# COSTS AND CONSEQUENCES OF THE FEDERAL ESTATE TAX

## A JOINT ECONOMIC COMMITTEE STUDY


**Chairman Jim Saxton (R-NJ)**

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**Executive Summary**

This study examines the arguments for and against the federal estate tax, finding that the benefits of the tax are often overstated, and in any case are far smaller than the documented costs. In light of this finding, there is no compelling reason to keep the tax, and a number of reasons to reduce or abolish it.

- The estate tax impedes economic growth through high compliance costs and economic inefficiencies, and has reduced the stock of capital in the economy by approximately $847 billion.
- The estate tax hinders entry into self-employment and breaks up family-run businesses, many of which lack the liquid resources needed to meet their estate tax obligations. The tax is also an impediment to upward income and wealth mobility.
- Much research indicates that the estate tax is an ineffective tool for fighting wealth and income inequality. In fact, some estimates indicate that the tax exacerbates inequality.
- The benefits of the charitable deduction are often overstated, with recent research indicating the tax has only a modest, if any, impact on gifts to charity.



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***-- EXECUTIVE SUMMARY --***

This study examines the arguments for and against the federal estate tax, finding that the benefits of the tax are often overstated, and in any case are far smaller than the documented costs. On balance, the analysis finds that the costs imposed by the estate tax outweigh any potential benefits that the tax might produce. In light of this finding, there is no compelling reason to keep the tax, and a number of reasons to reduce or abolish it.

**Arguments for the Estate Tax**

- Inequality: The paper draws on a large body of theoretical and empirical research showing the estate tax is an ineffective tool for fighting wealth and income inequality. As one liberal economist has said, "The reformer eyeing the estate tax as a means to reduce inequality had best look elsewhere."
- Charitable Giving: Recent research indicates that the charitable deduction exerts only a modest, if any, stimulative effect. In fact, the estate tax may actually be a significant barrier to charitable giving, as estate taxes crowd out charitable bequests.
- Tax Revenue: The estate tax clearly results in some losses in the federal income tax, meaning that the true net revenue of the estate tax is less than the official, static measures of its revenue yield. Although the exact magnitude of the effect is not known, some research suggests that repeal of the estate tax will not result in a revenue loss for the federal government.

**Costs of the Estate Tax**

- Economic Growth: The estate tax exerts a negative effect on the economy by generating extremely high compliance costs, introducing economic inefficiencies, and by reducing the stock of capital in the economy. The present study estimates that the estate tax has reduced the stock of capital in the economy by approximately $847 billion.
- Small Business: The estate tax has a negative influence on entrepreneurial activity by hindering entry into self-employment and by breaking up family-run businesses. Family-run firms and farms particularly feel the pinch of the estate tax because they are less likely to have the liquid resources needed to meet their estate tax liabilities.
- Social Mobility: Because the estate tax disrupts the transmission of family wealth to succeeding generations, the estate tax hinders upward income mobility. One study estimates that the estate tax will consume 11 to 13 percent of African-American wealth over the next 50 years. With the number of minority-run businesses surging in recent years, the estate tax will come to affect more and more such firms.
- Fairness, Simplicity and Efficiency: The large number of tax avoidance options means that the tax burden is distributed unfairly among payers of the tax, is unnecessarily complicated, and will distort taxpayer behavior. As two liberal economists have noted, "tax liabilities depend on the skill of the estate planner, rather than on capacity to pay."
- Environment: A 2001 study found that approximately 2.6 million acres of forest land must be harvested each year to pay for the estate tax. Another 1.3 million acres must be sold to raise funds to pay estate taxes, of which close to one-third (29 percent) is either developed or converted to other uses.

# ASSESSING THE FEDERAL ESTATE TAX: COSTS AND BENEFITS

## I. INTRODUCTION

Benjamin Franklin observed over 200 years ago that "in this world nothing can be said to be certain, except death and taxes."[1] Death and taxes may indeed be inevitable, but the simultaneous convergence of the two in the federal estate tax has produced one of the most contentious components of the federal tax code. Part of this debate is driven by the very nature of the estate tax itself. Many people simply find it objectionable as a matter of principle to tax the savings someone has accumulated over his or her lifetime, most of which have already been previously subjected to the income tax at least once. That the estate tax is imposed upon the death of a loved one only exacerbates the grief of loss.

This study examines the arguments for and against the federal estate tax to find that benefits of the tax are often overstated, and in any case are far smaller than the documented costs. Supporters of the tax defend it on the grounds that it reduces inequality, encourages charitable giving, and raises much needed tax revenue. However, this paper identifies a large body of theoretical and empirical research showing the estate tax is an ineffective tool for fighting wealth and income inequality. With respect to charitable giving, the available evidence does not support the contention that people are greatly motivated by tax incentives when making gifts from their estates. Even the $25 billion the tax raised in 2005 is overstated because it fails to take into account income tax losses that result from the multitude of estate tax avoidance strategies.

The rather small potential benefits of the estate tax stand in sharp contrast to large and significant costs of the tax. The estate tax discourages savings and capital accumulation, thus impeding economic growth. Small businesses and innovation suffer as well, as the estate tax reduces funds available for investment and employment, and destabilizes the business at a vulnerable moment, the death of the founder or current leader of the enterprise. Since owning a small business is a key means for lower- and middle-income families to accumulate wealth, the estate tax also hinders economic mobility. Even the environment is harmed by the estate tax, since the enormous liquidity demands of the tax force owners to sell and develop environmentally-sensitive habitats in order to meet their estate tax obligations. On top of all these costs, the estate tax lacks the basic features of good tax policy due to its complexity and lack of equity.

When the costs of the estate tax are paired with the benefits, the mismatch is easy to discern, with the costs far exceeding the benefits. On balance, then, this study finds that the costs imposed by the estate tax outweigh any benefits that the tax might produce. In light of this finding, there is no compelling reason to keep the tax, and a number of reasons to reduce or

[1] John Bartlett, *Familiar Quotations*, 16th ed. (Boston, MA: Little, Brown and Company, 1992), 310.

abolish it. To preview the results of the present analysis, consider the conclusion drawn by Henry Aaron and Alicia Munnell, two prominent liberal economists, in their study of the estate tax:

> In short, the estate and gift taxes in the United States have failed to achieve their intended purposes. They raise little revenue. They impose large excess burdens. They are unfair.[2]

This paper updates and extends two previous Joint Economic Committee studies on the estate tax.[3] The current report builds on the previous studies to reflect more recent data and legislation. Readers wishing additional information on the various arguments for and against estate taxation should consult the earlier studies.

## II. OVERVIEW OF THE FEDERAL ESTATE TAX

The estate tax, also known as the death tax, is a tax imposed on transfers of savings made at the holder's death.[4] Three times in this nation's history a federal death tax has been imposed only to be repealed shortly thereafter. In each instance, the tax was implemented to provide revenue on a short-term basis to finance military activities (1797-1802, 1862-1870, and 1898-1902). With the advent of World War I, the federal estate tax was reintroduced for a fourth time in 1916 and has existed ever since. Many states also impose their own death taxes.

The modern estate tax regime began in 1976, when legislation implemented a unified system of wealth transfer taxes. The unified system consists of three separate taxes: the estate tax, the gift tax, and the generation-skipping transfer (GST) tax.[5] Estate and gift taxes are imposed on transfers made at death and during life, respectively. Tax liabilities are a function of taxable assets, less any deductions, above the exemption amount. The GST tax is generally imposed on asset transfers that skip a generation (e.g., from grandparents to grandchildren) above the exemption amount. Throughout this paper, estate tax is used to refer to this unified system of taxing intergenerational transfers.

An important feature of the estate tax is the step-up in basis for transferred assets. The basis of an asset is used as its cost for the purpose of calculating capital gains. Under the unified wealth transfer tax system, when a decedent transfers an asset to an heir, the asset's basis is increased, or stepped-up, to its current market value. The effect of this step-up is to exempt from capital gains taxation the amount of the step-up.

The 2001 Economic Growth and Tax Relief Reconciliation Act (EGTRRA) implemented, among other things, a gradual reduction in federal estate taxes, beginning in 2002

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[2] The authors, however, favor reforming the estate tax, not repealing it. Henry J. Aaron and Alicia H. Munnell, "Reassessing the Role for Wealth Transfer Taxes," *National Tax Journal* 45, no. 2 (June 1992): 138.
[3] Dan Miller, *The Economics of the Estate Tax*, U.S. Congress, Joint Economic Committee (December 1998); and Dan Miller, *The Economics of the Estate Tax: An Update*, U.S. Congress, Joint Economic Committee (June 2003).
[4] The term death refers to all taxes imposed at death. Estates taxes are levied on a deceased's estates, while inheritances taxes are paid by the recipients of transfers.
[5] For additional information, see John R. Luckey, "Federal Estate, Gift, and Generation-Skipping Taxes: A Description of Current Law," Congressional Research Service, Report 95-416A (updated January 5, 2005).

**Table 1. Effective Estate Tax Rates & Exemptions for the Estate, GST and Gift Taxes**

| Fiscal Year | Effective Estate Tax Rates | | Exemption Amount | GST Tax Exemption | Gift Tax Exclusion |
|---|---|---|---|---|---|
| | Starting | Top | | | |
| 2001 | 37% | 60%* | $675,000 | $1.06 million | $10,000 |
| 2002 | 41% | 50% | $1 million | $1.1 million | $11,000 |
| 2003 | 41% | 49% | $1 million | $1.12 million | $11,000 |
| 2004 | 45% | 48% | $1.5 million | $1.5 million | $11,000 |
| 2005 | 45% | 47% | $1.5 million | $1.5 million | $11,000 |
| 2006 | 46% | 46% | $2 million | $2 million | $12,000 |
| 2007 | 45% | 45% | $2 million | $2 million | † |
| 2008 | 45% | 45% | $2 million | $2 million | † |
| 2009 | 45% | 45% | $3.5 million | $3.5 million | † |
| 2010 | -- *Estate and GST Taxes Repealed* -- | | | | † |
| 2011 & After | 41% | 60%* | $1 million | † | † |

* The top statutory rate is 55 percent, plus there is a 5 percent surtax for taxable estates of $10.0 million to $17.2 million. EGTRRA repealed the surtax for 2002 to 2010.

† The gift tax exclusion is adjusted annually for inflation, and the GST exemption will resume inflation adjustment in 2011.

Source: Noto; Internal Revenue Service.

and culminating in full repeal in 2010 (Table 1).[6] For the estate tax, the exemption amount is gradually increased to $3.5 million and the top estate tax rate is lowered to 45 percent between 2002 and 2009. The GST tax exemption amount is eventually raised to $3.5 million by 2009. For gifts, the annual exclusion amount continues to be adjusted for inflation ($12,000 in 2006), subject to a cap of $1 million in tax-free lifetime gift transfers. Also effective in 2010, gift taxes will be cut to equal the top applicable income tax rate, and the GST tax will be repealed. EGTRRA replaces the step-up in basis with a modified carryover basis in 2010, with taxable gains subject to an exemption of up to $4.3 million ($1.3 million for any heirs, plus an additional $3 million for transfers to spouses).[7]

The estate tax reduction and repeal set forth by EGTRRA, however, contains a sunset provision. Starting in 2011, the legislation repealing the estate tax expires and the estate tax system is restored to the pre-2001 law, with the exemption amount previously scheduled to increase to $1 million. Congress is currently considering a permanent repeal of the estate tax.[8]

[6] Public Law No: 107-16. Table 6 at the end of the paper presents the rate structure of the estate tax in greater detail. Nonna A. Noto, "Calculating Estate Tax Liability during the Estate Tax Phasedown Period 2001-2009," Congressional Research Service, Report RL31092 (updated April 1, 2005).

[7] For additional detail, see Nonna A. Noto, "Estate and Gift Tax Law: Changes under the Economic Growth and Tax Relief Reconciliation Act of 2001," Congressional Research Service, Report RL31061 (updated January 29, 2002).

[8] The U.S. House of Representatives passed H.R. 8, the Death Tax Repeal Permanency Act of 2005, on April 13, 2005 by a vote of 272 to 162.

## III. ARGUMENTS FOR ESTATE TAXATION

Advocates of the estate tax generally rely on three different arguments to support the tax. First, supporters claim the estate tax is necessary to reduce inequality. Second, estate tax advocates contend that the deduction for charitable bequests induces substantial giving to nonprofit organizations. Finally, supporters argue that the $28 billion the tax is expected to raise in fiscal year 2006 warrants the estate tax's existence.

### A. Inequality and the Distribution of Wealth, Income and Consumption

Perhaps the most common argument made in favor of the estate tax is that it reduces income and wealth inequality. Supporters of the estate tax maintain that since the high tax rates apply only to the "rich," the tax should unambiguously reduce inequality. This assertion actually relies on two assumptions: normatively, that high estate tax rates are consistent with a liberal political philosophy; and empirically, that high estate tax rates do in fact reduce inequality.

Both of these assumptions are flawed. First, the estate tax fails on liberal and progressive grounds because it discourages work and savings in favor of conspicuous consumption. The liberal philosophical argument against the estate tax has been articulated by legal scholar Edward McCaffery of the University of Southern California Law School, who is a "self-acknowledged liberal (in the modern sense of the term), who believes that it is appropriate for the government to distribute or redistribute resources from rich to poor."[9] McCaffery argues that the estate tax undermines the very concepts of fairness and equality that liberals ought to support:

> Liberals should think that a death tax encourages behaviors that a liberal society ought not to like – high-end leisure, encrusted forms of ownership, aggressive *inter vivos* giving – while discouraging the socially beneficial behaviors of work, savings, and thrift. … The material equality that a liberal should care about is precisely equality in consumption or lifestyle. What we should all want our wealthiest, most economically productive citizens to do is to continue to work and save, not spend it all on themselves or stop working and consume leisure time. Yet once again a death tax is precisely backwards on this – liberal – score.[10]

On the second assumption, there is little evidence that the estate tax actually reduces inequality to any substantive degree. A large body of empirical and theoretical research has emerged showing that inheritance either is not a major source of inequality, or that government policies aimed at breaking up inheritance are likely to be ineffective. There are five reasons for such findings.

First, there is only a weak correlation between wealth and income. For example, a person can be very wealthy, but have little or negative income (or vice versa). An article published in the Federal Reserve Bank of Minneapolis' *Quarterly Review* found that many low-income

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[9] Edward J. McCaffery and Richard E. Wagner, "A Declaration of Independence from Death Taxation: A Bipartisan Appeal," Public Interest Institute, Policy Study (July 2000), 4. See also, Edward J. McCaffery, "The Uneasy Case for Wealth Transfer Taxation," *Yale Law Journal* 104, no. 2 (November 1994): 283-365.
[10] McCaffery and Wagner, 6, 18-19.

households have substantial amounts of wealth, and vice versa. For example, the average wealth of the bottom 1 percent of the income distribution is enough to place such a household in the top wealth quintile.[11] Conversely, households in the bottom 1 percent of the wealth distribution have an average income that places them in the middle of the income distribution.[12] One reason for such results is the life-cycle of income and savings: as workers enter retirement, their income falls dramatically while their asset levels are relatively high. In addition, some wealthy households may have transitory businesses losses or losses in capital income that temporarily place them at the bottom of the income distribution. Thus, a reduction of wealth transfers can have only a limited impact on the distribution of earnings.

Alan Blinder, a member of President Bill Clinton's Council of Economic Advisers, found that only about 2 percent of inequality was attributable to the unequal distribution of inherited wealth, leading him to conclude that "a radical reform of inheritance policies can accomplish comparatively little income redistribution."[13] Elsewhere Blinder has written that "The reformer eyeing the estate tax as a means to reduce inequality had best look elsewhere.[14]

Second, efforts to curtail savings transfers induce wealth holders to increase their consumption, thereby increasing the inequality of consumption. Joseph Stiglitz, who served as Chairman of President Clinton's Council of Economic Advisers, has found that, taking into account the long-term impact on capital accumulation, the estate tax may ultimately *increase* income inequality. Even if the government acts to offset these capital accumulation effects, Stiglitz argued that 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." [15]

Stiglitz further argued that inheritances actually decrease inequality: because inheritances redistribute income within families, they may decrease inequality in lifetime consumption.[16] In yet another analysis, Stiglitz concluded that "it would seem clear that inheritances are unambiguously equality increasing" in terms of consumption, and an argument can be made that inheritances reduce inequality of income and wealth as well.[17] The conclusions reached by Blinder and Stiglitz have been replicated by numerous other researchers.[18]

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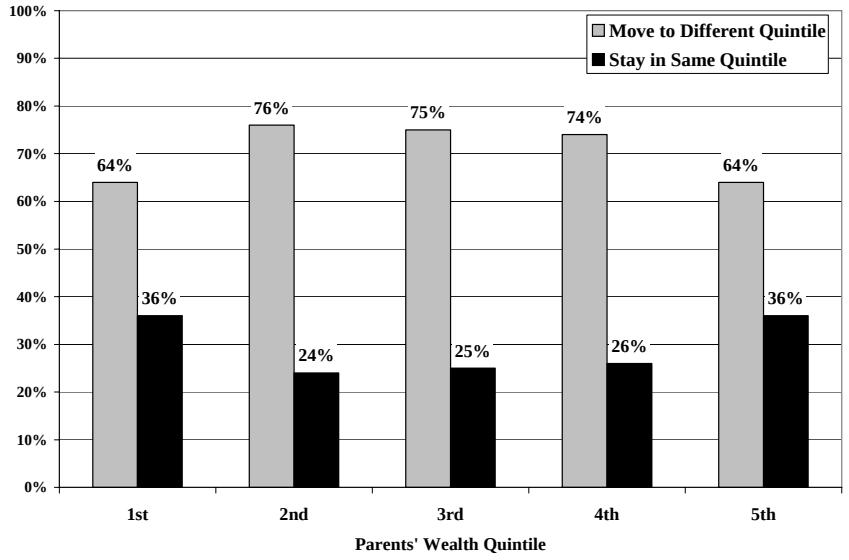
[11] Santiago Budría Rodríguez, Javier Díaz-Giménez, Vincenzo Quadrini and José-Víctor Ríos-Rull, "Updated Facts on the U.S. Distributions of Earnings, Income, and Wealth," Federal Reserve Bank of Minneapolis, *Quarterly Review* 26, no. 3 (Summer 2002): 6.
[12] *Ibid*.
[13] Alan S. Blinder, *Toward an Economic Theory of Income Distribution* (Cambridge, MA: MIT Press, 1974).
[14] Alan S. Blinder, "Inequality and Mobility in the Distribution of Wealth," *Kyklos* 29 (1976): 618-9.
[15] Joseph E. Stiglitz, "Notes on Estate Taxes, Redistribution, and the Concept of Balanced Growth Path Incidence," *Journal of Political Economy* 86, no. 2 (1978): S137-S150.
[16] David L. Bevan and Joseph E. Stiglitz, "Intergenerational Transfers and Inequality," *Greek Economic Review* 1, no. 1 (August 1979): 13.
[17] Joseph E. Stiglitz, "Equality, Taxation and Inheritance," in *Personal Income Distribution: Proceedings of a Conference Held by the International Economic Association, Noordwijk aan Zee, Netherlands, April 18-23, 1977*, eds. Wilhelm Krelle and Anthony F. Shorrocks, 283 (New York, NY: North-Holland Publishing Company, 1978).
[18] For a review of additional research, see the discussion of Davies (1982), Hugget (1996), and Verbit (1978) in Miller, *The Economics of the Estate Tax*, 6.

Third, empirical and theoretical research on intergenerational wealth transfers has repeatedly found that such transfers have relatively little impact on the distribution of income and wealth. For example, a theoretical model of wealth distribution by Jagadeesh Gokhale and Laurence Kotlikoff found that bequests actually reduce wealth inequality.[19] Shinichi Nishiyama, in a technical paper from the Congressional Budget Office, simulated the effect of a 100 percent estate and gift tax, concluding that income and wealth inequality would be no better, and by some measures worse, than the baseline estimate.[20] In a similar vein, Edward Wolff's analysis of wealth distribution led him to write:

> The most surprising finding is that inheritances and other wealth transfers tend to be equalizing in terms of the distribution of household wealth. Indeed, the addition of wealth transfers to other sources of household wealth has had a sizable effect on reducing the inequality of wealth…. Oddly enough, though wealth inequality has risen in the United States between 1983 and 1998, the increase may have been even greater were it not for the mitigating effects of inheritances and gifts.[21]

Fourth, the considerable degree of wealth and income mobility in society means that government efforts to redistribute wealth will necessarily meet with limited success. Many U.S. households move up and down the income and wealth ladder. For example, one study found that between 1966 and 1981, more than half of all households changed wealth quintiles.[22] Another study reported that one-third of households in the bottom wealth quintile move up to a higher

**Figure 1. Children Leaving Their Parents' Wealth Quintile**




Source: Charles and Hurst.

[19] Jagadeesh Gokhale and Laurence J. Kotlikoff, "Simulating the Transmission of Wealth Inequality," *American Economic Review* 92, no. 2 (May 2002): 265-269.
[20] Shinichi Nishiyama, "Bequests, Inter Vivos Transfers, and Wealth Distribution," Congressional Budget Office, Technical Paper Series 2000-8 (December 2000), 22-23.
[21] However, Wolff also writes that "the current structure of the estate tax is quite good from the standpoint of equity." Edward N. Wolff, "Bequests, Saving, and Wealth Inequality: Inheritances and Wealth Inequality, 1989-1998," *American Economic Review* 92, no. 2 (May 2002): 263.
[22] Nancy A. Jianakoplos and Paul L. Menchik, "Wealth Mobility," *Review of Economics and Statistics* 79, no. 1 (February 1997): 18-31.

wealth quintile after just five years.[23]

To illustrate the degree of wealth mobility, consider the results of a study by economists Kerwin Kofi Charles and Erik Hurst, published in the *Journal of Political Economy*.[24] That study found robust movement up and down wealth quintiles across generations. Figure 1 displays the percent of families that changed wealth quintiles from one generation to the next. For example, close to two-thirds (64 percent) of children of parents in the poorest wealth quintile (i.e., poorest fifth of families) ended up in a higher wealth quintile than their parents. Likewise, children of parents in the wealthiest quintile had a 64 percent chance of being in a different wealth quintile than their parents.[25] In other words, for every person who remains in the same wealth quintile as their parents, two to three change to a different quintile.

Thus, not only do children in poorer households move up the wealth distribution, but children in wealthier households move down. Alexis de Tocqueville observed this phenomenon back in 1835, when he wrote "wealth circulates with inconceivable rapidity, and experience shows that it is rare to find two succeeding generations in the full enjoyment of it."[26] More recently, there is evidence of such patterns in the *Forbes* annual list of the richest Americans. For example, of the original top 400 richest persons who made the first list in 1982, only 50 names – just 13 percent – were still on the list in 2004.[27] In fact, many of the famous fortunes in America from the early twentieth century did not have a single family member left on the 2004 list, including such notable families as DuPont, Mellon and Rockefeller.[28]

The fifth reason that the estate tax is likely to be ineffective at reducing inequality is that most wealthy households did not become wealthy because of inheritances. Numerous studies confirm the conclusion that inheritances are not a major source of wealth for many of the wealthy. A survey of wealthy investors by Prince & Associates found that just 7 percent of respondents identified inheritance as the source of their wealth.[29] In *The Millionaire Next Door*, authors Thomas Stanley and William Danko report that 81 percent of millionaires are first-generation rich, and just 14 percent cite inheritance as the source of their wealth.[30] A 1989 study that examined the top 10 percent of the income distribution found that only 9 to 12 percent of such households attributed more than half of their wealth to gifts and inheritances.[31] RAND economist James P. Smith has found that inheritances account for less than 8 percent of the

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[23] Ana Castañeda, Javier Díaz-Giménez and José-Víctor Ríos-Rull, "Accounting for the U.S. Earnings and Wealth Inequality" *Journal of Political Economy* 111, no. 4 (August 2003): 848.
[24] Kerwin Kofi Charles and Erik Hurst, "The Correlation of Wealth across Generations," *Journal of Political Economy* 111, no. 6 (December 2003): 1155-1182.
[25] Similar results were found by Executive Office of the President, Council of Economic Advisers, *The Annual Report of the Council of Economic Advisers* (Washington, DC; Government Printing Office, 2003), 199.
[26] Alexis de Tocqueville, *Democracy in America - Volume I* (1835; reprint, New York: Vintage Books, 1945), 53.
[27] Maria Elena Lagomasino, "How to Stay Rich," *Forbes*, 10/11/04, online at http://www.forbes.com/400richest/.
[28] Peter Newcomb, "Family Fortunes," *Forbes*, 10/11/04, online at http://www.forbes.com/400richest/.
[29] "Majority of Rich Investors Made Fortunes through Hard Work According to Private Asset Management Study," *Business Wire*, 6/14/94.
[30] Thomas J. Stanley and William D. Danko, *The Millionaire Next Door: The Surprising Secrets of America's Wealthy* (Atlanta, GA: Longstreet Press, 1996), 16, 32.
[31] Michael D. Hurd and Gabriella Mundaca, "The Importance of Gifts and Inheritances among the Affluent," in *The Measurement of Saving, Investment, and Wealth*, eds. Robert E. Lipsey and Helen Stone Tice, 737–763 (Chicago, IL: University of Chicago Press, 1989).

wealth in the wealthiest 5 percent of households.[32] Among Forbes' 2003 list of the top 100 richest Americans, inheritance is the source of wealth for just 8 percent, compared to 76 percent who made the list through entrepreneurship (Table 2).[33] In a survey of households worth at least $5 million done for Deutsche Bank Private Banking, respondents estimated that on average 18 percent of their wealth came from inheritance or gifts, and that in the combined pool of wealth of all surveyed households, less than 11 percent originated from inheritance.[34] While the exact point estimates differ from study to study, they are remarkably consistent in showing that less than 20 percent of the assets of the wealthy originates from inheritance.

**Table 2. Source of Wealth for 100 Richest Americans**

| | Number of | Net Worth | |
|---|---|---|---|
| **Source of Wealth** | **Persons** | **Billions** | **Percent** |
| Inheritance | 8 | $18.8 | 3.0% |
| Finance | 16 | $99.4 | 15.9% |
| Entrepreneurship | 76 | $506.7 | 81.1% |
| Communications | 12 | $70.4 | 11.3% |
| Entertainment | 3 | $9.5 | 1.5% |
| Industry | 13 | $72.7 | 11.6% |
| New Economy | 12 | $152.7 | 24.4% |
| Oil | 6 | $19.8 | 3.2% |
| Real Estate | 9 | $28.4 | 4.5% |
| Retailing | 21 | $153.2 | 24.5% |
| **Total** | **100** | **$624.9** | **100.0%** |

Source: *Forbes* and Samuelson and Nordhaus.

The fact that four out of five millionaires are first-generation rich raises the question: if inheritance is not the source of their wealth, how did these did these individuals become millionaires? The data in Table 2 already demonstrate the central importance of entrepreneurship. In addition, Stanley and Danko show that a primary mechanism of achieving wealth is for families to manage their money effectively and lead a frugal lifestyle. Contrary to conventional wisdom, most millionaires do not lead high-priced lifestyles. For example, the typical millionaire has never spent more than $400 on a suit and paid just $24,800 for his current automobile.[35]

## B. Charitable Contributions

Another objection to a reduction in the estate tax is that it would reduce contributions to charitable organizations. Because the estate tax allows individuals to deduct from their taxable estate any bequests to charitable organizations, there is a significant tax advantage to donate money at one's death. Reducing the tax on estates, the argument goes, could cause people to donate less money to charity. Recent research on this subject, however, indicates that the charitable tax deduction exerts only a modest, if any, stimulative effect. Although the charitable deduction may affect the timing of donations, it may not significantly alter the overall level of giving.

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[32] James P. Smith, "Inheritances and Bequests," In *Wealth, Work, and Health*, ed. James P. Smith and Robert J. Willis, 121-149 (Ann Arbor, MI: University of Michigan Press, 1999), 137.
[33] Analysis of October 2003 *Forbes* data in Paul A. Samuelson and William D. Nordhaus, *Microeconomics*, 18th ed. (Boston, MA: McGraw Hill, 2005), 388.
[34] Paul G. Schervish and John J. Havens, "Extended Report of the Wealth with Responsibility Study," Social Welfare Research Institute, Boston College (March 2001), 10.
[35] Stanley and Danko, 31, 112.

**Figure 2. Average Charitable Bequests on Estate Tax Returns**


Note: Amounts in 2005 inflation-adjusted dollar.
Source: Joint Economic Committee calculations using Internal Revenue Service data.

Despite the substantial tax benefits, a casual review of the data provides little evidence that tax incentives greatly affect charitable bequests. According to IRS data, only 18.5 percent of taxable estate tax returns actually made a charitable bequest on returns filed in 2004.[36] In other words, four out five taxable estate tax returns did *not* take advantage of the price benefit of a charitable bequest. Given the steep marginal tax rates of the estate tax, one might expect charitable bequests to be much more common. Remarkably, a similar percentage – 22 percent – of households nationwide (most of whom do not receive tax benefits from charitable bequests) have either already included a charitable bequest in their will (8 percent) or are considering doing so (14 percent).[37]

In addition to looking at patterns of giving among estate tax returns, it is useful to consider patterns of charitable giving over time. Proponents of the estate tax assert that all else being equal, a reduction in estate taxes reduces the tax benefit of charitable bequests, and should result in lower bequest levels. The estate tax reductions that began in 2002 provide an opportunity to test this assertion.

The picture is somewhat complicated, however, by the fact that EGTRAA requires fewer estates to file returns. Some estates that no longer are required to file returns may still be making charitable bequests, but those gifts are not included in IRS data. Between 2001 and 2004 the number of estate tax returns filed with the IRS fell 42 percent, and the aggregate value of gross estates on those returns dropped by $23 billion (16 percent) in inflation-adjusted dollars. In light of these numbers, it is perhaps not surprising that total charitable bequests on estate tax returns fell $2.3 billion between 2001 and 2004, though the decline among taxable estates was just $923 million (in 2005 dollars). An additional consideration is that there are significant fluctuations from year to year unrelated to changes in tax policy. Looking over a 46 year time period (1959 to 2004), total charitable bequests are closely correlated with overall charitable giving.[38]

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[36] The term "taxable estate tax returns" refers to returns that actually paid some amount of estate tax. Joint Economic Committee calculations based on data from Internal Revenue Service, "Estate Tax Returns for 2005," online at http://www.irs.gov/taxstats/indtaxstats/article/0,,id=96442,00.html.

[37] Scott R. Lumpkin, "A New Perspective on Philanthropy: Planned Giving in the United States," *Trusts & Estates* 140, no. 6 (June 2001): 14-17, 48.

[38] The correlation statistic between the two data series is 0.990. The data being compared are total charitable giving from all sources and all charitable bequests (including those from decedents who did not file an estate tax return).

Nonetheless, the evidence suggests that the impact of the estate tax reductions has been mild or even non-existent. In fact, the 2005 edition of *Giving USA*, published annually by the AAFRC Trust for Philanthropy (an organization that seeks to advance philanthropy), reported that "Despite predictions, there has been no observed impact on charitable giving from the gradual change in estate tax filing requirements."[39] A number of facts are consistent with such a conclusion. First, the total amount of charitable bequests in nominal dollars, on and off of estate tax returns, was exactly the same in 2001 (before EGTRRA) and 2004: $19.8 billion.[40] Second, the size of the average charitable bequest on estate tax returns has increased significantly, rising more than 40 percent between 2001 and 2004 (Figure 2).[41] Third, bequests as a share of gross estate have increased after EGTRAA, growing from 7.4 percent over 1999-2001, compared to 7.9 percent for 2002-2004; among taxable returns, the share rose from 7.4 percent to 8.5 percent.[42] Finally, the percent of estate tax returns that made a charitable bequest rose from 16.9 percent for the period 1999-2001 to 17.7 percent for the period 2002-2004; for taxable returns, the rates were 20.6 percent and 21.2 percent, respectively.[43] As noted above, IRS data do not tell the whole story, since the data exclude charitable bequests by estates no longer subject to the estate tax.

Notably, these changes generally follow the same patterns across different estate sizes. For example, among taxable returns, total bequests for estates greater than $5 million declined just eight tenths of a percentage point; bequests were also similar for estates greater than $10 million. Likewise, the increases in the percent of estates leaving a bequest and bequests as share of estates are all concentrated in the larger estates (the very estates mostly like to face the highest marginal rates, and which therefore might be expected to be most responsive to rate reductions).

To a certain degree, even these numbers overstate the scope of charitable giving, as a very small number of estates account for the vast majority of bequests to charity. The most recent data indicate that the wealthiest 0.5 percent of decedents in the U.S. accounted for 76 percent of all charitable bequests made in 2004. In fact, a mere 0.011 percent of decedents (272 estate tax returns out of 2.4 million deaths) accounted for close to one-third (31 percent) of all charitable bequests that year.[44] This concentration of charitable bequests among a very few decedents raises the question of why some wealthy estates make very large donations, while others make none at all.

The evident answer to this question is that gifts to charity are influenced by factors other than tax benefits, such as altruism or amount of after-tax wealth. As Boston College researcher

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JEC calculation using data from AAFRC Trust for Philanthropy, *Giving USA 2005* (New York, NY: AAFRC Trust for Philanthropy, 2005), 194-195.

[39] *Ibid*., 29.

[40] In constant terms, the change between 2001 and 2004 was a drop of 6.2 percent. AAFRC Trust for Philanthropy, 194.

[41] Joint Economic Committee calculations based on data from Internal Revenue Service, "Estate Tax Returns," (various years), online at http://www.irs.gov/taxstats/indtaxstats/article/0,,id=96442,00.html.

[42] *Ibid*.

[43] *Ibid*.

[44] A similar pattern holds over the last five years as well. Joint Economic Committee calculations based on data from AAFRC Trust for Philanthropy; Internal Revenue Service; and U.S. Department of Health and Human Services, Center for Disease Control, *National Vital Statistics Reports* 53, no. 21 (June 28, 2005), data updated 2/15/2006, 1.

Paul Schervish has observed, "Charitable giving, while spurred on by increased material wherewithal, is advanced even more by increased spiritual wherewithal."[45] Survey data show that charitable intent outweighs tax incentives as a motivation for charitable bequests. For example, in one survey of very wealthy families, the number one factor cited by respondents as likely to increase charitable giving was "Find worthy cause that you feel passionate about."[46] Other research bears out such findings.[47]

Formal research into the impact of a reduction in estate taxes generally finds that there are two opposite effects. First, there is an increase in the tax price of making a donation, which dampens the tax benefits of giving. Second, there is an increase in the amount of after-tax wealth, which boosts giving by augmenting available resources. Debate over the impact of estate tax repeal on charitable giving generally boils down to which of these two effects dominates. Some research has found that the charitable deduction significantly increases charitable bequests.[48] One study even predicted repealing the estate tax would reduce charitable bequests by between 22 percent and 37 percent.[49]

Other research, however, suggests that the stimulative effect of the charitable deduction is not as large. For example, a 2000 study by economist David Joulfaian found that charitable giving is highly sensitive to after-tax wealth. The net impact of the estate tax on charitable bequests is difficult to quantify, leading Joulfaian to suggest that "the estate tax has a modest effect on giving."[50] In a 2005 study from the U.S. Treasury Department's Office of Tax Analysis, Joulfaian utilized more recent data to find that the estate tax "has little effect on bequests."[51] That study went on to conclude:

> The estimated effects of estate taxation vary considerably depending on whether behavior and estate planning reflect the current or expected tax regimes. If donors are assumed to respond to the tax regime in place at the date of death, then estate tax repeal would lead to a small reduction in bequests. On the other hand, **if donors plan with the future tax regime in mind, then estate tax repeal may lead to a small increase in gifts**.[52] (emphasis added)

One of the most revealing studies on this subject found that individuals who gave generously during their life gave little at death, while those who gave little during life tended to

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[45] Paul G. Schervish, "Wealth and Philanthropy," in *Philanthropy in America: A Comprehensive Historical Encyclopedia*, ed. Dwight F. Burlingame, 507 (Santa Barbara, CA: ABC-CLIO, 2004).
[46] Schervish and Havens, 27.
[47] See, for instance, Len Scholl, "Successful Charitable Planning Starts with an Understanding of Client Motivations," *National Underwriter: Life & Health* 108, no. 47 (December 13, 2004): 14-15; and Janice H. Burrill, "The Effects of Estate Tax 'Repeal' on Philanthropy," *Trusts & Estates* 140, no. 10 (October 2001): 20-26.
[48] See, for example, Michael J. Brunetti, "The Estate Tax and Charitable Bequests: Elasticity Estimates Using Probate Records," *National Tax Journal* 63, no. 2 (June 2005): 165-188.
[49] Jon M. Bakija and William Gale, "Effects of Estate Tax Reform on Charitable Giving," Urban-Brookings Tax Policy Center (July 2003).
[50] David Joulfaian, "Estate Taxes and Charitable Bequests by the Wealthy," National Bureau of Economic Research, Working Paper 7663 (April 2000), 21.
[51] David Joulfaian, "Estate Taxes and Charitable Bequests: Evidence from Two Tax Regimes," U.S. Department of Treasury, Office of Tax Analysis, OTA Paper 92 (March 2005), 19.
[52] *Ibid*., 20.

give much more at death.[53] In brief, this research suggests that tax incentives play a relatively limited role in determining total lifetime giving. Tax incentives may induce some donors to give their contributions earlier in life, but on balance, it appears that tax incentives (both income and estate) do not greatly alter the total amount of charitable giving made over an individual's lifetime.

The estate tax may actually be a significant barrier to charitable giving, as estate taxes crowd out charitable bequests. Decisions about charitable bequests typically are made on the basis of after-tax wealth. If an estate faces a large tax liability, then there are fewer resources left over to allocate between heirs and charities. An increase in after-tax wealth could therefore offset, in part or in whole, the effect of losing the tax benefit of giving.

**Table 3. Desired & Expected Distribution of Estates**

| | Expected | Desired | Difference |
|---|---|---|---|
| Heirs | 47% | 64% | +17% |
| Taxes | 37% | 9% | -28% |
| Charity | 16% | 26% | +10% |
| Other | 0% | 1% | +1% |

Source: Schervish and Havens.

Survey evidence supports this perspective. A survey of wealthy households (net worth of at least $5 million) found that respondents *expected* to distribute 16 percent of their estates to charity and 37 percent to taxes (Table 3). However, respondents also indicated how they would *prefer* to distribute their wealth, with 26 percent going to charity and just 9 percent to taxes. In other words, for a $10 million estate, the wealth holder might expect to leave $1.6 million to charity. In the absence of excessive estate taxation, the amount going to charity would increase more than 60 percent to $2.6 million.[54]

### C. Federal Revenue

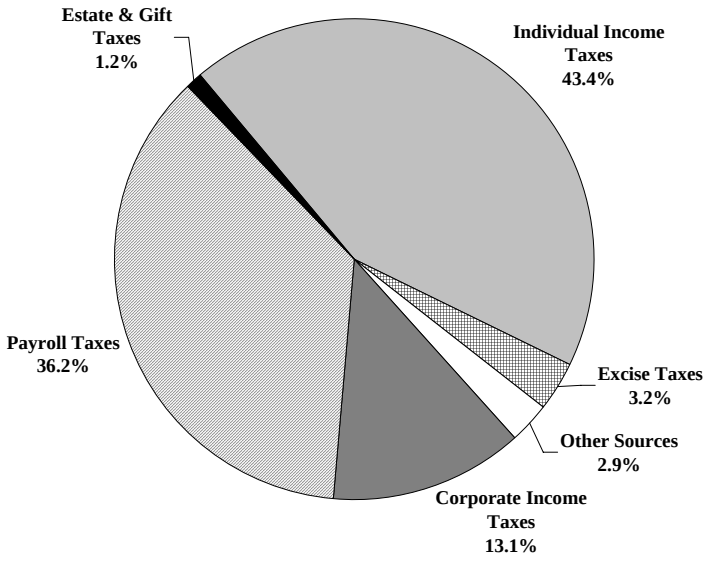
A third objection to cutting estate taxes is the loss of government revenue. The estate tax accounts for a relatively small portion of federal revenue. Although the $28 billion that the estate tax is expected to raise in 2006 is hardly insignificant, it amounts to only 1.2 percent of the $2.3 trillion in total receipts (Figure 3). Over the next five years (2006-2010), the Congressional Budget Office estimates that estate tax revenue will account for 1.0 percent of total revenue.[55]

In a curious twist of analysis, the Joint Committee on Taxation (JCT) has estimated that the total revenue loss from estate tax repeal would actually *exceed* the revenue the tax raises. At the time of JCT's analysis, the estate tax was expected to raise $218 billion over 2011 to 2015 (the years when the current reduction and repeal of the estate tax expires).[56] However, JCT

[53] Eugene Steuerle, "Charitable Giving Patterns of the Wealthy," in *America's Wealth and the Future of Foundations*, ed. Teresa Odendahl, 203-221 (New York, NY: The Foundation Center, 1987).
[54] Schervish and Havens, 35.
[55] U.S. Congress, Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 2007-2016* (Washington, DC: Congressional Budget Office, 2005), 84.
[56] U.S. Congress, Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 2006-2015* (Washington, DC: Congressional Budget Office, 2005), 78.

estimates that over that same time period repeal would lose $281 billion.[57] In other words, the revenue lost from estate tax repeal equals 129 percent of the actual revenue that it is supposed to raise.[58] This appears to be the same as pouring 13 gallons of water out of a 10 gallon jug.

**Figure 3. Distribution of Estimated 2006 Federal Revenues**




Source: Congressional Budget Office.

Notwithstanding JCT's peculiar methods of accounting, there is abundant evidence that the estate tax, along with its high compliance costs and impact on capital accumulation, may actually cause income tax revenue losses for the federal government. In addition, the primary payers of the estate tax, the wealthy, tend to be well-educated about and willing to engage in extensive tax avoidance strategies.[59] In fact, the estate tax affords so many avoidance and minimization opportunities that some observers have dubbed it a "voluntary tax."[60] It is difficult for any tax to assess accumulated savings and capital because such holdings can be manipulated through tax-free transfers and favorable asset valuation.

Estate taxes, as well, are ultimately self-defeating in the sense that they simply encourage consumption of savings rather than leaving bequests. This fact led Joseph Stiglitz, chairman of President Clinton's Council of Economic Advisers, to conclude that,

> **Of course, prohibitively high inheritance tax rates generate no revenue; they simply force the individual to consume his income during his lifetime.**[61] (emphasis added)

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[57] The JCT maintains that estate tax repeal would also reduce capital gains revenue. U.S. Congress, Joint Committee on Taxation, "Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2006 Budget Proposal," JCX-10-05 (3/9/2005).

[58] For a critique of JCT's methodology, see Daniel Clifton, "Learning from History: JCT's Static Score Can Not Determine the Real Revenue Effect of Repealing the Estate Tax," American Family Business Institute (July 2005).

[59] See generally Munnell, *infra* note 75; and Wojcieh Kopczuk and Joel Slemrod, "The Impact of the Estate Tax on the Wealth Accumulation and Avoidance Behavior of Donors," National Bureau of Economic Research, Working Paper 7690 (October 2000).

[60] See George Cooper, *A Voluntary Tax?: New Perspectives on Sophisticated Estate Tax Avoidance* (Washington, DC: Brookings Institution, 1979); and Edward J. McCaffery, "A Voluntary Tax? Revisited," in *Proceedings: 93rd Annual Conference on Taxation and Minutes of the Annual Meeting of the National Tax Association, November 9-11, 2000*, ed. James R. Hines, Jr., 268-274 (Washington, DC: National Tax Association, 2001).

[61] Bevan and Stiglitz, 21.

The impact of the estate tax on overall revenues primarily comes from reduced wealth accumulation (or increased consumption) and increased tax avoidance efforts. These factors impact revenue through the inefficiencies and distortions introduced by the estate tax, which in turn, reduce the amount of taxable income and wealth in the economy, thereby depressing federal tax revenue.

The impact of these effects is most apparent in the negative impact on income tax revenue. Most assets generate some degree of taxable income: stocks are taxed on their dividends and realized capital gains, checking and savings accounts produce taxable interest, annuities typically yield income that is at least partially taxable, and many bonds generate taxable interest. If taxable asset levels are lowered due to the estate (either from reduced savings or increased avoidance), then the income and other taxes are also reduced.

A study by Stanford University economist Douglas Bernheim examined the impact of just one aspect of tax avoidance: the tax-induced shifting of resources from parents to heirs. In general, income tax revenue is lost whenever assets are transferred from parents in high income tax brackets to children (who typically face lower tax rates) or to tax-exempt organizations through charitable bequests and family trusts. Through an analysis of estate tax returns under different assumptions and tax regimes, Bernheim found that the income tax revenue loss associated with these factors is very large relative to the revenue raised by the estate tax. In sum, Bernheim concluded:

> Although it is very difficult to estimate these effects precisely, **in recent years true estate tax revenues may well have been negative**.[62] (emphasis added)

Additional research shows that tax rates have a significant impact on such giving to heirs. Bernheim and others have found that such *inter vivos* giving is "highly responsive to applicable gift and estate tax rates."[63] Joulfaian also has reached results that "demonstrate that taxes have significant effects on the timing of transfers."[64] These findings lend credence to the contention that the estate tax results in at least some revenue loss under the income tax due premature transfers to heirs.

In addition, a growing body of literature examines the effect of the estate tax on the size of estates reported to the IRS. Most recently, David Joulfaian, of the U.S. Treasury's Office of Tax Analysis, has published evidence that suggests that "estate taxes have a dampening effect on the reported size of taxable estates."[65] Analyzing data from a 50 year period (1949-2001), Joulfaian estimates that the estate tax reduces the size of reported estates by 14 percent.

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[62] B. Douglas Bernheim, "Does the Estate Tax Raise Revenue?" in *Tax Policy and the Economy*, vol. 1, ed. Lawrence H. Summers, 113-138 (Cambridge, MA: MIT Press, 1987).
[63] B. Douglas Bernheim, Robert J. Lemke and John Karl Scholz, "Do Estate and Gift Taxes Affect the Timing of Private Transfers," National Bureau of Economic Research, Working Paper 8333 (June 2001), i.
[64] David Joulfaian, "Choosing Between Gifts and Bequests: How Taxes Affect the Timing of Wealth Transfers," U.S. Department of the Treasury, Office of Tax Analysis, OTA Paper 86 (May 2000), 23.
[65] David Joulfaian, "The Behavioral Response of Wealth Accumulation to Estate Taxation: Time Series Evidence," Office of Tax Analysis, U.S. Department of the Treasury, OTA Paper 96, (November 2005), 1.

To put the 14 percent estimate in perspective, consider that for 2004, total taxable estates reported to the IRS amounted to approximately $108 billion. If that amount reflects the 14 percent reduction estimated by Joulfaian, then the true level of taxable estates was actually $125 billion. In other words, the estate tax itself reduced the reported level of estates by $17.5 billion.

In another study on the subject, Wojciech Kopczuk and Joel Slemrod examined the size of reported estates and summary measures of the estate tax rate structure. Looking at data from 1916 to 1996, they found that higher rates are "generally negatively related to the reported aggregate net worth of the top estates as a fraction of national wealth," a finding that is consistent with the notion that estate taxes reduce wealth accumulation and increase tax avoidance.[66] The authors go on report a negative relationship between marginal estate taxes and the reported net worth of estates, concluding:

> When we investigate measures of the tax rate that prevailed during one's lifetime rather than at death, the estimated negative behavioral response to estate taxes is more pronounced. In particular, the marginal tax rate at the age of 45 dominates all other measures, and the estimated elasticity with respect to (one minus) the tax rate is 0.16, and is statistically significant. Such a number is also economically significant, because it implies that an estate tax rate of 50 percent would reduce the reported net worth of the richest half of the population by 10.5 percent when its effect is fully realized many years later.[67]

In yet another study, Kenneth Chapman, Govind Hariharan and Lawrence Southwick, Jr. found evidence that higher estate tax rates result in reduced asset levels. Following significant rate increases in 1941 and 1977, estate tax revenue as a share of GDP decreased. In contrast, after rates were lowered in 1984, revenue as a share of GDP increased.[68] A regression analysis of revenue data and tax rates provided "evidence that tax revenues from the estate tax declined during periods of higher tax rates, which suggests that individuals may be reducing the amount of their bequeathable (taxable) estates in response to the higher taxes."[69] In other words, the evidence indicates that higher tax rates are associated with a smaller amount of taxable assets. This finding reinforces the findings of Joulfaian and Kopczuk and Slemrod reported above.

Other research has quantified the true revenue effect from repeal of the estate tax. The CONSAD Research Corporation developed a computer simulation model to estimate the revenue impact of permanent estate tax repeal coupled with limited step-up in basis for the calculation of

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[66] Wojciech Kopczuk and Joel Slemrod, "Wealth Accumulation and Avoidance Behavior," in *Rethinking Estate and Gift Taxation*, eds. William G. Gale, James R. Hines, Jr. and Joel Slemrod, 338-339 (Washington, DC: Brookings Institution Press, 2001).
[67] *Ibid*., 339.
[68] Under the Economic Recovery Act of 1981 and subsequent legislation, to top statutory estate tax rates were gradually reduced from 70 percent to 55 percent. The year 1984 marks the completion of the rate phase down.
[69] Kenneth Chapman, Govind Hariharan and Lawrence Southwick, Jr., "Estate Taxes and Asset Accumulation," *Family Business Review* 9, no. 3 (Fall 1996): 267.

estates' capital gains realizations.[70] The CONSAD model predicts such a proposal would yield a net gain to the U.S. Treasury:

> Those results demonstrate that immediate repeal of the estate tax and adoption of the specified limited step-up in basis will generate a cumulative net increase in government tax revenues equal to $38.0 billion over the period from 2003 through 2012. That net increase will consist of $231.2 billion in additional revenues from the capital gains tax and the personal income tax, which will more than offset the forgone $193.0 billion in estate tax revenues.[71]

The conclusion to be made from this collection of research is that the estate tax clearly results in losses in federal income tax revnues. Even aside from economic loss caused by reduced asset accumulation, the true net revenue of the estate tax to the federal treasury is less than the official, static measures of its revenue yield. Although the exact magnitude of the effect is not known, the research of Bernheim and CONSAD supports the contention that repeal of the estate tax will not result in a revenue loss for the federal government (and may even result in a net revenue gain).

## IV. ARGUMENTS AGAINST ESTATE TAXATION

Opposition to the estate tax generally emphasizes five negative effects of the tax. The five arguments considered here are that the estate tax: inhibits capital accumulation and economic growth; threatens the survival of family businesses and depresses entrepreneurial activity; hinders income and wealth mobility; violates the principles of good tax policy, such as simplicity and fairness; and adversely impacts the conservation of environmentally sensitive land.

### A. Economic Growth

Of all taxes imposed by the federal government, the estate tax is one of the most harmful to economic growth when measured on a per-dollar-of-revenue-raised basis.[72] Although relatively small in terms of revenue raised, the estate tax exerts a disproportionately negative impact on the economy. At its basest level, the estate tax adds yet another layer to the already heavy taxation of savings and investment. Most of these savings have already been previously subjected to the income tax at least once.

The negative economic effects primarily manifest in three ways. First, the estate tax has excessively high compliance costs. Although it is possible to largely avoid estate taxes, doing so

[70] Under the proposal reviewed by CONSAD, assets would receive no step-up in basis. Instead, heirs would receive a $1.3 million exemption from capital gains taxes, but everything above that level would be taxed at the capital gains tax rate when the assets are sold.
[71] Wilbur A. Steger and Frederick H. Rueter, "The Effects on Government Revenues from Repealing the Federal Estate Tax and Limiting the Step-Up in Basis for Taxing Capital Gains," (Pittsburgh, PA: CONSAD Research Corporation, 2003), 4.
[72] Of course, the true net revenue yield of the estate tax may be significantly closer to zero. If so, the ratio of costs to revenue raised is much higher.

requires substantial expenditures and undesired allocation of resources.[73] Alicia Munnell, a member of President Clinton's Council of Economic Advisers, estimated that the costs of complying with estate tax laws are roughly the same size as the revenue raised. Specifically, in an article co-authored with Henry Aaron, Munnell wrote that

> In the United States, resources spent on avoiding wealth transfer taxes are of the same general magnitude as the [revenue] yield, suggesting that the ratio of excess burden to revenue of wealth transfer taxes is among the highest of all taxes.[74]

Elsewhere, Munnell has written:

> The compliance, or more appropriately, the avoidance costs of the transfer tax system may well approach the revenue yield.[75]

The estate tax is expected to raise $28 billion in fiscal year 2006. If the estate tax generates $1 in compliance costs for every $1 in revenue, then the aggregate cost of the estate tax would amount to roughly $56 billion in 2005: $28 billion in revenue costs and $28 billion in avoidance costs. Thus, for every dollar of tax revenue raised by the estate tax, another dollar is wasted simply to comply with or avoid the tax.

A 2001 report from Douglas Holtz-Eakin (former the Director of the Congressional Budget Office) and Donald Marples provides estimates of the distortion costs of the estate tax that are consistent with the figures above. Holtz-Eakin and Marples report that the distortion costs of the estate tax are equivalent to approximately 26 percent of pre-retirement savings.[76] Over the 2001-2005, these costs averaged $34 billion per year.[77]

Second, the estate tax results in significant economic inefficiencies. For example, Holtz-Eakin and Marples have found that replacing the estate tax with a simple capital income tax would increase economic efficiency.[78] A 1988 study by Roger Gordon and Joel Slemrod found that differences in the rate of taxation on capital exacerbate distortions caused by the tax system.[79] In tandem with the high compliance costs, the distortions caused by the estate tax decrease economic efficiency and serve as a negative influence on economic growth.

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[73] See *supra* note 60.
[74] Aaron and Munnell, 139.
[75] Alicia H. Munnell, "Wealth Transfer Taxation: The Relative Role for Estate and Income Taxes," *New England Economic Review*, Federal Reserve Bank of Boston (November/December 1988): 19.
[76] Douglas Holtz-Eakin and Donald Marples, "Estate Taxes, Labor Supply, and Economic Efficiency," Special Report, American Council for Capital Formation (January 2001).
[77] Joint Economic Committee calculations using the methodology described in Holtz-Eakin and Marples, "Estate Taxes," *supra* note 76; and inflation-adjusted (2005 dollars) data from U.S. Department of Commerce, Bureau of Economic Analysis, "Personal Income and Its Disposition," Tables 2.1 and 1.1.9, online at http://www.bea.gov/bea/dn/nipaweb/index.asp.
[78] Douglas Holtz-Eakin and Donald Marples, "Distortion Costs of Taxing Wealth Accumulation: Income Versus Estate Taxes," National Bureau of Economic Research, Working Paper 8261 (April 2001), 21.
[79] Roger H. Gordon and Joel Slemrod, "Do We Collect Any Revenue from Taxing Capital Income," in *Tax Policy and the Economy*, vol. 2, ed. Lawrence H. Summers, 89-130 (Cambridge, MA: MIT Press, 1988).

Finally, the estate tax is a tax on capital, and ultimately reduces the amount of capital in the economy. This effect results both from reduced incentives to save and invest, and because the tax forces privately-held assets to be liquidated and transferred to governmental control. Wealth that would otherwise serve productive uses in the economy as capital assets shifts to consumption-intensive government uses. Holtz-Eakin and Marples, for example, have reported a clear and significant negative relationship between capital accumulation and estate taxes.[80] Similarly, James Poterba, an economist at the Massachusetts Institute of Technology, has estimated that the federal estate tax increases the effective tax burden on capital income by 1.3 to 1.9 percentage points.[81]

By reducing the after-tax return on investment, the estate tax encourages consumption and discourages savings, which in turn cause the capital stock to grow at a slower rate. To illustrate this effect, consider a situation where parents must choose between leaving an asset to their children or consuming it themselves. When faced with a 46 percent marginal tax rate, the "price" of bequeathing $1 is $1.85 (i.e., in order for an heir to receive $1, the decedent must leave $1.85 in pre-tax assets). Alternatively, the parents could consume significantly more of that $1.85 for their own benefit. In the presence of high marginal estate tax rates, the decision between consumption and saving is significantly biased in favor of consumption. In his public finance textbook, Stiglitz, while admitting to some ambiguity, argues that on balance estate taxes "probably" reduce savings.[82]

In addition, the U.S. imposes one of the heaviest tax burdens on estates among industrialized economies. According to an American Council for Capital Formation survey of 50 nations, the average tax rate on estates is just 24 percent.[83] With a top estate tax rate of 46 percent in 2006, family businesses and intergenerational transfers are at a significant disadvantage internationally. Only Japan and South Korea have steeper tax rates on estates than the U.S. Nearly half the countries surveyed – including Canada, China, Australia, Mexico, Russia, India, Sweden and Switzerland – have no death tax whatsoever.

A comprehensive estimate of all the negative impacts of the estate tax on the economy is beyond the scope of this paper. However, an econometric framework is available for analyzing the effect of the estate tax on the existing capital stock. According to published research, every $1 reduction in the annual flow of intergenerational transfers is associated with a corresponding loss of roughly $39 in the long-run amount of capital in the economy.[84] The 1998 Joint Economic Committee study *The Economics of the Estate Tax* estimated that the effect of the

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[80] Holtz-Eakin and Marples, "Distortion Costs of Taxing Wealth Accumulation." See also Kopczuk and Slemrod, "Wealth Accumulation."

[81] James Poterba, "The Estate Tax and After-Tax Investment Returns," University of Michigan, Office of Tax Policy Research, Working Paper 98-11 (December 1997), 17, 40.

[82] Joseph E. Stiglitz, *Economics of the Public Sector*, 1st ed. (New York: W.W. Norton & Company, 1986), 487.

[83] American Council for Capital Formation, "New International Survey Shows U.S. Death Tax Rates among Highest," Special Report (July 2005), online at http://www.accf.org.

[84] Laurence J. Kotlikoff and Lawrence H. Summers, "The Role of Intergenerational Transfers in Aggregate Capital Accumulation," *Journal of Political Economy* 89, no. 4 (1981): 706-732; and Laurence J. Kotlikoff and Lawrence H. Summers, "The Contribution of Intergenerational Transfers to Total Wealth: A Reply," in *Modelling the Accumulation and Distribution of Wealth*, eds. Denis Kessler and André Masson, 53-76 (Oxford, England: Clarendon Press, 1988).

estate tax on capital accumulation in 1995 was a loss of approximately $497 billion. Using the same methodology, but with updated data, the present study estimates that the estate tax has reduced the stock of capital in the economy by approximately $847 billion, or 3.8 percent.[85] To put this figure in perspective, the estate tax raised $761 billion (in inflation-adjusted dollars) over 1942 to 2001. While it is likely that some of these tax payments would have been consumed instead of saved, it is also likely that considerably more resources would have been transferred intergenerationally due to increased saving, reduced compliance costs and compounding. The estimate of lost capital does not account for any of the incentive, compliance or distortion effects noted above.

Thus, if the estate tax had not existed over the last several decades, the amount of capital in the economy would be nearly $850 billion higher. Since capital is a fundamental ingredient for economic growth, the loss of such capital reduces economic output. Although the exact magnitude of the impact on economic growth is difficult to assess, the direction of the effect is unambiguously negative.[86]

**B. Family Businesses and Entrepreneurial Activity**

In addition to the aggregate effect on capital accumulation and economic efficiency, the estate tax exerts a strongly negative influence on entrepreneurial activity. Entrepreneurship infuses the economy with risk-takers willing to exploit new technologies and enables families to achieve upward income mobility. By hindering entry into self-employment and by breaking up family-run businesses, the estate tax inhibits economic efficiency and stifles innovation.

Prior to EGTRRA, the tax code offered family businesses some limited estate tax relief. The chief provision was a deduction for qualified family-owned businesses that allowed such firms to shelter up to $1.3 million from estate taxation. However, EGTRRA repealed this provision effective in 2004, when the unified credit increased to allow all estates to shield $1.5 million in assets, thus superseding the older provision. Other provisions preserved in EGTRRA for family-run businesses include the ability to apply to the IRS to pay estate tax bills in installments over 14 years. This feature is useful for family farms, which may be asset-rich but cash-poor. Family businesses may also attempt to apply special valuation rules to their enterprise, which allow them to be valued at their current actual usage (subject to caps on the reduction in value), rather than at a potentially more valuable usage. EGTRRA made it easier for family businesses to qualify for these benefits.

Although these tax provisions provide some relief, they are often inadequate to prevent the estate tax from breaking up many family businesses. A 2005 article in *Tax Notes* dissects estate tax relief targeted at family businesses to find that such provisions are of limited value.

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[85] The estimate of $847 billion represents the long-run increase in private fixed assets that would exist in 2001 if the estate tax did not exist. The estimate was calculated as the steady-state amount of capital that would result if all estate tax payments were instead passed from one generation to the next. For a more detailed description of the methodology used to quantify the impact on capital accumulation, see the Methodology Appendix in Miller, *The Economics of the Estate Tax*, 36-39.

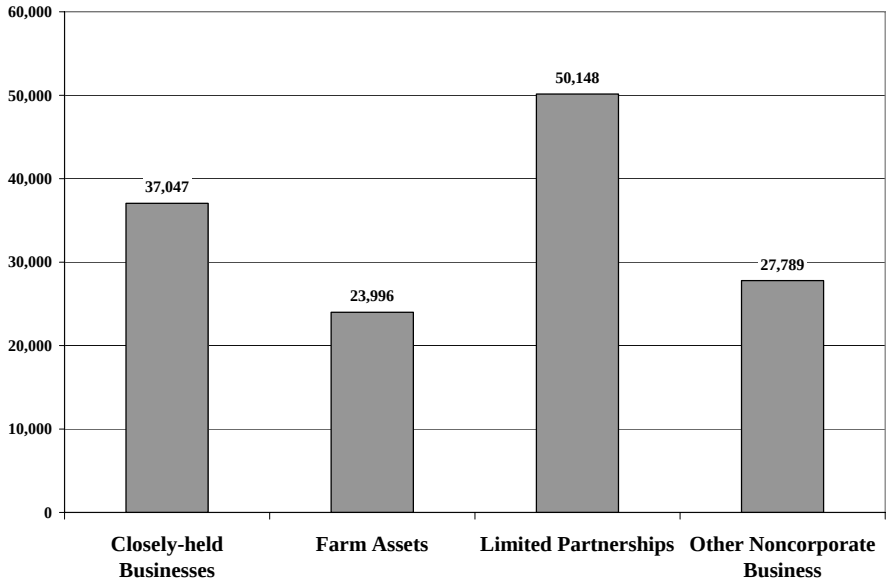
[86] Nishiyama (*supra* note 20) provides an alternative perspective confirming this finding. Simulating the effect of a 100 percent estate and gift tax, Nishiyama found that gross national product (GNP) would drop by between 3.6 percent and 4.9 percent. National wealth would fall even further, declining 11 percent to 16 percent.

The complexity of the relevant laws and regulations is sufficient to deter many law firms from even considering seeking such relief for their clients.[87]

The actual usage patterns of the family business provisions reflect this conclusion. Prior to EGTRRA, there were three provisions primarily aimed at providing relief to small and family-owned businesses: special "current use" valuation (Internal Revenue Code sec. 2032A), an additional exemption for qualified family-owned businesses (sec. 2057), and extended payment period (sec. 6166). In 1999, there were 103,979 estate tax returns filed, of which 11,0196 returns included a closely-held business interest.[88] Of these firms, just 225 estates took advantage of the special use valuation, and 888 made use of the exemption for family business; a relatively meager 524 returns elected to use the extended payment option.[89]

IRS data indicate that between 1995 and 2004, more than 37,000 estates that paid estate taxes included closely-held businesses among their assets, and that these closely-held business assets were worth a cumulative total of $67 billion in 2005 dollars.[90] In addition, taxable estate tax returns included 24,000 with farm assets, 50,000 with limited partnerships, and nearly 28,000 with other noncorporate businesses over the last ten years (Figure 4).[91] The assets in these three categories had a cumulative value of $37 billion. Thus, tens of thousands of small and family

**Figure 4. Taxable Estate Tax Returns with Listed Asset, 1995-2004**




Note: Data indicate number of taxable returns with each indicated asset for 1995-2004.
Source: Joint Economic Committee calculations using Internal Revenue Service data.

[87] William W. Beach, Harold I. Apolinsky and Craig M. Stephens, "Targeted Family Business Carveout Fails to Avoid Estate Tax," *Tax Notes* (4/18/2005): 365-368.
[88] Internal Revenue Service.
[89] U.S. Congress, Joint Committee on Taxation, *Description and Analysis of Present Law and Proposals Relating to Federal Estate and Gift Taxation*, JCX-14-01 (3/14/2001), 34.
[90] This is a conservative estimate of the number of firms affected by the estate tax since it ignores businesses that did not pay estates taxes, either because they expended enough resources to avoid the tax or because the costs of estate planning impeded the growth of such firms. Joint Economic Committee calculations based on data from Internal Revenue Service.
[91] Note that these tax data only list farm assets and do not include the value of farmland (which is included in the broad category of real estate assets). However, since the presence of farm assets likely correlates closely with farm businesses, the number of taxable returns with farm assets is a reasonable proxy for the number of farm businesses.

businesses, worth $104 billion, were subject to the estate tax over the last ten years. These data clearly indicate that the estate tax has broad and significant costs for thousands of family businesses.

Survey data suggest that the estate tax continues to be a primary reason why small businesses fail to survive beyond one generation. Close to two-thirds (64 percent) of respondents in one survey of family businesses reported that the estate tax makes survival of the business more difficult.[92] In other surveys, 87 percent of black-owned firms and 93 percent of manufacturing firms responded that the estate tax was an impediment to survival.[93] A survey of family business owners by Prince & Associates found that 98 percent of heirs cited "needed to raise funds to pay estate taxes" when asked why family businesses fail.[94] Even if only a small percentage of the 550,000 small businesses that fail annually are attributable to the estate taxes, the cumulative number affected over time could be substantial.[95] In the context of the survey and tax data described here, it is easy see how the estate tax has contributed to the failure of thousands of small and family-run businesses.

Estate tax planning is crucial for the succession of family businesses to the next generation. The presence of the estate tax already makes such succession planning unnecessarily complicated and painful. Yet the current situation in which the level of estate taxation is uncertain precludes sound planning. As the law now stands, the estate tax will slowly be phased out over the next few years until it is completely repealed in 2010. However, effective January 1, 2011, the repeal itself is revoked, and the estate tax returns to the level that existed in 2001. Thus, a difference in death of just a single day could mean the difference between no estate tax at all or extremely punitive taxation.

The estate tax represents a significant barrier to small and family-run businesses. Research showing this fact comes from Holtz-Eakin and Marples, who wrote in 2001 (prior to the estate tax phase-down and repeal in EGTRRA):

> The study shows that **entrepreneurs face an expected estate tax liability that is typically nearly five times as large as that of non-entrepreneurs**. Of course, one might immediately suspect that entrepreneurs, especially those who survive to later in their working careers, are simply more successful. The data, however, show that simply having greater wealth is not the whole story; instead, entrepreneurs face significantly higher average and marginal tax rates because of the type of investments they make.[96] (emphasis added)

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[92] Joseph H. Astrachan and Roger Tutterow, "The Effect of Estate Taxes on Family Business: Survey Results," *Family Business Review* 9, no. 3 (Fall 1996): 303-314.
[93] Joseph H. Astrachan and Craig E. Aronoff, "A Report on the Impact of the Federal Estate Tax: A Study of Two Industry Groups" (Marietta, GA: Kenneseaw State College, Family Enterprise Center, 1995).
[94] Russ Alan Prince and Karen Maru File, *Marketing to Family Business Owners* (Cincinnati, OH: National Underwriter, 1995), 35.
[95] Also, there were an estimated 23.7 million small businesses in 2003. Joint Economic Committee calculations using 1999-2003 data from U.S. Small Business Administration, Office of Advocacy, *The Small Business Economy* (Washington, DC: Government Printing Office, 2004), and data online at http://www.sba.gov/advo/index.html.
[96] Holtz-Eakin and Marples, "Estate Taxes, Labor Supply, and Economic Efficiency," 4.

Not only do entrepreneurs face higher tax rates, but they are also less likely to have the resources needed to meet their estate tax liabilities. Facing high estate tax rates, many business owners purchase life insurance to provide their heirs with additional liquid resources to pay the estate tax. However, even the addition of life insurance payments leaves businesses with insufficient resources. Researchers Holtz-Eakin, John W. Philips and Harvey Rosen, writing in a 1999 study, reported:

> Our results suggest that owners of businesses buy more [life] insurance than other individuals, but even together with the liquid assets in their portfolios, there is insufficient money to cover estate taxes.[97]

The principal reason that estate taxes cause such disruption to family businesses is that they impose large cash demands on firms that generally have limited access to liquid assets. For example, the typical small business owner has 60 percent of the family net worth invested in the business.[98] Smaller firms, typically lacking access to capital from financial markets, may be unable to obtain the optimal amount of capital to finance their investments. Intergenerational transfers function, in essence, as a sort of internal financing mechanism. To the degree that estate taxes reduce or limit intergenerational transfers, they also reduce the amount of financing available for investment in small or family-run enterprises.

Inheritances play an important role in alleviating the liquidity constraints that impede the formation and success of small businesses. A 1994 study found that individuals who receive an inheritance are more likely to become self-employed, and those who are already self-employed are more likely to remain so.[99] Overall, the authors estimate that receiving a $270,000 inheritance results in a 1.3 percentage point increase in survival probability and a 20 percent increase in gross receipts.[100] Larger inheritances would further improve survival probabilities.

### C. Social Mobility

The estate tax also has consequences for social mobility. Limiting intergenerational transfers impedes the ability of families to climb the economic ladder from one generation to the next. For many parents, bequeathing accumulated savings to their children may allow the succeeding generation to move into higher wealth or income groups. For others, passing on the family business creates the opportunities needed for heirs to improve their economic well-being.

To the degree that the estate tax disrupts the transmission of family wealth to succeeding generations, the estate tax hinders upward income mobility. Entrepreneurship is a key means by which lower-income households move to a higher income class. For instance, one study found that low-wealth workers who become self-employed are more than twice as likely to move to a

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[97] Douglas Holtz-Eakin, John W. Phillips and Harvey S. Rosen, "Estate Taxes, Life Insurance, and Small Business," National Bureau of Economic Research, Working Paper 7360 (September 1999), 23.

[98] John L. Ward, Drew Mendoza, Joseph H. Astrachan, and Craig E. Aronoff, "Family Business: The Effect of Estate Taxes" (Chicago, IL: Center for Family Business and Family Enterprise Center, 1995), 29.

[99] Douglas Holtz-Eakin, David Joulfaian and Harvey S. Rosen, "Sticking It Out: Entrepreneurial Survival and Liquidity Constraints," *Journal of Political Economy* 102, no. 1 (February 1994): 68-71.

[100] Holtz-Eakin, Joulfaian and Rosen estimate the effect to be $150,000 in 1985 dollars. When adjusted for inflation (using the consumer price index), that amount translates to $272,258 in 2005 dollars.

higher wealth class than are individuals who continue traditional work.[101] Research shows that blacks are more likely to become self-employed if their parents are self-employed, and that self-employed black and Hispanic men have higher long-run earnings than their wage and salary counterparts.[102] By making it more difficult for minorities to continue a family business, the harmful effects of estate taxes are magnified for black-, Hispanic- and Asian-owned enterprises.

Key black business leaders have advocated estate tax repeal, arguing that it is only since the Civil Rights Act of 1964 that blacks have been able to accumulate wealth. Robert L. Johnson, the founder of Black Entertainment Television and contributor to Democrat political causes, has even argued that "Elimination of the estate tax will help close the wealth gap in this nation between African-American families and white families."[103] Oprah Winfrey has lamented the negative aspects of the estate tax on her TV show, saying "I think it's irritating that once I die, 55 percent of my money goes to the United States government. … You know why that's irritating? Because you would have already paid nearly 50 percent."[104] Harry C. Alford, the president and CEO of the National Black Chamber of Commerce, summed up the importance of wealth accumulation for the black community:

> We, as a people, have been freed from physical slavery for over 134 years and we have yet to begin building wealth. We cannot begin utilizing all of the advantages of this free economy until we have gained enough wealth to actively participate. It's just not civil rights; civil rights can get you dignity and respect but we need more. It's just not political empowerment; look at Zimbabwe or South Africa where we now have enormous political empowerment but, yet, no power due to lack of Black wealth. Civil rights and political clout are nice but economic empowerment will get you freedom and authority. Freedom and authority are the keys to earthly happiness.…
>
> Getting rid of the 'death tax' will start to create a needed legacy and begin a cycle of wealth building for Blacks in this country. That would be a great start to breaking the economic chains that bind us.[105]

A similar sentiment has been expressed by leaders in the Hispanic community. The significance of passing a family business to the next generation was the subject of a 2004 article in *Hispanic Trends* by J.R. Gonzales, former president of the Hispanic Chamber of Commerce:

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[101] Vincenzo Quadrini, "Entrepreneurship, Saving and Social Mobility," Federal Reserve Bank of Minneapolis, Discussion Paper 116 (March 1997).

[102] Robert W. Fairlie, "The Absence of the African-American Owned Business: An Analysis of the Dynamics of Self-Employment," *Journal of Labor Economics* 17, no. 1 (January 1999): 80-108; and Robert W. Fairlie, "Does Business Ownership Provide a Source of Upward Mobility for Blacks and Hispanics?" in *Public Policy and the Economics of Entrepreneurship*, ed. Douglas Holtz-Eakin and Harvey S. Rosen, 153-179 (Cambridge, MA, MIT Press, 2004).

[103] Ernest Holsendolph, "Bush Picks up Unexpected Ally in BET founder," *The Atlanta Journal and Constitution*, 8/26/2001. See also "African-American Business Leaders Call for End to Estate Tax," *New Pittsburgh Courier*, 4/11/2001.

[104] Oprah Winfrey, as quoted in Editorial, "Death's Taxes," *Wall Street Journal* (7/28/1999).

[105] Harry C. Alford, "Blacks Should Help In Doing Away with the 'DEATH TAX'," National Black Chamber of Commerce, online at http://www.nationalbcc.org/editorials/article.asp?id=62&scope=editorials [accessed 4/19/06].

> What's happening here is that as Hispanics begin achieving the American Dream, they become more focused on keeping it – passing their hard-earned success to the next generation. While other issues continue to be of concern – immigration, health care and education, in particular – new issues like repeal of the Death Tax begin to move forward.
>
> These Hispanic business owners have undertaken enormous financial risk: often, they were forced to borrow from friends and family to build their businesses and keep them afloat, and they feel a unique responsibility, as Hispanics, to pass on what they've built to their children.[106]

A 2004 study by Boston College researchers John Havens and Paul Schervish shows that much African-American wealth will be subject to the estate tax: 29 percent of African-American wealth is now held in estates worth $1 million or more.[107] African-Americans are also increasingly likely to be subject to the estate tax, with the number of estates worth at least $1 million increasing by more than 130 percent over the next generation.[108] The authors further estimate that over 2001-2055, African-American households are likely to pay between $192 billion and $257 billion in federal estate taxes.[109] Put another way, the estate tax will wipe out between 11 and 13 percent of all African-American wealth.

Recent data from the U.S. Census Bureau also suggest that minority-owned businesses are increasingly likely to be affected by the estate tax. Census Bureau data show that the number of Hispanic-, black- and Asian-owned business grew rapidly between 1997 and 2002, greatly exceeding the growth rate for the rest of U.S. businesses.[110] As can be seen in Table 4, the number of Hispanic-owned firms grew by 31 percent between 1997 and 2002. Over the same time period, the number of black-owned firms jumped by a dramatic 45 percent, and Asian firms rose 23.7 percent. These growth rates far outpace the 6.7 percent rate for the rest of U.S. businesses. These data imply that more minority-owned firms will be affected by the estate tax in the future. Ironically, the more successful Asian-, Hispanic- and black-owned firms are the very ones to be hit hardest by the estate tax.

**Table 4. Growth of Minority-Owned Businesses**

| | 1997 | 2002 | Change |
|---|---|---|---|
| Hispanic | 1,199,896 | 1,573,600 | **31.1%** |
| Black | 823,499 | 1,197,661 | **45.4%** |
| Asian | 893,590 | 1,105,329 | **23.7%** |
| Rest of U.S. | 17,904,949 | 19,098,095 | **6.7%** |

Source: Author's calculations and U.S. Census Bureau.

For many low-income minority or ethnic groups, the estate tax represents an obstacle to successful family businesses.

[106] J.R. Gonzales, "The Death Tax: A Menace to Entrepreneurship," *Hispanic Trends* (October 31, 2004).
[107] John J. Havens and Paul G. Schervish, "Wealth Transfer Estimates for African American Households," Boston College, Center on Wealth and Philanthropy (October 2004), 19.
[108] *Ibid.*, Table 10.
[109] *Ibid.*, 16-17.
[110] Data on business ownership come from the 2002 Economic Census, Survey of Business Owners. The data presented come from three different sources, all published by the U.S. Census Bureau: *Black-Owned Firms: 2002*, SB02-00CS-BLK (4/18/06); Hispanic-Owned Firms: 2002, SB02-00CS-HISP (3/21/06); and "Preliminary Estimates of Business Ownership by Gender, Hispanic or Latino Origin, and Race: 2002" (7/28/05), online at http://www.census.gov/csd/sbo/.

In a 2004 survey of Hispanic business owners by the Impacto Group, two out of three (66 percent) respondents said the estate tax affects their ability to meet company goals by distracting their attention and wasting resources.[111] Half of all respondents in that survey report knowing of a Hispanic small business that has experienced hardship because of the estate tax liability, including "selling off" equipment or the business. One quarter of respondents said they themselves would sell part of the business to pay the tax, and 10 percent would delay expansion of the business. In addition, as previously noted, 87 percent of black-owned firms in a 1995 survey responded that the estate tax was an impediment to survival.[112]

The experiences of many of the 200-plus black newspapers in the U.S. illustrate this point. Many of these firms are family-run businesses that are struggling to maintain circulation and are underfinanced.[113] For example, *The Chicago Defender*, founded in 1905, was one of the leading African-American newspapers in the U.S. for much of the twentieth century. In 1997, however, the owner and publisher of the newspaper, John Sengstacke, died and left a $3 million estate tax liability that the family could not afford. The paper was in serious danger of going under until a nephew of the owner came forward with a proposal to buy the paper.[114] Although *The Chicago Defender* survived, its story demonstrates how the estate tax can threaten the survival of family-businesses with marginal financial health.

**D. Fairness, Simplicity and Efficiency**

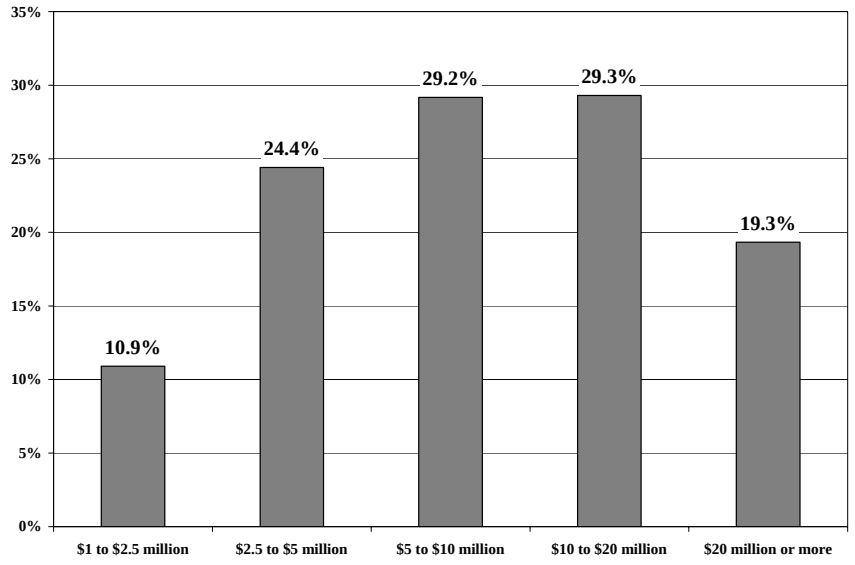
The estate tax violates the three principles of good tax policy: equity (fairness), simplicity and efficiency. The large number of tax avoidance options permitted under the estate tax means that the tax will result in a tax burden distributed unfairly among payers of the tax, will be unnecessarily complicated, and will significantly distort taxpayer behavior.

In terms of equity and simplicity, the existence of so many loopholes virtually guarantees that the estate tax will violate the principles of horizontal and vertical equity, as well as that of simplicity. An individual worth $5 million can not only pay less in estate taxes than other individuals worth $5 million, but can pay less than those worth $1 million. According to IRS data for 2004 returns, the average estate tax rate for the largest estates (gross estates over $20 million) is actually lower than the average tax rate for estates in the $2.5 to $5 million range (Figure 5).[115] This aspect of estate taxation was summarized by Munnell, who wrote:

> Horizontal and vertical equity considerations have disappeared in the estate and gift area; **tax liabilities depend on the skill of the estate planner, rather than on capacity to pay**.[116] (emphasis added)

[111] Impacto Group LLC, "Five-State Executive Interview Study of 100+ Hispanic Family-Owned Businesses on Federal Estate Taxes" (Washington, DC: Impacto Group LLC, 7/14/2004).
[112] Astrachan and Aronoff.
[113] Kathy Bergen, "Black Papers Fight for Life; Population Grows, but Readership, Ads in Decline," *Chicago Tribune*, 8/4/2002.
[114] Mark J. Konkol, "Judge Gives Approval to Sale of Defender," *Chicago Sun-Times*, 5/2/2002.
[115] Joint Economic Committee calculations based on data from Internal Revenue Service.
[116] Munnell, 18.

**Figure 5. Average Tax Rate on 2004 Estate Tax Returns**




Note: Data only include taxable returns.
Source: Joint Economic Committee calculations using Internal Revenue Service data.

An efficient tax is one that raises a given amount of revenue while causing the least distortion in behavior. An efficient tax should not impede economic growth or change the way people behave. As previously noted, Aaron and Munnell estimate that the compliance costs of the estate tax are roughly the same size as the amount of revenue raised:

> In the United States, resources spent on avoiding wealth transfer taxes are of the same general magnitude as the [revenue] yield, suggesting that the ratio of excess burden to revenue of wealth transfer taxes is among the highest of all taxes.[117]

In 2006, the estate and gift taxes are expected to raise $28 billion. However, if the ratio of revenue to costs equals one, then the true cost to the economy of these taxes will be closer to $56 billion. In other words, for every $1 removed from the economy to pay estate taxes, another $1 is wasted in order to comply with or legally avoid the tax. The estate tax also causes changes in savings, investment and consumption behavior.[118] Measured in these terms, the estate tax is highly inefficient.

## E. Environmental Conservation

An often overlooked aspect of the estate tax is its harmful effect on the environment. The impact manifests when heirs are forced to divide up or develop environmentally sensitive land in order to pay estate taxes. The problem of estate taxation faced by private landowners was addressed in 1995's *The Keystone Report*, the collective efforts of environmentalists, landowners, business groups, and government agencies to identify and recommend solutions to the problems that private landowners face in conserving threatened and endangered species and habitats. With regard to estate taxes, *The Keystone Report* found that:

> Federal estate tax requirements are a major obstacle for private landowners whose land stewardship has been sensitive to its environmental value and who would

[117] Aaron and Munnell, 139.
[118] For examples of distortions, see *supra* notes 61 to 66, 69, 78, 79, 81, 82, and 85, and accompanying text.

> like to be able to pass on their land to their heirs without destroying that value. The imposition of federal estate taxes often forces large parcels of environmentally valuable land to be broken up into smaller, less environmentally valuable parcels. Some of the best remaining habitat for endangered species is put at risk in this manner.[119]

When the time comes to pay estate taxes, real estate assets often generate a substantial tax liability that can only be paid by developing the land. The impact is most apparent for natural habitats that are destroyed. Endangered species are affected as well, since half of all listed species are primarily found on privately-owned land.[120] These effects of estate taxation led Michael Bean of The Nature Conservancy to label the estate tax as "highly regressive in the sense that it encourages the destruction of ecologically important land in private ownership."[121]

A 2001 analysis of estates and rural land holdings found that estate taxes have a significant impact on land use. According to this study, conducted prior to EGTRRA, approximately 2.6 million acres of forest land must be harvested each year to pay for the estate tax.[122] Another 1.3 million acres must be sold to raise funds to pay estate taxes, of which close to one-third (29 percent) is either developed or converted to other uses. Moreover, 36 percent of forest estates incur an estate tax liability, a rate far higher than the overall rate in the U.S. population. The estate tax undoubtedly is bad for environmentally-important habitats and is a serious impediment to preserving endangered and threatened species.

In recognition of the adverse environmental impact of taxing estates, the federal tax code grants limited estate tax relief for qualifying conservation easements, land that is set aside for environmental conservation. Land owners are exempt from paying estate taxes on the value of land that is lost due to the conservation easement (subject to several requirements). The Taxpayer Relief Act of 1997 granted estates that donate such easements an additional tax deduction worth 40 percent (up to a maximum of $500,000) of the remaining value of the land.[123] EGTRRA further assisted conservation efforts by repealing a key limit on land eligibility, making more land eligible to qualify as a conservation easement.

Unfortunately the potential benefits of conservation easements are curtailed by a number of restrictions and limitations that discourage or prevent land owners from taking advantage of them. The restrictions that land owners must meet in order to qualify for a conservation include the overall value of the exclusion amount relative to the size of the estate, how long the decedent owned the land and whether or not the land acquisition was debt-financed. Other considerations which might discourage use of a conservation easement include the exclusion of the value of any development rights and the inability to step-up the land's basis.

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[119] Keystone Center, *The Keystone Dialogue on Incentives for Private Landowners to Protect Endangered Species – Final Report* (Washington, DC: Keystone Center, 1995), 26.
[120] U.S. Fish & Wildlife Service, Endangered Species Program, "Our Endangered Species Program and How It Works with Landowners" (May 2003), online at http://www.fws.gov/endangered/landowner/index.html.
[121] Michael J. Bean, "Shelter from the Storm," *The New Democrat* (April 1997).
[122] John Greene, Tamara Cushing, Steve Bullard, and Ted Beauvis, "Effect of the Federal Estate Tax on Rural Land Holdings in the U.S.," in *Forest Policy for Private Forestry: Global and Regional Challenges*, eds. Lawrence D. Teeter, Benjamin Cashore and Dao Zhang, 211-218 (New York, NY: CABI Publishing, 2003).
[123] Public Law No: 105-34.

Ultimately, the benefit of conservation easements should be measured by their actual usage. Data from the IRS indicate that very few estates actually take advantage of the conservation easement. In 2004, just 46 estates out of 62,718 estate tax returns (0.07 percent) set aside land for conservation easements (Table 5).[124] Over the last five years (2000-2004), the total number of conservation easements was just 232 out of 443,000 returns (0.05 percent). The value of deductions for conservation easements is also small, just $11.7 million in 2004, or 0.004 percent of the value of all estate returns reported that year.

**Table 5. Use of Conservation Easements, 200-2004**

| Year | Number of Conservation Easements | Number of Estate Tax Returns | Percent of Returns with Easements |
|---|---|---|---|
| 2000 | 43 | 108,322 | 0.040% |
| 2001 | 63 | 108,112 | 0.058% |
| 2002 | 32 | 98,359 | 0.033% |
| 2003 | 48 | 66,044 | 0.073% |
| 2004 | 46 | 62,718 | 0.073% |
| **Total** | **232** | **443,555** | **0.052%** |

Source: IRS data.

As these data suggest, the conservation easement provisions fall considerably short of remedying the tax's adverse environmental impact. Even with the limited conservation easement now in place, many estates will not, for a variety of reasons, take advantage of the option. Although many environmentalists would prefer expanding conservation easement options rather than complete repeal of the estate tax, it is nonetheless clear that the federal estate tax is harmful to endangered and threatened species and their habitats.

## V. CONCLUSION

This study documents the extensive costs associated with the federal estate tax. The detrimental effects of the estate tax are grossly disproportionate to the modest amount federal revenue it raises (if it raises any net revenue at all). Estate taxes result in a large amount of wasted economic activity. Over its lifetime, the presence of the estate tax has cost the economy roughly $850 billion in capital stock. Moreover, the estate tax destabilizes family businesses at one of their most vulnerable points, the succession from one generation to the next. Not only have the enormous liquidity demands of the estate tax have contributed to the break up of thousands of small businesses, but the tax also inhibits income and wealth mobility. Lastly, the estate tax threatens the destruction of environmentally sensitive land. In generating these outcomes, the estate tax violates the basic principles of a good tax system – simplicity, fairness and efficiency.

If the estate tax generated sufficiently large benefits, then an argument could be made to justify its existence. However, the weight of evidence indicates that the estate tax lacks sufficiently redeeming qualities. A large and growing body of theoretical and empirical research supports the contention that the estate tax does little, if anything, to reduce inequality. In addition, research indicates that the deduction for charitable bequests stimulates little or no additional giving. Even the $28 billion in revenue it raises is misleading, since estate tax

[124] Internal Revenue Service, Statistics of Income Division, unpublished data provided by Martha Eller Gangi, 4/3/06.

avoidance activities likely generate substantial revenue losses under the income tax. In short, the estate tax is characterized by significant economic, social and environmental costs, yet generates little in the way of measurable benefits.

The estate tax is an unnecessary feature of the current federal tax system. The estate tax's punitive tax rates are not only the highest of all federal taxes, but are imposed at the most inappropriate of times – the death of a loved one. As if mourning such a loss were not enough, the federal government worsens the pain by seeking to confiscate up to one-half of all the decedent's savings, very often accumulated through hard work, frugality, deferred consumption and entrepreneurship. This final injurious grievance simply strengthens the conclusion that the estate tax generates costs to taxpayers, the economy and the environment that far exceed any potential benefits that it might arguably produce. Based on the facts and analysis presented here, there is no compelling reason to even have a permanent estate tax, and a number of reasons to eliminate the tax altogether. Death and taxes may indeed be inevitable, but there is no reason the two have to converge simultaneously.

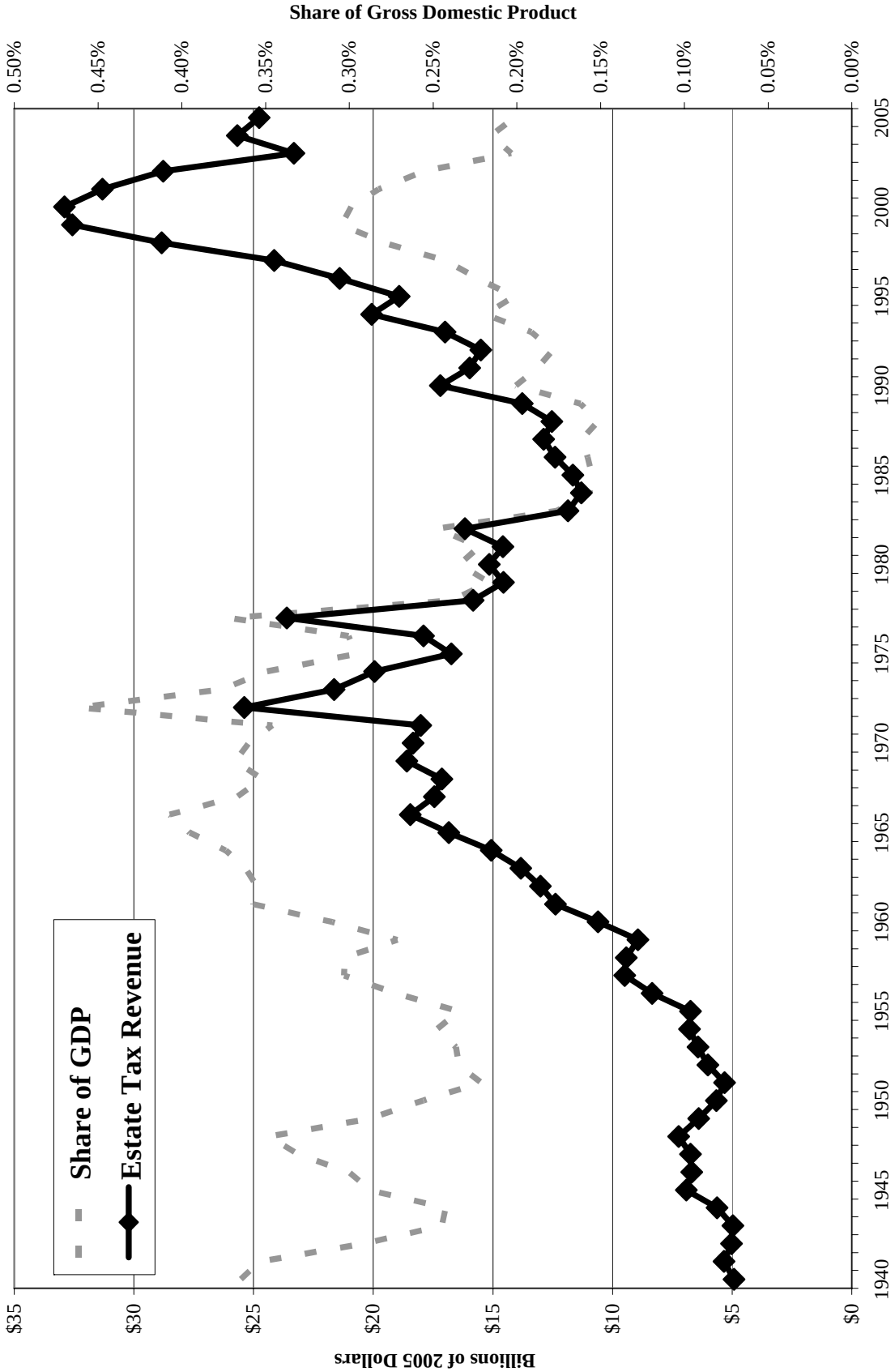
Dan Miller
Senior Economist

**Table 6. Estate Tax Rates Before, During and After EGTRRA, 2001-2011†**

| | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011+ |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **Exclusion Amount (millions)** | **$0.675** | **$1.0** | **$1.0** | **$1.5** | **$1.5** | **$2.0** | **$2.0** | **$2.0** | **$3.5** | **N/A** | **$1.0** |
| **Taxable Estate‡** | | | | | | | | | | | |
| Less than $750,000 | 37% | | | | | | | | | N/A | |
| $750,000 to $1 million | 39% | | | | | | | | | N/A | |
| $1 - $1.25 million | 41% | 41% | 41% | | | | | | | N/A | 41% |
| $1.25 - $1.5 million | 43% | 43% | 43% | | | | | | | N/A | 43% |
| $1.5 - $2 million | 45% | 45% | 45% | 45% | 45% | | | | | N/A | 45% |
| $2 - $2.5 million | 49% | 49% | 49% | 48% | 47% | 46% | 45% | 45% | | N/A | 49% |
| $2.5 - $3 million | 53% | 50% | 49% | 48% | 47% | 46% | 45% | 45% | | N/A | 53% |
| $3 - $10 million | 55% | 50% | 49% | 48% | 47% | 46% | 45% | 45% | 45% | N/A | 55% |
| $10 - $17.184 million* | 60% | 50% | 49% | 48% | 47% | 46% | 45% | 45% | 45% | N/A | 60% |
| More than $17.184 million | 55% | 50% | 49% | 48% | 47% | 46% | 45% | 45% | 45% | N/A | 55% |

† Under EGTRRA, the estate tax is phased down during 2002-2009 and is completely repealed for 2010. In 2011, the estate tax provisions of EGTRRA expire, returning the exemption and rates set forth by pre-EGTRRA law.
‡ Taxable estate equals total estate less any deductions. Table does not show inframarginal rates rendered ineffective by the exclusion amount.
* Prior to EGTRRA, taxable estates worth $10 to $17.184 million were subject to an additional 5 percent surtax. The purpose of the surtax was to eliminate the benefits of inframarginal rates (i.e., starting at $10 million, taxable estates start to lose the benefits of tax rates less than the top statutory rate).
Source: Nonna A. Noto, "Calculating Estate Tax Liability during the Estate Tax Phasedown Period 2001-2009," Congressional Research Service, Report RL31092 (updated April 1, 2005).

**Figure 6. Estate Tax Revenues, 1940-2005.**



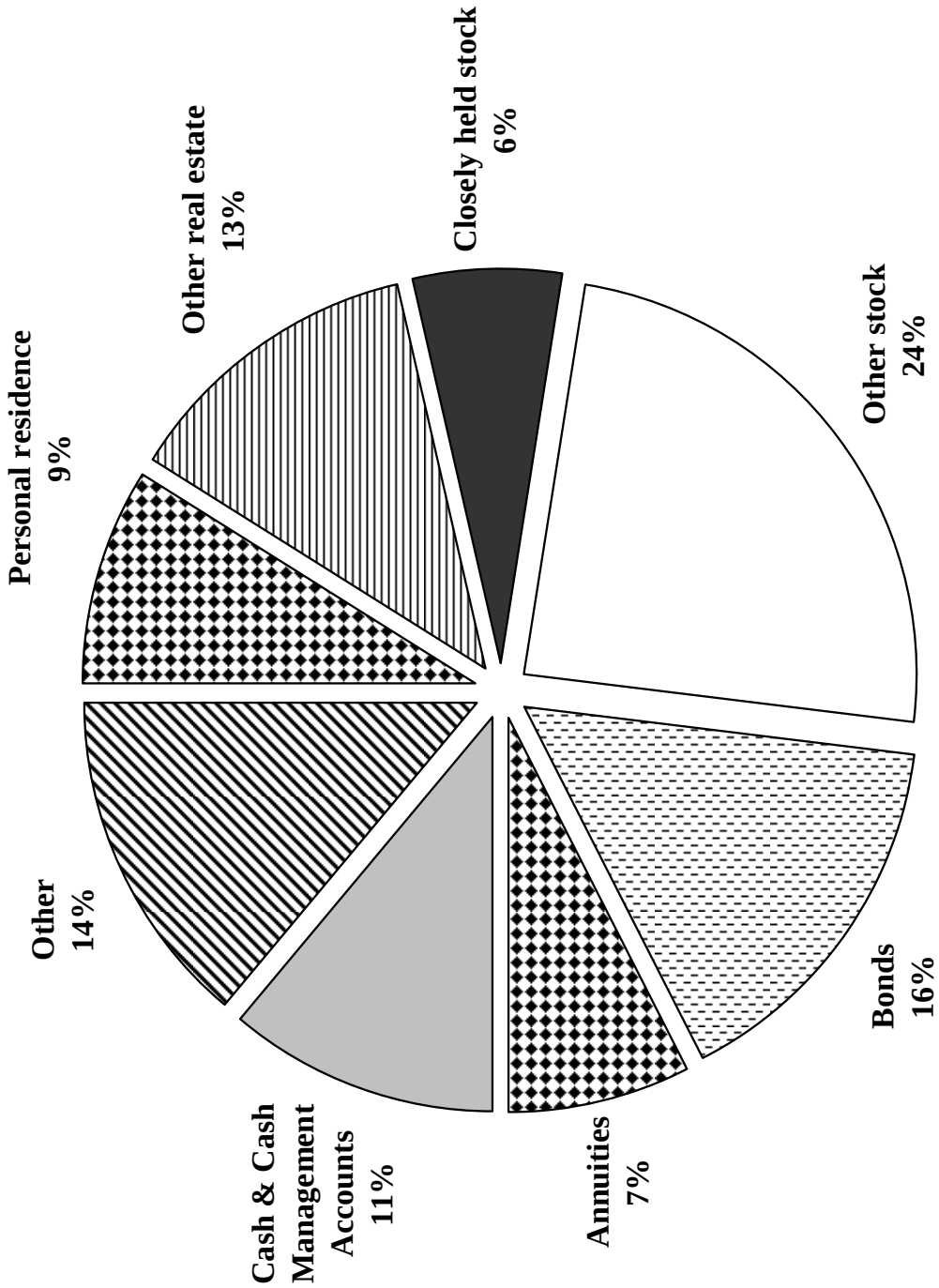

Source: Office of Management and Budget

**Table 7. Estate and Gift Tax Revenue, 1940-2006.**

| Fiscal Year | Revenue Nominal | Revenue Real (2005$) | Fiscal Year | Revenue Nominal | Revenue Real (2005$) |
|---|---|---|---|---|---|
| 1940 | $353 | $4,924 | 1974 | $5,035 | $19,946 |
| 1941 | $403 | $5,345 | 1975 | $4,611 | $16,738 |
| 1942 | $420 | $5,025 | 1976 | $5,216 | $17,895 |
| 1943 | $441 | $4,971 | TQ* | $1,455 | $4,951 |
| 1944 | $507 | $5,634 | 1977 | $7,327 | $23,613 |
| 1945 | $637 | $6,921 | 1978 | $5,285 | $15,825 |
| 1946 | $668 | $6,690 | 1979 | $5,411 | $14,561 |
| 1947 | $771 | $6,745 | 1980 | $6,389 | $15,147 |
| 1948 | $890 | $7,235 | 1981 | $6,787 | $14,578 |
| 1949 | $780 | $6,394 | 1982 | $7,991 | $16,172 |
| 1950 | $698 | $5,662 | 1983 | $6,053 | $11,866 |
| 1951 | $708 | $5,323 | 1984 | $6,010 | $11,300 |
| 1952 | $818 | $6,017 | 1985 | $6,422 | $11,659 |
| 1953 | $881 | $6,426 | 1986 | $6,958 | $12,399 |
| 1954 | $934 | $6,787 | 1987 | $7,493 | $12,879 |
| 1955 | $924 | $6,740 | 1988 | $7,594 | $12,542 |
| 1956 | $1,161 | $8,344 | 1989 | $8,745 | $13,773 |
| 1957 | $1,365 | $9,487 | 1990 | $11,500 | $17,191 |
| 1958 | $1,393 | $9,430 | 1991 | $11,138 | $15,971 |
| 1959 | $1,333 | $8,939 | 1992 | $11,143 | $15,508 |
| 1960 | $1,606 | $10,605 | 1993 | $12,577 | $17,001 |
| 1961 | $1,896 | $12,384 | 1994 | $15,225 | $20,064 |
| 1962 | $2,016 | $13,016 | 1995 | $14,763 | $18,919 |
| 1963 | $2,167 | $13,831 | 1996 | $17,189 | $21,403 |
| 1964 | $2,394 | $15,070 | 1997 | $19,845 | $24,144 |
| 1965 | $2,716 | $16,839 | 1998 | $24,076 | $28,842 |
| 1966 | $3,066 | $18,453 | 1999 | $27,782 | $32,573 |
| 1967 | $2,978 | $17,439 | 2000 | $29,010 | $32,906 |
| 1968 | $3,051 | $17,135 | 2001 | $28,400 | $31,323 |
| 1969 | $3,491 | $18,590 | 2002 | $26,507 | $28,780 |
| 1970 | $3,644 | $18,330 | 2003 | $21,959 | $23,311 |
| 1971 | $3,735 | $18,011 | 2004 | $24,831 | $25,676 |
| 1972 | $5,436 | $25,383 | 2005 | $24,764 | $24,764 |
| 1973 | $4,917 | $21,628 | 2006† | $27,523 | NA |

Note: Adjustments for inflation were made using the CPI.
* TQ stands for transition quarter, when the federal government shifted the start of the fiscal year from June 1 to October 1.
† Projected.
Source: Office of Management and Budget.

**Figure 7. Distribution of Assets, All Estate Tax Returns 2004.**




Source: Internal Revenue Service.

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