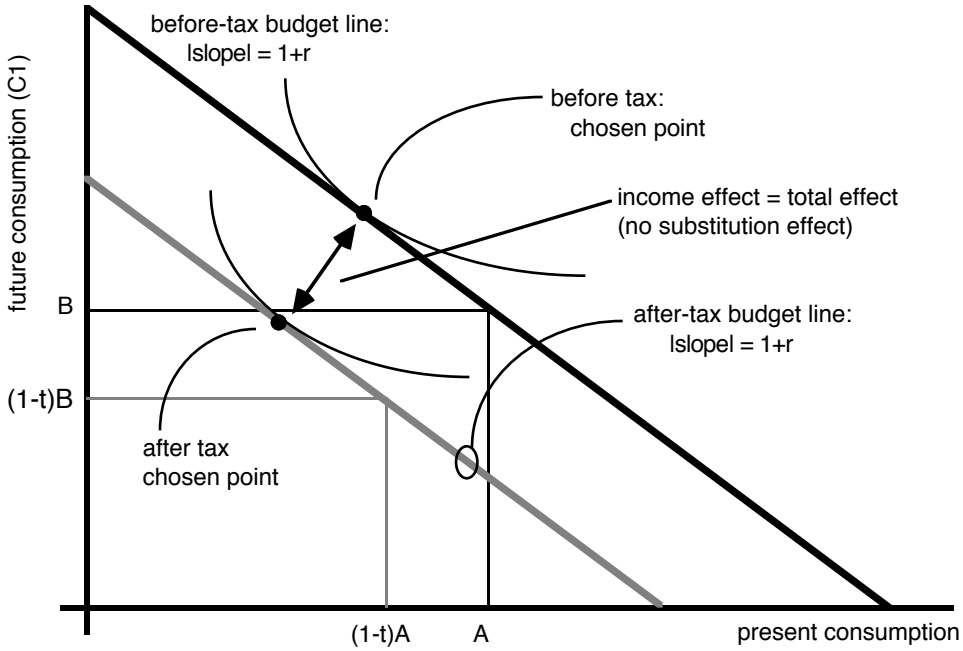
University of California, Davis
Department of Economics
ECONOMICS 131

L. Jay Helms

Answers to Problem Set #8

1. Consumption Taxation and Saving



a. In the absence of taxation the budget set has slope -(1+r) and goes through the endowment point (A,B). The utility-maximizing point is the tangency shown in the diagram.

b. In the presence of a consumption tax at rate t the budget set still has slope -(1+r) but goes through the point ((1-t)A,(1-t)B). Again, the utility-maximizing point is a tangency as shown in the diagram.

c. As relative prices between present and future consumption (the slope of the budget line) are unchanged, there is no substitution effect; the entire effect is an income effect.

2. The Estate and Gift Taxes

There are two features of the estate tax calculation which "integrate" it with the gift tax. First, the decedent's estate is taxed not only on the value of the estate but also on the value of all gifts made since 1976 which were subject to the gift tax. (Spousal transfers and gifts up to $10,000 per year per recipient are excluded altogether.) Secondly, the estate is allowed a credit equal to the entire amount of the gift taxes paid since 1976.

Because of these features, the gift tax works like a withholding device for the estate tax, and the marginal tax rate is determined by the *cumulative* gifts and bequests, irrespective of the division between gifts and bequests.

3. Property Tax Reform

a. Case against tax reform: Because tax differences are already capitalized (i.e., prices of over-assessed properties are depressed to compensate) the inequities are already removed (in the sense that net returns are already equated). Unless current landowners are the ones who owned the property when the tax was first announced (and the windfall losses were borne), reform only creates a new set of inequities (windfall profits for owners of over-assessed property).

b. Case for tax reform: Incentives to maintain and improve property are affected by differential rates: even though the return to land is equated by capitalization, a relatively high nominal rate lowers the return to improvements (which are also taxed at the high rate).