Remarks
by
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at
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Roundtable on Jobs, Growth, and Abolition of the Death Tax

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In my remarks, I will focus on two aspects of the estate tax – who really pays it and how it really affects government revenue. I believe that public discussion and official analysis of both issues have often been fundamentally flawed. An economically sound examination of these issues helps explain why the estate tax is misconceived.

Incidence

Let me begin with the issue of who really pays the estate tax. Defenders of the estate tax often claim that it is highly progressive. It is certainly the case that the tax is levied only on the largest 2 percent of estates. From this fact, defenders of the tax claim that its burden falls only on the richest 2 percent of Americans.

If you look more closely at this argument, you will see that it rests on a particular, and I believe untenable, theory of tax incidence. This argument is coherent only under the assumption that the burden of the estate tax falls entirely on the decedent. In other words, it makes sense if the rich dead guy takes the tax hit. When estate taxes are included in official distributional analyses, this is precisely what is assumed. This assumption is easy and natural for tax analysts because, by law, the decedent's estate is responsible for paying the tax.

This approach, however, reflects a theory of incidence that the economics profession has repudiated for at least a century. Official distributional analyses reject it in many other settings. We know that taxes do not stay where Congress puts them. In technical terms, the economic incidence of a tax does not match the statutory incidence. Who bears the burden of a tax depends on the underlying economic fundamentals, not on who writes the check to the government. When the government taxes car companies, for instance, the burden falls not only on the company shareholders. It also falls on car buyers and car workers, and most likely on consumers and workers in other industries as well.

Incidence studies recognize this principle in many ways. The economists who prepare distributional tables wisely pay no heed to Congress' statements about who pays excise taxes. Instead, they assume that the burden of excise taxes falls on consumers. Similarly, these economists ignore Congress' declaration that the Social Security-Medicare payroll tax burden is split equally between employers and employees. Instead, they generally assume that the burden is borne entirely by the employees. Although these conclusions about where the tax burden falls may not be exactly right, they are reasonable conjectures based on solid economics.

Unfortunately, the same insights have not been applied to the estate tax. Under what circumstances would the estate tax actually fall only on the decedent? That would happen if the tax prompted the decedent to reduce his consumption during his lifetime, so that he could satisfy the tax obligation without diminishing the after-tax bequests left to his loved ones. In other words, the estate tax would have to reduce lifetime consumption and promote estate accumulation.

Simply stating this assumption casts doubt upon it. A good rule of thumb is that when you tax an activity, you get less of it. The estate tax makes estate building less attractive and probably reduces the size of bequests. Empirical research confirms that, in fact, the estate tax reduces the amount that decedents accumulate and pass on to their heirs. As a first approximation, it would make more sense to distribute the burden of the tax to the estate's beneficiaries rather than to the decedent.

What would happen if we allocated the estate tax burden to heirs rather than decedents? At first blush, one might think that it would not make much difference. After all, are not the children of rich people rich?

It turns out that the answer is "not always." A number of economists have taken a careful look at this difficult question, using a variety of data sets and methodological approaches. Their results are roughly similar. The correlation between the lifetime earnings of successive generations is around 0.4 or 0.5. Even adding in inheritances, the figure increases to only about 0.7. This is nowhere near a perfect correlation. And the correlation is far smaller when we look at the link between grandparents and grandchildren, and probably smaller still if we consider nephews, nieces, and other possible heirs. The bottom line is, once we move away from the standard assumption that the entire burden falls on the decedents, the tax appears much less progressive than one might have guessed.

But this departure from the standard assumption, as dramatic as its implications may be, is only the beginning of the story. The estate tax is a tax on capital. As such, one would naturally expect it to discourage capital accumulation. Now, put this together with the fact that a smaller capital stock reduces productivity and labor income throughout the economy and the implication is clear: the repeal of the estate tax would stimulate growth and raise incomes for everyone, even those who never receive a bequest.

The average worker has little reason to know that his weekly paycheck is smaller because of the existence of the estate tax. He may never realize that he bears part of the burden of the estate tax. But these subtle, indirect effects are at the heart of how economies work. Giving this worker (or, at least, his elected representatives) that information is an important part of an economist's professional responsibility.

Data limitations and resource constraints make applied incidence analysis very difficult, and I cast no aspersions on those doing this important task. But I want to emphasize that the distribution tables for the estate tax produced by tax analysts and reproduced in newspapers are based on faulty economics. These tables systematically bias the analysis by making the estate tax appear more progressive than it is in reality.

Revenues

Now, let me turn to the revenue effects of repealing the estate tax. Here, too, discussions of the estate tax are often at odds with sound economics.

One argument for keeping the estate tax is that, if all else fails, it raises revenue. This is not much of an argument for keeping an economically harmful tax when there are better ways to raise revenue. Besides, estate and gift tax collections were only 1.4 percent of federal revenue in fiscal 2001.

But even that small number is likely to overestimate the tax's *net* contribution to total federal revenue. A more accurate number might be zero or negative.

Let me be perfectly clear here. Tax reductions are generally <u>not</u> self-financing. In the vast majority of cases, the behavioral responses to changes in tax rates just are not high enough to yield that result. But estate tax repeal could be an exception to that general rule. It is conceivable that repeal could actually increase total federal revenue. Or, if not, the revenue loss could be small.

The estate tax encourages people to take avoidance actions, such as making gifts to their children. Since their children are almost always in lower tax brackets, these gifts reduce income tax collections. Repealing the estate tax would remove the incentive for such gifts and would thereby boost income tax revenues.

More important, however, is the effect I emphasized above – the depressing effect of the estate tax on capital accumulation. As a matter of policy, revenue estimates exclude these macroeconomic effects. I understand why such effects would be difficult to routinely incorporate in revenue estimates. Nevertheless, their omission can seriously skew the analysis of changes such as estate tax repeal.

It is hard to estimate how much capital we do not have thanks to the estate tax. But the issue is of paramount importance. Research has established that intergenerational transfers accounts for a large fraction of capital accumulation in the U.S. economy. It is very possible that the depressing effect of estate tax on economic growth offsets a significant part of the revenue attributed to it.

Fairness: Back to Basics

Let us go back to where this discussion started—the notion that the estate tax is a good tax because it is a fair tax. I've argued that when we make realistic assumptions about behavioral responses, this assertion does not hold water. But let me go beyond these economic arguments. I believe that, based on the principle of horizontal equity, the tax is not at all a fair tax.

Let me explain. Consider the story of twin brothers – Spendthrift Sam and Frugal Frank. Each starts a dot-com after college and sells the business a few years later, accumulating a $10 million nest egg. Sam then lives the high life, enjoying expensive vacations and throwing lavish parties. Frank, meanwhile, lives more modestly. He keeps his fortune invested in the economy, where it finances capital accumulation, new technologies, and economic growth. He wants to leave most of his money to his children, grandchildren, nephews, and nieces.

Which brother should pay higher taxes? It seems natural that they should face the same tax burden. They both started life with the same resources. What principle of fairness suggests that they should face different tax burdens? What principle of social justice says that Frank should be penalized for his frugality? None that I know of.

Several years ago the book, *The Millionaire Next Door,* made bestseller lists with the message that getting rich is more often the result of patience than of good luck. Recent research suggests that this is right on the mark. Whether a person reaches old age wealthy or penniless mostly depends on the percentage of his earnings he saved - not on the total amount he made in his lifetime. This means that most of the burden of the estate tax falls not on those who have been lucky throughout life but rather on those who have been frugal. In other words, when the government taxes your estate, it is, literally, taxing your patience.

Conclusion

The estate tax unfairly punishes frugality, undermines economic growth, reduces real wages, and raises little, if any, federal revenue. No principles of good tax policy justify this tax and I support the President's call for its permanent repeal.