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THE CASE FOR REPEALING THE ESTATE TAX

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INTRODUCTION

Virtually from the beginning of government in human society, death and taxes have been closely linked as well as inevitable. The passing of well-to-do individuals has been a lucrative moment for tax collectors. Most nations today impose death, estate, and inheritance taxes, and the United States is no exception.

This ancient practice, however, is beginning to change. Motivated by mounting evidence that death-related taxes may hold back the economic well-being of the living, several countries and American states recently have repealed their taxes on estates or significantly scaled them down. The U.S. Congress also is reexamining the wisdom of these taxes. Two bills, one in the House and another in the Senate, call for outright repeal of the estate and gift tax,[1] and dozens of others in both chambers propose significant modifications that give taxpayer relief.

Support for these proposals still comes primarily from advocates of limited government. But a growing number of liberals recently have shown a keen interest in repeal. Like so many critics of the estate tax, these new critics are disturbed by the growing evidence that this tax:

✗ **Reduces** economic growth, hurting the jobs and incomes of the very people that wealth redistribution was intended to aid;

1 In the House of Representatives, H.R. 784 is sponsored by Representative Christopher Cox (R-CA). In the Senate, S. 628 is sponsored by Senator Jon Kyl (R-AZ).

- ✗ **Increases** the cost of capital, slowing down research and development and the use of machines that would increase worker productivity—and thus wages;
- ✗ **Keeps** interest rates on home loans and other major purchases higher than they should be; and
- ✗ **Raises** very little money—in fact, it may cost the government and the taxpayers more in administrative and compliance fees than it raises in revenue.

Current wealth taxation policy stems from the mistaken view that redistributing income leads to the redistribution of economic power. Nearly a century of wealth taxation, however, shows that well-to-do Americans (including a great number of middle-class families) simply find ways of legally avoiding the tax collector. Not only do they save less and consume more of their income, thus benefiting from the lower taxes on consumption, but they also make less productive investments, such as large life insurance policies and substantial charitable contributions, thus reducing the chances that their death will leave a large taxable estate. The policy of using the estate tax to redistribute economic power actually leads to a distorted distribution of consumption and a less productive economy. Both of these unexpected outcomes worsen the economic condition of the less economically powerful.

The Founders understood the critical importance of reducing legal barriers to economic opportunity as the best public means of allowing every citizen to achieve economic fulfillment. This understanding found a home in the original U.S. Constitution, where direct taxes on wealth and income were prohibited except in time of national emergency. But soon after the ratification of the Sixteenth Amendment (which lifted the ban on federal income taxation) in 1913, the federal government began a 60-year effort to create a more democratic economy through the forcible redistribution of wealth. That policy has imposed costs on economic growth as well as fundamental liberties.

It is time to repeal the estate, gift, and generation-skipping tax. The case for this turns on three factors: the diminishing importance of the estate tax as a federal revenue stream; the failure of the tax to achieve its public policy objectives, principally the creation of economic benefits for lower-income Americans; and the continuing damage the tax exacts on the economy in terms of jobs, output, and growth. Transcending all of these factors is the growing appreciation that wealth taxation infringes on fundamental liberties and is inconsistent with the principle of limited government.

If the estate tax were repealed, the effect on the economy would be significant. According to an econometric study conducted by Professor Richard Wagner of George Mason University, the effect of the estate tax on the cost of capital is so great that within eight years, a U.S. economy without an estate tax would be producing $80 billion more in annual output and would have created 250,000 additional jobs and a $640 billion larger capital stock.

An analysis by The Heritage Foundation using two leading econometric models also found that repealing the estate tax would have a large and beneficial effect on the economy. Specifically, the Heritage analysis found that if the tax were repealed this year, over the next nine years:

- ✔ The nation's economy would average as much as $11 billion per year in extra output;

- ✔ An average of 145,000 additional new jobs could be created;
- ✔ Personal income could rise by an average of $8 billion per year above current projections; and
- ✔ The deficit actually would decline, since revenues generated by extra growth would more than compensate for the meager revenues currently raised by the inefficient estate tax.

The estate tax has few friends, other than tax attorneys, and raises very little revenue at a heavy cost to the economy. It generates complex tax avoidance schemes. The hardest hit by the tax are small businesspeople who work hard to pass on an enterprise of value to their children. And its bias against saving and wealth generation is the antithesis of the American dream.

HOW WEALTH TAXES BEGAN IN AMERICA

Current public policy on the taxation of intergenerational wealth stems from roots laid down in the American Revolution and, oddly enough, in the Revolutionaries' efforts to create a society in which all citizens would be free to become as wealthy as their talents allow. As with so many principles that trace back to the Revolutionary period, the liberty to acquire and dispose of personal property became, by the 20th century, subsidiary to another element of the country's founding: the drive to create democratic equality of economic opportunity.[2]

The Early Years

Alexis de Tocqueville paid considerable attention to the views Americans held about wealth and economic opportunity when he made his famous tour of the early Republic in 1831. On the one hand, Americans had a nearly universal disdain for aristocracy and any non-republican show of wealth. But on the other hand, nearly everyone with whom Tocqueville became acquainted wanted desperately to be rich:

> I do not mean that there is any lack of wealthy individuals in the United States; I know of no country, indeed, where the love of money has taken stronger hold on the affections of men and where a profounder contempt is expressed for the theory of the permanent equality of property. But wealth circulates with inconceivable rapidity, and experience shows that it is rare to find two succeeding generations in the full enjoyment of it.[3]

Removing Barriers to Wealth. The democratization of acquiring wealth constituted the touchstone of the new civilization that the Revolutionaries sought to build. Theirs was a battle against barriers erected in the Old World to prevent the rise of the common man. For centuries, laws had been applied differently to rich and poor people. The Revolutionaries overturned this by embracing the legal principle of equality before the law, extending it to all free Americans, and giving it the sharp legal teeth of natural liberty in

2 For a brilliant survey of the tensions engendered in the early republic by widespread, ambiguous views of wealth, see Gordon S. Wood, *The Radicalism of the American Revolution* (New York, N.Y.: Alfred A. Knopf, 1992).

3 Alexis de Tocqueville, *Democracy in America* (New York, N.Y.: Alfred A. Knopf, 1972), Book One, p. 51.

one's life and property. They freed labor and capital from taxes, turned over to communities virtually all regulation of commerce, and tried in many other ways to remove government from everyday life. This truly was the age of the individual. Liberated from the oppressive economic and social networks that had surrounded the Crown and that prevented ordinary people from rising, the Revolutionaries emphasized the importance of allowing the marketplace rather than birth and influence to be the measure of personal worth. As Gordon Wood writes in his Pulitzer Prize-winning history of this period,

> A man was now praised for having arrived and risen "without friends," for having been "the architect of his own fortune," or for never having been "borne on the shoulders of patronage." For many Americans the ability to make money—not whom one knew, or who one's father was, or where one went to college—now became the only proper democratic means for distinguishing one man from another.[4]

Nothing epitomizes the zeal of the Revolutionaries for fundamentally altering the process of acquiring wealth better than the rapid abolition of primogeniture and the narrowing of entail. The ancient practice of primogeniture settled the entirety of an estate on the first-born male, thus leaving the remaining male children and all female children without inheritance. Primogeniture made birth order rather than merit the principal cause of wealth. Thus, dullards were as likely as commercial geniuses to end up ruling vast properties and exercising immense social and political influence. Entail nicely complemented primogeniture by making it all but impossible for real estate to leave a family, no matter how desirous a family one day might be to part with the property or how badly they managed their estate. Together, primogeniture and entail put a gigantic weight around the neck of economic progress and reduced the rate of commercial improvement to an obese creep.

Thomas Jefferson, himself initially a victim of primogeniture and then its beneficiary upon the death of his older brother, vigorously opposed both practices and saw legislation that he had written in 1777 abolishing primogeniture passed by the Virginia House of Burgesses in 1785. Within a few years, every new state government had followed Virginia's lead, and no subsequent state ever seriously considered allowing it. For Jefferson, the reform of entail and abolition of primogeniture were two of the most important actions taken in the early Republic to create "a system by which every fibre would be eradicated of ancient or future aristocracy, and a foundation laid for a government truly republican."[5]

Even a cursory reading of the Revolutionary texts underscores this unrelenting focus of the Founders on removing barriers to the wealth-creating process. Early American public policy was not aimed at redistributing wealth or at restraining its growth. Rather, the early Republic pursued a public policy of removing obstacles to entrepreneurship and economic self-improvement. If an egalitarian theme was present in early American pub-

4 Wood, *Radicalism of the American Revolution*, p. 342.

5 Thomas Jefferson, *Autobiography*, p. 51, in *The Life and Selected Writings of Thomas Jefferson*, ed. Adrienne Koch and William Peden (New York, N.Y.: Random House, 1944).

lic policy, it was the theme of equality before the law, which often meant the elimination of legal privileges that gave one class an economic advantage over another.

This attitude to wealth creation can be found in the Constitution of the United States. A straightforward reading of the following paragraph from Article I, Section 9 appears to prohibit all direct taxes, which would include a prohibition against taxes on income and wealth: "No Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken."[6]

Changing Attitudes Toward Wealth and Taxation

National Emergencies. It was generally accepted during the 19th century that Congress had extensive authority to bend the Constitution during times of national emergency. For example, the writ of *habeas corpus* could be suspended in times of war or rebellion in order to advance the public good. Thus, it appeared well within Congress's emergency powers to impose taxes on wealth and inheritance to meet the wholly unexpected revenue requirements of the federal government during dangerous times.

Congress wasted no time in testing its expansive wartime authority: Taxes on estates were imposed first during the Quasi-War with France (1797-1799), but repealed in 1802. Still, had it not been for the Civil War, it is possible that after 1802, the 19th century would have been an uninterrupted period of no estate or intergenerational wealth taxation. But the expenses of the Union government exhausted its revenue sources so quickly that President Lincoln and the war Congresses employed the emergency clauses of the Constitution to enact the first modern intergenerational wealth tax. The Revenue Act of 1862 revived the death tax of the Quasi-War Congress and recrafted it into a true inheritance tax. Congress repealed the tax on wealth in 1870.[7]

Wealth Seen As an Obstacle to Economic Opportunity. While costly national emergencies occasionally challenged the idea of unrestricted wealth creation and ownership, more important in the long run was a change of attitude in some circles toward the relationship between wealth and economic opportunity. Between 1880 and 1916, the party of Lincoln overflowed with political warriors who saw no American problem that could not be solved by righteous citizens wielding the policy tools of the newly powerful federal government. Just as they had overcome the Southern assertion of states' rights, they would be victorious over the growing concentrations of private economic power that they viewed as fundamentally threatening the bedrock American value of equal economic opportunity.

The reform Republicans created many tools for achieving their "new economic democracy," but perhaps none was so important to this project as the income tax. If the principal post-war threat to the Republic came from the great wealth that industrialization created for a few privileged people, and from the opportunities this wealth provided for corrupting political institutions, reformers needed above all else a legal means of redistributing wealth, thus diffusing the political power that great wealth provided. In 1894, Con-

6 Constitution of the United States, Article I, Section 9, paragraph 4.

7 John R. Luckey, "A History of Federal Estate, Gift, and Generation-Skipping Taxes," *CRS Report for Congress*, Congressional Research Service, March 16, 1995, p. 4.

gress took its first tentative step in this direction by passing the Income Tax Act. Significantly, the heart of the Act was a definition of gifts and inheritances as income.

The Supreme Court wasted little time in striking down the Income Tax Act. In 1895, the Court ruled[8] that the Act constituted a direct tax on certain forms of income that did not meet the Constitution's requirement of apportioning such a tax according to population. Without a change in the Constitution, the Court concluded, all such efforts at taxing income would fail to pass constitutional review.

The constitutional obstacle was removed in 1913 with ratification of the Sixteenth Amendment.[9] Congress quickly passed an income tax in 1914 that levied a 3 percent rate on all incomes above $30,000 (about $900,000 in 1996 dollars).[10] It then launched the modern period of estate and gift taxation through the Revenue Act of 1916.

The Revenue Act of 1916 established rules for valuing a decedent's estate, for capturing taxable lifetime transfers into the estate, and for determining those transfers made for inadequate consideration and those that became effective only upon death. It created exemptions and deductions that continue to be a part of estate tax law today. Most important, the Act introduced progressive taxation into estate tax policy.[11] This element clearly distinguished its public policy objective from earlier death taxes: The central mission of federal estate and gift taxation would be the redistribution of wealth.[12]

After 1916, and despite a few efforts to retreat from estate and gift taxation immediately following World War I, taxes on intergenerational wealth transfers became a permanent feature of U.S. tax policy.

The history of wealth transfer taxation between 1920 and 1976 consisted largely of expanding the tax base for estate and gift taxes and increasing the tax rates. Congress raised the top marginal rate for estate taxes to 40 percent in 1924. In 1932, the top rate rose to 45 percent and the gift tax became permanent. The imminence of hostilities in 1941 caused Congress to search for additional revenues and led to a further increase in the top rate on estates to 77 percent.[13]

Figure 1 shows the rapid increase in estate and gift tax collections after the end of World War II. Intergenerational taxes grew significantly in both amount and rate, even when adjusted for inflation. This growth probably stemmed as much from the demo-

8 *Pollock v. Farmers' Loan and Trust Company*, 158 U.S. 429 (1895).

9 The Sixteenth Amendment reads: "The Congress shall have power to lay and collect taxes on income, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."

10 There is little foundation for a claim that the U.S. government levied taxes on incomes in 1914 because it needed additional revenues. Federal budget surpluses in 1911 and 1912 led to a reduction in total federal debt in 1913 and 1914, and these latter two years had very small deficits of about $400,000 each. Bureau of the Census, *Historical Statistics of the United States: Colonial Times to 1970*, Part 2, 1975, p. 1104, Series Y, column 336.

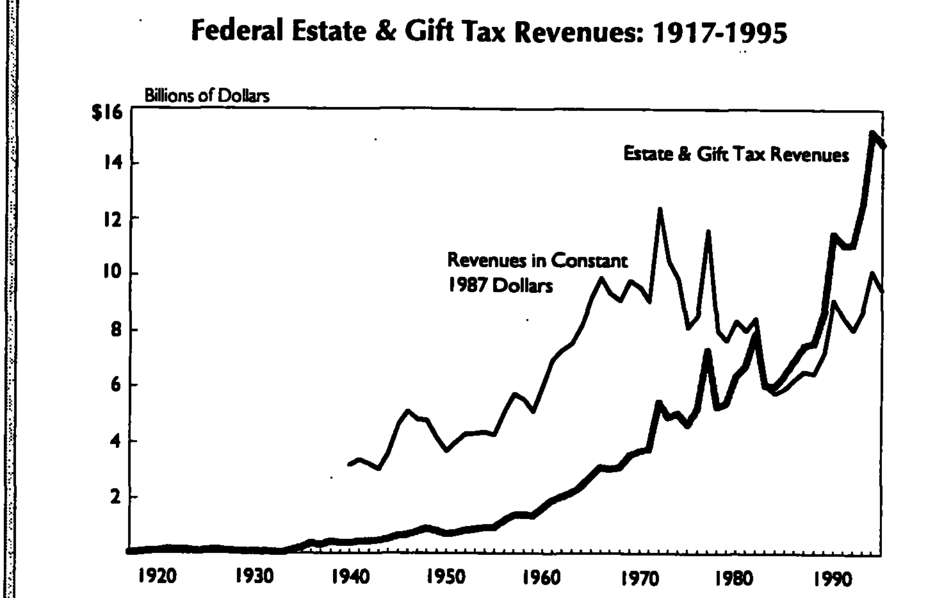
11 Congress exempted the first $50,000 and taxed the remainder of the estate at rates that ranged from 1 percent to 10 percent on values above $5,000,000. Luckey, "A History of Federal Estate, Gift, and Generation-Skipping Taxes," p. 7.

12 The Revenue Act of 1916 was, of course, challenged immediately. The U.S. Supreme Court heard the challenge and upheld the statute in 1920. See *New York Trust Company v. Eisner*, 256 U.S. 345 (1920). It perhaps is significant that the Court's majority opinion was delivered by Oliver Wendell Holmes.

13 Luckey, "A History of Federal Estate, Gift, and Generation-Skipping Taxes," pp. 9-12.

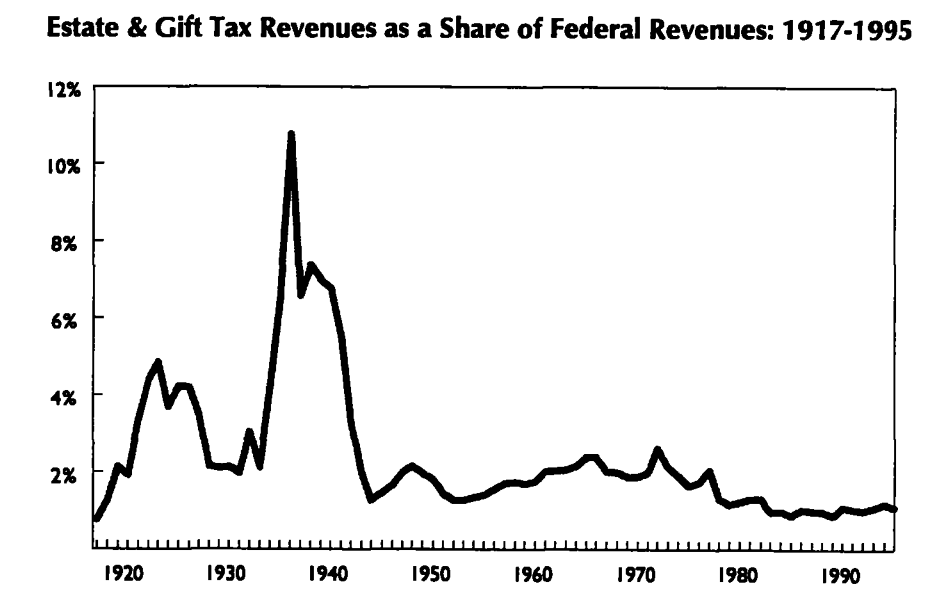
graphics of the transfer taxes as from high tax rates: The late 1960s saw the beginning of generational transfers from those Americans who had weathered the storms of depression and world war. Transfers increasingly consisted of small businesses and farms as well as stocks, bonds, and liquid assets. And as the number of taxable estates containing businesses grew, so did the pressure for estate tax relief.

Chart 1



Source: Bureau of the Census, *Historical Statistics of the United States: Colonial Times to 1970; Economic Report of the President*, 1985, 1996; and Heritage calculations.

Chart 2



Source: Bureau of the Census, *Historical Statistics of the United States: Colonial Times to 1970; Economic Report of the President*, 1985, 1996; and Heritage calculations.

Congress recognized in 1976 that a tax intended to diminish the power of great wealth more frequently ended up taxing ordinary Americans who had accumulated taxable estates through nothing more than frugality, entrepreneurship, and plain hard work. The Tax Reform Act of 1976 addressed the concerns of these people through a number of policy changes. Specifically, the Act:

✔ **Unified** the estate and gift tax, enabling taxpayers to apply unused gift tax allowances as deductions against their taxable estates;

✔ **Lowered** the top marginal rate to 70 percent and expanded the marital deductions for estates of moderate size; and

✔ **Created** special rules for estates consisting primarily of small businesses and family farms that allowed more of these entities to escape estate taxes altogether.[14]

Congress's eagerness in 1976 to address problems with intergenerational taxation coincided with a growing understanding among many academics and politicians that high tax rates retard economic growth.[15] This growing awareness led the Congresses of the 1980s to reduce the economic influence of intergenerational taxes, largely through tax cuts and more generous deductions. The Economic Recovery Tax Act of 1981 in particular reflected this redirection in public policy. For example, the Act created the unified credit that currently exempts the first $600,000 in an otherwise taxable estate from any tax liability,[16] and it cut the top marginal rate from 70 percent to 50 percent. In addition, the Act further liberalized the rules governing the tax valuation of closely held businesses and farms, and lengthened the period of time for the payment of estate taxes by estates that contain such businesses.

With few exceptions, tax and budget bills passed between 1981 and 1992 adhered to the policy changes contained in the Economic Recovery Tax Act of 1981.[17] Even in the largest tax increase in U.S. history—the Omnibus Reconciliation Act of 1993—it was apparent that revenue goals and not class warfare was the basis of the wealth tax provision. While Congress added two new rates (53 percent and 55 percent) to the estate and gift tax, these still did not go above Ronald Reagan's top rate. And while two new income tax rates (35 percent and 39.6 percent) were enacted, they still were just over half as high as the nearly confiscatory rates that prevailed during the administration of Dwight Eisenhower. In fact, without notice, wealth transfer tax policy has lost its ideological thrust. Its philosophical justification is disappearing; its roots in public policy are growing shorter every year; and its retention depends on its value as a revenue-raiser. But as we shall see later, besides its damaging impact on wealth creation and economic well-being, as a source of revenue it is more trouble than it is worth.[18]

14 Pub. L. 94-555, Sec. 2003(a). See Luckey, "A History of Federal Estate, Gift, and Generation-Skipping Taxes," p. 15.

15 For a review of academic opinion on the relationship between economic growth and tax policy, see section on "The Liberal Case for Repealing the Estate Tax," *infra*.

16 Pub. L. 97-34, Sec. 401.

17 However, the Deficit Reduction Act of 1984 (DFRA) extended until 1988 a 55 percent top tax rate that had been scheduled to fall to 50 percent in 1985. The Tax Reform Act of 1986 introduced a tougher penalty on generation-skipping wealth transfers by taxing all such transfers at the top marginal rate of 55 percent. And the Omnibus Budget Reconciliation Act of 1987 further forestalled the fall in the top tax rate until the end of 1992.

18 For a comprehensive case from a "liberal" perspective for moving away from the estate tax, see Edward J. McCaffery, "The Uneasy Case for Wealth Transfer Taxation," *The Yale Law Journal*, Vol. 104 (November 1994), pp 283-365.

THE ESTATE AND GIFT TAX TODAY

Current federal wealth transfer law is a confusing maze through which only the bravest taxpayers will travel without an experienced guide. The federal government taxes intergenerational wealth transfers through the estate, gift, and generation-skipping tax systems.[19]

The Estate Tax

The largest component of the federal government's three-part wealth taxation system is the estate tax. Current estate tax law itself has three basic elements: 1) definition of the estate tax base, or the gross estate of a decedent; 2) deductions that can be made from the gross estate to arrive at the taxable estate; and 3) the computation of estate tax liability.

1) The Tax Base

Estate tax law defines the gross estate of a decedent as the "fair market value"[20] of all personal or real property, wherever situated and however tangible, at the time of the decedent's death.[21] This valuation of an estate's property attempts to quantify such property at its "highest and best use." However, the valuation of a business or a farm on a "fair market value" standard may actually result in an artificially low value of an ongoing enterprise. For example, consider a start-up business in a good part of town. The owner suddenly dies, and his son wants to continue the business. If the estate tax value is determined by recent sales of other businesses located near it, then it may be valued at an amount well above its actual worth based on the cash generated by the business (which may even be operating at a loss in this early phase). This makes a big difference to an estate, since the business may have to be sold in order to pay the estate tax because the son is unable to raise a loan to pay the tax. In 1976, Congress recognized this negative potential of the "fair market value" rule and permitted estates containing small businesses and farms to be valued at their present use rather than at their "market value."[22]

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19 This section of the paper relies heavily on John R. Luckey's comprehensive summary of federal wealth taxation. See John R. Luckey, "Federal Estate, Gift, and Generation-Skipping Taxes: A Description of Current Law," *CRS Report for Congress*, Congressional Research Service, March 16, 1995.

20 "Fair market value" apparently means the value of an asset that a fully informed buyer would pay in a market for the asset. The concept implies the existence of a willing seller and able buyer, which is rarely the case when an estate is valued for tax purposes. Thus, executors must rely on various proxy prices for an estate's assets, such as recent closing prices for stocks and bonds and property sales of similar assets that are contemporary with the death of the decedent. The value of "good will" is a particularly vexing problem in estate tax valuation. Due to the numerous artifices that executors and courts must employ to place a value on estates, the resulting "gross estate" frequently bears little relationship to its market value. For example, an estate consisting solely of art that has been held for many years may have little market value if the tastes of the art-buying public have changed dramatically during the holding period.

21 While "fair market value" at the time of death is the most common method of quantifying a decedent's death, an executor of an estate paying tax can elect an alternative valuation date that is somewhat earlier or six months after the date of death. This alternative date method applies particularly to estates dominated by bonds or stocks in companies whose value is significantly affected by the death of the decedent. See 26 U.S.C. Secs. 2031(a) and 2032(a).

22 26 U.S.C. Sec. 2032A. This is one of the most complex sections of the estate tax code and has been the source of substantial litigation. The statute is 11 pages long.

Table 1

Current Federal Rate Table for Unified Estate and Gift Taxes

Taxable Transfer	Statutory Rate	Effective Average Tax Rate
$0 to $10,000	18%	0.00%
$10,000 to $20,000	20	0.00
$20,000 to $40,000	22	0.00
$40,000 to $60,000	24	0.00
$60,000 to $80,000	26	0.00
$80,000 to $100,000	28	0.00
$100,000 to $150,000	30	0.00
$150,000 to $250,000	32	0.00
$250,000 to $500,000	34	0.00
$500,000 to $600,000	37	0.00
$600,000 to $750,000	37	7.40
$750,000 to $1,000,000	39	15.60
$1,000,000 to $1,250,000	41	21.32
$1,250,000 to $1,500,000	43	25.80
$1,500,000 to $2,000,000	45	31.50
$2,000,000 to $2,500,000	49	37.24
$2,500,000 to $3,000,000	53	42.40
$3,000,000 to $4,000,000	55	46.75
$4,000,000 to $5,000,000	55	48.40
$5,000,000 to $10,000,000	55	51.70
$10,000,000 to $21,040,000	55	55.00
Above $21,040,000	55	55.00

Source: John R. Luckey, "Federal Estate, Gift and Generation-Skipping Taxes: A Description of Current Law," *CRS Report for Congress*, March 16, 1995.

✔ **Insurance Policies.** Special rules apply to the value of insurance policies contained in the decedent's estate. If the life insurance policy is paid out to benefit the estate, of if the decedent either held a property right in the policy or conveyed this property right within three years of death, then the value of the policy is added to the gross estate. A similar rule applies to annuities.[23]

✔ **Joint Property.** A property rights rule also applies to property owned jointly by the decedent and someone other than the decedent's spouse: Such jointly owned property is included in the gross estate to the extent of the ratio of consideration furnished. With respect to property owned jointly with a surviving spouse, only 50 percent of such property becomes a part of the gross estate.[24]

23 Luckey, "Federal Estate, Gift, and Generation-Skipping Taxes," p. 2.

24 26 U.S.C. Sec. 2040(b).

✔ **Gifts.** Gifts and other transfers of property made by the decedent well before death also may be included in the gross estate if the decedent retained the ability to influence the disposition and use of such property. Similar inclusion in the gross estate applies to gifts that occur only upon death. However, sales of property and other alienation of property from the decedent's control made throughout his or her life are not included in gross estate.

2) Deductions

Once the total value of an estate has been calculated, numerous deductions may be applied. The result of these subtractions from the gross estate is the taxable estate.

The first category of deductions relates to direct expenses of the estate: All costs of the funeral, of legal claims against the estate, of the executor's administration of the estate, and of mortgages paid by the estate may be deducted.[25] Second, the value of property passing to the decedent's surviving spouse may be deducted. Finally, the estate may deduct the value of all charitable bequests to organizations recognized by the federal government as tax-exempt.

3) Tax Liability

The taxable estate that results from the application of these gross estate deductions is taxed according to a somewhat cumbersome four-step process. First, the value of all taxable gifts made over the decedent's lifetime is added to the net estate. Second, a before-credits tax is calculated by multiplying this "grossed up" estate by the relevant tax rate. Third, this before-credits tax is reduced by subtracting the tax on all gifts made after 1976. And fourth, various credits are applied to the remaining sum.[26]

There are four credits available for estate tax reduction, but by far the most significant is the unified transfer tax credit.[27] This credit is a flat $192,800, which equates to a $600,000 net taxable estate. Thus, the unified transfer tax credit means that current law exempts from taxation all otherwise taxable estates up to $600,000 in value.

Above $600,000, estates face a tax rate table that contains no fewer than 17 different rates, ranging from 18 percent to 55 percent. There is a 5 percent surcharge for estates between $10,000,000 and $21,040,000, intended to phase out the unified transfer credit. Thus, estates up to $21 million in value face a 60 percent marginal rate.[28]

The Gift Tax

The second layer of federal wealth transfer taxation is the levy made on lifetime property gifts. Like the definition of gross estate, current law contains a host of decisions that the courts and executors must make in determining the value of taxable gifts.

25 Luckey, "Federal Estate, Gift, and Generation-Skipping Taxes," p. 4.

26 26 U.S.C. Sec. 2001(b).

27 The other three credits are for death taxes imposed by a state government, foreign death taxes, and estate taxes paid by a previous estate on property currently contained in the taxable estate.

28 26 U.S.C. Sec. 2001(c)(3).

1) The Tax Base.

Perhaps the most difficult decision of all is the one that must be made first: determining the value of the decedent's lifetime giving. This difficulty arises on two fronts:

- ✗ **First,** a gift is the transfer of property for something less than full legal consideration to a party generally within the donor's family. On the one hand, the executor must determine which gift transfers meet the test of insufficient legal consideration. On the other hand, the executor must distinguish gifts made for income tax purposes that require "detached and disinterested generosity" from those that qualify for the gift tax.[29]

- ✗ **Second,** the executor or the court must wrestle with the question of "fair market value." The federal gift tax requires that *all* wealth transfers made as gifts over the decedent's entire life be valued for taxation. That means, incredibly, that appraisals of value must be made for gifts made decades before the decedent's death. Moreover, these gifts must be appraised in terms of their "fair market value" at the time they were made, which is a task that often stretches the frontiers of property appraisal to its breaking point.

Such extraordinary efforts at valuation and record reconstruction must be made in order to determine whether the annual level of gift giving exceeded the allowed limits. An estate may exclude from the gift tax base all annual present interest gift transfers of $10,000 or less per donee.[30] But if the donor made the gift to meet the donee's tuition or medical expenses, the limit does not apply. Furthermore, if the donor's spouse elects to make a similar gift to the same donee (a practice known as gift-splitting), the annual limit rises to $20,000. All gifts above these limits become part of the gift tax base.

2) Deductions.

Like the estate tax base, the gift tax base can be reduced by certain deductions. Besides gift-splitting, certain gifts to one's spouse may be deducted. Also, gifts to charities recognized by the IRS as tax-exempt organizations can be deducted from the gift tax base.[31] Finally, special rules apply to the division of property in a divorce or separation, and this leads to more gift tax deductions.[32]

3) Tax Liability.

Computing the amount of gift tax is relatively simple. First, taxable gifts for the current and all previous calendar years are summed and taxed using the tax rate table for estates. Second, this total amount of gift tax then is reduced by any unused unified transfer tax credit.

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29 *Comm'r v. Duberstein*, 363 U.S. 278 (1960). Luckey, "Federal Estate, Gift, and Generation-Skipping Taxes," p. 8.

30 Prior to 1982, the annual limit was $3,000 per donee. 26 U.S.C. Sec. 2503.

31 26 U.S.C. Sec. 2522.

32 26 U.S.C. Sec. 2516.

To illustrate, suppose that a married couple gave their only child $10,000 a year for a period of 20 years, for a cumulative total of $200,000. These gifts equal the maximum annual amount that taxpayers may exclude from the federal gift tax base. However, for four years this couple made additional gifts to their child of $100,000 a year, for a total of $400,000. This latter amount is above the limit and is taxable. Now suppose that the gross taxable estate of this couple equals $1,000,000, which includes the taxable gifts. The executor of the estate will use the unified credit of $600,000 to reduce the taxable amount and will pay taxes on the remaining $400,000, or the additional gifts the couple gave their child.

The Generation-Skipping Tax

Wealth transfer taxes have been so consistently high throughout this century that a substantial cottage industry devoted to estate tax avoidance has blossomed within the legal and financial communities. One of their cleverest inventions was a trust established by a parent for the lifetime benefit of his or her children that passed tax-free to the parent's grandchildren upon the parent's death (or bypassed the children completely and went directly to the grandchildren). The trust avoided estate taxes altogether because such taxes are never levied on amounts that cannot be controlled by the taxpayer. However, some trusts were designed to pay out to the grandchildren upon the death of the taxpayer's children. Thus, the taxpayer could target specific individuals to receive benefits from the estate if the taxpayer could skip a generation through the creative use of a tax-free trust.

Congress enacted a cumbersome tax law change in 1976 to close the indirect generation-skipping transfer, but it left unaddressed the trust or bequest that directly skipped the parent's children. Both of these loopholes were addressed by Congress in 1986. As part of the Tax Reform Act of 1986, Congress established a flat-rate tax of 55 percent on all generation-skipping transfers. Transfers subject to the tax are those made from a trust to a "skip person" (someone two or more generations removed from the donor); those made by a donor directly to a "skip person" without going through a trust; and those that result from termination of an interest in a property or trust, which usually happens upon the death of the donor.[33]

As with the estate tax and the gift tax, several exclusions and exemptions apply. The same $10,000 annual exclusion and tuition and medical exemptions found in the gift tax law apply to generation-skipping taxes. A total lifetime exclusion of $1,000,000 ($2,000,000 for married couples) is allowed. Finally, transfers made prior to January 1, 1990, are exempt up to $2,000,000 ($4,000,000 for married couples).[34]

THE LIBERAL CASE FOR REPEALING THE ESTATE TAX

This complex tax edifice rests on the foundation that taxing intergenerational wealth transfers results in less concentrated wealth holdings and that this leads in turn to greater economic opportunity and a more democratic society. Certainly simplicity cannot be raised in support of this tax policy, as the above discussion indicates. And, as Figures 1

33 26 U.S.C. Secs. 2612 and 2613.

34 Luckey, "Federal Estate, Gift, and Generation-Skipping Taxes." p. 12.

and 2 show, the estate and gift tax cannot be justified as playing an important role in financing government: The unified estate and gift tax now brings in less than 1.7 percent of total federal revenues.

The Liberal Egalitarian Argument for Intergenerational Wealth Taxation

The case for the estate tax turns on the tax's effectiveness in achieving greater economic democracy through the redistribution of wealth. If its supporters cannot sustain the argument that the estate tax improves equality of economic opportunity, then there exists little else (except perhaps inertia) to recommend continuation of this part of U.S. tax policy. Other, simpler taxes could meet revenue objectives far more efficiently.

Academic support for intergenerational wealth taxation remains warm, in large part because of the role it plays in the most important theoretical treatise on liberal egalitarianism, John Rawls's *A Theory of Justice*.[35] Since its publication in 1971, this careful, magisterial presentation of the case for liberal democracy infused with just institutions has permeated thinking on most issues in social and political theory. It is fair to say that no stronger theoretical case for intergenerational wealth taxation exists.

At the center of Rawls's case for wealth taxation is the principle that "[a]ll social primary goods—liberty and opportunity, income and wealth, and the bases of self-respect—are to be distributed equally unless an unequal distribution of any or all of these goods is to the advantage of the least favored."[36] While at first blush this principle would appear to suggest radical egalitarianism in economic and political life, Rawls recognizes the superiority of "free" over socialized markets to produce benefits for the least advantaged citizens, which leads him and many like-minded political theorists to support significant differences in the economic conditions of individuals within a generation. After a century of economic experimentation, there can be little doubt that everyone achieves greater economic benefit when individuals are allowed to discover their own comparative advantage and focus their labor in the area where they can make the greatest economic difference.

This tolerance for intragenerational differences leads Rawls to oppose all income taxes, since economic income stems from natural differences in talent and from differing propensities of individuals to apply themselves to hard work.[37] However, two principled considerations compel Rawls to take substantial exception to intergenerational differences in economic condition.

First, Rawls opposes the transfer of accumulated property to succeeding generations because it undermines the first principle of a just society: that everyone has "an equal right to the most extensive total system of equal basic liberties compatible with a similar system of liberty for all."[38] Those who begin with a significant unearned endowment of

35 John Rawls, *A Theory of Justice* (Cambridge, Mass.: Harvard University Press, 1971).

36 *Ibid.*, p. 303.

37 Rawls advances a consumption tax to replace income taxes. "For one thing, it is preferable to an income tax (of any kind) at the level of common sense precepts of justice, since it imposes a levy according to how much a person takes out of the common store of goods and not according to how much he contributes (assuming here that income is fairly earned)." *Ibid.*, p. 278.

38 *Ibid.*, p. 302.

property resources place others not so advantaged in a less equal condition, and this undermines the principle that everyone should have access to the same system of equal basic liberties.

Second, this difference might be tolerated if it produced greater benefits for the least advantaged than for the advantaged. However, intergenerational wealth transfers create benefits that flow in the opposite direction: Over time, they enhance the advantages of inheriting generations and generally degrade the liberties of the unbenefitted. Thus, "[t]he taxation of inheritance and income at progressive rates (when necessary), and the legal definition of property rights, are to secure the institutions of equal liberty in a property-owning democracy and the fair value of the rights they establish."[39]

While Rawls does not advance confiscatory taxation of intergenerational wealth transfers, his argument does imply substantial taxing discretion by the state. In his universe, the state guides the institutions of distribution; should government determine that wealth transfers constitute significant barriers to the equal enjoyment of liberties (as defined by Rawls), it clearly has the power to tax away as much of the wealth that moves between generations as it deems necessary to restore justice.

Objections to the Liberal Egalitarian Case for the Estate Tax

A number of objections could be raised against the Rawlsian case for wealth transfer taxation, not the least of them being the questionable assertion of government authority over the intergenerational disposition of private property. If wealth is acquired legally and transferred peacefully (that is, in some non-tortious fashion that breaches no contract pertaining to the property), government has no ethical standing to interfere with its disposition.

Of course, liberal egalitarians claim a more expansive role for government, a principal element of which is the progressive enhancement of equality of condition among citizens. Thus, it is important first to consider the estate tax within the context of the argument that justifies the tax's existence. If it can be shown that the estate tax does not advance the ethical program of the liberal egalitarians, then other objections to this tax that can be raised without assuming this ethical and moral framework become more compelling.

This approach to analyzing the estate tax was taken in a seminal monograph by Edward J. McCaffery published in *The Yale Law Journal* in 1994.[40] Professor McCaffery comes to the debate over the estate tax with impeccable political credentials. Unlike many critics of intergenerational taxation who frame their objections within a larger, politically conservative analysis of contemporary government, MaCaffery formulated his critique of the estate tax within a liberal framework. As he stated last year before the U.S. Senate Committee on Finance:

> I am an unrequited liberal, in both the classical and contemporary political senses of that word, whose views on social and distributive justice might best be described as progressive. I used to believe in the gift and estate tax

39 *Ibid.*, p. 279.

40 McCaffrey, "The Uneasy Case for Wealth Transfer Taxation."

as a vehicle for obtaining justice. As to the latter belief, only, I am now prepared to confess that I "was blind, but now can see."[41]

McCaffery raises five general objections to the liberal egalitarian argument supporting intergenerational wealth taxation. Each of them assumes the ethical and moral objectives of the liberal political program.

1) **The currently combined income and estate tax system encourages large *inter vivos* gift transfers, which have the effect of creating a greater inequality of starting points or a less level economic playing field.** This predictable effect of the estate tax law is aggravated further by the fact that high estate tax rates encourage the consumption rather than the transfer of wealth. Purchasing goods and services instead of saving the funds that support that consumption produces larger differences between rich and poor people. Thus, the estate tax is illiberal because it undermines rather than advances the liberal egalitarian objective of equality of economic opportunity.

2) **While higher wealth transfer taxes might reduce the level of *inter vivos* gifts, and other tax law changes could be made to penalize the spending behavior of rich families, it currently is both practically and politically impossible to do so.** On the one hand, analysts are becoming increasingly aware of the intergenerational focus of much current saving behavior at all income levels. Liberals should promote the creation of transferable wealth among the less advantaged. On the other hand, politicians are becoming increasingly aware of how much voters want taxes to fall, not rise. The estate or inheritance tax has been repealed in Australia, Canada, Israel, and California; and the movement for tax reform is a spreading, worldwide movement.

3) **There will always be differences between the starting conditions of people in a non-ideal world.** If liberal egalitarians attempted to eliminate all the differences that stem from intergenerational wealth transfers, they would risk leaving the least advantaged even worse off than they were before. Not only would confiscatory taxation reduce the consumption behavior of wealthy people, thereby also reducing employment and incomes among poorer citizens, but it would depress the amount of economic capital as well, thereby reducing economic expansion and income growth, both of which are central to improving the conditions of the least advantaged.

4) **"[It] is the use and not the mere concentration of wealth that threatens reasonable liberal values."**[42] Generally speaking, the accumulation of savings and the promotion of earnings that underlie the growth of savings are "goods" that liberals like. Earnings and savings create a "common pool" of resources that can be used to promote improvements in the general welfare through public and private means. Liberals generally regard the consumption behavior of the wealthy as objectionable; thus, wealth transfer taxation, which attacks savings and promotes wanton consumption, is wholly ill-suited to the attainment of an ideal liberal society.

41 Edward J. McCaffery, "Testimony before the Senate Committee on Finance, June 7, 1995."

42 McCaffery, "The Uneasy Case for Wealth Transfer Taxation," p. 296.

5) **The best tax policy that liberal egalitarians could pursue, if attaining liberal social and political objectives truly motivates the liberal program, is one that taxes consumption, not savings.** McCaffery writes that:

> [b]y getting our reasonable political judgments wrong—by taxing work and savings while condoning, even encouraging large-scale use [consumption]—the status quo impedes the liberal project.... The real threats to liberty and equality from private possession alone turn out, on closer scrutiny, to relate to possession *qua* potential or actual use, each of which can be addressed—indeed, can *best* be addressed—in a tax system without an estate tax.[43]

Not only, then, is the estate tax inconsistent with a liberal program of promoting equality of economic condition, but it encourages behavior that works against liberal objectives. It supports consumption and depletion by penalizing savings and earnings. It encourages the kind of strange world where it costs less for a millionaire like Steve Forbes to spend $30 million of his own money on a presidential campaign than to save $30 million for his children's future—an investment upon which he will pay a 55 percent transfer tax as opposed to a campaign expenditure upon which no additional taxes are ever levied. How many new jobs and new businesses did Mr. Forbes's campaign create as opposed to the same amount saved in a bank that lends the funds to entrepreneurs and business managers? Liberals and conservatives are beginning to answer this question in precisely the same way.

Few Friends. The weaknesses of the estate and income tax system as a tool for redistribution long have been known, even to its academic friends. Joseph Stiglitz, who now serves as the Chairman of President Clinton's Council of Economic Advisers, concluded in 1978 that the estate tax effectively transfers resources from the saver to the spender, which, absent any offsetting tax policy change, reduces the stock of capital and leads to lower levels of national wealth.[44] Furthermore, wrote Stiglitz,

> because of capital accumulation effects, the estate tax may not achieve the objective to which it is presumably directed, that is, equalizing the distribution of income; if the government takes actions to offset these accumulation effects, the tax will lead to an increase in equality of income and wealth. The desirability of the estate tax may still be questioned, not only because of the distortions which it introduces but also because it may actually increase inequality in the distribution of consumption.[45]

Alan Blinder, another member of the President's initial Council of Economic Advisers and subsequently Vice-Chairman of the Federal Reserve System's Board of Governors, also has raised serious doubts about the redistributional promises of the estate tax.[46] He

43 *Ibid.*; emphasis in original.

44 Joseph E. Stiglitz, "Notes on Estate Taxes, Redistribution, and the Concept of Balanced Growth Path Incidence," *Journal of Political Economy*, Vol. 86 (1978), Supplement, pp. 137-150.

45 *Ibid.*, p. 137.

46 Alan S. Blinder, "A Model of Inherited Wealth," *Quarterly Journal of Economics*, Vol. 87 (1973), pp. 608-626. See also Blinder, "Inequality and Mobility in the Distribution of Wealth," *Kyklos*, Vol. 29 (1976), pp. 607, 619, as quoted in McCaffery, "The Uneasy Case for Wealth Transfer Taxation," p. 322, note 143: "[a] doubling of the tax rate, which must be

has been joined by Michael Boskin, Martin Feldstein, Gary Becker, Laurence Kotlikoff, Lawrence Summers, and many other economists with prominent connections to mainstream economics.[47]

THE ECONOMIC CASE AGAINST THE ESTATE TAX

In addition to the Left's declining enthusiasm for the ideology of wealth taxes, two economic issues have added to the momentum for repeal. One is the mounting weight of economic and financial evidence against the estate and gift tax as such. The other is the rapidly spreading general view that income taxes and the multiple taxation of savings reduce economic growth, which in turn slows the rate of economic improvement by the least advantaged. Among the economic problems associated with the tax:

✗ The estate tax raises little money and encourages inefficient tax-avoidance schemes.

Bolstering the skepticism about the efficiency of the estate and gift tax is the striking fact of how little revenue it raises for the federal government. Despite the tax's broad reach, theoretically touching upon nearly all transferable wealth, the unified tax raised only $14.7 billion in 1995.[48] As Figure 1 shows, the estate and gift tax consistently has fallen as a percentage of total federal revenues, while at the same time the total amount of wealth has risen dramatically.

When a tax raises significantly less than the estimate of its potential, it is often because taxpayers have discovered ways to avoid the tax and have changed their economic behavior in ways that reduce the pool of funds from which the tax is drawn. To understand the extent to which this happens, it is necessary to estimate just what estate tax collections theoretically should look like.

Public finance economists have struggled for a long time with this question. Producing an adequate answer, however, requires knowing a great deal more than we now do about the size of legal tax avoidance and the degree to which taxpayers change their economic behavior in order to reduce their estate tax liabilities. Moreover, economists do not know the size of the wealth pool within which estates are formed. The Commerce Department's Bureau of Economic Analysis periodically estimates household net worth, or the sum of durables, savings, and equities held by households.[49] The Bureau currently estimates this net worth to be about $26.4 tril-

considered as barely (if at all) within the realm of political feasibility, reduces both the average level and inequality of inherited wealth—but by very modest amounts. Even the ridiculous 60% tax rate has effects which are far from revolutionary. The reformer eyeing the estate tax as a means to reduce inequality had best look elsewhere."

47 Michael Boskin, "An Economist's Perspective on Estate Taxation," in *Death, Taxes and Family Property: Essays and American Assembly Report*, ed. Edward C. Halback, Jr. (St. Paul, Minn.: West Publishing Co., 1977); Lawrence H. Summers, "Capital Taxation and Accumulation in a Life Cycle Growth Model," *American Economic Review*, Vol. 71 (1981); Martin Feldstein, "The Welfare Cost of Capital Income Taxation," *Journal of Political Economy*, Vol. 86 (1978); Laurence J. Kotlikoff, "Intergenerational Transfers and Savings," *Journal of Economic Perspectives*, Vol. 2 (1988).

48 Council of Economic Advisers, *Economic Report of the President*, February 1996, Table B-77.

49 See Table 2.1 of the National Income and Product Accounts, *Personal Income and Its Disposition*, and Federal Reserve Board, MPS No. 138.

lion, of which $8.4 trillion is in equities. While this amount by no means constitutes the tax base for the estate tax, a portion of this enormous sum most certainly does. For example, Laurence J. Kotlikoff estimates that slightly more than 50 percent of household wealth is held as intergenerational savings.[50] If one assumes that this 50 percent (or $13.2 trillion) is transferred in equal amounts over two generations, or 46 years, then about $290 billion annually is moving to the next generation.

Even this figure probably overstates the tax base for the estate tax. Many economists argue that taxpayers who believe they will pay estate taxes will change their economic behavior in ways that result in a huge shrinkage of the estate tax base.[51] B. Douglas Bernheim argues that high estate tax rates lead taxpayers to make far more cash gifts to their children than they otherwise would, in large part because their children pay taxes at lower rates than they do. Bernheim estimates that 50 percent to 75 percent of all intergenerational gifts are made because of the estate tax. Charitable gifts and other revenue losses are between 70 percent and 80 percent of total estate tax revenue. Put another way, indirect revenue losses in 1995 might have been $11 billion on revenues of $14.7 billion.[52]

The revenue data strongly imply significant tax avoidance and other economic behavior that responds to high tax rates by moving national wealth (and thus taxable estates) from savings to consumption. It is exceptionally difficult, however, for analysts to go from implication to quantification. Recent breakthroughs in the economic understanding of household savings may lead ultimately to convincing estimates of how much savings behavior stems from income and estate tax policy. Even so, economists can offer a number of important insights about the deleterious economic effects of tax policy on economic performance.

✗ The estate tax discourages savings.

Savings take many different forms—cash reserves in a bank, stock in a corporation, art, land, housing, ownership of a business, and so forth—that serve many different purposes. Households hold cash in a bank largely to finance future consumption, like the purchase of a house, or as a hedge against unanticipated household expenses like costly medical care. Similarly, the equity component of a mortgage is designed to be used to purchase future housing. These two forms of savings are largely liquid and thus earn relatively low rates of return. Households put money in a bank with the understanding that their funds can be withdrawn virtually at any time the household prefers. The bank, in turn, lends these savings with this same under-

50 Kotlikoff, "Intergenerational Transfers and Savings."

51 For the latest detailed data on estate and gift tax collections, see Internal Revenue Service, Statistics of Income Division, Estate Tax Returns Filed in 1993, Table 2: Gross Estate by Type of Property, Deductions, Taxable Estate, Estate Tax After Credits, by Tax Status and Size of Gross Estate. In 1993, there were 27,508 taxable estate tax returns with a total gross value of $59.2 billion.

52 B. Douglas Bernheim, "Does the Estate Tax Raise Revenue?" in *Tax Policy and the Economy*, Vol. 1, ed. Lawrence H. Summers (Cambridge, Mass.: National Bureau of Economic Research and MIT Press Journals, 1987), pp. 121-132. Bernheim attributes a sizable portion of this loss to charitable gifts. But see John S. Barry, "The Flat Tax and Charitable Contributions," Heritage Foundation *Backgrounder*, forthcoming. See also David Joulfaian, "Charitable Bequests and Estate Taxes," *National Tax Journal*, Vol. 44 (1991), pp. 169-180.

standing in mind, and therefore prefers relatively short-term, low-risk loans that contain significant liquidity for the bank. So if a household saves in a long-term time deposit (for example, a 10-year certificate of deposit), it will demand a higher rate of return as compensation for not having these funds available for consumption. The bank, in turn, is freer to invest in riskier ventures for which it also can demand a higher rate of return. The bank's cost of a loan failure also falls when it is working with longer-term savings: It knows it has a certain period of time to make successful loans that cover its contract with the saver and yield the bank a profit.

The decision to save largely follows this simple story. When households consume most of their income, any long-term investment must earn a high return. However, when they increase their savings relative to their consumption of income, they require less compensation for foregone consumption, and the required rate of return falls. Economists are divided between those who believe that households have a relatively fixed savings percentage over their lifetimes (which implies relatively fixed time preferences) and those who see the percentage of savings as something that fluctuates as certain preferences (including time or consumption) and costs (particularly taxes) change. It is this latter viewpoint that is particularly relevant to estate tax analysis.

Taxes play a role in savings decisions because they increase the cost of saving relative to consuming income. For example, if a household invests 25 percent of its income after taxes in a bank account that earns interest, it will pay additional taxes on any interest it takes as income. If another household decides to invest its 25 percent in corporate stocks, it will pay additional taxes on any capital gains it takes as income. However, if both households take that same 25 percent of after-tax income and buy expensive shoes, no additional income taxes will be collected. No doubt sales taxes will be collected on the shoe purchases, but sales tax rates are almost always less than the income tax rate one would pay on the same amount of money. Thus, taxes discourage saving by increasing its cost relative to consumption. If the household saves anyway, it will demand a higher rate of return to compensate it for the taxes it must pay on interest earnings. Likewise, a household purchasing stocks will demand a higher and more secure rate of return on its stocks. In both cases, the cost of capital to the borrower—to the bank or to the corporation—has risen because of taxes.

One way for a household to save and avoid additional taxation is to purchase an asset like art or land that appreciates slowly over a very long period of time. This kind of purchase, however, also increases the economy-wide cost of capital by reducing the fund of money available to banks and businesses. Still another way to reduce the tax cost of saving is to invest in tax-advantaged funds, such as IRAs or 403(b) and 401(k) plans. These types of funds annuitize savings, which means essentially that only low-risk, long-term, low-yield to medium-yield investments will be supported by them. While they do reduce current tax liabilities, they are especially costly for the saver in two ways: In addition to shrouding these plans in penalties and taxes should they be liquidated before the saver reaches a certain age, the government has significantly discounted the future value of these savings by delaying taxes on earnings until they are at their highest level.

The unified estate and gift tax adds yet another layer of taxes on any savings decision a household makes. Successful saving always raises the possibility of creating a taxable estate, at which point the tax cost of a dollar saved increases by an amount somewhere between 7.4 cents and 55 cents. So if the household persists in its decision to save, it will require some long-term premium return on its investments roughly equal to its estimate that estate taxes will not be avoided. Naturally, this premium further increases the cost of capital.

✗ The estate tax hurts small business.

Investing in a business is one of the many forms of saving—for some families, the only form. For most small firms, every available dollar goes into the family business—the dry-cleaning business, the restaurant, the trucking company—because the business creates an asset for the children and incomes for the owners. Women re-entering the work force after raising children often find self-employment the only entry-level employment open to them. Minorities know the reasons for self-employment only too well.

Minorities Hit Hard. All of the financial security provided by these businesses is put at risk if the owner dies with a taxable estate. In an important 1995 study of how minority businesses perceive the estate tax,[53] Joseph Astrachan and Craig Aronoff found that:

- ✔ Some 90 percent of the surveyed minority businesses knew that they might be subject to the federal estate tax;
- ✔ About 67 percent of these businesses had taken steps (including gifts of stock, ownership restructuring, life insurance purchases, and buy/sell agreements) to shelter their assets from taxation;
- ✔ Over 50 percent of these same businesses indicated that they would not have taken these steps had there been no estate tax; and
- ✔ Some 58 percent of all the businesses in the survey anticipated failure or great difficulty surviving after determining their estate taxes.[54]

The Astrachan/Aronoff study echoes findings in a 1994 study by Patrick Fleenor and J. D. Foster of the Tax Foundation, a Washington-based tax policy organization,[55] who presented estimates of lifetime effective tax rates for a taxable corporation, a non-corporate business, an individual earning high amounts of labor income, and a large business. In each case, Fleenor and Foster found that the presence of the estate tax raised the lifetime tax rate to a figure above 65 percent. The large business simulation determined a tax

53 Joseph H. Astrachan and Craig E. Aronoff, "A Report on the Impact of the Federal Estate Tax: A Study of Two Industry Groups," Family Enterprise Center of the Coles School of Business, Kennesaw State College, July 24, 1995.

54 *Ibid.*, pp. B10-B17. Similar findings are reported for small businesses generally in a survey conducted by the Center for the Study of Taxation, a public policy organization focused on estate tax reform. See *Federal Estate and Gift Taxes: Are They Worth the Cost?*, Center for the Study of Taxation, 1996, pp. 9-11.

55 Patrick Fleenor and J. D. Foster, "An Analysis of the Disincentive Effects of the Estate Tax on Entrepreneurship," Tax Foundation *Background Paper* No. 9, June 1, 1994.

rate of 72 percent. Nearly every public finance economist of the last 50 years has concluded that tax rates of this magnitude significantly reduce the taxpayer's willingness to earn more and take entrepreneurial risk. And these two effects—reductions in labor and in new business formation—directly depress the rate of general economic growth, which should deeply concern everyone interested in improving economic welfare in the United States.

While Professor McCaffery appears unaware of the Fleenor/Foster study, it includes precisely the kind of evidence he has marshaled to assail the estate tax as inimical to the expansion of economic opportunity. He is not, however, unaware of Richard E. Wagner's important 1993 monograph, *Federal Transfer Taxation: A Study in Social Cost*, which ties together the many threads of this emerging theoretical canon on estate taxation.[56]

Professor Wagner's study stands virtually alone in presenting macroeconomic estimates of the estate tax's effects on individual decisions to work and save. Using a model that trades labor for capital according to their relative costs and that represents this dynamic interaction through key indicators of macroeconomic activity, Wagner found that the tax premiums created by the estate tax raise the cost of capital sufficiently to reduce national output, employment, and capital stock by measurable amounts. In a simulation that modeled the U.S. economy without the current estate tax, Wagner found that:

- ✔ Nominal gross domestic product (GDP) would have been $80 billion higher after eight years than in an economy without the estate tax;
- ✔ 228,000 more jobs would have been created;
- ✔ The capital stock would have been $640 billion larger;[57] and
- ✔ The larger economy resulting from the repeal of estate taxes produced increases in all other taxes over the eight-year simulation period, though not quite by an amount equal to the loss of the estate tax.[58]

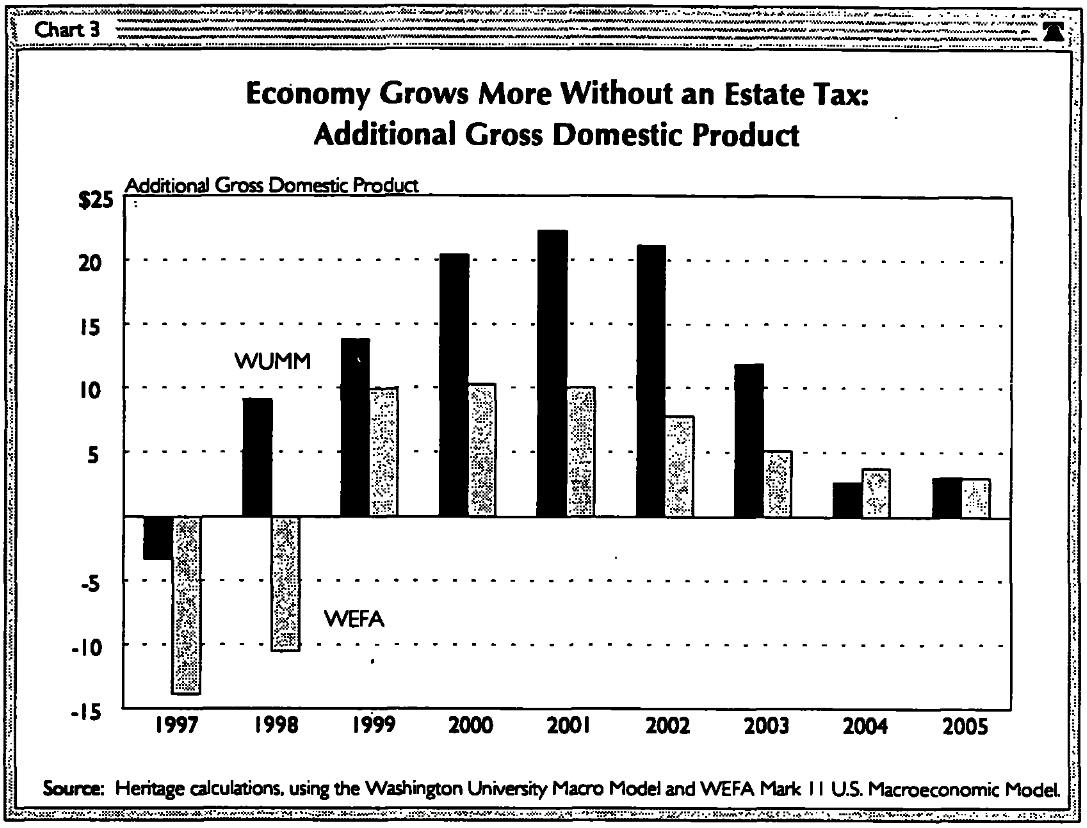
THE IMPACT OF REPEALING THE ESTATE TAX

While analysts have made significant progress in understanding the microeconomic effects of intergenerational taxation, the dearth of studies similar to Wagner's shows that much work still needs to be done on measuring the tax's macroeconomic effects. It is little wonder, however, that such studies are not more numerous. As Stiglitz noted, there are many remaining questions about the tax's effects on wealth accumulation. And with-

56 Richard E. Wagner, *Federal Transfer Taxation: A Study in Social Cost* (Washington, D.C.: Institute for Research on the Economics of Taxation, 1993). Professor McCaffery, however, criticizes the study for not simulating other policy changes that might mitigate some of the macroeconomic effects found by Wagner and his associates. See McCaffery, "The Uneasy Case for Wealth Transfer Taxation," p. 306.

57 Wagner, *Federal Transfer Taxation*, p. 19.

58 *Ibid.*, p. 27. Total losses in estate taxes equaled $125.1 billion over the eight-year simulation period. Increases in other revenue streams equaled $86.4 billion, for a net revenue change of-$38.7 billion over eight years.



out a good knowledge of these effects, economists cannot create that most elementary but crucial of concepts in any tax analysis: the tax base.

Bearing in mind these limitations, the author and Heritage Foundation analysts have estimated the economic impact of repealing the estate and gift tax beginning in 1997. The Heritage analysis made certain assumptions about the effect of repeal. Each of these assumptions was introduced into two leading models of the U.S. economy: the Washington University Macro Model (WUMM) and the Mark 11 macroeconomic model of Wharton Econometric Forecasting Associates.[59] These two statistical models of U.S. economic activity are highly regarded, exceptionally accurate tools for estimating the effects of public policy changes on the general economy and are widely used for this purpose by America's leading corporations and government agencies.

Given the substantial doubt that annual estate tax filings fully reflect the size of the tax base,[60] estimates of the tax's economic effects must start from another foundation. The macroeconomic estimates presented here were built from estimates of changes in the

59 This Study was prepared by The Heritage Foundation using tax simulation models developed by The Heritage Foundation and the Washington University Macro Model and the Mark 11 U.S. Macro Model of Wharton Econometric Forecasting Associates. The methodologies, assumptions, conclusions, and opinions herein are entirely those of The Heritage Foundation. They have not been endorsed by, and do not necessarily reflect the views of, the owners of these two macroeconomic models.

60 From an economic standpoint, a tax's base is composed of some quantifiable behavior that is being affected by the tax. The estate tax base could be viewed as the sum of all those dollars that are managed annually so as to avoid paying the tax, plus those that end up on a tax form.

U.S. labor force and domestic capital stocks associated with removing the estate tax portion of the after-tax cost of labor and capital. These estimates then were introduced into the macroeconomic models to compute the effects.

Cost of Capital Assumptions

The cost of capital (the so-called rental price of investment) results from at least three factors: 1) the cost of attracting investors to supply capital funds and not do something else with their money, 2) the ratio of a capital good's depreciation relative to the value of output it produces, and 3) taxes. If a business or a household borrows money, it must pay the lender or investor enough to attract that lender or investor away from other opportunities. A portion of this "opportunity cost" payment is the tax that the lender expects to owe on the loan's earnings. Under current law, a business may offset some of this tax premium by deducting its annual depreciation and interest payments. In some cases, businesses also may claim various investment tax credits that further reduce the tax premiums they have had to pay to lenders. However, a substantial portion of the cost of operating a business is not tax deductible, and this results in a positive, residual tax premium in real-world capital costs.

Of course, taxes on ordinary income constitute a substantial percentage of the tax premium in the cost of capital. Every investor attempts to earn the highest possible return on every investment so that his earnings cover the income taxes the investment incurs. The estate tax, however, also is a part of this premium. Just as households are the source of all investment funds, they also are the source of all estate taxes. When individuals begin to see that their income and investment efforts will produce a future taxable estate, they generally do two things: see a financial advisor or estate planner, and increase their earnings requirements to build the funds needed to pay the wealth transfer taxes.

Using data associating incomes with tax liabilities and holdings of corporate paper and equities, Heritage analysts estimated that the present value of future estate tax liabilities for the class of households that holds most corporate debt is slightly more than 3 percent of the average yield on corporate bonds. Thus, if corporate bonds currently yield 10 percent, eliminating wealth transfer taxes would reduce the required yield to 9.7 percent. This estimate of the estate tax component of the tax premium was used to adjust projected corporate bond yields over the period 1997 through 2005.

Labor Effect Assumptions

Economists also argue that high taxes reduce the supply of labor. At a certain point, when faced with rising taxes, workers decide to consume more leisure and produce less labor. Wealth transfer taxes are widely assumed to produce this effect, particularly among a class of individuals who clearly perceive the adverse tax consequences of working harder and building greater taxable net worth.

To capture this effect of estate taxes and introduce it into the U.S. macroeconomic model, Heritage analysts estimated the number of wage or salaried workers and self-employed individuals in this same class of households that hold most of America's corporate debt. Eliminating the estate tax would be equivalent to increasing after-tax lifetime earnings by the average effective estate tax rate, or by 18 percent. This percentage, of course, is the minimum amount of earnings change that estate tax repeal would cause: A significant but unknown amount of time and income now is devoted to positioning assets

Table 2

Economic Effects Resulting from Repealing the Estate Tax

Simulation Results from Washington University Macro Model

Economic Indicator		1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Gross Domestic Product	With Estate Tax	6890.10	7035.52	7173.94	7307.16	7446.95	7630.96	7813.38	7973.00	8144.73	8350.97
(In Billions of 1992 Dollars)	Without Estate Tax	6890.10	7032.22	7183.04	7320.97	7467.35	7653.25	7834.48	7984.82	8147.39	8354.03
	Difference	0.00	-3.30	9.10	13.82	20.40	22.28	21.11	11.82	2.65	3.06
Non-Farm, Private Employment	With Estate Tax	99.79	100.71	101.44	102.17	102.91	104.41	106.09	107.30	108.56	110.29
(In Millions)	Without Estate Tax	99.79	100.64	101.50	102.40	103.21	104.74	106.41	107.51	108.57	110.21
	Difference	0.00	-0.07	0.05	0.22	0.30	0.33	0.33	0.21	0.01	-0.08
Cost of Capital	With Estate Tax	7.10	7.29	7.27	7.20	7.13	7.03	6.85	6.75	6.68	6.74
Required Rate of Return	Without Estate Tax	7.10	7.04	6.97	6.92	6.87	6.82	6.68	6.61	6.51	6.53
	Percent Difference	0.00%	-3.42%	-4.10%	-3.84%	-3.55%	-3.01%	-2.45%	-2.07%	-2.51%	-3.20%
30-Year Government Bond	With Estate Tax	6.7	6.7	6.6	6.4	6.4	6.4	6.4	6.4	6.4	6.4
(Percent)	Without Estate Tax	6.7	6.7	6.6	6.5	6.5	6.5	6.5	6.5	6.5	6.5
	Difference	0.0	0.0	0.0	0.0	0.0	0.1	0.1	0.1	0.1	0.1
Federal Deficit	With Estate Tax	-122.27	-102.52	-104.25	-110.03	-132.40	-140.93	-152.75	-186.27	-222.00	-246.38
(Fiscal Years, in Billions)	Without Estate Tax	-122.27	-100.67	-101.48	-103.90	-124.04	-132.01	-144.45	-181.78	-222.67	-249.76
	Change in Deficit	0.00	1.85	2.77	6.13	8.36	8.92	8.30	4.49	-0.68	-3.38

Simulation Results from WEFA U.S. Macroeconomic Model

		1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Gross Domestic Product	With Estate Tax	6947.97	7109.56	7276.37	7443.85	7602.41	7772.05	7933.9	8102.46	8276.44	8451.48
(In Billions of 1992 Dollars)	Without Estate Tax	6947.97	7095.73	7265.86	7453.73	7612.67	7782.03	7941.69	8107.54	8280.22	8454.52
	Difference	0	-13.83	-10.51	9.88	10.26	9.98	7.79	5.08	3.78	3.04
Non-Farm, Private Employment	With Estate Tax	100.72	101.9	103.59	104.94	106.3	107.68	109.05	110.46	111.92	113.38
(In Millions)	Without Estate Tax	100.72	101.70	103.48	105.20	106.50	107.88	109.23	110.55	112.01	113.45
	Difference	0	-0.20	-0.11	0.26	0.20	0.20	0.18	0.09	0.09	0.07
Cost of Capital	With Estate Tax	110.11	110.69	112.7	108.09	103.48	97.12	96.15	97.54	98.54	99.2
Index of User Cost of Capital	Without Estate Tax	110.11	105.92	107.93	103.93	99.23	93.03	92.22	93.71	94.9	95.67
	Percent Difference	0.00%	-4.31%	-4.23%	-3.85%	-4.11%	-4.21%	-4.09%	-3.93%	-3.69%	-3.56%
30-Year Government Bond	With Estate Tax	6.6	6	5.8	5.69	5.69	5.66	5.53	5.66	5.75	5.74
(Percent)	Without Estate Tax	6.6	5.96	5.77	5.71	5.68	5.65	5.55	5.69	5.82	5.82
	Difference	0	-0.04	-0.03	0.02	-0.01	-0.01	0.02	0.03	0.07	0.08
Federal Deficit	With Estate Tax	-138.2	-134.2	-123.1	-101.0	-89.5	-85.7	-80.1	-65.6	-73.5	-89.2
(Fiscal Years, in Billions)	Without Estate Tax	-138.2	-134.6	-123.7	-99.3	-91.8	-87.5	-81.7	-68.5	-77.1	-95.5
	Change in Deficit	0.0	-0.4	-0.6	1.8	-2.4	-1.8	-1.7	-3.0	-3.6	-6.4

Source: Heritage calculations, using the Washington University Macro Model and WEFA Mark 11 U.S. Macroeconomic Model.

and paying accountants in order to avoid significant estate tax liabilities. This estimate also fails to capture the substantial costs borne by taxpayers and relatives when businesses fail because of estate tax liabilities. In any event, multiplying a standard labor supply elasticity of 0.3 percent by this percentage reduction in taxes, and then multiplying this product times the 18 million individuals in this class of households, yields a labor supply effect of 97,200. This number was used to adjust upwards all estimates of the civilian labor force for the period 1997 through 2005.

Budget Assumptions

Besides introducing new labor force and capital cost settings into the macroeconomic model, Heritage also made two adjustments in the federal government's budget for the period 1997 through 2005. First, the total amount of federal revenues was reduced by the forecasted amount of the estate tax. Second, expenditures for non-defense purchases were reduced by an amount exactly equal to the "lost" estate tax revenue. Thus, repealing the estate tax is assumed to be offset by spending reductions, so there is no net contribution to the deficit because of lost estate tax revenue.

It is highly likely that eliminating the estate tax would result in slightly greater federal income tax receipts. Without an estate tax, taxpayers would make fewer gift transfers to their children, who commonly pay income taxes at rates lower than their parents. However, estimating the size of this effect on income tax revenues involves overcoming a host of problems raised by incomplete estate tax data. The IRS simply is unwilling to disclose important details on intergenerational giving. Thus, the following analysis does not contain estimates of the positive effects of estate tax repeal on income tax receipts. If we had made these estimates, the macroeconomic effects of repeal would have been even more positive.

By adapting the macroeconomic models in the manner described above, the resulting estate tax simulation measures the economic effects of repealing this tax on December 31, 1996. That is, it shows how differently the economy would have behaved had taxpayers not faced the prospect of estate taxes beginning in 1997. This simulated economy is compared to a "baseline" economy in which the current estate tax is still present. The differences between the baseline and simulated economies are the dynamic impacts of estate tax repeal. Again, these estimates should be viewed as a minimum assessment of the tax's economic effects.

Table 2 indicates that a stronger economy would result from the repeal of wealth transfer taxes.

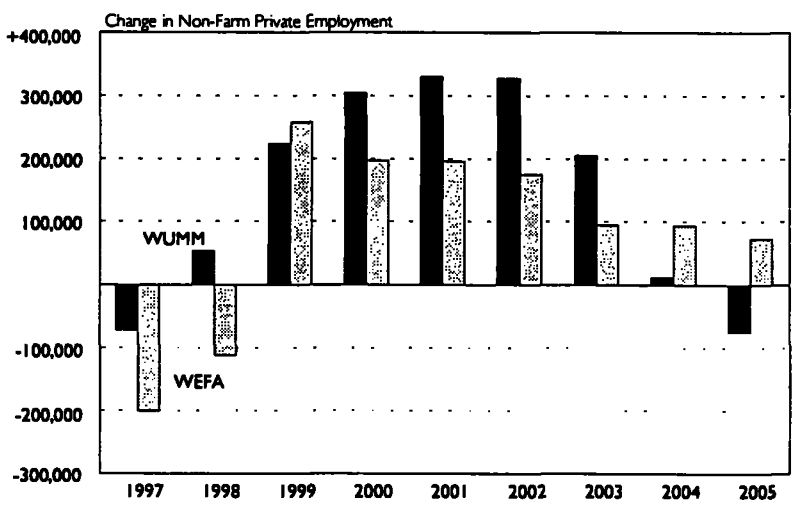
✔ The most general measurement of economic health (GDP adjusted for inflation) quickly jumps above baseline by as much as 0.4 percent in the Heritage analysis using the WUMM. The increase in real GDP averages $11.2 billion per year over the nine-year period between 1997 and 2005. Figure 3 shows the effects on GDP caused by estate tax repeal. When the Heritage assumptions are fed into the WEFA model, the economy grows above baseline by an average of $2.83 billion over this period.[61]

61 Even though these two estimates of additional GDP are different, the two models indicate the same general result: The economy grows more without the estate tax. The outputs of econometric models often differ, even when employing the

- ✔ Behind the growth in GDP is a strong increase in investment. A drop in the cost of capital caused by estate tax repeal leads to increased business purchases of buildings and machines. Investment in the goods that make labor more productive grows 2 percent faster between 1997 and 2005 than it otherwise would. Using the WEFA model, investment grows 0.9 percent faster over this same time period. Economists widely believe that growth in capital goods is closely related to economic growth, and that this helps explain the higher growth in GDP.
- ✔ In addition to stimulating the growth of private investment, repealing the estate tax reduces the tax costs that workers face. Lower taxes on income are widely believed to result in a larger labor force. The Heritage estate tax simulation results in a significant growth in non-farm private employment, whichever model is used. Total non-farm employment grows by an average of 145,000 above baseline during the nine-year period using the WUMM. This growth subsides in subsequent years as wages rise to reflect the greater productivity of labor caused by the greater amount of capital per laborer. By 2003, total non-farm employment has returned to its long-term growth trend. The Heritage analysis using the WEFA model estimates average employment growth to be 86,000 over this period.
- ✔ Not only do businesses take advantage of lower capital costs to buy new plant and equipment, but families increase their purchases of new homes. Housing starts jump sharply during the first two years after repeal. The Heritage simulation using the WUMM model predicts that estate tax repeal would lead to a first-year increase of 49,000 in housing starts. This effect is caused by a significant drop in the mortgage in-

Chart 4

Economy Without Estate Tax Produces More Jobs



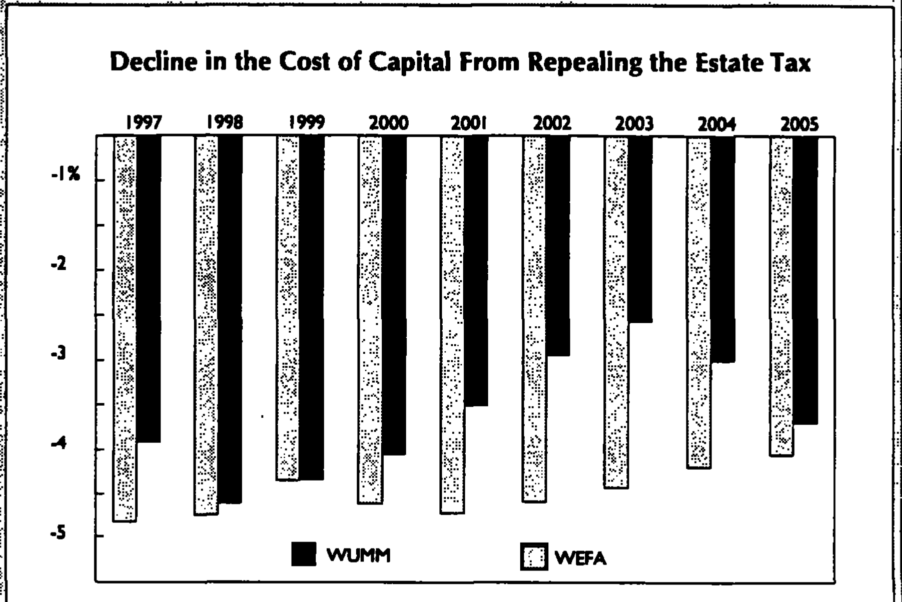
Source: Heritage calculations, using the Washington University Macro Model and WEFA Mark I I U.S. Macroeconomic Model.

very same assumptions, because of subtle differences in the theoretical viewpoints upon which the models are constructed. After all, such models are intended to give analysts insight into how changes in specific economic relationships affect the macroeconomy. The differences between the two models used in this study stem largely from WUMM's greater emphasis on the rental price of investment as a driver of economic activity.

terest rate. The fact that it does not drop more in subsequent years explains why housing starts return to baseline after the third year following repeal.

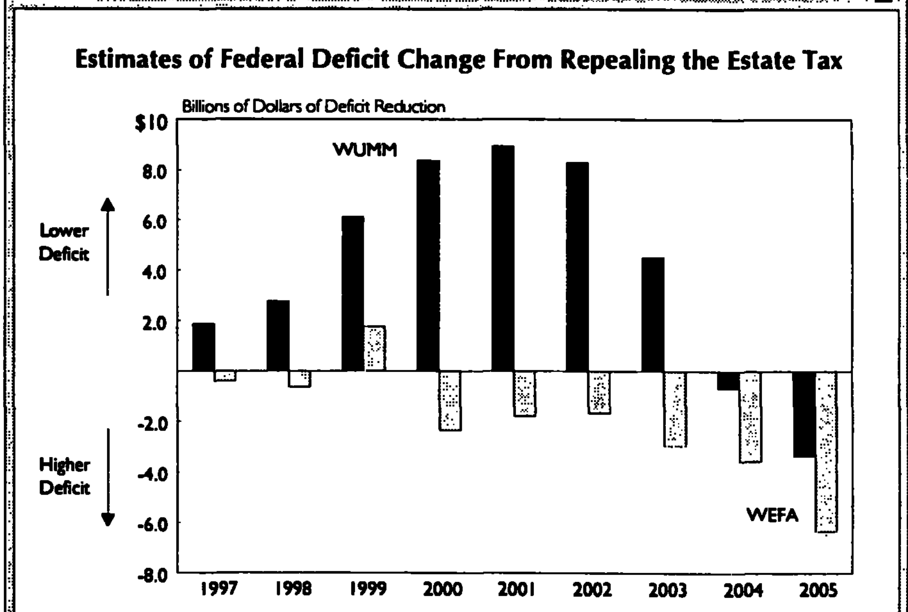
✔ The boost in housing and the growth in business investment expenditures reflect the lower capital costs that result from removing the estate tax premium on capital. The cost of corporate capital and the secondary mortgage rate fall by an average of 21 and 27 basis points, respectively, in the Heritage analysis using the WUMM. While this decline is less dramatic in the WEFA model, the user cost of capital remains solidly below baseline throughout the nine-year period. As economic activity builds following repeal of the estate tax, demand for capital rises, leading to small increases in both the long bond rate and the federal funds rate. Subtle elevations in these market lending rates would be the expected result in an economy that is adding more jobs and creating more capital goods than an economy still burdened by high tax rates.

Chart 5



Source: Heritage calculations, using the Washington University Macro Model and WEFA Mark I I U.S. Macroeconomic Model.

Chart 6



Source: Heritage calculations, using the Washington University Macro Model and WEFA Mark I I U.S. Macroeconomic Model.

✔ The growth in household income also supports the increase in housing starts. Between 1997 and 2005, inflation-adjusted household disposable income (broadly, what is left after taxes) grows by an average of $12 billion per year in the Heritage analysis using the WUMM model. Similar growth also occurs in total personal income, which increases by an average of $8 billion per year. Both of these income indicators rise because of higher levels of employment, greater worker productivity, and stronger household and business consumption. The WEFA model shows inflation-adjusted disposable income rising by an average of $9 billion per year and personal income growing by an average of $5 billion per year over this nine-year period.

✔ Despite the loss of $15 billion in annual revenue and $15 billion less in government spending, the federal deficit does not worsen over this nine-year period. In fact, the WUMM simulation shows that a stronger economy leads to deficit improvement. For each of the first seven years in the estate tax simulation, the deficit is slightly *less* after estate tax repeal than in an economy with an estate tax. During the last two years of the simulation, higher interest rates cause a gentle rise in federal expenditures. Te WEFA simulation indicates minor deficit changes throughout the nine-year period. Both simulations, however, point to the same conclusion: The economic benefits from estate tax repeal should not be sacrificed because of concerns about a federal deficit.

CONCLUSION

It is easy in this season of big tax reform proposals to overlook the federal estate tax. This tax, after all, is a relatively minor source of federal revenue that has been declining for the past 20 years. Indeed, many of those involved in the ongoing tax policy debate simply ignore it.

This is a mistake. As this study has shown, the economic cost of the estate tax is many times greater than the revenue it produces, and its reach into American households extends far beyond those few which pay it. Every day, social and economic decisions are made with the estate tax in mind. Minority businesspeople suffer anxious moments wondering whether the savings they have built in their businesses, and that they plan to hand to their children, will be destroyed by the estate tax bill. Poor people, for whom the estate tax has no immediacy, wonder at the scarcity of entry-level jobs or the absence of low-cost educational loans. Factories drone on with worn-out equipment that would be replaced if capital costs fell. Women who have raised their children struggle to find ways to re-enter the work force without upsetting the family's estate tax avoidance plan. Rich people buy vacations in Vail and fine art in Lisbon, rather than new businesses that create jobs and incomes, because the government has a claim on more than half of everything they cannot spend.

The estate and gift tax does much to perpetuate the social and economic distortions produced generally by taxes on income. Should Congress repeal this tax, however, the result would be a growing economy, more abundant jobs, and offices and factories with the kind of new equipment that elevates productivity and supports higher wages. Lower capital costs also would mean new small businesses, which traditionally have served as economic havens for minority families and launching pads for young workers. By repealing the estate and gift tax, Congress would be making significant progress toward creating a tax policy that complements rather than undermines other efforts to expand economic opportunity by creating a growing economy.