would have to deal with it, no matter how small, whereas in Version 1 only three estates in 1,000 have to file an estate tax return. Since there are fixed costs to dealing with the estate tax, these need to be considered as well.

Of course, I agree with Professor Mulligan that, generally speaking, we should aim for broader bases and lower tax rates. For example, we could immediately cut income tax rates if we got rid of the home mortgage and charitable giving deductions. I would favor this, but does anyone in Congress?

I have thought about whether the 45 percent tax rate might be so high that it is on the downward sloping part of the Laffer Curve, that is, past the point where revenues are maximized.

Arthur Laffer’s idea, that lowering taxes could increase revenues, was logically correct. If tax rates are high enough, then people will go to such lengths to avoid them that cutting taxes can increase revenues. What he was wrong about was in thinking that income tax rates were already so high in the 1970s that cutting them would raise revenues. George H. W. Bush famously called this Voodoo Economics.

Is it possible that lowering the estate tax rate to, say, 35 percent, could increase revenues?

There is little empirical evidence to go on here, but the experts I have discussed this with seem to think this result is not implausible because people might do less to avoid the tax if the rate were lower.

In evaluating this outcome, however, it is necessary to point out that a lower tax rate would also likely decrease charitable contributions, since donating some of their fortune to charity is one
way people avoid paying estate taxes. Readers can judge for themselves what those charitable contributions are worth in the broader context of this debate.

Finally, the point I want to reiterate is that, as far as I know, no one is really proposing something that will completely eliminate the tax burden created when an affluent person dies. For estates with more than $1.3 million but less than $7 million, 2010 may turn out to be not the best year to die. And trying to find the original purchase price of goods obtained a long time ago will not be a bundle of joy for anyone.