MICHIGAN
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Product Number WP 2000-11
October 30, 2000

OTPR
OFFICE OF TAX POLICY RESEARCH

From the
Office of Tax Policy Research

WORKING PAPER SERIES

We Tax Dead People

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Note: The opinions expressed are those of the authors and do not represent the views of any of the organizations with which they are affiliated.

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ABSTRACT

In both 1999 and 2000, the U.S. Congress voted to eliminate the federal estate and gift tax, only to have President Clinton veto the bill. Republican presidential nominee George W. Bush favors eliminating it, as well. Regardless of the outcome of the 2000 election, the intensity of the debate will surely increase, as increasing wealth puts more people at risk of entering its tax net.

This paper reviews the history of the estate tax and the state of current law. It then assesses the arguments made against and in favor of the tax in light of economic theory and evidence. It concludes that wealth transfer taxes can play an important role in the U.S. tax system. Although many of the charges leveled against the tax are specious, there is also an important undercurrent of truth. A tax that features effective marginal tax rates of up to 73 percent with substantial opportunities to shelter assets is likely to be problematic. It remains, however, the most progressive instrument in the federal tax system at a time of growing wealth inequality.

We Tax Dead People

William G. Gale and Joel B. Slemrod

In discussing the Stamp Act passed by the British Parliament on March 22, 1765, Benjamin Franklin famously asserted that "in this world, nothing is certain but death and taxes." More than 200 hundred years later, and recent advances in corporate tax shelters and cryogenic prolongation of life notwithstanding, Franklin's assertion remains uncontroversial. However, the decision to impose taxes that depend on death is a policy choice, not a certainty.

The idea of making death a taxable event, or a lucrative event for tax collectors, infuriates some people. Winston Churchill called estate taxes an attempt to tax dead people rather than the living. Steve Forbes campaigned in favor of "no taxation without respiration." Economist Bruce Bartlett points out that a key plank in the Communist Manifesto was the abolition of inheritance rights. In economic terms, the estate tax is alleged to reduce aggregate capital accumulation, wages, jobs and economic growth; destroy small businesses, farms and the environment; treat frugal households unfairly compared to spendthrifts; and require an army of attorneys that generates huge compliance costs and ingenious avoidance strategies.

On the other hand, others might feel entitled to ask what all of the fuss is about. The tax is levied on the estates of fewer than 2 percent of Americans who die. It raises less than 2 percent of federal revenues—less than the federal tax on gasoline. Under current law, with minimal planning a married couple with wealth of less than $1.35 million need pay no tax upon death, rising to $2 million by 2006. In addition, taxpayers can make significant amounts of tax-free gifts to their descendants, and unlimited gifts to non-profit organizations. Special provisions generously address the needs of small businesses and farms. As a result, half of estate and gift tax payments are made by decedents with estates in excess of $5 million, who account for only 1 out of every 1,000 deaths in the United States. Thus, supporters argue, the estate tax is a progressive and relatively cost-effective way to raise revenue. In addition, the tax may have other social benefits as well, by breaking up large concentrations of wealth and encouraging giving to charitable causes.

Besides its association with the rich and the dead--two never-ending sources of fascination--estate taxes raise a number of intriguing issues. First, the tax raises in extreme form the pervasive trade-off between equity and efficiency in the design of government policy. There is a *prima facie* case that the tax is progressive, since it is levied only on the wealthiest households. On the other hand, the tax base is closely tied to accumulated wealth, so there is also a *prima facie* case that the tax reduces the labor supply, effort and saving that create wealth and are crucial for prosperity. These conclusions may be wrong, for reasons discussed below, but they are the right place to start the debate.

In addition, the impact and proper role of estate taxes depends on issues as personal and sensitive as parents' rights to provide for their offspring, and the nature of relations between parents and their children. Some bequests are motivated by altruism, some might be considered a form of payment for services that children provide, and some are undoubtedly an after-thought in that they were intended to provide for the parent's expenditures, but the parent died before consuming the funds. Each alternative provides different implications for the right way, if at all, to tax estates.

To jaded viewers of seemingly endless and predictable policy debates between liberals and conservatives, the estate tax offers a welcome respite. It's true that most liberals support the tax and most conservatives oppose it, all for the usual reasons. But some liberals, such as attorney Edward McCaffery, of the University of Southern California, vociferously oppose the tax. McCaffery believes it encourages more unequal distribution of consumption. In contrast, some conservatives, such as Irwin Stelzer of the American Enterprise Institute, enthusiastically support near-confiscatory estate taxes. Stelzer argues that allowing large inheritances is basically affirmative action -- which as a good conservative he opposes -- for rich kids. Thus, at the very least, these patterns indicate that analysis of transfer taxes may well cut across the fissures that traditionally demarcate policy debates.

And the estate tax is hot. In 1999, in a vote split almost completely along partisan lines, Congress voted to abolish the estate tax over 10 years. President Clinton vetoed the bill. In June of this year, though, 65 Democrats in the House joined Republicans to vote the tax out again, and some Democratic Senators also did so as the Senate voted for the tax's elimination. President Clinton vetoed it again. Republican presidential nominee George W. Bush advocates repeal as well. And, regardless of the Presidential election, the intensity of the debate is likely to rise in the near future. Even supporters of estate taxes in general often see the need for reform of the existing laws. The aging of the population, the stock market boom of the last two decades, and other factors suggest that estate and gift tax revenues may grow significantly over the next 10 years.

How it Works

History Taxes on transfers of wealth were levied as far back as the 7th century B.C. in Egypt. The first American tax on wealth transfers dates to 1797 when, faced with the expenses of dealing with French attacks on American shipping, Congress imposed a stamp duty on receipts for legacies and probates for wills. The tax was eliminated in 1802. Similar, short-lived taxes were enacted during the Civil and Spanish-American Wars. The modern estate tax also originated in a time of war preparation, if not war itself, in 1916. However, this incarnation of the tax survived World War I because it rode the movement of the time to reduce the reliance of federal revenue on customs and excise taxes, viewed by many to be regressive, with more progressive tax methods.

Current Law The laws that govern how and to whom property may pass are the exclusive domain of the states, with each state regulating how property may be transferred to heirs, and the extent to which certain classes of family members, principally spouses and children, are protected from oversight or disinheritance. In contrast, Federal law governs the taxation of such transfers, although states may also impose estate or inheritance taxes. The executor of an estate must file a federal estate tax return within nine months (fifteen, if a filing extension is approved) of the death of a U.S. resident if the gross estate exceeds $675,000. The unified federal estate and gift tax applies a single graduated rate schedule to cumulative lifetime taxable transfers made by an individual during life or at death.

The first step in determining estate tax liability is to calculate the value of the gross estate. Gross asset value is sometimes difficult to determine, and in particular closely-held businesses are allowed to value assets at their "use value" rather than their highest alternative marketoriented value. In addition, it is often possible to discount the valuation of assets by placing them in a mediated ownership form, such as a family limited partnership, rather than holding them directly. In order to prevent avoidance of the tax through gifts made during life (*inter vivos* gifts), the tax base also includes gifts made by the decedent in excess of an exemption of an annual $10,000 per donor per donee.

The next step is to determine the taxable estate--the difference between gross estate and allowable deductions. All transfers to a surviving spouse are fully deductible, as are contributions to charitable organizations. Deductions are also allowed for debts owed by the estate, funeral expenses, administrative and legal fees associated with the estate. A limited credit against tax liability is given for state-levied inheritance and estate taxes; most states now levy so-called "soak-up" taxes that fall within the credit limit, so that they transfer revenue from the federal to the state treasuries without adding to the total tax burden on the estate.

The unified credit currently exempts taxes on the first $675,000 of lifetime taxable transfers, a figure that will rise to $1 million by 2006. For estates larger than that, the tax rate begins at 37 percent and rises gradually until it is 55 percent on taxable transfers above $3 million. For estates that are predominantly closely-held businesses, the tax payments can be spread out over 14 years, with the first five years being just interest payments.

<u>Other countries</u> Nearly all of the OECD countries levy some kind of a wealth transfer tax, but other than the U.S. only New Zealand and the United Kingdom levy "pure" estate taxes; the others have an inheritance tax or a mixture of inheritance and estate taxes. As of 1996, in only Japan and South Korea did wealth transfer taxes exceed 1% of total tax revenues, as they do in the U.S. However, note that the U.S. is one of the fifteen OECD countries that does not levy a

net wealth tax. The trend of the last few decades is clearly toward reduced reliance on wealth transfer taxes.

Who Pays?

In 1999 the federal estate and gift tax collected $28 billion. This compares to $879 billion raised by the individual income tax, $185 billion raised by the corporation income tax, and amounts to 1.5 percent of total federal revenues. The recent rapid increase in personal net worth fueled by the boom in the stock market and real estate values suggests that the estate tax, even with the legislated gradual increase in the exemption level, will grow in relative importance as a revenue raiser, although the projections of the Congressional Budget Office do not reflect this.

Estate tax liability is extraordinarily concentrated among high-wealth families. In 1997 estates with gross value over $5 million account for nearly half of all estate tax revenues, but accounted for only about 5 percent of all taxable estates and about 1 out of every 1,000 deaths. The average tax payment among these estates is $3.5 million dollars. Although the marginal tax rate reaches 55 percent, the average tax rate (tax divided by gross estate) in this group is less than 19 percent, reflecting the credit and lower rates as well as the deduction for charity and spousal bequests. In contrast, the 85 percent of taxable estates with a gross value below $2.5 million account for only 30 percent of estate tax revenues, and face an average tax rate of about 12.5 percent.

Clearly estate tax payments are highly concentrated among the wealthiest households in America. To emphasize this point, one can also classify tax burdens according to household income. Doing so is fraught with conceptual and data difficulties, but the U.S Treasury Department--in a careful attempt to do so--concluded that households in the top 5 percent of the income distribution bear 91 percent of estate taxes compared to 49 percent of income taxes. Households in the top 20 percent of the distribution bear 99 percent of estate taxes, compared to 77 percent of income taxes. Not only is the estate tax is highly progressive, it is considerably more so than the income tax.

Among the top 5 percent of households, estate taxes are the equivalent of about 6 percent of income taxes. Thus, abolishing the estate tax amounts to a permanent 6 percent reduction in income taxes for this group. Lest you worry that the Treasury has cooked its analysis, an independent analysis published in 1990 by Daniel Feenberg, Andrew Mitrusi, and James Poterba for the National Bureau of Economic Research reached about the same conclusion.

Issues

Controversy concerning the estate tax touches on a wide variety of arguments, for and against. Here we try to keep score of the various issues. In the next section, we link the various arguments made to specific proposals for change.

1. The appropriateness of imposing taxes at death

Opponents of transfer taxes often view death as an illogical time to impose taxes at best, and a morally repugnant one at worst. Compounding the grief of a family with a *tax*, of all things, seems a bit heartless, to be sure, and it is this queasiness that the opponents play on by labeling the estate and gift tax the "*death tax*." As evocative as it is, this label is seriously misleading. First, death is neither sufficient nor necessary to trigger the estate and gift tax. It isn□t sufficient because less than 2 percent of decedents pay any tax at all. It isn□t necessary because gifts between living people can trigger a tax liability. Second, estate tax liabilities can be effectively pre-paid via life insurance purchases tied to the expected tax liability or, in the case of qualified family businesses, can be delayed and paid over a 14-year period after the death of the owner. Thus, although death may trigger the tax liability, the payment can be remitted at any of a number of times. Third, leaving the morality aside, death is very likely to be a convenient "tax handle." The public nature of the probate process reveals information about a family's level of affluence that is difficult to obtain in the course of enforcement of the income tax, but that may be relevant for societal notions of the appropriate level of progressivity. This aspect of taxation at death likely explains why inheritance and estate taxes date back for millennia. Fourth, at least some component of estate tax payments--for example, payments on unrealized capital gains--can be thought of as a "final settlement" with respect to the income tax. Such taxes would be triggered by death even if the estate tax were abolished and replaced with income taxation of previously unrealized capital gains at death.

Finally, much of the derisiveness focused on so-called death taxes is simply disingenuous. Note that no opponent of estate taxes objects to the fact that income taxes are due on 401(k) and IRA balances at death. Nor do any of the opponents suggest that, in exchange for eliminating estate taxes, they would support increased taxes on the wealthy during life; the latter of course would be the logical solution to the particular problems created by taxation at the time of death.

Many economists, in fact, have argued that taxes payable at death are preferable to taxes paid during life, because the former have smaller disincentive effects on lifetime labor supply and saving than do equivalent-revenue taxes imposed during life. For all of these reasons, turning a tragic but inevitable life event into a taxable event may be off-putting, but is perfectly sensible from a tax administration point of view.

2. Progressivity

Progressivity has been the traditional justification for the highly graduated estate tax and remains the principal defense in the 21st century. However, one might reasonably ask why the desired degree of progressivity can't be achieved solely through the income tax. The answer usually given is that the capacity of the income tax to impose progressive burdens is limited by several factors, most notably the preferential treatment of capital gains. Capital gains are taxed at a lower rate than other capital income; they are taxed only when the underlying assets are sold as opposed to when the gains accrue; and, most importantly, gains are excused from income taxation at death. Another factor, as noted above, is that the public nature of probate may provide new information that is relevant to progressivity calculations.

Certainly the standard liberal defense of the estate tax on progressivity grounds is partly a knee-jerk resistance to a tax change whose benefit accrues primarily to the most well-to-do. On the other hand, the standard conservative attack on the estate tax is partly a knee-jerk response to any tax that is progressive (witness the attacks over the last few years on the graduated income tax and capital gains taxes, support for the flat tax, and so on). Neither liberals nor conservatives, though, are arguing for a low-exemption, flat-rate estate tax that would be paid by almost everyone upon death. Instead the policy debate concerns a tax that applies only to the rich. It would help if opponents of the estate tax clarified whether they are advocating a large reduction in the progressivity of the tax burden, or just a change from one progressive tax instrument to another (it's the former). Likewise, it would help if supporters of the estate tax clarify whether they would support an equally progressive alternative tax, or whether there is something about taxation of wealth transfers *per se* that is essential.

3. Backstop to the income tax

Supporters of the estate tax often note that it serves as a backstop for the income tax, imposing taxes on income that escaped taxation during life. One source of such income is capital gains that have never been realized. As noted above, they elude the income tax net and they are bequeathed to inheritors with a stepped-up basis, so that these capital gains would never be taxed. (Basis step-up also occurs for transfers from one spouse to another, even though such transfers are deductible from the gross estate. As a result, the estate tax contains a potentially very large marriage bonus that has received little attention.)

To the extent that the estate tax is meant to capture tax on previously accrued but unrealized capital gains, the tax should apply only to unrealized capital gains and should be capped at the highest capital gains tax rate. Needless to say, that is not what the estate tax looks like, now or in the past.

4. The concentration of wealth

From its beginning the estate tax was viewed as a counterweight to an undue concentration of wealth. These days some opponents claim that the estate tax fails to achieve this goal. True enough, it isn't obvious that the concentration of wealth is less in the era of high estate taxes than it was before. But the real question is whether the concentration of wealth is less than it would be in the absence of the tax. It is probably unrealistic to expect that a tax that in a typical year raises revenue equal to 0.3 percent of GDP and 0.1 percent of household net worth would make a serious dent in overall wealth inequality. Small programs typically have small effects. This reduces the scale of both costs and benefits, but doesn't settle the argument about whether the benefits exceed the costs. In fact, on its face, the opponents' claim could be construed as an argument for increasing, rather than decreasing, the tax.

5. Effects on saving, labor supply, and economic growth

Combined with the income tax, the marginal tax disincentive to work and save created by the estate tax for the affluent can be so high as to potentially seriously discourage work and saving. The top federal income tax rate of 39.6 percent combined with the top estate tax rate of 55 percent implies that the tax penalty of a dollar earned with the intent to bequeath is taxed at an effective rate of almost 73 percent.

In the 18th and 19th century there was a lively discussion among such luminaries as Adam Smith, David Ricardo, and J.B. McCulloch as to whether an estate tax is a serious hindrance to saving, and therefore to capital accumulation. (Ricardo thought so, but McCulloch and others disagreed). The debate focused on whether a tax liability due so far in the future, and attached to an event many people prefer not to think about, could really be a disincentive to activities undertaken in the prime of life.

Today, this issue remains controversial, but now revolves around the question of what motivates people to give bequests, which turns out to be critical to sorting out the impact of an estate tax on saving. Consider the implications of bequests being unintentional, or accidental, and arising out of people's inability to annuitize their wealth to ensure that they do not outlive it. In that case, an estate tax would not only not be a disincentive to save, it would not be a burden to the bequeathor (although the donee would be less well off, to be sure). What if bequests are really payment for services rendered by children to parents in their later years? Then an estate tax merely raises the price of purchasing such services, and will cause more or less such expenditures (i.e., bequests) depending on the mundane detail of the price elasticity of demand for these services. Since people are likely motivated by a combination of factors in their bequests, the impact of estate taxes on saving by the estate owner is difficult to sort out.

Because first principles can't even determine the *sign* of the effect of the tax on the donor's saving, we must rely on the statistical evidence to resolve what its impact is. Indirect evidence from analyses of the effects of *income* taxes on labor supply and savings is of course relevant, and in both cases the bulk of the evidence suggests that the effect is small. Estate taxes are levied at higher rates, which might suggest a larger effect, but they are also levied at more distant points in the future, suggesting possibly smaller effects. In any case, direct evidence of the impact of estate taxes on behavior is sparse. Over the history of the U.S. estate tax, it does seem to be true that in years when the estate tax has been relatively high, reported estates as a fraction of national wealth are lower than otherwise. This pattern is consistent with either a depressing effect on wealth accumulation or an encouraging effect on estate tax avoidance, or both. Closer examination of estate tax returns reveals that this association is statistically fragile, though, so we are still without any hard evidence that U.S. capital accumulation has been and continues to be held back by this tax.

All of the above discussion focuses on saving by the donor of the transfer. But evidence shows that large inheritances reduce the work effort of transfer recipients (consistent with Andrew Carnegie's famous conjecture) and raise their consumption, too. Thus, to the extent that the estate tax reduces net-of-tax inheritances, it can raise saving by the recipients.

Ultimately, the progressivity of the tax depends on its impact on saving and labor supply. If the estate tax discourages significant amounts of wealth accumulation, it could drive wages down by reducing the amount of capital per worker. In this case, the impact of the tax would be felt (indirectly) by workers. Because the impacts on saving and labor supply appear to be relatively small but have not been firmly established, we feel it is appropriate to maintain the view that the estate tax is progressive until new evidence is provided. Certainly, the alignment of forces pro and con is consistent with the view that the tax is progressive.

6. Family-owned businesses and farms

Even if the estate tax does not affect the level of saving, it could well affect the ability of family businesses and farms to survive the death of the owner. In part because of the inordinate political importance of Iowa in the presidential election process and the political visibility of farmers and small business generally, these issues have received a lot of attention. Estate tax opponents claim that a large proportion of American businesses never make it to the second generation and assert that the estate tax is the reason why.

This is, though, surely a case of the tail wagging the dog. First of all, farms and other small businesses represent a small fraction of estate tax liabilities. In 1997, farm assets were reported on less than 6 percent of all taxable estates, and farm assets totaled a microscopic 0.3 percent of taxable estate value. For small businesses, the figures are larger but still small. Less than 10 percent of taxable returns in 1997 listed closely held stock, which accounted for only 7 percent of taxable estate value. Limited partnerships and "other noncorporate business assets" accounted for an additional 2.7 percent of taxable assets. Thus, using a very expansive definition, farms and small businesses account for at most 10 percent of all assets in taxable estates. The vast majority of estate taxes are paid by people who own neither farms nor small businesses. This implies that scaling back or eliminating the estate tax is a very blunt instrument for dealing with this issue.

Moreover, family farms and businesses already receive special treatment under the estate tax. Taxpayers are entitled to calculate the taxable value of family farms and businesses on the basis of the farm or business net worth to family proprietors (rather than market value), which can significantly reduce estate tax liabilities. In addition, the estate tax liability due to family farms and businesses can be paid in installments over a 14-year period. Legislation enacted in 1997 permits a special deduction of up to $675,000 worth of family-owned farms and businesses when they constitute at least 50% of an estate and in which heirs materially participate.

On top of all that, recall that small businesses already receive numerous tax subsidies—for investment, for example--under the income tax as well as under the estate tax. In addition, a significant portion of the value of the family-owned businesses consists of unrealized capital gains (a 1989 study using Federal Reserve Board data pegged the figure at two-thirds). This income has never been taxed under the income tax. Exempting it from estate tax as well would provide an even larger subsidy to small businesses than currently exists. No convincing case has ever been made for the current level of subsidies, much less for expanding them further.

Finally, there are many reasons why businesses do not pass from one generation of a family to another. Because only a very small portion of small businesses and farms ever even pay estate taxes, it is unlikely that the estate tax has a very important impact on the proportion of businesses that make it to the second generation or beyond.

7. Fairness

While progressivity issues focus on the treatment of those with higher income or wealth relative to those with less, another component of fairness focuses on how "equals"—different households with the same income or wealth—are treated relative to each other. The estate tax raises many difficult issues along these lines.

For example, opponents claim that the estate tax inequitably burdens those families that are intergenerationally altruistic relative to those who are selfish, and punishes those who are unwilling or unable to engage in sophisticated tax planning to avoid the tax. To be sure, the estate tax is a tax on one way to dispose of one's wealth, passing it along in financial form to one's chosen heirs. Comparing two families of the same (considerable) means, this tax will not burden the one that chooses to spend every penny on themselves, or even the family that gives it away to charity, but burdens only those families that pass their good fortune along to their own.

Put this way, from the perspective of the donor, it seems to violate principles of equity to single out for tax families that are altruistic toward their own children or grandchildren. Edward McCaffery stresses this "horizontal" inequity of the estate tax. Moreover, many economists argue that intergenerational giving is an example of an activity with positive externalities, because the bequest not only provides satisfaction to the giver, but also to the receiver of the bequest.

The perspective, however, is crucial to this argument. Yes, from the point of view of the giver, the tax seems to single out the altruistic for taxation, leaving the squanderers untouched. But from the perspective of the next generation, inheritance provides an advantage to some rather than others. Supporters claim that advantages so derived are unearned and unfair. They claim that inheritances provide large benefits to people who may not have demonstrated any other skill than that of choosing affluent parents. They argue that this seriously distorts notions of equality of opportunity, and is detrimental to widely shared notions of fair play. This is, of course, related to the arguments above about progressivity and the distribution of wealth.

A second line of debate concerns parental versus societal rights regarding the institution of inheritance. Opponents of the tax note that parents can pass resources to their children in a variety of ways: by investing in their education, providing social contacts and networks, bringing them into a family business, giving gifts of up to $10,000 per year, etc. They question why transfers at death should be treated differently from these other transfers. They also note that inheritances play only a small role in generating overall inequality.

Supporters of the estate tax look at the same set of transfers already being made and say "enough is enough." Irwin Stelzer, for example, notes that high estate taxes do not stop parents from passing on huge amounts of human capital, family reputation and connections, a common set of values, etc. He simply questions whether, given all of those existing the transfers, the net social gains to having large amounts of financial resources passed on through probate exceeds the costs. He concludes that high estate taxes do not seriously impinge on a parent's ability to provide for their offspring, that they provide good incentives for younger people to work hard and that they help meet societal notions of fair play among the recipient generation. Stelzer also notes that putting limits on the use of one's property is a natural, continuing and appropriate role for society to play. Others have argued, for more than two centuries, that inheritance is a civic right, not a natural right, so that government has not only the right but the duty to regulate such activity.

These fairness issues hinge to a significant extent on value judgments, fairness being always and everywhere "in the eyes of the beholder." As a result, it is quite difficult to resolve these issues analytically, and even more difficult to do so in a political arena.

8. Administrative and avoidance costs

It is often alleged that the estate tax is inefficient because avoidance and compliance costs are so high and the tax is so easy to avoid. A Brookings study from the 1970s referred to the tax as "voluntary" because of the large number of ways it could be avoided. Although tax reforms over the last two decades have tightened up a number of the most egregious features, aggressive sheltering (bordering, frankly, on the abusive) remains a serious issue for the estate tax.

One issue is how high the costs really are. The widely-cited claim that the costs of complying with the estate tax laws are roughly the same magnitude as the revenue raised is back-of-the-envelope, at best. It is based on valuing the time of those American Bar Association members that report probate and estate law as their area of concentration. Even this methodology, inexact to be sure, yielded costs that came to just 15 percent of revenues, and the 100 percent number from the same study has no quantitative basis. So the oft-cited number is a hunch and no more, and is also more than a decade out of date. Other, more recent, estimates based on consultations with tax professionals about their average charges for typical estate tax planning produce a total cost of collection equal to only 7 percent of revenues. Thus, the available range of estimates of compliance costs relative to revenues is huge. We are inclined to believe that the truth lies much closer to the 7 percent figure. Moreover, an unknown fraction of this may be estate planning, *inter alia* about intergenerational succession of the business, that is unrelated to taxation and thus would likely be incurred regardless of whether there was an estate tax.

In addition, if there are high compliance costs, it is not clear whether that would suggest that the tax should be cut back or, alternatively, be bolstered by broadening the base—eliminating loopholes—and reducing tax rates.

9. The non-profit sector

Supporters note that the deduction in the estate tax for charitable contributions generates a significant increase in contributions to the non-profit sector, especially among the wealthiest households. In 1997, of the 329 taxable estates with gross estates in excess of $20 million, 182 made charitable contributions and those that did contributed an average of over $41 million! Thus, supporters believe that elimination of the tax would reduce contributions to the non-profit sector.

Opponents counter with two claims: first, that the effect of the estate tax deduction for charitable giving is not that large, especially relative to the overall funds raised by the private sector; second, that eliminating the estate tax would raise wealth among the wealthiest families, which would in itself increase charitable contributions. Note, however, that the second claim is inconsistent with the claim that estate tax does not affect the concentration of wealth. The first claim is an example of the selective use of assertions of large behavioral impacts of taxation. Opponents of the estate tax argue that it significantly alters decisions about saving, but play down its impact on the decision to donate. (They are not alone in using this tactic, of course.)

10. Revenues

Finally, opponents argue that the estate tax raises very little revenue, so that abolishing it would make little difference to federal revenues. This does not appear to be correct as a factual matter: over the long-term, elimination of the estate tax is estimated to cost over $50 billion per year. But even it is right, it begs the relevant question, which is whether taxes should be cut in this way, some other way, or not at all.

A more sophisticated version of the "little revenue" argument is that stated revenues may vastly overstate the net revenue effect of the estate tax because the tax avoidance schemes that tend to reduce estate taxes also tend to reduce income taxes. Thus, for example, Stanford economist Douglas Bernheim argued several years ago that, to a first-order approximation, the estate tax raises no revenue. If this is the case, then the estate tax would be difficult to justify, as it would create distortions to behavior but on net raise no revenue. This assertion is, however, based on speculative calculations and has not been corroborated by subsequent investigation.

Where do we go from here?

The most radical reform would be to abolish the tax. This, of course, removes the existing problems, but may create a host of additional issues. It would eliminate what is by far the most progressive tax instrument in the federal tax arsenal, right after a period where the distributions of income and wealth have already become far more skewed. It could hurt non-profits. It would reduce federal revenues. It may not even raise saving, labor supply or growth, as its advocates hope, and it would create a gaping loophole with regard to capital gains in the income tax. Moreover, the case for abolition appears to be backed largely by loose rhetoric about the immorality of taxing at death and the supposed impact on a tiny component of those who would benefit.

Elimination, or scaling back, of the estate tax could be coupled with the extension of the capital gains tax to the gains accrued but unrealized at death. But this proposal would raise only about a quarter to a third of the revenue of the estate tax, and would raise it from a quite different set of people, and would have many of the complexities of the estate tax, so it is neither an attractive or likely option by itself. Moreover, it would have a large impact on small businesses and farms, one of the groups that reform is intended to relieve of tax burdens.

The bill passed in the House earlier this year tied elimination of the estate tax to another significant change in the taxation of capital gains, under which heirs would assume the decedent's basis for capital gains purposes -- "carryover basis" -- for transfers from estates valued in excess of $1.3 million. Linking the two changes is designed to address the concern that the appreciated value of some assets might escape both income and estate taxation with no estate tax and step-up basis. However, this would raise even less revenue than taxing gains at death, and would be substantially more complicated, in part because records would have to be kept for an even longer period of time. A similar item was passed in the late 1970s but was repealed before it ever came into effect partly because of anticipated implementation problems. These implementation problems have not grown any easier in the ensuing 20 years. Thus, it seems likely that what the House really passed was simply an abolition of the estate tax.

Other than tossing the tax out, the appropriate direction for more modest changes in the estate and gift taxes depend in large part on what the system is intended to accomplish. If the goal is to help family-owned business and farms, then the effective exemptions for those purposes could be raised. But if that is done, it may make more sense simply to raise the exempt amount for all purposes, since doing so only for selected forms of assets creates both horizontal equity problems and inefficient sheltering incentives.

If the goal is to chip away at an undue concentration of wealth, then the effective exemption could be raised substantially—since only the extremely wealthy are the target here--and the high tax rates maintained. This could greatly reduce the number of people that have to pay estate taxes and simplify the tax, but would also reduce revenues.

If the goal is to improve equality of opportunity, then estate tax revenues could be earmarked for special education and training programs, or for the kind of means-tested asset accumulation subsidies supported by President Clinton, Vice President Gore, and Governor Bush.

Base-broadening—that is, loophole closing--and rate reduction carried the day in the last comprehensive income tax reform in 1986 and could improve the equity, efficiency and simplicity of the estate tax as well. Treating different assets in a more similar fashion would reduce sheltering opportunities and thus make the tax simpler and fairer. For example, legislation could address unwarranted valuation discounts and abusive trust arrangements that abound.

Reducing rates would reduce the incentive to shelter or change behavior in the first place.

Finally, it might make sense to replace taxes on estates and gifts given with taxes on gifts and inheritances received, as is the practice in several U.S. states and many foreign countries. Under a progressive inheritance tax (but not under an estate tax), spreading a given bequest among more legatees reduces the total tax burden. Some argue that by encouraging the splitting of estates, a progressive inheritance tax is a more effective instrument for restraining the concentration of wealth. In addition, a unified tax system would tax all the sources or all the uses of income. Currently, the income tax burdens sources and the estate tax falls on a particular use of resources. In contrast, the income tax combined with a tax on inheritances and gifts received would cover all major sources of income over the lifetime.

The historical record shows that transfer taxes of one sort or another can play an important role in the tax system. And, although many of the arguments put forth against the current estate and gift tax system are specious, there is also an important undercurrent of truth. Likewise, supporters of such taxes need to distinguish between the potential benefits of such taxes in principle and the design problems that arise in practice. A transfer tax system that couples effective marginal tax rates of up to 73 percent with substantial opportunities to shelter funds is asking for trouble. An income tax with similar features in the 1970s was swept out in favor of a broader-base, lower-rate system in the 1980s. In light of these considerations, a package of lower rates and a higher exemption level, combined with a thorough cleaning of the tax base and perhaps judicious earmarking of estate tax revenues, may well be the lifeblood an effective transfer tax system needs to survive.

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