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ECONOMIC SCENE

The Estate Tax: Efficient, Fair and Misunderstood

By ROBERT H. FRANK

THE Bush administration has proposed permanent repeal of the estate tax, the tax people pay when they inherit money. Citing overwhelming support even among middle-class voters, some predict that the Senate will soon approve a repeal bill similar to the one the House passed last month.

But is support for repeal of the estate tax as broad as it appears? Survey respondents are typically told only that repeal of the tax has been proposed and are then asked whether they are in favor of such a move. Although two-thirds or more of respondents in most surveys respond affirmatively, this may tell us only that people find taxes of any sort unpleasant.

Well, sure, but that does not mean taxes are unnecessary. The alternative, after all, would be to have no army, which would eventually mean paying taxes to some other government whose army conquered us

Repealing the estate tax would reduce federal revenues by close to \$1 trillion from 2012 to 2021, according to the Center on Budget and Policy Priorities. This shortfall would require at least one of the following steps: raising income taxes, sales taxes or other taxes;



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Estate tax repeal seems to have broad support, even though the tax falls on fewer than 1 percent of heirs. Its revenue comes mostly from inheritances larger than \$10 million.

further cuts in government services; or increasing the rate at which we borrow from the Chinese, Japanese and others. Additional borrowing would have to be repaid at market rates of interest, however, so the last option would also entail eventual tax increases or service cuts.

Many opponents of the estate tax argue that the revenue shortfall caused by its repeal will reduce bloated government. But in our current political system, spending cuts are more likely to take aim at basic public services than wasteful pork barrel projects. For example, President Bush, who campaigned as an enemy of government waste, recently proposed a 16 percent reduction in spending for veterans' health care, a 15 percent reduction for education and vocational training, and a 9.6 percent reduction for nutritional assistance for poor mothers with small children. So, unless we are willing to raise other taxes, repeal of the estate tax will entail further cuts in valued services.

Would voters still favor repealing the estate tax if they took these repercussions into account? To find out, I asked the Survey Research Institute at Cornell to administer two versions of a national telephone survey. In the first, respondents were asked simply whether they favored or opposed the Bush administration's proposal. Typical of the findings in other, similar surveys, these respondents favored repeal by almost three to one.

In the second version, respondents were reminded that the revenue shortfall from repealing the estate tax would entail raising other taxes, cutting government services or increasing federal borrowing. Strikingly, these respondents opposed repeal by almost four to one. Although the sample sizes in both surveys were small (only 42 in the first group, 66 in the second), the odds of observing such a sweeping reversal by chance are remote.

If support for the abolition of the estate tax is an illusion, as it appears, is there an affirmative case for retaining this tax? Our basic goal is to pay for government services with a tax system that is as efficient, fair and painless as possible. On all counts, it is difficult to imagine a better tax than the estate tax. Every dollar we collect from it is one less dollar we need to collect from some other tax that is worse in at least one of these dimensions.

Among the important advantages of the estate tax is that it has virtually no negative effects on incentives. High income tax rates may discourage effort or investment. But who would become a slacker merely to avoid estate taxes? Because the estate tax enables income tax rates to be lower than they would otherwise be, it actually increases the incentive to invest and take risks.

Another attraction of the estate tax is that it works like a lawyer's contingency fee. Injured parties who could not otherwise afford access to the legal system can try to

recover damages because lawyers are willing to work without pay if their client does not win. Similarly, the estate tax enables us to enjoy valuable public services that we would be happy to pay for if we knew we would end up wealthy, but that we might be reluctant to demand otherwise. With the estate tax, the surcharge kicks in only if we are lucky enough to be one of life's biggest winners.

The estate tax also provides an incentive for charitable giving, which reduces the need to pay for many public services with tax money. Recent estimates by the Brookings Institution and the Urban Institute suggest that its repeal may reduce such giving by as much as \$15 billion a year. Finally, having estate taxes means paying lower taxes while we are alive, and taxes are generally more painful to the living than the dead.

Some opponents complain that the estate tax imposes an unreasonable burden on the owners of small businesses and farms. But inheritances of less than \$1.5 million (\$3 million for married couples) are currently untaxed, an exemption that will rise to \$3.5 million (\$7 million for couples) by 2009. Far fewer than 1 percent of heirs will ever pay a penny of estate tax; most of the revenue from estate taxes comes from inheritances larger than \$10 million.

Many parents say they dislike the estate tax because they fear it will prevent them from doing all they can to assure that their children are financially secure. Yet current exemption levels allow parents to leave their children more than enough to start a business, finance a premium education, buy a large house in a good school district, and still have several hundred thousand dollars left for a rainy day.

On reflection, would a parent really want them to inherit more than that? Old money has long been wary of the corrosive effect of guaranteed wealth on children's ability to set out on successful careers of their own - a concern that has prompted Warren E. Buffett and others to limit their bequests to their children. But even if Mr. Buffett were to change his mind, he could still leave an after-tax bequest of more than \$20 billion under current tax laws.

In sum, although there are many taxes we ought to reduce or eliminate, the estate tax is not one of them. It is the closest thing to a perfect tax we have. And when the implications of its repeal are in plain view, most people seem to recognize their interest in keeping it. Even among Republicans, 70 percent opposed its repeal in the second version of my survey.

Robert H. Frank, an economist at the Johnson School of Management at Cornell University, is the co-author (with Philip Cook) of "The Winner-Take-All Society."

Graphic: A Tale of Two Surveys

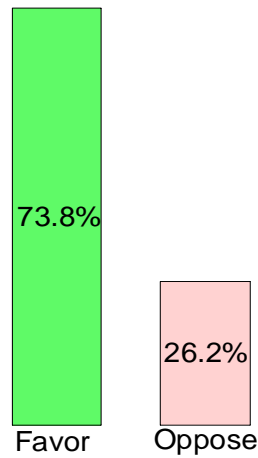
(Random national telephone surveys performed by Survey Research Institute, Cornell University)

Survey 1

The Bush Administration has proposed to eliminate the estate tax, the tax people pay when they inherit money.

Do you favor or oppose this proposal?

Survey Dates: April 29-May 6, 2005
Sample size: 42
Margin of error: 13.3%



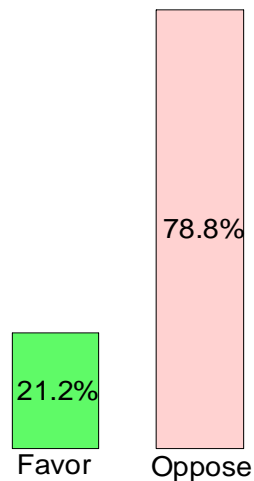
Survey 2

The Bush Administration has proposed repeal of the estate tax, the tax people pay when they inherit money.

The resulting revenue shortfall would require at least one of the following actions: raising other taxes; implementing further cuts in government services; or increasing the rate at which the Federal government has been borrowing money.*

All things considered, do you favor or oppose the Bush Administration's proposal to eliminate the estate tax?

Survey Dates: April 29-May 6, 2005
Sample size: 66
Margin of error: 9.9%



* This paragraph is abridged because of space constraints. The actual survey questionnaire is available on request from the author (rhf3@cornell.edu).

