Rhetoric and Economics in the Estate Tax Debate

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ABSTRACT

In this paper, we evaluate and critique ten principal claims made in recent debates on the estate tax, distinguishing five types of statements: facts, rhetoric, value judgments, economic reasoning, and informed speculation. Economics can not fully resolve the debate because economic knowledge is inconclusive and because value judgments help determine optimal choices. Nevertheless, economic analysis can contribute substantially to informing these debates and we show that many of the claims on both sides are incorrect or incomplete, given what is known.

Economists often bemoan the apparent lack of sophistication in policy debates, where loose rhetoric too often drives out objective economic thinking. But economic theory and evidence cannot fully resolve most policy debates, for at least two reasons. First, the current state of economic knowledge is inconclusive regarding a wide variety of economic responses that are relevant for policy; as a result, economic evidence often cannot even reliably quantify the various trade-offs that policy makers and the public face. Second, even when those trade-offs can be quantified reliably, the appropriate policy choice depends on people's value judgments, a subject about which economics provides no guidance.

The debate over the estate tax is a prime example of these phenomena. Many of the most important theoretical and empirical issues regarding transfer taxes remain unresolved, and research is clearly in an early stage. At the same time, advocates on both sides fervently believe that views on the estate tax reflect fundamental values and contain crucial moral elements. As a result, opponents of the tax sometimes latch onto any argument that puts the tax in a bad light, even if some of their claims are mutually inconsistent. Likewise, supporters frequently dismiss these arguments out of hand, without reference to their economic merit.

In this paper, we evaluate and critique ten principal claims made by one side or the other in recent policy debates on the estate tax. We aim to distinguish five types of statements:

- *Facts,*
- *Rhetoric,*
- *Value judgments,*

- *Economic reasoning, and*
- *Informed speculation.*

In doing so, we acknowledge at the outset the extent of uncertainty about the economic effects of the tax. But that uncertainty does not mean that anything goes; rather, we show that many of the claims on both sides are incorrect (or at least incomplete), given what is known. To organize the discussion, we focus first on issues relating to the trade-off between equity and efficiency. We then analyze statements related to the impact of the estate tax on economic behavior. Finally, we discuss two rhetorical claims.

I. Trade-offs between Equity and Efficiency

Claim 1: The estate tax imposes economic burdens

We begin with some *facts*: in 1998 the federal estate and gift tax collected $21.3 billion in revenue. In addition, there were $5.3 billion of credits offered against state-level estate and inheritance taxes, so that the total tax revenue collected by the tax was $26.6 billion (IRS 2000). Thus, the anecdotal evidence that the tax imposes real burdens should not be a surprise.

Economic reasoning implies that the economic burden is larger than the revenue cost indicates. This is because the tax induces people to undertake activities and change their behavior to reduce the tax liability. Thus, they are worse off because of the changed behavior (though by less than the tax they saved), in addition to being worse off because of the tax that is actually paid.

The argument that economic burden exceeds the revenue collected generally applies to all taxes that are not lump-sum or correctives to externalities. In the case of taxes on wealth transfers, however, *economic reasoning* also shows that the applicability of this point depends on the motivation for bequests (Kaplow 2001). For example, if bequests are unintended, in the sense that people die before they expect to and thus do not manage to consume all of their wealth, an estate tax would have no effect on the donor's behavior because it changes the relative price of something—the bequest—to which the donor attributes no value. Thus, the tax creates no excess burden, as would be true under a lump-sum tax. But, unlike a lump-sum tax, the estate tax in this case does not make the donor worse off. This makes such a tax look like a "utility machine," as it produces revenue for the government without hurting the donor. Of course, the potential inheritors would be worse off because of the tax.

Alternatively, if bequests are payment for services provided by potential heirs, the estate tax is simply an excise tax on purchases by the parent of services provided by the child (Cox 1987). Standard commodity tax theory implies that the economic burden created depends on the price elasticity of the parents' demand for such services.

In pure altruism models (Barro 1974, Becker 1974), transfers create a sort of externality since the parent cares about both her own utility and her child's utility. In equilibrium, the parent chooses transfers by trading off (a) the reduction in her own utility from reduced consumption and (b) the increase in her utility from the child's increased consumption. In contrast, a planner maximizing a social welfare function that summed the utilities of all individuals would consider the same two effects *plus* the effect of the transfer on the child's utility. In general, the child's marginal utility from the

transfer will be positive. As a result, in equilibrium too few transfers will be provided, leading to an efficiency argument for a *subsidy*, rather than a tax, on transfers to children.[1] These findings, however, are sensitive to alternative modeling assumptions, and in some cases where parental altruism is combined with opportunistic behavior on the part of children, it is possible that estate taxes have welfare-improving properties.[2] Thus, economic reasoning alone cannot resolve issues regarding the efficiency cost of transfer taxes.

In principle, some *informed speculation* might be possible based on theoretical and empirical results from Holtz-Eakin and Marples (2001). They find that raising the tax rate on capital income and using the revenues to reduce the estate tax rate would be efficiency-enhancing. But their results depend on the assumption that charitable contributions induced by the estate tax have no social value, and their analysis omits considerations of the transfer recipient and the motive for transfers, which makes efficiency analysis virtually impossible in this case. In addition, the empirical analysis upon which the results are based is fragile, as discussed below (claim 4).

Claim 2: The economic burdens of the tax are only borne by the rich.

Again, we begin with *facts*. In 1998, 47,483 estates incurred a tax liability, compared to 2,282,055 adult deaths (IRS 2000, Murphy 2000). Thus, estates with a tax liability represented only 2.1 percent of adult deaths. All of these estates had wealth in excess of $625,000. About 51 percent of the estate tax was paid by estates in excess of $5 million (Gale and Slemrod 2001). These estates represent 5 percent of all taxable estates and 0.1 percent of all adult deaths.

Economic reasoning, however, implies that these facts may or may not be relevant to understanding who bears the economic burden of the tax. Economic theory implies that the incidence of the tax must be traced to some individual, not to the estate itself. If the estate tax is borne by donors, then it is clearly paid by wealthy families. Whether these were precisely the very richest families is somewhat a matter of *informed speculation*, and depends on the extent and nature of tax avoidance and evasion (see claim 6).

If it is the heirs rather than the donors that bear the burden of the estate tax, the burden is less concentrated. However, Gale and Slemrod (2001) present *facts* showing that, even under this assumption, the burden is still quite progressive, since the recipients of inheritances from estates subject to estate tax are themselves very wealthy.

To the extent that the tax reduces wealth accumulation (see claim 4), the burden may be shifted more broadly though a lower long-run capital-labor ratio and therefore a lower level of real wages.

Claim 3: Because it is a tax on the rich, the estate tax should be retained at all costs.

Should there be an estate tax? Certain *facts* are *not* relevant to this question. One is that the estate tax raises only a small fraction of total federal revenues, 1.4 percent in 2000. Opponents sometimes cite this fact as evidence that the tax could not be very effective in achieving its goals, and therefore should be jettisoned, but the logic is simply false. The essential issue not the magnitude of revenue raised, but whether the benefits associated with the estate tax—in terms of revenue, distributional and behavioral effects, and other issues—are worth the costs.[3]

On the other hand, *informed speculation*, based on the discussion of claim 2 above and of claim 4 below, suggests that the estate tax is the most progressive tax instrument currently at the federal government's disposal. Is that alone a sufficient reason to retain the tax in its current form? Certainly not. If it were clear that the costs of raising revenue in this way vastly exceeded the cost of alternative taxes, then the tax should be abandoned. But what exactly does "vastly" mean in this context? Have we descended into mere *rhetoric*?

Economic reasoning—in particular, the modern theory of optimal taxation—provides a framework for evaluating these issues. Using the notation of Slemrod and Yitzhaki (2001), in an optimal tax system at the margin the following must hold for an estate tax, denoted E, and an alternative means of raising revenue, denoted A:

$$MECF_E*DC_E = MECF_A*DC_A.$$

In this expression MECF stands for the marginal efficiency cost of raising funds,[4] and is equal to the ratio of the (dollar equivalent of) the utility cost to the taxpayers divided by the revenue net of administrative cost received by the government. The larger is the behavioral response to taxation, the higher will be the MECF. The expression DC is the distributional characteristic of the tax burden. This depends on the distribution of burden, and the social weight placed on burden incurred by families at different levels of well-being. The value of DC is lower the more progressive is the distribution of the burden at the margin. Coming up with these relative weights is a matter of *value judgment*.

If $MECF_E*DC_E$ is greater than $MECF_A*DC_A$, then the estate tax should be reduced; if $MECF_E*DC_E$ is less than $MECF_A*DC_A$, it should be increased. If the estate tax is more progressive than the alternative, someone who values progressivity will set DC_E lower than DC_A. Under these conditions, the existing estate tax could still be part of an optimal tax system even if its marginal efficiency cost at its current level exceeds that of alternative taxes.

The framework underlying this approach allows the social marginal valuation of income to vary across families of different levels of well-being. It does not, though, accord any value to reducing the concentration of wealth, per se, one of the objectives cited by supporters of the estate tax since its inception. Some of the arguments given for this objective are extra-economic, such as reducing the concentration of political power that is alleged to be associated with concentration of wealth. Nor does it accord any value to reducing the concentration of inheritances per se. That objective is sometimes justified on the grounds of moving towards equal opportunity. Dworkin (2000) associates equal opportunity with equalizing the extent of differences in well-being that are outside of the individual's control, which would certainly include inheritance, although what else it includes is controversial. In sum, although the theory of optimal taxation provides a framework for evaluating the efficiency and equity implications of the estate tax, some potentially relevant issues lie outside this framework.

II. Economic Effects of the Estate Tax

Claim 4: The estate tax reduces saving

There is substantial *rhetoric* to the effect that the estate tax reduces capital accumulation, but very few *facts*, so we start with several elements of *economic reasoning*. First, the tax reduces the return to wealth accumulated with the intention of bequeathing it to anyone other than a charity. For the wealth owner, the change in the rate of return induces income (or wealth) and substitution effects that in total are ambiguous in sign. Second, the effects of the tax on the donor's saving should also depend on the donor's motives for giving—for example, if bequests are accidental, estate taxes should have no effect on wealth accumulation by donors. (See Gale and Perozek 2001 for further discussion). Third, the effects of the tax on overall saving will depend on how the recipient of the transfer responds to any change in transfers induced by changes in the tax.

Existing simulation modeling and empirical work provide a basis for some *informed speculation*. Laitner (2001) develops a steady-state simulation model where parents have altruistic preferences toward their children and concludes that estate taxes do reduce wealth accumulation among the top 1 percent of households. This analysis incorporates the behavior of both donors and recipients, but does not include other transfer motives.

Kopczuk and Slemrod (2001) use estate tax return data from 1916 to 1996 to explore links between changes in the estate tax rate structure and reported estates. These links reflect the impact of the tax on both wealth accumulation and avoidance behavior. They find that an aggregate measure of reported estates is generally negatively associated with summary measures of the level of estate taxation, holding constant other influences. In pooled cross-sectional analysis that makes use of individual decedent information,

however, the relationship between the concurrent tax rate and the reported estate is fragile and sensitive to the set of variables used to capture exogenous tax rate variation. The negative effect of taxes appears to be stronger for those who die at a more advanced age and with a will, both of which are consistent with the theory of how estate taxes affect altruistic individuals. Perhaps of most interest, the tax rate that prevailed at age 45, or ten years before death, is more clearly (negatively) associated with reported estates than the tax rate prevailing in the year of death.

Holtz-Eakin and Marples (2001) use variation in state-level estate and inheritances tax rates to identify the impact of transfer taxes on households' wealth accumulation using data from the 1992 Health and Retirement Study. They find a modest negative effect of transfer taxes on wealth. However, their underlying wealth equation omits factors such as current or lifetime earnings, and pensions and social security wealth, which are typically considered to be important determinants of saving. Moreover, the results are fragile: inclusion of control variables for state of residence cuts the estimated impact of estate taxes by more than 50 percent and removes any statistical significance of the effects.

There is also evidence on how transfers influence the behavior of recipients. Weil (1994) shows that the past or anticipated receipt of an inheritance raises a household's consumption by between four and ten percent, after controlling for income, age, education and other factors. Given the magnitude of typical household saving rates, Weil's results suggest that reduced inheritances due to estate taxes would substantially raise the donee's saving out of earned income. Holtz-Eakin, Joulfaian, and Rosen (1994a, 1994b) show that receipt of a large inheritance raises the likelihood that a

household starts a business and raises the probability of the recipient's existing business surviving and expanding. Thus, to the extent that inheritances relieve liquidity constraints associated with investment, reduced inheritances due to estate taxes could reduce investment among recipients.

Claim 5: The estate tax imposes undue burdens on family-owned businesses and farms

A seemingly never-ending stream of *rhetoric* proclaims the damaging impact of the estate tax on family-owned small businesses and farms, so we begin with a *fact*: According to the New York Times, as of April of this year, representatives of the American Farm Bureau Federation—a major lobbyist for estate tax abolition—could not cite a single instance of a family farm that was forced out of business because of the estate tax (Johnston 2001).

There are two broad issues regarding small businesses and farms. The first issue is how large is the actual impact of the estate tax on small businesses? Some *facts* can help evaluate this question. In particular, the vast majority of family businesses are not subject to estate tax, either because they fall well before the death of the owner or because their value is well below the estate tax exemption. Harl (1995), for example, documents that 95 percent of family-owned farms could have passed to heirs with no estate tax liability under the rules in place in 1995.

Moreover, few business owners would have difficulties paying estate taxes without liquidating the business. Holtz-Eakin, Phillips, and Rosen (1999) find that among business owners in their fifties, 77 percent would either face no estate tax liability or could pay the tax out of insurance, liquid assets, stocks and bonds alone, without

having to use any non-liquid assets or the business itself to pay estate taxes. This estimate surely understates the true percentage of businesses that can pass to recipients without fear of being broken up by the estate tax, for three reasons. First, the authors do not allow for any reduced valuation of businesses in probate, or any other estate tax planning or avoidance, such as family limited partnerships. Second, they understate available non-business assets because they omit life insurance held in trusts, non-financial assets, and balances in 401(k)s or other pension accounts. Third, they only examine business owners in their fifties. Younger business owners would likely have lower wealth. Thus, the vast majority of closely-held businesses do not appear to face demise due to estate tax considerations.

There is some, albeit weak, evidence that estate taxes reduce entrepreneurial activity. Holtz-Eakin (1999) uses a survey of about 400 business owners in New York state, and concludes from regression analysis that businesses in which the owner would be subject to the estate tax if he or she died immediately had significantly less employment growth over the previous five years than other firms. However, the conclusions are suspect because the regressions do not control for the age of the owner. One might suspect that older owners were more likely to be wealthy, and thus more likely to be subject to estate taxes upon death, but less likely to push for aggressive growth than younger owners. Moreover, the data are based on responses to a mail survey and so may not be very representative.[5]

Examining the life insurance holdings of business owners can provide additional evidence. Insuring the life of a business owner is good business practice, even without an estate tax, but is especially good practice for owners of closely-held business who want

the business to remain in family hands after their own death. Thus, if business owners were especially concerned about their ability to pass on the business to their descendants, they might be expected to be particularly heavily insured. This does not appear to be the case, though. Holtz-Eakin, Phillips and Rosen (1999) show that small business owners do hold somewhat more life insurance than others with the same wealth. But they also find that the insurance purchases of business owners are less responsive to estate tax considerations than are the purchases of other households. This suggests either that business owners do not anticipate problems—given their current life insurance holdings and other assets—in passing the business along to their descendants, do not consider giving the business to their descendants a high priority, or are planning poorly. None of these conclusions justifies changing the estate tax, which leads directly to the second issue.

The second issue is what to do about the impact of the estate tax on family-owned businesses and farms. Even under the assumption that every claim about the problems the tax creates for family-owned businesses is correct, there is little logic in the view that those problems merit abolition of the entire estate tax. Some *facts* can inform this view. Farms and other small businesses represent a small fraction of estate tax liabilities. Farm assets were reported on 6 percent of taxable returns filed in 1998; farm real estate was reported on 12 percent. Together, these items constituted just 1.7 percent of taxable estate value. About 8.7 percent of taxable returns in 1998 listed closely held stock, which accounted for 6.6 percent of taxable estate value. Limited partnerships and "other non-corporate business assets" accounted for an additional 2.6 percent of taxable estate. Thus, using a very expansive definition, farms and small businesses account for at most

11 percent of assets in taxable estates (IRS 2000).[6] Clearly, the vast majority of estate taxes are paid by people who own neither farms nor small businesses, and the effects on farms and small businesses provide no justification for abolishing the estate tax.[7]

Whether the estate tax should be reformed to address the issues of small businesses and farms can also be informed by several *facts*, the most important of which is that family farms and businesses already receive special treatment under the estate tax. Besides the $675,000 effective exemption that everyone is provided, owners of small businesses and farms benefit from several additional provisions. First, legislation enacted in 1997 permits a special deduction (which combined with the effective exemption removes $1.3 million from taxation) for family-owned farms and businesses when they constitute at least 50 percent of an estate and in which heirs materially participate. Second, taxpayers are entitled to calculate the taxable value of the real estate used in a farm or closely-held business on the basis of their current-use value, rather than market value. As noted above, this can reduce the value of the taxable gross estate by up to $770,000 for decedents who died in 2000.[8] Third, because such assets do not trade in liquid markets, there is often substantial discretion (and hence substantial discounts) used in determining value.

Taken together, these effects can be sizable. Consider a couple with a business worth $3.9 million. Suppose the value for estate tax purposes can be reduced by one-third using the valuation techniques noted above, and other avoidance procedures.[9] The remaining value, $2.6 million, would not be taxable, given the business deduction and the unified credit. The entire business could pass to heirs in a tax-free manner. Thus, the various deductions, exemptions, and valuation procedures already in place provide a very

high effective floor under which family businesses can pass tax-free.

And even when taxes are due, there is a fourth subsidy: estate tax liability that is due to family farms and businesses can be paid in installments over a 14-year period, with only interest charged for the first four years. The applicable interest rate is 2 percent on estate tax liability stemming from the first $1 million of taxable assets with higher, but still below-market, rates on larger amounts. This not only provides reduces the cash flow needs for the business, it significantly reduces the present value of estate tax liabilities.

Another relevant *fact* is that in recent years, the vast majority of small business wealth subject to estate taxes has taken the form of unrealized capital gains (see claim 10). This income has never been taxed under the income tax and would never be taxed at all if exempted from the estate tax.

All of these subsidies raise questions of horizontal equity: why, between two families with the same size estate, should the one whose assets are in business form have a smaller tax liability? Ultimately, a satisfactory answer must include the facts and evidence above, as well as *value judgments* regarding the best way to tax.

<u>Claim 6: The estate tax is easy to avoid and evade, especially by the wealthiest families</u>

Although at first blush this statement might seem to contradict the idea that the estate tax is borne by the wealthy (claim 2), it is not. It is logically possible that the richest families evade and avoid enough that their taxable estates attract little or no taxation, so that the 2.1 percent of decedents with the highest taxable estates pay all the tax, but the truly wealthy escape tax.

What *facts* might inform this question? First, consider evasion. Eller, Erard and

Ho (2001) show that sixty percent of audited estates in 1992 resulted in an additional positive assessment, 20 percent resulted in no change in tax liability, and 20 percent resulted in a reduced tax bill. Extrapolating from the results of a sample of those estate tax returns that were audited, Erard (1998) estimated overall evasion to be 13 percent of the potential tax base. This figure is slightly lower than the estimated tax gap for the income tax. It also provides no support for the view that the distribution of tax by the level of reported estates vastly misstates the distribution by actual end-of-life wealth. Of course, evasion is difficult to measure, and these audits almost certainly do not pick up all the evasion that is going on, so that conclusion remains *informed speculation*.[10]

A more general statement made by some opponents of the estate tax is that avoidance renders the tax regressive, at least among the highly wealthy that are subject to the tax. For example, in commenting on 1997 estate tax returns, the Joint Economic Committee (1998, p. 31) writes:

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

It is a *fact* that in 1997, the ratio of net estate tax to gross estate was lower for estates above $20 million (11.8 percent) than for estates between $2.5 million and $5 million (15.0 percent). But this apparent anomaly in the face of graduated tax rates

occurs for straightforward reasons that are certainly not related to evasion or to any sophisticated tax planning schemes. The wealthier group had higher charitable deductions, 28.4 percent of gross estate versus 5.7 percent, and higher credits for gift taxes and for state death taxes, 5.6 percent of gross estate versus 3.3 percent (Johnson and Mikow 1999). Moreover, the pattern that arose in the 1997 returns did not arise in 1998. Estate taxes in 1998 were 16 percent of gross estate for estates between $2.5 million and $5 million, and 17 percent for estates above $20 million. For all transfer taxes, the average tax rates of 20 percent and 26 percent, respectively.

The important context is that these figures pertain to the pattern of average tax rates among the very wealthiest families, so have nothing to do with usual standards of progressivity or regressivity—even if the average tax rate among the set of estate taxpayers were unrelated to the level of estate, it would still be a highly progressive tax. These figures thus provide no evidence that evasion or sophisticated avoidance strategies undermine the progressivity of the estate tax.

Taken together, claim 2 (the tax reduces saving) and claim 6 (the tax is easy to avoid), seem to be a violation of *economic reasoning*. How could a tax that is not paid be a deterrent to anything? As Galbraith (2000) puts it, "Why would someone who can evade the tax easily also decrease their work effort (or perhaps redouble private consumption) in order to avoid the initial accumulations?" As Slemrod (2001) details, this can be true, depending on the technology of tax avoidance or, in other words, the pricing of tax avoidance strategies. What do we know? Schmalbeck (2001) suggests that, for all but the largest estates, the avoidance technology often features a fixed fee for an avoidance device (for example, a trust) that reduces the effective tax rate on an unlimited

amount of wealth that is passed through the device. This reduces the effective marginal tax rate (on wealth above the level that makes the fixed cost of using this device worthwhile), and therefore reduces the effective progressivity of the estate tax. For the largest estates, Schmalbeck notes that there is often an hourly fee for advice and planning. If the fee is not related to the size of the tax saving, the same conclusion applies. These findings imply that avoidance opportunities typically do reduce the effective marginal tax rate at high wealth levels, and therefore do reduce the deterrence to wealth accumulation below what the statutory rate structure suggests. Thus, avoidance opportunities do mitigate the real disincentive effects that would otherwise be generated.

Claim 7: The costs of administering the estate tax are roughly equal to the revenue raised

It is frequently claimed that the costs of administering and avoiding the estate tax are about the same size as the revenue raised (see for example Friedman 2001). It should be noted that there are no *facts* that support this view. The view stems from mis-representation of what can best be described as an *informed speculation*.

Estimates of the compliance cost of the estate tax vary enormously, partly because the methodologies are suspect. Munnell (1988) is cited as claiming that “the costs of complying with the estate tax laws are roughly the same magnitude as the revenue raised” (Joint Economic Committee 1998). But Munnell actually wrote that compliance costs “may well approach the revenue yield.” Even this more modest conclusion, however, is based on a number of rough calculations and more or less informed guesses, rather than hard evidence.

Munnell noted that, at the time, the American Bar Association reported that

16,000 lawyers cited trust, probate, and estate law as their area of concentration. Valuing their time at $150,000 per year on average and assuming they spend half time on estate taxes yields $1.2 billion in avoidance costs, compared to estate tax revenues of $7.7 billion in 1987. To get from $1.2 billion to close to $7.7 billion, Munnell refers to "accountants eager to gain an increasing share of the estate planning market," financial planners and insurance agents who devote a considerable amount of their energies to minimizing estate taxes, and the efforts of the individuals themselves, and concludes that the avoidance costs "must amount to billions of dollars annually." It is also worth noting that Munnell's estimates are now out-of-date and that estate tax revenues have risen dramatically during the intervening period. Thus, even if compliance costs at that point were almost equal to revenues, they may not be today.

Davenport and Soled (1999) estimate tax planning costs by surveying tax professionals about average charges for typical estate planning in six different estate size classes and applying these estimates to the number of returns filed in 1996. This yields estimated costs for planning of $290 million. Using fairly *ad hoc* but not implausible adjustments for such factors as the number of nontaxable decedents that do tax planning and tax planning that has to be repeated when tax laws change, they estimate planning costs of $1.047 billion in 1999. They add $628 million for estate administration costs, based on taking one-half of the total lawyers' fees and other costs reported on estate tax returns, and reducing that number by 45 percent to reflect the tax deductibility of the costs. (Note that the last reduction is inappropriate for measuring the social, rather than private, costs of the activity.) The sum of their estimates for planning and estate administration comes to $1.675 billion in 1999, or about 6.4 percent of expected receipts.

They allocate another 0.6 percent of revenues for the administrative costs of IRS estate tax activities, for an estimated total cost of collection of 7.0 percent of revenues.

The Davenport-Soled (DS) estimate is more recent and more detailed than Munnell's. Although both estimates require some arbitrary assumptions, it is difficult to see how the basic DS methodology could be re-done with an alternative set of reasonable assumptions to yield an estimate that avoidance costs are anywhere close to 100 percent of revenues.

Claim 8: The estate tax raises charitable contributions

Economic reasoning suggests that the estate tax lowers the price of a charitable bequest with respect to any other bequest. To someone with a large estate, at the margin a one dollar gift to a charity comes at a cost of only 45 cents of after-tax bequest to a non-charity. The impact of this tax preference on charitable giving is uncertain. A large empirical literature, cited in Joulfaian (2000), generally finds that the subsidy raises charitable giving. Joulfaian (2000) concludes that eliminating the estate tax, and with it the deduction for charitable giving, would reduce charitable bequests by about 12 percent, or about $1.3 billion of charitable bequests in 1998. This is not a *fact*, it is *informed speculation*, and one that could probably be sharpened by taking advantage of the variation over time in the tax incentive to make charitable bequests at death and during life. But it is certainly preferable to simply asserting that for this margin of behavior taxes do or do not matter.

On the surface, it is internally inconsistent for opponents of the estate tax to highlight the fact that taxes affect behavior on one set of margins (wealth accumulation,

avoidance), but downplay this argument when it applies to another margin (charity). The qualitative arguments that have been made denying the importance of incentives sound very similar. It is, though, conceivable, that people's wealth accumulation is highly responsive to changes in the after-tax return, while charitable giving is quite insensitive.

Another contradiction is that opponents claim the estate tax does not reduce the concentration of wealth, but that eliminating the tax would not hurt charitable giving because the wealthy would have more wealth to give away.

IV. Rhetorical Issues

Claim 9: The estate tax is the death tax, and death should not be a taxable event

Opponents have taken to calling the estate tax the "death" tax. This is clearly an act of *rhetoric*, and in some ways it is highly misleading. First, only 2 percent of deaths result in positive estate tax payments, but all deaths generate basis step-up on the value of capital gains. Thus, 98 percent of the population receives a "death subsidy." Second, death is neither necessary nor sufficient to trigger transfer taxes. It is insufficient because, as just noted, 98 percent of people who die pay no estate tax. It is unnecessary because transfers between living persons can trigger gift taxes. In addition, although death may trigger a tax liability, payment can be made at different times. Estate tax liabilities can be effectively pre-paid, via life insurance purchases tied to the expected tax liability. And in the case of qualified family businesses, the tax can be paid over a 14-year period.

Opponents have also argued that death should not be a taxable event. This is a *value judgment.* However, several comments are relevant here. First, there must be some

provisions to deal with the taxes of a decedent. These provisions need to include, at least, the taxation of retirement accounts, the treatment of capital gains on assets held by the decedent. There appears to be little objection, and certainly no moralistic fervor, regarding the fact that IRA and 401(k) balances are taxed at death as if they were withdrawn. Second, if the problem is really that the tax is imposed at the time of death, it should be noted that the tax can be pre-paid. Third, if the problem is really that the tax is associated with death at all, then the logical solution is to replace the estate tax with an equally progressive tax imposed during life. The fact that such a solution is not supported by opponents of the tax suggests that taxation at death is not the real issue.

Moreover, while contemplation of death is not pleasurable, taxation at death may have other administrative, equity, and behavioral advantages. First, the probate process may reveal information about lifetime economic well-being that is difficult to obtain in the course of enforcement of the income tax, but is nevertheless relevant to societal notions of who should pay taxes. Second, taxes imposed at death may have smaller disincentive effects on lifetime labor supply and saving than taxes that raise the same revenue (in present value terms) but are imposed during life.[11] Third, if society does wish to tax lifetime transfers between adult households, it is difficult to see any time other than death at which to assess the total transfers made.

Claim 10: The wealth in estates has already been taxed once and sometimes more than that.

It is a *fact* that money used to make bequests other than charitable bequests *may* be taxed more than once. For example, after income tax on labor income is paid,

invested income may also be subject to a corporation income tax, followed by taxes on dividends and capital gains, after which the estate tax is but one of "four or five levels of taxation."[12]

However, counting the levels of tax is an exercise in *rhetoric*, and has no economic significance other than to remind us that, in calculating the effective tax disincentive, all relevant taxes must be considered and that the administrative and compliance costs may be higher when collected in a piecemeal way.[13] For example, in a value-added tax, goods are taxed at each stage of production; in a retail sales tax, they are only taxed once, at the retail level. Yet economists understand that—aside from administrative features—the two systems are economically equivalent, and the difference in the number of times the item is taxed is economically meaningless.

Moreover, it turns out that much of the wealth subject to the estate tax has *not* been taxed previously. Under the income tax, capital gains are taxed if and only if they are realized—that is, if the underlying asset is sold. Table 1 reports data on unrealized gains calculated from Poterba and Weisbenner (2001). The estimates imply that in 1998 about 36 percent of all wealth held by those who died consisted of unrealized capital gains. For estates in excess of $10 million, that figure rises to 56.4 percent. About 80 percent of all closely-held business and farm wealth consists of unrealized capital gains. Thus, especially for the wealthiest decedents and for decedents who owned closely-held businesses and farms, a significant majority of wealth in the estate has never been subject to income tax. This *fact* directly contradicts the notion that all wealth in estates has already been taxed once or more.

Conclusions

In an ideal world, whenever the Congress convened a panel of economists to comment on tax policy, it would confine them to identify statements of fact, economic reasoning, and informed speculation, each appropriately labeled. Congress would then convene a panel of ethicists, theologians, and philosophers, who would be confined to value judgments.[14] (The rhetoric, of course, is left to the politicians!). This never happens, though, and the economists' policy prescriptions are a mixture of what they think they know about economics and their value judgments, the latter of which have no special calling on the Truth. The debate over the estate tax is no exception, and may contain an even more unpalatable mixture of these elements than usual. We offer this paper in an effort to help separate out what we know, from what we reason to be true, from what we speculate about, from what we go on about, from what we value.

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[1] This analysis assumes that there are no labor supply effects of giving or receiving transfers. If larger transfers cause recipients to reduce their labor supply, then the case for a subsidy is weakened (Kaplow 2001). See also Bernheim (1989).

[2] If parental altruism is combined with opportunistic behavior on the part of children, a "Samaritan's Dilemma" arises: if the parent is altruistic toward the child, and the child knows that, the child has incentives to behave in ways that are counter to the parent's overall interest (Bruce and Waldman 1990). For example, the child would have incentives to overconsume when young in order to elicit a larger bequest from the parent. In this case, by making it more difficult for the parent to transfer resources to the child, the estate tax reduces the extent of overconsumption by the child, which would help correct the original imperfection (Gale and Perozek 2001).

[3] The relatively small size of the tax does imply is that it is exceedingly difficult to detect its impact, if any, on macroeconomic variables such as the concentration of wealth. For example, Bartlett (2000) notes that "international data suggest that wealth is probably more unequally distributed in the United States than in countries with no estate tax." But a tax that raises only 0.3 percent of GPD and 0.1 percent of net worth is probably not going to have a major impact on the aggregate distribution of wealth, even if almost all of its revenues serve to redistribute wealth. Moreover, high wealth inequality could be the reason we have an estate tax. More generally, any observed relationship with wealth inequality is of interest only if other determinants of inequality can be held constant, in a statistical sense.

[4] Note that we have now added a sixth type of statement, jargon.

[5] Other survey evidence is highly suspect, in part because it is based on people's stated intentions rather than their actions. Astrachan and Tutterow (1996) report that in a survey of 983 family-owned businesses, more than 60 percent reported that paying estate taxes will limit business growth, 13 percent said it would

make growth impossible, more than 60 percent said paying would threaten business survival, 8 percent said it would make survival impossible, and 33 percent said that paying estate taxes will require selling all or part of the business. But somewhat contradictorily, 45 percent of respondents said they had no knowledge of their likely estate tax liability.

[6] Holdings of farms and businesses are particularly low among the smallest taxable estates. Among taxable estates worth less than $1 million, only 1.0 percent of taxable estate value was due to small businesses. For those between $1 million and $2.5 million, small businesses account for only 2.6 percent of taxable estate value. But among the largest estates—those in excess of $20 million—closely-held businesses account for 32 percent of taxable estates.

[7] To put these figures in perspective, consider the following exercise. First, note that any estate with less than half of its wealth in farm or business assets could pay estate tax liability out of the rest of the estate without hurting the business. Second, in 1998, about 3 percent of taxable estates had more than half of gross assets in farm and small businesses (Committee on Ways and Means, 2000). Suppose the federal government had given each such estate $1 million in cash—surely a sufficient amount, given all of the other inducements for businesses, to allow any well-run, profitable small business to pay the 2 percent interest costs for 5 years and probably for longer than that. The total cost, $1.4 billion, would have comprised only 6 percent of transfer tax revenue in 1998 (Office of Management and Budget 2000).

[8] The special use value of real estate is obtained by capitalizing the income expected from the property in its current use.

[9] Schmalbeck (2001) suggests that this would not be a conservative adjustment. Empirical evidence also suggests that valuation discounts, or other avoidance measures, are substantial. Poterba and Weisbenner (2001) apply mortality probabilities to household wealth data in the 1998 SCF and project that about 49 percent of the wealth in estates above $10 million were due to active businesses and farms. In contrast, the corresponding figure in actual estate tax returns is between 13 percent and 22 percent (Gale and Slemrod 2001).

[10] Note that evasion is not without costs to the evader.

[11] This view has been expressed by J.R. McCulloch (1848), John Stuart Mill (1994), Richard Musgrave (1959), Joseph Pechman (1983), A. C. Pigou (1960) and others.

[12] "Non-Stop Taxes" (2001).

[13] The marginal efficiency cost of a given tax will be higher to the extent that existing taxes already affect the relevant margin.

[14] We call the readers' attention to the thought-provoking forthcoming book, *Justice in Taxation*, by the noted philosophers Liam Murphy and Thomas Nagel.

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Table 1:
Unrealized Capital Gains as a Percentage of Asset Values

	Estate Size (thousands of dollars)						
	All	Less than 250	250-500	500-1,000	1,000-5,000	5,000 to 10,000	10,000 and above
Primary Residence	66.8	61.0	73.9	62.3	79.1	53.1	65.5
Other Real Estate	47.5	46.1	22.1	73.3	51.5	67.0	56.4
Business and Farm	80.1	54.3	67.4	57.8	77.4	79.2	82.6
Other Business	76.2	n.a.	67.4	92.3	77.4	87.8	77.1
Public Stock and Mutual Funds	26.8	-32.5	12.3	31.6	34.5	25.8	33.0
Total	36.3	36.2	33.7	34.0	34.6	24.0	56.4

Source: Authors' calculations based on Poterba and Weisbenner (2000).