THE JAMES A. BAKER III INSTITUTE FOR PUBLIC POLICY
RICE UNIVERSITY

THE U.S. EXPERIENCE WITH THE ESTATE TAX AND ITS IMPLICATIONS FOR WEALTH TRANSFER TAXATION IN LATIN AMERICA

BY

GEORGE R. ZODROW, PHD
PROFESSOR OF ECONOMICS AND RICE SCHOLAR
TAX AND EXPENDITURE POLICY PROGRAM
JAMES A. BAKER III INSTITUTE FOR PUBLIC POLICY
RICE UNIVERSITY

AND

JOHN W. DIAMOND, PHD
EDWARD A. AND HERMENA HANCOCK KELLY FELLOW IN TAX POLICY
TAX AND EXPENDITURE POLICY PROGRAM
JAMES A. BAKER III INSTITUTE FOR PUBLIC POLICY
RICE UNIVERSITY

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I. Introduction

Severe income inequality has long characterized the countries of Latin America and prompted calls for policy reforms of many kinds, including reforms of federal tax systems. A recent World Bank (2003) report concludes that income inequality is worse in Latin America than in all the other major regions of the world studied in the report, and that the situation has worsened somewhat in recent decades. The report goes on to describe a number of policies that might be employed to reduce income inequality, including improving access to high quality education and health care, enacting land reforms and increasing property taxation, broadening provision of public infrastructure and public services, improving the development of markets especially for labor, avoiding macroeconomic instability, strengthening the income and value-added tax systems, and reforming and extending welfare programs to the poor including means-tested cash transfers. It is interesting to note, however, that an increased level of wealth transfer taxation in the form of taxes on gifts and bequests or inheritances is not even among the options discussed in the report. In contrast, in this paper, we focus on this issue – that is, on the question of whether the introduction or expansion of existing wealth transfer taxes might be effective in mitigating the income and wealth disparities that characterize the countries of Latin America. In particular, we examine the question of how the experience with estate and gift taxation in the United States, including the recently passed reform measures that phase out the tax entirely by 2010 only to have it reemerge in full force in 2011, might inform the debate on the use of similar taxes in Latin America.[1]

The paper is organized as follows. The following section provides some recent data on the extent of income inequality in Latin America as well as a discussion of the social problems associated with such inequality.[2] Section III summarizes briefly the current extent of wealth

[1] The estate tax has received considerable attention in the US in recent years, due both to the prospect of its increased importance as the population ages and a determined effort, described in detail in Graetz and Shapiro (2005), to eliminate the tax entirely.

[2] Wealth inequality is of course also an important issue, especially in the context of an analysis of wealth transfer taxation, and inequalities in the distribution of wealth are typically even greater than those in the distribution of income. However, since very little data are available on wealth inequality in Latin America, we focus instead on income inequality.

transfer taxation in Latin America. Section IV then reviews the history of estate and gift taxation in the United States, including the political and social factors that lead to the recent repeal of the tax, and also comments briefly on the use of wealth transfer taxes in other OECD countries. Section V examines the many economic arguments for and against wealth transfer taxes, focusing on issues of efficiency, equity, simplicity in compliance and administration including attempts to deal with tax evasion and avoidance, and the treatment of small businesses and farms. This section draws on Gale and Slemrod (2001), which is an outstanding recent collection of articles on estate and gift taxation in the United States. The final section draws out the implications of both recent experience in the US and the economic literature on wealth transfer transfers for the use of estate and inheritance taxation in Latin America.

II. Income and Wealth Inequality in Latin America

In a recent comprehensive report, the World Bank (2003) concludes that inequality in Latin America is extensive and pervasive, encompassing not only inequality in income and wealth but a wide variety of other areas as well, including access to education, health care, and other public services and infrastructure. Table 1 presents results on the distribution of per capita disposable income, including cash transfers but not in-kind transfers, for a sample of twenty Latin American countries.[3] Based on the most recently available data for each country, the income shares of the top deciles range from 33.5 to 47.2 percent, while the corresponding figures for the bottom two deciles range from 1.3 to 4.8 percent. These data suggest that, generally speaking, the average level of inequality in Latin America has declined only modestly over the past decade, with some countries experiencing greater inequality (e.g., Argentina and Venezuela) and others (e.g., Brazil) experiencing modest declines.

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[3] See World Bank (2003) for a description of the many difficulties involved and restrictive assumptions made in calculating these figures. Note that consumption per capita is generally a better indicator of well-being than disposable income, because it is less variable over time due to consumption smoothing and often is measured more accurately. For example, Elbers, et al. (2003) show that consumption-based measures suggest significantly less inequality in Brazil than income-based measures. Unfortunately, comprehensive cross-country data are available only for disposable income, so that most studies utilize that measure.

More importantly, however, the degree of inequality in Latin America is greater than in virtually all other regions. Indeed, World Bank (2003, p. 2-27) concludes that the empirical literature that has examined income inequality across regions "unambiguously suggests the Latin America is the region with the highest levels of inequality in the world, and that this has been true for as long as statistics have been kept." For example, Table 2 provides aggregate figures for the distribution of household per capita income in 1992 for Latin America relative to Africa, Asia, Eastern Europe, the developed countries and all countries other than Latin America. These data indicate that the bottom eight deciles have lower shares of income in Latin America than in the comparison regions, while the top two deciles have significantly larger shares. The share of the top decile in Latin America at 48% is especially large, with the corresponding share in all other cases other than Africa (where it is 42.2%) falling below 38%. By comparison, in the United States the top decile in 1997 earned 30.5 percent of disposable income while the bottom two deciles earned 5.2 percent.

Income inequality in a country or a region is also often described through the use of a single measure, the Gini coefficient. The Gini coefficient utilizes the Lorenz curve, shown in Figure 1, which plots the cumulative share of income as a function of the cumulative share of individuals in a country or a region, ordered from the lowest to the highest income levels. For example, with complete equality, the bottom 10 percent of the population would have 10 percent of income, etc., and the Lorenz curve would be a 45 degree line (the so-called "perfect distribution line" in Figure 1). With some inequality, the Lorenz curve will lie below the 45 degree line, and the extent to which it does so is an indicator of the level of inequality in the country or region. This notion is formalized in the Gini coefficient, which is defined as the ratio of the area between the Lorenz curve and the 45 degree line, to the area under the 45 degree line (which is always 0.5). The Gini coefficient thus varies from zero, which indicates complete equality, to one, which would occur if only one individual earned all the income in the economy (so the Lorenz curve would coincide with the horizontal axis until the 100th percentile was reached at which point it would jump to meet the 45 degree line).

The data on Gini coefficients confirm that inequality in Latin America is relatively high. Table 3 shows that in the 1990s the Gini coefficient in Latin America and the Caribbean of 52.2 was significantly higher (indicating more inequality in the distribution of income) than in Asia (41.2), the OECD industrialized countries (34.2) and Eastern Europe (32.8). These data also indicate a moderate increase in inequality in Latin America and the Caribbean, as the Gini coefficient has increased from 48.4 in the 1970s to 52.2 in the 1990s; however, increases in inequality also occurred in the other regions, with the increase in inequality over the 1970s-1990s in Latin America and the Caribbean larger than in Asia and the OECD countries, but less than in Eastern Europe.

Table 4 provides recent Gini coefficients during the 1990s and early 2000s for selected Latin American countries. These data indicate a modest decline in inequality over this time period, with the population-weighted average Gini coefficient declining from 51.9 in the early 1990s to 51.5 in the early 2000s. The most pronounced declines occurred in Honduras, Brazil, and Mexico, while the most pronounced increases occurred in Argentina, Venezuela, Peru, and Bolivia.

World Bank (2003) also reports that inequality in Latin America is extensive for other indicators, including education, health, and access to other basic public services. In general, greater progress has been made in recent years toward reducing inequality in these areas. Access to college education, however, is the important exception to this rule. Although there has been a substantial increase in average years of education in all Latin American countries during the 1990s, especially among women, the gap in years of education between the bottom and top quintiles increased in roughly half of these countries, especially in Brazil and Mexico. Given the dramatic increases in the return to college education that have occurred over the past 30 years, inequality in this dimension is especially troubling as it will perpetuate if not increase income inequality. By comparison, inequality in years of schooling at the primary and secondary levels and in access to basic services such water, electricity, access to hygienic restrooms and telephone service, is much less significant in all Latin American countries and has declined significantly in recent years. In the area of health care, Latin America is a region of relatively good average health levels, but also relatively high inequality.

The stark inequalities in income and wealth distribution in Latin America are problematical for a variety of reasons. Most obviously, inequalities of such magnitudes are commonly perceived to be fundamentally inequitable from a social perspective. Of course, such a position clearly reflects a value judgment and thus depends on individual and societal notions of fairness. Moreover, the issue is complicated by the fact that a significant degree of inequality will inevitably occur in any capitalist society, and indeed is required in order to create economic incentives for labor supply and saving and investment. In addition, "snapshots" of the income distribution taken at a single point in time do not provide any information about the degree of mobility among income classes within a country, that is, the extent to which the individuals in the various income classes change over time. A key factor in increasing income mobility is intergenerational mobility in education achievement. However, Behrman, Gaviria and Székely (2001) argue that intergenerational mobility in Latin American countries is relatively low, although Bourguignon, Ferreira and Menendez (2003) conclude that educational mobility in Latin America is increasing over time. In any case, it seems clear that the degree of inequality in Latin American countries is quite large by world standards, and that many observers believe that current levels of inequality are socially inequitable. This point of view is corroborated by survey data, which suggests that between 80-90 percent of Latin American citizens consider prevailing levels of income inequality to be appropriately categorized as "unfair" or "very unfair" (World Bank, 2003, p. S-7).

Apart from pure equity issues, efficiency and economic growth issues are also of concern. A high degree of inequality almost always implies a relatively high fraction of the population living near or below subsistence levels, deeply mired in poverty and plagued by a wide variety of social problems. Recent research also suggests that high levels of inequality limit rates of economic growth, and thus diminish the effectiveness of growth enhancing public policies. Economic growth opportunities in the modern economy characterized by largely skill-based technical change are greatest for semi-skilled and highly-skilled individuals, so that such opportunities will be limited in countries where a significant fraction of the population has limited access to education, especially at the college level, and is credit constrained and thus precluded from borrowing to make investments in their human capital. More generally, credit constrained individuals will not be able to take advantage of profitable investment opportunities, including entrepreneurial startup ventures. Thus reductions in the degree of inequality would appear to be desirable on both equity and efficiency grounds in most Latin American countries.

The World Bank report identifies a wide variety of policies that might be implemented to reduce inequality in Latin America. Measures not related to national tax policy include (1) increasing access to education, especially at the college level, and improving the quality of education throughout the system for minority populations including indigenous peoples; (2) continued efforts at land reform and the establishment of well-defined property rights to facilitate more widespread ownership of property; (3) increasing use of property taxation at the municipal level to obtain revenues for local public services and as a means of redistribution; (4) increasing access to public infrastructure, including electric power, telecommunications, roads and railways; (5) providing for more inclusive and efficient labor markets; and (6) improving the conduct of macroeconomic policy to avoid macroeconomic shocks, including those associated with financial crises, which tend to have costs that are highly regressive. In terms of national tax policy, the report notes that the ratio of national taxes to GDP in most Latin American countries is relatively low and that, given the tendency for relatively little reliance on personal income and property taxes, the overall effect of national taxes tends to be roughly proportional. Although a proportional tax system coupled with public services that are distributed roughly equally on a per capita basis can significantly reduce inequality, inequality in public service provision implies that this does not occur. This suggests that reductions in inequality might be achieved with both tax and expenditure reforms. However, as stressed by Bird and Zolt (2005), the potential for reducing inequality in developing countries through the use of progressive personal income taxes is severely limited due to their administrative, compliance, economic efficiency, and political costs. Thus, it is appropriate to focus on expenditure policy as a means of reducing inequality, with expenditure programs, including means tested cash transfers, carefully targeted toward the poor – to the extent politically feasible. Such an approach should be financed primarily with comprehensive consumption taxation in the form of a value added tax with only a few exemptions carefully targeted to reduce the tax burden of the poor supplemented by luxury tax rates, as administratively feasible.

Interestingly, neither World Bank (2003) nor Bird and Zolt (2005) even discuss the use of either bequest or inheritance taxation as a means of reducing income inequality. To some extent, this neglect simply reflects reality – taxation of intergenerational transfers is a small and decreasing source of revenues in both developing and developed countries. However, it may also reflect a sense that inheritances appear to play a relatively small role in income and wealth inequality,[4] and that such taxation has not been especially effective in reducing inequality.[5] We turn next to an overview of the use of bequest and inheritance taxes and then turn to an economic evaluation of the advantages and disadvantages of their use.

III. Wealth Transfer Taxes in Latin America

Wealth transfer tax policies differ significantly across Latin American countries, with some countries having no inheritance, gift or other wealth transfer taxes, others having flat rate taxes, and others utilizing relatively complicated progressive systems.[6] Those countries that utilize wealth transfer taxes follow what Pestieau (2001) describes as the "Continental" (European) model under which tax is assessed on the recipient (on inheritances and gifts) with rates that vary with the relationship between the donor and the recipient – in contrast to the "Anglo-Saxon" approach under which tax is assessed on the donor (on the estate) independent of its distribution.

Just over one third of Latin American countries have no wealth transfer taxes. These countries include Argentina, Costa Rica, El Salvador, Panama, Paraguay, Peru and Uruguay. Nicaragua, Colombia, Mexico and Ecuador do not have an explicit system of wealth transfer taxation, but tax inheritances and gifts as ordinary income to different degrees. In Nicaragua and Colombia, all inheritances and gifts are taxed as ordinary income. In Mexico, inheritances and bequests are not taxed, but certain gifts are taxed as ordinary income; however, small gifts and gifts to

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4 For example, Wolff (2003) finds that wealth transfers as a share of net worth decline with both income and wealth so that bequests and other transfers make the distribution of wealth more equal. Wolff also finds that the correlation between lifetime income and wealth transfers is almost zero.

5 For example, Blinder (1976, p. 618-9) analyzes the extent to which estate taxation is likely to reduce inequality and concludes that "estate taxation is not a very powerful weapon in the egalitarian arsenal."

6 The following descriptions are based on information provided in the International Bureau of Fiscal Documentation's Latin American Taxation database.

residents outside of Mexico are exempt from income taxation. Ecuador also has no explicit estate and gift taxes, but capital gains derived from inheritances, bequests and gifts in respect of property located in Ecuador are subject to a special income tax levied on the recipient.

Brazil has no national inheritance or gift taxes, but such taxes may be levied by individual states, at a maximum rate of 8%. For example, in São Paulo, gifts and inheritances are taxed at rates that range from 2.5% to 4%, depending on the value of the inheritance or gift.

Both Bolivia and Honduras have inheritance and gift taxes that are levied at flat rates. These rates depend on the relationship between the donor and the recipient. In Bolivia, tax rates range from 1% on transfers to direct descendants or the spouse up to 35% for transfers to non-relatives. In Honduras, transfers in excess of an exempt amount are taxed at rates that range from 1% for transfers to married children up to 20% for transfers to foreigners.

The remaining countries have progressive wealth transfer taxes. Under these systems, the tax rate depends on both the relationship between the donor and the recipient and the size of the recipient's annual tax base. In Chile, tax rates under the inheritance tax range from 1-25% for spouses or direct descendants, 1.2-30% for brothers/sisters, aunts/uncles, nephews/nieces or first cousins, and 1.4-35% for all others recipients. Various transfers are exempt from the inheritance tax, including life insurance proceeds and transfers to the state.

Guatemala also imposes a progressive tax on gifts and inheritances received with rates that vary with the relationship between the donor and recipient and the size of the recipient's annual tax base. Tax rates vary from 1-6% for spouses and children to 12-25% for transfers to non-relatives, with tax rates on all other relatives falling between these two extremes. Exempt transfers include bequests and gifts to the benefit of the Guatemalan State, and other public bodies and universities, churches, social welfare and educational institutions deemed to reflect the public interest.

Finally, Venezuela levies a gift and inheritance tax on gifts that exceed an exempt amount on spouses and children at rates that range from 1-25%, on brothers/sisters and nephews/nieces at rates that range from 2.5-40%, on uncles/aunts and first cousins at rates that range from 6-55%, and on all others at rates that range from 10-55%. These rates are reduced by one-half under certain circumstances, for example if the recipient is below the age of 21, has dependent children or is handicapped. In addition, transfers of a homestead to be used by the deceased's next of kin, insurance payments, and gifts to the state are tax exempt.

IV. Gift and Estate Taxation in the United States

A Brief History

Taxes on wealth transfers have a long history in the United States, but have never been an important source of revenue. Such taxes, which have included stamp taxes, inheritance taxes and estate taxes, were initially instituted on a temporary basis to help finance war efforts, specifically, an undeclared war against France at the end of the 18th-century, the Civil War, and the Spanish-American War. The initial version of the current estate tax, which had a maximum rate of 10 percent, appeared in 1916 as a means of helping retire the debt incurred during World War I, but became a lasting fixture of the tax code, along with the federal income tax passed in 1913. The tax has been reformed many times, with base broadening and rate reduction a common theme of recent reforms. Major reforms were enacted (1) in 1976, when a unified gift and estate tax system, including the generation skipping tax, was instituted and the top rate was reduced to 70% while the effective exemption amount was increased to roughly $175,000, (2) in 1981, when rates were cut again, the effective exemption amount was increased to $600,000, and unlimited marital deductions introduced, and (3) in 1997, when a phased in increase in the effective exemption amount to $1 million was enacted. Relief for closely held and small businesses has been another common theme of reform efforts, as the 1976 reform allowed closely held businesses to be valued at "use value" rather than market value and extended their payment to 14 years, and the 1997 law created new exclusions for qualified family businesses.

The most recent reform occurred as part of the Economic Growth and Tax Relief Reconciliation Act of 2001, under which the Estate and Gift Tax is phased out by 2010,[7] only to reappear in full force in 2011 (a budgetary ploy designed to limit the long-run revenue cost of the proposal). Before disappearing in 2010, the maximum rate under the tax is scheduled to decline to 45% and the amount effectively exempt from the estate tax is scheduled to increase to $3.5 million. In 2011, the maximum rate and the exemption amount are scheduled to return to their 2001 values of 55% (with a minimum effective rate of 37 percent) and $1 million. The U.S. Congress is currently discussing, in fits and starts, whether to make the repeal permanent; at the current time, a move to a reformed tax with lower rates and a relatively high exemption amount seems to be more likely, although permanent repeal is an article of faith in some circles (Graetz and Shapiro, 2005).[8]

Like the United States, most industrialized countries have some form of wealth transfer taxation. For example, 21 of the 30 industrialized countries in the Organization for Economic Cooperation and Development (OECD) have an inheritance tax (17 countries), both inheritance and estate taxes (Italy and Switzerland), or the estate tax (the UK and the US); countries that do not tax wealth transfers include Australia, New Zealand and Canada. However, transfer taxes are not an important source of revenue in any of these countries, with wealth transfer tax revenues averaging 0.44% of total revenues in 1997. The US, which raised 1.1% of revenues from transfer taxes (see below), ranks third among the OECD countries in the share of revenues raised by wealth transfer taxes. Note, however, that the US does not have a wealth tax; the share of combined wealth and wealth transfer taxes in the US is quite similar to the OECD average of 1.05% (Gale and Slemrod, 2001).

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7 The gift tax, however, would remain with a maximum tax rate equal to the top individual rate and a lifetime gift tax exemption of $1 million.

8 See Graetz and Shapiro (2005) for a detailed description of the politics of how repeal of the estate tax became a reality in the US, at least temporarily, despite the fact that 98 percent of the population is not affected directly by the tax. A key factor in their story is the widespread support for repeal of the "death tax" among those not subject to the tax (and whose taxes would be raised to offset the revenues lost with repeal), especially among small business owners and small farmers.

Calculation of Estate and Gift Tax Liability

The following provides a very brief outline of the calculation of tax liability under the Estate and Gift Tax in the US prior to the 2001 tax change (the structure to which the tax is supposed to revert in 2010); for more details, see Johnson, Mikow and Eller (2001).

The gross estate includes all property, real or personal, tangible or intangible in which the decedent had an interest at time of death, including most life-insurance proceeds, certain annuities, and transfers made during the decedent's life that were revocable or made at less than full value. Although most assets are valued at current fair market value, closely-held businesses receive special treatment (discussed further below). Deductions are allowed for bequests to a surviving spouse, charitable contributions, debts of the decedent, funeral costs, and the administrative and legal expenses of the estate, which when subtracted from the gross estate yields the taxable estate. The sum of the taxable estate and total taxable gifts (those in excess of $11,000 per year per recipient) made since 1976 is the adjusted taxable estate, which is further reduced by an exemption,[9] credits for state and local estate and inheritance taxes, gift taxes paid on taxable gifts, and estate taxes paid on previously inherited wealth, and then taxed at progressive rates that effectively begin at 37%,[10] rise to 60% including a 5% surtax (designed to eliminate for sufficiently large estates the benefit of rates below the maximum rate), and then decline to a rate of 55%.

The Estate and Gift Tax is supplemented by a "Generation Skipping Tax" that taxes intergenerational transfers in excess of $1 million per donor that skip one or more generations at rates up to 55%. This provision raises little revenue, but is effective in reducing avoidance in the form generation skipping transfer (e.g., from grandparent to grandchild).

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9 The exemption amount actually reflects a "unified tax credit" or "applicable credit amount" equal to the amount of tax that would be due on an estate equal in size to the exemption amount.

10 Although nominal tax rates begin at 18%, all the tax liability attributable to rates below the 37% rate is eliminated with the unified credit.

Taxable Estates and Revenues under the Estate and Gift Tax

The following discussion provides some general information on the number and size of taxable estates and revenues obtained from the unified Estate and Gift Tax, using 2003 data; see Gale and Slemrod (2001) and Johnson, Mikow and Eller (2001) for further details.

In 2003, the total number of filers under the estate and gift tax was about 72,540, and 32,991 of these returns were taxable, accounting for less than 2% of all US decedents. The total gross estate listed on returns was about $200 billion, less than 0.5% of total privately held net worth ($44,085 billion), and was comprised primarily of financial assets (62%), real estate (16%) and small businesses (5%). Total deductions of $91.3 billion represented 46% of the gross estate, and were comprised primarily of bequest to the surviving spouse (70%), contributions to charities (16%), and debts and administrative and legal expenses (14%).

The distribution of gross estates is highly skewed, with 42% (30%) of assets reported by the 7.9% (2.7%) of estates that have a value larger than $5 ($10) million. The relative importance of the various deductions varies with estate size, with bequests to surviving spouses important in all categories (57-74% of all deductions), but charitable contributions most significant for gross estates in excess of $20 million (23%, in comparison to 14% for estates below $1 million).

Estate tax revenues in 2003 were approximately $20.8 billion (in addition to gift tax revenues of $1.6 billion), or 1.1% of total federal receipts of $1,868.6 billion. The largest 3,500 of these estates – those with adjusted taxable estates in excess of $5 million – represented 7.9% of taxable estates but accounted for 59% of total estate tax revenues.

Burden of the Estate and Gift Tax

The statutory burden of the estate and gift tax is, not surprisingly given its structure, highly progressive, although the exact nature of the burden depends on whether the tax is borne by donors, by recipients, or shifted to some extent via market adjustments to other individuals. The burden of the tax is most progressive if it is borne by decedents. As noted above, only the top 2% of decedents have taxable estates, so the tax is inherently very progressive. Moreover, the tax is also progressive within classes of gross estates, with returns between $0.6-1.0 million facing an average transfer tax rate of 8%, between $1-2.5 million facing a 21 percent tax rate, and returns greater than $2.5 million facing rates that range form 32-35%.

One could also compare the distribution of the estate tax burden to that of the individual income tax. Cronin (1999) of the U.S. Treasury Office of Tax Analysis provides such estimates, again under the assumption that the burden of the tax is borne by decedents. She shows that estate tax burdens fall almost entirely on high-income individuals, with the top quintile of income bearing more than 99% of the tax, the top decile bearing 96%, the top 5% bearing 91%, and the top 1% of the income distribution bearing 64%.

Alternatively, the burden of the estate tax could be assigned to the recipients of gifts and bequests. Since the recipients typically have lower incomes than the donors, this assumption will reduce the progressivity of the tax. However, Joulfaian (1998) shows that the effects of this adjustment are relatively minor, as the recipients of large gifts and bequests tend to be very high income as well.

Finally, it should be noted that general equilibrium effects might alter the burden of the estate tax. In particular, as stressed in the literature on capital income taxation noted above, taxes on bequests may reduce saving, and thus investment and capital accumulation, which in turn will result in lower labor productivity and lower wages. As a result, part of the tax will be shifted to labor and its incidence will be less progressive. Indeed, Stiglitz (1978) argues that these general equilibrium effects are sufficiently important that an estate tax may increase income inequality. The most comprehensive investigation of the general equilibrium effects of estate taxes is by Laitner (2001), who analyzes this issue in an overlapping generations model that includes an altruistic bequest motive. In this context, eliminating the estate tax does in fact increase savings. However, it also increases the concentration of wealth, especially at the very top of the income distribution; that is, despite the increase in savings and capital accumulation and the associated increase in the productivity of labor and wages, the net effect of eliminating the estate tax in Laitner's model is to reduce progressivity.

V. Economic Analyses of Estate and Inheritance Taxes

The following discussion examines various arguments for and against wealth transfer taxes, focusing on equity, efficiency and administrative and compliance simplicity issues. It also considers the contentious issue of applying the estate tax to small businesses including small family-owned farms, and the effects of wealth transfer taxes on charitable contributions.

Equity Issues

Debates regarding the fairness of wealth transfer taxes in the form of taxes on gifts, estates, bequests and inheritances involve several issues. The most basic issue is whether – purely from the perspective of tax fairness – such taxes should be included among the tax instruments used to raise revenues, which typically include a relatively broad-based indirect consumption tax such as the value-added tax and an income tax on corporations and higher income individuals. Indeed, this issue has indeed been among the most contentious in the context of the recent US debate, with the political forces supporting elimination of the tax recently in the ascendancy (Graetz and Shapiro, 2005) despite the consternation of those who view the estate tax as highly desirable, especially given its status as the most progressive element of the tax system.

The issue of the fairness of the taxation of wealth transfers has a long history in the academic literature. Two closely linked but conceptually separate issues must be considered – "horizontal equity" which requires that individuals who are "equals" as defined by some measure of ability to pay tax should bear identical tax burdens, and "vertical equity" which requires that individuals with higher ability to pay tax should pay more (although how much more is of course highly contentious).

Horizontal Equity

The basic issue in the theoretical literature on tax fairness as applied to wealth transfer taxes is the determination of the appropriate measure of an individual's ability to pay tax when resources are, or at least can be, measured in a multi-generational context over a large number of years. There are two fundamentally different points of view on this critical issue – the "lifetime endowment" view and the "dynastic equity" view (Aaron and Munnell, 1992).[11] Proponents of the lifetime endowment approach to analyzing multi-generational equity, argue that the fundamental principle of horizontal equity (equal treatment of equals) requires that all individuals should be taxed on all the resources available during their lifetimes, regardless of how they are used. This view of equity implies that the tax base should be the lifetime analog of a comprehensive measure of annual income (often called Haig-Simons income), as it implies that the correct base for measuring ability to pay tax is a comprehensive measure of lifetime income including inheritances, regardless of how that lifetime income might be used. Thus, the lifetime endowment view implies that inheritances should be included in the tax base of the recipient as they reflect an increase in ability to pay tax over the lifetime,[12] and that bequests should not be deductible as they merely represent one form of consumption over the lifetime. Such treatment implies that both the recipient and the donor will effectively pay tax on the wealth transferred – an outcome that proponents of the estate tax view as eminently fair since both are separate taxpayers.

In marked contrast, under the alternative "dynastic" view of equity, all resources available to a multi-generational family should only be taxed once. If both labor and capital income are subject to a comprehensive annual income tax, additional taxes on bequests or inheritances are unnecessary and indeed undesirable because they represent inequitable double taxation – that is, neither the donor nor the heir should be taxed on a wealth transfer that is funded by income already subject to tax. The primary role of any taxes on wealth transfers under this view of

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[11] It is also interesting to note that the treatment of bequests and inheritances is often believed to be an important issue in the long-standing debate regarding whether income or consumption represents the best measure of ability to pay tax. The current debate regarding "fundamental tax reform" in the United States focuses on whether the current income tax should be replaced with a direct tax on consumption; for example, see the articles in Boskin (1996), Aaron and Gale (1996) and Zodrow and Mieszkowski (2002). For a similar analysis in a developing country context, see Zodrow and McLure (1991) and for applications to Bolivia and Colombia, see McLure and Zodrow (1996) and McLure, Mutti, Thuronyi and Zodrow (1990).

[12] Note that this argument implies that the inheritance taxes (or an accessions tax, under which some level of lifetime gifts and inheritances received would be tax exempt) that are typically used in those Latin American countries that utilize wealth transfer taxes are superior to the estate tax used in the US because under the former approach tax is assessed at the rate of the recipient rather than the donor; on this view, the use of estate taxes can be justified only as an administrative convenience, and will result in too high a tax burden if the tax rate of the donor is higher than the tax rates of the recipients. Note also that the goal of taxing the recipient could be achieved simply by including gifts received and inheritances in the income tax base, perhaps with averaging to avoid the situation in which a one-time increase in wealth forces the individual into an artificially high income tax bracket.

equity is that of a backstop to the income tax. For example, if under the income tax capital gains are taxed only upon realization and are entirely exempt from tax at death (as is the case in the US), such gains could be included in the base of an estate tax designed to tax gains that have escaped income tax entirely over the life of the donor.[13]

The choice between the lifetime endowment and dynastic approaches to evaluating intergenerational equity is contentious. Proponents of the lifetime endowment view argue that treatment consistent with their view is essential to ensure that all individuals with the same lifetime resources are treated equally, and that bequests should simply be treated as another form of consumption; in addition, they argue that limiting the transmission of huge fortunes across generations is highly desirable because it will promote more equality of opportunity across generations. In contrast, proponents of the dynastic equity view argue that such treatment amounts to obvious double taxation of the same income and creates a tax bias against both saving and transfers in the form of bequests relative to other forms, thus encouraging consumption on children in the form of expensive educations, cars, other consumer goods, etc.[14] The choice between the two approaches obviously involves personal value judgments and cannot be resolved by economic arguments.[15] However, for the purposes of discussion, we shall

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[13] The lifetime endowment and dynastic equity views are also relevant to the ongoing debate regarding the relative desirability of direct consumption taxes. There are two popular approaches to implementing such taxes. Under the "individual cash flow" approach, individuals receive deductions for all saving, with all withdrawals subject to tax; this approach is sometimes referred to as a "postpaid" consumption tax in that tax is paid in the future when savings are withdrawn. By comparison, under the "individual tax prepayment" approach, individuals are fully taxed on wage income regardless of whether or not it is saved, and all future capital income is tax exempt; this approach is sometimes referred to as a "prepaid" consumption tax in that tax is paid when earnings are received regardless of saving behavior so that future capital income need not be taxed. In these cases, the lifetime endowment view implies that all lifetime income, including inheritances, should be subject to tax regardless of whether it is used to fund consumption or the making of bequests. Thus, under a pre-paid consumption tax inheritances should be taxed upon receipt, and under a postpaid consumption tax inheritances should be taxed when consumed or when bequeathed (as bequests are treated as a form of consumption). By comparison, under dynastic equity view, resources should be taxed only when consumed; in particular, bequests merely represent a transfer of ability to pay and should not be included in the tax base of the donor. Thus, under a prepaid consumption tax inheritances should not be included in the tax base of the recipient (since the tax has been prepaid), and under a postpaid consumption tax inheritances should be included in the tax base but bequests should be deductible.

[14] Note that a tax bias against wealth transfers will tend to encourage consumption, and thus is likely to result in greater consumption inequality. To the extent that consumption inequality is more socially objectionable than wealth inequality, a tax on bequests will increase inequality (McCaffery, 1994).

[15] However, it is important to note that the choice between the dynastic and lifetime endowment views of equity has similar implications for the designs of both income and consumption taxes; it is an issue for the choice between the two taxes primarily to the extent that capital income taxation is perceived to supplement poorly administered (or substitute for non-existent) estate taxes. Cremer, Pestieau and Rochet (2003) show that capital income taxation may

generally adopt the lifetime endowment view of equity for the balance of the discussion – if not, the case for wealth transfer taxes would largely disappear. Nevertheless, it is important to remember that to the extent one adopts the dynastic view of equity the case for the taxation of bequests and inheritances is rather weak, as the role of backstop to the income tax could be better served by improving the income tax.

Absent income tax reform, however, under either view the "backstop" argument implies that estate taxes are desirable to the extent that capital income is not fully taxed under the income tax, and such income is successfully taxed under the estate tax. The validity of the "backstop" argument clearly depends on how effectively capital income is taxed under the income tax.[16] In practice, in all countries that utilize the income tax, actual income taxes fall far short of the ideal. In particular, capital income often benefits from various special preferences, such as tax deferral under a capital gains tax system based on realization, exemption of capital gains at death[17] or deferral until the heir sells the asset, preferential rates on capital gains and dividends, full deduction of interest expense coupled with only partial inclusion of interest income (since many bonds are held by tax-exempt institutions, in tax-exempt accounts or by low bracket individuals) and preferential treatment of investment in certain assets, including housing. As a result, capital income is far from fully taxed under most income tax systems.

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be desirable in a version of the Atkinson and Stiglitz (1976) model, modified to include bequests that are by assumption tax exempt, if the equity gains from indirectly taxing inherited wealth offset the efficiency costs of reducing saving and investment. Note also that capital income taxation can be justified as a proxy for a wealth tax that is assessed on the grounds that wealth confers utility beyond its consumption value in the form of prestige, security, and power, including political power (Carroll, 2000). However, consistent with the dynastic view of equity, Shaviro (2004) argues that such benefits reflect only the value of future consumption, which would be fully taxed under a consumption tax (although there would be no reduction in wealth accumulation under a consumption tax, in contrast to the case under an effective capital income tax).

16 The validity of the "backstop" argument also depends on whether income or consumption taxation is the appropriate tax system, since under the latter approach the taxation of capital income is assumed to be generally undesirable.

17 In the US, capital gains receive "step-up of basis" implying that the cost basis to the heir is stepped up to the value at the time of transfer, so that all gains during the life of the decedent are exempt from tax. Since the estate tax captures some of these gains, proposals to eliminate the estate tax are often accompanied by expanded income taxation of capital gains at death; for example, in the US, elimination of the estate tax in 2010 is to be accompanied by "carryover" of basis (the recipient assumes the cost basis of the decedent (or the market value if it is smaller)) although the first $1.3 million received by a recipient would still get step-up of basis. Poterba and Weisbenner (2001) estimate that in the US in 1998, unrealized capital gains accounted for roughly 36 percent of gross estates in the aggregate and 56 percent of estates valued over $10 million, and that the revenues raised from taxing capital gains in full at death are roughly 27 percent of the revenues that would be lost by eliminating the estate tax.

In particular, in the US, the effective tax rate on capital income appears to be substantially below statutory rates. Evidence of this proposition is provided in a series of papers by Slemrod and Gordon and several co-authors who have investigated the extent to which capital income is actually taxed under the existing income tax in the US. For example, Gordon and Slemrod (1988) find that if the US had in 1983 switched to a prepaid consumption tax regime (which exempts the normal return to capital at both the individual and business levels), the aggregate change in personal and corporate income tax revenues would have been virtually zero; that is, the taxation of capital income under the income tax at that time was sufficiently ineffective – primarily due to corporate and personal interest deductions that were not offset by interest income taxation at the individual level – that it raised virtually no revenue. Moreover, they also found that the burden of capital income taxation was disproportionately borne primarily by lower income investors who hold a relatively large share of their capital income in the form of taxable bonds, rather than by higher income investors, who tend to borrow heavily to invest in assets that generate more lightly taxed capital gains.[18] Gordon, Kalambokidis and Slemrod (2004) replicated this analysis for the 1995 structure. They obtained a similar distributive pattern for capital income taxes in the lower and middle income classes, but also showed that very high income taxpayers bore a significant portion of the capital income tax burden in that year. In addition, replacing the income tax with a prepaid consumption tax regime would have, after adjusting for cyclical factors, cost $92 billion in revenues, with the revenue increase relative to the analysis of 1983 data coming primarily from reduced opportunities for interest arbitrage by high income taxpayers due to lower interest rates and lower marginal tax rates, as well as the greater taxation of corporate income enacted as part of the Tax Reform Act of 1986. Finally, Gordon, Kalambokidis, Rohaly and Slemrod (forthcoming) replicate the analysis for 2004 and find that the amount of revenue from capital income taxation has declined, due primarily to the partial expensing provisions and dividend and capital gains rate cuts enacted in the 2002 and 2003 reforms, to only $63.8 billion or less than seven percent of combined personal and corporate annual income tax revenues, implying an effective tax rate on capital income of

[18] Indeed, McCaffery (2001) argues that in the US wealthy individuals can largely avoid taxation over their lifetimes by following a strategy of investing in, and then holding until death, assets that generate capital gains while financing current consumption with debt.

roughly 14 percent.[19] [20] These results suggest that the level of capital income taxation in the US is considerably below that associated with a comprehensive tax on income, so that the backstop role of wealth transfer taxes is likely to be important from the perspective of maintaining the integrity of the income tax. It seems likely that, given the extent of personal income tax avoidance in Latin America, that the backstop argument would be especially valid.

Another type of horizontal equity argument is that standard analyses that equate individual welfare with consumption (perhaps including bequests, in the case of the lifetime endowment view) over the lifecycle miss an important issue – the additional conceptually separate increment in welfare attributable to the ownership of wealth at any point in time due to the prestige, security, and power, including political power, that wealth brings (Carroll, 2000). If true, this argument supports an explicit annual tax on wealth. However, if a wealth tax is not available for political, administrative or economic reasons, then the taxation of wealth transfers could serve as an indirect means of taxing wealth. Note, however, that this argument is also fairly contentious; for example, most economic models do not account for this factor when modeling individual preferences. In addition, Shaviro (2004) argues that any such benefits of holding wealth reflect only the value of future consumption, and there is no reason for a separate wealth tax if future consumption is subject to tax, either directly or indirectly.

Yet another dimension to the horizontal equity issue arises because bequest and inheritance taxes in practice are often either (illegally) evaded or (legally) avoided. As a result, the incidence of such taxes is fairly haphazard, to the point that some observers have characterized bequest and inheritance taxes as essentially "voluntary." For example, the U.S. Joint Economic Committee

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19 They estimate that this figure would have been $138.7 billion if the partial expensing and dividend and capital gains tax rate reductions had not been enacted in 2002-03.

20 Gordon, Kalambokidis, Rohaly and Slemrod (forthcoming) also find that expanding prepaid savings accounts, as was proposed in 2004 and is currently being discussed, could result in a situation where the taxation of capital income loses revenue. This dramatically illustrates the point that piecemeal reforms that cobble together various elements of a consumption tax reform, but do not include all of its features including especially the elimination of interest deductibility, can be highly undesirable. In particular, the "five easy pieces" approach (Christian and Robbins, 2002) which would reduce rates (and eliminate the estate tax), allow expensing and exempt capital income from taxation at the individual level without providing for consumption-based tax treatment of interest expense, loses revenue and creates arbitrage opportunities while not gaining the advantages of consumption-based taxation in providing uniform tax treatment of all saving and investment decisions and a simplified tax system.

(1998, p. 30) asserts that, "Virtually any individual who invests sufficient time, energy and money in tax avoidance strategies is capable of avoiding the estate tax altogether." To the extent this characterization is accurate – an assertion that will be discussed below – such taxes are born only by those individuals who are unwilling to invest the time and effort to avoid or evade them. Moreover, taxes on wealth transfers encourage donors to increase current consumption to avoid the tax, implying that individuals who are relatively more willing to substitute current consumption for future bequests bear a lower tax burden.[21] For both of these reasons, opponents of the estate tax argue that it is highly inequitable from the perspective of horizontal equity.[22]

Vertical Equity

Taxes on bequests and inheritances also raise important vertical equity issues, and indeed such issues are the focus of most discussions of the fairness of taxes on wealth transfers. Because bequests and inheritances are so heavily concentrated among the wealthy, wealth transfer taxes are among the most progressive elements of a system of taxation. Those concerned about the distribution of income (and wealth) in an economy, especially given recent increases in income inequality not attributable to tax factors, typically believe that a progressive system of wealth transfer taxes is a highly desirable element of a successful tax system. However, as will be discussed further below, the standard model of optimal taxation suggests that distributional goals should be met with an appropriately progressive tax on wage income, with taxes on capital income, including wealth transfer taxes, set equal to zero. Nevertheless, even in this case, wealth transfer taxes may be an important supplement to a progressive wage tax if it is not applied comprehensively.

Opponents of estate taxation also note that by discouraging wealth transfers, such taxes tend to encourage conspicuous consumption by the wealthy (and reduce consumption by their heirs), and thus exacerbate differences in consumption levels across individuals; thus, to the extent that one is most concerned about vertical inequities in consumption (rather than total welfare), the

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21 The estate tax can also be "avoided" by working less; this efficiency issue is discussed further below.

22 Note, however, that while such a voluntary tax may be inequitable, it is efficient in the sense that it is paid primarily by those taxpayers who are relatively unconcerned about paying it.

estate tax may exacerbate inequality.[23] Indeed, on this view, bequests can be seen as a voluntary form of redistribution that reduces vertical inequities (assuming that the donors on average are richer than the recipients).

A closely related but conceptually separate issue is the question of whether government policies should explicitly discourage the intergenerational transmission of large fortunes. Proponents of this view argue that reducing wealth concentration, especially at the very top of the wealth distribution, is desirable in its own right in a democracy to reduce the extent to which economic and thus political power is concentrated in the hands of the wealthy few. On the other hand, numerous concentrations of wealth within a society may enhance democracy if their owners are willing to support different interests. In addition, estate taxes are seen by their proponents as facilitating the creation of equality of opportunity across generations. In contrast, opponents of this point of view argue that concentrations of wealth tend to dissipate naturally over time, and that any benefits of tax-induced reductions in wealth concentration are outweighed by the efficiency and administrative cost problems associated with bequest and inheritance taxation, and that in practice the relatively low revenue yield of gift and estate taxes implies that they can have at best a very modest salutary effect on the distribution of income.

Efficiency Issues

Taxes on wealth transfers are one form of taxing capital income, and economists have devoted great effort to analyzing the effects of capital income taxes. Much of this research has been done in the context of the choice between income and consumption based taxes, with the latter approach to taxation distinguished by its exemption of the normal returns to capital.[24] Far less research has focused on the effects of taxation of wealth transfers, but some recent papers have examined this issue.

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[23] For example, McCaffery (1994) argues that inequality in wealth is less undesirable than inequality in consumption since wealth gives rise to external benefits in the form of a larger capital stock and higher labor productivity and wages.

[24] Although consumption based taxes are sometimes described as entirely exempting capital income from tax, this characterization is inaccurate since both income and consumption taxes treat very similarly the returns to capital income that represent economic rents (or above normal returns) and the returns to risk-taking (see Zodrow (forthcoming) for a recent discussion). Thus, only the normal return to capital is exempt under a consumption tax.

Analyses of the efficiency properties of wealth transfer taxes are relatively complicated for several reasons. First, at any given point in time, in general it is relatively economically efficient to utilize taxes that have the effect of taxing the existing stock of capital, since such taxes are a relatively nondistortionary source of revenue. For example, Saez (2002), constructs a model in which the use of progressive capital income taxes (flat rate taxes above an exemption level, which are similar in their effects to estate taxes with exempt amounts) is desirable for a finite time period to reduce wealth accumulations existing at the time of the enactment of reform. Similarly, Cremer, Pestieau and Rochet (2003) show in a model that includes inherited wealth that capital income taxation may be desirable if the equity gains from indirectly taxing inherited wealth offset the efficiency costs of reducing saving and investment. Of course, the policy of taxing only existing capital suffers from a "time inconsistency problem." That is, although at any point in time it may in principle be desirable to impose a large tax on existing capital, especially as part of an agreement to exempt future returns to capital, investors will understandably be suspicious that future governments will renege on the agreement and similarly tax future accumulations of capital. If this perception is widespread, the predicted positive effects on saving and capital accumulation of exempting future capital income from tax will not fully materialize. In addition, introducing a tax on existing capital after it has been accumulated in the absence of the tax may be perceived to be inequitable and, like all taxes on capital, the introduction of a tax on wealth transfers would result in additional capital flight out of the country; this would especially be true in Latin America, given the generous treatment of foreign capital in the readily accessible US. Thus, a tax on existing capital, such as an estate or inheritance tax, is in practice far from nondistortionary. Nevertheless, a potential efficiency argument for wealth transfer taxes is that they represent a "one-time" relatively efficient source of revenue.

Because this is a fairly transparent result and because the political relevance of retroactive taxation of existing capital is open to question, most analyses have instead taken a long run perspective and focused on the properties of the taxation of bequests for future capital accumulation and intergenerational transfers, often neglecting initial accumulations of wealth. All of these models assume an overlapping generations lifecycle structure with bequests and inheritances. Kaplow (2001) argues that the results of these models can be best understood by treating gifts and bequests as a separate consumption commodity in the donor's utility function. In this case, he argues that although consideration of bequests and inheritances adds some new elements to the analysis, the basic issues are illuminated by examining a standard optimal taxation model with a similar overlapping generations structure without bequests.

Specifically, in the traditional lifecycle model, the representative individual has a two-period life cycle, supplying labor (demanding leisure), purchasing consumption goods and saving during the first "earnings" period, and consuming by drawing down savings during the second "retirement" period. In this model, a tax on wage income is equivalent to a uniform tax on consumption in the two periods, while a tax on capital income reduces the after-tax return to capital and thus effectively acts as a tax on future consumption. This problem is thus analogous to the often-studied issue of whether uniform or differential taxation of consumption commodities is optimal. As is well known, uniform commodity taxation is efficient only under certain circumstances, and analogous results obtain in this case. Specifically, the optimal capital income tax rate is zero (implying uniform taxation of consumption in both periods, as would occur under a consumption or wage tax) only if first and second period consumption are equally complementary with leisure.[25] [26] The intuition underlying this result reflects a balancing of two considerations. On the one hand, uniform taxation of consumption in the two periods tends to be efficient, as it avoids tax distortions of intertemporal consumption allocation decisions. On the other hand, the inability to tax leisure directly implies that taxation of the consumption goods will inefficiently reduce labor supply, so that differential taxation of consumption goods will be desirable if it can be used to offset the tax-induced increase in leisure demand and the associated reduction in labor supply. However, if consumption in the two periods is equally complementary to leisure and thus affects labor supply in the same way, any rationale for differential taxation disappears, and

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[25] For example, see Feldstein (1978), Bradford (1980), King (1980) and, in an explicitly dynamic context, Atkinson and Sandmo (1980). When applied to a "source-based" or production-based taxes on capital income, this argument is even stronger in the open economy context that would approximately characterize any Latin American country, since such taxes cannot lower the after-tax return to internationally mobile capital and thus are borne by local land and labor (Zodrow, forthcoming-a, and, in the context of Colombia, Echavarría and Zodrow, 2005). However, this issue does not arise in the case of residence-based taxes such as wealth transfer taxes, since such taxes are paid (in theory) irrespective of the location of assets.

[26] Goods that are complements tend to be consumed together. More formally, leisure and a consumption good are complements if an increase in the price of the consumption good reduces the demand for leisure (and thus increases labor supply).

uniform commodity taxation (a capital income tax rate of zero) is optimal. This condition is commonly described as "separability" in the individual utility function; that is, decisions regarding choices among consumption commodities must be independent of the decision regarding how much labor to supply (leisure to demand).[27] Although there is no guarantee that this condition is satisfied, Atkinson and Stiglitz (1980, p. 437), argue that it provides a reasonable benchmark that is based on "an assumption that has been made in nearly all studies of demand and labor supply functions."[28] Thus, the simple two-period model arguably suggests a presumption that an optimal tax system is, or is approximated by, tax exemption of capital income. When future consumption is interpreted as including bequests, this result implies that the taxation of wealth transfers is undesirable.

Perhaps surprisingly, this result regarding the optimality of exempting capital income from taxation is not necessarily reversed when equity concerns are added to the analysis. This issue is addressed in a seminal paper by Atkinson and Stiglitz (1976) (hereafter, AS) which focuses on optimal commodity taxation but can also be applied to analyze the optimal taxation of consumption across periods. The AS model focuses on whether differential commodity taxation is desirable to achieve a society's vertical equity goals (captured in a social welfare function that is a weighted sum of individual utility levels) if a nonlinear tax on wage income is also available and individuals differ only in their skill and thus in their wage levels. Within this context, AS show that if the conditions for uniform commodity taxation described above are satisfied and the nonlinear tax on wage income is set optimally, differential commodity taxation is unnecessary. The intuition behind this striking result is that optimal use of the nonlinear wage tax is sufficient to achieve all distributional goals, since individuals differ only in their skill levels, and at any given skill level all individuals have the same earnings and consumption pattern. Thus, the

27 In addition, as shown by Auerbach (1979), individual tastes must be "homothetic" with respect to the consumption goods, which implies that increases in wealth are distributed proportionately across consumption in all periods. This assumption, which is consistent with the generally accepted permanent income hypothesis, characterizes most lifecycle models.

28 Moreover, Balcer, Garfinkel, Krynski and Sadka (1983) argue that even in situations in which the conditions for uniform taxation are not satisfied and differential commodity taxation is theoretically desirable, the efficiency gains relative to a uniform commodity tax are quite small; moreover, these results were obtained within the context of taxes on various commodities within a single period, and it seems likely that differences in complementarities with

nonlinear wage tax used in isolation can achieve the socially desired distribution of income, as the only reason to also use distortionary commodity taxes would be to lessen the labor-leisure distortions resulting from the wage tax, but the fact that the conditions for uniform commodity taxation are satisfied implies that this is impossible.[29] As above, in the dynamic analog the consumption goods are interpreted as consumption in various periods in the lifecycle, and the result implies that capital income taxation – that is, differentially high tax rates applied to future consumption – is undesirable, and again by extension that capital income taxation in the form of taxation of wealth transfers is also undesirable. In this scenario, wealth transfer taxation is desirable only as a "backup" tax, if the optimal degree of progressivity cannot be achieved under the progressive tax on wages. Moreover, given the steeply progressive rates under the estate tax in the US and the possibility that saving for bequests and gifts and other intergenerational transfers is perhaps roughly half of total saving (Kotlikoff and Summers, 1981; Aaron and Munnell, 1992; Gale and Scholz, 1994),[30] the effective tax rates applied to capital income may be quite high, which in turn implies that the associated effects on investment and the capital stock may be large. Such results are in fact confirmed by Kotlikoff and Summers (1981), Caballe (1995), and Laitner (2001), but questioned by Gale and Perozek (2001), who argue that total saving may increase with an estate tax if it reduces inheritances and thus prompts children to save more.

The basic model analyzed by Kaplow simply treats bequests as a future consumption commodity and focuses on the welfare levels of the donor, which interact with the welfare levels of the recipient. More generally, analyses of the desirability of the taxation of bequests and inheritances are greatly complicated by the fact that there is considerable disagreement in the literature about the nature of bequest motives and thus the appropriate way to model bequests, and the efficiency implications of taxing bequests depend on how they are modeled (Johnson,

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leisure would be significantly greater across different types of consumption goods than across aggregate consumption in different periods, suggesting that uniform taxation is closer to optimal in the latter case.

29 Kaplow (2004) extends this result to the case in which the tax on wage income is not set optimally.

30 The relative importance of saving for bequests is, however, quite controversial. For example, Modigliani (1988) argues that roughly 80 percent of wealth reflects life-cycle saving; for further discussion of this debate, see Wolff (2003). More recent evidence on the extent to which the annuitization of wealth among the elderly has increased

Diamond, and Zodrow, 1997; Gale and Perozek, 2001). In particular, the fact that wealth transfers typically affect the welfares of both the donor and the recipient – and in some models reflect an exchange relationship between the two parties (e.g., a parent attempting to ensure greater attention in old age from a child) – raises some complex issues. Most of the literature assumes one of four alternative approaches to modeling bequest behavior; the following discussion considers each of these in turn.

Intergenerational Altruism

Under one popular approach to modeling bequest motives, the welfare of parents is a function not only of their own consumption over their lifetimes but also the welfare, generally discounted, of their children, with all individuals having the same preferences.[31] Such a preference structure is commonly cited as a rationale for the use of economic models that assume infinitely lived individuals; that is, since the utility of the parent is a function of the utility of the child, which is in turn a function of the utility of the grandchild, etc., the dynastic family can be approximated as an infinitely-lived individual. Under this scenario, taxes on bequests (which fund future consumption of the dynastic family) are roughly analogous to taxes on capital income, which effectively raise the price of future consumption.

In this case, the seminal results of Judd (1985) and Chamley (1986) show that in the long run the optimal capital income tax rate is zero, irrespective of the nature of individual preferences with respect to consumption and leisure. The intuition behind this result is as follows. By reducing the after-tax interest rate, a capital income tax increases the price of future consumption relative to current consumption. Although this distortion may be modest over a short time interval, it increases exponentially with time, so that even a small capital income tax rate will eventually be highly distortionary. Since the individuals in these models have perfect foresight over an infinite lifetime, their consumption patterns are highly distorted by such a tax, with significant declines in saving and capital accumulation. Indeed, in the Judd (1985) model, which has both

dramatically in recent years also suggests that the bequest motive may be becoming less important in explaining saving (Auerbach, Gokhale, Kotlikoff, Sabelhaus and Weil, 1995).

representative workers and capitalists, the negative effects of a capital income tax on saving and capital accumulation and thus on labor productivity and wages are sufficiently great that the optimal capital income tax rate is zero even if the government is concerned only about the welfare of workers. Judd and Chamley also demonstrate formally the result noted above – that is, even though capital income taxation should be avoided entirely in the long run, existing capital should initially be taxed to the maximum extent feasible since such taxation represents a nondistortionary source of revenue.[32]

The relevance of these analyses of the infinite horizon model to the issue of wealth transfer taxation is, however, limited since such models do not capture differences in welfare across generations. More directly relevant are overlapping generations models that explicitly include bequests and inheritances, and analyze the effects of wealth transfer taxation on individual utility and behavior. Of course, the standard arguments against the taxation of capital income – the desire to avoid distortions of consumption allocation decisions over time as well as negative effects on saving, investment and capital accumulation, and the associated increase in labor productivity and wages – apply in the overlapping generations case as well. In addition, as stressed by Kaplow (2001), such models capture the fact that in the altruistic model bequests and inheritances benefit both the donor and the recipient. This in turn suggests that rather than being taxed, wealth transfers should be subsidized since, unlike own consumption, they benefit two individuals. However, inheritances result in an offsetting negative efficiency effect in that they tend to reduce the labor supply of the recipient (and thus reduce future government revenues) – an effect noted long ago by Andrew Carnegie and empirically documented by Holtz-Eakin, Joulfaian and Rosen (1993) – and also is likely to reduce saving out of the earned income of recipients (Weil, 1994). These negative effects would be reduced with greater taxation of bequests or inheritances, and indeed might even offset the negative effects of bequest taxes on the level of donor saving. For example, Gale and Perozek (2001) construct several models in

[31] Note that this implies that bequests do not enter the donor's utility function directly, but only indirectly through the utility of the recipients. In a familial context, this implies that parents' bequests will be used to offset differences in the economic circumstances of children.

[32] Similarly, confiscatory capital income taxation may be desirable in the short run while capital-tax-induced distortions are relatively small.

which an increase in the estate tax may increase total saving, primarily because the saving of recipients increase; however, this model is incomplete because it does not consider the potentially negative effects on the saving of the recipients due to the taxation of their bequests (Gordon, 2001). Moreover, Kaplow (2001) argues that from a social welfare perspective, the behavioral effects on heirs theoretically cannot be large enough to offset the entire subsidy due to the joint benefits received from bequests. However, note that Kaplow does not consider the offsetting negative welfare effect associated with financing a subsidy for wealth transfers with other distortionary taxes. Moreover, the rationale underlying such a subsidy would be to give a targeted incentive for individuals to transfer wealth to their heirs to the extent it would raise overall social welfare. Hurd (2003) finds that the existence of an operative bequest motive is positively related to the level of wealth. His results suggest that very high wealth individuals are most likely to leave intentional bequests, while low wealth individuals are much less likely to leave significant bequests and that such bequests are more likely to be accidental rather than intentional. This implies that an economically rational subsidy would target the very wealthy and thereby increase their welfare, the welfare of their heirs, and social welfare, while potentially reducing the welfare of low income households who might bear the tax burden related to financing such a subsidy. The vertical equity implications of such a subsidy suggest that it is politically irrelevant, especially in the context of wealth transfer taxes that are designed to reduce inequalities in wealth and individual welfare.

The net effect of all these factors is of course difficult to ascertain. An excellent recent analysis is due to Laitner (2001), who examines the effects of the estate tax in an overlapping generations model under the assumption of altruistic behavior on the part of at least some individuals in the economy, for whom utility functions of parents depend on the utility of their children. The Laitner model includes heterogeneous earnings abilities, assumes inelastic labor supply, and the existence of efficient annuity and life insurance markets. Within this context, in his preferred specification, Laitner estimates that elimination of the estate tax in the US would stimulate savings enough to increase the long run capital output ratio by 2.5%. He argues that these effects are relatively large, especially given the relatively low revenues obtained by the tax. He also finds the elimination of the tax increases wealth inequality, especially among the top one percent, were wealth increases by 32%.

Several additional issues are of interest. Holtz-Eakin, Joulfaian and Rosen (1993) also show individuals who receive large inheritances have a greater tendency to start their own businesses or expand them. Thus taxes on inheritances are likely to reduce investments of this form. Another potentially relevant factor is that if a child is aware of the altruistic sentiments of the parent, he or she may attempt to take advantage of these sentiments, for example, by over-consuming when young in order to increase the potential bequest.[33] Under these circumstances, Gale and Perozek (2001) show that an estate tax may be efficiency enhancing by effectively limiting the strategic behavior of the child (with the effect of reducing the child's consumption and increasing saving). Thus, the case for wealth transfer taxes is not especially strengthened by assuming altruism between generations.

Although the altruism model has considerable intuitive appeal, the empirical evidence on its validity is mixed. Tomes (1981) and Becker and Tomes (1979, 1986) provide some evidence in support of the model. However, most studies argue that the empirical predictions of the model are not verified. In particular, differences in consumption levels among siblings are typically not offset by differential bequests as is predicted by the altruism model; rather equal division is generally the rule (for example, see Altonji, Hayashi and Kotlikoff, 1992, 1997).[34]

The "Joy of Giving" Motive

The simplest approach to modeling bequest behavior is to assume, as does Kaplow in his basic model, that gifts and bequests simply enter the utility function of the individual as another consumption good – that is, individuals enjoy the "warm glow" they receive from the act of giving to their heirs or others, or from the prestige they receive from leaving generous bequests, etc. (Andreoni, 1989). In this case, in contrast to the altruistic case analyzed above, the utility of the recipient (and thus his or her consumption levels) do not directly affect the utility of the donor. Nevertheless, from a social perspective, the analysis is similar even though the bequest

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33 This assumes that the parent cannot make a credible commitment to leave a bequest of a certain size, independent of the economic circumstances of the child.

34 However, Bernheim and Severinov (2000) argue that equal division is consistent with the altruism model if it is supplemented by the assumption that children perceive that the magnitude of the inheritance they receive is a signal of parental affection.

motives of the donor are different. In particular, bequests still generate benefits for both the donor and the recipient, creating a rationale for a subsidy, but simultaneously have negative effects on the work and saving incentives of the recipient as well as future tax revenues, implying that some taxation of inheritances (or a reduction of a subsidy for bequests) may be desirable. On balance, it is again difficult to construct a strong efficiency case for wealth transfer taxes.[35]

Strategic Bequests

A rather different approach to modeling bequest motives assumes strategic interaction between the donor and the recipient, typically interpreted as a parent and a child. In these models, parents use potential bequests as a means of eliciting certain types of behavior from their children, running the gamut from personal services to making "correct" choices involving marriage, childbearing, occupational choice, etc., to obtaining additional attention, including health care, during the retirement years.

In this case, from the perspective of the donor, the bequest is simply another consumption good – involving the purchase of services from the recipient, and the standard optimal commodity taxation analysis applies. On the other hand, from the perspective of the recipient, the bequest should be viewed as a payment for services rendered and thus should be treated either as taxable income and subject to an inheritance tax at the same rate applicable to taxable income. Thus, the strategic bequest model provides a strong argument for the taxation of inheritances. However, empirical tests of the strategic model of bequest behavior have been inconclusive (Bernheim, Schleifer and Summers, 1985; Cox, 1987; Perozek, 1998).

Accidental Bequests

In the final model commonly used to analyze bequest motives, bequests are purely accidental. Under this view, individuals are uncertain about their life spans and are concerned that they will run out of resources to finance consumption during very old age. This model assumes that such

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35 A further complication is that the donor's joy of giving may be a function not of the before-tax value of the bequest as assumed above, but its after-tax value (which is clearly the magnitude that is of concern to the recipient).

individuals are unable to annuitize their wealth because annuity markets are actuarially unfair[36] or because they are saving to finance potential health expenditures that cannot be adequately insured. Under the circumstances, individuals will virtually always die with positive asset holdings, but such asset holdings do not provide them with any additional utility.

Gale and Slemrod (2001) argue that the accidental bequest model may have significant explanatory power, and helps to explain why the elderly appear to draw down their savings to a lesser extent than predicted by standard life cycle theory. Nevertheless, they also note that it is highly unlikely that accidental bequests explain most bequest behavior, especially in light of the significant resources expended on avoidance of estate taxes, which presumably would not be spent if individuals were indifferent to the disposition of assets after death.

The accidental bequest model has potentially dramatic implications for the taxation of bequests. Specifically, if bequests are purely accidental, they could be subject to confiscatory tax rates without reducing the welfare of the donor. Of course, such taxation would have a negative impact on potential recipients, but the multi-generational penalty that typically characterizes the taxation of bequests does not arise under the accidental bequest model. Thus, the deleterious effects of estate taxation are much smaller under the accidental bequest model than they are under the alternative approaches. Moreover, because estate or inheritance taxes reduce the inheritances received by heirs, they are likely to improve efficiency by increasing their labor supply and saving (from levels that are inefficiently low due to the existence of other taxes) as well as the associated tax revenues.

To sum up, economic analysis does not provide an unambiguous answer to the question of whether wealth transfer taxes are desirable on efficiency grounds. The taxation of bequests is highly efficient to the extent it affects only capital existing at the time of enactment of the tax – that is, to the extent it can accurately be represented as a one-time windfall tax on existing capital. This characterization would be accurate only for those close to death at the time of enactment, while for all other individuals (with the effects being more important for young and

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36 Indeed, in the absence of actuarially fair annuity markets, a policy of introducing an estate tax to finance income tax reductions can be justified on efficiency grounds as a form of indirect annuity (Kopczuk, 2000).

future generations) wealth transfer taxes would distort decisions regarding saving, bequest behavior and labor supply. For such individuals, some general results from optimal tax theory suggest that capital income should, at least to a first approximation, be exempt from tax; moreover, this result obtains even if distributional concerns are considered, as long as equity goals can be achieved with an appropriately progressive tax on wage income. These results on the optimal taxation of capital income suggest that, at least in the long run when the windfall tax on existing capital is no longer an issue, that wealth transfer taxes on estates and inheritances should be avoided.

Turning to models that explicitly include bequests and inheritances, a central message is that the desirability of taxing bequests depends greatly on which of several alternative models best describes bequest motives. If parents are altruistic toward their children, or if parents attempt to influence the behavior of their children with promises of bequests, then bequests are significantly preferred to own-consumption since they generate welfare for both the donor and the recipient. Accordingly, under these circumstances bequests should be subsidized rather than taxed; that is, altruistic or strategic concerns tend to reinforce arguments against wealth transfer taxes based on their negative effects on saving, capital accumulation, labor productivity and wages. However, these results are countered by arguments that the taxation of wealth transfers may limit the deleterious effects of inheritances on the labor supply and saving behavior of recipients, and indeed may limit opportunistic over-consumption on the part of children designed to elicit larger bequests. Similarly, if bequests are given only because donors receive satisfaction from the act of giving, bequests simply become another form of consumption, with a presumption that such consumption should not be subject to differential taxation (in the form of an estate or inheritance tax). Subsidies to bequests may be desirable under this scenario as well, since both donors and recipients benefit from them, although the taxation of bequests again limits the negative effects of inheritances on the labor supply and saving decisions of recipients.

In contrast, if bequests are simply accidental, reflecting overaccumulation based on concerns that the donor will outlive his or her resources, then bequest taxes are an efficient source of revenue in that they do not distort the behavior of donors and reduce other tax-induced distortions of labor supply and saving behavior of recipients. Thus, the efficiency case for wealth transfer taxes is strongest if a significant fraction of bequests are accidental.

Administrative and Compliance Issues

Many observers have argued that the biggest problems with estate taxes in the United States and elsewhere is their high administrative and compliance costs, especially when taking into account various mechanisms by which the tax can be legally avoided. Indeed, Bernheim (1987) has argued that once administrative and compliance costs, as well as revenues that are diverted from the income tax through the use of avoidance devices, are taken into account, the net revenue raised by the tax is approximately zero. Similarly, Munnell (1988) concludes that the compliance costs of the estate tax may well approach its revenue yield. Such criticisms are important for several reasons. First, if administrative and compliance costs are in fact as large as argued by opponents of the tax, it is a highly inefficient revenue instrument – one that raises relatively little revenue while imposing significant additional costs. (Note, however, that if the tax is largely avoided, it is unlikely to create much in the way of inefficiencies in labor supply and saving behavior.) Moreover, the existence of various avoidance schemes – which are sufficiently prevalent that some observers characterize the tax as voluntary in the sense that it is paid only by those unwilling to spend the time and effort to avoid it (Cooper, 1979; McCaffery, 2001) – implies that the tax is highly undesirable on horizontal equity grounds.

However, it is not clear that the administrative and compliance costs are as large as suggested by the discussion above. In particular, more recent and more careful research by Davenport and Soled (1999) suggests that the administrative and compliance costs of the estate tax are approximately 7% of revenues. Gale and Slemrod (2001) note that this figure somewhat less than the 10% figure commonly cited for the corporate and individual income taxes.

There is also considerable disagreement about the extent of avoidance and evasion of the estate tax. For example, Wolff (1994) compares the potential and actual tax bases of the estate tax in the US in 1992 and concludes that the latter is reduced by roughly three quarters due to avoidance and evasion. However, Poterba (2000) conducts a similar analysis for 1995 and concludes that the avoidance and evasion are not quantitatively significant, as the actual tax base is within 10% of the potential base. Eller, Erard and Ho (2001) stress that these results differ primarily due to different (but generally reasonable) assumptions about (1) mortality (Poterba uses mortality tables for a sample of very wealthy (and longer-lived) individuals while Wolff uses population averages), (2) the use of the marital deduction, which Poterba assumes is used to eliminate estate tax liability whenever possible while Wolff uses average deductions, (3) the allocation of other deductions and credits, and (4) differences in mortality between singles and married couples, and which spouse is the first to die. Their estimate of 13% under-reporting under the estate tax is, however, roughly consistent with the results reported by Poterba. Kopczuk and Slemrod (2001) report that the size of taxable estates is sensitive to estate tax rates; they estimate that a 50% estate tax rate will in the long run reduce reported taxable estates by 10.5%. However, they are unable to ascertain from their analysis whether this reduction in reported wealth is attributable to decreased wealth accumulation or increased estate tax avoidance. Eller and Johnson (1999) report that estate tax returns are audited at a relatively high rate, with an average audit rate of nearly 20 percent, and an audit rate of nearly 50 percent for returns with a gross estate in excess of $5 million. Erard (1998) estimates that evasion of the estate tax is approximately 13%, slightly lower than most estimates for the income tax.

A key and controversial issue in the debate regarding the estate tax in the US is the extent to which the tax can easily be legally avoided – a claim that, as noted above, is often presented to support the argument that the tax is essentially a “voluntary tax” (Cooper, 1979). In a recent contribution to this debate, Schmalbeck (2001) concludes that although avoidance devices are available and important, the voluntary tax argument is an exaggeration. The following discussion of avoidance techniques draws heavily on this contribution.

Schmalbeck notes that in many cases a significant fraction of estate tax liability can be avoided with five relatively simple techniques – use of the annual gift tax exclusion, marital deductions, charitable contributions, insurance trusts, and favorable asset valuations, especially of closely held business property. Systematic use of the annual gift tax exclusion is perhaps the simplest avoidance device. Donors, including both partners of a married couple, are each allowed a gift tax exemption of $11,000 per donee, with such amounts never subject to any wealth transfer taxation. Schmalbeck constructs a simple example of a married couple in their fifties with two children and four grandchildren who, by making maximum use of the gift tax exclusion, can distribute more than $3 million tax-free ($6 million if one considers the earnings on distributed gifts) and largely free of the transactions costs that often characterize other estate tax avoidance devices. However, donors clearly have significant reservations about using this device to its fullest potential. Indeed, Poterba (1998) estimates that actual gifts are only approximately 15% of total potential gifts. This presumably reflects unwillingness on the part of donors to part with resources, presumably to maintain control over the resources and the power and prestige associated with additional wealth, to retain some control over the behavior of their children in line with the model of strategic bequest behavior described above, to avoid reducing the incentives for their children's own economic success, and to retain control over assets that might be used to finance unexpectedly long lifetimes or unexpected medical expenses, along the lines of the accidental bequest model discussed above.[37]

Charitable contributions also provide a means of reducing estate tax liability, although delaying the contributions until after death implies foregoing the income tax benefits of making the contributions. However, the options for reducing estate tax liability as well as income tax liability by making charitable contributions extend far beyond simple cash transfers. In particular, a variety of trust vehicles (e.g., charitable remainder annuity trusts and charitable lead trusts) can be utilized to separate the income from the principal on donated property, and thus obtain current benefits in the form of income tax deductions as well as subsequent estate tax reductions.

The combination of unlimited marital deductions and generous exemption amounts – scheduled to increase to $3.5 million by 2009 – also implies that significant amounts of wealth can be transferred tax-free. In particular, a basic strategy for a wealthy married couple is to ensure that both exemptions be utilized to their fullest. This is easily achieved by leaving enough assets to a surviving spouse to ensure that he or she will in the future be able to take full advantage of the

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37 Some of the problems associated with the use of the gift tax exclusion can be avoided through the use of trusts. In particular, a common device is a "Crummey trust" which allows eventual recipients only highly limited access to the resources within the trust, an option that is apparently seldom exercised, presumably in order to maximize the total amount of contributions that might be made to the trust over the lifetime of the donor.

exemption, while simultaneously bequeathing enough assets to heirs to exhaust the exemption of the decedent. Moreover, even if one spouse wishes to leave virtually all assets to the surviving spouse, property can be left to a "credit shelter trust" that provides income to the surviving spouse but leaves the principal to the heirs.

A more egregious form of avoidance arises with the use of insurance trusts. Life insurance proceeds are normally included in the gross estate. However, if an appropriately designed insurance trust has legal ownership to an insurance policy, all of the proceeds of the policy are tax-free. As noted by Schmalbeck (2001, p. 131), the existence of such a transparent but entirely legal device, which represents "a gross violation to common sense," is manifestly consistent with the notion that estate taxes are relatively easy to avoid.[38]

Finally, a variety of techniques are available to reduce the valuation for estate tax purposes of closely held businesses. One popular technique is the family limited partnership, under which the assets of a family business are transferred to a limited partnership comprised of family members. The advantage of this arrangement arises only because the courts have ruled that the value of such a partnership share is considerably less than a proportionate share of the assets transferred, since the share would sell at a discount to reflect the limited management control attributable to the limited partner. Schmalbeck concludes that discounts of 40% are common and that Texas is something of a "renegade state" in this context in that it allows discounts as high as 80%.

Schmalbeck (2001, p. 144) concludes that for smaller estates, with gross assets of $3 million or less, the estate tax can be avoided with minimum planning, while for even much larger estates discounts of about one third of the value should be achievable. He notes that although such discounts are significant, they do not imply that "the very wealthy can completely avoid transfer taxes through clever planning."

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38 Similarly, McCaffery (2001) notes that a growing number of states have recently allowed the formerly universally banned "dynastic trusts" which can be funded tax free with the $1 million per donor exemption from the generation skipping tax and be designed to exist in perpetuity.

The policy implications of this discussion are unclear. At one level, one could argue that the US does not really want an effective estate tax. After all, elimination of each of the five avoidance techniques described above – use of the annual gift tax exclusion, marital deductions, charitable contributions, insurance trusts, and favorable asset valuations, especially of closely held business property – with the possible exception of generous minority valuations, should be able to be achieved with the appropriate legislation and accompanying regulations. The fact that this has not occurred suggests that the political will for effective estate taxation is nonexistent, a view that is supported by the recent temporary repeal of the estate tax in the US. Moreover, the existence of these devices creates significant opportunities for avoidance, available only to those who take the time and spend the resources to discover and implement them; this increases the horizontal inequity of the tax system and, by fostering the perception that the wealthy can avoid the tax at will, puts at risk the high levels of compliance in the US that make the income tax collectible. Indeed, one might argue that the current situation (at least prior to 2010) is one in which the estate tax exists to create the illusion of highly progressive taxation, but the tax itself is largely avoided through the appropriate techniques by those who find the tax especially onerous. Nevertheless, the fact that a moderately significant level of revenues is collected under the estate tax clearly indicates that it is not entirely toothless.

Small Businesses and Farms

Discussions about estate tax reform in the US, especially the recent debate about the desirability of repealing the tax, have focused to a disproportionate extent on the effects of the tax on small businesses and farms. Popular debate and survey data suggest that the estate tax plays a major role in limiting business growth, increasing the likelihood of business failure, reducing and distorting investment decisions, and giving rise to situations in which part of a small business or farm must be sold in order to meet estate tax liability (Astrachan and Tutterow, 1996).

However, as stressed by Gale and Slemrod (2001), these arguments appear to be seriously overstated. In fact, most small businesses and farms are by definition small, so that their transfer does not incur estate tax liability due to the generous exemptions allowed under current law. For example, Harl (1995) finds that only 5% of farms in the US would have incurred estate tax liability in 1995. Moreover, Holtz-Eakin, Phillips and Rosen (1999) find that small business owners do not carry especially large amounts of life insurance (as they might if they were concerned about their heirs having to pay estate tax), and on average, business owners have sufficient funds on hand to cover more than 80% of their estate tax liability, so that the need to sell off part of the business to pay the estate tax seems relatively small.

Small businesses and family farms also receive a variety of tax preferences under the current estate tax. For example, small business assets are valued on the basis of current use value which is typically significantly less the market value, and current law provides for a special deduction for estates in which small businesses and farms constitute 50% of the estate and heirs are involved in the operation of the business. As a result, large amounts of small business and family farm assets can be transferred across generations tax free. In addition, any estate tax liability incurred by small businesses and farms can be paid in installments over a 14 year period with interest charged only for the first four years at below-market interest rates. Gale and Slemrod (2001) also note that the estates of the owners of small businesses and farms typically include a large amount of capital gains which have never been taxed under the income tax and small businesses and farms receive a variety of tax preferences under the income tax. Finally, they also estimate that even with a very broad definition of small businesses and farms, such entities constituted at most 11% of assets and taxable estates. Thus it is far from clear that the effects of the estate tax on small businesses and farms should play as large a role in the debate regarding the future of the estate tax in the United States as is currently the case.

Charitable Contributions

Proponents of the estate tax sometimes also argue that one of its benefits is that it encourages charitable contributions. Charitable contributions do not on average comprise a significant fraction of bequests, amounting to roughly 6% of bequests, and less than 3% for decedents with assets of more than $10 million (Joulfaian, 1998), although the future prospect of paying the estate tax may also stimulate charitable giving during life (Auten and Joulfaian, 1996). In any case, the amounts given are sufficiently large that the effects of wealth transfer taxation on charitable contributions are of interest; these are reviewed in Joulfaian (2001), on which the following discussion draws.

Joulfaian stresses that giving charitable contributions at death is primarily the province of the very wealthy, with individuals of more modest means tending to make contributions during life. He argues that this may occur because the wealthy are reluctant to sell parts of their businesses simply because they enjoy wealth accumulation. Joulfaian estimates that charitable gifts are quite sensitive to their bequest tax price – that is, charitable contributions tend to increase as the estate tax rate increases, driving up the cost of leaving noncharitable bequests. However, eliminating the estate tax also creates a wealth effect, as individuals have more after-tax wealth to spend on both bequests and charitable contributions. He estimates that this wealth effect is also significant, and indeed, in his final set of estimates, roughly offsets the price effect (although preliminary estimates suggested that charitable giving would decline by 13-31 percent with the elimination of the estate tax). Joulfaian (2001, p. 367) concludes that on net, "charitable giving … may change very little in the absence of the estate tax." This result is controversial, however. For example, Bakija and Gale (2003) argue that numerous studies suggest that estate tax repeal would significantly reduce charitable giving; in particular, they note that Clotfelter and Schmalbeck (2001) estimate that estate tax repeal would reduce charitable bequests by 24 to 45 percent. Bakija and Gale conclude that estate tax repeal would have significantly negative effects on the charitable contributions of individuals.

V. Conclusion: Implications for Wealth Transfer Taxation in Latin America

What then are the implications of the US experience with the estate tax and the academic literature on the advantages and disadvantages of wealth transfer taxation for estate and inheritance taxation in Latin America? The above analysis clearly indicates that there are a wide variety of plausible (and not so plausible) arguments made by both proponents and opponents of wealth transfer taxes, and that both theoretical models and empirical evidence on the effects of such taxes are informative but far from definitive. Accordingly, any Latin American country considering either instituting or expanding the use of such taxes must weigh the relative importance of these arguments – with respect to both its evaluation of the benefits of wealth transfer taxation and the potential costs – from its own unique perspective. Nevertheless, the analysis in this paper hopefully provides a useful framework within which to analyze this critical issue.

For example, if one adopts the "dynastic" view of multi-generational equity, which proscribes that the resources of a dynastic family should be taxed once but only once, then the role of wealth transfer taxation is limited to providing a backstop to the income tax, most importantly with respect to taxing unrealized capital gains.[39] In this case, it seems likely that the experience of most Latin American countries is similar to, or even more pronounced than, that of the United States in that much capital income goes untaxed. Of course, reform of the income tax would be more direct way of solving this problem – e.g., by providing for taxation of capital gains at death – and it would not require the administrative and compliance apparatus of wealth transfer taxation. Nevertheless, the backstop function provides a potentially compelling rationale for wealth transfer taxation for any Latin American country that is attempting to tax income on a reasonably comprehensive basis.

A wide variety of additional arguments for wealth transfer taxation apply if one adopts the "lifetime endowment" view of equity, under which all resources available to an individual over his or her lifetime should be taxed, regardless of whether they are used to finance consumption or the making of bequests. On this view, fairness requires that inheritances be taxed and no deductions be provided for bequests, so that all individuals can be taxed on their total lifetime resources, regardless of how they receive them or how they spend them; those Latin American countries that utilize wealth transfer taxes follow this model, taxing gifts and inheritances rather than estates. Moreover, if wealth confers additional benefits beyond potential consumption – e.g., in the form of prestige, security, or power including political power – then a wealth transfer tax can be justified as an indirect means of taxing this wealth if adequate wealth taxation is not available. Of course, in many circles, the primary argument for estate or inheritance taxes is that, because bequests and inheritances are extremely concentrated in the highest income groups, such taxes are the most progressive fiscal instrument available to most governments. Given the high degree of income inequality that characterize the countries of Latin America, the redistributive potential of wealth transfer taxes is often seen as a major advantage, especially to the extent it would be effective in reducing concentrations of wealth that perpetuate such severe inequality

[39] Of course, if one subscribes to the view that taxation on the basis of consumption is preferable to taxation on the basis of income or to the view that capital gains taxation is undesirable because the associated income has in

and limit equality of opportunity across generations. On the other hand, such extreme concentrations of wealth, including the often-cited concentration of land ownership, suggest that enactment or enhancement of wealth transfer taxes may face severe political obstacles.

In any case, although the arguments cited above may appear to provide a compelling case for wealth transfer taxation in Latin America, opponents of such taxes argue that all of their purported benefits are illusory while their costs are substantial and real. In practice, wealth transfer taxes raise relatively little revenue, and thus have historically had only a very limited impact in reducing inequality, despite apparently significant potential to do so. The low levels of revenues collected from estate and inheritance taxes reflect numerous factors. Perhaps most important is the lack of political willingness to design and enforce an effective tax on wealth transfers. Indeed, McCaffery (2001, p. 268-9) concludes that the "history of the estate tax suggests that whenever its burdens get too high as a percentage of GDP, avoidance techniques flourish and legislative weakening is forthcoming" and the same seems likely to be true in most Latin American countries, especially given the even higher degree of wealth concentration. In particular, the experience in the US suggests that estate tax liability can be reduced or eliminated with a wide variety of avoidance techniques, ranging from mundane mechanisms such as marital deductions, annual gift tax exclusions, deductions for charitable contributions, and favorable asset valuations, to more sophisticated avoidance techniques involving a wide variety of complex trusts and family business ownership structures. Numerous observers have argued that the administrative and compliance costs associated with the estate tax are especially high, implying that it is a relatively inefficient source of revenue and indeed that the net revenue from the tax may well be negative, once these administrative and compliance costs, as well as reductions in income tax revenues resulting from the use of estate tax avoidance techniques, are taken into account. Such a result would be especially counterproductive in most Latin American countries, where administrative talents are relatively scarce and should not be wasted on devising tax avoidance schemes and attempting to limit them. Moreover, an especially important consideration in the Latin American context is that estate taxes may give rise to capital flight, dramatically reducing their revenues and reducing domestic investment and growth. It must also

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most cases already been taxed at the business level, then this argument is not compelling.

be stressed that to the extent that the tax is essentially voluntary – that is, avoidable for anyone willing to devote the time and resources needed to avoid it – it is highly inequitable and, by creating the perception (and the reality) that taxes can be avoided by the wealthy, inhibits voluntary compliance with the tax system, which is already quite low in most Latin American countries.

Most economic analyses of wealth transfer taxes have focused on their efficiency properties, which depend on the nature of bequest motives. Under certain circumstances, estate and inheritance taxes can be relatively efficient fiscal instruments. In particular, at the time of its enactment, a wealth transfer tax is relatively nondistortionary since it is difficult to avoid in the short run. Moreover, to the extent that bequests are accidental, reflecting a situation in which the decedents were concerned about out-living their resources and saved more than necessary, bequest taxation is an efficient source of revenue.

However, numerous other models of bequest behavior suggest that wealth transfer taxes are a relatively inefficient source of revenue. In particular, most dynamic economic models suggest that in general capital income taxes, including taxes on wealth transfers, should be avoided because they result in significant distortions of the allocation of consumption over time, including reductions in saving that give rise to reduced investment and capital accumulation and thus reduced labor productivity and wages. Moreover, this result is robust to the inclusion of vertical equity concerns, as under certain circumstances capital income taxation is not needed in to achieve vertical equity goals, as long as appropriately progressive wage taxation is available. These general results must be supplemented by results specific to alternative models of bequest behavior. For example, if parents are altruistic toward their children, or if parents attempt to influence the behavior of their children with promises of bequests, then bequests are socially preferred to own-consumption to a significant extent since they generate welfare for both the donor and the recipient. Accordingly, under these circumstances bequests should be subsidized rather than taxed; that is, altruistic or strategic concerns tend to reinforce arguments against wealth transfer taxes based on their negative effects on saving, capital accumulation, labor productivity and wages. However, these results are countered by arguments that the taxation of wealth transfers may limit the deleterious effects of inheritances on the labor supply and saving behavior of recipients, and may also limit opportunistic over-consumption on the part of children designed to elicit larger bequests from their parents. Similarly, if bequests are given only because donors receive satisfaction from the act of giving, bequests simply become another form of consumption, with a presumption that such consumption should not be subject to differential taxation (in the form of an estate or inheritance tax). Subsidies to bequests may be desirable under this scenario as well, since both donors and recipients benefit from them, although the taxation of bequests again limits the negative effects of inheritances on the labor supply and saving decisions of recipients. On balance, the results of these models suggest that efficiency considerations imply that wealth transfer taxes should be avoided or used with great caution.

In summary, one can certainly make a case for the use in Latin American countries of wealth transfer taxes in the form of estate taxes or inheritance taxes, especially since the distribution of income is so unequal. However, experience in the US and elsewhere suggests that such taxes have not been especially effective in reducing inequality, generate relatively little revenue, especially net of administrative and compliance costs and negative effects on income tax revenues, are subject to a wide variety of avoidance schemes, and may have a significant negative impact on economic growth, investment, labor productivity and wages. These factors suggest that the enactment or enhancement of estate and inheritance taxes and Latin America should be approached with great caution. Indeed, the policy prescriptions of Bird and Zolt (2005), made in a different context, are instructive in this case. Bird and Zolt argue that developing countries should largely avoid the use of highly progressive income taxes as a means of reducing pervasive income inequality because such taxes in practice are far from comprehensive and not well enforced, thus raising little revenue and resulting in little redistribution, while imposing significant efficiency, administrative and compliance costs. They conclude that redistribution is better achieved with a roughly proportional tax structure, coupled with expenditures that are highly targeted toward the poor. The results of our analysis suggest that the same may very well hold true for estate and inheritance taxes in Latin America. At a minimum, it would appear that any such taxes should follow the traditional prescription of a relatively low rate applied to a comprehensive base, net of exemptions or deductions that remove the vast majority of the population from the tax base. Indeed, such an approach appears to be a likely outcome of the current debate in the United States, where permanent repeal appears to be increasingly unlikely in the face of ballooning deficits.

Appendix

Table 1. Distribution of Household Per Capita Income in Latin America (Income shares of deciles, various years)

Country	Year	Share of Deciles					
		1-2	3-4	5-6	7-8	9	10
Argentina	2001	3.1	7.2	12.3	21.0	17.5	38.9
Bolivia	1999	1.3	5.9	11.9	20.8	17.8	42.3
Brazil	2001	2.6	5.9	10.3	17.9	16.1	47.2
Chile	2000	3.4	6.6	10.5	17.4	15.2	47.0
Colombia	1999	2.7	6.5	10.9	18.0	15.4	46.5
Costa Rica	2000	4.2	8.9	13.7	21.7	16.7	34.8
Dominican Republic	1997	4.0	8.2	12.9	20.4	15.8	38.6
Ecuador	1998	2.6	6.8	11.4	19.1	15.9	44.2
El Salvador	2000	2.9	7.3	12.4	20.2	16.5	40.6
Guatemala	2000	2.4	6.2	10.8	18.2	15.6	46.8
Honduras	1999	2.8	6.7	11.8	19.9	16.7	42.2
Jamaica	1999	3.4	7.6	12.5	20.4	16.1	40.1
Mexico	2000	3.1	7.2	11.7	18.9	16.0	43.1
Nicaragua	1998	2.7	6.9	11.7	19.3	15.6	43.9
Panama	2000	2.4	6.5	11.2	19.6	17.0	43.3
Paraguay	1999	2.2	6.5	11.5	19.6	16.5	43.8
Peru	2000	3.1	8.4	14.1	21.5	16.0	36.9
Trinidad/Tobago	1992	3.2	8.5	13.4	21.1	17.2	36.6
Uruguay	2000	4.8	9.3	14.2	21.6	16.6	33.5
Venezuela	1998	4.0	8.6	13.7	21.4	16.7	35.6

Source: World Bank (2003), Table A.2

Table 2. Distribution of Household Per Capita Income Across Regions, 1992
(Income shares of deciles)

Regions	Latin America (i)	Africa (ii)	Asia (iii)	Eastern Europe (iv)	Developed Countries (v)	World without LA (vi)	Difference (i)-(vi) (vii)
Deciles							
1	1.6	2.1	2.6	2.2	2.5	2.4	-0.8
2	2.4	3.0	3.5	3.8	3.4	3.4	-1.0
3	3.0	3.7	4.8	5.1	5.3	4.8	-1.8
4	3.4	4.6	5.8	5.7	6.3	5.7	-2.2
5	5.0	5.5	6.5	7.5	7.3	6.7	-1.8
6	6.0	6.5	7.5	8.2	8.6	7.8	-1.7
7	7.6	8.6	9.0	9.4	10.5	9.5	-1.9
8	9.0	10.5	10.5	10.8	12.2	11.1	-2.2
9	14.0	13.3	12.4	12.8	14.8	13.5	0.5
10	48.0	42.2	37.4	34.7	29.1	35.1	12.9
Total	100.0	100.0	100.0	100.0	100.0	100.0	

Source: World Bank (2003), Table 2.2

Table 3. Gini Coefficients for Various Regions

Region	1970s	1980s	1990s	Overall Average
Levels				
Latin America and the Caribbean	48.4	50.8	52.2	50.5
Asia	40.2	40.4	41.2	40.6
OECD	32.3	32.5	34.2	33.0
Eastern Europe	28.3	29.3	32.8	30.1
Changes		1970-80s	1980-90s	1970-90s
Latin America and the Caribbean		2.4	1.3	3.7
Asia		0.2	0.8	1.1
OECD		0.2	1.7	1.9
Eastern Europe		1.0	3.5	4.5
Differences in Gini Coefficients: LAC vs.:				
Asia	8.3	10.4	10.	9.9
OECD	16.1	18.3	18.0	17.5
Eastern Europe	20.2	21.6	19.4	20.4

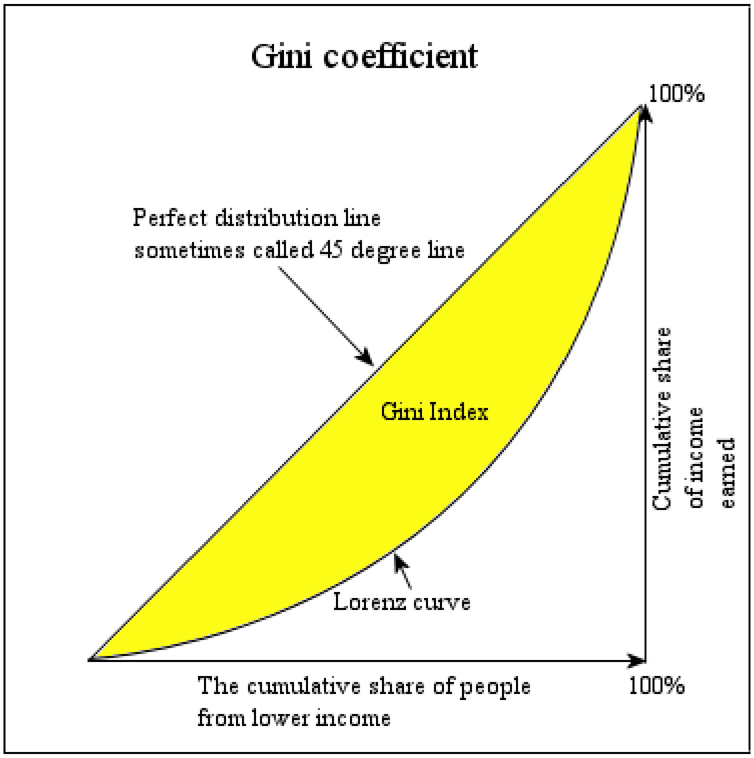
Source: World Bank (2003), Table 2.1

Table 4. Gini Coefficients for Selected Latin American Countries

Countries	Early 1990s	Mid 1990s	Early 2000s	Change
Argentina	42.6	45.8	50.4	7.7
Bolivia	54.3	55.8	55.9	1.6
Brazil	59.5	58.3	57.2	-2.3
Chile	54.7	54.9	56.1	1.4
Colombia	55.9	54.3	55.8	-0.1
Costa Rica	43.9	44.0	44.6	0.8
El Salvador	50.5	49.4	51.8	1.3
Honduras	55.6	54.1	53.0	-2.6
Jamaica	49.6	51.5	49.0	-0.6
Mexico	53.9	52.5	52.7	-1.2
Nicaragua	54.2	--	54.1	-0.1
Panama	54.7	54.0	54.4	-0.3
Peru	45.7	46.4	47.7	2.0
Uruguay	40.8	40.9	42.5	1.7
Venezuela	41.7	44.5	45.5	3.8
Average (non-weighted)	50.5	50.7	51.4	0.9
Average (weighted)	51.9	51.2	51.5	-0.4

Source: World Bank (2003), Table A.6

Figure 1. The Gini Coefficient



Source: Wikipedia http://en.wikipedia.org/wiki/Gini_coefficient

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