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Caviar, Cruises, and Cocaine

Two New Studies from a Right-Wing Foundation Say the Estate Tax Causes the Rich to Stop Working and Spend Away Their Millions

There is something very striking about the way tax policy is debated in Washington.

Certain taxes, like federal payroll taxes, which affect all working people, are rarely questioned or thought about.

Taxes that are more likely to impact upper-income people receive more attention. Hence, a great deal of debate swirls around the federal income tax, which is levied at higher rates on higher incomes.

But the tax that sparks the most heated debate is one that accounts for a tiny fraction of federal revenue and that only affects the small number of families that pass on more than several million dollars from one generation to the next. This, of course, is the federal estate tax.

Less than one percent of deaths in the United States result in payment of federal estate taxes,[1] and yet the attention lavished on this source of revenue from economic "experts," right-wing activists and their friends in Congress dwarfs the attention given to, say, payroll taxes.

In 2009, someone would have to pass on over $3.5 million (or $7 million for a married couple) before a single dollar of their estate would be taxed. Yet, according to a duo of new "studies" commissioned by a foundation established to promote repeal of the estate tax, eliminating this tax on the wealthiest few is crucial to our economy.

The "studies" are based on models that account for the costs allegedly imposed on the economy by the estate tax but that ignore the benefits of the public services that estate taxes and other taxes make possible. These "analyses" are thus rigged to produce the conclusion that the estate tax is a drain on the economy.

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[1] Citizens for Tax Justice, "Latest State-by-State Data Show Why Obama Should Scale Back His Proposal to Cut the Federal Estate Tax," December 3, 2008. http://www.ctj.org/pdf/estatetax20081203.pdf

One study, released a few months ago by Douglas Holtz-Eakin and Cameron Smith, claims that repealing the federal estate tax would create 1.5 million jobs.[2] The other, by Stephen Entin, claims that repealing the estate tax would actually result in *increased federal revenue*, not to mention higher gross domestic product (GDP).[3]

The claims made by both these studies are preposterous.

Supply-Side Economics: How Many Times Can a School of Thought Fail?

The "studies" are simply the latest episode in Washington's thirty-year addiction to the narcotic of "supply-side" economics. This school of thought claims cutting taxes, particularly taxes on the wealthy investor class, can unleash huge economic benefits that far outweigh any loss of government revenue, or might even result in an *increase* in government revenue due to the increased profits and incomes that result from a more efficient economy.

The two real attempts at supply-side policy-making (the Reagan administration and the George W. Bush administration) resulted in significantly lower revenues and big budget deficits. They also resulted in much weaker recoveries from recessions than were seen in the Clinton years, when the wealthy saw their taxes increased.[4]

But never mind all that. The logic of supply-side economics is especially absurd when applied to the estate tax. A key claim by the authors of these reports is that taxes on estates result in less saving and investment by wealthy people, resulting in less job-creation.

Their argument seems to be something like this. Rich people want to accumulate a whole lot of wealth so that they can pass it on to their children. So they work hard and they save and invest in businesses of all sorts. But, the more the government taxes this wealth upon their death, the less incentive these rich parents have to even try.

This logic is not exactly airtight. Wealthy people could just as easily respond to the estate tax by working even *harder* and saving and investing even *more* in order to leave behind whatever they believe is the optimal after-tax estate for their children. And, of

[2] "Douglas Holtz-Eakin and Cameron T. Smith, "Changing Views of the Estate Tax: Implications for Legislative Options," February, 2009. American Family Business Foundation. http://www.nodeathtax.org/files/AFBF_Holtz_Eakin_2009.pdf

[3] Stephen J. Entin, "Economic Impact of the Estate Tax: Effects of Various Possible Reform Options," June 2009. American Family Business Foundation. http://iret.org/pub/BLTN-93.PDF

[4] Michael Ettlinger and John Irons, "Take a Walk on the Wild Side: Tax Cuts on Profits, Savings, and the Wealthy Fail to Spur Economic Growth," September 2008. Economic Policy Institute and Center for American Progress. http://www.americanprogress.org/issues/2008/09/pdf/supply_side.pdf

course, it seems plausible that the *children* of rich people might work *harder* and save *more* in response to a tax that will reduce their inheritances.

So it's not obvious that supply-side theory accurately describes the incentives or disincentives created by the estate tax (or any other tax). But let's put that aside for now.

Caviar, Cruises and Cocaine: What Would Millionaires Do with their Money Besides Save and Invest It?

Let's just say the authors are right. Let's assume that the more the rich think the government will tax their wealth upon their death, the less they want to accumulate wealth in order to leave something behind for their families.

This must mean that the estate tax causes rich people to either 1) work less and earn less, or 2) to save and invest less of their millions. There are some major problems with both of these alternatives.

First, do estate taxes discourage work? If taxes of any sort really do discourage work then we would think that the estate tax discourages work *less* than most other taxes. After all, payroll and income taxes reduce the take-home pay of all working people, whereas estate taxes only affect the estates of millionaires *after they die*.

Surely the taxes that reduce my paycheck this week impact how I think about work a whole lot more than a tax that won't impact anything until after I die (and even then, only if I become a multi-millionaire).

Second, does the estate tax discourage people with millions of dollars from saving and investing it? The authors of these reports seem to think so. Holtz-Eakin and Smith explain that if a wealthy entrepreneur decides to "buy an around-the-world cruise, he reduces his estate and lowers his estate tax liability."

Can extremely wealthy people really spend away their millions on expensive dinners and cruises?

That's a lot of dinners and cruises. In 2004 (the last year before the amount of estates exempt from the tax was increased), 72 percent of estate taxes were paid on estates worth more than $3.5 million. (Of course, this year 100 percent will be paid on estates worth more than this since the exemption has increased to $3.5 million for singles and $7 million for couples for 2009.) And 61 percent of estate taxes were paid on estates worth over $5 million.[5] So, we're talking about folks who have lots and lots of money.

[5] Internal Revenue Service (IRS), Statistic of Income. http://www.irs.gov/pub/irs-soi/04es01fyx.xls

Let's say you had this sort of money and you wanted to keep your estate from being taxed by the federal government. What would you do? You can't put it in stocks or bonds or even a savings account. You can't buy fancy houses, because they would become part of your estate. Even if you buy expensive cars or yachts, those would be part of your estate as well (even if they lose some of their value before you die).

You would have to spend your entire estate on caviar or cruises or cocaine or something that won't be around after you die. It's unclear whether anyone can eat away, cruise away, or snort up their nose $5 million. (We won't say it's impossible, because we really don't want emails from over-eating, drug-addicted trust fund babies arguing this point.)

In other words, the claim that the estate tax will cause fabulously wealthy people to stop saving and investing is the sort of claim that could only be made by economists, who tend to think about incentives in an abstract way.

Questionable Use of Data

Well, you might ask, if this claim is so absurd, where do these economists get data that they think supports it? One answer is that they look at what people *report* to the tax collector, which should raise red flags for any observer.

Holtz-Eakin and Smith base much of their work on a 2000 study that looked at *reported* estate values from 1916 to 1996 and found that increases in estate taxes were "generally negatively correlated with the reported net worth of the top estates relative to national wealth."[6]

But even if this is true, does it mean that higher estate taxes cause people to save and invest less, or does it mean higher estate taxes cause people to *report* less on their estate tax returns?

If you look at the part of this 2000 study that Holtz-Eakin and Smith do not cite, you find its authors are uncertain how much of the negative correlation is due to *tax avoidance practices* and how much is due to reduced savings and investments. (In fact, the title of the 2000 study is "The Impact of the Estate Tax on the Wealth Accumulation and *Avoidance* Behavior of Donors.")

People can and do engage in practices to *avoid* the estate tax, which reduces the amount of estate value they *report* but not their actual savings and investment.

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[6] Joel Slemrod and Wojciech Kopczuk, "The Impact of the Estate Tax on the Wealth Accumulation and Avoidance Behavior of Donors," October 2008. National Bureau of Economic Research. http://www.nber.org/papers/w7960.pdf

There are a lot of ways to avoid the estate tax. The easiest just involve splitting up property between family members in certain ways that minimize the value of the taxable estate. There are also more complicated techniques, some of which require wealthy people to invest in ways that make it easier to reduce the taxable value of the estate.

Holtz-Eakin and Smith admit this much when they say that the research shows that people arrange their investment portfolios to include more "difficult-to-value assets" that create more opportunities to avoid the estate tax.

When people make investments to reduce taxes (instead of, say, to provide a product or service that people need), that results in a less efficient economy overall. This really does happen, as wealthy families engage in complicated planning to avoid the estate tax.

But it's not logical to say that if people avoid a tax, then that tax should be repealed. It would be far more logical to close the loopholes that allow these practices.

The Obama administration has taken some steps in this direction by proposing measures to block certain unjustifiable estate tax avoidance practices.[7] Anyone who is concerned about estate tax avoidance ought to support these efforts and call for even stronger measures, but somehow we doubt that the researchers commissioned by the American Family Business Foundation have that in mind.

But let's get back to Holtz-Eakin and Smith's paper. They zero in on the conclusion of the 2000 study on the relationship between *reported* estate values and estate taxes (which they call the "estimated elasticity of wealth accumulation"). They assume that this negative correlation is due to reduced savings and investment (rather than avoidance and underreporting) and then assume that any reductions in the estate tax will result in a proportionate increase in savings and investment.

$10.2 Trillion Is at Stake! Well, Over a Long, Long, Long Time...

There are more examples of how their analysis is extremely sloppy or just intentionally misleading. For example, Holtz-Eakin and Smith give us this gem:

> In 2004, individuals reported a total of $10.2 trillion in wealth on estate tax returns. Eliminating the estate tax would raise the wealth reported on estates by over $1.6 trillion.

First of all, if the estate tax is repealed, there will be no reason for anyone to report any estate value to the IRS so the "wealth reported on estates" will drop to zero.

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[7] Citizens for Tax Justice, "President Obama's Proposals to Raise Revenue," May 15, 2009. http://www.ctj.org/pdf/obamarevenueproposals.pdf

But putting that aside, individuals did *not* report a total of $10.2 trillion on their estate tax returns in 2004. Actually, in 2004 individuals reported a total of less than $0.2 trillion in net wealth on estate tax returns. The amount of wealth reported on *taxable* estate tax returns was only $0.1 trillion.[8]

The $10.2 trillion figure is actually an IRS estimate of the total value of the net worth of Americans with assets of more than $1.5 million in 2004.[9] Almost all of these people were obviously alive in 2004, and their estates were not going to be taxed in any one single year.

Thus, the $10.2 trillion is more like an estimate of the value of wealth that existed in 2004 and that might, one day, be subject to the estate tax.

So when the authors go on to say that eliminating the estate tax would increase this wealth by $1.6 trillion, they presumably mean over a span of fifty years or longer, or however long it takes those who were millionaires in 2004 to die out.

It's a little weird to speak about economic impacts in terms of half-centuries, but it's certainly a way to avoid being called out when your predictions don't pan out.

A 150% Tax on Investment Income?

In other places, the logic put forward by Holtz-Eakin and Smith is simply bizarre. For example, they argue that the marginal estate tax rate "is comparable to confiscatory annual taxes on the rate of return to capital."

What they mean, in English, is that the burden imposed by the estate tax is comparable to the burden that would be imposed if the government simply applied an income tax on the income generated from the estate to collect the same amount of revenue.

They give an example of someone whose estate is already large enough to be affected by the top estate tax rate of 45 percent. Each extra dollar earned and invested will be subject to the estate tax, the authors explain, which is the equivalent of subjecting the income from this investment to a 150 percent income tax over five years, or subjecting the income from the investment to a 26.6 percent income tax for 30 years. They then explain that such high implicit taxes on return to capital naturally discourage investment!

This is ridiculous. First of all, the estate tax is a tax paid on the estate that a person accumulated (through earning, saving, inheriting and receiving returns on investments) over the course of a lifetime, not five or even thirty years.

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[8] Internal Revenue Service (IRS), Statistic of Income. http://www.irs.gov/pub/irs-soi/04es01fyx.xls

[9] Brian G. Raub, "Personal Wealth, 2004," IRS, Statistics of Income Bulletin, Fall 2008. http://www.irs.gov/pub/irs-soi/08fallbulpw.pdf

Second, the analogy is simply wrong. If there was a 150 percent tax on the returns from investments, one could just put their money in a vault and avoid the tax. There would be some feasible (although not ideal) way to avoid such a tax. But, as explained earlier on, a person with $10 million doesn't really have any alternative to investing it. (See the caviar/cruise/cocaine discussion above.)

So the idea that the estate tax will result in fabulously wealthy people cutting back their investment and savings seems, once again, far-fetched to say the least.

Report Authors Seem to Think Roads, Schools, Policy and Army Serve No Benefit

Perhaps the strangest thing about the report by Holtz-Eakin and Smith and the report by Entin is that both assume taxes are collected by the government and then simply disappear. There is no thought given to the public services that are funded by taxes of all kinds. Of course, this approach leads both studies to conclude that repealing the estate tax would boost the economy, since no other conclusion is possible.

For example, Entin creates a mathematical model that includes a factor representing the cost taxes allegedly impose on the economy, but includes no factor representing the benefits of public services.

Obviously, any model that accounts for the costs, but not the benefits, of a particular thing is going to come to the conclusion that the thing being modeled is costly. It's difficult to imagine a respectable, peer-reviewed academic journal publishing an analysis this blatantly one-sided.

To put this in more concrete terms, if Congress repealed the estate tax, it would have to then cut public services in some way since there would be less revenue to fund public services. But what could Congress cut without doing more harm to the economy? Should Congress spend less on roads and schools to pay for repealing the estate tax? Couldn't one argue that this will have a negative impact on the economy, since transportation is crucial to commerce and education is key to a productive workforce?

Or do the authors of these reports think spending on law enforcement should be cut? Business tends to thrive in places where crime is kept to a minimum, so cutting law enforcement could hurt the economy at least as much as taxing the estates of dead millionaires.

Or should defense spending be cut? We don't think of this very often, but one thing that makes the U.S. an attractive place for investment is that we make this country such a difficult place to invade. It's at least plausible that lowering our defenses would make investment a little more risky.

Or do the authors believe that cuts in spending would not be necessary, and that increased budget deficits would be perfectly healthy for the economy?

These are questions that the authors of the two "studies" choose not to answer.

Does Congress Tax People Just for the Hell of It?

One has to wonder why Congress would bother to tax people at all if the tax dollars are not used to provide something beneficial to society and to our economy.

And besides, Entin argues, Congress could raise revenue by actually *cutting* taxes.

A true supply-sider, Entin believes that repealing the estate tax will increase investment so much, creating so many jobs and so much additional income, that the Treasury will actually collect more in taxes than it would lose.

Entin uses what supply-siders call "dynamic" analysis of the revenue effects of a change in tax policy. Whereas traditional analysis mostly views a tax cut as a loss of revenue for the Treasury, dynamic analysis takes into account the claimed benefits to the economy that allegedly result from a tax cut, and which might lead to increases in tax revenue that more than offsets the tax cut.

Now, if tax cuts could ever possibly pay for themselves, you really have to wonder why members of Congress don't unanimously enact more of them. Why would Congress ever raise taxes? Do they just enjoy it?

Obviously Congress only imposes taxes when it needs to pay for government services that the public wants more desperately than it wants a tax cut. If lawmakers could raise revenue by actually *cutting* taxes, of course there would be unanimous consent on that approach.

But the idea that tax cuts pay for themselves or increase revenue is not remotely supported by any evidence. Even President George W. Bush's Treasury eventually concluded that tax cuts do not pay for themselves.[10] And Holtz-Eakin, as head of the Congressional Budget Office, used dynamic analysis and eventually found that the positive revenue effects of tax cuts were tiny and could never offset but a fraction of the revenue losses that resulted.[11]

Perhaps that's why the estate tax study by Holtz-Eakin and Smith does not make such wild claims about revenue. But their study also has an odd way of assuming that

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[10] Robert S. McIntyre, "Report Retort," *American Prospect*, July 28, 2006. http://www.prospect.org/cs/articles?article=report_retort

[11] David Leonhardt, "Weighing a McCain Economist," *New York Times*, April 23, 2008. http://www.nytimes.com/2008/04/23/business/23leonhardt.html

Congress simply imposes taxes for no reason at all, since they argue for cutting the estate tax without telling us how Congress should deal with the resulting loss of revenue.

If You Think the Rich Should Pay Less and the Poor Should Pay More, Just Say That

Actually, they do imply an answer. They blithely note that the federal estate and gift taxes combined bring in around 2 percent of federal revenue and conclude, without any analysis, that the loss of this revenue "may be relatively easily offset with changes to the remainder of the revenue structure."

Asking Congress to "change the revenue structure" (i.e., raise taxes) to replace the 2 percent of the revenue they want to give to the richest one percent of Americans is pretty remarkable.

There is no tax that is more progressive than the estate tax. Almost any tax that replaces the estate tax would impact families less wealthy than the families who benefit from estate tax repeal.

And now we get to the heart of the matter. Forget these crazy econometric models with their bizarre assumptions and long equations. These folks believe it's wrong to ask some people to pay taxes at higher rates just because they have 500 times more than you and me. It is simply a philosophical matter to them.[12]

People who simply oppose progressive taxes are entitled to their opinion. But if they would just say that at the outset, it sure would save us from having to read all these equations with numbers and funny letters that claim to prove something about how taxes impact the economy.

[12] The idea that the tax system is currently too progressive seems to be driven by ideology rather than facts. Looking at the tax system as a whole (including all types of taxes paid at the federal, state and local levels) the share of taxes paid by a given income group roughly corresponds to the share of total income received by that group. For example, in 2008 the richest one percent of taxpayers paid 23 percent of the total taxes, but they also received 22.2 percent of the total income. The poorest 20 percent of taxpayers paid 2 percent of total taxes, but they only received 3.2 percent of total income. Citizens for Tax Justice, "Is Tax Day Too Burdensome for the Rich? The U.S. Tax System Is Not as Progressive as You Think," April 13, 2009. http://www.ctj.org/pdf/taxday2009.pdf