Wealth, Mobility, Inheritance and the Estate Tax

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Executive Summary

The federal estate tax has been instituted and repealed several times. Usually it has been seen as a source of revenue, rather than a means of redistributing wealth. But the current tax is clearly designed to redistribute wealth: it is imposed on estates with a value of as little as $675,000 and rises rapidly to an effective tax rate of 60 percent — the second highest estate tax rate of any country in the world.

Yet the estate tax does less to redistribute wealth than the continual churning of the American economy. Because wealth and income are both highly mobile in the United States, most fortunes are earned, rather than inherited, and rarely survive past the second generation.

- One study found that among the top 5 percent of households ranked by wealth, inheritances accounted for less than 8 percent of assets.
- A recent study of U.S. millionaires found that 80 percent acquired their wealth in a single generation, without the benefit of inheritances.
- U.S. Trust Corporation surveyed the wealthiest 1 percent of Americans and found that inheritances were a significant source of wealth for only 10 percent of respondents.

However, to the extent that the estate tax reduces parents' ability to leave an estate to their children, it will have a negative effect on their willingness to accumulate wealth through work, saving and investing.

Through expensive estate planning, the very wealthy are able to minimize their estate tax burden; consequently the heaviest burden falls on those who accumulate smaller estates. As a result, more than 50 percent of all estate tax revenue in 1997 came from estates of under $5 million. In fact, the effective tax rate is lower on estates above $20 million than on those between $2.5 million and $20 million.

For these reasons, the greatest impact of the estate tax is on small, family-owned farms and businesses. The effects can be devastating. According to a recent survey:

- Fifty-one percent of family businesses would have significant difficulty surviving in the event of a principal owner's death, due to the estate tax.
- Another 14 percent of businesses said it would be impossible for them to survive.

As the nation's wealth rises, more and more of those clearly in the middle class are affected by the estate tax, or at least believe that they might be. Thus, although just 2.03 percent of adult deaths in the United States are expected to result in taxable estates this year, the public supports elimination of the estate tax by a margin of almost three to one.

The wealthy benefit society in many ways, and the pursuit of wealth — including the desire to pass it on after death — is a major motivation for work, saving, investment, risk-taking, invention, innovation and entrepreneurship for many of our most productive citizens. In the process of acquiring their wealth, they create far more wealth for society.

Not only should the estate tax be abolished, but the war on wealth should cease.

I take it that it is best for all to leave each man free to acquire property as fast as he can. Some will get wealthy. I don't believe in a law to prevent a man from getting rich; it would do more harm than good.

Abraham Lincoln
March 6, 1860

You ought to be able to leave your land and the bulk of your fortune to your children and not to the government.

Hillary Rodham Clinton
April 26, 2000

Introduction

"The simple existence of wealth is economically of great importance."

While there are many economists and philosophers who have defended the right to become wealthy, few have defended wealth per se. But in fact, the simple existence of wealth is economically of great importance, quite apart from the familiar need for society to accumulate capital for investment. Wealth and the inequality it breeds are actually central to the functioning of our entire economic system. As Texas A&M University economist Finis Welch recently put it:[1]

> It is not much of an exaggeration to say that all of economics results from inequality. Without inequality of priorities and capabilities, there would be no trade, no specialization, and no surpluses produced by cooperation.

Consider the simple fact that many of the appliances and other conveniences that almost all Americans own would not have come into existence if there weren't rich people to buy them in the first place. It is easily forgotten that things like televisions, VCRs, microwave ovens, home computers and wireless phones, most of which are now owned by almost all middle class Americans — and even a significant number of those officially classified as poor — were not too long ago luxuries so expensive that only the very rich could afford them.

The first color televisions cost $1,000 in 1954, or $6,660 in 1997 dollars, requiring 562 hours of labor by a typical worker to buy.[2] Today, of course, almost all TVs are color and cost a fraction as much. In 1997, one could buy a 25-inch RCA color set for $299, or about 23 hours of labor. Furthermore, a 1997 model was far better in quality than its 1954 version. [See Figure I.]

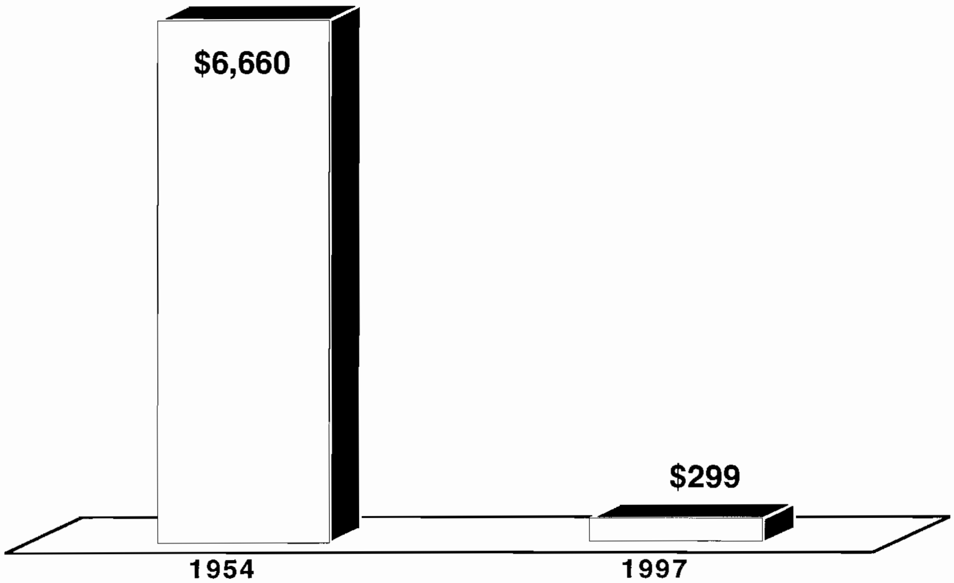
Even more dramatic is the computer. In 1970, it would have cost close to $5 million to buy a computer that was capable of performing 12.5 million

"Without 'rich' people to buy the first television sets, cheap ones would not be available to the masses today."

FIGURE I

Cost of a Color Television Set

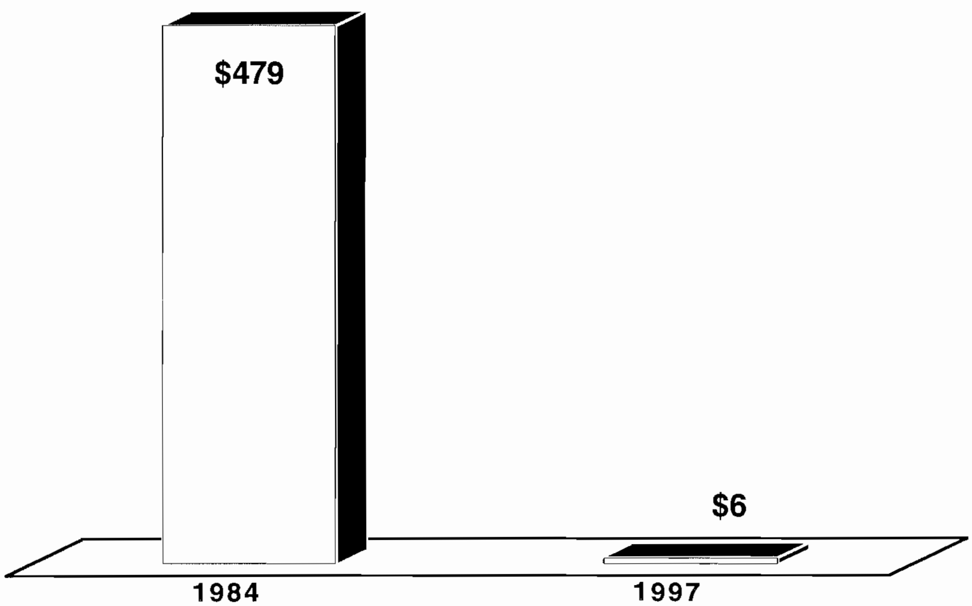
(1997 dollars)



Source: W. Michael Cox & Richard Alm, *Time Well Spent: The Declining Real Cost of Living in America* (Dallas: Federal Reserve Bank of Dallas, 1997).

Cost of Home Computers

(per million instructions per second)



"In effect, the rich underwrite the cost of bringing new products to market."

Source: W. Michael Cox & Richard Alm, *Time Well Spent: The Declining Real Cost of Living in America* (Dallas: Federal Reserve Bank of Dallas, 1997).

instructions per second (MIPS). This works out to almost $400,000 per MIPS. Such computers were, of course, available only to governments, universities and large corporations. Not even the richest American would have considered buying one for home use. By 1984, the cost of computers had fallen to within reach of the modestly well-to-do. A computer able to perform 8.3 MIPS could be had for about $4,000, or $479 per MIPS. In 1997, a good home computer capable of performing 166 MIPS could be had for less than $1,000, or $6 per MIPS. At such a price, even children could have computers with more power than all the computers on earth when their parents were born.

The point is that unless there were "rich" people out there willing to buy those $1,000 TVs in 1954 or the $4,000 computers in 1984, there would be no businesses producing such products for the masses today. Someone had to be willing and able to pay a seemingly exorbitant price to be the first to have the latest gadget. The profits made from selling these high-priced gizmos are what paid for the research and development and the capital investment needed to bring the first one to market. They also attracted competitors and other businesses that made the products cheaper and more valuable still. After all, what would television be without programming or computers without software?

"The unequal distribution of wealth was tolerated because equality of opportunity prevailed widely."

In a sense, therefore, the rich perform a public service when they engage in what sociologist Thorstein Veblen called "conspicuous consumption." They are in effect underwriting the cost of bringing new products to market that ultimately become ubiquitous, available even to the hoi polloi. Since it's not much fun to be rich if even the riffraff can enjoy the same products, the rich aid innovation by pushing the limit of what is possible, encouraging producers to meet their demands in return for large profits. For example, now that everyone has a color TV, the rich are buying high-definition televisions at $5,000 or more each. It may well be that 10 years from now such sets will be standard in every middle-class home. But unless someone buys them today, it won't happen.

Wealth is Tenuous in America

Wealth in America has always been distributed highly unequally, perhaps even more so before the Civil War than today.[3] This concentration of wealth was tolerated, however, because equality of opportunity prevailed widely. This meant that there was great mobility in and out of wealth. Alexis de Tocqueville noted that "the rich are constantly becoming poor" and "the rich daily rise out of the crowd and constantly return thither."[4]

Wealth Mobility in the 19th Century. Some recent scholarship suggests that wealth mobility was less than de Tocqueville thought.[5] However,

- A study of the late 1800s found that 82 percent of millionaires were "nouveau riche" and only 18 percent inheritors.[6]

- Another study found that there was substance to the "Horatio Alger" myth — a significant share of successful 19th century entrepreneurs had disadvantaged childhoods and overcame adversity.[7]

- In any case, there is no question that the perception of mobility was widespread and a key reason why government redistribution policies were unpopular in the 19th century.[8]

Wealth Mobility Today. However much or little mobility there was in 19th century America, there is little doubt that it was far greater than in Europe. Indeed, this still appears to be the case.[9] A study comparing the United States and Great Britain in the 1950s found that while income was distributed similarly in the two countries, wealth was distributed far more unequally in Britain.[10] Furthermore, it appears that inheritances play a larger role for those with great wealth in Britain than in America.[11] Research also shows that wealth is much more equally distributed in the U.S. than in Europe, Latin America and Asia.[12]

"Fortunes rarely survive past the second generation."

Recent data on mobility tend to support de Tocqueville's observation that fortunes rarely survive past the second generation. Moreover, the data show that inheritances continue to play a small role among the wealthiest Americans. A significant percentage of the largest American fortunes were accumulated in a single generation. To some extent this is due to the changing landscape of America's largest businesses, which have also undergone major churning.

Income and wealth mobility is unambiguously good because it mitigates inequality.[13] While there is a large literature on income mobility, there is much less on wealth mobility. The data show that incomes are highly mobile, with many of the rich becoming poor and many of the poor becoming rich within relatively short periods of time.[14] The more limited data on wealth indicate that its mobility is on the same order of magnitude as that of income:[15]

- A comparison of families between 1966 and 1976 found that 35.5 percent increased by at least one decile of wealth (one-tenth) and 18 percent moved up at least 2 deciles.

- Over the same period, 34.6 percent moved down at least one decile and 17.9 percent moved down at least 2 deciles.

A study of families between 1984 and 1994 found that:[16]

- 60 percent of families in the bottom decile of wealth the first year had reached a higher decile 10 years later.

- Of these, 40 percent jumped one decile, 26 percent rose two deciles and 11 percent leaped three deciles.

- An amazing 23 percent went up four or more deciles, with 1.42 percent rising from the lowest decile to the highest.
- Only 47 percent of those in the top decile in 1984 were in a lower decile 10 years later.
- However, about 10 percent fell more than three deciles and a few ended up all the way down in the bottom decile.

Sources of Wealth. Virtually all research shows that inheritances are insignificant as a source of major wealth in America. A 1961 survey found that:[17]

- Among the affluent, only 6 percent acquired most of their assets from gifts or inheritances.
- Sixty-two percent of the affluent reported no inheritances whatsoever.
- The vast bulk of wealth arose from saving and an increase in the value of assets.

Another study found that among the top 5 percent of households ranked by wealth, inheritances accounted for less than 8 percent of assets. [See Figure II.] The study concluded that "wealth inequality is largely the same when the direct effects of financial inheritances are removed."[18]

A recent study of U.S. millionaires found that 80 percent acquired their wealth in a single generation, without the benefit of inheritances.[19]

"Entrepreneurship is key both to the concentration of wealth in America and the high degree of mobility in and out of wealth."

U.S. Trust Corporation surveyed the wealthiest 1 percent of Americans and found that inheritances were a significant source of wealth for only 10 percent of respondents. Earnings from a privately owned business were the dominant source of wealth (46 percent), followed by earnings from corporate employment (33 percent) and earnings from a professional practice (29 percent).[20]

A study of the *Forbes* 400 in 1986 identified 265 separate fortunes among this group. Of these, 108 were inherited to some degree while 157 represented new wealth.[21] The latest data show 149 of the 400 having inherited some or all of their wealth, with 251 being self-made.[22]

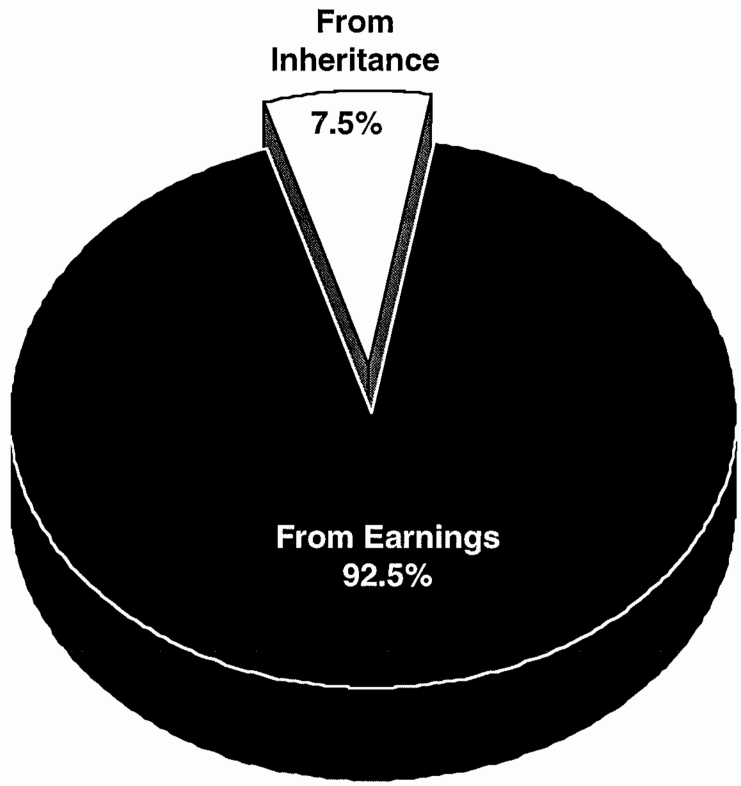
Causes of Mobility. Entrepreneurship is key both to the concentration of wealth in America and the high degree of mobility in and out of wealth. Entrepreneurs gain and lose wealth faster than workers.[23] Hence, a consequence of having a high degree of entrepreneurship, which all economists agree is essential to growth, is necessarily going to be a higher degree of wealth concentration, though mitigated by a higher degree of mobility as well.

Many factors explain why wealth tends not to perpetuate itself in the U.S. A key one simply is the dynamics of the American economy. Businesses and industries that are dominant at one time frequently lose their foot-

"Inheritance accounts for very little of the wealth of the richest Americans."

FIGURE II

Source of Wealth for Wealthiest 5 Percent of Americans



Source: James P. Smith, *Unequal Wealth and Incentives to Save* (Santa Monica, Calif.: Rand Corporation, 1995), p. 16.

ing and fall from grace. Consequently, fortunes based on declining businesses and industries soon dissipate, replaced by those based on newer, rising enterprises like companies exploiting the Internet today.

Not surprisingly, few of 1917's top companies are still among the top today; only AT&T is on both lists.[24] But the churning is also considerable over shorter periods. Only nine of 1969's 25 largest companies (by market capitalization) were still ranked as such in 1999. Indeed, many of today's largest companies didn't even exist 30 years ago — or even 10, as in the case of Yahoo![25]

In addition to the churning of industry, many other factors explain the fact that wealth is frequently dissipated, and why nouveaux riches are consistently able to break into the ranks of the wealthy. One is that rich men tend to marry younger women who outlive them, eventually consuming the family fortune. The sons and daughters of the wealthy often show no interest in running the family business or lack the skill to do so well. Finally, a not insignificant number of the rich die childless or leave their fortunes to charity.[26]

Consequences of Mobility. Whatever the reason, it is clear that very few great fortunes last more than two generations. Even the Rockefeller fortune, perhaps the greatest of all time, has been broken into so many pieces and been so depleted by charity and bad investments that little of it remains.[27]

The Question of Inheritance

Historically, providing for one's family after death was considered something laudable. The Bible says, "A good man leaves an inheritance to his children's children."[28] Nobel laureate F.A. Hayek noted that the transmission of assets after death is part of the family's role in transmitting society's standards and traditions.[29] Parents often use the promise of a bequest to influence the behavior of their children. They also use bequests to equalize the well-being of their children.[30] In this sense, inheritances are redistributive, aiding in the equalization of wealth.[31]

"The desire to leave an estate is one of the primary motivations for working and saving."

The desire to leave an estate is one of the primary motivations for working and saving later in life. To the extent that the estate tax reduces a parent's ability to leave an estate to his children, it will have a negative effect on his willingness to accumulate wealth through work, saving and investing.[32] Curtailment of inheritance will also erode family ties.[33]

The Right to Inherit. The right to private property would seem to include the right to give one's assets to whomever one pleases, including to one's children after death. The problem arises, however, that once one is dead, one's property rights cease. Rights are only for the living. Consequently, it has generally been held that there is no right to inheritance. In the words of John Stuart Mill: "Although the right of bequest, or gift after death, forms part of the idea of private property, the right of inheritance, as distinguished from bequest, does not."[34]

A long line of Supreme Court cases have upheld the right of the state to control or even abrogate the ability to transfer assets after death. As one commentator recently stated, "There is no right of inheritance in the United States Constitution. Congress could, therefore, theoretically abolish inheritance."[35]

The Right to Make Gifts. The right to make gifts during one's lifetime is much stronger. Gifts are also much harder to tax as a practical matter.[36] Moreover, the most valuable gift a parent gives a child is in the form of human capital, which is a perfect substitute for financial bequests.[37] No gift tax applies to education expenses, no matter how large they might be.[38] Given the immense and growing importance of education to one's long-term income, this factor alone may be the single most important means of transferring wealth from one generation to the next for most middle and upper-middle class families.[39]

The Desirability of Inheritance. Despite the fact that inheritances play a small role in the perpetuation of wealth in America, there are still those who oppose inheritance on principle.[40] They harken back to Plato, who advised, "Let no man covet wealth for his children's sake, that he may leave them in opulence; 'tis not for their own good nor for the state's."[41] It is also worth noting that the third plank of *The Communist Manifesto* says that the right of inheritance should be abolished.

Even the wealthy sometimes have supported the abolition of inheritance. In a famous essay, Andrew Carnegie[42] said that "he who dies possessed of enormous sums ... will die disgraced." The aim of the wealthy, he said, should be to die poor, having given away the bulk of their assets, as Carnegie himself did. Not only would the philanthropy benefit society, it would also prevent the corruption of offspring who would otherwise inherit the wealth. Said Carnegie:

> That the parent who leaves his son enormous wealth generally deadens the talents and energies of the son, and tempts him to lead a less useful and less worthy life than he otherwise would, seems to me capable of proof which cannot be gainsaid.

Of course, Carnegie was not advocating laws against inheritance, but rather urging voluntary action. In any event, empirical studies have not found the deadening effect of inheritances to be as great as he presumed. There is a likelihood that those receiving an inheritance will reduce their labor supply, but the effects are small.[43]

The Estate Tax

Although no serious effort has ever been made simply to ban inheritances, the government does make strenuous efforts to curtail them, mainly through the estate and gift tax.[44]

Early History. The estate tax is one of the oldest federal taxes. First imposed in 1797, its principal purpose was revenue, not redistribution. Hence, once the need for revenue fell, the tax was repealed in 1802. The tax was revived in 1862, again solely for revenue purposes. And as earlier, when the revenue requirement abated the tax was repealed in 1870. Another estate tax, imposed in 1898 to pay for the Spanish-American War, was abolished in 1902. The current estate tax dates from 1916, enacted to pay for World War I. This time, of course, it remained permanently.[45]

"The original purpose of the estate tax was revenue, not redistribution."

From Revenue to Redistribution. The original non-redistributive purpose of the current estate tax is shown by the fact that the initial top rate was just 10 percent. The estate tax did not become explicitly redistributive until the administration of Franklin Roosevelt. The Revenue Act of 1935, in particular, was almost solely concerned with redistribution. Roosevelt rationalized this policy as necessary to stave off even more redistributive proposals being propounded by Huey Long and others. To combat these "crackpot ideas," Roosevelt said, "it may be necessary to throw to the wolves the 46 men who are reported to have incomes in excess of one million dollars a year."[46]

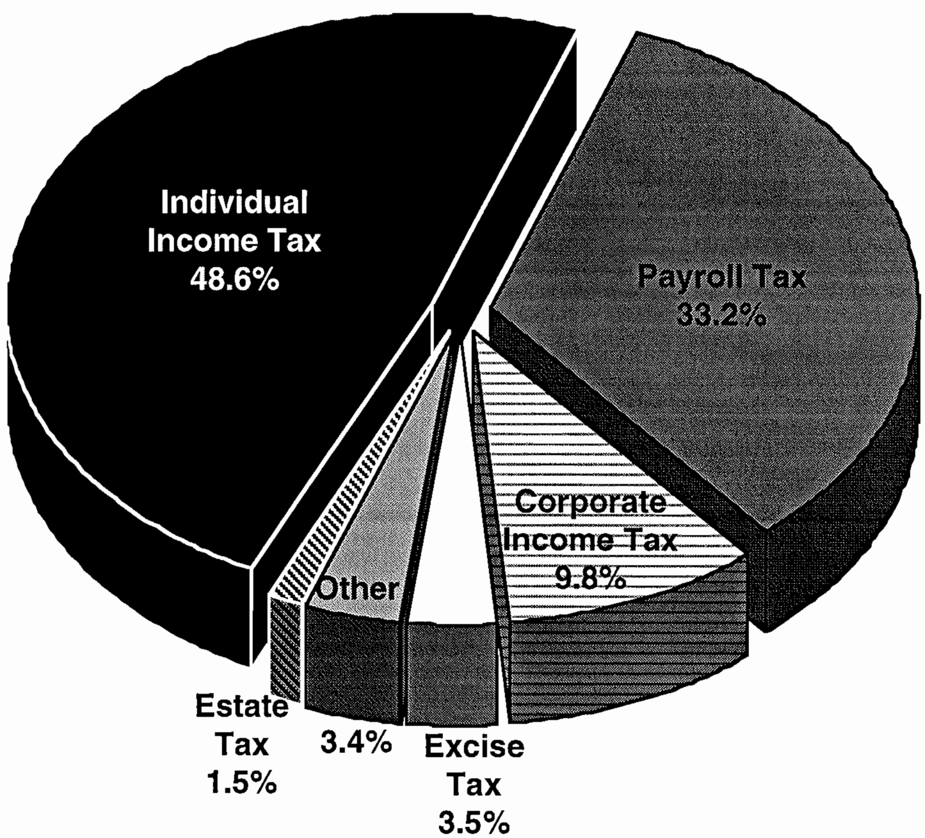
The top estate tax rate, which was 45 percent when Roosevelt took office, was ratcheted up to 60 percent in 1934 and 70 percent in 1935. This and other provisions of the legislation designed to "soak the rich" were heavily criticized by economists as undermining business confidence and shifting the tax system away from its primary purpose of raising revenue.[47] Nevertheless, it put the estate tax on a course from which it has never subsequently diverged.

Today the tax exists almost exclusively for redistributive purposes, since the revenue yield is minuscule. The estate and gift tax is the federal government's least significant revenue source. In fiscal year 2000 it is expected to raise just $30 billion, according to the Office of Management and Budget. With total federal revenues estimated at $2 trillion, the estate and gift tax contributes just 1.5 percent. [See Figure III.]

"The estate tax contributes only 1.5 percent of total federal revenue."

FIGURE III

Federal Tax Revenue, 2000



Source: Office of Management and Budget.

The current tax theoretically begins at a rate of 18 percent, and goes up to 55 percent. Taxpayers receive a credit of $220,550 on their estate tax liability. The effect of this is to exempt up to $675,000 of an estate from tax. Because of the difference between an exemption and a credit, however, this means that no one actually pays the bottom estate tax rate of 18 percent. The marginal tax rate on the first dollar of taxable estate is 37 percent. On estates between $10 million and $21 million the top rate actually is 60 percent, due to the phase-out of the unified estate and gift tax credit. This gives the U.S. the second highest top estate tax rate in the world; only Japan's 70 percent rate is higher.[48] Interestingly, recent press reports blame Japan's high estate taxes for much of the sluggishness of its economy.[49]

"The burden of the estate tax falls primarily on the recipient, not the giver."

Burden of the Estate Tax. A fundamental justification for the estate tax is that it is paid only by those who can most easily afford it, namely the rich. This year, just 2.03 percent of adult deaths in the United States are expected to result in taxable estates.[50] However, the burden of the tax falls primarily on the recipient, not the giver. For this reason, one cannot state with certainty what the distributional effect of the estate actually is, since heirs may be either wealthy or poor. This may be a sufficient reason to abolish the estate tax.[51]

The fact that the burden of the estate tax falls on heirs rather than decedents has important distributive implications. Generally speaking, heirs have less wealth and income than decedents. Hence, attributing the estate tax to the former rather than the latter would show the burden of the estate tax on those with middle incomes to be much higher than standard distributional tables indicate. Indeed, Congress's Joint Committee on Taxation has resisted inclusion of the estate tax in its distribution tables, owing to uncertainty about who actually bears the burden of the tax.[52]

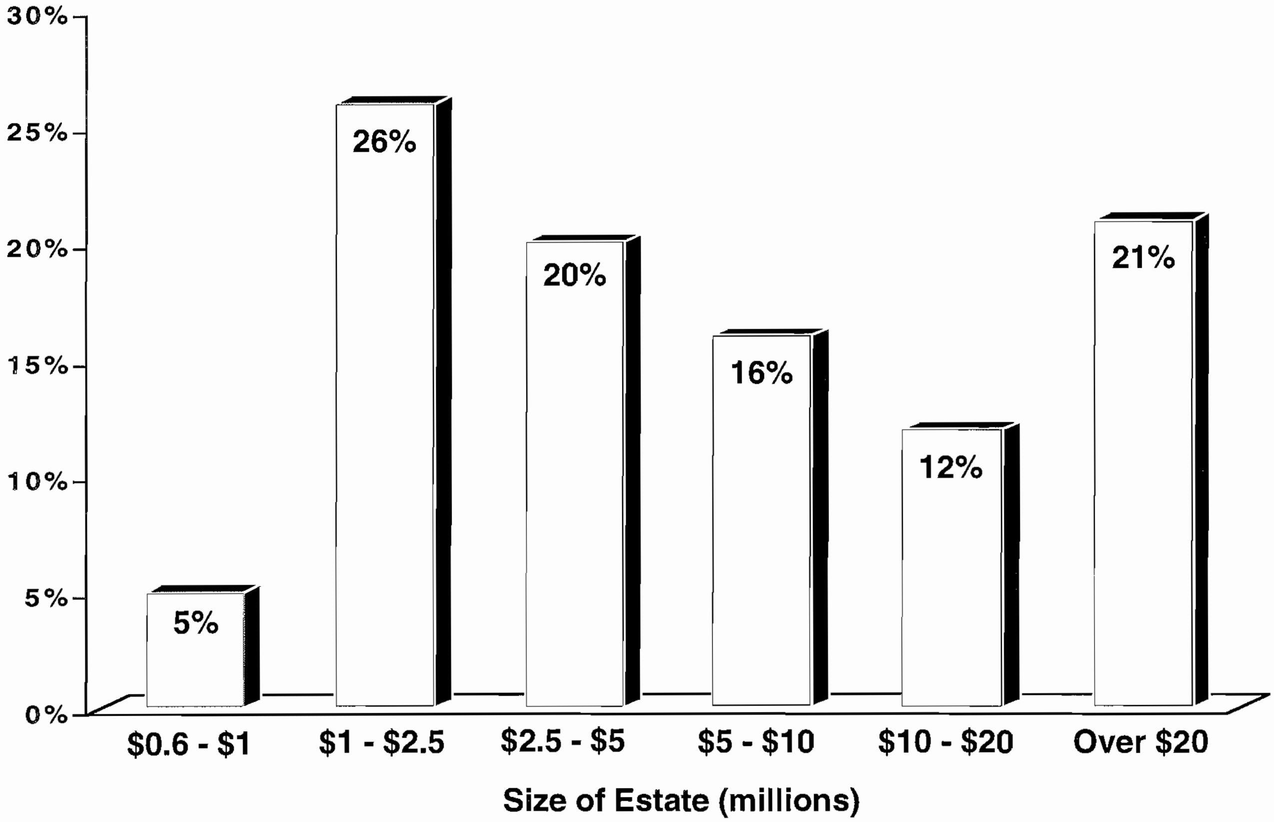
Estate Planning

Because of legal estate planning techniques, much less of the tax actually falls on the wealthy than is commonly believed. In 1997, more than 50 percent of all estate tax revenue came from estates under $5 million. [See Figure IV.] The effective estate tax rate actually falls for estates above $20 million.[53] [See Figure V.] A recent study estimates that two-thirds of the wealth of the nation's richest families go untaxed.[54]

Methods of Avoidance. The reason for this disparity is that careful estate planning can virtually eliminate the tax. At the simplest level, individuals can give away up to $10,000 per year per person free of gift tax. This means that a husband and wife with two married children, each with two children of their own, could give up to $160,000 per year to their offspring free of tax. Also, there is a large deduction for gifts made to spouses, whose estates may be taxed separately. Thus for most married couples, the estate tax only applies

FIGURE IV

Share of Estate Tax Revenue by Size of Estate, 1997



Source: Barry W. Johnson and Jacob M. Mikow, "Federal Estate Tax Returns, 1995-1997,"*Statistics of Income Bulletin*, Vol. 19, Summer 1999, pp. 69-129, at p. 107.

"More than half of all estate tax revenue comes from estates under $5 million."

to estates larger than $1.35 million. Beyond that, there are a number of increasingly complex methods for reducing the burden of the estate tax. They include life insurance trusts, qualified personal residence trusts, charitable remainder trusts, charitable lead trusts and generation-skipping trusts.[55]

So effective are these methods of avoiding estate taxes that it has been argued that the estate tax essentially is a voluntary tax. In the words of economist George Cooper: "The fact that any substantial amount of tax is now being collected can be attributed only to taxpayer indifference to avoidance opportunities or a lack of aggressiveness on the part of estate planners in exploiting the loopholes that exist."[56] Economists Henry Aaron and Alicia Munnell put it even more bluntly. In their view, estate taxes aren't even taxes at all, but "penalties imposed on those who neglect to plan ahead or who retain unskilled estate planners."[57]

Incentives to Avoid Estate Taxes. However, the ability to exploit existing tax-avoidance techniques is not uniform across estates. Those with the largest estates generally have the greatest ability to engage in estate planning. This is because many estate planning techniques are costly and require long lead times to implement. Families with long histories of wealth are more likely to be familiar with them. Thus a disproportionate burden of the estate tax often falls on those with recently acquired, modest wealth: farmers, small businessmen and the like. In many cases their incomes may not have been very high and they died not even realizing that they were "rich."

"The effective estate tax rate actually falls for estates above $20 million, thanks to careful estate planning."

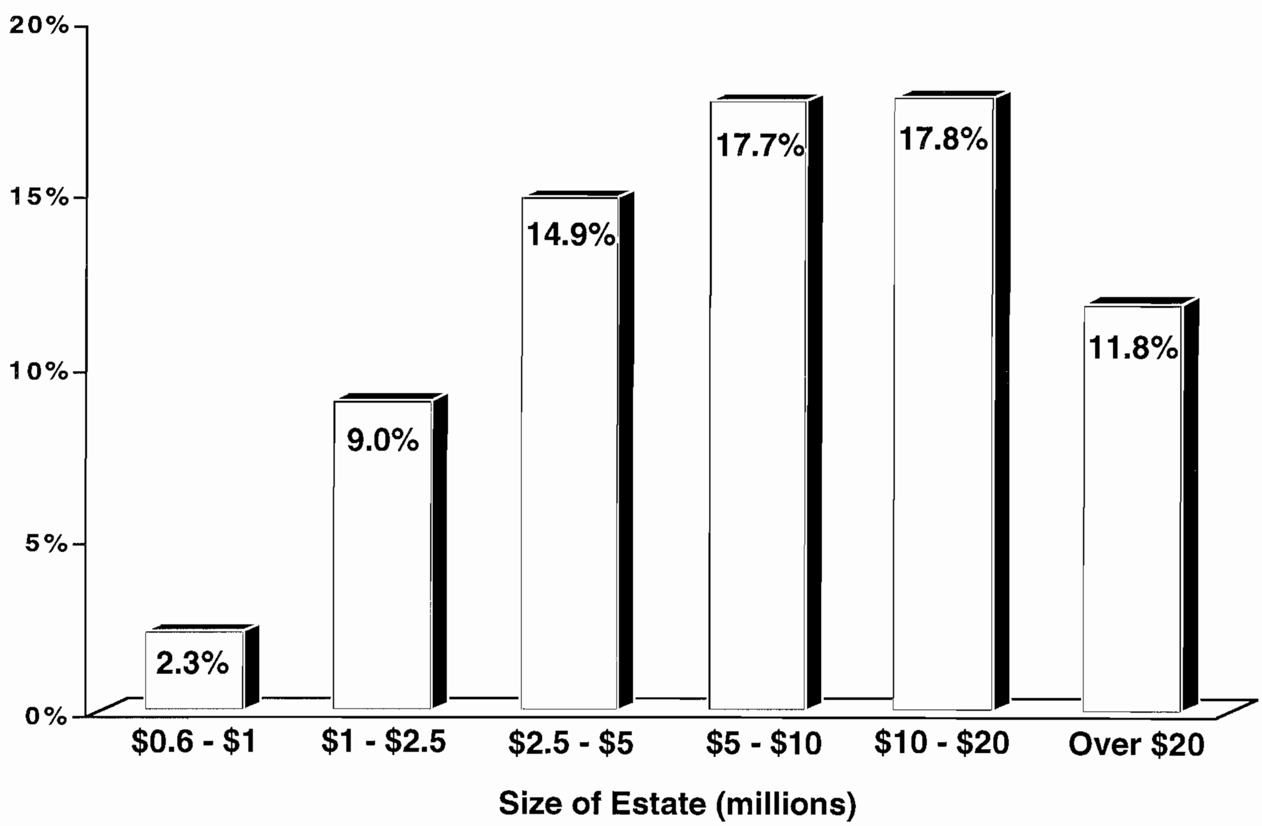
Another reason why those with larger estates are more likely to engage in complex estate planning is, of course, that they pay higher tax rates on their assets. Consequently, research shows that during periods when estate tax rates were rising, revenue from the estate tax fell as the incentive to engage in estate planning increased. Conversely, lower estate tax rates increased estate tax revenue, because it was no longer as profitable to engage in such planning.[58]

It should be emphasized that estate planning is costly, not just in terms of lawyers' fees and the like, but also because assets placed in trust may not earn as high a rate of return as they would under the original owner's control.[59]

Effects on Small Business. The impact of the estate tax on small businesses can be devastating. According to a recent survey:[60]

FIGURE V

Estate Taxes as a Share of Gross Estate, 1997



Source: Barry W. Johnson and Jacob M. Mikow, "Federal Estate Tax Returns, 1995-1997," *Statistics of Income Bulletin*, Vol. 19, Summer 1999, pp. 69-129, at p. 107.

- Fifty-one percent of family businesses would have significant difficulty surviving in the event of a principal owner's death, due to the estate tax.
- Another 14 percent of businesses said it would be impossible for them to survive.
- Only 10 percent said the estate tax would have no effect.

This same survey found that:

- Forty-one percent of businesses said they would have to borrow against equity to pay the estate tax.
- Thirty percent said they would have to sell all or part of the business.
- Eighty-one percent of family businesses reported having taken steps to minimize the estate tax bite, including purchasing life insurance, making lifetime gifts of stock, putting the business into trust or other arrangements.

Academic research has also looked at the impact of the estate tax on small businesses. According to one study, its main effect is on business liquidity. Since most small businesses are undercapitalized to begin with, the estate tax can literally suck the life blood out of a business. Increasing the ability of entrepreneurs to leave an inheritance can greatly increase the chances of a small firms' survival.[61] Other research found that the estate tax encourages small business owners to sell out or merge with large firms.[62]

The latest research reinforces these findings. A survey of family businesses in New York found that they had spent $125,000 each in estate planning. These include attorneys' fees, insurance premiums and other expenses designed to mitigate the effects of the estate tax.[63] In a review of the data from this survey, Douglas Holtz-Eakin concluded that the estate tax has a much greater distortionary effect on entrepreneurs than previously thought.[64] It causes them to cut back on labor, investment and risk-taking.

"Fifty-one percent of family businesses would have difficulty surviving the death of the principal owner, due to the estate tax.

Other Effects. The impact of estate planning goes beyond the estate tax and reaches the income tax as well. For example, under a charitable remainder trust one donates assets to a tax-exempt institution but retains income from the assets until death. Not only are the assets fully shielded from the estate tax, but the charitable donation reduces one's income taxes as well. Because of such interactions between the estate tax and the income tax, Douglas Bernheim estimated that lost income tax revenue may offset all of the revenue from the estate tax.[65] It should also be noted that lawyers' and accountants' fees for estate planning can, in many cases, be deducted from one's income taxes, which is another way in which the estate tax reduces income tax revenues.

Economic Impact

The estate tax also has a damaging effect on the national economy. It reduces saving, capital formation and therefore economic well-being. There is even academic evidence suggesting that the estate tax actually reduces federal revenue in the long run.

A Tax on Capital. With intergenerational transfers accounting for as much as 80 percent of the nation's capital stock, according to a study by Laurence Kotlikoff and Lawrence Summers,[66] this means that the estate tax is a direct tax on capital. James Poterba estimates that the estate tax adds a tax of one to two percentage points to recipients of capital income.[67] Therefore, it is reasonable to say that the nation's capital stock is reduced by at least the amount of the tax. The impact is even larger if it lowers the savings rate as well.[68] And it almost goes without saying that the bulk of the nation's saving comes from those with upper incomes, those most likely to be affected by the estate tax.[69]

Of course, anything that reduces capital formation in the economy ultimately makes everyone poorer. That is why economists historically have warned against estate taxes:

- Adam Smith: "All taxes upon the transference of property of every kind, so far as they diminish the capital value of that property, tend to diminish the funds destined for the maintenance of productive labor."[70]
- David Ricardo: "It should be the policy of governments ... never to lay such taxes as will inevitably fall on capital; since by so doing, they impair the funds for the maintenance of labor, and thereby diminish the future production of the country."[71]
- C.F. Bastable: "Succession duties first of all possess the grave economic fault of tending to fall on capital or accumulated wealth rather than on income; they therefore may retard progress."[72]

"Existing high estate tax rates do little to equalize the distribution of wealth."

Redistributive Effects. Ironically, the deleterious impact of the estate tax on saving and capital formation negates much of the redistributive effect of the tax. According to Joseph Stiglitz, to the extent that the estate tax lowers the capital stock it raises the return to the remaining capital.[73] Since the rich already own most of the existing capital, the effect of the estate tax is actually to make them richer. Consequently, it is not surprising that existing high estate tax rates appear to do virtually nothing to equalize the distribution of wealth. As Alan Blinder observes, "estate taxation is not a very powerful weapon in the egalitarian arsenal....The reformer eyeing the estate tax as a means to reduce inequality had best look elsewhere."[74]

Dead Weight Losses. The estate tax also imposes large dead weight costs on the economy. First is the cost of employing large numbers of Internal

Revenue Service agents to collect estate and gift taxes. Second is the cost of employing legions of tax lawyers to avoid the tax. Aaron and Munnell report that some 16,000 members of the American Bar Association cite trust, probate and estate law as their primary area of concentration. They conclude that compliance costs alone may eat up a sizable fraction of all estate tax revenues.[75] Gerald Moran has suggested that the government may get more revenue from taxing the incomes of estate tax planners than from the estate tax itself.[76]

Effect on Federal Revenues. While expressing some skepticism about the magnitude of the effect Bernheim identifies, Edward McCaffery believes that the deleterious effect of the estate tax on federal revenues may even be larger for other reasons.[77] In particular, he argues that the impact of the estate tax on economic growth may be significant, by reducing the incentive to work, save and invest. For example, he points out that if one's prime motivation is to leave a large estate to one's children, then the effective marginal tax rate on investment and labor is the income tax rate plus the estate tax rate. This rate can go as high as 73 percent at the federal level alone (39.6 percent top income tax rate plus 55 percent estate tax rate on the remainder), with state income taxes pushing it higher still. And McCaffery goes on to point out that these negative effects on saving and work effort are not limited to the very rich. Insofar as the estate tax encourages gifts to one's children during one's lifetime, it may have the effect of reducing their work and saving as well.

"It has been suggested that the government might get more revenue from taxing estate planners than from the estates themselves."

Few studies have looked at the macroeconomic effect of estate taxes. One that did concluded that repeal of the estate and gift tax would raise the level of GDP by 0.4 percent after five years. This is enough to raise federal revenues above the Congressional Budget Office baseline forecast.[78] This implies that the federal government would on net gain — rather than lose — revenue if the estate tax were abolished.

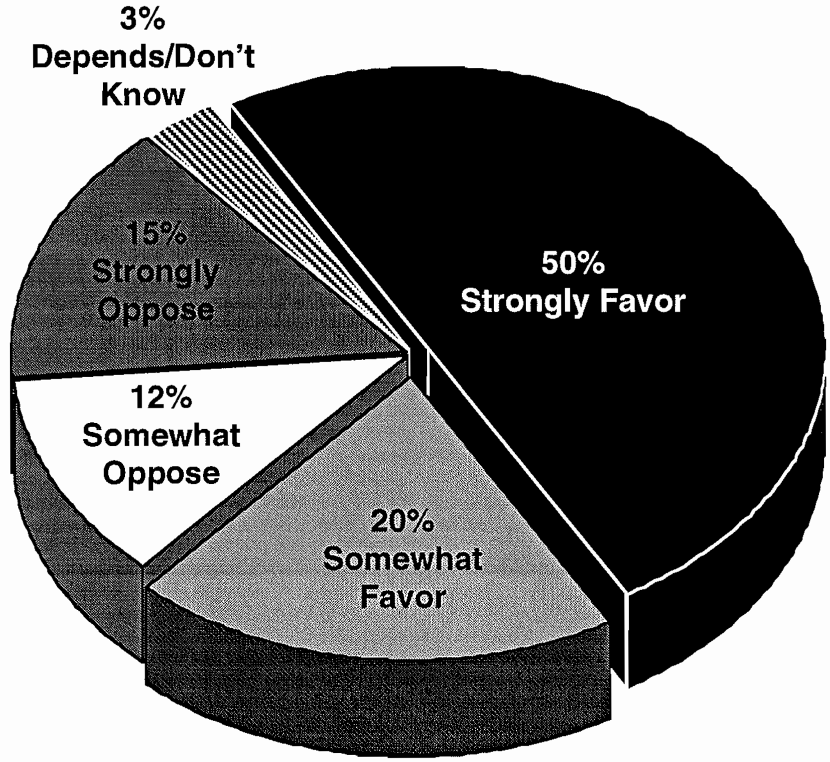
Prospects

The problems of the estate tax are now too large to be ignored. There are growing numbers of prominent legal theorists and economists calling for its abolition.[79] And even those who support a strong estate tax, either for revenue or redistributive purposes, now concede that it is so riddled with complexity, loopholes and distortions that it needs a thorough overhaul.[80]

Public Opinion Polls. Even the general public now supports elimination of the estate tax, despite the fact that very few people are likely to pay so much as a penny of estate tax. A Wirthlin Worldwide Poll in August 1999 found 50 percent of voters strongly favoring a phase-out of the estate tax, with another 20 percent somewhat in favor. Only 15 percent were strongly opposed. [See Figure VI.] A possible reason for these results may be found in a Newsweek Poll taken in June 1999, in which 41 percent of Americans thought

FIGURE VI

Public Support for Phasing Out the Inheritance Tax



Source: *Wirthlin Report*, September 1999.

"Supporters of repeal outnumber opponents by almost three to one."

it was very likely or somewhat likely that they would become wealthy. Only 26 percent thought they had no chance. This suggests that a key reason for opposition to the estate tax is that Tocqueville's vision is still alive and well in America.

Alternate Methods of Taxation. Some scholars are starting to suggest a middle ground in the estate tax debate: abolish the estate tax, but broaden the taxation of gifts by treating them as income.[81] The great economist Henry Simons once suggested that this is in fact the most theoretically sound means of taxing transfers.[82] It does not appear that there would be any constitutional bar to the inclusion of gifts in the income tax.[83] A variation of this idea would be to switch from an estate tax, where assets are taxed as a whole, to an inheritance tax, where heirs are taxed individually, as most other countries do.[84] This reform is supported by some liberals as encouraging the breakup of large estates.[85]

Another group sees taxation of capital gains at death as a better way of taxing estates than the current estate tax.[86] Under such a scheme, death would be treated as a realization of capital gains for tax purposes. Canada has such a system in lieu of an estate tax.[87] Not only would it raise about the same revenue as the estate tax, but it would redress an unfairness resulting from the step-up of basis at death.[88] Under current law, the increase in price of an asset that has appreciated in value is taxed as a capital gain when sold. Tax is owed on the difference between the purchase price, also called the basis, and the sale price. However, if someone dies without selling an appreciated asset, the capital gains tax is, in effect, forgiven. An heir receiving this asset has the basis stepped up to its value at the death of the original owner. Thus, when the heir sells this asset, capital gains taxes are paid only on the increase in value since he acquired it. Even conservative Republicans, such as Senator Jon Kyl of Arizona, now favor taxing capital gains at death as a substitute for the estate tax.

While either taxing gifts as income or taxing capital gains at death instead of taxing estates may have their own problems, at least they would lead to a sharp reduction in complexity and tax rates. The 39.6 percent top rate on incomes and 20 percent top rate on long-term capital gains are both well below the 55 percent (60 percent in some cases) top estate tax rate. And because assets would be taxed under existing provisions of the Tax Code, the entire estate tax section of the Code, all of its supporting regulations and court precedents could be dispensed with forever.

"It is likely that envy is responsible for most of the antagonism toward wealth."

The Continuing War Against Wealth. However, while the problems of the estate tax would seem to make it ripe for repeal or major reform, the vast growth in wealth in America is at the same time fueling support for new taxes on wealth. For example:

- A New York University economist has proposed an annual wealth tax for the U.S. of 0.3 percent on assets over $1 million, which he estimates would raise more than $40 billion per year.[89]
- Two Yale Law School professors have proposed a 2 percent annual wealth tax that would raise $255 billion per year in order to finance an $80,000 grant to all Americans on their twenty-first birthdays.[90]
- New York real estate developer Donald Trump proposed a one-time tax of 14.25 percent on all wealth above $10 million to pay off the national debt, during his abortive run for the Reform Party presidential nomination.[91]

The reality is that the war against wealth is a never-ending one. While there are those who genuinely believe, however naively, that preventing some people from gaining wealth via inheritance will somehow make everyone else better off, it is more likely that envy is responsible for most of the antagonism toward wealth.[92] While at present there appears to be some political support for abolishing the estate tax, it seems certain that if this were to occur something else would take its place. Meanwhile, those favoring new taxes on wealth have been busy and may yet find support.

Recent Legislative Action

On June 9, the U.S. House of Representatives voted 279 to 156 in favor of H.R. 8, which would abolish the estate and gift tax after 2010. At that time, a carryover basis regime will be instituted, requiring heirs to pay capital gains taxes on sales of inherited assets from the date of original acquisition. In other words, the step-up of capital gains at death will also be abolished.

"Supporters of repeal may conclude that some relief is better than none."

Prospects in the Senate are uncertain. President Clinton has vowed to veto the repeal legislation should it pass both the House and Senate. Also, the shortness of the legislative calendar and the probability of a filibuster in the Senate may make it impossible to complete action on estate tax repeal this year.

Attention is now becoming focused on a compromise offered by Representative Charles Rangel (D-N.Y.), ranking Democrat on the House Ways and Means Committee. His legislation would do the following:

1. Cut all estate tax rates by 20 percent across the board. This would lower the top rate from 55 percent to 44 percent.
2. Increase the estate tax exemption immediately by $150,000. This would raise the exemption from $675,000 to $825,000.
3. Raise the special estate tax exemption for farms and closely held businesses from $1.3 million to $4 million.

President Clinton has indicated a willingness to sign legislation along these lines. Supporters of repeal may conclude that something is better than nothing, and may in the end support something like the Rangel substitute in the Senate.

Conclusion

The fundamental justification for estate taxation is that great private wealth is per se socially undesirable. A secondary rationale is that inherited wealth is undeserved and perhaps even harmful to the recipient. Hence, high estate taxes are good for society and, perhaps, even for those who would otherwise be corrupted by inheriting unearned wealth. Hardly anyone argues that great private wealth is good for society. Yet unless that case is made, those seeking to abolish the estate tax will be vulnerable on their flank. Ultimately, the case for abolishing the estate tax must rest on a belief that failure to allow for the accumulation and free disposition of great wealth is bad for society as a whole.

To be sure, the wealthy have always suffered from bad press. In many cases, this was justified. Historically, great wealth has only been accumulated by royalty or aristocrats who acquired it through force. It is only since the Industrial Revolution moved the basic source of wealth away from land that the opportunity for great wealth that was not obtained by some form of coercion was even possible.

Many of the enemies of wealth will grudgingly concede that those who make it on their own have a moral claim to it. But they draw the line at passing such wealth on to the next generation. Those who inherit it not only have no legitimate claim to this unearned wealth, but are injured in the process, it is said. They lose the will to work, produce and create on their own, often becoming worthless degenerates in the process.

While it is unquestionably true that many of those who have inherited wealth have led lives of depravity and would have been better people without it, this is not the principal concern of those favoring confiscatory estate taxes. In their hearts, they believe that even those who earned great wealth by the sweat of their brow are inherently unworthy. They believe that somehow it is possible for great businesses to be founded, great financial risks taken, inventions created and discoveries made without having to enrich people in the process. Furthermore, they think that those who need the prospect of riches to motivate themselves to accomplish socially beneficial feats are concerned only with their own well-being, and not that of their children and potential heirs.

In reality, the urge to acquire great wealth is very much a function of the desire to give one's children the benefit of that wealth. Take that away and many entrepreneurs, businessmen and others who have managed to become financially successful would lose their desire to work, invest and be productive once they had enough to live out their days in comfort.

More fundamentally, estate taxes are an infringement on private property. If people cannot give their assets to whomever they please without penalty, they really don't own them. Since secure property rights are generally understood to be essential for economic growth, to the extent that estate taxes undermine those rights growth will suffer.

"If people cannot give their assets to whomever they please without penalty, they really don't own them."

Therefore the estate tax is a significant factor inhibiting the incentives of those for whom a major motivation in life is to see that their children receive the fruits of their labors. That may mean keeping a farm or business in the family, or it may mean giving a child the financial freedom to pursue a life of public service or philanthropy.

There will always be worthless heirs, who run fortunes into the ground along with their own lives. But those who decry the concentration of wealth should rejoice that this happens as often as it does. The bad judgment and character of those who have benefited from the industry of their parents and grandparents is a key reason why few fortunes perpetuate themselves in America, and why wealth isn't more concentrated than it is.

Unlike the fortunes of Europe, which are still heavily based on ancestry, the turnover among America's wealthy is astonishing. Very few fortunes survive more than two generations, and only a tiny number last longer than three. They invariably are dissipated by expanding numbers of heirs, dividing the fortune into smaller and smaller pieces, as well as the generally lesser abilities of those following in the footsteps of the fortune's originator. Were it otherwise, one could make a case for confiscatory estate taxation. Because it is not, the estate tax really rests not on the case against inheritance, but against wealth itself.

One must look primarily at the impact of estate taxes not on heirs, but on those who acquire wealth with a strong desire to pass it on. In short, one cannot look at the effects of the estate tax only on those at the receiving end. The main impact is on the givers. Here the danger is that the estate tax, coming as it does on top of income and other taxes, imposes a de facto marginal tax rate on our most productive citizens that approaches confiscation.

"Economists universally recognize the disincentive effects of high tax rates."

Economists now universally recognize the disincentive effects of high tax rates. But because the estate tax is imposed on wealth rather than income, and on the deceased instead of the living, it almost always falls outside the universe of taxes that economists mainly concern themselves with. But as the nation's wealth rises, more and more of those clearly in the middle class are affected by the estate tax, or at least believe that they might be. Consequently, they alter their work, investment and other decisions in ways that benefit neither themselves, their heirs, the economy nor the Treasury.

Thus one finds that the burden of the estate tax is far out of proportion to the revenue that it raises. Its personal and economic cost is large, while the revenue is small. In the end, the estate tax can only be justified on the grounds that wealth itself is bad, and it is worth the economic cost of breaking it up. The reality is that the wealthy benefit society in many ways and that the pursuit of wealth — including the desire to pass it on after death — is a major motivation for work, saving, investment, risk-taking, invention, innovation and entrepreneurship for many of our most productive citizens. In the process of acquiring their wealth, however great it might be, they create far more wealth for society.

Not only should the estate tax be abolished, but the war on wealth should also cease. The latter would include a tort law system that frequently treats corporate assets like free money to be dispersed to anyone with a grievance, regardless of the law or the merits of the case; a regulatory system that sees businesses as extensions of the welfare system, mandating them to provide benefits such as family leave as if they are free goods; and an out-of-control antitrust enforcement regime that views big as automatically being bad, and the bigger a business is the worse it is assumed to be.

Ultimately, the goal of egalitarianism should not be to bring the wealthy down, but to raise the poor up. The estate tax is an impediment to that goal. Ironically, it does more to keep the poor down than to bring down the wealthy. It does not promote equality, but does impose a heavy cost on the economy and society. It should be abolished.

NOTE: Nothing written here should be construed as necessarily reflecting the views of the National Center for Policy Analysis or as an attempt to aid or hinder the passage of any bill before Congress.

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About the Author

Bruce Bartlett is a Senior Fellow with the National Center for Policy Analysis. He was Deputy Assistant Secretary for Economic Policy at the U.S. Treasury Department from September 1988 to January 1993, and a Senior Policy Analysis in the White House Office of Policy Development in 1987 and 1988. Bartlett joined the staff of the Joint Economic Committee of Congress as Deputy Director in 1981, becoming Executive Director in 1983. Prior to joining the JEC staff, he served on the staffs of Reps. Ron Paul and Jack Kemp and was chief legislative assistant to Sen. Roger Jepsen. While with Rep. Kemp, he helped draft the Kemp-Roth tax bill. Bartlett has published more than 700 articles in national publications including the *Wall Street Journal*, *New York Times*, *Los Angeles Times* and *Washington Post*, and prominent magazines such as *Fortune*. His twice-weekly column on economic policy is published in the *Washington Times* and *Detroit News* and is nationally syndicated by Creators Syndicate. In 1996 one of Bartlett's columns inspired Bob Dole to propose a 15-percent tax reduction plan when he ran for president. Bartlett has also written for academic journals and published four books, including *Reaganomics: Supply-Side Economics in Action,* published in 1981. From 1985 through 1987 he was a Senior Fellow at the Heritage Foundation in Washington, D.C.

About the NCPA

The National Center for Policy Analysis is a nonprofit, nonpartisan research institute founded in 1983 and funded exclusively by private contributions. The mission of the NCPA is to seek innovative private-sector solutions to public policy problems.

The center is probably best known for developing the concept of Medical Savings Accounts (MSAs). The *Wall Street Journal* called NCPA President John C. Goodman "the father of Medical Savings Accounts." Sen. Phil Gramm said MSAs are "the only original idea in health policy in more than a decade." Congress approved a pilot MSA program for small businesses and the self-employed in 1996 and voted in 1997 to allow Medicare beneficiaries to have MSAs.

Congress also relied on input from the NCPA in cutting the capital gains tax rate and in creating the Roth IRA. Both proposals were part of the pro-growth tax cuts agenda contained in the Contract with America and first proposed by the NCPA and the U.S. Chamber of Commerce in 1991. Two other recent tax changes — an increase in the estate tax exemption and abolition of the 15 percent tax penalty on excess withdrawals from pension accounts — also reflect NCPA proposals.

Another NCPA innovation is the concept of taxpayer choice — letting taxpayers rather than government decide where their welfare dollars go. Sen. Dan Coats and Rep. John Kasich have introduced a welfare reform bill incorporating the idea. It is also included in separate legislation sponsored by Rep. Jim Talent and Rep. J. C. Watts.

Entitlement reform is another important area. NCPA research shows that elderly entitlements will require taxes that take between one-half and two-thirds of workers' incomes by the time today's college students retire. A middle-income worker entering the labor market today can expect to pay almost $750,000 in taxes by the time he or she is 65 years of age, but will receive only $140,000 in benefits — assuming benefits are paid. At virtually every income level, Social Security makes people worse off — paying a lower rate of return than they could have earned in private capital markets. To solve this problem, the NCPA has developed a 12-step plan for Social Security privatization.

The NCPA has also developed ways of giving parents the opportunity to choose the best school for their children, whether public or private. For example, one NCPA study recommends a dollar-for-dollar tax credit up to $1,000 per child for money spent on tuition expenses at any qualified nongovernment school — a form of taxpayer choice for education.

The NCPA's Environmental Center works closely with other think tanks to provide common sense alternatives to extreme positions that frequently dominate environmental policy debates. In 1991 the NCPA organized a 76-member task force, representing 64 think tanks and research institutes, to produce *Progressive Environmentalism*, a pro-free enterprise, pro-science, pro-human report on environmental issues. The task force concluded that empowering individuals rather than government bureaucracies offers the greatest promise for a cleaner environment. More recently, the NCPA produced *New Environmentalism*, written by Reason Foundation scholar Lynn Scarlett. The study proposes a framework for making the nation's environmental efforts more effective while reducing regulatory burdens.

In 1990 the NCPA's Center for Health Policy Studies created a health care task force with representatives from 40 think tanks and research institutes. The pro-free enterprise policy proposals developed by the task force became the basis for a 1992 book, *Patient Power*, by John Goodman and Gerald Musgrave. More than 300,000 copies of the book were printed and distributed by the Cato Institute, and many credit it as the focal point of opposition to Hillary Clinton's health care reform plan.

A number of bills before Congress promise to protect patients from abuses by HMOs and other managed care plans. Although these bills are portrayed as consumer protection measures, NCPA studies show they would make insurance more costly and increase the number of uninsured Americans. An NCPA proposal to solve the problem of the growing number of Americans without health insurance would provide refundable tax credits for those who purchase their own health insurance.

NCPA studies, ideas and experts are quoted frequently in news stories nationwide. Columns written by NCPA experts appear regularly in national publications such as the *Wall Street Journal, Washington Times* and *Investor's Business Daily.* NCPA Policy Chairman Pete du Pont's radio commentaries are carried on 359 radio stations across America. The NCPA regularly sponsors and participates in *Firing Line Debate*, which is aired on 302 public broadcasting stations. The NCPA each year sponsors 22 one-hour televised debates on the PBS program *DebatesDebates,* seen in more than 170 markets.

According to Burrelle's, the NCPA reached the average household 10 times in 1998. More than 36,000 column inches devoted to NCPA ideas appeared in newspapers and magazines in 1997. The advertising value of this print and broadcast coverage was more than $56 million, even though the NCPA budget for 1998 was only $4 million.

The NCPA has one of the most extensive Internet sites for pro-free enterprise approaches to public policy issues, www.ncpa.org, receiving about one million hits (page views) per month. All NCPA publications are available online, and the website provides numerous links to other sites containing related information. The NCPA also produces an online journal, *Daily Policy Digest,* which summarizes public policy research findings each business day and is available by e-mail to anyone who requests it.

What Others Say about the NCPA

"...influencing the national debate with studies, reports and seminars."

— *TIME*

"...steadily thrusting such ideas as 'privatization' of social services into the intellectual marketplace."

— *CHRISTIAN SCIENCE MONITOR*

"Increasingly influential."

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"The NCPA is unmistakably in the business of selling ideas...(it) markets its products with the sophistication of an IBM."

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