



Munich Personal RePEc Archive

Death Watch for the Estate Tax?

William Gale and Joel Slemrod

The Brookings Institution, University of Michigan

2001

Online at <http://mpa.ub.uni-muenchen.de/56440/>

MPRA Paper No. 56440, posted 11. June 2014 20:15 UTC

Death Watch for the Estate Tax?

William G. Gale and Joel B. Slemrod¹

November, 2000

The idea of making death a taxable event infuriates some people. Winston Churchill called estate taxes an attempt to tax dead people rather than the living. Steve Forbes campaigned in favor of "no taxation without respiration." Bruce Bartlett (1997) points out that a key plank in the Communist Manifesto was the abolition of inheritance rights. Opponents deride the "death tax" as inefficient, inequitable and complex, violating every norm of good tax policy. Supporters counter that the criticisms are overstated or wrong, and argue that a highly progressive tax that patches loopholes, helps provide equality of opportunity, breaks up concentrations of wealth and encourages charitable giving can't be all bad. These debates raise a number of fascinating research questions for economists.

In policy circles, however, the death watch for the U.S. estate and gift tax is on. In 1999, in a vote split almost completely along partisan lines, the Republican majority in Congress voted to phase out the estate tax over 10 years, but President Clinton vetoed the bill. In 2000, both Houses voted again to eliminate the tax, this time with significant Democratic support, and the bill was vetoed a second time. The election of President George W. Bush—who favors abolition

1. This article is forthcoming in the *Journal of Economic Perspectives*, February, 2001. William G. Gale is Joseph A. Pechman Fellow, Brookings Institution, Washington, D.C. Joel B. Slemrod is Paul W. McCracken Collegiate Professor of Business Economics and Public Policy, Professor of Economics and Director of the Office of Tax Policy Research, University of Michigan, Ann Arbor, Michigan. We thank Brad DeLong, Tim Taylor, Michael Waldman and numerous colleagues for very helpful comments on earlier drafts, and Samara Potter and Ben Harris for outstanding research assistance.

of the tax—combined with continuing, albeit slim, Republican majorities in both Houses suggests the estate tax may soon join the ranks of the departed.

How the Estate Tax Works

Federal law imposes a linked set of taxes on estates, gifts, and generation-skipping transfers. The executor of an estate must file a federal estate tax return within nine months of the death of a U.S. resident if the gross estate exceeds a threshold that was set at \$675,000 per decedent in 2000. Gross estate generally includes all of the decedent's assets, his or her share of jointly owned assets, proceeds from life insurance policies owned by the decedent, and gifts made by the decedent during life that were in excess of the gift exemption. This exemption is currently \$10,000 per donor per donee per year and is indexed for inflation. Typically, gross estate is valued at market value at the date of death, but the valuation date may be set six months later if asset the value of the gross estate and estate tax liability declined during this period. Closely-held businesses and farms are permitted to value assets at their "use value" rather than the price the market would bear. This can reduce estate value by up to \$770,000 for decedents who died in 2000. In addition, it is often possible to discount values by placing assets—even publicly traded financial assets--in mediated ownership forms, such as family limited partnerships.

Bequests to a surviving spouse or to charitable organizations are fully deductible, and account for the lion's share of deductions. Deductions are also provided for debts, administrative and legal fees and funeral expenses. A limited credit is given for state-levied

inheritance and estate taxes.²

In 2000, the unified estate and gift tax credit provided an effective exemption for the first \$675,000 of lifetime taxable transfers, a figure that is scheduled to rise to \$1 million by 2006. For estates above the exempt amount, the marginal tax rate begins at 37 percent and rises to 55 percent for taxable transfers above \$3 million. A 5 percentage point surtax is added on transfers between \$10 million and about \$17.18 million.³ Credits are also given for gift taxes previously paid and for estate taxes that were previously paid on recently inherited wealth.⁴

In 1999, federal transfer taxes collected about \$28 billion in revenues, of which about 90 percent stemmed from the estate tax and about 10 percent from the gift tax. Transfer taxes accounted for about 1.5 percent of federal revenues.

Federal law also imposes a separate tax on generation-skipping transfers. Under the estate and gift tax, a family that transferred resources over more than one generation at a time (e.g., from grandparents to grandchildren) would reduce the number of times the wealth was subject to tax over a given time period, and could greatly reduce its transfer tax liabilities. To close this avoidance mechanism, generation-skipping transfers in excess of \$1 million per donor face an additional 55 percent (tax-inclusive) tax.

2. Most states now levy so-called Asoak-up taxes that fall within the credit limit, so that they transfer revenue from federal to state treasuries without raising the total tax burden.

3. The surtax raises the effective marginal tax rate to 60 percent and phases out the “benefits” of having lower marginal estate tax rates on the first \$10 million in taxable estate. Prior to 1998, the surtax applied to estates of even higher value and took back the benefit of the unified credit as well. Due to a drafting error in the 1997 tax act, this part of the surtax was removed and has not been reinstated.

4. The latter credit phases out over 10 years from the date the wealth was inherited and is intended to reduce the extent of double taxation of recently inherited wealth.

Equity Issues

Progressivity has been the traditional justification for the highly graduated estate tax (Graetz 1983) and remains the principal defense in the 21st century. The large increases in the concentration of before-tax income and wealth over the last 20 years arguably make the progressivity justification even more compelling (Slemrod and Bakija 1999).

The progressivity of the estate tax depends, of course, on its economic incidence rather than the statutory incidence. Although the economic incidence is unclear, the most likely possibilities imply the tax is progressive. For example, if it is borne by decedents, the tax is extraordinarily progressive. Because of the large exemption level plus the deductions and credits noted above, estate tax liability is heavily concentrated among high-wealth families.

In 1997, 96 percent of adults who died had estates below the effective exemption, which was then \$600,000. About 3.5 percent of decedents had estates between \$600,000 and \$2.5 million. Their estates faced an average transfer tax rate of 8 percent and accounted for 30 percent of transfer tax revenues. About 0.3 percent of decedents had estates valued between \$2.5 million and \$5 million. These estates faced an average tax rate of 18 percent and paid 19 percent of transfer taxes. The richest 0.1 percent of decedents, with estates over \$5 million, paid an average transfer tax rate of 20 percent and accounted for 51 percent of all transfer tax payments. (Johnson and Mikow 1999, Gale and Slemrod 2000).⁵

Assuming it is borne by decedents, the estate tax is considerably more progressive than

5. Among the 4 percent of estates with value exceeding \$600,000 about half were taxable. Coupled with the 96 percent of decedents with estates below \$600,000, this implies that 98 percent of all deaths in 1997 resulted in no estate tax liability.

the income tax. A careful study by the U.S. Treasury Department concluded that households in the top 1 percent of the income distribution bear 64 percent of estate taxes, compared to 25 percent of income taxes (Cronin 1999).⁶

An alternative assumption is that the tax is borne by potential recipients of inheritances. Even in this case, though, the tax would still be highly progressive. Recipients of large inheritances are quite well off relative to the rest of the population. The average adjusted gross income (AGI) in 1981 for households that received inheritances from estates of 1982 decedents that were subject to estate tax was \$47,433. Recipients of inheritances from estates valued between \$2.5 million and \$10 million, had average AGI of \$123,000. For estates in excess of \$10 million, recipients' income averaged \$271,000 (Joulfaian 1994). By way of comparison, median money income of families was \$22,388 in 1981, and average money income in the top 5 percent was \$74,482 (U.S. Census 2000a, 2000b).

The only way the estate tax might not be progressive would be if it discouraged a significant amount of domestic wealth accumulation, which could drive wages down by reducing the amount of capital per worker (Stiglitz 1978). Because--as discussed below-- a significant impact on saving has not been definitively established, we feel it is appropriate to maintain the view that the estate tax is progressive until new evidence is provided.

If progressivity is a key justification, it is reasonable to ask why the desired degree of progressivity couldn't be obtained from the income tax alone, eschewing the need for an estate tax. The ability of the income tax to impose progressive burdens is limited by several factors,

6. Households in the top 5 (20) percent bear 91 (99) percent of estate taxes compared to 49 (77) percent of income taxes in Cronin (1999). Feenberg, Mitrusi, and Poterba (1997) generate similar results using an entirely different methodology.

most notably the preferential treatment of capital gains. Capital gains are taxed at a lower rate than other capital income; they are taxed only when the underlying assets are sold as opposed to when the gains accrue; and they escape income taxation completely if held until death. This issue applies especially to the largest estates. Poterba and Weisbrenner (2000) show that more than half of all estates in excess of \$10 million have more than half of their wealth in the form of unrealized capital gains. Thus, the estate tax may serve as a backstop for the income tax, imposing taxes on income that escaped taxation during life.⁷

While progressivity focuses on how those with higher income or wealth are treated relative to those with less, horizontal equity issues explore how different households with the same income or wealth are treated relative to each other. For example, among families of the same (considerable) means, the estate tax will not burden those that spend every penny on themselves, or give their wealth to charity. The tax will only burden families that pass their good fortune to their children. From the perspective of the donor, this seems to violate principles of equity (McCaffery 1994). However, from the perspective of the next generation, inheritance provides an advantage to some rather than others. Supporters of estate taxes claim that advantages from unequal inheritance are unearned, unfair and contribute to horizontal inequity. It is very difficult to resolve these conflicting views of horizontal equity.

Another equity issue regarding estate taxes is whether taxing at death is fair. Opponents of the tax view death as an illogical time to impose taxes at best, and a morally repugnant one at worst. Referring to the estate tax as the “death tax” plays on these feelings. Evocative as it is,

7. Some observers question whether estate taxes have had any impact on progressivity, since the distribution of wealth does not appear to be more equal in an era of high estate tax rates than it was in earlier periods. But many factors besides estate taxes influence the distribution of wealth. In addition, a tax that in a typical year raises revenue equal to 0.3 percent of GDP and 0.1 percent of household net worth is unlikely to make a serious dent in

this label is seriously misleading.

Death is neither necessary nor sufficient to create transfer tax liabilities. It isn't sufficient because 98 percent of decedents do not pay any tax at all. It isn't necessary because gifts between living people can trigger a tax liability. In addition, although death may trigger the tax liability, payment can be made at many different times. Estate tax liabilities can be effectively pre-paid via life insurance purchases tied to the expected tax liability or, in the case of qualified family businesses, can be delayed and paid over a 14-year period after the death of the owner.

But while contemplation of death is not pleasurable, that does not make taxing at death inappropriate or ineffective. Indeed, death may prove to be a convenient time to impose taxes in several ways. The probate process may reveal information about well-being that is difficult to obtain in the course of enforcement of the income tax, but is nevertheless relevant to societal notions of who should pay taxes. Also, a number of prominent economists (including John Stuart Mill (1994), J.R. McCulloch (1848), A. C. Pigou (1960), Richard Musgrave (1959), and Joseph Pechman (1983)) have argued that taxes imposed at death are likely to have smaller disincentive effects on lifetime labor supply and saving than taxes that raise the same revenue (in present value terms) but are imposed during life. Finally, if society does wish to impose a tax on lifetime transfers, it is difficult to see any time other than death at which to assess the total transfers made.

Much of the griping about taxation at death, however, is clearly and simply disingenuous. If taxation at death is really what upsets opponents of the estate tax, they are free to propose

overall wealth inequality, even if the tax is highly progressive.

equally progressive taxes imposed during life that would substitute for the estate tax. To our knowledge, such proposals have not been put forth.

Efficiency

Optimal tax theory indicates that, on pure efficiency grounds, taxes should distinguish among the different uses of labor income only to the extent that the uses are more or less complementary to leisure, which is not taxable. Taxing complements to leisure at a higher rate than other goods reduces the inefficiency created by the inability to tax leisure. A labor income tax distorts the choice between leisure and all consumption, but not among the uses of income, including bequests. In contrast, an estate tax distorts the choice between lifetime consumption and bequests. If lifetime consumption and bequests are equally complementary with respect to leisure, then both of these uses of labor income should be taxed equally in an efficient system. That is, there should be no special tax on bequests (Kaplow 2000).

This striking conclusion, however, may be tempered by several factors. First, an optimal tax system trades off efficiency and equity. The inclusion of equity considerations does not in itself change the conclusions above—it would still be most efficient to impose progressive taxes via a labor income (or consumption) tax; no estate tax would be needed. However, if the income tax is not capable of imposing burdens as progressive as society would prefer—for reasons discussed above—there is a potential role for the estate tax. Moreover, because the estate tax is more progressive than other taxes, it can still be part of an optimal tax system even if

its marginal efficiency cost is higher than that of other taxes (Slemrod and Yitzhaki 1999).⁸

The efficiency implications of taxes on intergenerational transfers also depend in crucial and surprising ways on why people give transfers and bequeath wealth in the first place. One explanation for transfers is that they are unintended, in the sense that some people die before they "expect" to and thus do not manage to consume all of their wealth (Davies 1981, Abel 1985, Hurd 1987).⁹ If this is the only reason for bequests, an estate tax would have no effect on the donor's behavior because it changes the relative price of something—the bequest—to which the donor attributes no value. Thus, the tax creates no excess burden, as would be true under a lump-sum tax. But, unlike a lump-sum tax, the estate tax in this case also does not make the donor worse off. This makes such a tax look like a “utility machine,” as it produces revenue for the government without hurting the donor. Of course, the potential inheritors will be worse off because of the tax take.

Alternatively, bequests may be payment for services provided by potential inheritors. In this case, the estate tax is simply an excise tax on purchases of services by the donor from the recipient. If bequests are simply payments for services provided (as in Cox 1987), the standard commodity tax argument implies that the optimal taxation of bequests depends on whether the services provided are complements or substitutes for leisure. If bequests are strategically manipulated by donors to alter children's behavior (as in Bernheim, Shleifer, and Summers 1985), the efficiency effects are likely more complex, but have not been thoroughly addressed.

8. The marginal efficiency cost depends in part on the net revenue raised by increases in the estate tax. For example, suppose increases in the estate tax raised no net revenue, because the avoidance mechanisms that reduce estate taxes also reduce income taxes (see Bernheim 1987). In that case, the marginal cost of raising revenue via the estate tax would be infinite, so that the estate tax would have no role in an optimal system. The claim that the estate tax raises no net revenue, however, has not been substantiated.

In pure altruism models (Barro 1974, Becker 1974), transfers create a sort of externality. Suppose a parent cares about her own utility and her child's, while the child cares only about his own utility. In equilibrium, the parent chooses transfers by trading off (a) the reduction in her utility from reduced consumption and (b) the increase in her utility from the child's increased consumption. In contrast, a planner maximizing a social welfare function that summed the utilities of all individuals would consider the same two effects *plus* the effect of the transfer on the child's utility. This means that in equilibrium too few transfers will be provided, leading to an efficiency argument for a *subsidy*, rather than a tax, on bequests.¹⁰

These results are, however, sensitive to alternative modeling assumptions. Combining parental altruism with opportunistic behavior on the part of children gives rise to a "Samaritan's Dilemma:" if the parent is altruistic toward the child, and the child knows that, the child has incentives to behave in ways that are counter to the parent's overall interest (Bruce and Waldman 1990). For example, the child would have incentives to overconsume when young in order to elicit a larger bequest from the parent. In this case, by making it more difficult for the parent to transfer resources to the child, the estate tax reduces the extent of overconsumption by the child, and thus may have welfare-*improving* properties (Gale and Perozek 2000).

Another motive for bequests may be that people enjoy the act of giving per se (Andreoni 1989, Kaplow 2000). Suppose now that the parent cares about her own utility and the amount she bequeaths, whereas the child cares only about his own consumption. Again, in equilibrium, the parent will make transfers until the loss in utility from the reduction in her consumption

9. Models along these lines often emphasize missing annuity markets, so that bequests arise out of people's unwillingness or inability to annuitize their wealth to ensure they do not outlive it.

10. This analysis assumes that there are no labor supply effects of giving or receiving transfers. If larger transfers cause recipients to reduce their labor supply, then the case for a subsidy is weakened (Kaplow 2000). See also

equals the gain in utility from the higher bequest. But a social planner would include those two effects plus the effects of the increased bequest on the child's utility. As before, this leads to an under-provision of the transfer and an optimal subsidy.¹¹

The multiplicity of possible transfer motives, the significant differences in optimal taxation under different motives, and the inability of the empirical literature to distinguish very clearly between the motives, imply that conclusions about the optimal taxation of transfers must be reached very cautiously (see Kaplow 2000, Gale and Slemrod 2000).

Other issues: Saving, Charity, Compliance Costs, and Small Business

The incidence and efficiency of transfer taxes depend on how people who give bequests and receive inheritances respond to the tax. For example, if the tax reduces personal saving and that in turn reduces domestic capital accumulation, the resulting reduction in wages will offset to some degree the extreme progressivity of the tax burden. To the extent that compensated tax changes affect people's behavior (externalities aside), the excess burden is higher and the tax is less efficient. Although it is routinely asserted that the estate tax reduces saving and entrepreneurship and encourages charitable contributions and avoidance activities, the evidence is not in all cases clear-cut.

Kopczuk and Slemrod (2000) explore the links between estate tax rate structure and

Bernheim (1989).

11. The joy-of-giving model has a particularly unappealing feature, though, from a welfare perspective. Because donor's utility depends on consumption as well as gifts given, the model implies that a social welfare function that sums up the value of the donor's and recipient's utility functions would under some circumstances favor a policy that lowers the consumption of both generations, if a greater amount of the lower level of consumption is financed by wealth transfers. This problem does not arise in the pure altruism or Samaritan's Dilemma models because utility in

reported estates, using estate tax return data from 1916 to 1996. They find that in years when the estate tax has been relatively high, reported estates as a fraction of national wealth are lower than otherwise. But the relation is statistically fragile, and is consistent with either a depressing effect on wealth accumulation by donors, an encouraging effect on estate tax avoidance, or both.¹² Evidence also suggests that large inheritances reduce the work effort of transfer recipients and raise their consumption (Holtz-Eakin, Joulfaian, and Rosen 1993, Weil 1994).

From the perspective of Gale and Perozek (2000), it is not surprising that the empirical evidence on saving is ambiguous because the impact of the tax on saving, like the efficiency effects, will depend critically on why people give transfers. If bequests are unintentional, estate taxes will not affect saving by the donor, but they will reduce the net-of-tax inheritance received by the recipient and thereby raise the recipient's saving. If bequests are payment for services provided by children, the impact of taxes depends on the elasticity of parents' demand for services. If demand is inelastic—as might be expected for the type of personalized attention that parents often care about and for which good market substitutes do not exist—then higher taxes will raise total parental expenditure on services, and thereby raise their saving. If bequests are motivated by altruism, the effects are ambiguous, but simulations suggest that the effect will be positive or non-negative under many circumstances.

Several studies suggest that the deduction in the estate tax for charitable contributions generates a significant increase in contributions to the non-profit sector, especially among the wealthiest households (Joulfaian 2000a,b, Auten and Joulfaian 1996, Clotfelter 1989). Among

those models is a function only of the parent's and child's consumption.

12. Interestingly, the tax rate prevailing ten years before death is more clearly (negatively) associated with reported estates than the tax rate prevailing in the year of death, suggesting that potential taxpayers are forward thinking.

estate tax returns filed in 1997, total charitable bequests were about \$14 billion, most of which was given by the very wealthiest contributors. Of the 329 taxable estates with gross estates in excess of \$20 million, 182 made charitable contributions and those that did contributed an average of over \$41 million. (Johnson and Mikow 1999). Thus, there is potential to affect very large gifts by altering the tax rate and/or the deductibility of contributions.

It is often alleged that the estate tax is inefficient and inequitable because avoidance and compliance costs are so high and the tax is so easy to avoid. Cooper (1979) refers to the estate tax as “voluntary” because of the large number of ways it could be avoided. Although tax reforms over the last two decades have tightened up a number of the most egregious features, aggressive sheltering remains a serious issue for the estate tax.

The actual costs of estate tax compliance, however, are often exaggerated. Munnell (1988) is widely cited as the source of the claim that "the costs of complying with the estate tax laws are roughly the same magnitude as the revenue raised" (Joint Economic Committee 1998). What Munnell actually wrote was that the compliance costs "may well approach the revenue yield." She estimates costs of 15 percent of revenues based on some arbitrary, but not unreasonable, assumptions about estate tax attorneys' value of time. The rest of the estimate is a hunch that costs "must amount to billions of dollars annually," based on “accountants eager to gain an increasing share of the estate planning market," financial planners and insurance agents who devote time to minimizing estate taxes, and the efforts of the individuals themselves.

Davenport and Soled (1999) estimate tax planning costs by surveying tax professionals about average charges for typical estate tax planning in six different estate size classes and applying these estimates to the number of returns filed in 1996. After a series of fairly *ad hoc*

but not implausible adjustments for the number of nontaxable decedents that do tax planning, tax planning that has to be repeated as laws change, estate administration costs, IRS costs related to estate taxes, and other factors, they estimate compliance costs equal to 7 percent of revenues. An unknown fraction of these costs are for estate planning—for example, transfer of business ownership—that would have to occur even if there were no estate tax. Thus, the estimates based on suppliers of estate tax avoidance techniques produce a huge range of collection cost estimates. These estimates, as well as estimates based on surveys of small business owner demanders of estate planning techniques (e.g, Repetti 2000), also suffer from disagreement about what fraction of costs arise from non-tax factors or other taxes.

The supposed impact of the estate tax on family farms and businesses has taken on a hugely disproportionate role in public policy debates. Estate tax opponents note (correctly) that a large proportion of American businesses never make it to the second generation, but then go on to assert that the estate tax is the reason why. But only a tiny fraction of small businesses and farms pay estate taxes. It is implausible that the estate tax has an important impact on the proportion of businesses that make it to the next generation.

In addition, scaling back or eliminating the estate tax is a very blunt instrument for dealing with the problems of small businesses or farms, since these assets represent only a small fraction of wealth subject to estate taxes. In 1998, farm assets were reported on only 6 percent of all taxable estates. Farm assets and farm real estate totaled 2.4 percent of taxable estate value. Fewer than 9 percent of taxable returns listed closely held stock, which accounted for only 5 percent of taxable estate value. Limited partnerships and “other noncorporate business assets” accounted for an additional 2 percent of taxable assets. Thus, using a very expansive definition,

farms and small businesses account for at most 10 percent of all assets in taxable estates.

Family farms and businesses already receive special treatment under the estate tax. Taxpayers are entitled to calculate the taxable value of the real estate used in a family farm or closely-held business on the basis of their current-use value (rather than market value), which can reduce the value of the taxable gross estate by up to \$770,000 for decedents who died in 2000. Legislation enacted in 1997 permits a special deduction of up to \$675,000 worth of family-owned farms and businesses when they constitute at least 50 percent of an estate and in which heirs materially participate. All told, this suggests that businesses worth up to about \$4 million can escape any estate tax at all. In addition, taxes that are owed can sometimes be paid in installments over a 14-year period. Finally, recall that small businesses and farms already receive numerous tax subsidies—for investment, for example--under the income tax. No convincing case has ever been made for the current level of subsidies, much less for expanding them further.

Not a Dead Issue

The appropriate role and effects of transfer taxes are still open questions. Any conclusion about the appropriate taxation of intergenerational transfers must take into account transfer motives, the political and technical limitations on other tax instruments, and other factors. In a real world filled with practical difficulties, political compromises, and economic uncertainties, it may take a variety of taxes to meet social goals, and the estate tax may well play a small but important role in the government portfolio of tax instruments. It adds to

progressivity in a way that the income tax cannot easily do, because of capital gains issues, and that society may choose not to do via income taxes, because taxing at death may have smaller costs than taxing during life. The supposed negatives of the estate tax—its effects on saving, compliance costs, and small businesses—lack definitive supporting evidence and in some cases appear to be grossly overstated. And there are some presumed benefits from increased charitable contributions and improved equality of opportunity. Nevertheless, it is equally clear that a tax with high rates and easy avoidance opportunities is ripe for change.

The political process is not going to wait for academic consensus to emerge on the issues discussed above. Rather, the forces that have propelled estate taxes to the forefront of the policy debate—including the stock market boom, the aging of the population, the budget surplus, and an adroit political lobbying campaign by estate tax opponents—will continue to force some resolution of the issue, and more likely sooner than later.

The most radical reform would be to abolish the tax. This removes the existing problems, but creates serious additional issues. It would eliminate what is by far the most progressive tax instrument in the federal tax arsenal, just after an extended period over which the distributions of income and wealth have become far more skewed. It could hurt non-profit organizations. It may not even raise saving, labor supply or growth, as its advocates hope, and it would expose a gaping loophole with regard to capital gains in the income tax.

Elimination, or scaling back, of the estate tax could be coupled with the extension of the capital gains tax to the gains accrued but unrealized at death. But this proposal would raise only about a quarter to a third of the revenue of the estate tax, and would raise it from a quite different set of people (Poterba and Weisbrenner 2000). In addition, it would have many of the

complexities of the estate tax, so it is neither an attractive or likely option by itself.

The bill passed in Congress in 2000 tied elimination of the estate tax to another significant change in the taxation of capital gains, under which heirs would assume the decedent's basis for capital gains purposes -- "carryover basis" -- for transfers from estates valued in excess of \$1.3 million. Linking the two changes is designed to address the concern that the appreciated value of some assets might escape both income and estate taxation with no estate tax and step-up basis. However, this would raise even less revenue than taxing gains at death (Poterba and Weisbrenner 2000), and would be substantially more complicated, in part because records would have to be kept for an even longer period of time (and across generations). A similar item was passed in the late 1970s but was repealed before it ever came into effect partly because of anticipated implementation problems. These implementation problems have not grown any easier in the ensuing 20 years.

Another direction for reform would be to replace taxes on estates and gifts given with taxes on gifts and inheritances received, as is the practice in several U.S. states and many foreign countries. Under a progressive inheritance tax (but not under an estate tax), spreading a given bequest among more legatees reduces the total tax burden and thus encourages the splitting of estates. In addition, a unified tax system would tax all sources or all uses of income. Currently, the income tax burdens sources and the estate tax falls on a particular use of resources. In contrast, the income tax combined with a tax on inheritances and gifts received would cover all major sources of income over the lifetime.

Perhaps the most reasonable--and politically likely--direction for reform is to follow the strategy invoked for income taxes in the Tax Reform Act of 1986: raise the exemption level,

close loopholes, and cut rates.¹³ Raising the exemption would reduce the number of people paying the tax while still chipping away at the concentration of wealth. It would also help smaller family-owned businesses, but without the horizontal equity problems that are involved in giving preferential treatment to business assets. Closing loopholes by treating different assets in a more similar fashion would reduce sheltering opportunities and thus make the tax simpler and fairer. Modestly reducing rates would reduce the incentive to shelter or change behavior in the first place. In light of these considerations, a package of lower rates, a higher exemption level, and fewer loopholes would probably cost some revenue but could well provide benefits in excess of the costs.

13. In addition, the tax brackets and the effective exemption created by the unified credit should be indexed for inflation.

References

- Abel, Andrew B. 1985. Precautionary Saving and Accidental Bequests. American Economic Review 75(4): 777-91.
- Andreoni, James. 1989. Giving With Impure Altruism: Applications to Charity and Ricardian Equivalence. Journal of Political Economy 97(6): 1447-1458.
- Auten, Gerald and David Joulfaian. 1996. Charitable Contributions and Intergenerational Transfers. Journal of Public Economics 59(1): 55-68.
- Barro, Robert. 1974. Are Government Bonds Net Wealth? Journal of Political Economy 82(6): 1095-1117.
- Bartlett, Bruce. 1997. The End of the Estate Tax? Tax Notes. (7 July): 105-110.
- Becker, Gary S. 1974. A Theory of Social Interactions. Journal of Political Economy 82(6): 1063-93.
- Bernheim, B. Douglas. 1987. Does the Estate Tax Raise Revenue? In Tax Policy and the Economy, edited by Lawrence H. Summers, 1: 113-138.
- Bernheim, B. Douglas. 1989. Intergenerational Altruism, Dynastic Equilibria, and Social Welfare. Review of Economic Studies 56(1): 119-28.
- Bernheim, B. Douglas, Andrei Shleifer and Lawrence H. Summers. 1985. The Strategic Bequest Motive. Journal of Political Economy 93(6): 1045-76.
- Bruce, Neil and Michael Waldman. 1990. The Rotten-Kid Theorem Meets the Samaritan's Dilemma. Quarterly Journal of Economics 105(1): 155-65.
- Clotfelter, Charles T. 1985. Federal Tax Policy and Charitable Giving. Chicago: University of Chicago Press.
- Cooper, George. 1979. A Voluntary Tax? New Perspectives on Sophisticated Estate Tax Avoidance Washington, D.C.: Brookings.
- Cox, Donald. 1987. Motives for Private Income Transfers. Journal of Political Economy 95(3): 508-46.
- Cronin, Julie-Ann. 1999. U.S. Treasury Distributional Analysis Methodology. Office of Tax Analysis Working Paper 85.
- Davenport, Charles and Jay A. Soled. 1999. Enlivening the Death-Tax Death-Talk. Tax Notes,

July 26 84(4): 591-630.

Davies, James B. 1981. Uncertain Lifetime, Consumption, and Dissaving in Retirement. Journal of Political Economy 89(3): 561-77.

Feenberg, Daniel R., Andrew W. Mitrusi, and James M. Poterba. 1997. Distributional Effects of Adopting a National Retail Sales Tax. In James M. Poterba, ed. Tax Policy and the Economy Cambridge, MA, MIT Press. 11: 49-89.

Gale, William G. and Maria Perozek. 2000. Do Estate Taxes Reduce Saving? In William G. Gale, James R. Hines Jr., and Joel B. Slemrod, eds. Rethinking the Estate and Gift Taxation Washington, D.C., Brookings Institution Press. Forthcoming.

Gale, William G. and Joel B. Slemrod. 2000. Rethinking the Estate and Gift Tax: Overview. In William G. Gale, James R. Hines Jr., and Joel B. Slemrod, eds. Rethinking the Estate and Gift Taxation Washington, D.C., Brookings Institution Press. Forthcoming.

Graetz, Michael J. 1983. To Praise the Estate Tax, Not to Bury It. Yale Law Journal 93(2): 259-86.

Holtz-Eakin, Douglas, David Joulfaian, and Harvey S. Rosen. 1993. The Carnegie Conjecture: Some Empirical Evidence. Quarterly Journal of Economics 108: 413-35.

Hurd, Michael D. 1987. Savings of the Elderly and Desired Bequests. American Economic Review 77(3): 298-312.

Johnson, Barry W. and Jacob M. Mikow. 1999. Federal Estate Tax Returns, 1995-1997. SOI Bulletin 19(1): 69-129.

Joint Economic Committee. 1998. The Economics of the Estate Tax. December.

Joulfaian, David. 1994. The Distribution and Division of Bequests in the U.S.: Evidence from the Collation Study. OTA Paper 71, U.S. Department of the Treasury.

Joulfaian, David. 2000a. Charitable Giving in Life and Death. In William G. Gale, James R. Hines Jr., and Joel B. Slemrod, eds. Rethinking the Estate and Gift Taxation Washington, D.C., Brookings Institution Press. Forthcoming.

Joulfaian, David. 2000b. Estate Taxes and Charitable Bequests by the Wealthy. National Tax Journal 53(3, part 2): 743-63.

Kaplow, Louis. 2000. A Framework for Assessing Estate and Gift Taxation. In William G. Gale, James R. Hines Jr., and Joel B. Slemrod, eds. Rethinking the Estate and Gift Taxation Washington, D.C., Brookings Institution Press. Forthcoming.

- Kopczuk, Wojciech and Joel B. Slemrod. 2000. The Impact of the Estate Tax on Wealth Accumulation and Avoidance Behavior of Donors. In William G. Gale, James R. Hines Jr., and Joel B. Slemrod, eds. Rethinking the Estate and Gift Taxation Washington, D.C., Brookings Institution Press. Forthcoming.
- McCaffery, Edward J. 1994. The Uneasy Case for Wealth Transfer Taxation. Yale Law Journal 104: 283-365.
- Mill, John Stuart. 1994. Principles of Political Economy and Chapters on Socialism. Jonathan Riley, ed. Oxford: Oxford University Press.
- McCulloch, John Ramsay. 1848. A Treatise on the Succession to Property Vacant by Death: Including Inquiries into the Influence of Primogeniture, Entails, Compulsory Partition, Foundations, etc. Over the Public Interests. London: Longman, Brown, Green, and Longmans.
- Munnell, Alicia H. 1988. Wealth Transfer Taxation: The Relative Role for Estate and Income Taxes. New England Economic Review Nov./Dec.: 3-28.
- Musgrave, Richard A. 1959. The Theory of Public Finance: A Study in Public Economy. New York: McGraw-Hill.
- Pechman, Joseph A. 1983. Federal Tax Policy. Washington, D.C., Brookings Institution Press.
- Pigou, A.C. 1960. A Study in Public Finance. London: MacMillan and Co. Third Revised Edition.
- Poterba, James M. and Scott Weisbrenner. 2000. The Distributional Burden of Taxing Estates and Unrealized Capital Gains at the Time of Death. In William G. Gale, James R. Hines Jr., and Joel B. Slemrod, eds. Rethinking the Estate and Gift Taxation Washington, D.C., Brookings Institution Press. Forthcoming.
- Repetti, James R. 2000. The Case for the Estate and Gift Tax. Tax Notes. March 13: 1493-1510.
- Slemrod, Joel B. and Jon Bakija. 1999. Does Growing Inequality Reduce Tax Progressivity? Should It? Office of Tax Policy Research Working Paper No. 99-3.
- Slemrod, Joel B. and Shlomo Yitzhaki. 1999. Integrating Expenditure and Tax Decisions: The Marginal Cost of Funds and the Marginal Benefit of Projects. Mimeo. University of Michigan. August.
- Stiglitz, Joseph. 1978. Notes on Estate Taxes, Redistribution, and the Concept of Balanced Growth Path Incidence. Journal of Political Economy 86(2): S137-S150.

U.S. Census Bureau. 2000a. March Current Population Survey. "Table F-3: Mean Income Received by Each Fifth and Top 5 Percent of Families (All Races): 1966 to 1999." October 30. <<http://www.census.gov/hhes/income/histinc/f03.html>>.

U.S. Census Bureau. 2000b. March Current Population Survey. "Table F-6: Regions—Families (All Races) by Median and Mean Income: 1953 to 1999." October 30. <<http://www.census.gov/hhes/income/histinc/f06.html>>.

Weil, David N. 1994. The Saving of the Elderly in Micro and Macro Data. Quarterly Journal of Economics 109(1): 55-81.