THE ECONOMICS OF THE ESTATE TAX

A JOINT ECONOMIC COMMITTEE STUDY

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Executive Summary

This analysis examines the arguments for and against the federal estate tax and concludes that the estate tax generates costs to taxpayers, the economy and the environment that far exceed any potential benefits that it might arguably produce.

- The existence of the estate tax this century has reduced the stock of capital in the economy by approximately $497 billion, or 3.2 percent.
- The estate tax is a leading cause of dissolution for family-run businesses. Large estate tax bills divert resources from investment and employment and often force families to develop environmentally sensitive land.
- Empirical and theoretical research indicates that the estate tax is ineffective at reducing inequality, and may actually increase inequality of consumption.
- The estate tax raises very little, if any, net revenue for the federal government. The distortionary effects of the estate tax result in losses under the income tax that are roughly the same size as estate tax revenue.

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EXECUTIVE SUMMARY

This analysis examines the arguments for and against the federal estate tax and concludes that the estate tax generates costs to taxpayers, the economy and the environment that far exceed any potential benefits that it might arguably produce.

This paper documents the extensive costs associated with the federal estate tax. Specifically, the report finds:

- The existence of the estate tax this century has reduced the stock of capital in the economy by approximately $497 billion, or 3.2 percent.
- The distortionary incentives in the estate tax result in the inefficient allocation of resources, discouraging saving and investment and lowering the after-tax return on investments.
- The estate tax is extremely punitive, with marginal tax rates ranging from 37 percent to nearly 80 percent in some instances.
- The estate tax is a leading cause of dissolution for thousands of family-run businesses. Estate tax planning further diverts resources available for investment and employment.
- The estate tax obstructs environmental conservation. The need to pay large estate tax bills often forces families to develop environmentally sensitive land.
- The estate tax violates the basic principles of a good tax system: it is complicated, unfair and inefficient.

In addition, a review of the arguments in favor of the estate tax suggests that the tax produces no benefits that would justify the large social and economic costs.

- The estate tax is a "virtue tax" in the sense that it penalizes work, saving and thrift in favor of large-scale consumption.
- Empirical and theoretical research indicates that the estate tax is ineffective at reducing inequality, and may actually increase inequality of consumption.
- The enormous compliance costs associated with the estate tax are of the same general magnitude as the tax's revenue yield, or about $23 billion in 1998.
- The deduction for charitable bequests stimulates little or no additional giving.
- The estate tax raises very little, if any, net revenue for the federal government. The distortionary effects of the estate tax result in losses under the income tax that are roughly the same size as estate tax revenue.

THE ECONOMICS OF THE ESTATE TAX

I. INTRODUCTION

Benjamin Franklin noted over 200 years ago that "in this world nothing can be said to be certain, except death and taxes."[1] Unfortunately, the convergence of these two inescapable events, in the form of the federal estate tax, results in a number of destructive outcomes in terms of slower economic growth, reduced social mobility and wasted productive activity. Moreover, the costs imposed by the estate tax far outweigh any benefits that the tax might produce. The purpose of this paper is to review and analyze the theoretical and empirical foundations of the federal estate tax, and to explore the potential effects of eliminating or reducing estate taxation.

On the surface, some observers might believe that the present estate tax is free from serious controversy. For example, it is often claimed that the tax only falls on the "rich" and thus serves to reduce income inequality. Other supporters of the estate tax point to the $23 billion in tax revenue it raised in 1998, or to the incentives to leave bequests to charitable organizations. Such claims notwithstanding, there are many reasons to question why the government should tax the accumulated savings of productive citizens. Not the least of these reasons is the widely-held belief that families who work hard and accumulate savings should not be punished for such sound budgeting. Additionally, it is unclear whether the estate tax raises any revenue at all, since most if not all of its receipts are offset by losses under the income tax.

To preview the results of the present analysis, consider the conclusion drawn by Henry Aaron and Alicia Munnell, two prominent liberal economists, in their study of the estate tax:

> In short, the estate and gift taxes in the United States have failed to achieve their intended purposes. They raise little revenue. They impose large excess burdens. They are unfair.[2]

The remainder of this paper is organized into four sections. Section II provides a brief overview of the history and mechanics of the estate tax. Section III reviews the arguments made in support of the estate tax, while Section IV addresses the tax's negative consequences. Section V concludes with a summary of the analysis and some general thoughts.

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[1] John Bartlett, *Familiar Quotations*, 16th ed. (Boston, MA: Little, Brown and Company, 1992), 310.
[2] The authors go on to prescribe ways to reform and improve the estate tax. Henry J. Aaron and Alicia H. Munnell, "Reassessing the Role for Wealth Transfer Taxes," *National Tax Journal* 45, no. 2 (June 1992): 138.

II. HISTORY AND MECHANICS OF THE FEDERAL ESTATE TAX[3]

The estate tax, also known as a death tax,[4] is simply a tax imposed on wealth transfers made at the holder's death. Death taxes have taken on several different forms in the United States, at both the state and the federal level. Three times in this nation's history, a federal death tax has been imposed only to be repealed shortly thereafter. In each instance, the estate tax was implemented to provide revenue on a short-term basis to finance military action.

The first federal death tax in this country was a death "stamp" tax established in 1797 to pay for a naval buildup in response to heightened tensions with France, and abolished just five years later in 1802. The federal death tax was absent the next 60 years, until Congress reenacted it in 1862 to raise revenue for the Civil War. After the war ended, Congress repealed the tax in 1870. The third federal death tax was enacted in 1898 to finance the Spanish-American War. As before, the estate tax was abolished after the war in 1902. With the advent of World War I, the estate tax was reintroduced in 1916 and has existed in various forms since.

The basic features of the current estate tax were adopted by the Tax Reform Act of 1976. This law established a unified system to tax all types of wealth transfers. The current estate tax thus consists of the traditional estate tax, plus two additional components designed to close "loopholes": a gift tax and a generation-skipping transfer (GST) tax. The gift tax requires that all taxable gifts made during life by the deceased be included when calculating the value of the estate. The GST tax captures wealth transfers that "skip" a generation, such as a trust that a grandmother leaves to her grandchildren. The value of all three types of wealth transfers are aggregated and taxed together at rates effectively ranging from 37 to 60 percent on net taxable estates. In certain instances involving GSTs, the combined marginal tax rate on estates can reach nearly 80 percent.[5]

Net taxable estate is defined as the gross value of estate assets and lifetime gifts, minus allowable deductions. The estate tax provides for many tax deductions. The most important of these is the unified credit which effectively exempts the first $625,000 of an estate from taxation. Other major provisions include an unlimited spousal deduction (so that transfers to spouses are not taxed), a deduction for bequests left to charitable organizations, and a credit for state death taxes. Other tax deductions are granted for specific situations, such as qualified family businesses or land set aside for environmental conservation.

Taxable gifts and GSTs are calculated separately before they are added to the aggregate estate. Donors are allowed to give $10,000 tax-free each year to any number of recipients.

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[3] This section draws heavily from John R. Luckey, "A History of Federal Estate, Gift, and Generation-Skipping Taxes," CRS Report for Congress 95-444 (Washington, DC: Congressional Research Service, 3/16/95).

[4] The term death tax refers to all forms of taxing wealth transfers between generations. Some systems impose a tax on wealth as it is received by the heirs (an inheritance or accessions tax), while other systems impose a tax as it leaves the possession of the decedent (an estate tax).

[5] Statutory rates range from 18 to 55 percent. The unified credit exempts from taxation estates below the 37 percent rate, and the phase-out of the unified credit for larger estates effectively raises the top marginal rate to 60 percent. Joint Committee on Taxation, Congress of the United States, *Present Law and Background Relating to Estate and Gift Taxes*, JCX-2-98 (Washington, DC: Joint Committee on Taxation, 1998), 2, 6, 15.

Thus, two parents together could give $20,000 annually to each of their children. Individuals are further granted a $1 million exemption for all generation-skipping transfers.

The Taxpayer Relief Act of 1997 sought to mitigate the impact of estate taxes by increasing available deductions.[6] The unified credit was raised from $600,000 per estate to its 1998 level of $625,000, and will gradually increase each year until it reaches $1 million in 2006. In addition, the Act indexed the deductions for gift and GST taxes for inflation beginning in 1998. Smaller provisions were also enacted to assist family-run businesses and land set aside for conservation.

III. ARGUMENTS FOR ESTATE TAXATION

Supporters of the estate tax generally rely on three different arguments. First, supporters claim the estate tax reduces inequality of wealth and income. Second, estate tax advocates contend that the deduction for charitable bequests encourages giving to nonprofit organizations. Finally, supporters argue that the $23 billion it raised in fiscal year 1998 warrants the estate tax's existence. The balance of this section considers each of these arguments in greater detail.

A. Inequality and the Distribution of Wealth

One of the most common arguments made in favor of the estate tax is that it reduces income and wealth inequality. Supporters of the estate tax contend that since the high tax rates apply only to the "rich," the effect should unambiguously reduce inequality. This assertion actually incorporates two interrelated assumptions: that high estate tax rates are theoretically justified in the context of a liberal, progressive philosophy; and that high estate tax rates do in fact reduce inequality.

This section demonstrates that both of these assumptions are flawed. First, the estate tax fails on liberal, progressive grounds because it discourages work and saving in favor of large-scale consumption. Second, there is no empirical evidence to support the view that the estate tax is effective at reducing inequality. In fact, much of the research which suggests that the estate tax is a poor tool to address inequality has been done by economists who themselves are generally sympathetic to issues of income inequality. Each of these arguments is examined in greater detail below.

The Liberal Philosophical Argument

The liberal philosophical argument against the estate tax is articulated by legal scholar Edward McCaffery, who identifies himself as an "an unrequited liberal … whose views on social and distributive justice might best be described as progressive."[7] McCaffery argues that the estate tax fails even (or perhaps especially) from a liberal perspective.[8] Taxation of wealth

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[6] Joint Committee on Taxation, Congress of the United States, *General Explanation of Tax Legislation Enacted in 1997*, JCS-23-97 (Washington, DC: Government Printing Office, 1997), 63-82.
[7] Edward J. McCaffery, "Rethinking the Estate Tax," *Tax Notes Today*, 6/22/95.
[8] McCaffery's published treatments of the estate tax include "The Uneasy Case for Wealth Transfer Taxation," *Yale Law Journal* 104, no. 2 (November 1994): 283-365; and "The Political Liberal Case against the Estate Tax," *Philosophy & Public Affairs* 23 (1994): 281-312.

transfers results in two general types of incentives: persons who want to leave inheritances can either avoid the tax through large *inter vivos* gifts and other tax loopholes; and they can reduce the size of their estate by consuming more of it or by work and saving less. McCaffery argues that both of these incentives contradict the basic values of work, saving and altruism which form the basis of the progressive liberal philosophy that McCaffery himself espouses.

On the first point, McCaffery argues that large *inter vivos* transfers, at best, "are not what the typical liberal political theorist seemed to have had in mind in supporting an estate tax."[9] At a minimum, parents who are induced to make large gifts early in their children's lives not only may reduce the labor supply of those children, but may also undermine whatever control they have over their children. Moreover, the porous nature of the current estate tax means that it will be ineffective at breaking up large concentrations of wealth and may in fact result in net revenue losses for the government. Efforts to tighten the estate tax by closing loopholes, however, would ultimately result in the even more detrimental outcome of reduced capital accumulation.

Second, and more importantly, McCaffery argues that estate taxation penalizes work and saving and encourages large-scale consumption by the very rich. If individuals know that they will be unable to pass on their wealth, then they may choose to simply produce less wealth or to consume their wealth. The accumulation of savings does not occur merely by accident or as a by-product of work. Rather, savings represent the conscious decisions of individuals to forgo immediate consumption.[10] The prospect of tax rates up to 60 percent, however, diminishes the value of their deferred consumption.

This incentive effect of the estate tax leads McCaffery to ask the question: what do liberals mean when they say they want greater equality? Is it equality of wealth or equality of consumption? According to McCaffery, the distinction between the two can be characterized as the difference between possession of wealth and use (i.e., consumption) of wealth. Ownership of wealth, McCaffery argues, is the preferred liberal outcome to consumption, since in the former case the wealth remains in the "common store of goods" where it produces a number of benefits through capital accumulation and its attendant outcomes.

McCaffery argues that in its basest form, the estate tax actually undermines the very concept of fairness and equality that the liberal progressive movement ought to support:

> The estate tax discourages behavior that a liberal, democratic society ought to like –work, savings, bequests – and encourages behavior that such a society ought to suspect – the large-scale consumption, leisure, and *inter vivos* giving of the very rich. Our polls and practices show that we like sin taxes, such as on alcohol and cigarettes. The estate tax is

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[9] McCaffery, "The Political Liberal Case," 290.

[10] Venti and Wise present evidence showing that individuals who retire with a significant amount wealth made conscious decisions to save rather than consume their excess earnings. Carroll shows how increased estate taxes can lead individuals to reduce their bequest by increasing their consumption. Stephen F. Venti and David A. Wise, "The Cause of Wealth Dispersion at Retirement: Choice or Chance?" *American Economic Review* 88, no. 2 (May 1998): 185-191; and Christopher D. Carroll, "Why Do the Rich Save So Much?" Working Paper No. 98-12, Office of Tax Policy Research, University of Michigan, (December 1997).

> an anti-sin, or a virtue, tax. It is a tax on work and savings without consumption, on thrift, on long-term savings. There is no reason even a liberal populace need support it.[11]

Empirical Evidence

A large body of empirical research has been produced which confirms the belief that inheritance either is not a major source of inequality, or that government policies aimed at inheritance are likely to be ineffective. There are three reasons for such conclusions. First, there is only a weak correlation between wealth and income. Thus, the elimination or curtailment of wealth transfers can have only a limited impact on the distribution of earnings. Second, efforts to curtail wealth transfers will induce wealth holders to increase their consumption, thereby increasing the inequality of consumption. Finally, the high degree of wealth and income mobility in the economy means that government efforts to redistribute wealth will necessarily meet with limited success. The remainder of this section will review the various empirical studies on the relationship between inheritance and inequality.

One of the more compelling arguments on the inequality aspect of estate taxation was prepared by Alan Blinder, a former member of the Federal Reserve Board appointed by President Clinton. In his book, *Toward an Economic Theory of Income Distribution*, Blinder attempted to decompose income inequality into its root causes, the results of which could then be used to identify policies that would be effective at reducing inequality. One finding of Blinder's analysis was that only about 2 percent of inequality was attributable to the unequal distribution of inherited wealth, leading him to conclude that "a radical reform of inheritance policies can accomplish comparatively little income redistribution."[12]

Subsequent research by Blinder attempted to explore in greater detail the role of estate taxation in reducing inequality. To account for the multi-generational nature of inheritance, Blinder developed an economic model that looked at families over a period of successive generations. Blinder then used the model to see what would happen to income inequality with different levels of estate taxation. Contrary to conventional wisdom, Blinder found that

> [E]state taxation is not a very powerful weapon in the egalitarian arsenal. A doubling of the tax rate, which must be 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% [average] 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.[13]

Another critical analysis of the estate tax was prepared by Joseph Stiglitz, who served as Chairman of President Clinton's Council of Economic Advisers. In a 1978 article in the *Journal*

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[11] McCaffery, "Rethinking the Estate Tax."

[12] Blinder uses the Gini ratio as the measurement of inequality. Alan S. Blinder, *Toward an Economic Theory of Income Distribution* (Cambridge, MA: MIT Press, 1974), 123, 137-139.

[13] By comparison, the average tax rate in 1995 was less than 18 percent. Alan S. Blinder, "Inequality and Mobility in the Distribution of Wealth," *Kyklos* 29 (1976): 618-9; and Martha Britton Eller, "Federal Taxation of Wealth Transfers, 1992-1995," *Statistics of Income Bulletin* 16, no. 3 (Winter 1996-1997): 42-46.

of Political Economy, Stiglitz argued that it was wrong to look at the distributional aspects of estate taxation without considering the long-term impact on capital accumulation. Using such an approach, Stiglitz found that the estate tax may ultimately cause an *increase* in income inequality.[14] Even if the government acts to offset these capital accumulation effects, Stiglitz argued that 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."[15]

In other research, Stiglitz argues more explicitly that inheritances actually *decrease* inequality. In a 1979 article, Stiglitz (writing with David Bevan) asserted that because inheritances are used to redistribute income within family units, they may decrease inequality in lifetime consumption.[16] In yet another analysis, Stiglitz concluded that "it would seem clear that inheritances are unambiguously equality increasing" in terms of consumption, and an argument can be made that inheritances reduce inequality of income and wealth as well.[17]

The conclusions reached by Blinder and Stiglitz have been replicated by numerous other researchers. For example, a 1982 article by economist James Davies reported that "inheritance has a small impact on inequality in annual income and lifetime resources."[18] Mark Hugget's 1996 analysis found that differences in annual earnings are more important in accounting for inequality than differences in inheritance.[19] Similarly, a review of the historical evidence by G. P. Verbit found that that the estate tax had virtually no impact on the distribution on wealth over the previous five decades.[20] Indeed, the measurable effect of the estate tax on inequality is so small that neither the Congressional Budget Office nor the Treasury Department's Office of Tax Analysis even includes the estate tax in their standard analyses of the distribution of the tax burden.[21]

To some observers, it may appear counterintuitive that the estate tax, which is mainly levied on the wealthy, is ineffective at reducing inequality. One explanation for this finding is the high degree of wealth and income mobility present in the American economy. Far from being a static economy where wealth is permanently locked in the hands of a few families, the American

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[14] According to Stiglitz, the estate tax may increase the share of output attributable to capital, and since "income from capital is more unequally distributed than is labor income, the increase in the proportion of income accruing to capital may increase the total inequality of income." Joseph E. Stiglitz, "Notes on Estate Taxes, Redistribution, and the Concept of Balanced Growth Path Incidence," *Journal of Political Economy* 86, no. 2 (1978): S137-S150.
[15] *Ibid*., S157.
[16] David L. Bevan and Joseph E. Stiglitz, "Intergenerational Transfers and Inequality," *Greek Economic Review* 1, no. 1 (August 1979): 13.
[17] Joseph E. Stiglitz, "Equality, Taxation and Inheritance," in *Personal Income Distribution: Proceedings of a Conference Held by the International Economic Association, Noordwijk aan Zee, Netherlands, April 18-23, 1977*, eds. Wilhelm Krelle and Anthony F. Shorrocks (New York, NY: North-Holland Publishing Company, 1978), 283.
[18] James B. Davies, "The Relative Importance of Inheritance and Other Factors on Economic Inequality," *Quarterly Journal of Economics* 97 no. 3 (1982): 495.
[19] Mark Hugget, "Wealth Distribution in Life-Cycle Economies," *Journal of Monetary Economics* 38, no. 3 (December 1996): 489-490.
[20] G. P. Verbit, "Do Estate and Gift Taxes Affect Wealth Distribution?" *Trusts & Estates* 117, no. 10 (October 1978): 598-616.
[21] Thomas A. Barthold, James R. Nunns, and Eric Toder, "A Comparison of Distribution Methodologies," in *Distributional Analysis of Tax Policy*, ed. David F. Bradford (Washington, DC: AEI Press, 1995), 107.

economy is best characterized as fluid and dynamic, where new wealth is constantly created and old wealth is naturally dispersed though intergenerational transfers.

The high degree of wealth mobility in America was noted as long ago as 1835 by Alexis de Tocqueville. De Tocqueville observed that in contrast to Europe where laws of primogeniture perpetuated family wealth, American wealth naturally dispersed over time:[22]

> The English laws concerning the transmission of property were abolished in almost all the states at the time of the [American] Revolution. The law [concerning inheritance] was so modified as not materially to interrupt the free circulation of property. The first generation having passed away, estates began to be parceled out; and the change became more and more rapid with the progress of time. And now, after a lapse of a little more than sixty years, the aspect of society is totally altered; the families of the great landed proprietors are almost all commingled with the general mass. In the state of New York, which formerly contained many of these, there are but two who still keep their heads above the stream; and they must shortly disappear. The sons of these opulent citizens have become merchants, lawyers, or physicians. Most of them have lapsed into obscurity. The last trace of hereditary ranks and distinctions is destroyed; the law of partition has reduced all to one level.
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> 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.**[23] *(emphasis added)*

More recently, wealth mobility was the focus of a 1997 study by Nancy Jianakoplos and Paul Menchik. Jianakoplos and Menchik found that between 1966 and 1981, more than half of all households changed wealth quintiles. Their analysis of why households moved up or down the wealth distribution is revealing. Importantly, they found that receiving an inheritance helped families become upwardly mobile. Inheritance was particularly important in allowing households to enter the top decile of wealth. These findings suggest that inheritance is an important mechanism by which households in the bottom or middle of the wealth distribution are able to achieve upward mobility.[24] Similarly, the authors' analysis indicates that many households move down the wealth distribution due to a variety of factors, such as a change in

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[22] The laws of primogeniture were a feature of feudalism specifically intended to prevent the dispersion of wealth (which in ancient and medieval times meant land). It was felt that allowing landowners to freely distribute their estates (which presumably would have resulted in the division of the estate among several descendents) would destabilize the feudal order. In fact, that is exactly what happened when such laws were done away with in the United States. See, James Kent, *Commentaries on American Law, Vol. IV*, ed. O. W. Homes, Jr., 12th ed. (1873; reprint, Littleton, CO: Fred B. Rothman & Co., 1989), 377-390, 412.

[23] Alexis de Tocqueville, *Democracy in America – Volume I* (1835; reprint, New York, NY: Vintage Books, 1945), 53.

[24] See also the discussion on estate taxes and entrepreneurship accompanying *infra* notes 107 through 125.

marital status. Overall, Menchik and Jianakoplos concluded that the data supported the "idea that many of the very wealthy are products of 'self-made fortunes.'"[25]

Other data confirm this conclusion. A study of wealthy investors by Prince & Associates found that just 7 percent of respondents identified inheritance as the source of their wealth. The vast majority – 83 percent – earned their fortune through hard work, a family business, a professional practice such as law or medicine, or corporate employment.[26] In their book *The Millionaire Next Door*, authors Thomas Stanley and William Danko report that 81 percent of millionaires are first-generation rich, and just 14 percent of millionaires cite inheritance as the source of their wealth.[27] Most millionaires did not receive one dime of inheritance, and the vast majority (80 percent) received less than 10 percent of their wealth through inheritance.

The fact that just four out of five millionaires are first generation rich raises the question: if inheritance is not the source of their wealth, how did these did these individuals become millionaires? Stanley and Danko's survey indicates that the primary mechanism of achieving wealth is for families to manage their money effectively and lead a frugal lifestyle. Contrary to conventional wisdom, most millionaires do not lead high-priced lifestyles. For example, the typical millionaire has never spent more than $400 on a suit and paid just $24,800 for his current automobile. Aside from Visa and MasterCard, the two most common credit cards held by millionaires are Sears and J.C. Penny's.

In the context of Stanley and Danko's findings, it is perhaps not surprising that public support for confiscatory estate taxation is not very strong. A survey of public opinion polls about wealth and income reveals that most Americans continue to view and support the concept of America as a land of opportunity. Overwhelming majorities of Americans believe that hard work allows anyone to get ahead. In fact, close to 90 percent of Americans admire people who get rich though hard work.[28] Most Americans (56 percent) believe that wealth accumulation is permissible (Table 1).[29] Even at the lowest income levels, a majority of Americans continue to support the opportunity to accumulate wealth.

Public attitudes toward death taxes are also reflected in legislation enacted at the state level. The will of the voters was directly expressed in a 1982 California referendum, when taxpayers voted by almost a two to one margin (64 percent to 36 percent) to eliminate the state's gift and inheritance taxes.[30] More recently, five states – New York, Louisiana, Kansas, Delaware, and

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[25] Nancy A. Jianakoplos and Paul L. Menchik, "Wealth Mobility," *Review of Economics and Statistics* 79, no. 1 (February 1997): 26.
[26] Ten percent cited real estate or other investments as their source of wealth. "Majority of Rich Investors Made Fortunes through Hard Work According to Private Asset Management Study," *Business Wire*, 6/14/94.
[27] Thomas J. Stanley and William D. Danko, *The Millionaire Next Door: The Surprising Secrets of America's Wealthy* (Atlanta, GA: Longstreet Press, 1996), 16, 32.
[28] 1997 survey by Pew Research Center, as reported in Everett Carll Ladd and Karlyn H. Bowman, *Attitudes toward Economic Inequality* (Washington, DC: AEI Press, 1998), 53.
[29] 1993 survey by the National Opinion Research Center, as reported in Ladd and Bowman, 109.
[30] *U.P.I.*, 2/7/83.

Iowa – have enacted legislation since 1997 that will either eliminate or significantly reduce the burden of their state death taxes.[31]

Table 1. Attitudes toward Wealth Accumulation

	"People should be allowed to accumulate as much wealth as they can even if some make millions while others live in poverty."		
	Strongly Agree or Agree	**Neither Agree nor Disagree**	**Strongly Disagree or Disagree**
Total	56%	11%	30%
Income level			
Under $15,000	51%	12%	33%
$15,000 to $19,999	59%	7%	33%
$20,000 to $29,999	54%	11%	34%
$30,000 to $49,999	60%	11%	27%
$50,000 to $74,999	60%	10%	27%
$75,000 and up	65%	12%	22%

Source: Ladd and Bowman.

Indeed, the story of "from rags to riches" is a familiar item in the American lexicon.[32] Proof of the dynamic nature of the American economy is evident in the *Forbes* annual list of the richest 400 Americans. Of the 400 persons who were on the first list in 1982, the vast majority – 74 percent – had completely dropped off the list 15 years later.[33] In the 1997 edition, self-made fortunes outnumbered inherited wealth by two to one.[34] Moreover, among the 10 wealthiest Americans, only three were even on the list of 400 back in 1982, and only one "old-time" family fortune made it into the top 10 (two heirs of Sam Walton were ranked ninth and tenth).[35]

In addition to the creation of "new" wealth, much wealth naturally dissipates over time through bequests and *inter vivos* gifts. Intergenerational transfers are by definition equality enhancing. For example, if a parent divides her estate evenly between her two children, then the concentration of wealth is reduced by one-half, and any wealth remaining after the second generation must then be distributed among the presumably larger pool of third generation heirs.[36] The effect of intergenerational transfers on inequality may be even larger if, as some evidence

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[31] In recent years, many states have shifted to a "pick up" estate tax. Pick-up taxes impose a state estate tax equal to the tax credit available under the federal estate tax. Thus, states can still raise revenue from their estate tax, but the federal credit ensures that no additional tax liability is imposed on the taxpayer. *State Tax Notes* from 2/6/97, 7/31/97, 8/12/97, 4/29/98, and 8/19/98.

[32] For some examples of self-made fortunes, see "Rags to Riches," *Inc.*, 8/97; and Paul Craig Roberts op-ed, "Building Fortunes the American Way," *The Washington Times*, 12/5/97.

[33] "When Billionaires Become a Dime a Dozen," *Forbes*, 10/13/97.

[34] "Richest List Has Gates at No. 1, Plus 83 Californians," *The Los Angeles Times*, 9/29/97.

[35] "The Forbes 400," *Forbes*, 10/13/97; and "The Forbes 400," *Forbes*, 9/13/82.

[36] Stanley and Danko observe that the receipt of inheritance and *inter vivos* gifts may stimulate consumption and depress savings for some recipients. In such situations, little if any inheritance may be left for transmission to third and succeeding generations. See Stanley and Danko, 141-170.

indicates, parents tend to give more to their less well-off children.[37] Because concentrations of wealth are broken up through such mechanisms, many families who move "from rags to riches" may find themselves "back to rags again" after just a few generations.

B. Charitable Contributions

One objection to a reduction in the estate tax is that it would reduce contributions to charitable organizations. Because the estate tax allows individuals to deduct gifts to charitable organizations, there is a significant tax incentive to donate money at one's death. Reducing the tax on estates, the argument goes, could cause people to donate less money to charity. Recent research on this subject, however, indicates that the charitable tax deduction exerts only a modest, if any, stimulative effect. Although the charitable deduction affects the timing of donations, it may not significantly alter the overall level of giving.

According to tax return data, charitable organizations (excluding most churches) held assets valued at nearly $1.2 trillion in 1994. Gross revenues for these organizations totaled $619 billion, about one-fifth of which came from donations.[38] Tax-deductible charitable bequests in 1994 amounted to $9.3 billion, or 1.5 percent of the total revenue of charitable groups.[39] The large majority of non-profit organizations received nothing from charitable bequests in 1992, with only one-third of such groups reporting income from legacies or bequests.[40]

The Deduction for Charitable Bequests

The argument that the tax deductibility of charitable bequests encourages such donations is based on the "price" effect of lower taxes. For example, an estate with $100 at the 60 percent marginal tax rate faces a tax liability of $60. If this individual donates $40 to charity, the tax liability drops by $24 ($40 x 60%). Thus, every $1 this person gives to charity really only costs 40 cents, because 60 cents are saved in taxes. Since basic economic theory predicts that when the price of something decreases there is an increase in the amount purchased, an analysis of the price effect in isolation suggests that lowering tax rates would reduce charitable giving.

This example greatly oversimplifies the actual set of tax incentives faced by potential donors. Because charitable donations are also deductible for income tax purposes, the tax system as a whole is much friendlier to gifts during life than to gifts made at death. Using the example in the previous paragraph, if the same $40 gift were made during life, then the giver would save

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[37] Cox and Raines report that transfers reduce income inequality among recipients, and McGarry and Schoeni show that parents tend to focus their financial assistance on their children with lower incomes. Donald Cox and Fredric Raines, "Interfamily Transfers and Income Redistribution," in *Horizontal Equity, Uncertainty, and Economic Well-Being*, eds. Martin David and Timothy Smeeding (Chicago, IL: University of Chicago Press, 1985), 403; and Kathleen McGarry and Robert F. Schoeni, "Transfer Behavior in the Health and Retirement Study – Measurement and the Redistribution of Resources within the Family," *Journal of Human Resources* 30 (supplement 1995): S184.
[38] Figure includes 501c(3) non-profit organizations, private foundations and charitable trusts. Paul Arnsberger, "Private Foundations and Charitable Trusts, 1994," *Statistics of Income Bulletin* 17, no. 2 (Fall 1997): 173-194; and Cecelia Hilgert, "Charities and Other Tax-Exempt Organizations, 1994," *Statistics of Income Bulletin* 17, no. 4 (Spring 1998): 89-110.
[39] Eller, 39.
[40] Figure excludes religious congregations. Virginia A. Hodgkinson, Murray S. Weitzman, Stephen M. Noga, and Heather A. Gorski, *A Portrait of the Independent Sector* (Washington, DC: Independent Sector, 1993), 67.

close to $16 on income taxes ($40 x 39.6%) in addition to the $24 savings on estate taxes (assuming top marginal tax rates).

Despite the substantial tax benefits, a casual review of the data provides little support for the contention that tax incentives greatly affect charitable bequests. According to IRS data, relatively few estates even make charitable bequests, and fewer still account for most of the dollars given. Over 1992-1995, more than four out of five estates (82 percent) did *not* take advantage of the charitable deduction. Although that proportion increases with the value of the estate, even among estates worth at least $20 million, almost one-half (49 percent) do not claim any such deduction. To a certain degree, even these numbers overstate the scope of charitable giving, as a very small number of estates account for the vast majority of dollars donated to charity. The last four years of tax return data (1992-1995) indicate that the wealthiest 0.3 percent of decedents accounted for 81 percent of all charitable bequests made during that period. In fact, a mere 0.006 percent of decedents (555 estate tax returns out of 8.6 million deaths) accounted for close to 39 percent of all charitable bequests.[41]

The last major reduction in estate taxes occurred in the 1981 Economic Recovery Tax Act (ERTA), which lowered the top statutory marginal rate from 70 percent for 1981 decedents to 55 percent for 1984 and subsequent decedents. In the five years prior to the reduction in the estate tax (1977-1981), total charitable bequests in the U.S. amounted to $31.9 billion.[42] After the rate cuts, total charitable bequests increased in real terms by nearly 23 percent, to $39.1 billion over the following five years (1982-1986). Charitable bequests as a share of GDP increased as well, rising from 0.105 percent to 0.123 percent.

Empirical Research on the Charitable Deduction

Despite the best efforts of econometric models, it remains extremely difficult to estimate the precise effect of tax incentives on charitable giving. The large number of factors that affect individual decisions hampers researchers' efforts to isolate and quantify the impact of one single consideration.[43] Although a number of studies have attempted to quantify the relationship between tax rates and charitable deductions, the conclusions have been varied. Some studies indicate that tax rates are quite important,[44] while other research demonstrates that tax rates play little, if any, role in encouraging charitable giving.[45] Unfortunately, a number of data and

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[41] Calculations based on data from AAFRC Trust for Philanthropy, *Giving USA 1997* (New York, NY: AAFRC Trust for Philanthropy, 1996), 198; Eller; and U.S. Bureau of the Census, *Statistical Abstract of the United States 1997* (Washington, DC: Government Printing Office, 1997), 74.
[42] Dollar amounts in inflation-adjusted 1996 dollars. AAFRC Trust for Philanthropy, 198-199, 205.
[43] For example, recent research suggests that government spending itself depresses private donations. A. Abigail Payne, "Does the Government Crowd-Out Private Donations? New Evidence from a Sample of Non-Profit Firms," *Journal of Public Economics* 69, no. 3 (September 1998): 323-345. See generally, Barry W. Johnson and Jeffrey P. Rosenfeld, "Examining the Factors that Affect Charitable Giving," *Trusts & Estates* 130, no. 8 (August 1991): 29-37.
[44] See, for example, Gerald Auten and David Joulfaian, "Charitable Contributions and Intergenerational Transfers," *Journal of Public Economics* 59, no. 1 (January 1996): 55-68; and Charles T. Clotfelter, *Federal Tax Policy and Charitable Giving* (Chicago, IL: University of Chicago Press, 1985).
[45] Thomas Barthold and Robert Plotnick, "Estate Taxation and Other Determinants of Charitable Bequests," *National Tax Journal* 37, no. 2 (June 1984): 225-237.

methodological problems inherent to charitable bequest models limit the usefulness of specific econometric estimates.[46]

One of the most revealing studies on this subject matched estate tax returns to the income tax returns of the same decedents in the years prior to death. The analysis, prepared by Eugene Steuerle of the Urban Institute, thus allows for examination of the giving patterns of the wealthy both during life and at death.[47] Steuerle's data indicate that individuals who gave generously during their life gave little at death, while those who gave little during life tended to give much more at death. For example, close to one-half (49 percent) of estates making charitable bequests of $250,000 or more reported less than $1,000 in itemized charitable donations on their income tax returns prior to death. This finding suggests that the tax incentives to give may not be strong enough to alter the combined level of giving during life and at death.

One explanation that Steuerle offers for this weak link is the form in which the wealthy hold their assets. Much of their wealth comes in a form that is not immediately affected by the income tax, such as the appreciated value of stock or real estate. Tax incentives, however, only work when income is realized and subject to taxation. Steuerle concluded that,

> [S]ince recognition of capital income at the individual level is largely a discretionary event, tax incentives to give will only apply to that income for which such discretion is exercised. For income that is not recognized or is sheltered by artificial losses, the price effect is basically zero. For many taxpayers, therefore, **the existing tax system may discourage the recognition of income so much that a charitable incentive applies only to a small portion of the true economic income of the taxpayer**. …
>
> In effect, taxes can induce individuals to give only to the extent that their income is taxable. Given the fact that many of the very wealthy realize only a small part of their capital income, there is only a limited income tax incentive for them to donate significant portions of their wealth to charity during their lifetimes.[48] *(emphasis added)*

In brief, then, Steuerle's research suggests that tax incentives may play a relatively limited role in determining total lifetime giving. Some individuals choose to give during life in order to take advantage of the tax benefits in the income and estate taxes. Other individuals choose, for a variety of reasons, to hold on to their wealth and make their charitable giving at death. Tax incentives may induce some donors to give their contributions earlier in life, but on balance, it appears that tax incentives (both income and estate) do not greatly alter the total amount of charitable giving made over an individual's lifetime.[49]

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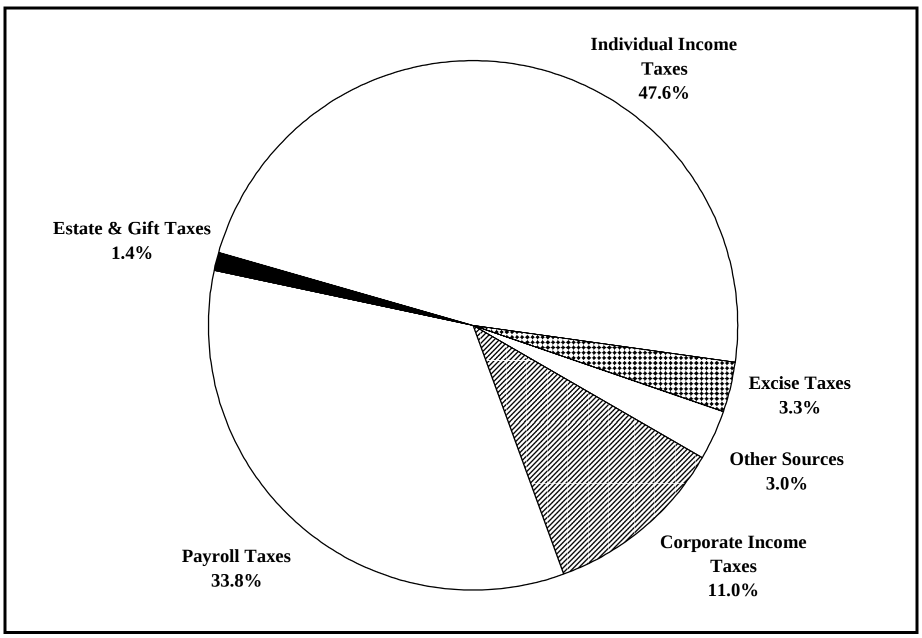
[46] See Charles W. Christian, James R. Boatsman and J. Hal Reneau, "The Interpretation of Econometric Estimates of the Tax Incentive to Engage in Philanthropy," *Journal of the American Taxation Association* (Spring 1990): 7-16; and William S. Reece and Kimberly D. Zieschang, "Consistent Estimation of the Impact of Tax Deductibility on the Level of Charitable Contributions," *Econometrica* 53, no. 2 (March 1985): 271-293.
[47] Eugene Steuerle, "Charitable Giving Patterns of the Wealthy," in *America's Wealth and the Future of Foundations*, ed. Teresa Odendahl (New York, NY: The Foundation Center, 1987), 203-221.
[48] *Ibid*., 217-218.
[49] A related argument has been put forth by Alan Reynolds, who observes that over the long run charitable donations represent a fixed share of GDP, a share that does not vary with changes in tax rates. Alan Reynolds, "Death Taxes and Giving: The Conventional Wisdom and Why It Is Wrong," *Philanthropy* (Winter 1997).

Other research confirm Steuerle's findings. An analysis by William Randolph of the Congressional Budget Office found that individuals "time their contributions to take advantage of transitory price changes."[50] Although taxes may affect the timing of gifts to charity, there may be no effect on the overall size of the donations. The effect of the tax deductibility of charitable contributions may therefore be analogous to "a family whose lifetime purchases of light bulbs are unaffected by price but which nonetheless buys all its bulbs when they are on sale."[51] Although Randolph does not directly address the issue of estate taxes, the implications are clear. Even if a reduction in the estate tax were associated with a decrease in the amount of charitable deductions made for estate tax purposes, there may be no long-term net effect since individuals may offset their reduction in donations at death with an increase in donations made during life.

C. Federal Revenue

A third objection to cutting estate taxes is the alleged loss of revenue to the federal government. The estate tax accounts for a relatively small portion of federal revenue. Although the $23.1 billion that the estate tax raised in 1998 is hardly insignificant, it amounts to only about 1.4 percent of the $1.7 trillion in total receipts (Figure 1), a level that has remained relatively stable during the past five decades.[52] In fact, the individual income tax raised more revenue in 1998 alone than the estate tax has raised during the entire 20th century.[53]

Figure 1. Distribution of 1998 Federal Revenues



Source: Office of Management and Budget.

[50] William C. Randolph, "Dynamic Income, Progressive Taxes, and the Timing of Charitable Contributions," *Journal of Political Economy*, 103, no. 4 (1995): 735.

[51] Gerald E. Auten, Charles T. Clotfelter and Richard L. Schmalback, "Taxes and Philanthropy among the Wealthy," Working Paper No. 98-15, Office of Tax Policy Research, University of Michigan (December 1997), 29.

[52] Office of Management and Budget, *FY 1999 Mid-Session Review* (Washington, DC: Government Printing Office, 1998), 23; and Office of Management and Budget, *Historical Tables* of *Budget of the United States Government, Fiscal Year 1997* (Washington, DC: Government Printing Office, 1997), 40-41, 169-170.

[53] Calculations use 1998 inflation-adjusted dollars and data from Office of Management and Budget, *Historical Tables*; U.S. Bureau of the Census, *Historical Statistics of the United States* (Washington, DC: Government Printing Office, 1976), 224; Jeffrey P. Rosenfeld, "Selected Components of Estate Portfolios, 1916-1990," in *Compendium of Federal Estate Tax and Personal Wealth Studies*, ed. Barry W. Johnson (Washington, DC: Internal Revenue Service, 1994), 94.

From a static revenue perspective, a reduction in either the rate of taxation or the tax base may result in a loss of revenue. However, there are at least two reasons why the traditional static analysis of the estate tax is inappropriate: estate tax avoidance strategies reduce income tax revenue, and revenue from estates is highly sensitive to the health of the economy.

Effect on Income Tax Revenue

The available data indicate that the estate tax may actually result in a net revenue loss for the federal government. The primary payers of the estate tax, the wealthy, tend to be well-educated about and willing to engage in extensive tax avoidance strategies. Moreover, it is difficult for any tax to assess accumulated savings and capital because such holdings can be manipulated through tax-free transfers and favorable asset valuation. These features of the estate tax led Joseph Stiglitz, former chairman of President Clinton's Council of Economic Advisers, to conclude that,

> Of course, prohibitively high inheritance tax rates generate no revenue; they simply force the individual to consume his income during his lifetime.[54]

A more in-depth examination of the net revenue effect of the estate tax is provided by Stanford University economist Douglas Bernheim.[55] As has been well documented, the estate tax affords many opportunities to avoid paying any tax at all.[56] However, such avoidance strategies principally occur by shifting resources from parents to their heirs prior to the parents' death. In general, revenue is lost whenever assets are transferred from parents in high income tax brackets to children (who typically face lower tax rates) or to tax-exempt organizations through charitable bequests.[57] Bernheim notes a few of the more relevant options used to avoid the estate tax:

- ***Direct gifts during life:*** The current estate tax allows up to $10,000 in annual tax-free gifts for each donor and recipient. Thus, a married couple with three children can transfer $60,000 each year to their heirs without paying taxes.

- ***Indirect gifts through advanced estate planning:*** Assets can also be transferred using sophisticated planning techniques such as issuing certain forms of stock in closely-held businesses or changing ownership of life insurance plans.

- ***Indirect gifts through profitable investment opportunities:*** Many parents are able to transfer wealth simply by letting their children participate in profitable investments in which they would not otherwise be involved. Parents can also provide low-cost financing or loan guarantees.

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[54] Bevan and Stiglitz, 21.
[55] B. Douglas Bernheim, "Does the Estate Tax Raise Revenue?" in *Tax Policy and the Economy*, vol. 1, ed. Lawrence H. Summers (Cambridge, MA: MIT Press, 1987), 113-138.
[56] See generally, George Cooper, *A Voluntary Tax?: New Perspectives on Sophisticated Estate Tax Avoidance* (Washington, DC: Brookings Institution, 1979).
[57] This revenue effect holds regardless of whether or not the charitable deduction induces additional giving.

- ***Unreported gifts:*** These gifts include hard-to-detect transfers of assets such as family heirlooms, clothing or other household items.

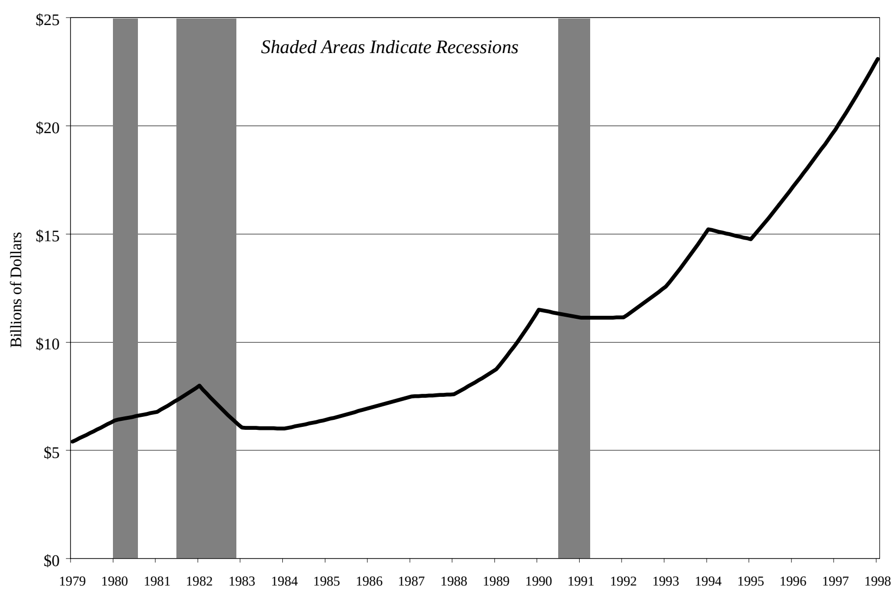
Through an analysis of estate tax returns under different assumptions and tax regimes, Bernheim found that the income tax revenue loss associated these factors is very large relative to the revenue raised by the estate tax. In sum, Bernheim concluded:

> Although it is very difficult to estimate these effects precisely, **in recent years true estate tax revenues may well have been negative**.[58] *(emphasis added)*

Health of the Economy

The second reason that static analyses fail to accurately measure the revenue effect of estate tax cuts is that estate tax revenue is highly sensitive to how the assets are valued, which in turn depends on the health of the economy.[59] To illustrate this effect, Figure 2 presents estate and gift tax revenue (in nominal dollars) from 1979 to 1998, covering both pre- and post-ERTA estate tax rates. Periods of economic recession are indicated with gray shading.

Figure 2. Estate Tax Revenue, 1979-1998



Source: Office of Management and Budget.

On the surface, it would appear that the estate tax cuts that went into effect in 1982 (affecting estate tax returns filed in 1983) lost a significant amount of revenue. Between 1982 and 1983, estate tax revenue dropped 24 percent. However, consideration of the tax cut in isolation ignores other relevant factors. A better understanding of the actual revenue effect of the 1981 estate tax cut requires that the changes be examined in the context of the 1981-1982 recession.

[58] Bernheim, 135.

[59] In order to determine the value of the taxable estate, executors may choose to value assets either at the time of the decedent's death or six months thereafter. Thus, the prospect of an ailing economy affords executors the option of accepting the later valuation in order to minimize property values.

The economy's poor performance significantly reduced the value of many estate assets, such as homes and corporate stocks.[60] Estate tax returns filed in 1983 primarily covered deaths in 1982. Thus, to see the effect of the economy on 1983 estate tax receipts, the appropriate point of comparison is how asset values changed in 1982 (when they were valued for estate tax purposes) relative to the previous year. Between August 1981 and January 1982, the median sales price of existing single-family homes dropped 2.5 percent.[61] Likewise, between the middle of 1981 and the middle of 1982, the New York Stock Exchange and the S&P 500 both fell close to 19 percent.[62] As home values and financial assets plummeted during the 1981-1982 recession, the diminished estate tax base resulted in revenue loss.

After the tax cuts were fully implemented, revenues grew steadily. Between 1983 and 1998, estate tax revenue more than tripled, increasing by 282 percent.[63] During that period, estate taxes were one of the fastest growing sources of revenue, outpacing the growth in total receipts, individual income taxes, payroll taxes, and excise taxes.

To further illustrate the relationship between the economy and estate tax receipts, Table 2 presents data on the three largest revenue jumps and declines since 1980. The first column of Table 2 lists annual changes in estate tax revenue. The next two columns present the largest possible change in the S&P 500 index and the median sales price of existing single-family homes.[64]

Table 2. Estate Tax Revenue, the S&P 500 and Median Sales Price of Homes

	Change in revenue	Change in S&P 500*	Change in median sales price of existing homes*
Year with large revenue decline			
1983	-24.3%	-18.6%	-2.5%
1991	-3.1%	-11.9%	-4.3%
1995	-3.0%	-4.0%	-2.0%
Year with large revenue increase			
1982	+17.7%	+30.6%	+17.6%
1990	+31.5%	+39.2%	+8.9%
1994	+21.1%	+14.4%	+7.0%

Source: Joint Economic Committee calculations.
* Indicates largest possible change. See note 64.

60 IRS data indicate that just over one-half of the gross estates of 1983 returns was in either real estate or corporate stock. Mary F. Bentz, "Estate Tax Returns, 1983," in *Compendium of Federal Estate Tax and Personal Wealth Studies*, ed. Barry W. Johnson (Washington, DC: Internal Revenue Service, 1994), 3-14.
61 The market value of more expensive homes likely experienced greater fluctuations during the recession that did the median home. Data from National Association of Realtors, "Home Sales" (monthly release).
62 Data published in *The Wall Street Journal*.
63 Calculations based on data from Office of Management and Budget, *Historical Tables*, 23-28, 40-41.
64 All data are nominal. For fiscal years with revenue decreases, change is measured as the difference between the low point of the previous calendar year and the high point of the year before that. For years with revenue increases, the points of comparison are the high point of the previous year and the low point of year before that.

As the data clearly indicate, years characterized by a booming stock market and rising home values are associated with revenue increases. Likewise, years in which the stock market was weak or home prices dropped are associated with declines in revenue, regardless of changes in the estate tax regime. Although the estate tax cuts that were passed in 1981 may have had some effect on revenues, these data suggest that a large part of the observed revenue loss was attributable to the 1981-1982 recession. Over the long term, the data also suggest that estate tax revenues were boosted by ERTA to the degree that the tax cuts stimulated economic growth.

Other evidence confirms these findings. A 1996 study examined estate tax rates and revenues over four decades to conclude that higher estate taxes increase tax avoidance.[65] Thus, increasing (or decreasing) the estate tax does not necessarily mean an increase (or decrease) in revenue. In fact, the authors' statistical analysis suggests that marginal tax rates are *inversely* related to the revenue raised. That is, higher tax rates actually lower the amount of tax collections. This point is confirmed by Douglas Shackelford, who observes that revenue lost due to reduced estate taxes would be partially offset in two ways.[66] First, the substantial resources expended on tax avoidance strategies could be redeployed toward more fruitful uses, such as capital investment. Second, the elimination of the estate tax's administrative and compliance cost would allow businesses to increase productivity and efficiency.

IV. ARGUMENTS AGAINST ESTATE TAXATION

This section of the paper reviews the theoretical and empirical arguments against estate taxation. The four arguments considered here are that estate taxes: inhibit capital accumulation and economic growth; threaten the survival of family businesses and depress entrepreneurial activity; violate the fairness, simplicity and efficiency principles of tax policy; and adversely impact the conservation of environmentally sensitive land.

A. Economic Growth

Of all taxes imposed by the federal government, the estate tax is one of the most harmful to economic growth when measured on a per-dollar-of-revenue-raised basis. Although the estate tax is relatively small in terms of revenue raised, it exerts a disproportionately negative impact on the economy. This section discusses some of the ways in which the estate tax hinders economic growth and reviews the empirical research on how the tax affects capital accumulation.

At its basest level, the estate tax adds yet another layer to the already heavy taxation of savings and investment. First, income is taxed at the individual level as it is earned. Second, interest or dividend income derived from savings or investments is subject to taxation. Third, capital gains taxes must be paid on the appreciated value of the asset, regardless of whether the asset value has increased beyond the rate of inflation. Fourth and lastly, savings and investments are hit by estate taxes when passed on to the next generation.

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[65] Kenneth Chapman, Govind Harihan and Lawrence Southwick, Jr., "Estate Taxes and Asset Accumulation," *Family Business Review* 9, no. 3 (Fall 1996): 253-268.
[66] Douglas A. Shackelford, "The Tax Environment Facing the Wealthy," Working Paper No. 98-5, Office of Tax Policy Research, University of Michigan (September 1997), 38.

Inheritance (commonly referred to as "bequests" or "intergenerational transfers" in the economics literature) is simply the transfer of any unconsumed assets from one generation to the next.[67] Estate taxes are intended to reduce the volume of such transfers. To the degree that they reduce the amount of assets passed from individuals to heirs, estate taxes directly diminish the stock of capital in the economy.[68] The negative economic effects of wealth transfer taxes were noted as long ago as 1776, when Adam Smith wrote in his classic work *The Wealth of Nations*:

> All taxes upon the transference of property of every kind, so far as they diminish the capital value of that property, tend to diminish the funds destined for the maintenance of productive labour.[69]

Thus, by reducing the amount of capital available in the economy, estate taxes ultimately reduce the amount of wealth that ends up in the hands of workers. This negative effect on economic growth manifests in at least three ways. First, the estate tax has excessively high compliance costs. Although it is possible to avoid most, if not all tax liability on estates, doing so requires a substantial amount of planning and undesired allocation of resources. Alicia Munnell, a former member of President Clinton's Council of Economic Advisers, estimated that the costs of complying with estate tax laws are roughly the same magnitude as the revenue raised;[70] this would amount to about $23 billion in 1998.[71] Thus, for every dollar of tax revenue raised by the estate tax, another dollar is squandered in the economy simply to comply with or avoid the tax.

Second, by affording so many tax avoidance options, the estate tax encourages owners of capital to shift resources from their most productive uses into less efficient (though more tax-friendly) uses. The estate tax introduces an extraneous element to resource allocation decisions that would otherwise be focused on maximizing economic efficiency. Estate tax planners must base their decisions in part on minimizing their estate tax liability. For instance, rather than investing in a more productive business opportunity, estate planners may elect a more tax-friendly option, such as some forms of life insurance or private charitable trusts. Regardless of how the resources are ultimately allocated, the fact that a criterion other than efficiency is included necessarily reduces output. David Ricardo identified this point over 180 years ago:

> [T]axes on the transference of property … prevent the national capital from being distributed in the way most beneficial to the community. For the general prosperity there cannot be too much facility given to the conveyance and exchange of all kinds of property, as it is by such means that capital of every species is likely to find its way into the hands of those who will best employ it in increasing the productions of the country.[72]

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[67] The estate tax nominally only applies to transfers made at death. However, since the punitive nature of the tax affects patterns of consumption and saving prior to death, the appropriate level of analysis is all transfers made.
[68] Throughout this paper, the term "capital stock" is used to refer to all privately-owned wealth and assets.
[69] Adam Smith, *The Wealth of Nations* (1776; reprint, Chicago, IL: University of Chicago Press, 1976), 391.
[70] Alicia H. Munnell, "Wealth Transfer Taxation: The Relative Role for Estate and Income Taxes," *New England Economic Review*, Federal Reserve Bank of Boston (November/December 1988): 19; Aaron and Munnell, 139.
[71] Office of Management and Budget, *Mid-Session Review*, 23.
[72] David Ricardo, *The Principles of Political Economy and Taxation* (1817; reprint, Homewood, IL: Richard D. Irwin, Inc., 1963), 83.

Finally, and most importantly, the estate tax is a tax on capital, and as such it reduces the incentive to save and invest. The estate tax directly results in the loss of capital because it forces privately-held assets to be liquidated and transferred to governmental control. Wealth that would otherwise serve productive uses in the economy as capital assets, are transferred to consumption-intensive government uses.[73] According to James Poterba, an economist at the Massachusetts Institute of Technology, the federal estate tax increases the effective tax burden on capital income by 1.3 to 1.9 percentage points.[74] The effect is most pronounced for households headed by older individuals. For individuals age 70 to 79, federal estate taxes raise the tax on capital by approximately 1.7 to 2.7 percentage points, and for persons age 80 and up, the effective tax on capital is increased by between 14 and 19 percentage points.

By reducing the after-tax return on investment, the estate tax encourages consumption and discourages savings, which in turn cause the capital stock of grow at a slower rate. To illustrate this effect, consider a situation where parents must choose between leaving an asset to their children or consuming it themselves.[75] When faced with the 60 percent marginal tax rate, the "price" of bequeathing $1 is raised to $2.50. Alternatively, the parents could consume significantly more of that $2.50 for their own benefit. In the presence of high marginal estate tax rates, then, the decision between consumption and saving is significantly biased in favor of consumption. This effect may be particularly pronounced for those individuals (such as the elderly) who are most aware of their impending estate tax liability. Since their children will receive less than half of each additional dollar left as inheritance, many parents who are at the margin will choose to consume their savings. In his public finance textbook, Stiglitz, while admitting to some ambiguity, argues that on balance estate taxes "probably" reduce savings.[76]

To put the magnitude of estate tax disincentives in perspective, economists J.D. Foster and Patrick Fleenor of the Tax Foundation estimated the income tax rate equivalent of the estate tax.[77] In others words, they estimated what the income tax would have to be in order to result in the same after-tax estate (assuming the estate tax were repealed). Their analysis suggests that the present estate tax has the equivalent effect as an individual income tax rate of approximately 67 percent, significantly higher than the current top marginal rate of 39.6 percent. Corporate income taxes would have to be similarly adjusted, rising to roughly 68 percent. Thus, the estate tax has more or less the same disincentive effect as would the doubling of income tax rates.

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[73] Only about 13 percent of the federal budget is spent on physical investments, research and development, and education and training programs. Office of Management and Budget, *Analytical Perspectives* of *Budget of the United States Government, Fiscal Year 1998* (Washington, DC: Government Printing Office, 1997), 102.

[74] If state death taxes are included, the total tax rate is raised by 1.7 to 2.5 percentage points. James Poterba, "The Estate Tax and After-Tax Investment Returns," Working Paper 98-11, Office of Tax Policy Research, University of Michigan (December 1997), 17, 40.

[75] There are many reasons why parents save and bequeath. For a review, see Carroll; and B. Douglas Bernheim, "How Strong Are Bequest Motives? Evidence Based on Estimates of Demand for Life Insurance and Annuities," *Journal of Political Economy* 99, no. 5 (October 1991): 899-927.

[76] Joseph E. Stiglitz, *Economics of the Public Sector*, 1st ed. (New York: W.W. Norton & Company, 1986), 487. A similar conclusion is reached by Laurence S. Seidman, "Taxes in a Life Cycle Growth Model with Bequests and Inheritances," *American Economic Review* 73, no. 3 (June 1983): 437-441.

[77] J.D. Foster and Patrick Fleenor, "The Estate Tax Drag on Family Business," *Family Business Review* 9, no. 3 (Fall 1996): 233-252.

As these arguments demonstrate, estate taxes directly and negatively impact economic growth by impeding the accumulation of capital. The direction of this effect is unambiguously negative, since the notion that capital is a critical determinant of economic growth is one of the most basic tenets of economics. For instance, noted economist Dale Jorgenson, writing with Barbara Fraumeni, concluded that "growth in capital input has emerged as the predominant source of U.S. economic growth during the postwar period."[78] The relevant question for the present discussion is not one of direction, but one of magnitude: to what *degree* are transfers of wealth from one generation to the next responsible for the accumulation of capital?

One answer to this question is provided by Boston University economist Laurence Kotlikoff and Lawrence Summers, who currently serves as the Deputy Secretary of the U.S. Treasury Department. Data presented by Kotlikoff and Summers in a pair of articles indicate that approximately 30 percent of the current stock of wealth is the result of bequests made at death.[79] However, another 10 to 36 percent of existing capital is attributable to other intergenerational transfers such as trusts and *inter vivos* gifts. Since it is clear that the estate tax induces avoidance through such transfers, it is appropriate to include them when considering the effect of the estate tax on capital accumulation. Thus, research by Kotlikoff and Summers indicates that between 41 and 66 percent of the current stock of wealth is attributable to the transfer of assets from one generation to the next.[80] The midpoint of this range is 53 percent.

Other research confirms this finding. Two separate studies, using distinct research approaches, arrived at nearly identical estimates of the share of wealth attributable to intergenerational transfers. In the first study, Brookings Institute scholar William Gale and John Karl Scholz (who formerly served in the Treasury Department as Deputy Assistant Secretary for Tax Policy) estimated in a 1994 study that 51 percent of wealth comes from bequests made at death and other asset transfers made before death.[81] The second study, by Henry Aaron and Alicia Munnell, arrived at a comparable figure of 52 percent.[82] Not only are the estimates of 51 percent and 52 percent nearly identical, but they are also remarkably close to the midpoint of the range of estimates based on Kotlikoff and Summers' research. Based on the research reviewed

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[78] Barbara M. Fraumeni and Dale W. Jorgenson, "The Role of Capital in U.S. Economic Growth, 1948-1979," in *Measurement Issues and Behavior of Productivity Variables*, ed. Ali Dogramaci (Boston, MA: Kluwer Nijhoff Publishing, 1986), 163.

[79] Laurence J. Kotlikoff and Lawrence H. Summers, "The Role of Intergenerational Transfers in Aggregate Capital Accumulation," *Journal of Political Economy* 89, no. 4 (1981): 706-732; and Laurence J. Kotlikoff and Lawrence H. Summers, "The Contribution of Intergenerational Transfers to Total Wealth: A Reply," in *Modelling the Accumulation and Distribution of Wealth*, eds. Denis Kessler and André Masson (Oxford, England: Clarendon Press, 1988), 53-76.

[80] Kotlikoff and Summers actually estimate that intergenerational transfers account for 78 percent of accumulated capital. Their definition of transfers, however, includes transfers which some critics argue should not be classified as wealth transfers (such as expenditures for their children's college education). To follow a more conservative approach, the range used in this paper, and indicated in the text above, excludes education expenditures. See the Appendix for description of the methodology for these calculations.

[81] William G. Gale and John Karl Scholz, "Intergenerational Transfers and the Accumulation of Wealth," *Journal of Economic Perspectives* 8, no. 4 (Fall 1994): 156.

[82] Aaron and Munnell, 131.

here, it would therefore appear reasonable to conclude that roughly one-half, and perhaps more, of all privately-held capital is transferred from previous generations.[83]

A comprehensive estimate of all the negative impacts of the estate tax on economic growth is beyond the scope of this paper. However, Kotlikoff and Summers provide an econometric framework for analyzing the effect of the estate tax on the existing capital stock. According to their research, every $1 reduction in the annual flow of intergenerational transfers is associated with a corresponding loss of roughly $39 in the long-run amount of capital in the economy.[84] Over the past two decades, estate tax revenue has equaled approximately 5.9 percent of the annual flow of asset transfers. If one assumes that all this revenue would otherwise have been preserved as capital, then it is possible to arrive at a rough estimate of the wealth effect of the estate tax.[85] If annual asset transfers had been 5.9 percent higher, the amount of privately-held capital in the economy would have been $497 billion higher in 1995, an increase of approximately 3.2 percent.[86]

Survey data provide an alternative way to quantify the effect of the estate tax on economic growth. A 1995 survey of family-owned equipment distributors found, among other things, that close to one-half (46 percent) of these firms restructured their business ownership solely for estate tax purposes, at an average cost of $149,000.[87] Moreover, these businesses spent an average of $434,000 in gift taxes related to the transfer of ownership, and a cumulative total of $170,000 on life insurance policies (a common means of providing funds to pay the expected estate tax liability). Most of these expenditures occurred solely as a result of estate tax planning. Without the estate tax, these expenditures could be redirected to purchase additional labor and capital.

Finally, the effect of eliminating the estate tax can be estimated using macroeconomic simulation models. While such models suffer from a number of intrinsic weaknesses, they nonetheless shed some light on the potential outcome of estate tax repeal. A simulation commissioned by the Research Institute for Small & Emerging Business estimated that repeal of the estate tax would produce a number of substantial benefits, including larger gross domestic product, more jobs, and lower interest rates (Table 3).[88] In addition, the economic effects would fully offset the annual static revenue loss by the fifth year.

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[83] In contrast to the three studies cited here, Modigliani estimates that intergenerational transfers account for a significantly smaller share of total wealth. Franco Modigliani, "The Role of Intergenerational Transfers and Life Cycle Saving in the Accumulation of Wealth," *Journal of Economic Perspectives* 2, no. 2 (Spring 1988): 15-40.

[84] Both Gale and Scholz and Aaron and Munnell arrive at smaller estimates of this relationship. Data from Gale and Scholz imply that $1 in transfers produces roughly $37 in long-term wealth, while the comparable figure from Aaron and Munnell's data is $35. See *infra* note 86 and the Appendix for a fuller explanation.

[85] While this assumption may be overstated to the degree that some assets are not liquidated to pay estate taxes, it is understated to the degree that it fails to account for the distortionary effects and compliance costs of the estate tax.

[86] This figure is an estimate of the long run, steady-state effect of the estate tax. It is, in other words, an attempt to calculate how much larger the capital stock would be if there had no estate tax at all. See the Appendix for a more detailed discussion of the methodology and the sensitivity of the estimates to certain behavioral assumptions.

[87] Joseph H. Astrachan and Craig E. Aronoff, "A Report on the Impact of the Federal Estate Tax: A Study of Two Industry Groups" (Marietta, GA: Kenneseaw State College, Family Enterprise Center, 1995).

[88] Analysis assumes the estate tax repeal takes effect in 1997. Research Institute for Small & Emerging Business, "The Effects of the Federal Estate and Gift Tax on the Aggregate Economy" (Washington, DC: Research Institute for Small & Emerging Business, 1998).

Table 3. Macroeconomic Impact of Estate Tax Repeal (After 7 Years)

Indicator	Change	Percent change
Gross domestic product (GDP)	+$33.5 billion	+0.4%
Employment	+240,000	+0.2%
Disposable personal income	+$24.4 billion	+0.4%
Private investment	+$14.3 billion	+1.1%
Long-term interest rates	-22 basis points	NA

Note: Dollar amounts are in inflation-adjusted 1992 dollars.
Source: Research Institute for Small & Emerging Business.

B. Family Businesses and Entrepreneurial Activity

Aside from the aggregate effect on capital accumulation and economic efficiency, the estate tax exerts a strongly negative influence on entrepreneurial activity. As distinguished from the direct build-up of capital investment, entrepreneurial activity infuses the economy with risk-takers willing to exploit new technologies and enables families to achieve upward income mobility. By hindering entry into self-employment and by breaking up family-run businesses, the estate tax inhibits economic efficiency and stifles innovation.

Small businesses are a critical component of the American economy. According to the National Federation of Independent Business, small businesses have accounted for roughly two out of every three new jobs created since the early 1970s.[89] Such firms are a major contributor to economic growth. A survey of family-owned businesses reveals that two-thirds enjoyed positive revenue growth in the previous year and that the typical family-run business employs 50 full-time workers.[90] Small businesses further account for upwards of 10 percent of the economy's non-residential fixed investment, amounting to around $85 billion in 1997.[91]

The past two decades have witnessed a remarkable increase in the number of self-employed individuals operating small businesses. As these entrepreneurs age, more and more small businesses will be forced to deal with the looming burden of estate taxes. A survey of family-owned businesses by Arthur Anderson and MassMutual found that the next few years will see an unprecedented number of family business successions. According to the survey, 28 percent of family businesses expect the current leader to retire in the next five years and 53 percent to retire in the next 10 years.[92] Thus, in the absence of additional tax relief, the adverse impact of estate taxes on family businesses is likely to greatly increase over the next five to 10 years.

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[89] James Wicket, National Federation of Independent Business, Testimony to the Subcommittee on Tax, Finance and Exports, Committee on Small Business, U.S. House of Representatives, 6/12/97.
[90] Arthur Andersen Center for Family Business and MassMutual, "American Family Business Survey '97" (1997), online at http://www.massmutual.com/fbn/html/res97.html.
[91] Robert Carroll, Douglas Holtz-Eakin, Mark Rider, and Harvey S. Rosen, "Entrepreneurs, Income Taxes, and Investment," National Bureau of Economic Research, Working Paper 6374 (January 1998), 1; Council of Economic Advisers, *Economic Report of the President 1998* (Washington, DC: Government Printing Office, 1998), 302.
[92] Arthur Andersen Center for Family Business and MassMutual. See also, Daniel Golden, "Family Fortune, Family Feuds," *The Boston Globe*, 12/14/97.

The existing tax code already offers family businesses limited estate tax relief. Family-run businesses may apply to the IRS to pay their estate tax bill in installments over 14 years.[93] This is particularly useful for family farms, which may be asset-rich and cash-poor. Family businesses may also attempt to apply special valuation rules to their enterprise, which allows them to be valued at their current actual usage, rather than at a potentially more valuable usage.[94] In addition, the Taxpayer Relief Act of 1997 introduced an additional tax exclusion for qualifying family-owned businesses.[95]

Although these tax provisions do provide some relief, they are often inadequate to prevent the estate tax from breaking up many family businesses. Survey data indicate that the estate tax continues to be a primary reason why small businesses fail to survive beyond one generation. In fact, the estate tax is more likely to be the cause of failure during business succession than is the health or success of the business itself. A survey of family business owners by Prince & Associates found that 98 percent of heirs cited "needed to raise funds to pay estate taxes" when asked why family businesses fail.[96]

Despite the provisions noted above, IRS data indicate that between 1990 and 1996, more than 20,000 estate tax returns paid taxes on closely-held businesses worth a cumulative total of $34 billion in 1997 dollars.[97] Return data also indicate that another $15.5 billion in other noncorporate businesses were subjected to the estate tax, including farm assets, limited partnerships and other noncorporate businesses. Thus, upwards of $50 billion in small and family businesses were subjected to the estate tax over the last seven years. Moreover, stringent eligibility requirements and IRS hostility to favorable valuations limit the use of the tax benefits noted above.[98]

Although it is impossible to know the ultimate disposition of all family firms subjected to the estate tax, perhaps as many as 28 percent are either sold or discontinued, totaling around 5,600 family businesses thus far in the 1990s.[99] Although family firms are discontinued for many reasons, it would seem reasonable in light of the Prince & Associates survey to conclude that the estate tax has contributed to the sale or dissolution of thousands of family firms.

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[93] Joint Committee on Taxation, *Estate and Gift Taxes*, 6-7.
[94] See Gary L. Maydew, "How to Convey a Family Business without Raising a Bumper Crop of Inheritance Taxes," *The National Public Accountant* (April 1995); and Thomas I. Hausman, "Family Limited Partnerships," *Tax Notes Today*, 1/5/98.
[95] Joint Committee on Taxation, *Estate and Gift Taxes*, 4-5.
[96] Russ Alan Prince and Karen Maru File, *Marketing to Family Business Owners* (Cincinnati, OH: National Underwriter, 1995), 35.
[97] This is a highly conservative estimate of the number of firms affected by the estate tax since it ignores businesses that did not pay estates taxes, either because they expended enough resources to avoid the tax or because the costs of estate planning impeded the growth of such firms. In addition, the figure does not account for family firms that are not classified as closely-held businesses. Eller, 24-47; Barry W. Johnson, "Estate Tax Returns, 1989-1991," in *Compendium of Federal Estate Tax and Personal Wealth Studies*, ed. Barry W. Johnson (Washington, DC: Internal Revenue Service, 1994), 51-85; and Internal Revenue Service, "Estate Tax Returns Filed in 1996" (4/16/98), online at http://www.irs.ustreas.gov/prod/tax_stats/soi/est_etr.html.
[98] See, Jeffrey N. Kelm and Jeffrey M. Wright, "IRS Assaults on FLPs; Family Limited Partnerships," *Tax Adviser*, 11/97; and Jerry A. Kasner, "Untangling the Family-Owned Business Exclusion," *Tax Notes Today*, 10/15/97.
[99] Calculations based on sale and discontinuance rates for businesses 13 years or older that were stilled owned by the founder. Thomas J. Holmes and James A. Schmitz, Jr., "On the Turnover of Business Firms and Business Managers," Federal Reserve Bank of Minneapolis (April 1994), Table 4.

According to the Prince & Associates survey, firms that failed during the transition from parents to children tended to be financially successful, with a median number of employees of close to 100.[100] The vast majority (91 percent) of these failed businesses had experienced average annual growth rates of more than 5 percent in the preceding five years. Given these figures, it is not surprising that at the 1995 White House Conference on Small Business, repeal of the estate tax ranked fourth on the Conference's list of 60 formal recommendations, garnering the support of close to 80 percent of the Conference delegates.[101]

Table 4 presents the results of a series of surveys conducted among family business owners. These surveys were conducted by researchers at the Family Enterprise Center of Kennesaw State College and the Center for Family Business at Loyola University.[102] The data consist of a large survey of family firms (first column) that included a sub-sample of family farms (column 2). In addition, two separate surveys examined black-owned firms (column three) and firms associated with the manufacturing industry (members of the American Equipment Distributors (AED), column four). The surveys asked respondents a series of questions about the impact of estate taxes and the characteristics of their business.[103]

As can be seen in Table 4, a sizeable minority of family businesses are unaware of their potential estate tax liability. Overall, only slightly more than one-half (55 percent) of family-run firms are aware of the potential estate tax bill. The awareness of the future estate tax bill is somewhat higher among manufacturing firms and somewhat lower among black-owned firms.[104] Such figures are of concern because they suggest that despite the high cost of estate taxes, many family firms are failing to adequately prepare for succession to the next generation.

Importantly, planning for estate taxes reduces the resources available for investment and employment. One reason for this is that the need to pay future estate taxes encourages business owners to keep liquid assets available. Thus, rather than investing in a profitable expansion or project, business owners may feel obligated to hold cash or other liquid assets in case the need to pay the estate tax arises.[105] According to the general family-business survey (column one of Table 4) more than one in three respondents stated that as a result of their expected estate tax liability, they were less likely to wait for an investment to pay for itself. Close to seven in 10 respondents felt that the estate tax made them less likely to invest in higher risk projects.

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[100] Prince and File, 36.

[101] White House Conference on Small Business, "60 Recommendations" (1995), online at http://www.whcsb.org:81/fropen.htm.

[102] John L. Ward, Drew Mendoza, Joseph H. Astrachan, and Craig E. Aronoff, "Family Business: The Effect of Estate Taxes" (Chicago, IL and Marietta, GA: Center for Family Business and Family Enterprise Center, 1995); Astrachan and Thomas E. Kaplan, "The Impact of Federal Estate Taxes on Family Business and the Agriculture Industry" (Kennesaw, GA: Family Enterprise Center, 1997); and Astrachan and Aronoff.

[103] Since not all questions were asked in every survey, only the published results are presented.

[104] The lower level of awareness among black-owned firms may be attributable to their younger age. The average starting year of the black-owned firms in this survey was 1984, compared to starting years in the 1950s for other family businesses.

[105] A formal model of this dynamic can be found in Rubin Saposnik, James Tomkins and Roger Tutterow, "Estate Taxes and the Investment Decision in Closely Held Firms," *Family Business Review* 9, no. 1 (Fall 1996): 315-320.

Table 4. Estate Taxes and Family Business (amounts are median unless otherwise indicated)

	All	Sub-group surveys		
	Firms	Farm	Black	AED
Impact of paying estate taxes:				
Aware of their estate tax liability	55%	–	43%	65%
Less willing to wait for an investment to pay for itself	36%	46%	–	–
Less likely to invest in higher risk projects	68%	68%	–	–
Makes growth of business more difficult	61%	–	90%	96%
Makes survival of business more difficult	64%	–	87%	93%
If due tomorrow, percent selling or liquidating	33%	37%	29%	31%
Number of jobs that would be lost	30	23*	4	18
Percent hiring more people if tax were eliminated	60%	54%	–	–
Number of new jobs that would be added	5	13*	–	–
Average cumulative amount spent on:				
Lawyers	$16,113	$12,100	$14,206	$19,908
Accountants	$14,632	$8,100	$12,215	$11,940
Other financial advisers	$2,392	$1,300	$13,143	$11,212
Life insurance policies	$318,074	$176,100	–	$169,843
Annual cost of life insurance	$45,576	$16,400	$28,350	$26,778
Characteristics of businesses:				
Year business founded	1953	1954	1984*	1957*
Percent in first-generation	19%	21%	100%	42%
Total number of employees	80	47	96*	45
Jobs created in last 5 years	–	–	10	9
Annual revenue growth over last 5 years	7%	–	–	–
Annual revenue growth over next 5 years	6%	–	–	–

* Average.
Average among responding firms.
Source: Ward, Mendoza, Astrachan, and Aronoff; Astrachan and Kaplan; and Astrachan and Aronoff.

Approximately 61 percent of the businesses reported that the estate tax made the long-term growth of their business more difficult or impossible. A similar percentage (64 percent) believed that the estate tax threatened the very survival of their business. Respondents from the AED and black-owned sub-groups reacted much more negatively to the estate tax. Nearly all (96 percent) the manufacturing firms and 90 percent of the black-owned firms felt that the estate tax impeded their long-term business growth. Similarly large majorities of these firms (93 percent and 87 percent respectively) reported that the estate tax made survival of their family business either more difficult or impossible altogether.

Among all family firms, one-third believed that if the principal owner of their family-business died tomorrow, the heirs would be forced to sell off or liquidate part of their business. If such an action were taken, a median of 30 jobs would be destroyed. Remarkably similar results were reported for each of the three sub-groups, ranging from 29 percent for black-owned firms to 37 percent for family farms. The number of jobs that would be lost ranged from four for black-owned firms to 23 for farms. Conversely, if the estate tax were eliminated, most family businesses (60 percent) would hire additional employees, with the typical firm adding five workers.

The direct costs of estate tax planning are alarmingly high. The average amount already spent on lawyer fees was over $16,000. The cost of accountants involved in estate planning averaged more than $14,000, while other financial advisers have cost approximately $2,400. Among family firms that have purchased life insurance as a means of covering their estate tax bill, the typical cost-to-date totaled more than $318,000. The average cost of life insurance premiums was over $45,000 each year. Although the three sub-group surveys indicate that those businesses spent less on annual life insurance premiums, it is not clear why they spent less. Two possible explanations are that respondents were simply unable to afford higher premiums or that they failed to accurately perceive the magnitude of their estate tax liability.

The harmful impact of the estate tax is further highlighted by the degree to which these firms were successful and created jobs. The median number of employees at the firms in the survey was 80. The farm and manufacturing firms had a median of 47 and 45 employees respectively, while black-owned businesses employed an average of 96 workers. In addition, the typical family-owned firm had experienced 7 percent annual growth in gross revenues over the previous five years. Such firms also projected that their future revenue would grow at an average annual rate of 6 percent.

A separate study by MassMututal (not listed in Table 4) found that family business owners are more concerned with estate taxes than they are with capital gains taxes. Although the income tax was identified as the tax of greatest concern by 38 percent of respondents, more than twice as many owners cited the estate tax (28 percent) than the capital gains tax (14 percent). This finding led the sponsors of the survey to conclude that,

> Advocates of reducing tax burdens on business to stimulate economic growth have traditionally placed a greater emphasis on capital gains taxes than on estate taxes. When it comes to family businesses, however, estate tax reform would appear to be more welcome – and may be a greater stimulus.[106]

To the degree that the estate tax disrupts the transmission of a family business to succeeding generations, the estate tax impedes upward income mobility. Entrepreneurship is a key means by which lower-income households move to a higher-income class. For instance, one study found that low-wealth workers who become self-employed are more than twice as likely to move to a higher wealth class than are individuals who continue traditional work.[107] Other data show that self-employment is an increasingly common trait of the wealthy.[108]

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[106] MassMutual, "1995 Research Findings" (1995), online at http://www.massmutual.com/fbn/html/res95.html.
[107] Vincenzo Quadrini, "Entrepreneurship, Saving and Social Mobility," Federal Reserve Bank of Minneapolis, Discussion Paper 116 (March 1997).
[108] Using data from the 1992 Survey of Consumer Finances, Wolff shows that 69 percent of the wealthiest 1 percent of Americans were self-employed. That figure is dramatically higher than the 1983 level of 38 percent. Edward N.

Concerns about the obstacles involved in passing a family business on to the next generation are especially prevalent among minority groups. Research indicates that the intergenerational link of self-employment is stronger for blacks than for whites.[109] That is, blacks are more likely to become self-employed if their parents are self-employed than are other ethnic groups. Thus, by making it more difficult for blacks to continue their family business, the harmful effects of estate taxes are magnified for black-owned enterprises. Moreover, intergenerational transfers are a major aid in allowing blacks to start their own businesses, since data indicate that asset levels are more important in determining self-employment among blacks than among whites.[110] In fact, wealth accumulation is considered such an important issue in minority communities that the lead essay in the National Urban League's *The State of Black America 1998* concluded "new and bold policy initiatives are needed to help African Americans accumulate assets to undergird their own social mobility and that of their children."[111]

For many low-income minority or ethnic groups, the estate tax represents a major obstacle to a successful family business. The survey of black-owned family firms (cited above) asked owners to rate their level of concern over the estate tax. On a scale of one to ten (with ten being the greatest concern), more than one-half of respondents answered with a nine or a ten.[112] The importance of passing a family business to the next generation was the subject of a 1995 article in the magazine *Black Enterprise*, which reported:

> Leaving a legacy for future generations is a key motivation for pursuing entrepreneurship, particularly for African Americans. But achieving that legacy isn't easy. Only one in three family firms survives two generations; only one in six survives three generations. "The challenge is not starting a family business, but being able to pass it on from generation to generation," says John Sibley Butler, professor of management and chairman of sociology at the University of Texas at Austin.[113]

A similar sentiment is reflected in the advice of the financial planning book *The Black Woman's Guide to Financial Independence*:

> Estate taxes are the most expensive taxes you will ever have to pay. The federal estate tax has graduated rates ranging from 40-55%. The more you have, the higher the tax rate. This is money you have earned and should be passed on to your heirs instead of to the federal government.[114]

Wolff, "Who Are the Rich? A Demographic Profile of High-Income and High-Wealth Americans," Working Paper No. 98-6, Office of Tax Policy Research, University of Michigan (September 1997), 12.

109 Robert W. Fairlie, "The Absence of the African-American Owned Business: An Analysis of the Dynamic of Self-Employment," *Journal of Labor Economics* (forthcoming).

110 *Ibid*.

111 Melvin L. Oliver and Thomas N. Shapiro, "Closing the Asset Gap," in *The State of Black America 1998* (Washington, DC: National Urban League, 1998).

112 Astrachan and Aronoff, B-11.

113 Adreienne S. Harris, "Saluting the Past, Shaping the Future; The Future of Black-Owned Family Business," *Black Enterprise*, 8/95.

114 Cheryl D. Broussard, *The Black Woman's Guide to Financial Independence* (New York, NY: Penguin Books, 1996), 151.

The burdensome nature of the estate tax is illustrated by the story of Chester Thigpen. Thigpen, the great-grandson of slaves, managed to scrape up enough funds to buy some land in 1940. Eventually, he obtained enough land to start a tree farm in 1960. After close to four decades, the business is still a family-run operation. However, land prices have increased so rapidly that the Thigpen family faces the prospect of dismantling the very business that allowed them to achieve a higher standard of living. Thigpen's testimony to the Ways and Means Committee in Congress highlights these issues:

> It took us half a century, but Rosett and I have managed to turn our land into a working Tree Farm that has been a source of pride and income for my entire family. Our Tree Farm made it possible to put our five children through college. It made it possible for Rosette and me to share our love of the outdoors and our commitment to good forestry with our neighbors. And finally, it made it possible for us to leave a legacy that makes me very proud: beautiful forests and ponds that can live on for many, many years after my wife and I pass on. …
>
> Right now, people tell me my Tree Farm could be worth more than a million dollars. All that value is tied up in land or trees. We're not rich people. My son and I do almost all the work on our land ourselves. So, under current law, my children might have to break up the Tree Farm or sell off timber to pay the estate taxes.[115]

Entrepreneurial Survival and Liquidity Constraints

The principal reason that estate taxes cause such disruption to family businesses is that they impose large cash demands on firms that generally have limited access to liquid assets. For example, the typical small business owner has 60 percent of the family net worth invested in the business.[116] Moreover, financial markets may not provide adequate capital to small businesses on account of imperfect information.[117] Smaller firms, therefore, may be unable to obtain the optimal amount of capital required to finance their investments. Intergenerational transfers function, in essence, as a sort of internal financing mechanism. To the degree that estate taxes reduce or limit intergenerational transfers, they also reduce the amount of financing available for investment in small or family-run enterprises.

The available empirical evidence supports the contention that liquidity constraints (not all of which are attributable to estate taxation) significantly impede the ability of new businesses to succeed and grow. For example, one analysis found that smaller firms have difficulty obtaining the optimal amount of external capital financing.[118] A 1989 study estimated that liquidity constraints prevent approximately 1.3 percent of the population from chosing self-

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[115] Chester Thigpen, Testimony to the Committee on Ways and Means, U.S. House of Representatives, 2/1/95.
[116] Ward, Mendoza, Astrachan, and Aronoff, 29.
[117] In fact, imperfect information may impose liquidity constraints even in otherwise functioning credit markets. See Joseph E. Stiglitz and Andrew Weiss, "Credit Rationing in Markets with Imperfect Information," *American Economic Review* 71, no. 3 (June 1981): 393-410.
[118] Steven M. Fazzari, R. Glenn Hubbard and Bruce C. Peterson, "Financing Constraints and Corporate Investment," *Brookings Paper on Economic Activity* 1 (1988): 141-206.

employment.[119] Similarly, a 1998 study reported that the most common reason traditional workers did not become self-employed was the shortage of available capital.[120]

The individuals who are most adversely impacted by liquidity constraints are lower-income persons who have the motivation and talent to start their own firm, but lack the necessary capital. As one of the studies cited above notes:

> [Liquidity] constraints mean that a wealthier person can start a business with a more efficient capital level and thereby realize a greater return than a poorer one. … Only high-ability/low-asset people are affected by the wealth constraint. But it is precisely these people who are most likely to want to switch to self-employment. Those with high ability can earn more in self-employment than in wage work, especially if they have poor wage earnings. But those with poor wage earnings are also likely to have accumulated relatively few assets.[121]

Inheritances play an important role in alleviating the liquidity constraints that impede the formation and success of small businesses. A 1994 study found that individuals who receive an inheritance are more likely to become self-employed, and those who are already self-employed are more likely to remain so.[122] Overall, the authors estimate that receiving a $150,000 inheritance (in 1985 dollars) results in a 1.3 percentage point increase in survival probability and a 20 percent increase in gross receipts. Another study by the same authors found that a $100,000 inheritance increased the probability of the recipient becoming self-employed by 3.3 percentage points.[123]

Other evidence further confirms the belief that intergenerational transfers play a major role in relieving liquidity constraints. A 1990 study in the *Quarterly Journal of Economics* examined patterns of *inter vivos* gifts.[124] The data show that such gifts generally occur in the form of loans or subsidies within family units. The givers tend to have greater amounts of financial assets, while the gifts themselves are targeted toward individuals who face significant liquidity constraints. Likewise, a 1998 article found that receipt of an inheritance significantly increased the probability of self-employment, and that "most small businesses were begun not with bank loans but with own or family money."[125]

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[119] David S. Evans and Boyan Jovanovic, "An Estimated Model of Entrepreneurial Choice under Liquidity Constraints," *Journal of Political Economy* 97, no. 4 (August 1989): 824.

[120] David G. Blanchflower and Andrew J. Oswald, "What Makes an Entrepreneur?" *Journal of Labor Economics* 16, no. 1 (January 1998): 26-60.

[121] Evans and Jovanovic, 819, 824.

[122] Douglas Holtz-Eakin, David Joulfaian and Harvey S. Rosen, "Sticking It Out: Entrepreneurial Survival and Liquidity Constraints," *Journal of Political Economy* 102, no. 1 (February 1994): 68-71.

[123] Douglas Holtz-Eakin, David Joulfaian and Harvey S. Rosen, "Entrepreneurial Decisions and Liquidity Constraints," *RAND Journal of Economics* 25, no. 2 (Summer 1994): 342. However, elsewhere Holtz-Eakin and Dunn found that liquidity constraints are not a major factor limiting *entry* into self-employment. Thomas Dunn and Douglas Holtz-Eakin, "Financial Capital, Human Capital, and the Transition to Self-Employment: Evidence from Intergenerational Links," National Bureau of Economic Research, Working Paper 5622 (June 1996).

[124] Donald Cox, "Intergenerational Transfers and Liquidity Constraints," *Quarterly Journal of Economics* 105, no. 1 (February 1990): 187-217.

[125] Blanchflower and Oswald, 51.

C. Fairness, Simplicity and Efficiency

One of the most distinguishing attributes of the estate tax is the broad range of avoidance options it permits. There are so many legal loopholes in the estate tax that it has earned the nickname "the voluntary tax."[126] The tax avoidance options available to the estate planner are extensive and well-documented.[127] Virtually any individual who invests sufficient time, energy and money in tax avoidance strategies is capable of escaping the estate tax altogether. Some estate tax critics have noted that the only reason individuals submit to the tax at all is either ignorance of the available avoidance options or the avoidance options seemed too costly.[128]

The large number of tax avoidance options permitted under the estate tax means that the tax will result in a tax burden distributed unfairly among payers, be unnecessarily complicated, and significantly distort taxpayer behavior. According to the 1996 *Economic Report of the President*, "Three main traits define a well-designed tax system: fairness, economic efficiency, and simplicity."[129] This section of the paper demonstrates how the estate tax fails to meet any of these three criteria.[130]

Fairness

The fairness (or equity) of a particular tax is measured along two dimensions. The first dimension is vertical equity, which refers to the progressivity of the tax. A tax is said to be progressive when individuals with fewer resources pay less taxes than those with greater resources. Horizontal equity requires that taxpayers with the same amount of resources pay the same tax. That is, all taxpayers worth $1 million should have the similar estate tax liabilities.

The existence of so many loopholes virtually guarantees that the estate tax will violate the principles of horizontal and vertical equity. Taxpayers all along the income and wealth spectrum can eliminate or greatly reduce their estate tax liability with enough advance planning. Thus, an individual worth $5 million can not only pay less in estate taxes than other individuals worth $5 million, but can pay less than those worth $1 million. This aspect of estate taxation was summarized by Munnell, who wrote:

> Those people who take advantage of these [tax avoidance] opportunities will end up paying little or no tax, while those who do not plan ahead will pay significant amounts. Horizontal and vertical equity considerations have disappeared in the estate and gift area; **tax liabilities depend on the skill of the estate planner, rather than on capacity to pay.**[131] *(emphasis added)*

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[126] Cooper.
[127] For a sampling, see Cooper; Bernheim; and Munnell.
[128] See Cooper, 79-82; and John E. Donaldson, "The Future of Transfer Taxation: Repeal, Restructuring and Refinement, or Replacement," *Washington & Lee Law Review* 50 (Spring 1993): 548.
[129] Council of Economic Advisers, *Economic Report of the President 1996* (Washington, DC: Government Printing Office, 1996), 84.
[130] These issues are explored in greater detail in Donaldson, 545-553.
[131] Munnell, 18.

One way to measure vertical equity is to compare the average tax rates for different income or asset levels. Based on this criterion, the estate tax does not exhibit vertical equity. According to IRS data, the average estate tax rate for the largest estates (gross estates over $20 million) is actually *lower* than the average rate for estates in the $2.5 to $5 million range.[132]

Efficiency

The efficiency of a tax system refers to the costs of complying with the tax. An efficient tax should not impede economic growth or change the way people behave. Measured in these terms, the estate tax is highly inefficient. As previously noted, Aaron and Munnell estimate that the compliance costs of the estate tax are roughly the same size as the amount of revenue raised:

> In the United States, resources spent on avoiding wealth transfer taxes are of the same general magnitude as the [revenue] yield, suggesting that the ratio of excess burden to revenue of wealth transfer taxes is among the highest of all taxes.[133]

In 1998, the estate and gift taxes raised $23 billion. However, based on Aaron and Munnell's analysis, the true cost to the economy of these taxes was closer to $46 billion. In other words, for every $1 removed from the economy to pay estate taxes, another $1 is wasted in order to comply with or legally avoid the tax.

Because the estate tax is so confiscatory, individuals are often compelled to alter the ownership structure of their assets in suboptimal manner. As noted above in the section Economic Growth, tax avoidance strategies interject an extraneous element (tax liability) into decisions regarding resource allocation. Restructuring a family business may reduce the estate tax liability, but doing so may also result in reduced production.[134] In addition, the estate tax clearly alters many people's consumption and saving decisions, encouraging the former and discouraging the latter.[135]

Simplicity

The estate tax and the attendant tax avoidance strategies constitute one of the most complex federal tax regimes. The basic tax form for estate tax returns (not counting gift taxes) totals 41 pages, and the accompanying instructions consume an additional 22 pages. The IRS itself estimates that properly completing the estate tax return takes close to one full work week – over 36 hours. Assuming (generously) that the IRS estimate is accurate, 1996 estate tax returns consumed at least 2.9 million hours of labor – the equivalent of over 18,000 persons working full-time for a month.[136] The IRS estimate, however, likely understates the actual time required for estate planning. A 1995 survey of family business owners found that the actual time

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[132] Internal Revenue Service, "Estate Tax Returns Filed in 1996."
[133] Aaron and Munnell, 139.
[134] See *supra* note 87 and accompanying text.
[135] See *supra* note 10, as well as text accompanying *supra* notes 74 and 105 and Table 4.
[136] Includes time spent on record keeping, learning about the law or form, preparing the form, and sending the form to the IRS. Internal Revenue Service, "Instructions for Form 706" (April 1997), 1; and Internal Revenue Service, "Estate Tax Returns Filed in 1996."

dedicated to estate planning was more than four times higher – 167 hours on average.[137] The complexity of filing an estate tax return is further seen in the fact that 86 percent of taxable estates in 1996 retained a lawyer, at an average cost of over $23,000.[138]

Although the estate tax affords many tax avoidance opportunities, taking advantage of such opportunities can be extremely complicated. For example, one tax avoidance strategy available to small businesses is a preferred stock recapitalization, in which one type of stock is issued to business owners and another type to heirs. Similarly, donating land to a conservation easement requires detailed knowledge of property valuation, eligibility requirements and ownership structures. Even a strategy as simple as taking advantage of the $10,000 annual gift tax exemption requires a significant amount of planning and record-keeping. Implementing any of these tax avoidance strategies can be quite complicated and elaborate. A great deal of expertise is required in order to ensure compliance with all the tax rules and laws.

D. Environmental Conservation

An often-overlooked aspect of the estate tax is its harmful effect on the environment. The impact principally manifests when heirs are forced to sell or develop environmentally sensitive land in order to pay the estate tax. The problem of estate taxation faced by private landowners was one of the issues addressed by *The Keystone Report*. *The Keystone Report* represents the collective efforts of environmentalists, landowners, business groups, and government agencies to identify and recommend solutions to the problems that private landowners face in conserving threatened and endangered species and habitats. With regard to estate taxes, *The Keystone Report* found that:

> Federal estate tax requirements are a major obstacle for private landowners whose land stewardship has been sensitive to its environmental value and who would like to be able to pass on their land to their heirs without destroying that value. The imposition of federal estate taxes often forces large parcels of environmentally valuable land to be broken up into smaller, less environmentally valuable parcels. Some of the best remaining habitat for endangered species is put at risk in this manner.[139]

Landowners (particularly farmers and ranchers) often find themselves in a position where they are "land rich" and "cash poor." The problem was articulated by Doug Stinson, a family tree farmer and member of the American Tree Farm System:

> Today, family-owned Tree Farms and small businesses are still being destroyed by the federal estate tax because many of them are highly illiquid. For Tree Farmers, much of our cash is literally in our standing trees. You've heard the saying "land rich and cash poor." Well, that's an apt description of many forest landowners. The annual household income of the average Tree Farmer is less than $50,000. Yet on paper, the typical Tree Farm can be valued at well above $2 million. Even with the increase in the

[137] Ward, Mendoza, Astrachan, and Aronoff, 24.
[138] Internal Revenue Service, "Estate Tax Returns Filed in 1996."
[139] The Keystone Center, *The Keystone Dialogue on Incentives for Private Landowners to Protect Endangered Species – Final Report* (Washington, DC: Keystone Center, 1995), 26.

> exemption under the unified credit and newly created business exclusion which provides a total exclusion of $1.3 million, the Death Tax "hit" on these forestlands can be several hundred thousand dollars. This forces many families to liquidate the timber, or even worse, to fragment the woodland by selling off pieces of their property.[140]

When the time comes to pay estate taxes, real estate assets often produce a substantial tax liability that can only be paid by selling the land for development. The impact of the estate tax is most apparent in terms of natural habitats that are destroyed. Endangered species are affected as well, since about one-half of all listed species are found only on privately-owned land.[141] These effects of estate taxation led Michael Bean of The Nature Conservancy to label the estate tax as "highly regressive in the sense that it encourages the destruction of ecologically important land in private ownership."[142]

In recognition of the adverse environmental impact of taxing estates, the current federal tax code grants limited estate tax relief for qualifying "conservation easements," land that is set aside for environmental conservation. As the law now stands, there are two provisions of the tax code that apply.[143] Under the first provision, land owners are exempt from paying estate taxes on the value of land that is lost due to the conservation easement. The Taxpayer Relief Act of 1997 supplemented the first provision by granting estates that donate such easements an additional tax deduction worth 40 percent (up to a maximum of $500,000) of the remaining value of the land.

The conservation easement provisions, however, fall considerably short of remedying the tax's adverse environmental impact. A number of factors limit the effectiveness of the conservation easement provisions. First, only a relatively small portion of land is even eligible to qualify as an easement. Estate tax law requires that a conservation easement be located either within 25 miles of a metropolitan area, national park, or national wilderness area, or within 10 miles of an urban national forest. However, the land covered by metropolitan areas and national parks represents a relatively small portion (less than 24 percent) of the U.S. total, leaving many environmentally-sensitive areas ineligible for conservation easements.[144] In addition, the Treasury Secretary may disallow some conservation easements by making the determination that the land is not under "significant development pressure."[145]

Second, some land may not qualify for a conservation easement because it is currently used for commercial purposes. However, the current commercial use may still be preferable to an alternative, higher-valued use. For example, land that is used for tree farming or grazing is generally less harmful to the environment than some residential or industrial applications. As

[140] Douglas P. Stinson, Testimony to the Committee on Ways and Means, U.S. House of Representatives, 1/28/98.
[141] The Keystone Center, 31.
[142] Michael J. Bean, "Shelter from the Storm," *The New Democrat* (April 1997).
[143] The specific aspects of the conservation easement provision of estate tax law are quite complicated. For a thorough treatment, see C. Timothy Lindstrom and Stephen J. Small, "New Estate Tax Relief for Land under Conservation," *Tax Notes Today*, 3/2/98.
[144] Calculation based on data from U.S. Bureau of Land Management, Department of the Interior, *Public Land Statistics 1997* (1998), online at http://www.blm.gov/natacq/pls97/part5.html; and U.S. Bureau of the Census, *Statistical Abstract*, 39, 250.
[145] Applies to easements that qualify due to their proximity to a national park or wilderness area.

one environmental activist put it, "cows are better than condos."[146] Nonetheless, the imposition of estate taxes may force land into less environmentally friendly uses.

Even with the limited conservation easement now in place, many estates will not, for a variety of reasons, take advantage of the option. In fact, the Office of Management and Budget estimates that deductions for conservation easements over the next five years (1999-2003) will reduce estate tax revenue by less than two-tenths of one percentage point (0.18 percent).[147] As Jean Hocker, president of the Land Trust Alliance, put it:

> All too often heirs without other sizable assets with which to pay the estate tax bill must sell for development land that was previously undeveloped or in low impact use. So while current law does encourage sophisticated taxpayers with good estate planning advice to donate land or easements for conservation, land in the estate of a decedent who did not, or could not, take such steps will often have to be sold.[148]

One provision of the conservation easement law actually undermines the preservation of environmentally sensitive land – the reverse effect that was intended. This outcome results from the requirement that the easement must represent at least 30 percent of the land value in order to receive the full tax benefit. In other words, the easement must constitute a significant portion of the total land value in order to qualify for the favorable tax treatment. In many cases, however, existing federal laws or regulations have already reduced the value of environmentally important land. For example, the presence of wetlands or endangered species may have lowered the market value of the land subject to a conservation easement. According to one tax planning report,

> The 30 percent threshold may actually penalize the owners of land having wetlands regulated under section 404 of the Clean Water Act or providing habitat to endangered species under the provisions of the Endangered Species Act. This is because the existence of those conditions triggers federal regulation that may reduce the value of land to such an extent that a conservation easement will have only a negligible effect on its value. If that occurs it is likely that the requirement that the easement reduce the value of the land by at least 30 percent for the donor to enjoy the full 40 percent exclusion may deny the donor of an easement on federally regulated land any meaningful benefit under the new law. For the same reason an easement on such land may not result in any other significant tax benefits.[149]

Although most environmentalists would prefer expanding conservation easement options rather than complete repeal of the estate tax, it is nonetheless clear that the federal estate tax in its current form represents a continuing threat to endangered and threatened species and habitats.

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[146] Comment by ornithologist Susan Lohr, in Eric Pooley, "Cows or Condos? Putting aside their Differences, Conservative Cattlemen and Left-Leaning Environmentalists Team up to Save a Valley," *Time*, 7/7/97.
[147] Office of Management and Budget, *Analytical Perspectives*, 41, 120.
[148] Jean Hocker, Testimony to the Subcommittee on Oversight, Committee on Ways and Means, U.S. House of Representatives, 7/16/96.
[149] Lindstrom and Small.

VI. CONCLUSION

This paper has documented the extensive costs associated with the federal estate tax. The detrimental effects of the estate tax are grossly disproportionate to the modest amount federal revenue it raises (if it raises any net revenue at all). Estate taxes result in a large amount of wasted economic activity. Over its lifetime, the presence of the estate tax has cost the economy roughly one-half a trillion dollars in capital stock. Moreover, the estate tax destabilizes family businesses at one of their most vulnerable points, the succession from one generation to the next. The enormous liquidity demands of the estate tax have contributed to the break up of thousands of small businesses as well as the destruction of environmentally sensitive land. In generating these outcomes, the estate tax has violated the basic principles of a good tax system – simplicity, fairness and efficiency.

If the estate tax generated sufficiently large benefits, then an argument could be made to justify its existence. However, all the evidence indicates that the estate tax has no redeeming qualities. There is no theoretical or empirical basis to suggest that the estate tax promotes fairness or reduces inequality. In addition, research indicates that the deduction for charitable bequests stimulates little or no additional giving. Even the $23 billion in revenue it raises is illusory, since estate tax avoidance activities likely generate equally large revenue losses under the income tax.

The estate tax is an unfortunate feature of the current federal tax system. The estate tax's punitive tax rates are not only the highest of all federal taxes (reaching nearly 80 percent), but are imposed at the most inappropriate of times – the death of a loved one. As if mourning such a loss were not enough, the federal government worsens the pain by seeking to confiscate upwards of one-half of all the decedent's accomplishments and successes.

This final injurious grievance simply strengthens the conclusion that the estate tax generates costs to taxpayers, the economy and the environment that far exceed any potential benefits that it might arguably produce. The balance of evidence reviewed here suggests that this nation's forefathers followed the correct policy: in the absence of a national emergency, there is no compelling reason to warrant the permanent imposition of the estate tax. Death and taxes may indeed be inevitable, but these twin hardships need not always converge with consequences as burdensome and destructive as those of the estate tax.

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APPENDIX: METHODOLOGY

Percent of Wealth from Intergenerational Transfers

In a pair of articles published in 1981 and 1988, Kotlikoff and Summers estimate that 78.1 percent of all wealth is attributable to intergenerational transfers.[150] However, this estimate includes an unspecified amount of non-asset transfers, such as expenditures by parents for their children's college education. Since the focus of this paper is the effect of estate taxes on the capital stock, it is necessary to isolate the portion of Kotlikoff and Summers' estimate that pertains to direct transfers of assets or wealth. Although Kotlikoff and Summers do not provide a precise estimate of such transfers, it is possible to identify the range of possibilities.

Table 5. Percent of Total Wealth Attributable to Intergenerational Transfers

Type of Transfer	Percent
Bequests	30.5%
Life insurance	2.9%
Trusts	7.1%
Educational expenditures	11.9%
Other transfers	25.7%
Total Intergenerational Transfers	**78.1%**

Source: Kotlikoff and Summers (1981 and 1988).

The data in Table 5 indicate the distribution of transfer wealth as estimated by Kotlikoff and Summers. Of the 78.1 percent of total wealth attributable to transfers, 11.9 percent is due to educational expenditures and do not count as direct asset transfers. Omitting such transfers leaves a remainder of 66.2 percent. Of this remainder, bequests, life insurance and trusts (all of which count as asset transfers) represent 40.5 percent, while 25.7 percent are other, unclassified transfers. Some of these unclassified transfers are in the form of assets, while others are not. By definition, then, the percent of wealth attributable to asset transfers must lie somewhere between 40.5 percent (where none of the "other" transfers are assets) and 66.2 percent (where all of the "other" transfers are assets). Thus, the Kotlikoff and Summers data suggest that the transfer of assets from one generation to the next accounts for at least 41 percent and perhaps as much as 66 percent of the total stock of wealth in the economy. The median of this range, 53.4 percent, is the value used to calculate the capital stock effects described below.[151]

Wealth Lost Due to the Estate Tax

Kotlikoff and Summers provide an econometric framework for analyzing the effect of the estate tax on the existing capital stock. In their 1988 paper, the authors present the following formula which defines the long run steady-state equilibrium stock of capital:

(1) $$T = \frac{t}{(r-n)} e^{(r-n)D} \left[1 - e^{(n-r)(G-I)}\right] e^{(n-r)I}$$

[150] See *supra* note 79.

[151] As noted in the text above, other researchers have arrived at different estimates of the share of wealth attributable to intergenerational transfers. See *supra* notes 79 through 83 and accompanying text.

In Equation 1, T represents the accumulated stock of wealth that is derived from intergenerational transfers; t is the amount of wealth transferred between generations each year (or the flow of transfers); r is the after-tax interest rate; n is the population growth rate; D is the age of death; G is the age at which the gift (transfer) is made; and I is the age at which is the gift is received.[152] This equation allows the researcher to answer to following question: what level of annual intergenerational transfers are necessary to produce a given stock of wealth?

Equation 1 can be reduced to a simpler form if α is defined as:

(2) $$\alpha = \frac{e^{(r-n)D}\left[1 - e^{(n-r)(G-I)}\right]e^{(n-r)I}}{(r-n)}$$

so that Equation 1 can be rewritten as follows:

(1a) $$T = t * \alpha$$

Assuming the values specified by Kotlikoff and Summers for the variables r, n, D, G, and I, α then becomes a constant with the value of 38.67. Equation 1a can now be re-written as:

(3) $$T = t * 38.67$$

Thus, the formulas and data supplied by Kotlikoff and Summers indicate in the long run, a $1 increase in annual transfers results in $38.67 in additional capital. The question now becomes: how much larger would the annual flow of transfers (t) be in the absence of the estate tax?

One simplified approach is to increase the annual flow of transfers by the amount of revenue raised by the estate tax. This approach, in effect, assumes that all tax revenue would otherwise have been passed on to younger generations in the form of assets. The validity of this assumption is difficult to assess, since there are arguments that the effect could be either greater or smaller. For example, if the elimination of the estate tax causes either decedents or their heirs to increase their consumption or reduce their level of work and saving, then the assumption may overstate the impact on the capital stock.[153] Conversely, if the elimination of the estate tax results in a more efficient allocation of resources, reduced consumption by decedents, or increased work and saving by decedents, then the assumption may understate the impact.[154] Without a better understanding of the motivations affecting bequests, there is no way to determine which factors are stronger. This paper avoids making such a determination by simply assuming that estate tax revenues represent resources that would otherwise have been left in the stock of capital.

[152] For a more detailed explanation of the formula and terms, see Kotlikoff and Summers, "Contribution of Intergenerational Transfers."
[153] For examples, see *supra* note 36 and Cox.
[154] For examples, see *supra* note 10, as well as text accompanying *supra* notes 74, 76, 105 and Table 4.

Since *t* represents the annual flow of capital in a steady-state equilibirum, the appropriate measure of lost intergenerational transfers is the average relative size of estate tax revenue over a long period of time. Equation 3 can be used, in conjunction with the data in Table 5 and a time-series estimate of the capital stock, to estimate the annual flow of intergenerational transfers.[155] Comparing these estimates to historical revenue data suggests that over the long run estate tax revenues are equal to at least 5.9 percent of the annual flow of intergenerational transfers. Increasing the 1995 inferred flow of capital by 5.9 percent yields an increase in the 1995 stock of privately-owned capital of $497 billion, equivalent to 3.2 percent of the $15.7 trillion total stock.

The magnitude of the wealth effect estimated here is largely a function of the value of α, which Kotlikoff and Summers estimate to be close to 39. Gale and Scholz do not directly estimate α. However, the aggregate flows and stocks that they publish in their article imply that α has a value of approximately 37. If data from Gale and Scholz are substitued for Kotlikoff and Summers' data, then the wealth effect of the estate tax is $473 billion. The data supplied in Aaron and Munnell's article indicate that α has a value of approximately 35. If Aaron and Munnell's data are used, then the wealth effect amounts to $449 billion.

One-half a trillion dollars might seem to some readers a disproportionately large effect for a tax that raises only about $23 billion a year. For this reason, it is important to keep in mind the meaning of these calculations. The estimates presented in the preceding paragraphs represent the long run, cumulative impact of the estate tax on the steady-state equilibrium stock of capital. In other words, $497 billion is an estimate of how much larger the capital stock would have been in 1995 if there had been no estate tax at all over a very long period of time, perhaps 50 or 100 years. In fact, $497 billion does not seem quite as large in comparison to the $585 billion in revenues the estate tax has collected over the last 60 years alone.[156] The best interpretation of the figure of $497 billion is as a rough estimate of what the estate tax has cost the economy in terms of lost capital stock since its inception in 1916.

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[155] The measure of wealth used here includes all privately-owned fixed capital, not including durable goods owned by consumers. Arnold J. Katz and Shelby W. Herman, "Improved Estimates of Fixed Reproducible Tangible Wealth, 1929-95," *Survey of Current Business*, Bureau of Economic Analysis (May 1997): 69-92.
[156] In inflation-adjusted 1995 dollars. See *supra* note 53.

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