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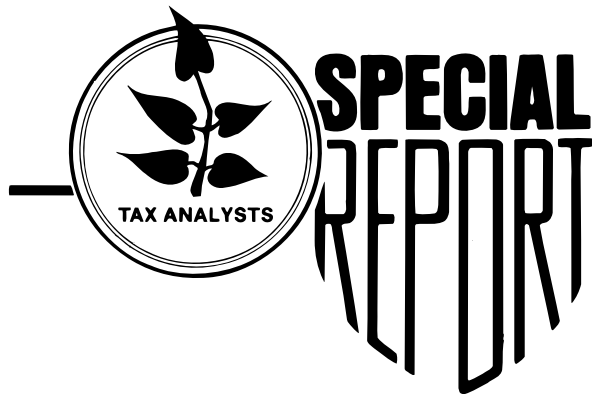
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STRAIGHT TALK ABOUT THE 'DEATH' TAX: POLITICS, ECONOMICS, AND MORALITY

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Ventry examines the political, economic, and moral cases against transfer taxes. First, he argues that the rhetoric surrounding the effort to repeal the estate and gift tax — particularly the charge that it destroys family farms and closely held businesses — is, at best, misleading, and at worst, disingenuous. Second, he demonstrates that the estate and gift tax does not necessarily threaten aggregate saving, labor supply, or economic growth as its critics maintain. Nor does it generate an insignificant amount of revenue, produce prohibitive compliance costs, primarily tax wealth that has already been taxed, or have little effect on the rate of charitable contributions, again, all of which critics maintain.

Finally, Ventry challenges the assertion that transfer taxes are immoral because they prevent parents from passing along hard-earned wealth to children, and because they tax saving, not consumption. The fact that we care about our children, he argues, does not make transfer taxes immoral, anymore than the fact that we care about what we consume makes consumption taxes immoral. More fundamentally, Ventry challenges the moral case against taxing wealth at death by invoking history. Americans have long considered wealth a civic right, not a birthright. Thus, taxing inherited wealth fulfills a moral obligation in a liberal democratic society.

Ventry concludes that the estate and gift tax should be reformed, not repealed. In the interest of preempting further calls to abolish the estate and gift tax, preserving one of the most progressive features of the federal tax system, and improving horizontal equity, he recommends raising the effective exclusion, broadening the tax base, and lowering marginal rates.

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In June, the U.S. House of Representatives passed H.R. 8, the Death Tax Elimination Act. In September, the Senate ratified the House bill. Days later, President Clinton vetoed the legislation. End of story? Not quite.

H.R. 8 represents the most recent initiative in a protracted and increasingly viable effort to abolish the federal estate and gift tax. In fact, critics of the so-called "death" tax seemed poised for victory this summer. Most telling, the partisanship that had characterized earlier proposals to eliminate the estate tax gave way to a bipartisan alliance. Democrats joined Republicans to repeal what Bill Archer, R-Texas, Chairman of the House Ways and Means Committee, called "the wrecking ball of a life's worth of achievement and success."¹ Sixty-five House Democrats helped pass H.R. 8, 279 to 136, and nine Senate Democrats co-sponsored the House bill, shuttling it to the president's desk by a vote of 59 to 39. Only the White House's concerted effort to shore up Democratic support prevented an override of the president's veto.

What's more, recent polling data indicates overwhelming public support for eliminating the estate and gift tax. A June 2000 Gallup Poll found that 60 percent of respondents favored "eliminating all inheritance taxes on estates over \$1 million." The latest numbers are even more damning. In surveys conducted in late August and early September, the Pew Research Center reported that 71 percent of respondents favored

¹Archer quoted in Ryan J. Donmoyer, "Clinton Gets Estate Tax Repeal As GOP Eyes Veto Override," *Tax Notes*, Aug. 28, 2000, p. 1071 at 1072.

“eliminating the inheritance tax.” Indeed, the future of the estate tax, arguably the most progressive component of the federal tax system, appears uncertain.²

Notwithstanding the widespread and bipartisan support for eliminating the estate and gift tax, the case against it does not withstand scrutiny. Its critics have conducted a “disinformation campaign” characterized by scare tactics, misleading economic evidence, and ill-informed arguments that construe transfer taxes as immoral.³ Average American taxpayers have been frightened into believing that the big, bad federal tax system will take all their assets at death, and leave their children destitute. The very existence of family-owned farms and businesses is in peril, according to this campaign. Inheritance taxes penalize savers, encourage lavish consumption, raise no revenue on net, discourage capital formation, and threaten the competitiveness of the U.S. economy. Evidently, the campaign has worked. A majority of Americans, both private citizens and elected officials, demonstrate support for eliminating a federal tax provision that if repealed would benefit less than 2 percent of the population.

This report argues that the estate and gift tax serves several important roles in the federal tax system: it generates not inconsequential federal revenues; improves overall progressivity (an especially legitimate role during a period of widening income and wealth disparities); provides incentives for charitable donations; and helps close the loophole in the federal income tax that allows basis step-up at death on appreciated capital assets. Moreover, under certain conditions transfer taxes might actually increase national saving, labor supply, and economic growth.

The defense of transfer taxes cannot rest on economic evidence alone. Equally important, transfer taxes fulfill moral imperatives that have been integral to U.S. public policymaking for more than 200 years. Contrary to recent arguments from politicians and academics, transfer taxes are not immoral. Rather, from the very beginning of the republic, the founding fathers (and mothers and brothers and sisters, too) considered inheritances and bequests an entitlement defined by society, not by birth. They were civic benefits, not birthrights. As such, they were perceived in relation to an individual’s moral responsibilities to society. In turn, these responsibilities, or what was more commonly known as republican values, comprised essential

components of a free and virtuous republic. They mitigated aristocratic concentrations of wealth, and at the same time established a stable political and economic order in which capitalism and democracy could coexist. Abolishing the estate tax would jeopardize this balance, and repudiate long-standing notions of social justice.

Although this report debunks much of the case for eliminating the federal estate and gift tax, it does not suggest that the tax is beyond criticism. In fact, it proposes significant reforms of the estate and gift tax, primarily through raising the effective exemption, broadening the base, and lowering rates. Admittedly, I make these suggestions with an eye toward preserving transfer taxes and their attendant social justice implications. But I also commend them to reconcile evolving public perceptions of wealth accumulation as a public good with more traditional norms regarding an individual’s moral responsibility to society and the state. Transfer taxes and beneficiaries of the new economy need not be adversaries.

Rhetoric Versus Reality

Critics of the estate and gift tax talk as if they represent a popular uprising. “Ordinary citizens across America are calling for freedom from death taxation,” law professors Edward McCaffery and Richard Wagner write.⁴ Republican Congressman Jon Kyl of Arizona for his part, portends, “This is a dam about to burst.”⁵ And the editors at *The Wall Street Journal* claim that “estate-tax repeal has rolled over the political class on a wave of grassroots support, notably from farmers and small business, but also from average folks who think it’s unfair to confiscate the fruits of a lifetime of hard work.”⁶

Estate- and gift-tax critics maintain that abolishing transfer taxes will benefit all Americans, from farmers to small businessmen, from retired old economy workers to new economy professionals. A vote against repeal is a vote against average citizens. In criticizing Bill Clinton’s veto of H.R. 8, for example, Speaker of the House Dennis Hastert, R-Ill., stated that the president “disappointed millions of Americans who worry that a lion’s share of their life’s work will be passed on to the Internal Revenue Service rather than left to families.”⁷

²For the Gallup numbers, see <http://www.gallup.com/poll/surveys/2000/topline000622/topline000622.asp>. For the Pew poll data, see The Pew Research Center for the People and the Press, “Independents Still on the Fence: Issues and Continuity Now Working for Gore,” News Release, Sept. 14, 2000, pp. 15 and 58. Technically, an inheritance tax is levied on heirs, while estate and gift taxes fall on the net assets of deceased individuals. For purposes of this report, I use the terms interchangeably, primarily because the lexicon of public discourse (and even the majority of expert debate) does not distinguish between the two tax instruments.

³For “disinformation campaign,” see Bob Herbert, “A Handout for the Wealthy,” *The New York Times*, June 26, 2000, p. A21.

⁴McCaffery and Wagner, “A Bipartisan Declaration of Independence From Death Taxation,” *Tax Notes*, Aug. 7, 2000, p. 801 at 814. McCaffery has argued elsewhere that the “unpopularity of the so-called death tax runs deep and wide,” and that “popular opposition” is seething. See McCaffery, “In Favor of Repeal,” in Edward J. McCaffery, Charles Davenport, and James Halpern, “Should We End Life Support for Death Taxes?” *Tax Notes*, Sept. 11, 2000, p. 1373 at 1382.

⁵Kyl quoted in Ryan Donmoyer and Heidi Glenn, “Estate Tax Repeal Glides to Doomed Finish Line,” *Tax Notes*, July 17, 2000, p. 295.

⁶Editors, “Death Tax Revolt,” *The Wall Street Journal*, July 13, 2000, p. A26.

⁷Hastert quoted in Ryan J. Donmoyer, “Clinton Wilds Veto Pen on GOP Estate Tax Bill,” *Tax Notes*, Sept. 4, 2000, p. 1184.

Although opponents decry transfer taxes in the name of all Americans, they have made small farmers and business owners their poster children. “Families who toil all their lives to build a business or family farm and diligently save and invest should not be penalized for their hard work when they die,” Senate Finance Committee Chairman William Roth, R-Del., has argued.⁸ Preserving the estate and gift tax “will hit our nation’s farmers and small business owners the hardest,” Speaker Hastert concludes. “The death tax can take up to 55 percent of a farmer or small business owner’s assets”; it “prompts . . . children to sell off the family business to cover the tax.”⁹ And Nydia Velazquez, Democratic Congresswoman from New York, has written that “the reality for family-owned small businesses is that one-third will be forced to sell or partially liquidate themselves to pay estate taxes on the owner’s death.”¹⁰

To a certain very limited extent, these claims ring true. Polling data, as we have seen, demonstrate that the majority of respondents support abolishing inheritance taxes. Transfer taxes certainly influence financial decisions within family-owned farms and businesses. An increasing number of Americans, moreover, are likely to feel the effects of the estate and gift tax under current law. And in fact some of these estates will pay marginal estate tax rates of 55 percent and even 60 percent.¹¹

But in a broader, more practical sense, the rhetoric far outpaces the reality.

Critics of the estate and gift tax talk as if they represent a popular uprising.

First, polling data on this issue are not reliable. Respondents demonstrate confusion, for example, over who would benefit from estate and gift tax repeal. Seventeen percent of those surveyed by Gallup in June indicated that they would “personally benefit” from the elimination of inheritance taxes. But less than 2 percent of all estates passing to heirs in any given year pay transfer taxes. This evident confusion does not prevent the public from favoring repeal of inheritance taxes, however. Thirty-nine percent of those surveyed during the June Gallup Poll did not “know enough to say” whether repealing transfer taxes would help or hinder them, and 43 percent believed repeal “would not personally benefit” them. But 60 percent indicated a preference for eliminating inheritance taxes. Thus, if

we assume that all respondents who believed they would benefit from estate-tax repeal also indicated a favorable response for repeal, we can deduce that a majority of those who did not know whether they would win or lose from eliminating transfer taxes still expressed support for repealing them.

Such reflexive opposition to the estate tax is hardly surprising. The public historically opposes all taxes. Asking whether or not it favors abolishing a particular tax invites a predictable response. Pollsters could control for this effect, scholars have noted, by replacing true-false questions, such as “Do you favor repealing inheritance taxes,” with multiple-choice or open-ended questions, such as “Which one of the following tax cuts should be made first?” The recent polling data indicating public approval for abolishing the estate and gift tax use the more predictable true-false structure, a format that does little to advance our understanding of public opinion on transfer taxation.¹²

Second, the anti-inheritance tax rhetoric grossly misrepresents the impact of the estate and gift tax. This misrepresentation of the facts not only further invalidates polling data, but also begs the question, “Who stands to gain from repealing the estate and gift tax?”

The fact of the matter is that for the vast majority of Americans, transfer taxes are a “nonissue.”¹³ In 1997, 42,901 estates — less than 2 percent of all estates passing to heirs that year — paid any federal estate tax. The other 98 percent of estates paid no tax. Estates valued at less than \$5 million accounted for 94.5 percent of taxable returns, but only 56.3 percent of gross estate value. By comparison, estates valued at more than \$5 million represented just 5.5 percent of taxable returns, but nearly 47 percent of gross estate. And less than 1 percent of all estates — that is, those with gross estate exceeding \$20 million — paid taxes on more than 25 percent of all gross estate. Repealing the estate tax would have given estates worth more than \$5 million an average tax cut of \$3.47 million. For estates exceeding \$20 million, the average tax cut would have surpassed \$10 million.¹⁴

Thus it seems the campaign to abolish inheritance taxes has very little to do with helping “millions” of “hard-working” Americans pass on their “life’s work” to children.

Neither does it involve saving family-owned farms and businesses. In 1997, only 6 percent of all taxable

⁸Donmoyer, “Clinton Gets Estate Tax Repeal as GOP Eyes Veto Override,” p. 1072.

⁹Focus on Congress, “Hastert Release Promises Override of Clinton Veto on Estate Tax Relief,” *Tax Notes*, Sept. 4, 2000, p. 1244.

¹⁰Velazquez, “Abolish the Estate Tax,” *The New York Times*, June 15, 2000, p. A31.

¹¹For estates valued between \$10 million and \$17.184 million, the top marginal estate-tax rate reaches 60 percent. This “bubble rate” results from a phaseout of infra-marginal tax rates of less than 55 percent for estates in this range.

¹²Law professor Charles Davenport has recently noted the anti-tax bias inherent in polling data. See Davenport, “The Search for Legacy,” *Tax Notes*, July 17, 2000, p. 421.

¹³Gene Koretz, “Death Knell for Taxes?” *Business Week*, July 31, 2000, p. 34.

¹⁴For data on 1997 federal estate tax returns and gross estate, see Barry W. Johnson and Jacob M. Mikow, “Federal Estate Tax Returns, 1995-1997,” *Statistics of Income Bulletin* 19:1 (Summer 1999): 69-129. For the average tax cut for estates valued above \$5 million and \$20 million, respectively, see Iris J. Lav and James Sly, “Estate Tax Repeal: A Windfall for the Wealthiest Americans,” Center on Budget and Policy Priorities, Aug. 30, 2000.

estates included farm assets, and the value of farm assets amounted to a mere 0.3 percent of total taxable estate value. In addition, family-owned business assets (including closely held stock, limited partnerships, and noncorporate business entities) accounted for 9.7 percent of all taxable assets. In total, farms and small businesses accounted for no more than 10 percent of all assets in taxable estates. If we limit the analysis to estates that reported more than 50 percent of their gross assets in family-owned farms and businesses (that is, those farms and small businesses that in theory might be forced to liquidate assets to meet rising estate tax obligations), the universe shrinks further: these 1,200 estates accounted for only 3 percent of all taxable estates. "This is a crisis?" the editors at *The Economist* have asked.¹⁵

It seems the campaign to abolish inheritance taxes has very little to do with helping 'millions' of 'hard-working' Americans pass on their 'life's work' to children.

Focusing more narrowly on family-owned farms and businesses with taxable estates valued below \$5 million belies the existence of a crisis still further. According to a 1998 Treasury Department study, farms and family-owned business assets comprised less than 4 percent of all assets in these "smaller" estates. Of the 47,482 taxable estates in 1998, only 776 (or 1.6 percent of all taxable estates) claimed family-owned business assets amounting to at least half the gross estate. And only 642 estates (or 1.4 percent of all taxable estates) included farm assets comprising the majority of the estate. In combination, these estates paid less than 1 percent of all estate taxes in 1998.¹⁶

Only a fraction of all family-owned farms and businesses pay estate taxes, in part because they already enjoy considerable privileges under the estate tax. Family farms and businesses are allowed to determine the value of estates on the basis of their use by the family proprietors. Everyone else must base the calculation on market value. This privilege can result in lower estate tax values by as much as \$750,000 and lower average liabilities by one-third. Even lower liabilities can result from the fact that the subjective valuation of assets takes place outside the traditional market. In 1997, moreover, Congress allowed a special \$675,000 deduction for estates that could demonstrate both that closely held farms and businesses comprised at least half the estate

in question and that heirs contributed materially to the estate. In combination, these special tax breaks may allow family-owned farms to avoid paying estate taxes until the farm value exceeds \$4.1 million (less for most nonfarm businesses). If family enterprises manage to accumulate estate tax liability in spite of these myriad special provisions, Congress allows them to pay it off in installments spread out over 14 years and with below-market interest and with only interest being paid during the first five years.¹⁷

In addition to the obviously troubling horizontal inequities created by these tax preferences, the evidence suggests that the beneficiaries do not necessarily need the tax relief. Families that own small businesses have been found to report annual incomes at nearly two times the typical U.S. family. And they own assets valued at more than five times the average family.¹⁸ The closely held businesses and farms subject to the estate tax are even more wealthy. According to Charles Davenport, "Some run into the billions of dollars. We are not talking about mom-and-pop grocery stores on the corner or even the stereotypical family farm."¹⁹ Rather, "The owners are among the wealthiest 1 percent of people in the United States."²⁰ Moreover, although the federal estate tax reaches a marginal rate of 60 percent, the average estate tax rate is considerably lower. In 1997, the average federal estate tax owed on all taxable estates equaled just 17 percent. Even some of the largest estates, valued at between \$3 million and \$20 million and subject to the highest marginal rates, paid average estate taxes of only 25 percent.

In light of these facts, it is difficult to argue that inheritance taxes should be abolished on the basis that they are breaking up farms or causing heirs to liquidate family businesses. It seems more likely that critics of the estate and gift tax have used farmers and small businessmen as "shills" to obscure the true winners of repealing federal transfer taxes.²¹

¹⁷For the valuation of small farms and businesses, see Richard Schmalbeck, "Avoiding Federal Wealth Transfer Taxes," from *Rethinking Estate and Gift Taxation*. For the remaining tax privileges, see Gale and Slemrod, "Rethinking the Estate and Gift Tax: Overview," p. 62.

¹⁸For income and assets of families owning businesses, see Charles Brown, James Hamilton, and James Medoff, *Employers Large and Small* (Cambridge, Mass.: Harvard University Press, 1990).

¹⁹Davenport, "Against the Repeal," in McCaffery, Davenport, and Halpern, "Should We End Life Support for Death Taxes?" p. 1374.

²⁰Davenport, "The Search for Legacy," p. 421.

²¹For farms and small businesses as "shills" for the wealthy, see Jane Bryant Quinn, "Winners, Whiners, and the Estate Tax," *The Washington Post*, Aug. 13, 2000, p. H02. In what can only be described as a choreographed stunt, congressional Republicans arranged for a real-life rancher to deliver H.R. 8 to the White House on a tractor. As part of his veto message, President Clinton challenged the linkage between repealing the estate tax and assisting farmers. "Over half the benefit of that bill that came down here on a tractor goes to 3,000 people," the president observed. "And I'll bet you not a single one of them ever drove a tractor." See Donmoyer, "Clinton Wields Veto Pen on GOP Estate Tax Bill," p. 1185.

¹⁵For data on taxable estates, see William G. Gale and Joel B. Slemrod, "Rethinking the Estate and Gift Tax: Overview," pp. 63-64, in *Rethinking the Estate and Gift Tax*, Office of Tax Policy Research and the Brookings Institution, Washington, D.C., May 4-5, 2000. The proceedings of this conference are on file with the author, and will appear in a forthcoming volume (Washington, D.C.: The Brookings Institution Press). For "This Is a crisis?" see Editors, "Death and Taxes," *The Economist*, July 8, 2000, p. 80.

¹⁶For Treasury findings, see Lav and Sly, "Estate Tax Repeal: A Windfall for the Wealthiest Americans," p. 2.

The “true winners,” as many commentators have pointed out, are extremely wealthy families. Philanthropist George Soros recently argued, “The truth is that repealing the estate tax would give a huge tax windfall to the wealthiest 2 percent of Americans. . . . For the rest of the public, it is a cruel hoax.”²² Regarding these inequitable effects, columnist Jane Bryant Quinn has written sardonically, “I’m trying really hard to feel sorry for the rich. When they die, their estates have to pay a ‘death’ tax, which means less for their heirs. Poor kids. All that heavy lifting in the stock market by Mom and Dad, and the kids don’t get to keep it all. Where’s the justice? Who will stand up for the rights of the descendants of multimillionaires?”²³ Not to fear, their rights are well-represented. But not through any democratic, grass-roots movement, as opponents of inheritance taxes would have us believe. Rather, the rights of heirs to receive huge accumulations of wealth tax free is being represented by what economist Paul Krugman has called the simple “power law” that says, “money talks.”²⁴

The ‘true winners,’ as many commentators have pointed out, are extremely wealthy families.

There is truth to Krugman’s claim. An organization of small businesses calling themselves Americans Against Unfair Family Taxation, has spent more than \$1 million over the course of the last year on radio ads, pamphlets, and mailings in an attempt to turn public opinion against inheritance taxes. As we have already seen, appeals to abolish the estate tax in the name of average Americans obscure the wealthier beneficiaries of repeal. The estate-tax obfuscation infiltrated the 2000 presidential race as well. Earlier this year, presidential candidate George W. Bush told the National Council of La Raza, a Latino advocacy group, that he supported abolishing inheritance taxes, because they hurt average Americans. In particular, they hurt a Mexican-American taco shop owner whom Bush knew personally, and who feared the estate tax would force his heirs to sell the family business. After the speech, reporters pressed Bush aides for details about the small businessman. They found that the family business in ques-

tion was valued at \$300,000, well below the point at which it would become subject to the estate and gift tax.²⁵

It turns out that very little of the effort to sway public opinion against inheritance taxes is what it seems. Even the term critics use to describe all forms of transfer taxes — “death” taxes — is seriously misleading. For one thing, no one gets taxed simply by virtue of dying; 98 percent of deaths do not trigger the payment of inheritance taxes. Moreover, individuals can be subject to “death” taxes while still alive; the act of exchanging gifts can trigger gift tax liability, for instance. In addition, individuals can fulfill future estate and gift tax liabilities well before they die by purchasing life insurance policies based on the expected value of an estate. As economists William Gale and Joel Slemrod have concluded, “[D]eath is neither necessary nor sufficient to trigger the estate and gift tax.”²⁶

The Economics of Inheritance Taxes

While the rhetorical and political case against inheritance taxes is easy enough to dispel, the economic case against them requires more attention. The economic effects of transfer taxes depend on a range of assumptions, including why individuals make bequests or accumulate wealth, and how heirs react to inheritances. Therefore, determining whether the estate tax does or does not reduce personal saving, for instance, is hardly an exact science. Despite the relative ambiguity involved in considering the behavioral consequences of the estate and gift tax, this section demonstrates that the economic case against inheritance taxes, like the political case, is not strong enough to justify repeal.

The economic case against inheritance taxes proceeds on several levels. According to critics, it adversely affects saving, labor supply, and aggregate economic growth. On a secondary level, the tax allegedly promotes avoidance and creates huge compliance costs, which, in combination with paltry receipts, yield no revenue on net. In addition, the estate and gift tax double- and triple-taxes earnings, and has little or no effect on charitable giving.

The *prima facie* case suggests that transfer taxes decrease saving and aggregate capital accumulation, particularly when considered in combination with other components of the federal tax system. Combining the top marginal estate-tax rate, 60 percent, with the top marginal income tax rate, 39.6 percent, yields significant disincentives to earn and save. In fact, a dollar of income taxed at 39.6 percent, with the remainder

²²Soros, “Kill the Death Tax Now . . . No Keep It Alive to Help the Needy,” *The Wall Street Journal*, July 14, 2000, p. A14.

²³Quinn, “Winners, Whiners, and the Estate Tax,” p. H02. For similar commentary on how eliminating the estate tax would be a boon for the rich, see Albert B. Crenshaw, “What if the ‘Death Tax’ Died?: Large Estates Would Benefit From Proposed Repeal,” *The Washington Post*, Aug. 6, 2000, p. H02; and Lav and Sly, “Estate Tax Repeal: A Windfall for the Wealthiest Americans.”

²⁴Krugman, “Death and Taxes,” *The New York Times*, June 14, 2000, p. A31.

²⁵For Americans Against Unfair Family Taxation and Bush’s taco shop owner, see Jacob M. Schlesinger and Nicholas Kulish, “As Paper Millionaires Multiply, Estate Tax Takes a Public Beating,” *The Wall Street Journal*, July 13, 2000, p. A1.

²⁶See Gale and Slemrod, “Resurrecting the Estate Tax,” Policy Brief, No. 62, June 2000, The Brookings Institution, Washington, D.C., p. 2.

taxed at death at 60 percent, yields just 24 cents on the dollar, for a cumulative levy of 76 percent.²⁷

The estate and gift tax can adversely effect saving in still other ways. First, it theoretically reduces the aggregate stock of bequests and *inter vivos* transfers, which researchers tell us comprise at least half of all wealth accumulation.²⁸ Second, the estate and gift tax does this quite efficiently; that is, it impacts the nation's wealthiest citizens, or where bequests, *inter vivos* gifts, and wealth are most concentrated.²⁹ By reducing saving and capital stock, inheritance taxes can, in turn, reduce long-run economic growth, and decrease the capital-to-labor ratio, which has the effect of increasing the return to capital and decreasing wages.

Given the potentially disastrous impact the estate and gift tax could have on saving, capital, and labor supply, surprisingly little work has been conducted on the subject. Perhaps even more surprising, the analysis to date is ambivalent regarding the influence of transfer taxes on saving and capital.

While the rhetorical and political case against inheritance taxes is easy enough to dispel, the economic case against them requires more attention.

Scholars have found that transfer taxes have a small negative effect on aggregate capital stock, and that repealing the estate tax would slightly increase the long-term ratio of capital to labor.³⁰ Moreover, a few studies indicate a correlation between increased estate tax rates and reduced labor supply, and others suggest

a similarly negative correlation between the receipt of inheritances and labor supply.³¹ Alternatively, some researchers argue that even though repealing the estate and gift tax might increase saving and capital stock, it would also create intolerable wealth inequalities.³² Still others have found that inheritance taxes can actually *raise* saving and capital stock for both the donor and the recipient. The effect of the estate and gift tax, these researchers suggest, depends on a range of transfer motives including why donors accumulate and transfer wealth, how heirs respond to inheritances, and what the government does with transfer-tax revenue.³³ For example, to the extent inherited wealth induces heirs to reduce work effort and increase consumption, the estate tax might increase aggregate saving. To the extent the estate and gift tax successfully reduces after-tax inheritances, it might also increase saving in households that receive inherited wealth.³⁴

Relevant indirect evidence from studies on how the income tax influences work, saving, and labor supply indicates a weak, nearly insignificant, negative correlation. Of course, estate tax rates are set higher than income tax rates, which might suggest more extreme behavioral distortions. However, unlike the income tax, the impact of the estate tax is nonrecurring, and it falls at a distant, unknowable point, suggesting that behavioral distortions correlated to the estate tax might be less extreme than those relating to the income tax.

While ambiguities characterize the evaluation of how transfer taxes influence saving, capital formation, and labor supply, the remaining economic examination of the estate and gift tax yields more definitive conclusions.

Notwithstanding its opponents' misleading claims, the estate and gift tax generates revenue that is hardly insignificant. In 1999, the tax generated \$28 billion, or

²⁷Using the more common 55 percent for the top marginal estate tax rate yields a calculation of 27 cents on the dollar. For representative work on how the estate and gift tax reduces saving and capital accumulation, see Edward J. McCaffery, "The Uneasy Case for Wealth Transfer Taxation," *Yale Law Journal* 104 (1994): 283-365; and Joseph Stiglitz, "Notes on Estate Taxes, Redistribution, and the Concept of Balanced Growth Path Incidence," *Journal of Political Economy* 86 (1978): S137-S150. For more on how the estate tax interacts with other taxes to raise effective tax rates on capital income, see James Poterba, "The Estate Tax and After-Tax Investment Returns," and William G. Gale's subsequent "Comment" in *Does Atlas Shrug?: The Economic Consequences of Taxing the Rich*, edited by Joel B. Slemrod (New York: Russell Sage Foundation and Cambridge, Mass.: Harvard University Press, 2000).

²⁸See William G. Gale and John Karl Scholz, "Intergenerational Transfers and Accumulation of Wealth," *Journal of Public Economics* 8:4 (1994), pp. 145-60.

²⁹See Henry J. Aaron and Alicia H. Munnell, "Reassessing the Role for Wealth Transfer Taxes," *National Tax Journal* 45:2 (June 1992), pp. 119-43; and Christopher D. Carroll, "Why Do the Rich Save So Much?" in *Does Atlas Shrug?: The Economic Consequences of Taxing the Rich*.

³⁰See Laurence J. Kotlikoff and Lawrence H. Summers, "The Role of Intergenerational Transfers in Capital Accumulation," *Journal of Political Economy* 89:4 (1981), pp. 706-32; and John Laitner, "Simulating the Effects on Inequality and Wealth Accumulation of Eliminating the Federal Gift and Estate Tax," in *Rethinking Estate and Gift Taxation*.

³¹For the relationship between estate tax rates and labor supply, see Douglas Holtz-Eakin, "The Death Tax: Investments, Employment, and Entrepreneurs," *Tax Notes*, Aug. 2, 1999, pp. 782-92. For the relationship between inheritances and reduced labor supply, see Douglas Holtz-Eakin, David Joulfaian, and Harvey S. Rosen, "The Carnegie Conjecture: Some Empirical Evidence," *Quarterly Journal of Economics* 108 (1993), pp. 413-35.

³²Laitner, "Simulating the Effects on Inequality and Wealth Accumulation of Eliminating the Federal Gift and Estate Tax."

³³For the most recent examination of these various transfer motives and their effects on recipients, see William G. Gale and Maria G. Perozek, "Do Estate Taxes Reduce Saving?" in *Rethinking Estate and Gift Taxation*; and Louis Kaplow, "A Framework for Assessing Estate and Gift Taxation," from *Rethinking Estate and Gift Taxation*.

³⁴Partially on these grounds, and partially because they view inherited wealth as affirmative action for rich kids, libertarians have advocated raising estate tax rates to confiscatory heights. Irwin Stelzer, for one, has asked, "What economic or social purposes are served by preferential tax treatment that gilds the lily of birth?" Quoted in Albert R. Hunt, "Reform the Estate Tax, Don't Repeal It," *The Wall Street Journal*, June 8, 2000, p. A25. See also Irwin M. Stelzer, "Inherit Only the Wind," *The Weekly Standard*, Mar. 26, 1997, pp. 27-9.

1.5 percent of federal revenue. To put this amount in perspective, it nearly equaled the cost of the Earned Income Tax Credit; it surpassed the revenue lost to stepped-up basis at death; and it exceeded the cost of the HOPE scholarship credit by a multiple of 6, of the Lifetime Learning credit by a multiple of 12; of the research credit by a multiple of 16; and of the work opportunity credit by more than 100 times. Moreover, its revenue significance will continue to grow. The Congressional Budget Office has estimated that by 2010, estate and gift tax revenues will reach nearly \$50 billion per year, even though the exemption will steadily increase to \$1 million by 2006.

Notwithstanding its opponents' misleading claims, the estate and gift tax generates revenue that is hardly insignificant.

Critics of the estate and gift tax argue that it is inefficient, and yields far less revenue than proponents believe.³⁵ Some critics go so far as to say that repealing the estate and gift tax would "raise total tax revenue."³⁶ According to these arguments, the tax suffers from significant fraud and compliance problems, which, in turn, raise administrative costs. Cumulatively, these costs exceed revenue.

The evidence belies these claims. Charles Davenport and Jay Soled have concluded that costs associated with estate and gift tax planning and compliance add up to \$1.675 billion, or 6.4 percent of gross receipts. They estimate another 0.6 percent of revenues for IRS administrative costs, bringing the total costs to 7.0 percent of revenues.³⁷ With regard to avoidance specifically, recent work suggests that compliance rates for the estate and gift tax compare favorably with those for the income tax. Economist Brian Erard has found that tax avoidance associated with the federal estate and gift tax amounts to 13 percent of the total tax base, approximately the tax gap associated with the federal income tax.³⁸

Researchers have also debunked the myth of double- and triple-taxation. Admittedly, some of the wealth subject to the estate and gift tax has already been taxed

in one form or another. But one can hardly argue credibly that as a whole it represents "an unfair tax on income that has already been taxed."³⁹ Economists James Poterba and Scott Weisbenner found that for all households in 1998 (that is, for households which may or may not be subject to the estate tax), 37 percent of expected estate value at death was in the form of unrealized capital gains. In other words, 37 percent of expected aggregate estate value had not been taxed — ever. For estates with assets valued above \$10 million, more than 58 percent of the expected estate value is in the form of appreciated capital assets.⁴⁰ Charles Davenport reports even more incriminating data: Almost 75 percent of all wealth subject to the estate and gift tax is in the form of appreciated property.⁴¹ With these figures in mind, the estate and gift tax can be said to limit what already represents a significant loophole in the federal income tax basis step-up at death.⁴²

Finally, the available evidence indicates that the estate and gift tax raises contributions to the nonprofit sector. The deduction for charitable contributions, in combination with high marginal estate tax rates, increases charitable giving both during life (in anticipation of estate and gift tax liabilities) and at death (to avoid higher estate and gift tax levies). In 1997, more than 15,000 estates used the unlimited charitable deduction, donating more than \$14 billion.⁴³

The size of charitable contributions, moreover, rises faster than estate value. William Gale and Joel Slemrod report that in 1997 charitable contributions from estates valued below \$1 million amounted to 11 percent of deductions. For estates valued above \$20 million, by comparison, charitable contributions comprised 40 percent of deductions. As a percentage of gross estate, Gale and Slemrod show that charitable contributions increased from 3 percent for estates valued at below \$1 million to 28 percent for estates valued at above \$20

³⁹Feldstein, "Kill the Death Tax Now . . .," p. A14.

³⁵See B. Douglas Bernheim, "Does the Estate Tax Raise Revenue?" in *Tax Policy and the Economy*, edited by Laurence H. Summers 1 (1987): 113-138; George Cooper, *A Voluntary Tax?: New Perspectives on Sophisticated Estate Tax Avoidance* (Washington, D.C.: The Brookings Institution Press, 1979); and Alicia H. Munnell, "Wealth Transfer Taxation: The Relative Role for Estate and Income Taxes," *New England Economic Review* (November-December 1988): 3-28.

³⁶Martin Feldstein, "Kill the Death Tax Now . . .," *The Wall Street Journal*, July 14, 2000, p. A14.

³⁷Davenport and Soled, "Enlivening the Death-Tax Death-Talk," *Tax Notes*, July 26, 1999, p. 591-603.

³⁸Erard, "Estate Tax Underreporting Gap Study: A Report Prepared for the Internal Revenue Service Economic Analysis and Modeling Group," Order No. TIRNO-98-P-00406, Internal Revenue Service, 1998.

⁴⁰James M. Poterba and Scott Weisbenner, "The Distributional Burden of Taxing Estates and Unrealized Capital Gains at the Time of Death," from *Rethinking Estate and Gift Taxation*. In addition, Poterba and Weisbenner report that unappreciated capital gains for smaller estates overwhelmingly take the form of owner-occupied real estate. In fact, primary residences account for more than 90 percent of unrealized capital gains for households with net worth of less than \$500,000. For households with net worth of \$10 million and more, the corresponding figure is less than 4 percent. For these estates, the vast majority of unrealized capital gains are derived from business interests (75 percent for estates valued at more than \$10 million) and stock holdings (12 percent).

⁴¹Davenport, "The Search for Legacy: Estate Tax Repeal," p. 421.

⁴²For more on the relationship between transfer taxes and basis step-up at death, see James Poterba, "Estate and Gift Taxes and Incentives for *Inter Vivos* Giving in the United States," NBER Working Paper No. 6842, December 1998; and Poterba and Weisbenner, "The Distributional Burden of Taxing Estates and Unrealized Capital Gains at the Time of Death."

⁴³Lav and Sly, "Estate Tax Repeal: A Windfall for the Wealthiest Americans," p. 10.

million. Of the 329 estates with gross assets exceeding \$20 million, 182 reported charitable contributions at an average of \$41 million per estate.⁴⁴

The most recent research suggests that marginal estate tax rates significantly influence the scale and scope of these contributions. They also indicate that abolishing the estate and gift tax would reduce charitable bequests to the nonprofit sector. Treasury Department economist David Joulfaian estimates that for tax year 1997, if the estate tax had not been in effect, charitable bequests would have decreased by at least 12 percent, or \$1.7 billion.⁴⁵

These calculations surely underestimate the extent to which repealing inheritance taxes would reduce charitable giving. In addition to making bequests, individuals make charitable contributions while alive to reduce their ultimate estate and gift tax liability. In 1997, for example, 82,176 charitable remainder trusts, with more than \$60.5 billion in assets, were in existence. This tax device enables individuals to transfer assets into a trust, live off the trust income, and at death donate the remainder of the trust assets to charity without ever accounting for them as part of their taxable estate.⁴⁶

Anecdotal evidence, too, indicates that abolishing inheritance taxes would dry up charitable contributions. Philanthropist George Soros, well-schooled in the art of both giving and benefiting from tax-deductible contributions, argues, "Abolishing the estate tax would remove one of the main incentives for charitable giving."⁴⁷ And Leon Botstein, long-time president of Bard College, speaks from experience when he says, "Estate taxes have been a key impetus behind the creation of our major foundations. . . . Those of us who raise money on behalf of tax-exempt charities have learned that necessity [in the form of estate taxes] has been a reliable restraint on selfishness and an inspiration to civic duty." Not only do estate taxes increase charitable giving. They also encourage wealthy individuals to "devote part of their wealth to the public good."⁴⁸

Thus, the economic case for repealing the estate and gift tax falls just as flat as the political case for repeal.

⁴⁴See Gale and Slemrod, "Rethinking the Estate and Gift Tax: Overview," p. 7; and Gale and Slemrod, "Resurrecting the Estate Tax," p. 6. For additional evidence that the estate and gift tax positively effects charitable contributions, see Gerald Auten and David Joulfaian, "Charitable Contributions and Intergenerational Transfers," *Journal of Public Economics* 59:1 (1996): 55-68.

⁴⁵David Joulfaian, "Estate Taxes and Charitable Bequests by the Wealthy," NBER Working Paper 7663, April 2000; and David Joulfaian, "Charitable Giving in Life and at Death," from *Rethinking Estate and Gift Taxation*.

⁴⁶Lav and Sly, "Estate Tax Repeal: A Windfall for the Wealthiest Americans," p. 10.

⁴⁷Soros, "Kill the Death Tax Now. . . . No Keep It Alive to Help the Needy," p. A14.

⁴⁸Botstein, "America's Stake in the Estate Tax," *The New York Times*, July 23, 2000, Week in Review, p. 15.

Inheritance taxes certainly influence behavior.⁴⁹ But not as adversely as critics suggest. In fact, as we have seen, preserving transfer taxes provides benefits that accrue to a wide swath of society. To fully debunk the case against the estate and gift tax, however, we must address the question of whether or not inheritance taxes are immoral, particularly because its fiercest critics have argued that the case against the estate tax "is not an economics-based case"; rather, it is "primarily a moral case."⁵⁰

The Moral Case for the Estate and Gift Tax

Many of the individuals who argue against inheritance taxes on moral grounds operate from the basis that taxation is fundamentally a moral issue. I agree. Tax policymaking in the United States has historically involved both social and economic factors. From the founding of the republic, Americans have used the tax system to regulate economic privilege, and to restore equitable income and wealth distributions. Tax justice "American-style" has measured relative societal burdens against relative societal benefits, and it has reflected prevailing notions of social and economic justice. Since World War II, tax policymakers, particularly economists, have ceded the social justice and distributive aspects of taxation to legal scholars and philosophers. Despite this unfortunate trend among theorists, tax issues still involve moral and normative considerations.⁵¹

However right these individuals are to emphasize the moral underpinnings of taxation, they are wrong to attack the estate and gift tax as immoral.

However right these individuals are to emphasize the moral underpinnings of taxation, they are wrong to attack the estate and gift tax as immoral. Their argument goes something like this. Inheritance taxes add to the pain and suffering of grieving heirs. It penalizes frugal savers. It discourages successful individuals and families from passing along hard-earned wealth to

⁴⁹The work of economist David Joulfaian lends historical evidence to this assertion. He finds that the sharp increase in gift tax receipts for tax year 1977 coincided with increased gift tax rates that were to go into effect beginning in tax year 1978. See Joulfaian, "The Federal Estate and Gift Tax: Description, Profile of Taxpayers, and Economics Consequences," Office of Tax Analysis, Paper 80 (December 1998). William Gale and Joel Slemrod suggest analogous explanations for abnormal gift tax receipts in 1935, 1936, and 1942. See Gale and Slemrod, "Rethinking the Estate and Gift Tax: Overview," p. 15.

⁵⁰McCaffery, "In Favor of Repeal," p. 1378. Emphasis in the original.

⁵¹For a more thorough treatment of the moral considerations surrounding tax policy, including the above-mentioned post-World War II effort to separate the overtly moral and normative aspects of taxation from tax policymaking, see Joseph J. Thorndike III and Dennis J. Ventry Jr., eds., *Tax Justice for the 21st Century: Reconsidering the Moral and Ethical Bases of Taxation* (Washington, D.C.: Urban Institute Press, forthcoming).

their children. And it encourages Americans to “die broke.”⁵²

Implicit (and sometimes explicit) in the argument is the objection that inheritance taxes impact the wrong people. That is, they fall on savers not spenders. Abolishing the estate and gift tax, it is said, would be the morally right thing to do based on the presumption that a liberal, democratic society should care about enhancing future generations, and removing inequitable consumption patterns.

This conclusion is simply untenable. First, the fact that we care about our children does not make estate taxation immoral, anymore than the fact that we care about what we consume makes consumption taxes immoral. Or as law professor Richard Schmalbeck suggests, “There is nothing immoral in consuming food, clothing, shelter, medical care, and education for the benefit of oneself and one’s family.”⁵³ We may consider excessive consumption immoral, but that consideration is merely a matter of taste. One person’s excessive consumption is another person’s level of subsistence. Reasoning for repeal of the estate and gift tax on the basis that consumption is morally bankrupt is itself a morally ambiguous presumption.

Second, the estate and gift tax is hardly immoral from the standpoint that it subverts the values of a liberal democratic state. On the contrary, it reinforces the philosophical foundations of the very first liberal democratic state, the United States. As historians and political philosophers have shown, the founding fathers worried that political equality would conflict with individual liberty. They reconciled this tension through the concept of “republicanism,” which embodied the ideal of civic virtue. Republicanism, with its emphasis on communal responsibilities, mitigated excessive economic liberties as well as the “tyranny of the majority.” That is, republicanism struck a balance between the right to property (or Lockean liberalism) and democratic ideals of equality.⁵⁴

⁵²For “die broke,” see McCaffery and Wagner, “A Bipartisan Declaration of Independence From Death Taxation,” p. 805. An assortment of individuals have made these claims. Earlier in this report, we witnessed how some politicians have characterized the estate and gift tax as immoral (calling it “the wrecking ball of a life’s worth of achievement and success,” “confiscatory,” and “unfair”). For academic work on the subject, see Edward J. McCaffery, “Grave Robbers: The Moral Case Against the Death Tax,” *Tax Notes*, Dec. 13, 1999, p. 1429 (equating the estate and gift tax with exhuming the dead). And for testimony from “average” Americans, see Art Linkletter, host of the television show, “Kids Say the Darndest Things,” quoted in *The Boston Sunday Globe*, May 7, 2000, p. G17 (asking, “Why should people who’ve spent their lives trying to assemble something have it all taken away when they pay taxes on it all the way through?”).

⁵³Richard Schmalbeck, “Estate Tax Debate Is No Slouch Either,” *Tax Notes*, Aug. 21, 2000, p. 1060.

⁵⁴For an introduction to the concept of republicanism and its influence on the political economy of the early U.S. republic, see Joyce Appleby, *Liberalism and Republicanism in the Historical Imagination* (Cambridge, Mass.: Harvard University Press, 1992), and Drew R. McCoy, *The Elusive Republic: Political Economy in Jeffersonian America* (New York: Norton, 1982).

With regard to taxation, this compromise resulted in a tax system that taxed wealthy individuals despite a national aversion to infringements on individual liberty. The state protected individuals who pursued personal wealth and property through labor and reason. But the state prevented individuals from asserting entitlement through birth. That is, it tolerated persons who created wealth, but not those who inherited it; the latter reflected the distinguishing characteristic of an aristocratic society.⁵⁵

In this spirit, Congress created a federal wealth transfer tax in 1797 to help pay for American naval buildup against France, with whom the nascent United States was at war. The new tax was levied on receipts for legacies and probates for wills. Congress abolished the tax in 1802, but continued to search for alternative ways to use taxation to represent republican ideals.

Early federal and state legislators employed taxation to restrict privilege (by taxing corporate charters, for example), and to “affirm communal responsibilities, deepen citizenship, and demonstrate the fiscal virtues of a republican citizenry.”⁵⁶ The emphasis on communal responsibilities created a unique form of ability-to-pay taxation that was hostile to excess accumulation. The U.S. constitution restricted the federal government from levying direct, nonuniform taxes thereby limiting its ability to promote distributive forms of taxation. States faced no such restriction, however, and actively used the tax system to prevent aristocratic concentrations of wealth. State governments taxed property at a flat, ad valorem rate, for example, believing that high-income individuals spent a larger share of their income on land and property than low-income persons. Throughout the first half of the nineteenth century, states expanded their use of the general property tax to include both tangible property (land, equipment, household goods) and intangible property (cash, credits, stocks, mortgages). By including intangible property, states increased the percentage of taxes paid by wealthy citizens, and raised their aggregate contribution to both the community and the government. Several states even experimented with income taxes before the Civil War “with the avowed purpose of removing inequalities in the tax system,” and increasing the civic role of its wealthy residents.⁵⁷

⁵⁵Leon Botstein has recently alluded to the moral significance of preventing inherited wealth from passing freely from generation to generation. See Botstein, “America’s Stake in the Estate Tax,” p. 15. Others commentators, too, have perceived the moral justifications for preserving the estate and gift tax. For example, Alan Wolfe, director of the Center for Religion and American Public Life at Boston College, looks to the philosophy of Immanuel Kant, and argues that social justice suggests passing inheritances along to society, not to heirs. See Wolfe, “The Moral Sense in the Estate Tax Repeal,” *The New York Times*, July 24, 2000, p. A23.

⁵⁶W. Elliot Brownlee, “Historical Perspective on U.S. Tax Policy Toward the Rich,” in *Does Atlas Shrug?: The Economic Consequences of Taxing the Rich*.

⁵⁷Roy G. Blakey, “The New Income Tax,” *American Economic Review* 4:1 (March 1914), pp. 25-46.

In this historical context, wealthy individuals owed a debt to society. Their success depended on the ability of the society in which they lived to sustain economic and political order. Certainly, these individuals created wealth. But they also benefited from the system in which they operated. These obligations were not lost on subsequent generations. At the end of the 19th century, Populists and Progressives aggressively advocated a graduated federal income tax on the grounds that it could reach what were perceived to be inequitable concentrations of economic power. In 1906, President Theodore Roosevelt, while arguing for a graduated inheritance tax and a progressive income tax, stated, "The man of great wealth owes a peculiar obligation to the State, because he derives special advantages from the mere existence of government."⁵⁸ In 1916, Congress argued that the newly enacted federal estate tax made the revenue system "more evenly and equitably balanced" by obtaining a "larger portion of our necessary revenues" from the "inheritances of those deriving most protection from the government."⁵⁹ And in 1942, President Franklin Roosevelt proposed capping after-tax incomes at \$25,000.

Theodore Roosevelt stated, 'The man of great wealth owes a peculiar obligation to the State, because he derives special advantages from the mere existence of government.'

Perhaps these words and proposals seem strangely divorced from our own time, aberrations from a more idealistic era. But the fundamental moral imperatives they represent still resonate. The ideal of a virtuous citizenry, animated by civic duty, remains at the heart of American political culture. We tolerate deviations from this norm, to be sure, but only because they are checked by countervailing forces of equal opportunity. Abolishing the estate and gift tax could jeopardize the delicate balance between individual liberty on the one hand and equality of opportunity on the other. Indeed, as Leon Botstein argues, "[I]f inheritance taxes are eliminated, the historic and unique character of American society and culture will be placed in jeopardy." Worse, according to Botstein, it could instigate social unrest. Abolishing the estate and gift tax "after decades marked by the unparalleled accumulation in wealth and a widening gap between the poor and rich,

might trigger an unwillingness by Americans to continue to accept equality of opportunity as a surrogate for actual material equality."⁶⁰

Regardless whether one subscribes to Botstein's prediction, the moral foundation of inheritance taxes cannot be denied. Repealing the estate and gift tax would confer advantages on individuals "who may not have demonstrated any other skill than that of choosing affluent parents."⁶¹ Moreover, it would distort long-standing notions of fairness, equal opportunity and communal responsibility. Most important, it would subvert American democracy and its historical rejection of aristocratic wealth accumulation.

Conclusion: Reform, Not Repeal

This report has defended the estate and gift tax on political, economic, and moral grounds. In conclusion it recommends several improvements to the tax designed to further entrench it as the most progressive federal revenue instrument, and to reconcile it with prevailing perceptions of wealth accumulation.

Raising the effective exemption, for one, would make it impossible for critics to claim that transfer taxes threaten the future of family farms and businesses in America. Moreover, removing the "lesser" rich from the estate-tax rolls would all but remove the critics' poster children from the grip of transfer taxes. "Without small businesses and farmers in the mix," economist Martin Sullivan has argued, "the momentum the Republicans now have on estate taxes would stall. And their efforts to repeal the estate tax would crash."⁶²

Raising the exemption would not be hard. In fact, it is scheduled to increase steadily over the next few years, from \$675,000 per person in 2000-2001 to \$1 million in 2006. Moreover, Congress recently demonstrated a willingness to accelerate raising the cap on exemption levels. Throughout the last legislative session, various congressional members from both parties proposed legislation designed to increase the effective exemption over several years between \$2.5 million and \$10 million.⁶³ In addition, the Democratic House sub-

⁵⁸Botstein, "America's Stake in the Estate Tax," p. 15.

⁶¹Gale and Slemrod, "Rethinking the Estate and Gift Tax: Overview," p. 23.

⁶²Martin Sullivan, "Estate Tax Compromise or Repeal: The Rich Versus the Super Rich," *Tax Notes*, July 17, 2000, p. 298 at 300.

⁶³The plans included (but were not limited to): H.R. 4111, Rep. Thomas W. Ewing, R-Ill., increase unified credit over four years to \$10 million, and index it for inflation thereafter, cosponsored by Ways and Means members, Phil English, R-Pa., and Jerry Weller, R-Ill.; H.R. 4324, Rep. Collin C. Peterson, D-Minn., increase the unified credit to an exclusion equaling \$2.5 million, and apply capital gains rate to taxable estates; H.R. 4562, Rep. Bob Etheridge, D-N.C., increase the maximum estate tax deduction for family-owned business interests to \$4 million by 2005, and index for inflation; H.R. 5058, Rep. James A. Leach, R-Iowa, lower estate and gift taxes to 30 percent and increase unified credit to \$10 million; S. 2717, Sen. Charles E. Schumer, D-N.Y., increase the estate tax deduction for family-owned business interests over the next seven years to \$5,375,000.

⁵⁸Theodore Roosevelt, *Congressional Record* 41 (Dec. 4, 1906), p. 27.

⁵⁹Quoted in "Message from the President of the United States Transmitting Request for a Revision of the Tax Laws," from U.S. Congress, House, *Revenue Revision of 1950*, Volume 1, Hearings before the Committee on Ways and Means, 81st Congress, 2nd Session (Washington, D.C.: Government Printing Office, 1950), p. 5.

stitute to H.R. 8 would have immediately increased the \$1.3 million exclusion for farms and closely held businesses to an effective \$4 million exclusion per family; and the Democratic Senate substitute (in addition to the House changes) would have immediately raised the exemption for all individuals to \$2 million, and for all married couples to \$4 million.⁶⁴ Most recently, the Democratic “Blue Dog” coalition proposed immediately doubling the exemption, and then raising it to \$4 million over several years.⁶⁵

Increasing the exemption would also make good policy. First, it would more accurately reflect American society’s rapidly changing perception of wealth. Specifically, it would accommodate higher modern thresholds regarding what is and what is not excessive wealth accumulation. One plausible explanation for why so many Americans favor repealing the estate and gift tax, despite the fact that less than 2 percent of estates pay inheritance taxes, is that “attitudes about wealth are clearly changing as more Americans either experience it, or hope to do so in the future.”⁶⁶ That is, not only do more Americans feel that it is okay to be wealthy. They also believe in the dream of achieving wealth. The estate and gift tax threatens that dream. Raising the effective exemption would remove the threat.⁶⁷

Meaningful reform of the estate and gift tax would involve more than raising exemption levels. It would also improve horizontal equity by broadening the tax base, removing distortions, and lowering marginal rates. Some of the most obvious reforms include eliminating valuation discounts on passively held assets, abusive trust devices, and tax-motivated expatriation. The tax could be simplified further by abolishing the complicated family-owned business interest qualification requirements, and by removing abnormalities in the rate structure (such as the “bubble-bracket” of 60 percent). In addition, any changes to exemption levels should be indexed for inflation. More nuanced reform could complement the effort to prevent family enterprises from experiencing harsh estate tax obligations by increasing the number of

partners in firms, for example, for the purpose of qualifying as an interest in a closely held business that would be eligible for deferral and installment payment of the estate and gift tax.

All of these reforms could be implemented without damaging the progressivity of the tax. In fact, raising the exemption would increase progression, an arguably laudable policy goal during the decades-long trend toward greater income and wealth inequalities.⁶⁸ In 1997, 5.4 percent of taxable estates reported gross estate values of more than \$5 million. These estates comprised 43 percent of total gross estate and more than half of all transfer tax revenues.⁶⁹ Raising the exemption to \$5 million would make the estate and gift tax more sharply progressive while still generating significant amounts of revenue. Equally important, it would reflect the tax’s original moral purpose of limiting concentrations of inherited wealth.⁷⁰

Critics believe the estate and gift tax is already too progressive. When referring to the U.S. transfer tax, editors at *The Economist* recently opined, “‘Soaking the rich’ is not a principle of good taxation.”⁷¹ Indeed, not. But determining whether the current estate and gift tax — or even a reformed estate and gift tax — can be considered representative of “soak-the-rich” taxation is open for debate. It is both an economic and a moral question. So, too, is it a political question. Some researchers might prefer to leave these issues to empiricists in the interest of “objectivity” and “scientific rigor.” But as we have seen, the debate over the estate and gift tax involves normative considerations that do not lend themselves to scientific inquiry alone. Rather, they require analytical, theoretical, and political inputs. The ultimate fate of transfer taxes in the United States will be decided in the political arena. Economics will certainly inform the debate. But so will political grandstanding, rhetorical slights of hand, and moral philosophizing.

Participants in the next round of debates over the future of the estate and gift tax will serve an educative

⁶⁴For the two substitute bills, see Sullivan, “Estate Tax Compromise or Repeal: The Rich Versus the Super Rich,” p. 299.

⁶⁵Warren Rojas, “Tanner, Blue Dogs Throw Estate Tax Relief a Lifeline,” *Tax Notes*, Oct. 2, 2000, p. 47. The Blue Dog coalition is a group of congressional Democrats committed to a 10-year national budget that allocates spending according to a 50-25-25 plan, with 50 percent of the on-budget surplus going toward debt reduction, 25 percent toward targeted tax cuts, and 25 percent toward discretionary spending.

⁶⁶Schlesinger and Kulish, “As Paper Millionaires Multiply, Estate Tax Takes a Public Beating,” p. A1.

⁶⁷Martin Sullivan sees similarities between the public clamor to repeal the estate and gift tax and the effort to reform the alternative minimum tax. Although both were “only intended for the rich,” Sullivan argues, “as time marches forward, more and more middle-income taxpayers who never gave the individual AMT or the estate tax a second thought are getting blindsided by a tax system with which they have had no prior experience.” Sullivan, “The Estate Tax and the New Economy,” *Tax Notes*, Jan. 31, 2000, p. 583 at 585.

⁶⁸For patterns of income and wealth inequality, see Joel Slemrod and Jon Bakija, “Does Growing Inequality Reduce Tax Progressivity? Should It?” NBER Working Paper No. 7576, March 2000; Edward N. Wolff, “Recent Trends in Wealth Ownership,” Jerome Levy Economics Institute Working Paper No. 300, April 2000.

⁶⁹Gale and Slemrod, “Rethinking the Estate and Gift Tax: Overview,” Table 1.

⁷⁰Critics of the estate and gift tax have argued that in addition to its other shortcomings, the tax has not curbed rising wealth inequalities, and therefore should be abolished. But as Gale and Slemrod correctly observe, “[T]he real question is whether concentration of wealth is lower than it would be without the tax.” Clearly, the answer is yes. For the estate and gift tax as progressive, see Poterba and Weisbenner, “The Distributional Burden of Taxing Estates and Unrealized Capital Gains at the Time of Death,” p. 5 (“The estate tax is highly progressive.”); and Gale and Slemrod, “Rethinking the Estate and Gift Tax: Overview,” p. 18 (“Most estimates suggest that it is the most progressive federal tax.”). See also Aaron and Munnell, “Reassessing the Role for Wealth Transfer Taxes.”

⁷¹Editors, “Death and Taxes,” p. 80.

role. And they will have to account for inputs other than their own if they wish to successfully defend their position. In July, at the height of congressional squabbles over transfer taxes, the editors at *Commonweal* argued that “repealing the estate and gift tax is an idea that should be resisted on political, fiscal, and moral grounds.”⁷² The debate is multi-faceted. To be heard will require an understanding of not just the revenue or behavioral effects of inheritance taxes, but also their political, social, and moral ramifications.

Those of us who wish to preserve the letter as well as the spirit of transfer-tax law have some ground to

make up. Whether through empirical research, surveys of the literature, opinion pieces, congressional testimony, policy briefs, or radio appearances, proponents have an obligation to clarify the misrepresentations that surround the estate and gift tax. Only through education will the debate move forward, characterized by reality instead of rhetoric. Indeed, only through education will all Americans — experts, average citizens, and elected officials — feel compelled to participate in the discussion over the future of transfer taxes, and thus, over the meaning of citizenship in a modern democratic state.⁷³

⁷²Editors, “The Cost of Democracy,” *Commonweal*, July 14, 2000, p. 5.

⁷³Advocates of the estate and gift tax might heed the implicitly educative advice of Paul Krugman. “If middle-class Americans had any realistic sense of how rich the rich really are,” Krugman predicts, “policy moves that cater specifically to the wealthy — like the repeal of the inheritance tax — would face a much rougher ride.” We can only hope.

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