Death, wealth, and taxes

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WHILE there are many economists and philosophers who have defended the right to become wealthy, few have defended wealth per se. But in fact, the simple existence of wealth is economically of great importance, quite apart from the familiar need for society to accumulate capital for investment. Wealth and the inequality it breeds are actually central to the functioning of our entire economic system.

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

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expensive that only the very rich could afford them.

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

An even more dramatic example is the computer. In 1970, it would have cost close to $5 million to buy a computer that was capable of performing 12.5 million instructions per second (MIPS). This works out to almost $400,000 per MIPS. Such computers were, of course, available only to governments, universities, and large corporations. Not even the richest American would have considered buying one for home use. By 1984, the cost of computers had fallen to within reach of the modestly well-to-do. A computer able to perform 8.3 MIPS could be had for about $4,000, or $479 per MIPS. In 1997, a good home computer capable of performing 166 MIPS could be had for less than $1,000, or $6 per MIPS. At such a price, even children could have computers with more power than all the computers on earth when their parents were born.

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

In a sense, therefore, the rich perform a public service when they engage in what Thorstein Veblen called “conspicuous consumption.” They are, in effect, underwriting the cost of bringing new products to market that ultimately become ubiquitous and available to everyone. Since it’s not much fun to be rich if everyone can enjoy the same products, the rich aid innovation by pushing the limit of what is possible, encouraging producers to meet their demand in return for large profits. But if the rich perform a valuable social function, must we conclude that they be allowed to pass on their wealth to their descendants and heirs? Does it necessarily follow that the inheritance and estate tax should be abolished? Does the drive to pass wealth on to one's heirs contribute in some fundamental way to the creation of wealth?

Rise and fall of rich and poor

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

Some recent scholarship by historian Edward Pessen suggests that wealth mobility was less than Tocqueville thought. However, recent data on mobility tend to support Tocqueville's observation that fortunes rarely survive past the second generation. Moreover, the data show that inheritances continue to play a small role among the wealthiest Americans. A significant percentage of the largest American fortunes were accumulated in a single generation. To some extent, this is due to the changing landscape of America's largest businesses, which have also undergone major churning.

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

A comparison of families between 1966 and 1976 found that 35.5 percent increased by at least one decile (a 10 percent bracket) of wealth and 18 percent moved up at least two deciles. Over the same period, 34.6 percent moved down at least one decile and 17.9 percent moved down at least two deciles. A study of families between 1984 and 1994 found 60 percent of families in the bottom decile of wealth the first year in a higher decile 10 years later. Of these, 40 percent jumped one decile, 26 percent rose two deciles, and 11 percent leaped three deciles. An amazing 23 percent went up four or more deciles, with 1.42 percent rising from the lowest decile to the highest. Only 47 percent of those in the top decile in 1984 were in a lower decile 10 years later. However, about 10 percent fell more than three deciles and a few ended up all the way down in the bottom decile. In part due to high mobility, research shows that wealth is much more equally distributed in the United States than in Europe, Latin America, and Asia, according to the latest World Wealth Report.

Virtually all research shows that inheritances are insignificant as a source of major wealth in America. A 1961 Brookings Institution survey found that among the affluent, only 6 percent acquired most of their assets from gifts or inheritances. Sixty-two percent of the affluent reported no inheritances whatsoever. The vast bulk of wealth arose from saving and an increase in the value of assets. Another study, by economist James P. Smith, found that among the top 5 percent of households ranked by wealth, inheritances accounted for less than 8 percent of assets. The study concluded that "wealth inequality is largely the same when the direct effects of financial inheritances are removed." And a recent study of U.S. millionaires found that 80 percent acquired their wealth in a single generation, without the benefit of inheritances. Likewise, a U.S. Trust Corporation survey of the wealthiest 1 percent of Americans found that inheritances were a significant source of wealth for only 10 percent of respondents. Earnings from privately owned businesses were the dominant source of wealth (46 percent), followed by earnings from corporate employment (33 percent), and earnings from a professional practice (29 percent).

There are many reasons why wealth tends not to perpetuate itself in the United States. One has to do with the dynamics of the American economy: Businesses and industries that are dominant at one time frequently lose their footing and fall from grace. For example, few of the top companies in 1917 are still on top today; only AT&T is on both lists. But the churning is also considerable over shorter periods. Only 9 of the 25 largest companies (by market capitalization) in 1969 were still ranked as such in 1999. Indeed, many of today's largest companies didn't even exist 30 years ago—or even 10, as in the case of Yahoo!. Consequently, fortunes based on declining businesses and industries soon dissipate, replaced by those based on newer enterprises, which is precisely the case with the Internet today.

In addition to the churning of industry, many other factors also explain why wealth frequently dissipates, and why newcomers are able to break into the ranks of the wealthy. One is that rich men tend to marry younger women who outlive them, eventually consuming the family fortune. The sons and daughters of the wealthy often show no interest in running the family business or lack the skill to do so effectively. Finally, a not insignificant number of the rich die childless or leave their fortunes to charity. Whatever the reason, it is clear that very few great fortunes last more than two generations. Even the Rockefeller fortune, perhaps the greatest of all time, has been broken into so many pieces and been so depleted by charity and bad investments that little of it remains.

But if inheritances are not the source of wealth, they are a primary motivation for its creation. The desire to leave an estate drives people to work and save. To the extent that the estate tax reduces a parent's ability to leave an estate to his children, it will have a negative effect on his willingness to accumulate wealth through work, saving, and investing.

Use it or lose it

Although no serious effort has ever been made simply to ban inheritances, the government does make strenuous efforts to curtail them, mainly through the estate and gift tax. The estate tax is one of the oldest federal taxes. First imposed in 1797, its principal purpose was revenue, not redistribution. Hence, once the need for revenue fell, the tax was repealed in 1802. The tax was revived in 1862, again solely for revenue purposes. And as earlier, when the revenue requirement abated in 1870, the tax was repealed. Another estate tax was imposed in 1898 to pay for the Spanish-American War and was abolished in 1902. The current estate tax dates from 1916, enacted to pay for World War I. This time, of course, it remained permanently.

Though the estate tax was historically a revenue source, today it serves mainly redistributive purposes, since the revenue yield is minuscule. The estate and gift tax is the federal government's least significant revenue source. In fiscal year 2000, it is expected to raise just $30 billion, according to the Office of Management and Budget. With total federal revenues estimated at $2 trillion, the estate and gift tax contributes just 1.5 percent.

Originally, the top rate of the estate tax was 10 percent, evidencing its nonredistributive purpose. But today, the tax begins at a rate of 18 percent, going up to 55 percent. On estates between $10 million and $21 million the top rate is actually 60 percent, due to the phaseout of the unified credit. This gives the United States the second highest top estate tax rate in the world; only Japan's 70 percent rate is higher. Interestingly, recent press reports blame Japan's high estate taxes for much of the sluggishness of its economy.

The estate tax did not become explicitly redistributive until the Revenue Act of 1935, passed by the Roosevelt Administration for the sole purpose of redistribution. Roosevelt rationalized this policy as necessary to stave off even more redistributive proposals being propounded by Huey Long and others. To combat these "crackpot ideas," Roosevelt said, "it may be necessary to throw to the wolves the forty-six men who are reported to have incomes in excess of one million dollars a year."

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

It is important to remember that the $675,000 estate tax exemption is not in fact an exemption. Taxpayers receive a credit of $220,550 on their estate tax liability. The effect of this is to exempt up to $675,000 of an estate from tax. Because of the difference between an exemption and a credit, however, this means that no one actually pays the bottom estate tax rate of 18 percent. The marginal tax rate on the first dollar of taxable estate is 37 percent.

A fundamental justification for the estate tax is that only those who can most easily afford pay—i.e., the rich. This year, just 2.03 percent of adult deaths in the United States are expected to result in taxable estate. However, the burden of the tax falls primarily on the recipient, not the giver. For this reason, one cannot state with certainty what the distributional effect of the estate actually is, since heirs may be either wealthy or poor. This alone may be sufficient reason to abolish the estate tax. Moreover, that the burden of the estate tax falls on heirs rather than decedents also raises important distributive questions. Generally speaking, heirs have less wealth and income than decedents. Hence, attributing the estate tax to the former rather than the latter would show the burden of the estate tax on those with middle incomes to be much higher than standard distributional tables indicate. Indeed, Congress's Joint Committee on Taxation has resisted inclusion of the estate tax in its distribution tables, owing to uncertainty about who actually bears the burden of the tax.

Estate planning

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

The reason for this disparity is that careful estate planning can virtually eliminate the tax. At the simplest level, individuals can give away up to $10,000 per year, per person, free of gift tax. This means that a husband and wife with two married children, each with two children of their own, could give up to $160,000 per year to their offspring free of tax. Also, there is a large deduction for gifts made to spouses, whose estates may be taxed separately. Thus for most married couples, the estate tax only applies to estates larger than $1.35 million. Beyond that, there are a number of increasingly complex methods for reducing the burden of the estate tax. They include life-insurance trusts, qualified personal-residence trusts, charitable-remainder trusts, charitable-lead trusts, and generation-skipping trusts.

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

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

It should be emphasized that estate planning is costly, not just in terms of lawyers fees and the like but also because assets placed in trust may not earn as high a rate of return as they would under the original owner's control. And the impact of the estate tax on small businesses can be devastating. According to a recent survey, 51 percent of family businesses would have significant difficulty surviving in the event of a principal owner's death because of the estate tax. And 14 percent of businesses said it would be impossible for them to survive; only 10 percent said the estate tax would have no effect. This same survey found that 41 percent of businesses would have to borrow against equity to pay the estate tax, and 30 percent said they would have to sell all or part of the business. Eighty-one percent of family businesses reported having taken steps to minimize the estate tax bite. These included purchasing life insurance, making lifetime gifts of stock, putting the business into trust, or other arrangements.

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

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

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

Prospects for tax reform

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

The general public supports elimination of the estate tax, despite the fact that very few people are ever likely to pay so much as a penny of estate tax. A Wirthlin Worldwide Poll in August 1999 found that 50 percent of voters strongly favor a phaseout of the estate tax, with another 20 percent somewhat in favor. Only 15 percent were strongly opposed. A possible reason for these results may be found in a *Newsweek* poll taken in June 1999, in which 41 percent of Americans thought it was very likely or somewhat likely that they would become wealthy. Only 26 percent thought they had no chance. This suggests that a key reason for opposition to the estate tax is that Tocqueville's vision is still alive and well in America.

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

Another group sees taxation of capital gains at death as a better way of taxing estates than the current estate tax. Under such a scheme, death would be treated as a realization of capital gains for tax purposes. Canada has such a system in lieu of an estate tax. Not only would it raise about the same revenue as the estate tax but it would redress an unfairness resulting from the "step-up" of basis at death. (Under the current law, the value of assets is "stepped-up" at death—meaning that an heir who acquires an asset through inheritance will pay capital gains tax only on any increase in value from the time he received it. Any increase in value during the life of the person who originally purchased the asset thus escapes taxation.) Even conservative Republicans, such as Senator Jon Kyl of Arizona, now favor taxing capital gains at death as a substitute for the estate tax.

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

However, while the problems of the estate tax would seem to make it ripe for repeal or major reform, the vast growth in wealth in America is, at the same time, fueling support for new taxes on wealth. For example, New York University economist Edward Wolff has proposed an annual wealth tax for the United States of 0.3 percent on assets over $1 million, which he estimates would raise more than $40 billion per year. Two Yale Law School professors have proposed a 2 percent annual wealth tax that would raise $255 billion per year in order to finance an $80,000 grant to all Americans on their twenty-first birthdays. And during his abortive run for the Reform party presidential nomination, Donald Trump proposed a one-time tax of 14.25 percent on all wealth above $10 million to pay off the national debt.

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

Abolish the estate tax

The fundamental justification for estate taxation is that great private wealth is socially undesirable. A secondary rationale is that inherited wealth is undeserved and perhaps even harmful to the recipient. Hence, high estate taxes are good for society and perhaps even for those who would otherwise be corrupted by inheriting unearned wealth. Hardly anyone argues that great private wealth is good for society. Yet unless that case is made, those seeking to abolish the estate tax will not likely prevail. Ultimately, the case for abolishing the estate tax must rest on a belief that failure to allow for the accumulation and free disposition of great wealth is bad for society as a whole.

Behind the drive to acquire wealth is the laudable desire to give one's children the benefit of that wealth. Take that away and many successful entrepreneurs and businessmen would lose the desire to work, invest, and be productive once they had enough to live out their own days in comfort. More fundamentally, estate taxes are an infringement on private property. If people cannot give their assets to whomever they please without penalty, they really don't own them. Secure property rights are generally understood to be essential for economic growth. And thus to the extent that estate taxes undermine those rights, growth will decline and society as a whole will suffer.

One must look primarily at the impact of estate taxes not on heirs but on those who acquire wealth and desire to pass it on. In short, one cannot look at the effects of the estate tax only on those at the receiving end, for the main impact is on the givers. Here the danger is that the estate tax, coming as it does on top of income and other taxes, imposes a de facto marginal tax rate on our most productive citizens. Economists now universally recognize the disincentive effects of high tax rates. But because the estate tax is imposed on wealth rather than income, and on the deceased instead of the living, it almost always falls outside the universe of taxes that economists concern themselves with. But as the nation's wealth rises, more and more of the middle class are affected by the estate tax, or at least believe that they might be. Consequently, they alter their work, investment, and other decisions in ways that benefit neither themselves, their heirs, the economy, nor the Treasury. The reality is that the pursuit of wealth—including the desire to pass it on after death—is a major motivation for work, saving, investment, risk-taking, invention, innovation, and entrepreneurship. In the process of acquiring personal wealth, however great it might be, individuals create far more wealth for society.

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