

Death and Taxes

There are good arguments for keeping the federal inheritance tax, but 70 percent of Americans—and Congress—disagree.

BY IRWIN M. STELZER

Several years ago I suggested in these pages that it would be good conservative policy to raise, rather than lower, inheritance taxes. After all, American conservatives, traditional and neo, believe in a meritocracy in which material success should depend mostly on our own efforts and accomplishments, rather than those of our ancestors.

But Congress disagrees. Or at least the House does. It has voted to eliminate inheritance taxes permanently, and the Senate now has to decide whether to go along. Many Democrats, ever alert to new sources of revenue and to opportunities to strike a blow in the class war, oppose repeal, while most Republicans favor it in the apparent belief that income received from a relative who is departing this world should be treated more kindly by the tax collector than income earned by hard work or entrepreneurial risk-taking.

A rational discussion of the issue is possible only if we jettison some of the misrepresentations and inflammatory jargon in which it has become encrusted.

- Surviving spouses will suffer. No. Inheritance taxes are not levied on spousal transfers—quite right, since we now recognize that the accumulated wealth of husband and wife is due to the efforts of both.

- Inheritance taxes are “death duties” or “vulture taxes.” No. They are not levied on people foolish enough to die, but on those lucky enough to be named beneficiaries in a will. The *Wall Street Journal*’s rallying cry, “No taxation without respiration,” is catchier than it is accurate.

- Inheritance taxes constitute “double taxation.” No. They are one-time taxes on the income of the recipients of inherited assets, not a double tax on those who earned the money in the first place. Besides, as William Gale (Brookings) and Joel Slemrod (University of Michigan) point out in a paper prepared for a National Tax Association symposium,

“It turns out that much of the wealth subject to the estate tax has *not* previously been taxed.”

- Inheritance taxes force the sale of small businesses or farms. No. Any such entity surely has borrowing power in excess of the amounts required to meet the taxman’s demands, and can therefore raise any needed cash. Besides, a study for the National Bureau of Economic Research by Thomas Dunn and Douglas Holtz-Eakin (the latter is now director of the Congressional Budget Office) suggests that an entrepreneur’s “propensity to become self-employed” is affected far more by the human capital he or she inherits than by inherited financial assets. So inheritors of businesses, and of that “self-employed propensity,” are not likely to sell out and join the ranks of wage earners merely because the value of the enterprise they inherit is taxed.

- Inheritance taxes contribute significantly to the reduction of inequality. No. Princeton economist and former vice chairman of the Board of Governors of the Federal Reserve System Alan Blinder’s empirical studies led him to conclude, “Estate taxation is not a very powerful weapon in the egalitarian arsenal. The reformer eyeing the estate tax as a means to reduce inequality had best look elsewhere.”

So much for the fear-mongering on both sides of this debate. On to the substantive issues.

The argument in favor of retaining, or even raising, inheritance taxes is rather straightforward. We believe in equality of opportunity. We are, of course, wise enough to know that goal is unattainable, since people are born with different levels and types of intelligence. Nobel laureate economist Gary Becker has pointed out that some benefit more than others from family connections and skill-creating environments, or from “networks of social affiliation” and “parenting skills,” as Glenn Loury notes.

But there seems little reason to add to such inherited (via genes or environment) advantages the financial assets created and accumulated by the efforts of others. And, on a more pragmatic level, at a time when the government is badly in need of revenue to meet the president’s goal of cutting the budget deficit in half, abolishing receipts from the inheritance tax will increase pressure on Congress to

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find other sources of revenue, sources far more likely to create disincentives to economic growth.

The political lineup on this issue mirrors that of the recent presidential election. Favoring retention of the tax we have the usual Democratic suspects, who have never met a tax they don't like, and assorted billionaires. The billionaires, who can regularly be counted on to support almost any liberal cause, include Warren Buffett, George Soros, and two Rockefellers. Buffett says that repealing the estate tax would be the equivalent of "choosing the 2020 Olympic team by picking the eldest sons of the gold-medal winners in the 2000 Olympics."

Then there are some mere millionaires, men and women who worry about the effects of large windfalls on their children, whom they are eager to protect from "affluenza," or sudden wealth syndrome, the term used by the new army of counselors being retained by investment advisers to ease the minds of their wealthy clients. Upper-bracket Americans are so determined that what British columnist Simon Heffer calls "the habits of industry" not be lost that 99 percent of rich children are made to tidy their rooms, 85 percent to take out the trash, and 77 percent and 81 percent, respectively, to take part-time jobs while in high school or at college, according to a survey of affluent Americans by U.S. Trust. (I wonder about the trash bit.)

Alas, it seems that much of this training in "the habits of industry" cannot overcome the incentive to indolence created by a substantial inheritance. Studies done for the Maxwell Center for Demography and Economics of Aging at Syracuse University conclude (with appropriate caveats), "An inheritance received by a family reduces the probability that both spouses will continue to work, and increases the probability that both will retire."

This is supported by other data. A survey by Britain's Economic & Social Research Council found that only 16 percent of "higher professionals," and a tiny minority of administrators (6 percent), routine nonmanual (3 percent), supervisor/technician (4 percent), skilled manual (3 percent), and semi/unskilled manual workers (2 percent) say they work for "enjoyment." The vast majority say they work "to earn money to live," a statement repeated almost verbatim by 70 percent of the men and 50 percent of the women responding to a survey by Michael White of the Policy Studies Institute and Stephen Hill of the London School of Economics. Satisfy that compelling need, and the odds increase that many will drop out of the workforce. Indeed, it is puzzling that conservatives, who fear that wel-

fare benefits reduce the incentive of the poor to work, don't worry that windfall inheritances will have a similar effect on the rich.

Andrew Carnegie, although not endowed with the econometric techniques and survey data that allegedly enrich modern economic research, came to a similar conclusion about the effect of inherited wealth. "The parent who leaves his son enormous wealth," he wrote, "generally deadens the talents and energies of the son and tempts him to lead a less useful and less worthy life than he otherwise would."

Carnegie, of course, was also the most famous philanthropist of his day, and gave away a large portion of his wealth (estimated by British chancellor Gordon Brown at \$100 billion in today's dollars) before he passed on to his just reward. Which is the tax-avoidance technique that those who favor permanent repeal of the inheritance tax contend will be used if the inheritance tax is restored: Tax them, and they will give it away before the taxman cometh.

But that is far from certain. Data on the effects of taxes on lifetime giving are difficult to decipher. Wojciech Kopczuk and Joel Slemrod (University of British Columbia and University of Michigan) offer the "tentative"

estimate that the estate tax increases charitable bequests by 12 percent, possibly more, but James Poterba (MIT) notes that if somewhat different statistical techniques are used, "the relation between the estate tax and the charitable giving share disappears." We do know that charitable bequests account for only 1.5 percent of the total revenue of charitable groups, and that only one-third of nonprofit organizations report income from legacies or bequests. We know, too, that tax avoidance is not the sole reason for charitable giving, since people of means so modest that they have little need for major tax deductions are generous supporters of their favorite charities. Besides, if the retention of the inheritance tax does induce people to donate to charities in order to avoid that tax, conservatives should be delighted: Rather than turn their hard-earned money over to the government for disposition by politicians, the donors will have decided for themselves how their money should be used. Tax avoidance that allows individuals rather than government to decide who among the needy are worthy is not a result to be scorned.

They might not give it to charities, respond the repeal proponents, but those who have accumulated capital

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might avoid estate taxes by giving their wealth to their children long before they shuffle off this mortal coil—what estate planners call *inter vivos* transfers. Once again, the data suggest that is not the case. Studies by Poterba show that “most households, even those with net worth high enough to virtually ensure that their estate will be taxable, do not make large *inter vivos* transfers. . . . Limited use of *inter vivos* gifts has been a persistent feature of transfer behavior by high net worth individuals.” Poterba reasons that “the low-wealth wealthy” fear they will need their resources for health care or other retirement needs. As for the superrich, “There’s just a reluctance to give up control of assets—even if the transfer would lead to substantial tax savings. . . . Some households may not be particularly altruistic with respect to their children.”

But as with charitable giving, even if *inter vivos* giving is used as a device to avoid inheritance taxes, society is hardly the loser. The transfer of accumulated wealth from the elderly to the young might take the form of spending more on their education, thereby adding to society’s stock of human capital.

Or it might reduce the number of golf clubs sold to retirees, and increase the number of electronic gadgets sold to their heirs. As Heffer puts it, failing to enjoy one’s money is “the ultimate wasted opportunity. After all, life is not a rehearsal. . . . [By spending] we are saluting the link between our effort and reward.” The net effect on GDP and the economic growth rate of an intergenerational shift in spending should be negligible, and the net effect on total satisfaction of a pre-death movement of spending power from old to young is difficult to estimate without making judgments as to the relationship between age and capacity for enjoyment. That would require a combination of non-nostalgic recollection of past triumphs and defeats, and a cold-blooded appraisal of the quality of life at present that is not available to most people. Besides, if good policy requires that transfers to children be prevented, the gift tax can be brought into play.

Equally difficult is any measurement of the effect of a decision to cheat the taxman by retiring early, thereby reducing lifetime earnings in order to minimize the value of assets unconsumed by the time of death. Society would be deprived of the labor of the early retiree, but would receive in exchange the labor of the young forced to work rather than live on the inheritance for which they had been hoping, but of which they would be deprived by their parents’ decision.

There is still another reason to retain some form of inheritance tax. None other than Adam Smith was, in the words of the *Economist*, “broadly in favor” of it. In his *The Wealth of Nations*, supposedly the bible of many conservatives, Smith wrote that taxes must meet the criteria of “evi-

dent justice and utility.” Some tax on wealth inherited by children “who have got families of their own, and are supported by funds separate and independent of their father” would, Smith argued, meet those criteria.

I hasten to add that the economic studies and arguments I have marshaled here should not be determinative of public policy, especially since debates still rage over the usefulness of the many relevant studies that have been and are being done, many of which can be found in *Death and Dollars*, a Brookings Institution compendium. There is a reason 71 percent of respondents to a Pew Research Center Poll said they favor elimination of the inheritance tax, a reason other than Americans’ opposition to all taxes, a factor that the American Enterprise Institute’s Karlyn Bowman says might artificially inflate the 71 percent figure. Two reasons, in fact.

First, most Americans expect to be rich some day, and they just don’t like the idea of the government getting its hands on anything they might have failed to spend or give away during their lifetimes. Good for them.

Second, as a now-departed friend, Woodrow Wyatt (Lord Wyatt at the time of his passing—a peerage earned by service to Margaret Thatcher’s government, and neither inherited nor heritable), said to me when I mooted the idea of a 100 percent inheritance tax to fund reductions in growth-stifling marginal tax rates, inheritance taxes “are against human nature.” He was, of course, merely stating in shortened and more attention-getting form what Frédéric Bastiat said some 150 years ago:

No theory, no flights of oratory can succeed in keeping fathers from loving their children. The people who delight in setting up imaginary societies may consider this regrettable, but it is a fact. A father will expend as much effort, perhaps more, for his children’s satisfaction as for his own. If, then, a new law contrary to Nature should forbid the bequest of private property, it would not only in itself do violence to the rights of private property, but it would also prevent the creation of new private property by paralyzing a full half of human effort.

If it were the case that economics trumps all other policy considerations, the case for restoring the inheritance tax so as to equalize opportunity would, in my view, be made. Fortunately, economists provide only one of the many inputs looked to by politicians. My guess is that the 71 percent who oppose the tax will count for more than all of the studies I have just cited. Not necessarily a bad thing. But the burden will be on the inheritance-tax repealers to decide which taxes they will raise to make up for the lost revenue—\$1 trillion over 10 years. Unless, of course, they favor a still-larger deficit. ♦