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## TIME TO REPEAL FEDERAL DEATH TAXES: THE NIGHTMARE OF THE AMERICAN DREAM

**WILLIAM W. BEACH**

In August 1996, when The Heritage Foundation first published "The Case for Repealing the Estate Tax,"<sup>1</sup> few in Washington or around the country believed that such reform was possible. Today, not only does it appear likely, but support in Congress is strong. Congress, which twice had sent to the President legislation that would end America's 85-year-old policy of taxing the fruits of hard work, thrift, and intergenerational saving, is poised to send President George W. Bush its third repeal of death taxes, and the White House has signaled that such legislation would be welcome.

Important reform and repeal legislation continues to attract significant support in both the House and the Senate. The House is now considering H.R. 8, which the Ways and Means Committee approved on March 29, 2001, to phase out federal death taxes over a 10-year period. The leading immediate repeal bill in the House is H.R. 330, the Family Heritage Preservation Act, which already enjoys 179 cosponsors just two months after its introduction. In the Senate, the leading reform legislation is S. 275, the Estate Tax Elimination Act of 2001. This bill proposes to repeal immediately all federal death taxes, to exempt about \$3 million in

family assets from capital gains taxation, and to tax the intergenerational wealth transfers above this amount at the long-term capital gains tax rate of 20 percent.

By majorities consistently above 60 percent since the last presidential campaign began, support for death tax repeal among voters is strong, even among those who know they never will have to pay estate, gift, or generation-skipping taxes. Nevertheless, the effort to repeal the death tax may prove difficult. Even with strong congressional support throughout most of the 1990s,<sup>2</sup> a new President who has pledged to sign legislation repealing federal estate taxes, and a public generally opposed to taxing a family's wealth again at death, estate taxes remain a source of revenue.

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1. See William W. Beach, "The Case for Repealing the Estate Tax," *Heritage Foundation Backgrounder* No. 1091, August 21, 1996. This analysis is based on that study and updates its findings.

Bolstered by President Bush's tax proposal that includes death tax repeal, Congress should make eliminating the death tax a priority this year. The evidence is growing that the death tax:

- **Reduces economic growth**, which hurts the jobs and incomes of the very people wealth redistribution was intended to aid;
- **Increases the cost of capital**, thus slowing research and development and investment in assets that would increase worker productivity and wages;
- **Keeps interest rates higher** than they should be on home loans and other major purchases;
- **Raises very little revenue**—in fact, the death tax may cost the government and taxpayers more in administrative and compliance fees than it raises in revenue; and
- **Leads to tax evasion.** Current wealth taxation policy stems from the mistaken view that redistributing income leads to the redistribution of economic power. Nearly a century of wealth taxation shows, however, that such policy leads to tax evasion, encouraging well-to-do and even middle-class American families to find legal ways to avoid the tax collector. Not only are they saving less and consuming more of their incomes, benefiting from the lower taxes on that consumption, but they also make less productive investments, such as large life insurance policies and substantial charitable contributions, to reduce the chances that their death will leave a large taxable estate.

The policy of using the estate tax to redistribute economic power actually leads to a distorted distribution of consumption and a less productive economy. Both of these unexpected outcomes worsen the economic condition of the less economically powerful.

As the Founders understood, reducing legal barriers to economic opportunity is the best public means of enabling every citizen to gain wealth. The U.S. Constitution prohibited direct taxes on

wealth and income except in times of national emergency until the ratification of the Sixteenth Amendment, which lifted the ban in 1913, and wealth taxation remains inconsistent with the principle of limited government. The case for repealing the estate, gift, and generation-skipping tax turns on three factors:

1. The **diminishing importance** of the estate tax as a federal revenue stream;
2. The **failure** of the tax to achieve its public policy objectives, principally the creation of economic benefits for lower-income Americans; and
3. The **continuing damage** the tax death exacts on the U.S. economy in terms of jobs, output, and growth.

The evidence can be found in academic and econometric studies. A recent Heritage Foundation econometric simulation of the effects of estate tax repeal confirms the findings of four such studies: Repeal would lead to a jump in total employment by an average of 142,000 jobs per year over the next 10 years. Inflation-adjusted disposable income would grow by an average of \$22 billion and would end the 10-year period at more than \$32 billion above the current-law baseline. Indeed, the new economic strength produced by death tax repeal would create enough new taxable income that total federal revenues would fall by less than half the amount expected.<sup>3</sup>

A 1996 Heritage Foundation analysis, using two leading econometric models, also found that repealing the estate tax would have a large and beneficial effect on the economy.<sup>4</sup> (See the appendix.) Over a nine-year period following the repeal of the death tax, the nation's economy would average up to \$11 billion per year in extra output; an average of 145,000 additional new jobs would be created; personal income would rise by an average of \$8 billion per year above current projections; and the federal deficit would decline, since revenues generated by the extra growth

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2. The Family Heritage Preservation Act, introduced by Representative Christopher Cox (R-CA), has consistently attracted substantial bipartisan support each year it has been filed. The Cox bill and S. 275, introduced by Senator Jon Kyl (R-AZ), are the leading repeal bills now before Congress.

would more than compensate for the meager revenues raised by the inefficient tax.

An econometric study conducted in 1993 by Professor Richard Wagner of George Mason University found that within eight years of eliminating the tax, annual production would increase by \$80 billion, creating an additional 250,000 jobs and \$640 billion more in capital stock.<sup>5</sup>

More recently, work by the Institute for Small and Emerging Business has found that immediate estate tax repeal and the introduction of capital gains taxes imposed on intergenerational wealth transfers would produce significant economic benefits. According to this analysis, employment would rise by an average of 131,000 per year, after-tax disposable income for average-income households would increase by an average of \$18.1 billion after inflation, and inflation-adjusted GDP would jump by four-tenths of a percent. The study's authors also found that federal revenues would recover from the "loss" of estate taxes by the fifth year following repeal. In other words, substituting capital gains taxation on transfers at a 20 percent rate for estate taxes that begin at 39 percent actually would raise as much revenue after a relatively short period of time.<sup>6</sup>

Gary and Aldonna Robbins published similar results in 1999.<sup>7</sup> They used the Fiscal Associates Tax Model to show that repeal of federal death

taxes would likely result in average employment gains of 112,000 jobs. They also found that federal revenues completely recover from estate tax repeal by the seventh year following repeal. Much of this strong growth in revenue would come from the boost given to the nation's capital stock following death tax repeal. The Robbins predict that U.S. capital would be higher by almost \$1.5 trillion following repeal than it would be without it.

The estate tax has few remaining friends. It raises little revenue at a heavy cost to the economy, and it generates complex tax avoidance schemes. The hardest hit by the tax are small-business people who work hard to pass on an enterprise of value to their children. And its bias against saving and wealth generation is the antithesis of the American dream.

## **HOW THE ESTATE AND GIFT TAX WORKS**

Current federal wealth transfer law is a confusing maze. Even some who navigate the estate, gift, and generation-skipping tax laws with professional assistance find the journey daunting.<sup>8</sup>

### **The Estate Tax**

The largest component of the federal government's wealth taxation system is the estate tax. Current estate tax law has three elements:

3. This March 2001 simulation was performed by analysts in the Center for Data Analysis at The Heritage Foundation using the Mark 11 U.S. Macro Model of WEFA, Inc., formerly Wharton Econometric Forecasting Associates. The model was developed in the late 1960s by Nobel Prize-winning economist Lawrence Klein and several of his colleagues at the University of Pennsylvania's Wharton School of Business. It is widely used by Fortune 500 companies, prominent federal agencies, and economic forecasting departments. The methodologies, assumptions, conclusions, and opinions herein are entirely the work of Heritage Foundation analysts. They have not been endorsed by, and do not necessarily reflect the views of, the owners of the model.
4. Beach, "The Case for Repealing the Estate Tax."
5. Richard E. Wagner, *Federal Transfer Taxation: A Study in Social Cost* (Washington, D.C.: Institute for Research on the Economics of Taxation, 1993).
6. See Richard F. Fullenbaum and Mariana McNeill, "The Effects of the Federal Estate and Gift Tax on the Aggregate Economy," Working Paper Series 98-01, Research Institute for Small and Emerging Business, 1998, pp. 14-17. Forthcoming econometric research by Wilbur Steger of Carnegie Mellon University also finds significant economic benefits from repeal. See Steger, "Testimony Before the Senate Finance Committee Subcommittee on Taxation and IRS Oversight on Preserving and Protecting Family Business Legacies," March 13, 2001, pp. 2-3.
7. Gary Robbins and Aldonna Robbins, "The Case for Burying the Estate Tax," Institute for Policy Innovation Policy Report No. 150, 1999, pp. 19-20.

(1) determining the gross estate, or the estate tax base, of a decedent; (2) determining the taxable estate, after allowable deductions are taken from the gross estate; and (3) computing estate tax liability.

**1. The Tax Base.** Estate tax law defines the gross estate of a decedent as the “fair market value”<sup>9</sup> of all personal or real property, wherever situated and however tangible, at the time of death.<sup>10</sup> This valuation of an estate attempts to quantify such property at its “highest and best use.” However, the valuation of a business or a farm on a “fair market value” standard may actually result in an artificially low value for an ongoing enterprise. For example, consider a start-up business in a good part of town. The owner suddenly dies, and his son wants to continue the business. If the estate tax value is determined by recent sales of other businesses located near it, then it may be valued at an amount well above its actual worth based on the cash generated by the business (which could even be operating at a loss in this early phase). This valuation makes a big difference to an estate, since the business may have to be

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- 8. The following section relies heavily on a comprehensive summary of federal wealth taxation in John R. Luckey, “Federal Estate, Gift, and Generation-Skipping Taxes: A Description of Current Law,” CRS Report for Congress, Congressional Research Service, March 16, 1995, and Staff of the Joint Committee on Taxation, “Description and Analysis of Present Law and Proposals Relating to Federal Estate and Gift Taxation,” Prepared for the Subcommittee on Taxation and IRS Oversight of the Senate Committee on Finance, March 15, 2001.
  - 9. “Fair market value” apparently means the value of an asset that a fully informed buyer would pay in a market for the asset. The concept implies the existence of a willing seller and able buyer, which is rarely the case when an estate is valued for tax purposes. Thus, executors of estates must rely on various proxy prices for an estate’s assets, such as recent closing prices for stocks and bonds and property sales of similar assets that are contemporary with the death of the decedent. The value of “good will” is a particularly vexing problem in estate tax valuation. Due to the numerous artifices that executors and courts must employ to place a value on estates, the resulting “gross estate” frequently bears little relationship to its market value. For example, an estate consisting solely of art that has been held for many years may have little market value if the tastes of the art-buying public have changed dramatically during the holding period.
  - 10. While “fair market value” at the time of death is the most common method of quantifying a decedent’s death, an executor of an estate paying tax can elect an alternative valuation date that is somewhat earlier or six months after the date of death. This alternative date method applies particularly to estates dominated by bonds or stocks in companies whose value is significantly affected by the death of the decedent. See 26 U.S.C. Secs. 2031(a) and 2032(a).
  - 11. 26 U.S.C. Sec. 2032A. This is one of the most complex sections of the estate tax code and has been the source of substantial litigation. The statute is 11 pages in length.
  - 12. See Joint Committee on Taxation, “Description and Analysis of Present Law,” pp. 4–8, for a discussion of changes in Sec. 2032 and Sec. 2057 of the tax code.
  - 13. Luckey, “Federal Estate, Gift, and Generation-Skipping Taxes,” p. 2.

sold in order to pay the estate tax if the son is unable to raise a loan to pay it.

In 1976, Congress recognized this negative potential of the “fair market value” rule and permitted estates containing small businesses and farms to be valued at their present use rather than at their “market value.”<sup>11</sup> Congress further modified the valuation rules in 1997 to expand the amount excluded from taxation for certain types of business assets and establishing new rules for valuing farm properties.<sup>12</sup>

**Insurance Policies.** Special rules apply to the value of insurance policies contained in a decedent’s estate. If the life insurance policy is paid out to benefit the estate, or if the decedent either held a property right in the policy or conveyed this property right within three years of death, then the value of the policy is added to the gross estate. A similar rule applies to annuities.<sup>13</sup>

**Joint Property.** A property rights rule also applies to property owned jointly by the decedent and someone other than the decedent’s spouse: Such jointly owned property is

included in the gross estate to the extent of the ratio of consideration furnished. With respect to property owned jointly with a surviving spouse, only 50 percent of such property becomes a part of the gross estate.<sup>14</sup>

**Gifts.** Gifts and other transfers of property made by the decedent well before death also may be included in the gross estate if the decedent retained the ability to influence the disposition and use of such property. Similar inclusion in the gross estate applies to gifts that occur only upon death. However, sales of property and other alienation of property from the decedent's control made throughout his or her life are not included in the gross estate.

2. **Deductions.** Once the total value of an estate has been calculated, numerous deductions may be applied. The result of these subtractions from the gross estate is the taxable estate. The first category of deductions relates to direct expenses of the estate: All costs of the funeral, legal claims against the estate, the executor's administration of the estate, and mortgages paid by the estate may be deducted.<sup>15</sup> Second, the value of property passing to the decedent's surviving spouse may be deducted. Finally, the estate may deduct the value of all charitable bequests to organizations recognized by the federal government as tax exempt.
3. **Tax Liability.** The taxable estate that results from the application of these gross estate deductions is taxed according to a somewhat cumbersome four-step process. First, the value of all taxable gifts made over the decedent's lifetime is added to the net estate. Second, a before-credits tax is calculated by multiplying

this "grossed up" estate by the relevant tax rate. Third, this before-credits tax is reduced by subtracting the tax on all gifts made after 1976. Fourth, various credits are applied to the remaining sum.<sup>16</sup>

There are four credits available for estate tax reduction, but by far the most significant is the unified transfer tax exemption.<sup>17</sup> This exemption currently stands at \$675,000 of net taxable estate. Thus, current law exempts from taxation the assets of otherwise taxable estates up to \$675,000 in value. Above \$675,000, estates face tax rates of from 39 percent to 55 percent.<sup>18</sup>

## The Gift Tax

The second layer of federal wealth transfer taxation is the levy on lifetime property gifts. Like the definition of gross estate, current law contains a host of decisions that the courts and executors must make in determining the value of taxable gifts.

1. **The Tax Base.** Perhaps the most difficult decision of all is the one that must be made first: determining the value of the decedent's lifetime giving. This difficulty arises on two fronts.

*First*, a gift is the transfer of property for something less than full legal consideration to a party generally within the donor's family. On the one hand, the executor must determine which gift transfers meet the test of insufficient legal consideration. On the other hand, the executor must distinguish between gifts made for income tax purposes that require "detached and disinterested generosity" and those that qualify for the gift tax.<sup>19</sup>

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14. 26 U.S.C. Sec. 2040(b).

15. Luckey, "Federal Estate, Gift, and Generation-Skipping Taxes," p. 4.

16. 26 U.S.C. Sec. 2001(b).

17. The other three credits are for death taxes imposed by a state government, foreign death taxes, and estate taxes paid by a previous estate on property currently contained in the taxable estate. See Joint Committee on Taxation, "Description and Analysis of Present Law," pp. 2-3.

18. 26 U.S.C. Sec. 2001(c)(3).

Second, the executor or the court must wrestle with the question of “fair market value.” The federal gift tax requires that *all* wealth transfers made as gifts over the decedent’s entire life be valued for taxation. This means, incredibly, that appraisals of value must be made for gifts made decades before the decedent’s death. Moreover, these gifts must be appraised in terms of their “fair market value” at the time they were made, which is a task that often stretches the frontiers of property appraisal to the breaking point.

Such extraordinary efforts at valuation and record reconstruction must be made in order to determine whether the annual level of gift giving exceeded the allowed limits. An estate may exclude from the gift tax base all annual present interest gift transfers of \$10,000 or less per donee.<sup>20</sup> If the donor made the gift to meet the donee’s tuition or medical expenses, however, the limit does not apply. Furthermore, if the donor’s spouse elects to make a similar gift to the same donee (a practice known as gift-splitting), the annual limit rises to \$20,000. All gifts above these limits become part of the gift tax base.

2. **Deductions.** Like the estate tax base, the gift tax base can be reduced by certain deductions. Besides gift-splitting, certain gifts to one’s spouse may be deducted. Also, gifts to charities recognized by the IRS as tax-exempt organizations can be deducted from the gift tax base.<sup>21</sup> Finally, special rules apply to the division of property in a divorce or separation, and this leads to more gift tax deductions.<sup>22</sup>
3. **Tax Liability.** Computing the amount of gift tax is relatively simple. Taxable gifts for the current and all previous calendar years are summed and taxed using the tax rate table for

estates. Then this total amount of gift tax is reduced by any unused unified transfer tax credit.

To illustrate, suppose that a married couple gave their only child \$10,000 a year for a period of 20 years, for a cumulative total of \$200,000. These gifts equal the maximum annual amount that taxpayers may exclude from the federal gift tax base. However, for four years this couple made additional gifts to their child of \$100,000 a year, for a total of \$400,000. This latter amount is above the limit and is taxable. Now suppose that the gross taxable estate of this couple equals \$1,000,000, which includes the taxable gifts. The executor of the estate will use the unified credit of \$675,000 to reduce the taxable amount and will pay taxes on the remaining \$400,000, or the additional gifts the couple gave their child.

### The Generation-Skipping Tax

Wealth transfer taxes have been so consistently high throughout this century that a substantial cottage industry devoted to estate tax avoidance has blossomed within the legal and financial communities. One clever invention was a trust established by a parent for the lifetime benefit of his children that passed tax-free to the parent’s grandchildren upon the parent’s death (or bypassed the children and went directly to the grandchildren). The trust avoided estate taxes altogether because such taxes are never levied on amounts that cannot be controlled by the taxpayer. However, some trusts were designed to pay out to the grandchildren upon the death of the taxpayer’s children. Thus, the taxpayer could target specific individuals to receive benefits from the estate if the taxpayer could skip a generation through the creative use of a tax-free trust.

19. *Comm'r v. Duberstein*, 363 U.S. 278 (1960); Luckey, “Federal Estate, Gift, and Generation-Skipping Taxes,” p. 8.

20. Prior to 1982, the annual limit was \$3,000 per donee; 26 U.S.C. Sec. 2503. In 1997, Congress legislated an annual inflation adjustment in the annual gift amount. However, for 2001, the amount remains \$10,000. See Joint Committee on Taxation, “Description and Analysis of Present Law,” p. 3.

21. 26 U.S.C. Sec. 2522.

22. 26 U.S.C. Sec. 2516.

In 1986, Congress addressed these loopholes for the indirect generation-skipping transfer and the trust or bequest that directly skipped the parent's children. As part of the Tax Reform Act of 1986, it established a flat-rate tax of 55 percent on all generation-skipping transfers. Subject to the tax are transfers made from a trust to a "skip person" (someone two or more generations removed from the donor); those made by a donor directly to a skip person without going through a trust; and those that result from termination of an interest in a property or trust, which usually happens upon the death of the donor.<sup>23</sup>

As with the estate tax and the gift tax, several exclusions and exemptions apply. The same \$10,000 annual exclusion and tuition and medical exemptions found in the gift tax law apply to generation-skipping taxes. Following the 1997 reforms, the lifetime exclusion is adjusted annually for inflation. For 2001, the generation-skipping tax exemption stands at \$1,060,000 for individuals and \$2,120,000 for couples.<sup>24</sup>

## THE LIBERAL CASE FOR REPEALING THE ESTATE TAX

This complex tax edifice rests on the foundation that taxing intergenerational wealth transfers results in less concentrated wealth holdings, which leads in turn to greater economic opportunity and a more democratic society.<sup>25</sup> Certainly, given the relatively small amount of annual federal revenues raised, the complex estate and gift tax cannot be justified as playing an important role in financing government: The unified estate and gift tax now brings in less than 2 percent of total federal revenues.

23. 26 U.S.C. Sec. 2612 and Sec. 2613.

24. Joint Committee on Taxation, "Description and Analysis of Present Law," p. 8.

25. This case most recently has been made by William H. Gates, Sr., in testimony before the Subcommittee on Taxation and IRS Oversight of the Senate Committee on Finance, March 15, 2001. Gates argued that he stood with "Theodore Roosevelt, Louis Brandeis, Herbert Hoover and scores of other wise observers in the early 1900s that it is not in the interest of this country to have large fortunes passed from generation to generation forming ever larger pools of money and accretion of power. While the estate tax does not completely prevent such transfer it does make serious inroads on what would, without it, be an ever increasing, inexorable build up of a larger and larger pool of money." See Gates testimony, p. 1.

26. John Rawls, *A Theory of Justice* (Cambridge, Mass.: Harvard University Press, 1971).

27. *Ibid.*, p. 303.

## Intergenerational Wealth Taxation

The case for the estate tax turns on the tax's effectiveness in achieving greater economic democracy through the redistribution of wealth. If its supporters cannot sustain the argument that the estate tax improves equality of economic opportunity, there is little else to support continuing this tax policy.

Nevertheless, academic support for intergenerational wealth taxation remains warm, in large part because of the role it plays in John Rawls's 1971 treatise on liberal egalitarianism, *A Theory of Justice*.<sup>26</sup> It is fair to say that no stronger theoretical case for intergenerational wealth taxation exists. At the center of Rawls's case for wealth taxation is the principle that

[a]ll social primary goods—liberty and opportunity, income and wealth, and the bases of self-respect—are to be distributed equally unless an unequal distribution of any or all of these goods is to the advantage of the least favored.<sup>27</sup>

This tolerance for intragenerational differences leads Rawls to oppose all income taxes, since economic income stems from natural differences in talent and from differing propensities of individuals to apply themselves to hard work.<sup>28</sup> However, two principled considerations compel Rawls to take exception to intergenerational differences in economic condition.

First, Rawls opposes the transfer of accumulated property to succeeding generations because it undermines the first principle of a just society: that everyone has "an equal right to the most extensive total system of equal basic liberties

compatible with a similar system of liberty for all.”<sup>29</sup> Those who begin with a significant unearned endowment of property resources place others not so advantaged in a less equal condition, and this undermines the principle that everyone should have access to the same system of equal basic liberties.

Second, this difference might be tolerated if it produced greater benefits for the least advantaged than it does for the advantaged. However, intergenerational wealth transfers create benefits that flow in the opposite direction: Over time, they enhance the advantages of inheriting generations and generally degrade the liberties of the unbefitted. Thus,

[t]he taxation of inheritance and income at progressive rates (when necessary), and the legal definition of property rights, are to secure the institutions of equal liberty in a property-owning democracy and the fair value of the rights they establish.<sup>30</sup>

Although Rawls does not advance confiscatory taxation of intergenerational wealth transfers, his argument does imply substantial taxing discretion by the state. In his universe, should government determine that wealth transfers constitute significant barriers to the equal enjoyment of liberties (as defined by Rawls), it clearly has the power to tax away as much of the wealth that moves between generations as it deems necessary to restore justice.

**Objections to the Liberal Case for the Estate Tax.** A number of objections could be raised against the Rawlsian case for wealth transfer taxation, not the least of which concerns the questionable assertion of government authority

over the intergenerational disposition of private property.

If wealth is acquired legally and transferred peacefully (that is, in some fashion that breaches no contract pertaining to the property), government has no ethical standing to interfere with its disposition.

Of course, liberal egalitarians claim a more expansive role for government, including the progressive enhancement of citizens' equality of condition. Thus, it is important first to consider the estate tax within the context of the argument that justifies its existence. If it can be shown that the estate tax does not advance the ethical program of the liberal egalitarians, then compelling objections to this tax can be raised without assuming this ethical and moral framework.

Edward J. McCaffery took this approach in an article published in *The Yale Law Journal* in 1994.<sup>31</sup> As he stated in 1995 before the U.S. Senate Committee on Finance:

I am an unrequited liberal, in both the classical and contemporary political senses of that word, whose views on social and distributive justice might best be described as progressive. I used to believe in the gift and estate tax as a vehicle for obtaining justice. As to the latter belief, only, I am now prepared to confess that I “was blind, but now can see.”<sup>32</sup>

McCaffery raises five general objections to the liberal egalitarian argument supporting intergenerational wealth taxation.

- **The combined income and estate tax system encourages large *inter vivos* gift transfers,**

28. Rawls advances a consumption tax to replace income taxes. “For one thing, it is preferable to an income tax (of any kind) at the level of common sense precepts of justice, since it imposes a levy according to how much a person takes out of the common store of goods and not according to how much he contributes (assuming here that income is fairly earned).” *Ibid.*, p. 278.

29. *Ibid.*, p. 302.

30. *Ibid.*, p. 279.

31. Edward J. McCaffery, “The Uneasy Case for Wealth Transfer Taxation,” *The Yale Law Journal*, Vol. 104 (November 1994), pp. 283–365.

32. Edward J. McCaffery, “Testimony Before the Senate Committee on Finance,” June 7, 1995.

which create a greater inequality of starting points or a less level economic playing field. This predictable effect of estate tax law is aggravated by the fact that high estate tax rates encourage consumption rather than transfer of wealth. Purchasing goods and services instead of saving the funds that support that consumption produces larger differences between the rich and poor. Thus, the estate tax is illiberal because it undermines rather than advances the liberal egalitarian objective of equality of economic opportunity.

- **Higher wealth transfer taxes and other tax law changes that could penalize the spending behavior of rich families are practically and politically impossible.** On the one hand, analysts are increasingly aware of the intergenerational focus of much current saving behavior at all income levels. Liberals should promote the creation of transferable wealth among the less advantaged. On the other hand, politicians are increasingly aware of how voters want taxes to fall, not rise. The estate or inheritance tax already has been repealed in Australia, Canada, Israel, and California, and the movement for tax reform is worldwide.
- **There will always be differences between the starting conditions of people in a non-ideal world.** If liberal egalitarians attempted to eliminate all the differences that stem from intergenerational wealth transfers, they would risk leaving the least advantaged even worse off. Not only would confiscatory taxation reduce the consumption behavior of wealthy people, thereby reducing employment and incomes among poorer citizens, but it would depress the amount of economic capital as well, thereby reducing economic expansion and income growth, both of which are central to improving the conditions of the least advantaged.
- **[It] is the use and not the mere concentration of wealth that threatens reasonable**

**liberal values.**<sup>33</sup> Generally speaking, the accumulation of savings and the promotion of earnings that underlie the growth of savings are “goods” that liberals like. Earnings and savings create a “common pool” of resources that can be used to promote improvements in the general welfare through public and private means. Liberals generally regard the consumption behavior of the wealthy as objectionable; thus, wealth transfer taxation, which attacks savings and promotes wanton consumption, is wholly ill-suited to the attainment of an ideal liberal society.

- **The best tax policy that liberal egalitarians could pursue, if attaining liberal social and political objectives truly motivates them, is one that taxes consumption, not savings.**

McCaffery writes that

[b]y getting our reasonable political judgments wrong—by taxing work and savings while condoning, even encouraging large-scale use [consumption]—the status quo impedes the liberal project.... The real threats to liberty and equality from private possession alone turn out, on closer scrutiny, to relate to possession *qua* potential or actual use, each of which can...best be addressed—in a tax system without an estate tax.<sup>34</sup>

Not only is the estate tax inconsistent with a liberal program of promoting equality of economic condition, but it encourages behavior that works against liberal objectives. It supports consumption and depletion by penalizing savings and earnings. It encourages a strange world in which it costs less for a millionaire like Steve Forbes to spend \$30 million of his own money on a presidential campaign than to save \$30 million for his children’s future—an investment upon which he will pay a 55 percent transfer tax as opposed to a campaign expenditure upon which no additional

33. McCaffery, “The Uneasy Case for Wealth Transfer Taxation,” p. 296.

34. *Ibid.*; emphasis in original.

taxes are levied. How many new jobs and new businesses did Mr. Forbes's campaign create as opposed to the same amount saved in a bank that lends the funds to entrepreneurs and business managers? Liberals and conservatives are beginning to answer this question in precisely the same way.

**Criticism of the Estate Tax.** The weaknesses of the estate and income tax system as a tool for redistribution of wealth are well-known. Joseph Stiglitz, who served as chairman of President Bill Clinton's Council of Economic Advisers, concluded in 1978 that the estate tax effectively transfers resources from the saver to the spender and, absent any offsetting tax policy change, will reduce the stock of capital and lead to lower levels of national wealth.<sup>35</sup> Furthermore, wrote Stiglitz,

because of capital accumulation effects, the estate tax may not achieve the objective to which it is presumably directed, that is, equalizing the distribution of income; if the government takes actions to offset these accumulation effects, the tax will lead to an increase in equality of income and wealth. The desirability of the estate tax may still be questioned, not only because of the distortions which it introduces but also because it may actually increase inequality in the distribution of consumption.<sup>36</sup>

Alan Blinder, a member of Clinton's initial Council of Economic Advisers and subsequently vice chairman of the Federal Reserve Board of Governors, also has raised serious doubts about the redistributional promises of the estate tax.<sup>37</sup> He has been joined by Michael Boskin, Martin Feldstein, Gary Becker, Laurence Kotlikoff, Lawrence Summers, and many other economists with prominent connections to mainstream economics.<sup>38</sup>

In a recent literature review on the economic effects of wealth transfer taxation, Bruce Bartlett of the National Center for Policy Analysis found nearly universal agreement among leading economists that taxing wealth transfer at death undermines economic efficiency, wages, and, ultimately, federal revenues.<sup>39</sup>

## THE ECONOMIC CASE AGAINST THE ESTATE TAX

In addition to declining enthusiasm among liberals for the ideology of wealth taxes, two economic issues add momentum to the calls for repeal of the estate tax. One is the mounting weight of economic and financial evidence against the estate and gift tax as such. The other is the growing understanding that income taxes and the multiple taxation of savings reduce economic growth and in turn slow the rate of economic

35. Joseph E. Stiglitz, "Notes on Estate Taxes, Redistribution, and the Concept of Balanced Growth Path Incidence," *Journal of Political Economy*, Vol. 86 (1978), Supplement, pp. 137–150.

36. *Ibid.*, p. 137.

37. Alan S. Blinder, "A Model of Inherited Wealth," *Quarterly Journal of Economics*, Vol. 87 (1973), pp. 608–626. See also Blinder, "Inequality and Mobility in the Distribution of Wealth," *Kyklos*, Vol. 29 (1976), pp. 607 and 619, as quoted in McCaffery, "The Uneasy Case for Wealth Transfer Taxation," p. 322, note 143: "[a] doubling of the tax rate, which must be considered as barely (if at all) within the realm of political feasibility, reduces both the average level and inequality of inherited wealth—but by very modest amounts. Even the ridiculous 60% tax rate has effects which are far from revolutionary. The reformer eyeing the estate tax as a means to reduce inequality had best look elsewhere."

38. Michael Boskin, "An Economist's Perspective on Estate Taxation," in Edward C. Halback, Jr., ed., *Death, Taxes and Family Property: Essays and American Assembly Report* (St. Paul, Minn.: West Publishing Co., 1977); Lawrence H. Summers, "Capital Taxation and Accumulation in a Life Cycle Growth Model," *American Economic Review*, Vol. 71 (1981); Martin Feldstein, "The Welfare Cost of Capital Income Taxation," *Journal of Political Economy*, Vol. 86 (1978); Laurence J. Kotlikoff, "Intergenerational Transfers and Savings," *Journal of Economic Perspectives*, Vol. 2 (1988).

39. See Bruce Bartlett, "Wealth, Mobility, Inheritance and the Estate Tax," National Center for Policy Analysis Policy Report No. 235, June 2000, pp. 5–7, 14–15.

improvement by the least advantaged. Among the economic problems associated with the tax:

- **The estate tax raises little revenue and encourages expensive tax avoidance.**

Despite the tax's broad reach, theoretically touching upon nearly all transferable wealth, the unified estate and gift tax raised only \$27.8 billion in 1999.<sup>40</sup> Since the early 1930s, the revenue from the tax has fallen steadily as a percentage of total federal revenue, while at the same time the total amount of wealth has risen dramatically.

When a tax raises significantly less in revenue than expected, often it is because taxpayers have discovered ways to avoid payment and have changed their economic behavior in ways that reduce the pool of funds from which the tax is drawn. Public finance economists have struggled for a long time with this issue, since both the size of legal tax avoidance and the degree to which taxpayers change their behavior in order to reduce their estate tax liabilities are unclear. Moreover, economists do not know the size of the wealth pool within which estates are formed. The Federal Reserve recently published new estimates of household net worth, which they suggest stood at \$28.9 trillion in 1998.<sup>41</sup> While this amount by no means constitutes the tax base for the estate tax, a portion of this enormous sum most certainly does. For example, Laurence J. Kotlikoff estimates that slightly more than 50 percent of household wealth is held as intergenerational savings.<sup>42</sup> If one assumes that this 50 percent (or \$14.5 trillion) is transferred in equal amounts over two generations,

or 46 years, then about \$314 billion annually is moving to the next generation.

Even this figure probably overstates the tax base for the estate tax. Many economists argue that taxpayers who believe they will pay estate taxes will change their economic behavior in ways that result in a huge shrinkage of the estate tax base.<sup>43</sup> B. Douglas Bernheim argues that high estate tax rates lead taxpayers to make far more cash gifts to their children than they otherwise would, in large part because their children pay taxes at lower rates than they do. Bernheim estimates that 50 percent to 75 percent of all intergenerational gifts are made because of the estate tax. Charitable gifts and other revenue losses are between 70 percent and 80 percent of total estate tax revenue. Put another way, indirect revenue losses in 1999 might have been \$22 billion on revenues of \$27.8 billion.<sup>44</sup>

These revenue data strongly imply significant tax avoidance and other economic behavior that responds to high tax rates by moving national wealth (and thus, generally, taxable estates) from savings to consumption. It is exceptionally difficult, however, for analysts to go from implication to quantification. Recent breakthroughs in the economic understanding of household savings may lead ultimately to convincing estimates of how much savings behavior stems from income and estate tax policy. Even so, economists can offer a number of important insights about the deleterious economic effects of tax policy on economic performance.

40. Joint Committee on Taxation, "Description and Analysis of Present Law," p. 24.

41. See Arthur B. Kennickell, Martha Starr-McCluer, and Brian J. Surette, "Recent Changes in U.S. Family Finances: Results from the 1998 Survey of Consumer Finances," *Federal Reserve Bulletin*, January 2000, p. 7, Table 3.

42. Kotlikoff, "Intergenerational Transfers and Savings."

43. For the latest detailed data on estate and gift tax collections, see Internal Revenue Service, *Statistics of Income Division, Estate Tax Returns Filed in 1993*, "Table 2: Gross Estate by Type of Property, Deductions, Taxable Estate, Estate Tax After Credits, by Tax Status and Size of Gross Estate." In 1993, there were 27,508 taxable estate tax returns with a total gross value of \$59.2 billion.

44. B. Douglas Bernheim, "Does the Estate Tax Raise Revenue?" in Lawrence H. Summers, ed., *Tax Policy and the Economy*, Vol. 1 (Cambridge, Mass.: National Bureau of Economic Research and MIT Press Journals, 1987), pp. 121–132. Bernheim attributes a sizable portion of this loss to charitable gifts. But see John S. Barry, "How the Flat Tax Would Affect Charitable Contributions," *Heritage Foundation Backgrounder* No. 1093, December 16, 1996. See also David Joulfaian, "Charitable Bequests and Estate Taxes," *National Tax Journal*, Vol. 44 (1991), pp. 169–180.

- **The estate tax discourages savings.**

Savings take many different forms—cash reserves in a bank, stock in a corporation, art, land, housing, ownership of a business, and so forth—that serve many different purposes. Households hold cash in a bank largely to finance future consumption, such as the purchase of a house, or as a hedge against unanticipated household expenses like costly medical care. Similarly, the equity component of a mortgage is designed to be used to purchase future housing. These two forms of savings are largely liquid and thus earn relatively low rates of return.

Households put money in a bank with the understanding that their funds can be withdrawn virtually at any time the household prefers. The bank in turn lends these savings with this same understanding in mind and therefore prefers relatively short-term, low-risk loans that contain significant liquidity for the bank. So if a household saves in a long-term time deposit (for example, a 10-year certificate of deposit), it will demand a higher rate of return as compensation for not having these funds available for consumption. The bank in turn is freer to invest in riskier ventures for which it also can demand a higher rate of return. The bank's cost of a loan failure also falls when it is working with longer-term savings: It knows it has a certain period of time to make successful loans that cover its contract with the saver and yield the bank a profit.

The decision to save largely follows this simple story. When households consume most of their income, any long-term investment must earn a high return. However, when they increase their savings relative to consumption, they require less compensation for foregone consumption, and the required rate of return falls. Economists are divided between those who believe that households have a relatively fixed savings percentage over their lifetime (which implies relatively fixed time preferences) and those who see the percentage of savings as something that fluctuates as certain preferences (including time or consumption) and costs (particularly taxes) change. It is this latter viewpoint that is particularly relevant to estate tax analysis.

Taxes play a role in savings decisions because they increase the cost of saving relative to consuming income. For example, if a household invests 25 percent of its income after taxes in a bank account that earns interest, it will pay additional taxes on any interest it takes as income. If another household decides to invest its 25 percent in corporate stocks, it will pay additional taxes on any capital gains it takes as income. However, if both households take that same 25 percent of after-tax income and buy expensive shoes, no additional income taxes will be collected. No doubt sales taxes will be collected on the shoe purchases, but sales tax rates are almost always less than the income tax rate one would pay on the same amount of money. Thus, taxes discourage saving by increasing its cost relative to consumption. If the household saves anyway, it will demand a higher rate of return to compensate it for the taxes it must pay on interest earnings. Likewise, a household purchasing stocks will demand a higher and more secure rate of return on its stocks. In both cases, the cost of capital to the borrower—to the bank or to the corporation—has risen because of taxes.

One way for a household to save and avoid additional taxation is to purchase an asset like art or land that appreciates slowly over a very long period of time. This kind of purchase, however, also increases the economy-wide cost of capital by reducing the fund of money available to banks and businesses. Still another way to reduce the tax cost of saving is to invest in tax-advantaged funds, such as IRAs or 403(b) and 401(k) plans. Such funds annuitize savings, which essentially means that only low-risk, long-term, low-yield to medium-yield investments will be supported by them. Although they do reduce current tax liabilities, they are especially costly for the saver: The government has shrouded them in penalties and taxes should they be liquidated before the saver reaches a certain age, and it has discounted their future value significantly by delaying taxes on earnings until they are at their highest level.

The estate and gift tax adds yet another layer of taxes on any savings decision a household makes. Successful saving always raises the possibility of creating a taxable estate, at which point the tax

cost of a dollar saved increases by an amount somewhere between 7.4 cents and 55 cents. Thus, if the household persists in its decision to save, it will require some long-term premium return on its investments roughly equal to its estimate that estate taxes will not be avoided. Naturally, this premium further increases the cost of capital.

- **The estate tax hurts small business.**

Investing in a business is one of the many forms of saving—for some families, the only form. For most small firms, every available dollar goes into the family business, the dry-cleaning business, restaurant, or trucking company because the business creates an asset for the children and incomes for the owners. Women re-entering the work force after raising children often find self-employment the only entry-level employment open to them. Minorities know the reasons for self-employment only too well.

All of the financial security provided by these businesses is put at risk if the owner dies with a taxable estate. In an important 1995 study of how minority businesses perceive the estate tax,<sup>45</sup> Joseph Astrachan and Craig Aronoff found that:

- Some 90 percent of the surveyed minority businesses knew that they might be subject to the federal estate tax;
- About 67 percent of these businesses had taken steps (including gifts of stock, ownership restructuring, life insurance purchases, and buy/sell agreements) to shelter their assets from taxation;

- Over 50 percent of these same businesses indicated that they would not have taken these steps had there been no estate tax; and
- Some 58 percent of all the businesses in the survey anticipated failure or great difficulty surviving after determining their estate taxes.<sup>46</sup>

Another important study is Professor Richard E. Wagner's 1993 monograph, *Federal Transfer Taxation: A Study in Social Cost*, which presents macroeconomic estimates of the estate tax's effects on individual decisions to work and save.<sup>47</sup> Using a model that trades labor for capital according to their relative costs and that represents this dynamic interaction through key indicators of macroeconomic activity, Wagner found that the tax premiums created by the estate tax raise the cost of capital sufficiently to reduce national output, employment, and capital stock by measurable amounts. In a simulation that modeled the U.S. economy without the current estate tax, Wagner found that:

- Nominal GDP would have been \$80 billion higher after eight years than in an economy without the estate tax;
- 228,000 more jobs would have been created;
- The capital stock would have been \$640 billion larger;<sup>48</sup> and
- The larger economy resulting from the repeal of estate taxes produced increases in all other taxes over the eight-year simulation period, though not quite by an amount equal to the loss of the estate tax.<sup>49</sup>

45. Joseph H. Astrachan and Craig E. Aronoff, "A Report on the Impact of the Federal Estate Tax: A Study of Two Industry Groups," Family Enterprise Center of the Coles School of Business, Kennesaw State College, July 24, 1995.

46. *Ibid.*, pp. B10–B17. Similar findings are reported for small businesses generally in a survey conducted by the Center for the Study of Taxation, a public policy organization focused on estate tax reform. See *Federal Estate and Gift Taxes: Are They Worth the Cost?* Center for the Study of Taxation, 1996, pp. 9–11.

47. Wagner, *Federal Transfer Taxation: A Study in Social Cost*. Professor McCaffery, however, criticizes the study for not simulating other policy changes that might mitigate some of the macroeconomic effects found by Wagner and his associates. See McCaffery, "The Uneasy Case for Wealth Transfer Taxation," p. 306.

48. Wagner, *Federal Transfer Taxation*, p. 19.

49. *Ibid.*, p. 27. Total losses in estate taxes equaled \$125.1 billion over the eight-year simulation period. Increases in other revenue streams equaled \$86.4 billion, for a net revenue change of -\$38.7 billion over eight years.

An update of Wagner's work and the 1996 analysis by The Heritage Foundation (described in the appendix) appeared in 1998. Richard Fullenbaum and Marianna McNeill analyzed the economic effects of moving from the current transfer tax system to one that taxed intergenerational bequests as ordinary long-term capital gains with an exempt amount. This tax policy change, they found, would achieve virtually the same economic benefits as outright repeal of the estate tax. They also found that the reform would produce enough offsetting capital gains tax revenue that after seven years total federal revenues would return to the same level they would have attained with no repeal.<sup>50</sup> Because Congress currently is debating just such a reform of current estate tax law,<sup>51</sup> this work warrants closer examination.

The economic analysis of estate tax repeal by Gary and Aldonna Robbins in 1999 reached similar results.<sup>52</sup> Using the Fiscal Associates Tax Model, they showed that repeal of federal death taxes would likely result in average employment gains of 112,000 jobs. They also found that federal revenues would completely recover from estate tax repeal by the seventh year following repeal. Much of this strong growth in revenue would come from the boost given to the nation's capital stock by death tax repeal. The Robbins predict that U.S. capital would be higher by almost \$1.5 trillion following repeal than without it.

Finally, analysts in the Center for Data Analysis at The Heritage Foundation recently completed a new simulation of how estate tax repeal would likely affect general economic activity.<sup>53</sup> This analysis used the Mark 11 U.S. Macro Model of WEFA, Inc., to estimate repeal's likely economic effects.<sup>54</sup> The analysis found that:

- Total civilian employment would jump an average of 142,000 jobs per year over the

10-year period of the analysis, 2002 through 2011.

- Inflation-adjusted GDP would increase by an average of \$15.1 billion per year, reaching \$24.6 billion in 2011.
- Inflation-adjusted fixed investment would grow by an average of \$10.1 billion per year and increase to \$18.1 billion in 2011.
- The user cost of capital would fall by 120 basis points by 2011.
- Inflation-adjusted disposable income (what households have left over after paying taxes) would grow by an average of \$22 billion and reach \$32.7 billion by 2011.

## CONCLUSION

It is easy in this season of big tax reform proposals to overlook the federal estate tax. This tax, after all, is a relatively minor source of federal revenue that has played little role in federal revenue growth over the past 20 years.

Overlooking this tax, however, would be a mistake. As this study shows, the economic cost of the estate tax is many times greater than the revenue it produces, and its reach into American households extends far beyond those few who pay it. Every day, social and economic decisions are made with the estate tax in mind. Minority businesspeople suffer anxious moments wondering whether the businesses they hope to hand down to their children will be destroyed by the estate tax bill. Factories drone on with worn-out equipment that would be replaced if capital costs fell. Women who have raised their children struggle to find ways to re-enter the work force without upsetting the family's estate tax avoidance plan. Rich people buy vacations in Vail and fine art in Lisbon, rather than start new businesses and create more jobs, because

50. See Fullenbaum and McNeill, "Effect of the Federal Estate and Gift Tax," p. 14.

51. See S. 275, the Estate Tax Elimination Act of 2001.

52. Robbins and Robbins, "The Case for Burying the Estate Tax," pp. 19–20.

53. See footnote 7, *supra*.

54. See Appendix for methodology used in this analysis and in a similar analysis conducted in 1996.

the government has a claim on more than half of everything they cannot spend.

Eliminating the estate tax would result in a growing economy, more abundant jobs, and offices and factories with the kind of new equipment that elevates productivity and supports higher wages. Lower capital costs would mean new small businesses, which traditionally have served as economic havens for minority families and launch-

ing pads for young workers. By repealing the death tax, Congress would make significant progress toward creating a tax policy that complements rather than undermines its efforts to expand economic opportunity and stimulate the economy.

—William W. Beach is the John M. Olin Fellow in Economics and Director of the Center for Data Analysis at The Heritage Foundation.

## APPENDIX

# THE IMPACT OF REPEALING THE ESTATE TAX

Although analysts have made significant progress in understanding the microeconomic effects of intergenerational taxation, the dearth of studies like Richard Wagner's noted in the text above shows that much work needs to be done on measuring the tax's macroeconomic effects. There are many remaining questions about the tax's effects on wealth accumulation, as Joseph Stiglitz has noted, and without a good knowledge of these effects, economists cannot create that most elementary but crucial of concepts in tax analysis: the tax base.

Bearing in mind these limitations, estimates of the economic impact of repealing the estate and gift tax have been conducted at The Heritage Foundation since 1996. Certain assumptions were made about the effect of repeal, which each were introduced into two leading models of the U.S. economy: the Washington University Macro Model (WUMM) and the Mark 11 macroeconomic model of WEFA, Inc.<sup>55</sup> These two statistical models are exceptionally accurate tools for estimating the effects of public policy changes on the U.S. economy and are widely used for this purpose by America's leading corporations and government agencies.

Given substantial doubt that annual estate tax filings fully reflect the size of the tax base,<sup>56</sup> estimates of the tax's economic effects must start from another foundation. The macroeconomic estimates presented here were built in 1996 from estimates of changes in the U.S. labor force and domestic capital stocks associated with removing the estate tax portion of the after-tax cost of labor and capital. These estimates were then introduced

into the macroeconomic models to compute the effects.

### **Cost of Capital Assumptions**

The cost of capital results from at least three factors: (1) the cost of attracting investors to supply capital funds and not do something else with their money, (2) the ratio of a capital good's depreciation relative to the value of output it produces, and (3) taxes. If a business or a household borrows money, it must pay enough to attract a lender or investor away from other opportunities. A portion of this "opportunity cost" payment is the tax that the lender expects to owe on the loan's earnings. Under current law, a business may offset some of this tax premium by deducting its annual depreciation and interest payments. In some cases, businesses also may claim various investment tax credits that further reduce the tax premiums they have had to pay to lenders. However, a substantial portion of the cost of operating a business is not tax-deductible, and this results in a positive, residual tax premium in real-world capital costs.

Of course, taxes on ordinary income constitute a substantial percentage of the tax premium in the cost of capital. Every investor attempts to earn the highest possible return on every investment so that his earnings cover the income taxes the investment incurs. The estate tax, however, also is a part of this premium. Just as households are the source of all investment funds, they also are the source of all estate taxes. When individuals begin to see that their income and investment efforts will produce a future taxable estate, they generally can do two things: (1) see a financial advisor or estate planner and (2) increase their earnings require-

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55. WEFA, formerly Wharton Econometric Forecasting Associates. The methodologies, assumptions, conclusions, and opinions herein are entirely those of The Heritage Foundation. They have not been endorsed by, and do not necessarily reflect the views of, the owners of these two macroeconomic models.

56. From an economic standpoint, a tax's base is composed of some quantifiable behavior that is being affected by the tax. The estate tax base could be viewed as the sum of all those dollars that are managed annually so as to avoid paying the tax, plus those that end up on a tax form.

ments to build the funds needed to pay the wealth transfer taxes.

Using data associating incomes with tax liabilities and holdings of corporate paper and equities, Heritage analysts estimated that the present value of future estate tax liabilities for the class of households that holds most corporate debt is slightly more than 3 percent of the average yield on corporate bonds. Thus, if corporate bonds currently yield 10 percent, eliminating wealth transfer taxes would reduce the required yield to 9.7 percent. This estimate of the estate tax component of the tax premium was used to adjust projected corporate bond yields over the period 1997 through 2005.

### **Labor Effect Assumptions**

Economists also argue that high taxes reduce the supply of labor. At a certain point, when faced with rising taxes, workers decide to consume more leisure and produce less labor. Wealth transfer taxes are widely assumed to produce this effect, particularly among a class of individuals who clearly perceive the adverse tax consequences of working harder and building greater taxable net worth.

To capture this effect of estate taxes and introduce it into the U.S. macroeconomic model, Heritage analysts in 1996 estimated the number of wage or salaried workers and self-employed individuals in this same class of households that hold most of America's corporate debt. Eliminating the estate tax would be equivalent to increasing after-tax lifetime earnings by the average effective estate tax rate, or by 18 percent. This percentage, of course, is the minimum amount of earnings change that estate tax repeal would cause: A significant but unknown amount of time and income now is devoted to positioning assets and paying accountants in order to avoid significant estate tax liabilities. This estimate also fails to capture the substantial costs borne by taxpayers and relatives when businesses fail because of estate tax liabilities. In any event, multiplying a standard labor supply elasticity of 0.3 percent by this percentage reduction in taxes, and then multiplying this product times the 18 million individuals in this class of

households, yields a labor supply effect of 97,200. This number was used to adjust upwards all estimates of the civilian labor force for the period 1997 through 2005.

### **Budget Assumptions**

Besides introducing new labor force and capital cost settings into the macroeconomic model, Heritage analysts in 1996 also made two adjustments in the federal government's budget for the period 1997 through 2005. First, the total amount of federal revenues was reduced by the forecasted amount of the estate tax. Second, expenditures for non-defense purchases were reduced by an amount exactly equal to the "lost" estate tax revenue. Thus, repealing the estate tax is assumed to be offset by spending reductions, so there is no net contribution to the deficit because of lost estate tax revenue.

It is highly likely that eliminating the estate tax would result in slightly greater federal income tax receipts. Without an estate tax, taxpayers would make fewer gift transfers to their children, who commonly pay income taxes at rates lower than their parents. However, estimating the size of this effect on income tax revenues involves overcoming a host of problems raised by incomplete estate tax data. The IRS has been unwilling to disclose important details on intergenerational giving. Thus, the following analysis does not contain estimates of the positive effects of estate tax repeal on income tax receipts. If these estimates could have been made, the macroeconomic effects of repeal would have been even more positive.

By adapting the macroeconomic models as described above, the resulting estate tax simulation measured the economic effects of repealing this tax on December 31, 1996. That is, it shows how differently the economy would have behaved had taxpayers not faced the prospect of estate taxes beginning in 1997. This simulated economy is compared to a "baseline" economy in which the current estate tax is still present. The differences between the baseline and simulated economies are the dynamic impacts of estate tax repeal. Again, these estimates should be viewed as a minimum assessment of the tax's economic effects.

The most general measurement of economic health—GDP, adjusted for inflation—quickly jumps above baseline by as much as 0.4 percent in the Heritage analysis using the WUMM. The increase in real GDP averages \$11.2 billion per year over the nine-year period between 1997 and 2005.

When the Heritage assumptions are fed into the WEFA model, the economy grows above baseline by an average of \$2.83 billion over this period.<sup>57</sup> Behind the growth in GDP is a strong increase in investment. A drop in the cost of capital caused by estate tax repeal leads to increased business purchases of buildings and machines. Investment in the goods that make labor more productive grows 2 percent faster between 1997 and 2005 than it otherwise would. Using the WEFA model, investment grows 0.9 percent faster over this same time period. Economists widely believe that growth in capital goods is closely related to economic growth and that this helps to explain the higher growth in GDP.

In addition to stimulating the growth of private investment, repealing the estate tax reduces the tax costs that workers face. Lower taxes on income are widely believed to result in a larger labor force. The Heritage estate tax simulation results in a significant growth in non-farm private employment, whichever model is used. Total non-farm employment grows by an average of 145,000 above baseline during the nine-year period using the WUMM. This growth subsides in subsequent years as wages rise to reflect the greater productivity of labor caused by the greater amount of capital per laborer. By 2003, total non-farm employment has returned to its long-term growth trend. The Heritage analysis using the WEFA model estimates average employment growth to be 86,000 over this period.

Not only do businesses take advantage of lower capital costs to buy new plant and equipment, but

families increase their purchases of new homes. Housing starts jump sharply during the first two years after repeal. The Heritage simulation using the WUMM model predicts that estate tax repeal would lead to a first-year increase of 49,000 in housing starts. This effect is caused by a significant drop in the mortgage interest rate. The fact that it does not drop more in subsequent years explains why housing starts return to baseline after the third year following repeal.

The boost in housing and the growth in business investment expenditures reflect the lower capital costs that result from removing the estate tax premium on capital. The cost of corporate capital and the secondary mortgage rate fall by an average of 21 and 27 basis points, respectively, in the Heritage analysis using the WUMM. While this decline is less dramatic in the WEFA model, the user cost of capital remains solidly below baseline throughout the nine-year period. As economic activity builds following repeal of the estate tax, demand for capital rises, leading to small increases in both the long bond rate and the federal funds rate. Subtle elevations in these market lending rates would be the expected result in an economy that is adding more jobs and creating more capital goods than an economy still burdened by high tax rates.

The growth in household income also supports the increase in housing starts. Between 1997 and 2005, inflation-adjusted household disposable income (broadly, what is left after taxes) grows by an average of \$12 billion per year in the Heritage analysis using the WUMM model. Similar growth also occurs in total personal income, which increases by an average of \$8 billion per year. Both of these income indicators rise because of higher levels of employment, greater worker productivity, and stronger household and business consumption. The WEFA model shows inflation-adjusted disposable income rising by an average of

57. Even though these two estimates of additional GDP are different, the two models indicate the same general result: The economy grows more without the estate tax. The outputs of econometric models often differ, even when employing the very same assumptions, because of subtle differences in the theoretical viewpoints upon which the models are constructed. After all, such models are intended to give analysts insight into how changes in specific economic relationships affect the macroeconomy. The differences between the two models used in this study stem largely from WUMM's greater emphasis on the rental price of investment as a driver of economic activity.

\$9 billion per year and personal income growing by an average of \$5 billion per year over this nine-year period.

Despite the loss of \$15 billion in annual revenue and \$15 billion less in government spending, the federal deficit does not worsen over this nine-year period. In fact, the WUMM simulation shows that a stronger economy leads to deficit improvement. For each of the first seven years in the estate tax simulation, the deficit is slightly *less* after estate tax

repeal than in an economy with an estate tax. During the last two years of the simulation, higher interest rates cause a gentle rise in federal expenditures. The WEFA simulation indicates minor deficit changes throughout the nine-year period. Both simulations, however, point to the same conclusion: The economic benefits from estate tax repeal should not be sacrificed because of concerns about a deficit.