ACCF
AMERICAN COUNCIL
FOR CAPITAL FORMATION
Center For
Policy Research

Special Report

December 2003

CEA Chairman N. Gregory Mankiw Makes the Case for Estate Tax Repeal

The ACCF Center for Policy Research* continues to be a principal source of research, analysis and commentary on the negative macroeconomic impacts of the estate tax. Dr. N. Gregory Mankiw, chairman of the President's Council of Economic Advisers and a former member of the Center's Board of Scholars shares the ACCF's belief that the estate tax must be repealed. Dr. Mankiw is a peerless proponent of full repeal and his insights on the issue are instructive. What follows is an abridged version of Dr. Mankiw's remarks on the estate tax at the National Bureau of Economic Research's Tax Policy and the Economy meeting, which was held at the National Press Club in Washington D.C. on November 4, 2003. The full text of Chairman Mankiw's remarks is available online at www.whitehouse.gov/cea/speeches.html.

INTRODUCTION

As you know, President Bush won repeal of the estate tax as part of the 2001 tax cut. Repeal does not take full effect until 2010 and is then scheduled to sunset at the end of that year, along with the rest of the 2001 tax cut. The President has consistently advocated making repeal permanent. This proposal won majority support in both houses of Congress last year, but failed to win the necessary 60 votes in the Senate. The future of the estate tax is likely to be a major topic of debate during the next few years.

The debate about the estate tax illustrates some general economic principles that are relevant to many areas of tax policy. I will focus on two in particular. The first is the distributional impact of taxes—who wins and who loses. The second concerns the effects of tax changes on government revenue. I believe that, along both dimensions, public discussion and official analysis of the estate tax are often fundamentally flawed.

Many of the problems arise from a fact about which all economists agree—taxes affect how people behave. These behavioral responses have implications for how the burden of the tax is distributed and for the revenue effects of a tax change. These implications, however, are often ignored.

WHO PAYS THE ESTATE TAX?

Let me begin with the issue of incidence. Defenders of the estate tax often claim that it is a highly progressive tax. 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 the burden of the tax 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. We know that taxes do not stay where Congress puts them.

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.

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.

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.

What would happen if we allocated the estate tax burden to heirs rather than decedents? At first blush, one might think that it

(Continued...)

*The ACCF Center for Policy Research is the education and research affiliate of the American Council for Capital Formation. Its mandate is to enhance the public's understanding of the need to promote economic growth through sound tax, trade, and environmental policies. For further information, contact the ACCF Center for Policy Research, 1750 K Street, N.W., Suite 400, Washington, D.C. 20006-2302; telephone: 202/293-5811; fax: 202/785-8165; e-mail: info@accf.org; Web site: www.accf.org.

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. 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.

The flaws in the distributional analysis of the estate tax also apply to analyses of capital income taxation in general, including the corporate income tax and the taxation of capital gains and dividends under the individual income tax. The burden of these taxes is almost always assumed to fall on the owners of capital. The burden shifted to labor is generally ignored.

WHAT REVENUES?

Now, let me turn to the revenue effects of permanently repealing the estate tax. This is the second aspect of discussions of the estate tax that is 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 revenues. A more accurate number might be zero or negative.

Tax reductions are generally not 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 account for a large fraction of capital accumulation in the U.S. economy. It is very possible that the depressing effect of the estate tax on economic growth offsets a significant part of the revenue attributed to it.

This point also applies more broadly, to capital taxes in general. Any increase in the tax burden on capital income is likely to reduce the amount of capital available to be taxed, particularly in the long run. It will also reduce the amount of labor income to be taxed, since capital accumulation is one determinant of labor productivity and wages. Taking this feedback into account could greatly diminish the revenue attributed to capital taxation.

To provide accurate information to policymakers about the revenue effects, we must find some way to incorporate these effects. The Joint Tax Committee and the Congressional Budget Office have recently taken steps in this direction. The exercise is called "dynamic scoring," although "realistic scoring" would be a more accurate term.

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.

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.

Now ask yourself: Which millionaire should pay higher taxes? It seems natural that they should face the same tax burden. They both started life with the same resources. What notion of fairness suggests that they should face different tax burdens? What principle of social justice says that Frank should be penalized for his frugality?

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. 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. There are no principles of good tax policy that support this tax, and I support the President's call for its permanent repeal.