Remarks at AALS Session on Wealth Transfer Taxes

January 6, 2012

First, thanks to Jim Repetti and Laura Rosenbury for organizing these panels, and including me in one of them.

I should confess at the outset that I am appearing under false pretenses. Jim and Laura wanted at least one critic of the current system for purposes of balance, but estate tax critics are scarce among academics, and the ones who truly qualified were unavailable. I am not a critic. I am on record—most recently just last month in a piece in Tax Notes with Jay Soled—as a supporter of the estate tax. Like many people in this room, I favor an estate tax with a tighter tax base, a moderate rate in the range of 35-40%, and an exemption equal to the amount of wealth I personally expect to leave at death. But I agreed to impersonate a critic for the theatrical purposes of this exercise.

And I will admit that there are, among the many disingenuous and otherwise defective arguments against wealth transfer taxes a couple that have enough merit to give me pause. So I will focus on those, so that I can do my impression of an estate tax opponent without having my head explode.

The first argument is that society tends to discourage that which it taxes. Despite efforts to style our wealth transfer taxes as "The Death Tax," it is in fact not a tax on death, but a tax on the intergenerational transfer of substantial wealth. So we have to presume as a default that the estate tax tends to discourage the creation and preservation of wealth. Maybe not, but that is certainly not implausible. Since we don't want to discourage those things, if we could avoid that effect, we surely should try to do so.

The second argument is that although the contribution of an estate tax to the overall progressivity of the tax system is—to its supporters—one of its virtues, there is surely something unsettling about a tax whose burdens are so narrowly shared. In recent years, no more than two percent of deaths have resulted in any net estate tax liability, and if the exemption is increased beyond the permanent level of $1,000,000—as seems highly likely—the proportion of estates burdened by this tax may decline to a fraction of one percent. When a tax is imposed on so few by so many, we should surely give some thought to whether it is an instance of tyranny of the majority, which must always be a central concern of democratic states.

But in thinking about the first point in particular, it will be useful to step back from partisan arguments on either side to consider an important conundrum in evaluating the incentive effects of the estate tax. Tax policy conventionally evaluates tax provisions in terms of two central paradigms regarding the behavior of Homo Economicus—rational economic man. H. Economicus is under assault from the behavioralists in any case, but even taking him at face value, there are reasons to wonder how well our standard assumptions capture the incentive structure faced by the very rich.

The norms assume that H. Economicus constantly faces a trade-off between labor and leisure, preferring the latter, but willing to be compensated to engage in the former. A tax on the fruits of labor alters the calculus, discouraging labor and encouraging leisure. But is this true among the great wealth-creators of our time? One has to think that Steve Jobs just liked developing cool gadgets, and that his willingness to labor over them ceased to be about the paycheck early in his career. He was very rich at 35, but continued to labor until his death.

The other major trade-off is between current consumption and future consumption, with interest rates being the compensation in this case that encourages people to defer consumption. Taxes again dull this effect, to the detriment of thrift. But one notes a profound blurring of the line between consumption and investment among the very rich. Many activities that look like consumption—buying diamonds, Impressionist paintings, and chalets in Gstaad, for example—turn out to have substantial investment elements. And, on the other hand, many apparent investment activities have sizable “play” elements, as when a distilling industry mogul takes on the guise of an entertainment entrepreneur (Edgar Bronfman and Vivendi), or a software mogul becomes the owner of a professional sports franchise, (Paul Allen and several others).

When consumption and investment blend into each other, it adds another dimension of perplexity to the task of deciding which way tax incentives will bend behavior. We have not come to grips with the challenge of untangling this in even the most rudimentary way.