

# DEMOCRACY, TAXES, AND WEALTH

JAMES R. REPETTI\*

*Congress adopted an estate tax in 1916 in response to concerns about the harmful social effects of wealth concentration. Recently, proposals have been put forward to abolish the estate tax. Professor Repetti explores traditional justifications for the estate tax and reviews political and economic research on the effects of wealth concentration. He determines that wealth concentration is detrimental to the nation's long-term economic growth because it creates educational disadvantages for the poor and sociopolitical malaise. It also harms the democratic process because it gives the affluent a disproportionately large political voice. He then evaluates the current estate tax and concludes that it provides the important benefits of decreasing dynastic wealth concentration and raising revenues. Moreover, empirical studies suggest that the tax does not discourage savings.*

## INTRODUCTION

Proposals to repeal the estate tax reflect growing disfavor with the use of a tax system to redistribute wealth.<sup>1</sup> This discontent is a reversal from prior years. Politicians had been concerned earlier about the adverse social effects of wealth concentration. For example, in 1935, fears about the effects of concentrated wealth prompted President Franklin D. Roosevelt to propose expanding transfer taxes. He stated that those large accumulations of wealth “amount to the perpetuation of great and undesirable concentration of control in a relatively few individuals over the employment and welfare of many, many others.”<sup>2</sup>

By the middle part of the twentieth century, the increased wealth concentration that Roosevelt feared had not developed. Wealth concentration in the United States decreased from 1929 to 1979.<sup>3</sup> The share of our country's net worth held by the top one percent of

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\* Professor of Law, Boston College Law School. B.A., 1975, Harvard; J.D., M.B.A., 1980, Boston College. The author thanks Catherine Wells, Marjorie Kornhauser, Karen Burke, Paul Caron, Hugh Ault, Joel Dobris, Joseph Dodge, Sanford Katz, and Paul McDaniel for insightful comments on earlier drafts. The author also thanks Amanda Gaul and Charles Glover for helpful research assistance, and Donna Gattoni and Donna McDermott for help in preparing the manuscript.

<sup>1</sup> Congress passed a bill repealing the estate tax in 1999. Death Tax Elimination Act, H.R. 8, 106th Cong. (1999). However, President Clinton vetoed the bill and House Republicans failed to override the veto. Ryan J. Donmoyer, House Fails to Override Clinton Veto of Estate Tax Repeal Bill, 88 Tax Notes 1292, 1292 (2000).

<sup>2</sup> Franklin D. Roosevelt, Message to Congress (June 19, 1935), in H.R. Rep. No. 74-1681, at 2 (1935).

<sup>3</sup> Edward N. Wolff, Top Heavy app. at 62 tbl.A-1 (1995).

wealthiest households declined from more than 44.2% in 1929 to 20.5% in 1979.<sup>4</sup> During the same period, productivity grew rapidly.<sup>5</sup> Beginning in the early 1980s, however, the share of net worth held by the top 1% increased markedly, and by 1989, it had grown to 35.7%.<sup>6</sup> After 1989, the concentration of wealth held steady.<sup>7</sup> The result was that at the end of the twentieth century, wealth was more concentrated in the United States than in the United Kingdom.<sup>8</sup> This was a reversal from the early years of the twentieth century when the U.S. tradition of “economic democracy” had resulted in a much lower concentration than the “royalist legac[y]” of Britain.<sup>9</sup>

This Article explores two important issues arising from the increased concentration in wealth. First, is President Roosevelt’s concern about the adverse impact of wealth concentration legitimate? What social harms might arise from the concentration of wealth in the same family from generation to generation? Second, should the tax system be used to decrease wealth concentration by taxing wealth transfers?

To answer the first question, this Article explores the economic and political science literature to examine the effects of wealth concentration on economies and democracies. Despite the fact that tax policy literature often refers to the prevention of wealth concentration as an important objective of wealth transfer taxation,<sup>10</sup> tax policy com-

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<sup>4</sup> *Id.* Net worth is defined as the value of real estate, securities, cash and demand deposits, pension plans, unincorporated businesses, and interests in trusts, less debt. *Id.* at 1.

<sup>5</sup> The growth rate of multifactor productivity for the period 1929-1996 was as follows:

|           |       |
|-----------|-------|
| 1928-1950 | 1.90% |
| 1950-1964 | 2.35% |
| 1964-1972 | 2.07% |
| 1972-1979 | 1.12% |
| 1979-1988 | 0.90% |
| 1988-1996 | 0.67% |

Robert J. Gordon, *U.S. Economic Growth Since 1870: One Big Wave?*, 89 *Am. Econ. Rev.* 123, 124 (1999).

<sup>6</sup> Wolff, *supra* note 3, app. at 62 tbl.A-1.

<sup>7</sup> Edward N. Wolff, *Recent Trends in the Size Distribution of Household Wealth*, *J. Econ. Persp.*, Summer 1998, at 131, 135.

<sup>8</sup> *Id.* at 149.

<sup>9</sup> Bruce Ackerman & Anne Alstott, *The Stakeholder Society* 95 (1999); see also Wolff, *supra* note 3, at 23 fig.5-1 (comparing wealth distribution in United States and United Kingdom from 1920 to 1990).

<sup>10</sup> For reviews of various justifications for the estate tax, see, for example, Mark L. Ascher, *Curtailing Inherited Wealth*, 89 *Mich. L. Rev.* 69, 87-99 (1990) (reviewing reasons to curtail inheritance, including leveling playing field and increasing charitable giving); Charles Davenport & Jay A. Soled, *Enlivening the Death-Tax Death-Talk*, 84 *Tax Notes* 591, 597-602 (1999) (reviewing justifications for estate tax, including raising revenue, progressivity, and diminishing concentrations of wealth); Louis Eisenstein, *The Rise and Decline of the Estate Tax*, 11 *Tax L. Rev.* 223, 235-36 (1956) (describing Roosevelt’s justifi-

mentators have ignored the burgeoning literature in political science and economics that explores the harmful impact of wealth concentration on democracies. Wealth concentration correlates with poor economic growth because of educational disadvantages for the poor and sociopolitical malaise.<sup>11</sup> Wealth concentration also harms the democratic process because it gives too much power to the affluent.<sup>12</sup> This Article suggests, therefore, that President Roosevelt's concern continues to be legitimate and needs to be addressed today.

To answer the second question, this Article examines rationales for including or excluding wealth transfers from a tax base. Approximately fifty percent of the wealth in this country is inherited.<sup>13</sup> This Article argues, therefore, that because of the harmful impact of wealth concentration, it is appropriate to design a tax system to raise revenues and to prevent wealth concentration, so long as the benefits of such prevention outweigh any harms. Rather than attempt to design a new system and then speculate about the new design's effects, this Article examines our current federal wealth transfer tax to determine whether it raises revenues and reduces wealth concentration. Despite the many flaws in our system, the evidence suggests that the benefits of taxing wealth transfers outweigh any associated harms. As a result, this Article concludes that the tax system should continue to be used to help disperse wealth.

This Article is organized as follows. Part I places the current debate in context by briefly summarizing the historic views of philosophers, economists, and political scientists about wealth concentration and wealth taxes. It then explores the legitimacy of the historic concerns about wealth concentration. It shows that empirical studies about the impact of wealth concentration on economic growth and about the disproportionate impact of wealth on the political process have proven that concerns about wealth concentration are legitimate. Part II then addresses whether the tax system should be used to decrease concentration of wealth. It argues that since a large portion of

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cation for estate tax as means of preventing overconcentration of wealth); Michael J. Graetz, *To Praise the Estate Tax, Not to Bury It*, 93 *Yale L.J.* 259, 269-73 (1983) (describing role of estate tax in providing progressivity in tax system); Harry L. Gutman, *Reforming Federal Wealth Transfer Taxes After ERTA*, 69 *Va. L. Rev.* 1183, 1190-92 (1983) (discussing role of estate tax in ensuring that wealth derived from tax-preferred sources is subject to tax); James R. Repetti, *The Case for the Estate and Gift Tax*, 86 *Tax Notes* 1493, 1494-1500 (2000) (reviewing estate tax objectives of raising revenues, preventing wealth concentration and family dynasties, encouraging charitable contributions, and making income tax more progressive).

<sup>11</sup> See *infra* Parts I.B.3 and I.B.4.

<sup>12</sup> See *infra* Part I.C.

<sup>13</sup> See *infra* note 142.

wealth in the United States is received by bequests or gifts, a federal wealth transfer tax is appropriate. It shows that, despite the many flaws of the American system, the federal wealth transfer tax raises revenues and helps disperse wealth in the United States.

## I

### AN EXAMINATION OF WEALTH CONCENTRATION

Part I.A provides a brief history of philosophers' views of wealth transfers. Then, Part I.B examines the macroeconomic studies of the impact of wealth concentration on economic productivity. Most of the published studies agree that high concentrations of wealth correlate with poor economic growth over the long term.<sup>14</sup> Next, Part I.C reviews the political science literature analyzing the effects of wealth on the political process. Those studies suggest that the political process is adversely affected by wealth.<sup>15</sup> Part I.D then argues that the adverse effects of concentrated wealth are particularly strong where the wealth is concentrated intergenerationally within the same family. This is troublesome, since approximately fifty percent of the wealth in this country is inherited or received as gifts.<sup>16</sup>

#### A. *A Brief History of the Worldly Philosophers' Views of Wealth Transfers*

For centuries, philosophers and economists have debated whether governments should curtail inherited wealth.<sup>17</sup> Philosophers have struggled with the question whether the social contract between citizens and the state requires protection of a decedent's property rights after death. John Locke, for example, argued that natural law required that parents be permitted to bequeath property to their children.<sup>18</sup> He viewed the ability to transfer property at death as a fundamental property right that the state should not abridge.<sup>19</sup>

Other philosophers, however, weighed social concerns more heavily than postmortem property rights. Jeremy Bentham, for exam-

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<sup>14</sup> See *infra* notes 39-48 and accompanying text.

<sup>15</sup> See *infra* part I.C.2.

<sup>16</sup> See *infra* note 142.

<sup>17</sup> For excellent discussions of this debate, see Ronald Chester, *Inheritance, Wealth, and Society* 11-33 (1982); Ascher, *supra* note 10, at 76-84.

<sup>18</sup> John Locke, *Two Treatises of Government* 206-07, 210 (Peter Laslett ed., Cambridge Univ. Press 1988) (1690); see also Barry W. Johnson & Martha Britton Eller, *Federal Taxation of Inheritance and Wealth Transfers*, in *Inheritance and Wealth in America* 61, 62 (Robert K. Miller, Jr. & Stephen J. McNamee eds., 1998) (summarizing Locke's theories on property inheritance).

<sup>19</sup> See Chester, *supra* note 17, at 13-14 (explaining Locke's theories).

ple, placed less importance on the entitlement of the property owner and more importance on the interests of society when he stated:

When property by the death of the proprietor ceases to have an owner, the law can interfere in its distribution, either by limiting in certain respects the testamentary power, in order to prevent too great an accumulation of wealth in the hands of an individual; or by regulating the succession in favour of equality in cases where the deceased has left no consort, nor relation in the direct line, and has made no will. The question then relates to new acquirers who have formed no expectations; and equality may do what is best for all without disappointing any.<sup>20</sup>

John Stuart Mill similarly favored taxing legacies heavily. He stated: "It is not the fortunes which are earned, but those which are unearned, that it is for the public good to place under limitation."<sup>21</sup> William Blackstone also asserted that there was no natural right to bequeath property at death, and, therefore, that the government could control transfers of property from the dead to the living.<sup>22</sup>

The debate among philosophers continues today. The modern philosopher John Rawls has advocated inheritance and gift taxes in order "gradually and continually to correct the distribution of wealth and to prevent concentrations of power detrimental to the fair value of political liberty and fair equality of opportunity."<sup>23</sup> In contrast, another modern commentator has argued that taxing bequests violates a major tenet of what he characterizes as "liberal" norms because, he asserts, the estate tax discourages saving.<sup>24</sup>

While philosophers debated the right to tax wealth transfers, economists examined the efficiency effects of restricting wealth transfers. Portending the argument of some present economists, Adam Smith asserted that death taxes transfer productive capital from private citizens to the government, "which seldom maintains any but un-

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<sup>20</sup> Jeremy Bentham, *Principles of the Civil Code*, in *The Theory of Legislation* 88, 122 (C.K. Ogden ed., Harcourt, Brace & Co. 1931) (1802).

<sup>21</sup> John Stuart Mill, *Principles of Political Economy* 808 (W.J. Ashley ed., Longmans, Green & Co. 1923) (1848).

<sup>22</sup> 2 William Blackstone, *Commentaries* \*10-\*13; see also Chester, *supra* note 17, at 19 (noting Blackstone's criticism of natural law argument).

<sup>23</sup> John Rawls, *A Theory of Justice* 277 (1971).

<sup>24</sup> Edward J. McCaffery, *The Uneasy Case for Wealth Transfer Taxation*, 104 *Yale L.J.* 283, 295-96 (1994). In the text I place quotation marks around the word "liberal" because, as Eric Rakowski has stated, "[l]iberalism is a woolly doctrine, a canopy sheltering a colorful array of theories . . ." Eric Rakowski, *Transferring Wealth Liberally*, 51 *Tax L. Rev.* 419, 419 (1995). See *infra* Part II.C for a discussion of the empirical evidence that suggests that taxation has a minimal effect on saving.

productive labourers."<sup>25</sup> Similarly, David Ricardo argued that death taxes prevented the efficient use of capital.<sup>26</sup> Some economists today, who argue that the estate tax discourages investment and saving, advance this argument.<sup>27</sup> Another strain of argument against death taxes can be found in the work of economist Leon Faucher, who argued that inheritance maximizes utility because it confers benefits on the transferor and transferee.<sup>28</sup> Presently, some have suggested that there is a net gain of social welfare in a system which does not tax wealth transfers.<sup>29</sup>

Finally, early political scientists expressed concerns about the effect that the transfer of wealth from generation to generation may have on political institutions. Alexis de Tocqueville described this concern when he stated:

When the legislator has once regulated the law of inheritance, he may rest from his labor. The machine once put in motion will go on for ages, and advance, as if self-guided, towards a point indicated beforehand. When framed in a particular manner, this law unites, draws together, and vests property and power in a few hands; it causes an aristocracy, so to speak, to spring out of the ground. If formed on opposite principles, its action is still more rapid; it divides, distributes, and disperses both property and power. Alarmed by the rapidity of its progress, those who despair of arresting its motion endeavor at least to obstruct it by difficulties and impediments. They vainly seek to counteract its effect by contrary efforts; but it shatters and reduces to powder every obstacle, until we can no longer see anything but a moving and impalpable cloud of dust, which signals the coming of the Democracy.<sup>30</sup>

Thomas Jefferson and Thomas Paine shared this view. Jefferson wrote in a 1789 letter to James Madison: "[T]he earth belongs in usufruct to the living; . . . the dead have neither powers nor rights over it.

<sup>25</sup> Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* 391 (Edwin Cannan ed., Univ. of Chi. Press 1976) (1776).

<sup>26</sup> David Ricardo, *Principles of Political Economy and Taxation* 107 (Prometheus Books 1996) (1817).

<sup>27</sup> E.g., Douglas Holtz-Eakin, *The Death Tax: Investments, Employment, and Entrepreneurs*, 84 *Tax Notes* 782 (1999) (arguing that estate taxes adversely affect entrepreneurial activity). But see James R. Repetti, *Entrepreneurs and the Estate Tax*, 84 *Tax Notes* 1541 (1999) (arguing that Holtz-Eakin's methodology in fact shows that estate taxes do not materially affect saving and entrepreneurial activity).

<sup>28</sup> Leon Faucher, *Property*, in 3 *Cyclopedia of Political Science, Political Economy and of the Political History of the United States* 383, 389-390 (John J. Lalor ed., New York, Charles E. Merrill & Co., 1888).

<sup>29</sup> See generally Louis Kaplow, *A Note on Subsidizing Gifts*, 58 *J. Pub. Econ.* 469 (1995).

<sup>30</sup> Alexis de Tocqueville, *1 Democracy in America* 48 (Henry Reeve trans., Alfred A. Knopf 1945) (1835).

The portion occupied by any individual ceases to be his when [he] ceases to be[,] and [it] reverts to the society.”<sup>31</sup> Similarly, Paine wrote: “[No] generation [has] a property in the generations which are to follow. . . . It is the living, and not the dead, that are to be accommodated. When man ceases to be, his power ceases with him . . . .”<sup>32</sup>

Many state legislatures in the United States disfavored devices which had been utilized in Great Britain to transfer family estates from generation to generation—trusts, primogeniture, and entail.<sup>33</sup> For example, the Massachusetts courts refused to enforce trusts<sup>34</sup> until the Massachusetts legislature adopted a statute permitting their enforcement in 1817.<sup>35</sup> For its first 150 years, however, the United States federal government only used an inheritance tax to raise revenue during times of war. It was not until President Theodore Roosevelt proposed adopting a heavily progressive income tax in 1906 that national focus shifted to using the tax to prevent concentrations of wealth as well as to raise revenues. He proposed a tax to prevent “the owner of one of these enormous fortunes to hand more than [a] certain amount to any one individual.”<sup>36</sup> The estate tax was not actually adopted until 1916.<sup>37</sup> At that time, the economist Irving Fisher urged an estate tax to address the “danger of an *hereditary* plutocracy” to “democratic ideals.”<sup>38</sup>

Should we care about the concentration of wealth? Some of the philosophers and politicians referenced above were concerned about the impact of wealth concentration on the economy and the democratic process. But there were no empirical studies to support or contradict their concerns. Currently, however, there is a burgeoning literature in economics and political science that supports them.

### B. *The Macroeconomic Effects of Wealth Concentration*

Economic studies are remarkably unanimous in suggesting that high concentrations of wealth correlate with poor economic performance in the long run. A survey of the studies stated: “[S]everal stud-

<sup>31</sup> Letter from Thomas Jefferson to James Madison (Sept. 6, 1789), in 5 *The Writings of Thomas Jefferson* 115-16 (Paul Leicester Ford ed., 1895) (quotation marks omitted).

<sup>32</sup> 1 *The Complete Writings of Thomas Paine* 251 (Philip S. Foner ed., 1969).

<sup>33</sup> Peter Dobkin Hall & George E. Marcus, *Why Should Men Leave Great Fortunes to Their Children?*, in *Inheritance and Wealth in America*, supra note 18, at 139, 142.

<sup>34</sup> *Prescott v. Tarbell*, 1 Mass. (1 Will.) 204, 208 (1804).

<sup>35</sup> Mass. Gen. Laws ch. 87 § 1 (1818); see also Hall & Marcus, supra note 33, at 145 (noting enactment of trust legislation in Massachusetts).

<sup>36</sup> Theodore Roosevelt, *Speech at the House of Representatives Office Site* (April 14, 1906), quoted in Chester, supra note 17, at 60.

<sup>37</sup> Act of September 8, 1916, ch. 463, 39 Stat. 777-780, 1002 (1916).

<sup>38</sup> Irving Fisher, *Some Impending National Problems*, 24 *J. Pol. Econ.* 694, 711 (1916).

ies have examined the impact of inequality upon economic growth. The picture they draw is impressively unambiguous, since they all suggest that greater inequality reduces the rate of growth."<sup>39</sup> Because data about wealth concentration are often difficult to obtain for extended periods in some countries, many studies use concentrations of income as a proxy for wealth. Economists believe that this does not alter the results, because concentrations of income follow the same patterns as concentrations of wealth in those countries for which both sets of data are available.<sup>40</sup>

Published studies that have examined twenty-five-year periods have found that high income concentration at the beginning of the twenty-five-year period correlates with poor economic growth in the subsequent twenty-five years.<sup>41</sup> For example, one study found that

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<sup>39</sup> Philippe Aghion et al., *Inequality and Economic Growth: The Perspective of the New Growth Theories*, 37 *J. Econ. Lit.* 1615, 1617 (1999).

<sup>40</sup> E.g., Aghion et al., *supra* note 39, at 1617-18; Roberto Perotti, *Growth, Income Distribution, and Democracy: What the Data Say*, 1 *J. Econ. Growth* 149, 154 (1996).

<sup>41</sup> E.g., Alberto Alesina & Dani Rodrik, *Distribution, Political Conflict and Economic Growth: A Simple Theory and Some Empirical Evidence*, in *Political Economy, Growth, and Business Cycles* 23, 34 (Alex Cukierman et al. eds., 1992) [hereinafter Alesina & Rodrik, *Distribution*] (describing results of model where increases in income shares of wealthiest population segments are associated with decreases in growth); Alberto Alesina & Dani Rodrik, *Distributive Politics and Economic Growth*, 109 *Q.J. Econ.* 465, 481 (1994) [hereinafter Alesina & Rodrik, *Distributive Politics*] (summarizing results of study as indicating that income inequality and subsequent growth are negatively correlated); François Bourguignon, *Growth, Distribution, and Human Resources*, in *En Route to Modern Growth: Latin America in the 1990s* at 43, 58 (Gustav Ranis ed., 1994) (describing inverse relationship between income inequality and growth suggested by study); Perotti, *supra* note 40, at 159 (finding that growth is positively associated with income equality); Torsten Persson & Guido Tabellini, *Growth, Distribution, and Politics*, in *Political Economy, Growth, and Business Cycles*, *supra*, at 11-15, 18 [hereinafter Persson & Tabellini, *Growth*] (concluding that income inequality is bad for growth); Torsten Persson & Guido Tabellini, *Is Inequality Harmful for Growth?*, 84 *Am. Econ. Rev.* 600, 607, 617 (1994) [hereinafter Persson & Tabellini, *Inequality*] (same).

It is important to note that rapid growth occasionally can occur, even with high concentrations of income, because many factors influence growth. For example, one commentator has suggested that the rapid growth in the late 1990s was attributable to an explosive increase in the use of computers. Pam Woodall, *Survey: The New Economy*, *The Economist*, Sept. 23, 2000, insert after 66, at 11-19. The studies of twenty-five years or more obviously span periods of both rapid growth and recession. The authors of the studies constructed multiple regression models that included several factors, in addition to income concentration, that may impact growth. The authors then tested their models using empirical data for the periods. The results of the regression models in all the studies show that there is statistically significant negative correlation between income concentration at the beginning of the period and subsequent growth. That is, high income concentration appears to be related to poor growth during the period, accounting for all other parameters included in the regression models. The findings of the long-term studies suggest that even in periods of rapid productivity growth, high concentrations of income cause slower growth than it otherwise would have been. Thus, wealth concentration is a serious matter, even during periods of high growth.

growth rates in per capita gross domestic product for the period from 1960 to 1985 in sixty-five democratic countries were correlated negatively with the portion of national income earned by the top five percent and twenty percent of earners in 1960.<sup>42</sup> The more concentrated income was, the lower the growth rate in productivity.<sup>43</sup> Another study of eighty countries, consisting of democracies and nondemocracies, found that over twenty-five years, "a more unequal size distribution of income is bad for growth in democracies, while more land concentration is bad for growth everywhere."<sup>44</sup> A similar study of sixty-seven countries for the period from 1960 to 1985 also found that unequal income distribution at the beginning of the period correlated with poor economic growth during the ensuing twenty-five year period.<sup>45</sup>

The majority of studies that have employed shorter periods of twenty, eighteen, fifteen, or ten years also have found that high concentrations of income at the start of the period correlate with poor economic growth during the period. For example, a study of the United States and eight European countries that divided data from the years 1830-1985 into seven twenty-year periods and one fifteen-year period (1970-1985) found that concentrated income distribution at the start of each period correlated with poor economic growth during that period.<sup>46</sup> Similarly, another study found that income inequality in 1970 correlated with poor growth for the period of 1970-1988.<sup>47</sup> A third study of sixteen industrial nations found that those countries with the greatest income inequality in 1980 (Australia and the United States) tended to have the lowest productivity growth during the ensuing ten years, while countries with greater equality had higher growth.<sup>48</sup> The findings of this study are reproduced below in Chart 1.

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<sup>42</sup> Alesina & Rodrik, *Distribution*, supra note 41, at 34-43; see also Alesina & Rodrik, *Distributive Politics*, supra note 41, at 481.

<sup>43</sup> Alesina & Rodrik, *Distribution*, supra note 41, at 23, 34-43; see also Alesina & Rodrik, *Distributive Politics*, supra note 41.

<sup>44</sup> Persson & Tabellini, *Growth*, supra note 41, at 18; see also Klaus Deininger & Lyn Squire, *New Ways of Looking at Old Issues: Inequality and Growth*, 57 *J. Dev. Econ.* 259, 266-69 (1998) (finding that inequality in initial land distribution in 1960 correlated with poor economic growth for period 1960-1992).

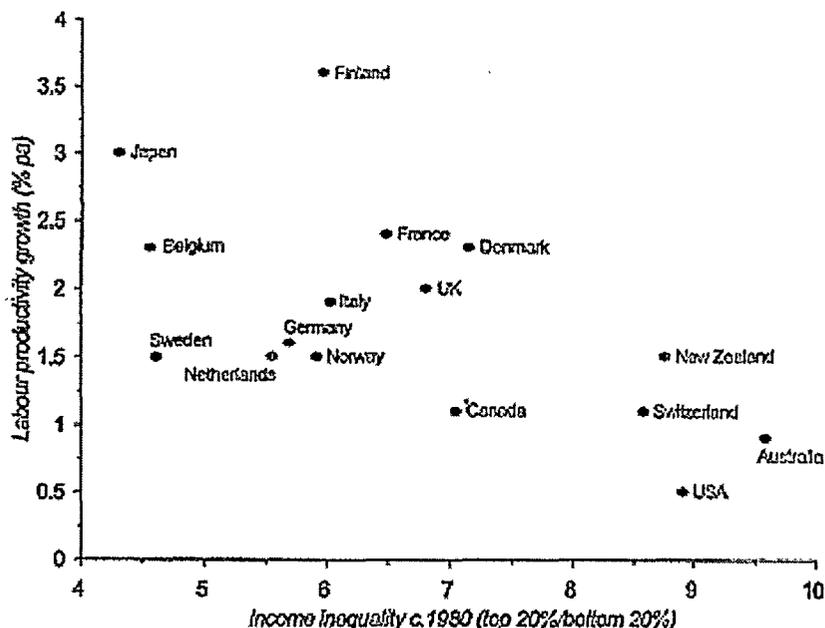
<sup>45</sup> Perotti, supra note 40, at 182.

<sup>46</sup> Persson & Tabellini, *Inequality*, supra note 41.

<sup>47</sup> George R.G. Clarke, *More Evidence on Income Distribution and Growth*, 47 *J. Dev. Econ.* 403, 422-24 (1995).

<sup>48</sup> Andrew Glyn & David Miliband, *Introduction to Paying for Inequality: The Economic Cost of Social Injustice* 1, 2-3 (Andrew Glyn & David Miliband eds., 1994).

CHART 1<sup>49</sup>  
 Productivity Growth vs. Income Inequality  
 in Cross-National Data, 1979-1990



One study conflicts with the results for ten-year periods. It included different countries and found that high inequality at the start of a ten-year period appeared related to high growth in wealthy countries but to low growth in poor countries.<sup>50</sup> Another recent study that used ten-year periods suggests that the relationship between inequality and growth for ten-year periods may be more complex than the other ten-year studies indicate. It found that *changes* in inequality (either positive or negative) correlate with slower growth.<sup>51</sup>

Where periods shorter than ten years are used, the results are more contradictory. Two studies that used five-year periods found that income inequality at the start of the period correlated with high growth during the period.<sup>52</sup> Another study, however, determined that

<sup>49</sup> Id. at 3 (reprinting data from World Bank and Organisation for Economic Cooperation and Development).

<sup>50</sup> Robert J. Barro, *Inequality, Growth, and Investment* 32 (Nat'l Bureau of Econ. Res., Working Paper No. 7038, 1999).

<sup>51</sup> Abhijit V. Banerjee & Esther Duflo, *Inequality and Growth: What Can the Data Say?* 2 (Mass. Inst. Tech., Working Paper No. 00-09, 2000).

<sup>52</sup> Andrea Brandolini & Nicola Rossi, *Income Distribution and Growth in Industrial Countries*, in *Income Distribution and High-Quality Growth* 69, 87-89 (Vito Tanzi & Ke-young Chu eds., 1998); Hongyi Li & Heng-Fu Zou, *Income Inequality is Not Harmful*

inequality in one year correlated with poor growth the following year.<sup>53</sup>

As summarized in Table 1, the foregoing studies clearly suggest that over a long period of time, wealth concentration hurts economic growth. All the published studies that have examined periods of twenty-five years have concluded that inequality at the start of the period correlates with poor economic growth during the period. Similarly, most of the studies that have examined periods of at least ten years have found that high levels of inequality correlate with poor economic growth. In contrast, the results of studies using periods of five years or less are mixed.

TABLE 1

| Authors                    | Time Period | Negative Correlation Between Initial Inequality and Subsequent Growth in Period | Positive Correlation Between Initial Inequality and Subsequent Growth in Period | Negative Correlation Between Changes in Inequality and Growth |
|----------------------------|-------------|---|---|---|
| Alesina & Rodrik (1992)    | 25          | X   |   |   |
| Alesina & Rodrik (1994)    | 25          | X   |   |   |
| Bourguignon (1999)         | 25          | X   |   |   |
| Deininger & Squire (1998)  | 25          | X   |   |   |
| Persson & Tabellini (1992) | 25          | X   |   |   |
| Perotti (1996)             | 25          | X   |   |   |
| Persson & Tabellini (1994) | 20          | X   |   |   |
| Clarke (1995)              | 18          | X   |   |   |
| Glyn & Miliband (1994)     | 10          | X   |   |   |
| Banerjee & Duflo (2000)    | 10          |   |   | X   |
| Barro (1999)               | 10          |   | X   |   |
| Li & Zou (1998)            | 5           |   | X   |   |
| Brandolini & Rossi (1998)  | 5           |   | X   |   |
| Banerjee & Duflo (2000)    | 1           | X   |   |   |

The long-term studies strongly challenge the conventional textbook maxim that “inequality is good for incentives and therefore good for growth . . . .”<sup>54</sup> The conventional wisdom was that inequality should contribute to increased growth because: (1) the wealthy had a higher marginal propensity to save than the poor; (2) only the wealthy could make the large capital commitments necessary for industrial growth; and (3) the poor would be motivated to work harder than the wealthy.<sup>55</sup>

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for Growth: Theory and Evidence, 2 Rev. Dev. Econ. 318, 327 (1998) (finding “significant, positive association” between income inequality and economic growth).

<sup>53</sup> Banerjee & Duflo, *supra* note 51, at 17-18.

<sup>54</sup> Aghion et al., *supra* note 39, at 1615.

<sup>55</sup> *Id.* at 1620.

However, the long-term studies suggest that other, more powerful forces may be involved. As a result, new explanations have been offered for why inequality corresponds with poor economic growth. As discussed below, the explanations with the most support—the presence of social unrest and the failure of countries with inequality to invest adequately in education—are also the explanations most likely to manifest themselves over a long period of time, not a short period. Thus, it is likely that the long-term studies better capture the relationship between inequality and poor economic growth than do the short-term studies.

### 1. *Kuznets's Hypothesis*

One of the early theories attempting to link inequality to growth was developed by the economist Simon Kuznets. He theorized that as a society develops from a rural to an industrial economy, inequality initially should increase because industrial workers earn higher incomes compared to rural workers.<sup>56</sup> Inequality subsequently should decrease, however, as more rural workers transition into industrial jobs.<sup>57</sup> The findings described above that link inequality to slow growth, therefore, may reflect merely the process of transition from a rural to an industrial economy. The difficulty with this explanation, however, is that inequality actually has increased in industrial countries,<sup>58</sup> contrary to Kuznets's hypothesis, leading many to question its validity.<sup>59</sup>

### 2. *Poor Fiscal Policy*

Dissatisfaction with the Kuznets hypothesis has caused some researchers to look for alternative explanations. Some scholars argue that countries with concentrated wealth experience poor growth rates because those countries seek to redistribute wealth by taxing income from capital and by applying higher rates to higher amounts of in-

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<sup>56</sup> Simon Kuznets, *Economic Growth and Income Inequality*, 45 *Am. Econ. Rev.* 1, 7-8, 12-18 (1955); see also Simon Kuznets, *Quantitative Aspects of the Economic Growth of Nations: Distribution of Income by Size*, 11 *Econ. Dev. & Cultural Change*, Jan. 1963, Part II, at 1, 67-69 [hereinafter *Kuznets, Quantitative Aspects*].

<sup>57</sup> Kuznets, *Quantitative Aspects*, supra note 56, at 67-69.

<sup>58</sup> See Josef Zweimüller, *Inequality, Redistribution, and Economic Growth 3-5* (Inst. for Empirical Res. in Econ., Univ. of Zurich, Working Paper No. 31, Jan. 2000) (noting increase in wealth concentration in industrialized countries); Deininger & Squire, supra note 44, at 275-76 (noting that inequality in several industrial countries has increased recently); supra text accompanying notes 3-9 (discussing same in United States).

<sup>59</sup> E.g., Zweimüller, supra note 58, at 3-5; Deininger & Squire, supra note 44, at 278.

come.<sup>60</sup> The theory is that in a democracy, the majority of voters will derive small amounts of income from labor and capital and, therefore, will favor higher tax rates on higher amounts of income. The higher tax rates will, in turn, discourage capital investment and thus impair growth.<sup>61</sup>

Initially, this explanation seemed to be supported by the findings of Alberto Alesina and Dani Rodrik that countries with high concentrations of wealth have low investment in capital as a percentage of their gross domestic product.<sup>62</sup> However, studies that directly have included tax rates in their regression models have found that high tax rates do not play a negative role in growth. A study of sixty-three countries (forty-five low-income and eighteen industrial) by Charles Garrison and Feng-Yao Lee found no support for the hypothesis that increases in tax rates adversely affect economic activity.<sup>63</sup> Similarly, Roberto Perotti found no empirical support for an adverse effect of taxes on the growth rate of the sixty-seven countries in his sample.<sup>64</sup> To the contrary, using the average marginal tax rate as the tax variable in his regression models, Perotti found that the coefficient for tax was positive and highly significant, suggesting that higher tax rates correlate with higher growth.<sup>65</sup>

There are many potential explanations for Perotti's findings. Perotti proposes that countries with higher tax rates may have adopted policies that increase investment in education, which pro-

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<sup>60</sup> Alesina & Rodrik, *Distribution*, supra note 41, at 23 (arguing that concentrated wealth in democracies leads to lower growth because growth-enhancing capital resources are taxed); Persson & Tabellini, *Growth*, supra note 41, at 9 (discussing theory that higher taxes discourage investment, and that investment is prediction for growth); Persson & Tabellini, *Inequality*, supra note 41, at 600 (presenting theory that policies like taxation that result in less private accumulation of capital also result in less growth); see also Giuseppe Bertola, *Factor Shares and Savings in Endogenous Growth*, 83 *Am. Econ. Rev.* 1184, 1191-92 (1993) (noting effects of distribution of wealth on fiscal policy and growth).

<sup>61</sup> Alesina & Rodrik, *Distribution*, supra note 41, at 23; Alesina & Rodrik, *Distributive Politics*, supra note 41, at 478-79.

<sup>62</sup> Alesina & Rodrik, *Distribution*, supra note 41, at 43.

<sup>63</sup> Charles Garrison & Feng-Yao Lee, *Taxation, Aggregate Activity and Economic Growth: Further Cross-Country Evidence on Some Supply-Side Hypotheses*, 30 *Econ. Inquiry* 172 (1992).

<sup>64</sup> Perotti, supra note 40, at 171.

<sup>65</sup> *Id.* at 170-71. One controversial study has found statistical support for the argument that higher marginal taxes are responsible for negative effects on the level of economic activity in countries with concentrated wealth. Reinhard B. Koester & Roger C. Kormendi, *Taxation, Aggregate Activity and Economic Growth: Cross-Country Evidence on Some Supply-Side Hypotheses*, 27 *Econ. Inquiry* 367 (1989). However, Charles Garrison and Feng-Yao Lee have concluded that the study's findings are the result of skewed data. Garrison & Lee, supra note 63, at 172.

notes productivity.<sup>66</sup> Many others also advance the failure to invest adequately in education as a likely cause of the correlation between concentrated wealth and poor productivity growth.<sup>67</sup> Alternatively, Perotti notes that countries with higher tax rates may have adopted redistributive policies that enhance social consensus and thereby increase productivity.<sup>68</sup> The following sections will discuss how investment in education and political stability that is attributable to a social consensus may promote growth.

### 3. *Failure to Invest in Education*

Many studies demonstrate the importance of education. Bruce Ackerman and Anne Alstott succinctly summarized the studies when they stated:

The statistics are strikingly consistent. Children who grow up in poor households are more likely to become teen mothers, to drop out of high school, to accumulate fewer years of education, and to perform worse on cognitive tests. Children whose parents did not complete high school are much more likely to become dropouts themselves. The adult children of the poor are more likely to be unemployed as young adults and more likely to be on welfare. Although there is significant controversy over the role of money in causing these divergent outcomes, the correlation is strong and widely acknowledged.

When we turn to the high side of the social scale, the link between money and prospects is obvious. SAT scores are strongly correlated with parental income. High-income students can more easily afford special coaching, remedial help, and private schools. And because they are more likely to attend prestigious private colleges, they have better odds of being admitted to graduate and professional schools.

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<sup>66</sup> Roberto Perotti, *Political Equilibrium, Income Distribution, and Growth*, 60 *Rev. Econ. Stud.* 755, 771-72 (1993).

<sup>67</sup> See Aghion et al., *supra* note 39, at 1622, 1648-49 (suggesting that redistribution of wealth from rich to poor increases productivity, because marginal productivity of investment for rich is lower than that for poor, particularly for investment in education); Woojin Lee & John E. Roemer, *Income Distribution, Redistributive Politics, and Economic Growth*, 3 *J. Econ. Growth* 217, 233 (1998) (arguing that, although high tax rate theoretically could reduce private investment, it also boosts public investment in activities, such as education, that promote productivity); see also Gilles Saint Paul & Thierry Verdier, *Inequality, Redistribution and Growth: A Challenge to the Conventional Political Economy Approach*, 40 *Eur. Econ. Rev.* 719, 725-26 (1996) (noting that redistribution via public education and crime reduction is not necessarily harmful for growth); cf. William Easterly & Sergio Rebelo, *Fiscal Policy and Economic Growth: An Empirical Investigation*, 32 *J. Monetary Econ.*, 417, 419, 421-22 (1993) (observing that public investment in transportation and communications positively affects growth rates but noting that effects of income tax are difficult to isolate empirically).

<sup>68</sup> Perotti, *supra* note 40, at 171-72.

All these advantages are particularly valuable at a time when the economic returns to higher education are high and rising.<sup>69</sup>

It is clear that the deprivations suffered by one generation have a long-term impact on the next generation. Studies of intergenerational income mobility find a significant correlation between parents' and children's incomes for life.<sup>70</sup> Thus, to the extent that the adverse effect of wealth concentration on economic growth is linked to a failure to invest adequately in education, the effects should appear over a long period of time.

The explanation for the link between wealth concentration and inadequate investment in education by the poor takes two forms. First, some suggest that where the poor have a difficult time borrowing, a family that is poor is constrained from investing in education.<sup>71</sup> The inability to invest in human capital traps many families in intergenerational poverty, thus slowing the nation's economic growth.<sup>72</sup> Alternatively, some suggest that there may be a more complex link between wealth, investment in education, and fertility. An increase in family wealth leads to lower fertility rates and to higher investment in human capital.<sup>73</sup> When wealth is highly concentrated, higher fertility

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<sup>69</sup> Ackerman & Alstott, *supra* note 9, at 160. For studies supporting this summary, see Robert Haveman & Barbara Wolfe, *Succeeding Generations: On the Effects of Investments in Children 188* (1994) (noting "high correlation between being a teenage unmarried mother and a wide variety of indicators of low achievement (e.g., failing to complete high school, being on welfare, being poor, and being out of the labor force)"); Christopher Jencks, *Rethinking Social Policy: Race, Poverty, and the Underclass 136-37* (1992) (explaining Chicago study that suggests strong correlation between pregnancies of unwed mothers and economic level of neighborhood); Susan E. Mayer, *What Money Can't Buy: Family Income and Children's Life Chances 44* (1997) (describing study showing that children from low-income families are more likely to have behavior problems, to become pregnant as teenagers, and to drop out of high school); Jeanne Brooks-Gunn, Greg J. Duncan & Nancy Maritato, *Poor Families, Poor Outcomes: The Well-Being of Children and Youth, in Consequences of Growing Up Poor 1, 10* (Greg J. Duncan & Jeanne Brooks-Gunn eds., 1997) (citing study showing that "income's effects on intelligence and verbal test scores [in the early childhood years] are quite large—about one-third of a standard deviation"); Robert Haveman & Barbara Wolfe, *The Determinants of Children's Attainments: A Review of Methods and Findings, 33 J. Econ. Literature 1829, 1855-63* (1995) (describing studies that show strong correlation between family income level and child education as well as likelihood of teenage pregnancy); cf. Sanders Korenman & Jane Miller, *Effects of Long-Term Poverty on Physical Health of Children in the National Longitudinal Survey of Youth, in Consequences of Growing up Poor, supra*, at 70, 97-98 (finding correlation between poverty and poor physical health).

<sup>70</sup> Gary Solon, *Intergenerational Income Mobility in the United States, 82 Am. Econ. Rev.* 393, 403-04 (1992); David J. Zimmerman, *Regression Toward Mediocrity in Economic Stature, 82 Am. Econ. Rev.* 409, 427 (1992).

<sup>71</sup> Oded Galor & Joseph Zeira, *Income Distribution and Macroeconomics, 60 Rev. Econ. Stud.* 35, 40 (1993); Perotti, *supra* note 40, at 152.

<sup>72</sup> Galor & Zeira, *supra* note 71, at 41, 43; Perotti, *supra* note 40, at 152.

<sup>73</sup> Perotti, *supra* note 40, at 177-82.

rates may result in lower investment in education, and as a result, lower productivity growth.<sup>74</sup> Perotti found direct statistical support for both versions of the explanations involving education, i.e., the borrowing constraint and the fertility models.<sup>75</sup> Support for the fertility model was somewhat stronger than for the borrowing constraint model.<sup>76</sup>

#### 4. *Sociopolitical Instability*

Perotti also has found strong support for the theory that large disparities of wealth cause sociopolitical instability, which impedes growth.<sup>77</sup> Instability discourages investment because it creates uncertainty and disrupts market activities and labor relations.<sup>78</sup> Using measures of instability such as the number of political assassinations, successful coups, unsuccessful coups, and violent deaths per million, the study found a significant negative impact on economic growth.<sup>79</sup> One need only look to the effect of social unrest in some American urban areas to appreciate the impact of such unrest on investment in those areas. Moreover, the long-lasting difficulties in attracting investment to those urban areas clearly cause a long-term waste of human capital.

#### C. *The Political Impact of Wealth*

In addition to having an adverse economic effect in the long run, concentrations of wealth have a harmful impact on the effectiveness of democracies to the extent that an objective of democracy is to give all participants an equal voice.<sup>80</sup> To understand the adverse effects of concentrations of wealth on the political system, it is helpful to review briefly the various descriptive models for democracies. Theorists propose three models to describe the manner in which a democracy may function.<sup>81</sup> The first, the "majoritarian" model, describes a parliamentary system in which voters can express their will quickly in national

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<sup>74</sup> *Id.*

<sup>75</sup> *Id.*

<sup>76</sup> *Id.*

<sup>77</sup> *Id.* at 173-77.

<sup>78</sup> *Id.* at 151; see also Jess Benhabib & Aldo Rustichini, *Social Conflict and Growth*, 1 *J. Econ. Growth* 125, 125-26 (1996) (noting study that found that investment rates are negatively correlated with political instability).

<sup>79</sup> Perotti, *supra* note 40, at 173-75, 182.

<sup>80</sup> For articles asserting that an objective of democracy is to give all participants an equal voice, see, for example, Edward B. Foley, *Equal-Dollars-Per-Voter: A Constitutional Principle of Campaign Finance*, 94 *Colum. L. Rev.* 1204, 1204 (1994); David A. Strauss, *Corruption, Equality, and Campaign Finance Reform*, 94 *Colum. L. Rev.* 1369, 1382 (1994).

<sup>81</sup> Anthony Gierzynski, *Money Rules: Financing Elections in America* 11-12 (2000).

elections in which major policy changes are debated.<sup>82</sup> The second, the “elite” model, posits that a “small political and socioeconomic elite controls our government.”<sup>83</sup> The third model is a “pluralistic” democracy in which persons and entities with common interests organize into groups to influence government.<sup>84</sup>

According to Anthony Gierzynski, most political scientists agree that the U.S. system does not fit the majoritarian model.<sup>85</sup> It is “rare that elections can bring about wholesale changes in government in the United States because the executive and legislative branches of the national and state governments (both of which hold power in the system) are elected from separate constituencies, at separate times.”<sup>86</sup> Similarly, most believe that it is unlikely that the “elite” control our government or constantly win political battles.<sup>87</sup> Instead, the majority of political scientists view the “pluralistic” model as the most descriptive one.<sup>88</sup>

However, it is not necessary to decide which model is correct. Concentration of wealth can have a significant impact on the operation of a democracy described in any of the three foregoing models because it gives the wealthy disproportionate power and influence.<sup>89</sup>

### 1. *Impact of Wealth on Communities*

The famous studies of Muncie, Indiana<sup>90</sup> in the books *Mid-*

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<sup>82</sup> *Id.* at 11.

<sup>83</sup> *Id.* at 12.

<sup>84</sup> *Id.*

<sup>85</sup> *Id.* at 11-12.

<sup>86</sup> *Id.* at 11.

<sup>87</sup> *E.g., id.*; see also Robert A. Dahl, *Who Governs? Democracy and Power in an American City* 227 (1961) (describing how numerous old American cities have undergone political revolution whereby government became controlled by nonelite); cf. John P. Heinz et al., *The Hollow Core: Private Interests in National Policy Making* 392-93 (1993) (asserting that elites prefer policy decisions to be minimally acceptable to potential participants to keep them inactive and to prevent dilution of their own influence).

<sup>88</sup> Gierzynski, *supra* note 81, at 11-12.

<sup>89</sup> Stephen Ansolabehere & James M. Snyder, Jr., *Money and Institutional Power*, 77 *Tex. L. Rev.* 1673, 1676-77 (1999) (explaining arguments that wealth is power and that campaign contributions buy influence); see also Nelson W. Polsby, *Community Power and Political Theory* 88 (1963) (noting strong political influence of one member of economic elite but speculating that this person's influence grew from political experience, not economic status).

<sup>90</sup> Though not identified at the time of publication, it was later revealed that Muncie, Indiana was the setting for the *Middletown* studies. See, e.g., John Herbers, *How They're Doing in Muncie, Ind.*, *N.Y. Times*, Apr. 18, 1982, § 7 (Book Reviews), at 11 (reviewing Theodore Caplaw et al., *Middletown Families: Fifty Years of Change and Continuity* (1982)).

*dletown*<sup>91</sup> and *Middletown In Transition*<sup>92</sup> support the notion that wealthy individuals exercise disproportionate local influence on their communities.<sup>93</sup> *Middletown* commented upon the effect that wealthy business owners have on the media through their placement of advertisements:

The growing profit in controlling the agencies of news diffusion has developed yet another use of the press—that of buttressing the interests of the business class who buy advertising; more than ever before it is the business class advertisers who are the supporters of the newspapers, rather than the rank and file of readers of the paper. It is largely taken for granted in *Middletown* that newspapers, while giving information to the reading public as best they may, must not do it in any way that will offend their chief supporters. Independence of editorial comment happens to be in rough inverse ratio to the amount of advertising carried. The leading paper rarely says anything editorially calculated to offend local business men; the weaker paper “takes a stand” editorially from time to time on such matters as opposition to child labor; while the third paper, the four-page weekly Democratic sheet, carries no advertising except such political advertising as must legally be given to a rival paper, and habitually comments freely and vociferously on local affairs.<sup>94</sup>

*Middletown* also noted that the affluent exerted control over the news content of the local newspapers:

Not only advertising and editorial comment but the actual news presented is not unaffected by *Middletown*'s dominant interests. It is generally recognized in *Middletown* that adverse news about prominent business class families is frequently treated differently,

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<sup>91</sup> Robert S. Lynd & Helen Merrell Lynd, *Middletown: A Study in American Culture* (1929).

<sup>92</sup> Robert S. Lynd & Helen Merrell Lynd, *Middletown In Transition: A Study in Cultural Conflicts* (1937).

<sup>93</sup> Others also have argued that wealthy individuals and corporations exert too much influence over the media in their communities. E.g., Ben H. Bagdikian, *The Media Monopoly* 5-6 (5th ed. 1997) (“‘Market dominant’ corporations in the mass media have dominant influence over the public’s news, information, public ideas, popular culture, and political attitudes.”); Michael Parenti, *Inventing Reality: The Politics of News Media* 33-37 (2d ed. 1993) (discussing influence of corporate owners and advertisers over media content). For example, it is alleged that the Dupont family suppressed stories and editorials when they owned the largest newspapers in Delaware. Bagdikian, *supra*, at 42.

Hollywood has expressed the theme as well. Frank Capra’s classic movie *It’s a Wonderful Life* portrayed a wealthy miser inflicting misery on his community. *It’s a Wonderful Life* (Liberty Films 1946); see also William S. Blatt, *Minority Discounts, Fair Market Value, and the Culture of Estate Taxation*, 52 *Tax L. Rev.* 225, 250 (1997) (studying how wealth concentration has surfaced as popular concept and pointing to *It’s a Wonderful Life*).

<sup>94</sup> Lynd & Lynd, *supra* note 91, at 475 (footnote omitted).

even to the point of being suppressed entirely, than news about less prominent people.<sup>95</sup>

Subsequently, *Middletown In Transition* discussed the political pressure which the affluent applied not only through the press but also through their employees:

The 1936 election witnessed perhaps the strongest effort in the city's history by the local big businessmen (industrialists and bankers) to stampede local opinion in behalf of a single presidential candidate. These men own Middletown's jobs and they largely own Middletown's press; and they made use of both sources of pressure—though not to the point of excluding summaries of President Roosevelt's speeches from the latter. . . . The pressure in the factories is reported to have been heavy and direct . . . .<sup>96</sup>

## 2. *Effect of Wealth on Elected Officials*

While analysis of the influence of wealthy individuals on their employees and on the media has been anecdotal, analysis of the effect of wealth on the electoral process and conduct of public officials has been based upon statistical analysis. The analysis shows that nearly half of all contributors making large donations (at least \$200) are individuals who have incomes over \$250,000 per year,<sup>97</sup> and that they wield significant influence.<sup>98</sup> Before evaluating these findings, it is helpful to review campaign finance law in the United States.

At first glance, it may appear that wealth could not influence the electoral process. Federal law prohibits corporations and unions from making contributions directly to candidates.<sup>99</sup> Moreover, dollar limits are imposed on contributions by individuals and political action committees (PACs). Individuals may not contribute more than \$1000 to each candidate in an election,<sup>100</sup> and PACs may not contribute more than \$5000 to each candidate in an election.<sup>101</sup>

These restrictions, however, fail to limit contributions. The use of a PAC allows individuals to circumvent the prohibitions against using their corporations or unions to influence the political process. Owners or managers of a corporation or members of a union can cause their corporation or union to form a PAC, which in turn can solicit contributions from persons associated with its sponsor, e.g., the corporation's stockholders, management, or employees, or the union

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<sup>95</sup> Id. at 476.

<sup>96</sup> Lynd & Lynd, *supra* note 92, at 360-61 (footnote omitted).

<sup>97</sup> See *infra* text accompanying note 110.

<sup>98</sup> See *infra* text accompanying notes 104-141.

<sup>99</sup> 2 U.S.C. § 441b (1994).

<sup>100</sup> Id. § 441a(a)(1)(A).

<sup>101</sup> Id. § 441a(a)(2)(A).

members.<sup>102</sup> Although the sponsoring corporation or union cannot make contributions to the PAC, it may pay the PAC's operating expenses and control the PAC's activities.<sup>103</sup>

It is also easy to circumvent the limits on the amounts of contributions to candidates. For example, individuals and the PACs they finance can spend unlimited amounts on their own advertisements to support or defeat candidates and to advocate issues.<sup>104</sup> Also, individuals can contribute unlimited amounts of so-called "soft money," defined below, to political parties. Federal Election Commission advisory opinions allow political parties to raise unlimited amounts of money from contributors of all types (including corporations and labor unions), which the parties can use to fund administrative expenses, voter registration and voter turnout programs, and state party organizations.<sup>105</sup> This type of funding is called "soft money." State organizations can use soft money for general state election campaign purposes if the contributions were legal under state law.<sup>106</sup> Large amounts of soft money are raised, and it has had a significant effect. One authority described the role of soft money in the 1996 elections as follows:

In 1996 the Republicans' national committees raised \$141.2 million. The national Democratic committees raised \$122 million. They used the money to run "issue ads" that benefited their presidential nominees; they distributed the rest to state party organizations that registered voters, campaigned on behalf of the parties' candidates (both state and federal), and got voters to the polls on election day.<sup>107</sup>

The result is that individuals (as opposed to corporations and unions) make most of the contributions to candidates and their parties. The Center for Responsive Politics has compiled the statistics on contributions in 1998, set forth in Table 2.

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<sup>102</sup> 11 C.F.R. §§ 114.1, 114.6 (2000).

<sup>103</sup> *Id.* §§ 114.5(b)-(d).

<sup>104</sup> See *Buckley v. Valeo*, 424 U.S. 1, 39-51 (1976) (per curiam) (holding unconstitutional, inter alia, \$1000 limit on expenditures "relative" to political candidates).

<sup>105</sup> FEC Advisory Opinion 1978-10 (Part A) (Aug. 29, 1978), reprinted in *Campaign Practices Guide: Federal Election Commission Advisory Opinions 1975-1984* (Cong. Q., ed. 1988); FEC Advisory Opinion 1976-72, reprinted in *Campaign Finance Reform: A Sourcebook 187-89* (Anthony Corrado et al., Brookings Inst. eds. 1997), available at <http://www.brook.edu/gs/cf/sourcecbk/chap6.pdf>; see also Gierzynski, *supra* note 81, at 45 (noting effects of congressional amendments to Federal Election Commission Act and FEC advisory opinions).

<sup>106</sup> Gierzynski, *supra* note 81, at 45.

<sup>107</sup> *Id.* (footnote omitted).

TABLE 2<sup>108</sup>  
1998 CONTRIBUTIONS TO FEDERAL CANDIDATES  
AND NATIONAL PARTIES (IN MILLIONS)

|  | Total    | Democrats | Republicans |
|--|----------|-----------|-------------|
| Small Donations (\$200 or less) from Individuals | \$351.4  | \$116.6   | \$236.8     |
| Large Donations (over \$200) from Individuals    | 463.7    | 206.8     | 252.1       |
| Political Action Committees                      | 269.2    | 129.6     | 139.4       |
| Soft Money                                       | 225.0    | 92.8      | 131.6       |
| Candidates                                       | 91.8     | 44.6      | 46.2        |
| Other  | 95.4     | 35.3      | 59.3        |
| Total  | \$1496.5 | \$625.7   | \$865.4     |

Note that total contributions from small individual donors, large individual donors, PACs (which receive their contributions from individuals), and candidates were \$1.176 billion, or approximately 79% of the total funding. Individuals may contribute an even larger portion, but aggregate data about the identity of the contributors of soft money, which can include corporations and unions, are not readily available.

A majority of the individuals making contributions are well-to-do. A study of congressional campaign contributions made in 1997 found that 81% of the contributors of \$200 or more to congressional candidates had annual family incomes of over \$100,000.<sup>109</sup> Forty-six percent of the donors had annual family incomes over \$250,000 and 20% over \$500,000.<sup>110</sup>

The contributions clearly influence election results and, as a result, cause the wealthy to have a disproportionate voice.<sup>111</sup> Studies have confirmed the important role that campaign financing plays in U.S. Senate elections,<sup>112</sup> gubernatorial contests,<sup>113</sup> and state legislative

<sup>108</sup> The Center For Responsive Politics, *The Big Picture: The Money Behind the 1998 Elections*, at Small Donations/Large Individual Donors/PACs, <http://www.opensecrets.org/pubs/bigpicture2000/overview/donations.ihtml> (last visited Apr. 13, 2001); *id.* at *Who Paid for This Election?*, [http://www.opensecrets.org/pubs/bigpicture2000/overview/who\\_paid.ihtml](http://www.opensecrets.org/pubs/bigpicture2000/overview/who_paid.ihtml) (last visited Apr. 13, 2001).

<sup>109</sup> John Green et al., *The Center for Responsive Politics, Individual Congressional Campaign Contributors: Wealthy, Conservative and Reform-Minded*, at <http://www.opensecrets.org/pubs/donors/donors.htm> (June 9, 1998).

<sup>110</sup> *Id.*

<sup>111</sup> Gierzynski, *supra* note 81, at 60.

<sup>112</sup> E.g., Alan I. Abramowitz, *Explaining Senate Election Outcomes*, 82 *Am. Pol. Sci. Rev.* 385 (1988); Charles Stewart III, *A Sequential Model of U.S. Senate Elections*, 14 *Legis. Stud. Q.* 567 (1989).

<sup>113</sup> E.g., Sarah M. Morehouse, *Money Versus Party Effort: Nominating for Governor*, 34 *Am. J. Pol. Sci.* 706 (1990); Samuel C. Patterson, *Campaign Spending in Contests for Governor*, 35 *W. Pol. Q.* 457, 475-76 (1982).

elections.<sup>114</sup> For example, in elections for open Senate seats, the financial resources and relative experience of the candidates are the most important determinants of the outcome.<sup>115</sup> Moreover, a challenger's campaign expenditures are the single most important variable affecting the incumbent senator's reelection chances.<sup>116</sup> Similarly, in elections for state legislatures, candidate spending is the "overwhelming" indicator of success where the primary elections are not preceded or followed by a convention.<sup>117</sup>

Once a candidate is elected, do the contributors exert power over the candidate? The studies have been mixed in finding a direct relationship between contributions and how senators or members of the House actually vote in highly visible roll calls on the floor.<sup>118</sup> However, the studies are much more consistent in finding evidence that the contributions do play a significant role in influencing the activities of legislators outside the limelight of roll call votes on the floor.

There is some evidence that contributions influence roll call votes on issues that do not attract significant publicity.<sup>119</sup> For example, contributions appear to have influenced votes on trucking legislation about which there was little publicity.<sup>120</sup> Similarly, contributions seem to have influenced votes on the Bank Underwriting Bill,<sup>121</sup> which received less publicity than other bills affecting the financial sector.<sup>122</sup> There also have been studies of state proceedings that found direct evidence that campaign contributions influence the voting records of state legislators.<sup>123</sup>

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<sup>114</sup> E.g., Gregory A. Caldeira & Samuel C. Patterson, *Bringing Home the Votes: Electoral Outcomes in State Legislative Races*, 4 *Pol. Behav.* 33 (1982) (discussing elections in California and Iowa); Anthony Gierzynski & David Breaux, *Legislative Elections and the Importance of Money*, 21 *Legis. Stud. Q.* 337 (1996) (analyzing twelve state legislative elections); Michael W. Giles & Anita Pritchard, *Campaign Expenditures and Legislative Elections in Florida*, 10 *Legis. Stud. Q.* 71 (1985) (examining Florida House elections).

<sup>115</sup> Abramowitz, *supra* note 112, at 397.

<sup>116</sup> *Id.*

<sup>117</sup> Morehouse, *supra* note 113, at 722.

<sup>118</sup> See generally Janet Grenzke, *Money and Congressional Behavior, in Money, Elections, and Democracy: Reforming Congressional Campaign Finance* 143 (Margaret Latus Nugent & John R. Johannes eds., 1990) (surveying studies); Richard A. Smith, *Interest Group Influence in the U.S. Congress*, 20 *Legis. Stud. Q.* 89 (1995) (same).

<sup>119</sup> See Grenzke, *supra* note 118, at 150-51 (summarizing studies).

<sup>120</sup> Woodrow Jones, Jr. & K. Robert Keiser, *Issue Visibility and the Effects of PAC Money*, 68 *Soc. Sci. Q.* 170, 170 (1987) (citing Senate vote on deregulation of trucking industry as example of closer association between campaign contributions and legislative results).

<sup>121</sup> H.R. 4040, 97th Cong. (1981).

<sup>122</sup> Jean Reith Schroedel, *Campaign Contributions and Legislative Outcomes*, 39 *W. Pol. Q.* 371, 373-74, 383 (1986).

<sup>123</sup> E.g., Michael Evans Begay, Michael Traynor & Stanton A. Glantz, *The Tobacco Industry, State Politics, and Tobacco Education in California*, 83 *Am. J. Pub. Health* 1214

One study also suggests that large contributors have greater access to elected officials than do other persons.<sup>124</sup> Laura Langbein found a strong correlation between contributions and the amount of time that elected officials spent with contributors.<sup>125</sup> Similarly, others have suggested that the patterns of campaign contributions are consistent with the pursuit of access.<sup>126</sup> PACs time their contributions around key votes in order to buy access and to encourage legislators to participate in the process.<sup>127</sup> It appears to work; Peter Calcagno and John Jackson found a correlation between PAC contributions to senators and their participation in floor votes on roll call issues.<sup>128</sup> They determined that voting participation increased as the percentage of contributions senators received from PACs increased.<sup>129</sup>

There is additional evidence that contributors seek influence. Janet M. Box-Steffensmeier and J. Tobin Grant found that PACs contribute to legislators who are successful in getting a large percentage of their sponsored bills enacted into law.<sup>130</sup> Further, a study of the Tax Reform Act of 1986<sup>131</sup> found that concerned citizens significantly increased their contributions to members of the House Ways and

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(1993) (examining tobacco industry's influence on California legislature); Stanton A. Glantz & Michael E. Begay, *Tobacco Industry Campaign Contributions Are Affecting Tobacco Control Policymaking in California*, 272 JAMA 1176 (1994) (same); Fred Monardi & Stanton A. Glantz, *Are Tobacco Industry Campaign Contributions Influencing State Legislative Behavior?*, 88 Am. J. Pub. Health 918 (1998) (examining tobacco industry's influence on state legislatures in six states). But see Jay K. Dow & James W. Endersby, *Campaign Contributions and Legislative Voting in the California Assembly*, 22 Am. Pol. Q. 334 (1994) (finding no effect of contributions by business groups or labor unions on California legislators).

<sup>124</sup> Laura I. Langbein, *Money and Access: Some Empirical Evidence*, 48 J. Pol. 1052, 1057-61 (1986) (suggesting relationship between contribution size and access).

<sup>125</sup> *Id.* at 1060-61.

<sup>126</sup> E.g., J. David Gopoian, *What Makes PACs Tick? An Analysis of the Allocation Patterns of Economic Interest Groups*, 28 Am. J. Pol. Sci. 259, 262-63 (1984) (discussing PAC desire to garner and maintain access); see also Smith, *supra* note 118, at 93-97 (summarizing studies evaluating influence of interest group contributions on voting discussions).

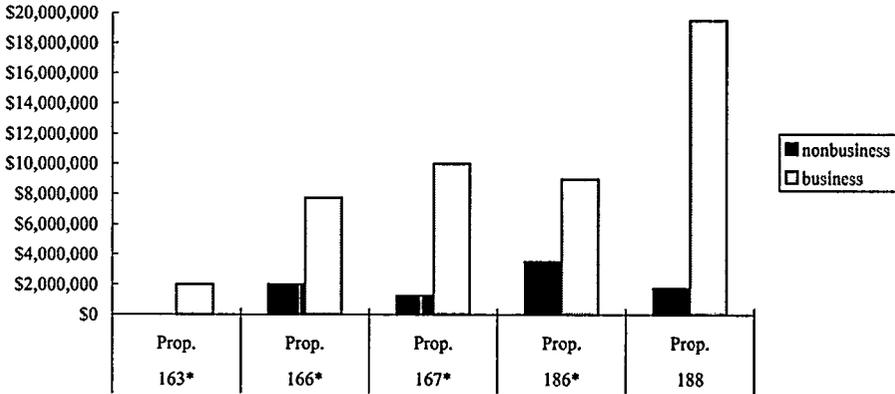
<sup>127</sup> Thomas Stratmann, *The Market for Congressional Votes: Is Timing of Contributions Everything?*, 41 J.L. & Econ. 85, 109-10 (1998) (summarizing results of study that show that date of legislative event and motivation to influence congressional voting are important determinants of contribution timing).

<sup>128</sup> Peter T. Calcagno & John D. Jackson, *Political Action Committee Spending and Senate Roll Call Voting*, 97 Pub. Choice 569, 582 (1998) (concluding that Senate voting participation is increasing because of PAC contributions).

<sup>129</sup> *Id.* at 582.

<sup>130</sup> Janet M. Box-Steffensmeier & J. Tobin Grant, *All in a Day's Work: The Financial Rewards of Legislative Effectiveness*, 24 Legis. Stud. Q. 511, 519 (1999).

<sup>131</sup> I.R.C. § 1 et seq. (1994).

CHART 2<sup>132</sup>

Prop. 163: ends taxation of certain food products

Prop. 166: basic health-care coverage

Prop. 167: state taxes

Prop. 186: health services, taxes

Prop. 188: preempt local tobacco laws

\* Business side in ballot question won

Means Committee and Senate Finance Committee during the period preceding the Act's adoption.<sup>133</sup>

Another study has found that contributions appear to motivate greater partisan activity at the committee level. Richard Hall and Frank Wayman examined the activities of members of three House committees on three bills (the Dairy Production Stabilization Act,<sup>134</sup> the Job Training Partnership Act,<sup>135</sup> and the Natural Gas Market Policy Act of 1984<sup>136</sup>) in relationship to campaign contributions.<sup>137</sup> They found that the greater the contributions, the greater the representatives' levels of committee activities consistent with the interests of the contributors.<sup>138</sup> The activities included attendance, voting, speaking, offering amendments, and behind-the-scenes negotiation.<sup>139</sup>

<sup>132</sup> Gierzynski, *supra* note 81, at 86.

<sup>133</sup> Jeffrey Milyo, *Electoral and Financial Effects of Changes in Committee Power: The Gramm-Rudman-Hollings Budget Reform, The Tax Reform Act of 1986, and the Money Committees in the House*, 40 *J.L. & Econ.* 93, 97 (1997).

<sup>134</sup> Pub. L. 98-180, 97 Stat. 1128 (1983).

<sup>135</sup> Pub. L. 97-300, 96 Stat. 1322 (1982).

<sup>136</sup> H.R. 4277, 98th Cong. (1984).

<sup>137</sup> Richard L. Hall & Frank W. Wayman, *Buying Time: Moneyed Interests and the Mobilization of Bias in Congressional Committees*, 84 *Am. Pol. Sci. Rev.* 797 (1990).

<sup>138</sup> *Id.* at 809-10, 813-15; see also Diana Evans, *Before the Roll Call: Interest Group Lobbying and Public Outcomes in House Committees*, 49 *Pol. Res. Q.* 287 (1996) (examining relationship between interest group contributions and congressional committee activities).

<sup>139</sup> Hall & Wayman, *supra* note 137, at 810-11.

Although the effect of spending on voter initiatives and referenda has not been the subject of extensive study, authors who have examined the issue also have found distortions. Anthony Gierzynski found that in ballot issues involving business interests, the business proponents greatly outspent the nonbusiness interests.<sup>140</sup> His findings are reproduced in Chart 2. Moreover, another study found that amounts spent are a key factor in determining who wins the initiative.<sup>141</sup>

#### *D. Wealth Concentration and The Role of Dynasties*

Parts A, B, and C have shown that the weight of evidence strongly supports worries about the concentration of wealth. Wealth concentration correlates with poor economic growth in the long run because of educational disadvantages for the poor and because of sociopolitical malaise generated by disparities in wealth. Moreover, concentrations of wealth enable wealthy individuals to influence disproportionately the elective and legislative process, as well as their communities. Indeed, such influence probably accounts for the difficulty Congress has adopting significant campaign finance reform that effectively limits wealthy donors' political power.

A large portion of wealth in the United States is dynastic. Studies indicate that approximately fifty percent of wealth in the United States is inherited.<sup>142</sup> In 1984, 241 of the wealthiest 400 individuals in the United States started with a significant inherited fortune.<sup>143</sup> In 1999, 149 of the 400 wealthiest individuals in the United States started with a significant inherited fortune.<sup>144</sup>

The harmful effects of wealth on the media and the political process are likely stronger in the case of dynastic wealth, as compared to

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<sup>140</sup> Gierzynski, *supra* note 81, at 86.

<sup>141</sup> Shaun Bowler et al., *Ballot Propositions and Information Costs: Direct Democracy and the Fatigued Voter*, 45 *W. Pol. Q.* 559, 564 (1992) (stating that study of ballot initiatives in California indicates positive correlation between campaign spending against proposition and percentage of vote against proposition).

<sup>142</sup> Henry J. Aaron & Alicia H. Munnell, *Reassessing the Role for Wealth Transfer Taxes*, 45 *Nat'l Tax J.* 119, 131 (1992) (finding that fifty-two percent of wealth is inherited based on life-cycle saving approach); William G. Gale & John Karl Scholz, *Intergenerational Transfers and Accumulation of Wealth*, *J. Econ. Persp.*, Fall 1994, at 145, 156-57 (finding that inheritance accounts for at least fifty-one percent of net worth accumulation when bequests are included); Laurence J. Kotlikoff & Lawrence H. Summers, *The Role of Intergenerational Transfers in Aggregate Capital Accumulation*, 89 *J. Pol. Econ.* 706, 722 (1981) (determining that majority of wealth held in 1974 was inherited). But see Franco Modigliani, *The Role of Intergenerational Transfers and Life Cycle Saving in the Accumulation of Wealth*, *J. Econ. Persp.*, Spring 1988, at 15, 18-19 (summarizing studies that show inherited wealth is less than twenty percent of individuals' total wealth).

<sup>143</sup> Dinesh D'Souza, *The Billionaire Next Door*, *Forbes*, Oct. 11, 1999, at 50, 50.

<sup>144</sup> *Id.*

wealth held by different families each generation. Where different families hold wealth each generation, it is likely that each new family will bring new perspectives, life experiences, and concerns to the political process and the media. Moreover, since the wealth will have been created by those that possess it, it is likely that such wealthholders also will have significant talents. In contrast, where wealth simply is transmitted from a generation that created it to subsequent generations in the same family, it is less certain that the subsequent generations will have new perspectives, life experiences, or great talent.<sup>145</sup> As the economist John Maynard Keynes bluntly stated: "The hereditary principle in the transmission of wealth and the control of business is the reason why the leadership of the capitalist cause is weak and stupid."<sup>146</sup>

Moreover, wealth passed from generation to generation magnifies political power. It is one thing to deal with a more powerful person than yourself; it is another to consider that your children will have to deal with the children of the powerful person, and that your grandchildren will have to deal with her grandchildren. Families seeking to preserve their power may exercise it to prevent others from acquiring wealth.<sup>147</sup> This would decrease diverse views and ideas which help create a vibrant society. In its worst form, of course, this creates a royalty, a concern addressed in a famous quote attributed to Alexis de Tocqueville: "What is most important for democracy is not that great fortunes should not exist, but that great fortunes should not remain in the same hands."<sup>148</sup>

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<sup>145</sup> See Paul Ryan, *Inheritance: Symbols and Illusion*, in *Paying for Inequality*, supra note 48, at 196-97 (arguing that when family businesses are passed down, adverse outcomes are likely in successor generations, since energy and ability of founder-owner are gone).

<sup>146</sup> John M. Keynes, 9 *The Collected Writings of John Maynard Keynes* 299 (Royal Econ. Soc'y ed., 1972).

<sup>147</sup> This parallels one of the concerns that motivated adoption of the Federal Trade Commission Act, 15 U.S.C. § 41 (1994). Legislators were concerned that businesses controlling large amounts of wealth would use it to the detriment of citizens. See, e.g., Robert H. Lande, *Wealth Transfers as the Original and Primary Concern of Antitrust: The Efficiency Interpretation Challenged*, 34 *Hastings L.J.* 65, 118-119 (1982) (describing legislators' fears regarding power of big business to dominate democracy).

<sup>148</sup> Melvin L. Oliver et al., "Them That's Got Shall Get": *Inheritance and Achievement in Wealth Accumulation*, in 5 *Research in Politics and Society: The Politics of Wealth and Inequality* 69, 73-74 (Richard E. Ratcliff et al. eds., 1995) (attributing quote to Alexis de Tocqueville, 2 *Democracy in America* app. 5 (London: Saunders & Otley, 1835)).

## II USING TAXES TO PREVENT CONCENTRATION OF WEALTH AND FAMILY DYNASTIES

Because of the concerns about dynastic wealth, society legitimately could decide to use the tax system to curb the transfer of wealth to those who did not create it.<sup>149</sup> The tax system should do more, however, than merely help check wealth concentration. The macroeconomic literature discussed above<sup>150</sup> on the effect of wealth concentration has emphasized the need for investment in human capital. This suggests that another objective of a tax system seeking to curb dynastic wealth should be to raise revenues to fund such investment. Also, it is important that the tax not create other problems that outweigh the foregoing benefits.

Since the only recent experience in the United States has been with the federal estate and gift tax, Part II uses the United States estate and gift tax to test whether a tax on wealth transfers can raise revenues and impact wealth concentration without creating other harms that outweigh these benefits. This endeavor is not without peril. Many have argued that the estate and gift tax is a failure and should be repealed.<sup>151</sup> Others have suggested that the objectives of a wealth transfer tax might be better accomplished by expanding the income tax to tax gifts and bequests as income<sup>152</sup> or by adopting either an accessions tax<sup>153</sup> or a wealth tax.<sup>154</sup> Moreover, there are many loopholes in the current tax regime that allow taxpayers to reduce their tax liability.<sup>155</sup> Nevertheless, Part II shows that even with all of

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<sup>149</sup> The foregoing review of the harmful effects of wealth also might support a highly progressive income tax to reduce the wealth of those creating it. However, I favor a wealth transfer tax because it probably has less of an impact on savings than a highly progressive income tax. See text accompanying notes 221-233. For an excellent analysis of the role of a progressive income tax, see generally Martin J. McMahon, Jr. & Alice A. Abreu, *Winner-Take-All Markets: Easing the Case for Progressive Taxation*, 4 Fla. Tax Rev. 1, 12-21 (1998).

<sup>150</sup> See *supra* notes 66-67, 69-69 and accompanying text.

<sup>151</sup> E.g., Joel C. Dobris, *A Brief for the Abolition of All Transfer Taxes*, 35 Syracuse L. Rev. 1215 (1984); John E. Donaldson, *The Future of Transfer Taxation: Repeal, Restructuring and Refinement, or Replacement*, 50 Wash. & Lee L. Rev. 539 (1993); Charles O. Galvin, *To Bury the Estate Tax, Not To Praise It*, 52 Tax Notes 1413 (1991); McCaffery, *supra* note 24.

<sup>152</sup> E.g., Joseph M. Dodge, *Beyond Estate and Gift Tax Reform: Including Gifts and Bequests in Income*, 91 Harv. L. Rev. 1177 (1978).

<sup>153</sup> E.g., William D. Andrews, *The Accessions Tax Proposal*, 22 Tax. L. Rev. 589 (1967).

<sup>154</sup> E.g., David Shakow & Reed Shuldiner, *A Comprehensive Wealth Tax*, 53 Tax L. Rev. 499 (2000).

<sup>155</sup> See, e.g., Laura E. Cunningham, *Remember the Alamo: The IRS Needs Ammunition in Its Fight Against the FLP*, 86 Tax Notes 1461, 1461-63 (2000) (discussing methods by which estate planners exploit current transfer tax system, including family limited part-

these problems, the current wealth transfer tax in the United States appears to raise revenues and help check concentrations of dynastic wealth. It also shows that the major harm said to be inflicted by a tax on wealth transfers, the discouragement of savings,<sup>156</sup> is not supported by the empirical studies or by theory. Lastly, Part II looks at the effect of the federal wealth transfer tax on family businesses and the costs of compliance and administration.

### A. Revenues

An important goal of a tax to prevent wealth concentration should be to raise revenues to fund education and build an infrastructure (including communications and transportation) that will increase opportunities for all citizens. The increased investment in education could occur either by the government increasing its investment or by individuals increasing their investments with grants received from the government. Despite its many imperfections, our current wealth transfer tax appears to raise revenues that could be used for this purpose. Revenues from the estate and gift tax are projected to be \$209 billion for the years 2000 through 2005.<sup>157</sup> These revenues are not insignificant. The 1999 revenue from the estate and gift tax of \$27.8 billion is greater than the entire 1998 individual income tax liability of taxpayers with an adjusted gross income under \$15,000 and forty-nine percent of the 1998 tax liability of taxpayers with an adjusted gross income between \$15,000 and \$30,000.<sup>158</sup>

As economist B. Douglas Bernheim has argued, however, the estate tax actually may reduce revenues when the income tax and estate tax are viewed together.<sup>159</sup> He suggests that this occurs because the

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nerships); Joseph M. Dodge, *Redoing the Estate and Gift Taxes Along Easy-to-Value Lines*, 43 *Tax L. Rev.* 241, 244 (1988) (outlining loopholes existing in current transfer tax system and proposing reforms to prevent undervaluation of gratuitous transfers); Gutman, *supra* note 10, at 1262-69 (discussing problems in current structure such as deferral of estate tax and special use valuation).

<sup>156</sup> See, e.g., McCaffery, *supra* note 24, at 320 (stating that for very wealthy, economic effects of estate tax regime favor consumption over savings).

<sup>157</sup> Office of Mgmt. and Budget, *Budget of the United States Government, Historical Tables* 41 tbl.2.5 (2000).

<sup>158</sup> The 1999 revenues from the estate and gift tax were \$27.8 billion. Office of Mgmt. and Budget, *supra* note 157, at 41 tbl.2.5. Data found in David Campbell, Michael Parisi, and Brian Balkovic, *Individual Income Tax Returns, 1998*, in IRS, *Statistics of Income Bulletin*, Fall 2000, at 8, 34-38 tbl.2 [hereinafter *IRS Bulletin*], shows the total 1998 tax liability of individuals with adjusted gross income from \$1 to \$15,000 was \$7.8 billion, and the total 1998 tax liability of individuals with adjusted gross incomes between \$15,000 and \$30,000 was \$40.8 billion. Statistics for the 1999 individual income tax were not available at the time this article was written.

<sup>159</sup> B. Douglas Bernheim, *Does the Estate Tax Raise Revenues?*, in 1 *Tax Policy and the Economy* 113, 135 (Lawrence H. Summers ed., 1987).

estate tax causes taxpayers to engage in transactions that decrease the amount of income taxes collected by more than the amount of estate and gift taxes collected.<sup>160</sup> The decline in revenue, Bernheim states, occurs in two ways. First, he argues that tax revenues are lost because high-income-tax-bracket taxpayers make gifts of income-producing property to low-bracket taxpayers.<sup>161</sup> To support this, he makes several critical assumptions. He estimates that, in any given year, the value of inter vivos gifts equals approximately 52.7% of the value of bequests in that year.<sup>162</sup> He further assumes that the maximum income tax rate applies to income of the donors and that lower tax rates apply to income of the donees.<sup>163</sup>

Subsequent studies suggest that these assumptions are wrong. For example, data about the value of gifts occurring each year appear to contradict Bernheim's assumption that annual inter vivos gifts equal 52.7% of annual bequests. An examination of estate tax returns for decedents who died in 1992 shows that during the period 1977 through 1992, decedents made aggregate taxable gifts equal to only two percent of their terminal wealth.<sup>164</sup> Similarly, for all taxable estate returns filed in 1995, taxable gifts comprised only 3.8% of the value of estates.<sup>165</sup> It is possible that taxpayers are making more non-taxable gifts (annual gifts of \$10,000 or less per donee).<sup>166</sup> However, James Poterba reviewed the 1995 Survey of Consumer Finances and found that the probability of a household making nontaxable gifts was only modestly greater than the probability of making taxable gifts.<sup>167</sup>

Also, it is unlikely that Bernheim's assumption that the donees of such gifts are in lower income tax brackets than the donors is correct. The adult children of wealthy donors are usually in high-income tax brackets themselves.<sup>168</sup> Moreover, investment income of donees

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<sup>160</sup> *Id.* at 124-26.

<sup>161</sup> *Id.* at 126-31.

<sup>162</sup> *Id.* at 126.

<sup>163</sup> *Id.* at 127.

<sup>164</sup> David Joulfaian, *The Federal Estate and Gift Tax: Description, Profile of Taxpayers, and Economic Consequences* 21 (Off. of Tax Analysis, U.S. Dept. of the Treasury, Paper No. 80, Dec. 1998).

<sup>165</sup> James Poterba, *Estate and Gift Taxes and Incentives for Inter Vivos Giving in the United States* 10 (Nat'l Bureau of Econ. Res., Working Paper No. 6842, Dec. 1998), <http://papers.nber.org/papers/W6842>.

<sup>166</sup> I.R.C. § 2503(b) (1994 & West Supp. 2001) excludes gifts of up to \$10,000 per donee that a taxpayer makes each year.

<sup>167</sup> Poterba, *supra* note 165, at 15, 18.

<sup>168</sup> A study found that in 1981, the average adjusted gross income of the children of decedents who died in 1982 with gross estates exceeding \$10 million was \$271,254 in 1981 dollars. David Joulfaian, *The Distribution and Division of Bequests: Evidence from the Collation Study* 42 tbl.11D (Off. of Tax Analysis, U.S. Dept. of the Treasury, Paper No. 71, Aug. 1994).

under age fourteen, such as the donors' grandchildren, is subject to income tax at their parents' maximum rate to the extent such income exceeds a minimal amount (\$1400 in 2000).<sup>169</sup> Lastly, if the gifts are in trusts that may accumulate income, the income tax brackets applicable to such income are highly compressed. The maximum rate of 39.6% applied to undistributed taxable income of a trust in excess of \$8650 in 2000.<sup>170</sup>

Bernheim's second explanation for why the estate tax results in a revenue loss is that it encourages contributions to tax-exempt charitable entities.<sup>171</sup> Bernheim assumes that charitable bequests would fall by about 79.3% without an estate tax.<sup>172</sup> Based on an assumption that income tax would have been paid at the *maximum statutory rate* on income generated by the bequeathed assets if the decedent's family had kept the assets, he estimates that the loss of revenue is \$.80 per dollar contributed to charities where the maximum individual statutory tax rate is 28% and \$1.25 per dollar contributed where the maximum statutory rate is 50%.<sup>173</sup>

Bernheim's estimate of the revenue loss, however, is too large. Income from the transferred property would not have been taxable to the donor at the maximum statutory rate. Since taxpayers can defer recognition of capital gains, it is likely that the effective tax rate on such gains is only one-third to one-quarter the statutory rate, ignoring inflation.<sup>174</sup> Moreover, it is likely that one-half of accrued gains are held until death and escape income taxation entirely.<sup>175</sup> Also, many theorists argue that other portfolio adjustments may allow sophisticated investors to escape taxation on most of their return from capital.<sup>176</sup> The data suggest that sophisticated investors are able to reduce their taxable income. David Joulfaian examined the 1981 income tax

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<sup>169</sup> I.R.C. § 1(g) (1994 & West Supp. 2000); Rev. Proc. 99-42, 1999-46 I.R.B. 568 (providing cost-of-living adjustments for 2000).

<sup>170</sup> I.R.C. § 1(e) (1994 & West Supp. 2000); Rev. Proc. 99-42, 1999-46 I.R.B. 568 (providing cost-of-living adjustments for 2000).

<sup>171</sup> Bernheim, *supra* note 159, at 131-32.

<sup>172</sup> *Id.* at 131.

<sup>173</sup> *Id.* at 127 tbl.2, 131-32.

<sup>174</sup> Introduction to *The Capital Gains Controversy: A Tax Analyst's Reader 1* (J. Andrew Hoerner ed., 1992).

<sup>175</sup> See Mervyn A. King & Dan Fullerton, *The Taxation of Income from Capital* 221-22 (1984) (explaining common assumption that nominal capital gains tax rate should be halved due to deferral advantage and halved again due to increase of basis at death and selective realization of losses); see also *The Capital Gains Controversy*, *supra* note 174, at 1 (noting that accrued gains disappear upon death).

<sup>176</sup> See, e.g., Noël B. Cunningham, *The Taxation of Capital Income and the Choice of Tax Base*, 52 *Tax L. Rev.* 17, 41 (1996) (demonstrating how investors can reduce burden of normative income tax on capital income to amount equal to borrowing rate on net capital investment times tax rate).

returns for decedents who died in 1982.<sup>177</sup> He found that wealthier individuals tended to have lower taxable income from capital as a percentage of their wealth,<sup>178</sup> as set forth in Table 3.

| Capital Income and Wealth of Estate Tax Decedent<br>(1981 Levels of Income and 1982 Levels of Wealth) |             |             |                       |
|---|-------------|-------------|-----------------------|
| Gross Estate  | Mean Income | Mean Wealth | Income/Capital Wealth |
| \$300,000-\$500,000   | \$32,122    | \$379,107   | 8.47%                 |
| 500,000-1,000,000   | 54,268      | 682,203     | 7.95%                 |
| 1,000,000-2,500,000   | 86,554      | 1,471,358   | 5.88%                 |
| 2,500,000-10,000,000  | 222,479     | 4,118,342   | 5.40%                 |
| 10,000,000 and over   | 1,219,559   | 27,834,296  | 4.38%                 |
| Total   | 55,270      | 810,229     | 6.82%                 |

Mean Income is defined as Adjusted Gross Income, less wages, in 1981. Mean Wealth is defined as the gross estate, in 1982.<sup>180</sup>

Note that the taxpayers with gross estates over \$10 million reported only one-half the taxable income from investments as a percentage of their wealth that taxpayers with gross estates between \$300,000 and \$500,000 reported.

In addition, any revenue loss from charitable contributions should be offset partially by the benefits generated by the income accruing to the charities. At least part of the income from charitable contributions is used to fund activities that would otherwise have to be funded by the local, state, or federal government. Although difficult to quantify, this also should be considered in estimating any revenue loss arising from charitable contributions.

In summary, the projected revenue of \$209 billion for the period 2000 to 2005<sup>181</sup> is significant when viewed in the context of the individual income tax. Bernheim's conclusion, that the transfer tax results in a large reduction in income tax revenues because it encourages transfers to donees who are in a low-income tax bracket, is probably incorrect for several reasons. First, empirical evidence suggests that the amount of gifts to taxable donees motivated by the estate tax is lower than Bernheim assumed. Second, it is likely that taxable investment income recognized by donees is taxed at the same rates that such income would have been taxed to the donors. Third, income from capital is probably taxed in the hands of transferors at tax rates well below the maximum statutory rates assumed by Bernheim.

<sup>177</sup> Joulfaian, *supra* note 164, at 31.

<sup>178</sup> *Id.*

<sup>179</sup> Joulfaian, *supra* note 164, tbl.24. Joulfaian computed the figures from the 1982 Estate Collation File. *Id.*

<sup>180</sup> *Id.*

<sup>181</sup> See *supra* note 157 and accompanying text.

### B. Does Taxation Affect Wealth Concentration and Dynasties?

The foregoing analysis has shown that a tax on wealth transfers raises significant revenue. However, even if it did not, the tax still would be justified if it helped curb wealth concentration, given the harms arising from wealth concentration that are identified in Part I. Bequests and gifts account for approximately fifty percent of all wealth accumulations in the United States.<sup>182</sup> Thus, it appears that a tax on wealth transfers should have an effect on concentrations of wealth.

The fact that the concentration of wealth in the United States has stayed relatively constant since 1989, after significant increases that occurred in the 1980s,<sup>183</sup> does not mean that the estate tax has failed to affect wealth concentration and family dynasties.<sup>184</sup> A recent study has sought to determine what the effect of the repeal of the estate and gift tax would be on wealth concentration.<sup>185</sup> The study determined that eliminating the estate and gift tax would increase the percentage of national wealth held by the top one percent from a conservative estimate of a ten percent increase to an aggressive estimate of a two-fold increase.<sup>186</sup>

Indirect evidence also suggests that the amount of wealth transferred from one generation to the next would have been larger without an estate tax. The amounts of estate tax paid by decedents with respect to taxable returns filed in 1997 represented twenty-four percent of the aggregate taxable estates reported in those returns.<sup>187</sup> Moreover, the estate tax reduces wealth transferred within a family, not only because of the amount of taxes paid, but also because it encourages charitable contributions. Most studies have concluded that

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<sup>182</sup> William G. Gale & John Karl Scholz, *Intergenerational Transfers and the Accumulation of Wealth 1-2* (Inst. for Res. on Poverty Discussion, Paper No. 1019-93, 1993) (summarizing studies); Henry J. Aaron & Alicia H. Munnell, *Reassessing the Role for Wealth Transfer Taxes*, 45 *Nat'l Tax J.* 119, 131 (1992) (noting that statistics support finding that 52% of wealth is inherited); see also Kotlikoff & Summers, *supra* note 142, at 721, 730 (determining that 78% of wealth is inherited). But see Modigliani, *supra* note 142, at 21 (arguing that only 15.5% to 18.5% of total wealth is inherited).

<sup>183</sup> See *supra* text accompanying notes 6-7.

<sup>184</sup> But see G.P. Verbit, *Do Estate and Gift Taxes Affect Wealth Distribution? Part I*, 117 *Tr. & Est.* 598, 598 (1978) (arguing that since wealth concentration has not changed, estate tax has no effect).

<sup>185</sup> John Laitner, *Simulating the Effects on Inequality and Wealth Accumulation of Eliminating the Federal Gift and Estate Tax* (Apr. 17, 2000) (unpublished manuscript, on file with *New York University Law Review*).

<sup>186</sup> Laitner, *supra* note 185, at 2.

<sup>187</sup> The net estate tax paid with respect to 1997 taxable returns was \$16.63 billion, and the aggregate taxable estates reported on such returns was \$68.14 billion. Barry Johnson & Jacob Mikow, *Federal Estate Tax Returns, 1995-1997*, in *IRS Bulletin*, *supra* note 158, at 107-08 tbl.1c.

the estate tax encourages charitable contributions.<sup>188</sup> As shown in Table 4, the percentage of 1997 estate tax returns claiming charitable deductions and the average charitable bequest per 1997 return increased as the size of the gross estate increased. Approximately fifty percent of returns with gross estates exceeding \$20 million claimed a charitable deduction, with an average contribution of \$40,206,536 per return claiming the deduction.

| Charitable Deductions Claimed in Estate Tax Returns Filed in 1997 |                   |  |  |                             |  |
|---|-------------------|--|--|-----------------------------|--|
| (1)   | (2)               | (3)  | (4)  | (5)                         | (6)  |
| Size of Gross Estate  | Number of Returns | Number of Returns Claiming Charitable Deductions | Percentage of Returns Claiming Charitable Deductions | Total Charitable Deductions | Average Charitable Deduction Per Return Claiming Deduction |
| \$600,000 but under 1,000,000                                     | 47,541            | 7164   | 15.07%   | 1,126,204,000               | 157,203  |
| \$1,000,000 but under 2,500,000                                   | 32,380            | 5644   | 17.43%   | 1,506,839,000               | 266,803  |
| \$2,500,000 but under \$10,000,000                                | 6686              | 1646   | 24.61%   | 1,300,423,000               | 790,050  |
| \$5,000,000 but under \$10,000,000                                | 2178              | 626  | 28.74%   | 1,015,740,000               | 1,622,258  |
| \$10,000,000 but under \$20,000,000                               | 804               | 288  | 35.82%   | 999,473,000                 | 3,456,503  |
| \$20,000,000 or more  | 417               | 207  | 49.64%   | 8,322,753,000               | 40,206,536   |

The combination of the estate tax liability and charitable contributions significantly reduces the amount of wealth transferred within a family. An important 1994 study that examined the tax returns for persons who died in 1982 found that the combination of charitable bequests, estate expenses, and taxes accounted on average for forty-one percent of the net worth (gross estate less debt) of decedents with gross estates over \$10 million.<sup>190</sup> The study's findings also suggest that taxing wealth transfers does not impose hardship on decedents' chil-

<sup>188</sup> E.g., Charles T. Clotfelter, *Federal Tax Policy and Charitable Giving* 222-52 (1985); Gerald Auten & David Joulfaian, *Charitable Contributions and Intergenerational Transfers*, 59 J. Pub. Econ. 55 (1996); David Joulfaian, *Charitable Bequests and Estate Taxes*, 44 Nat'l Tax J. 169 (1991). It is important to note, however, that estimates of price elasticities, which measure the percentage change in charitable giving to the percentage change in the after-tax cost of making the gift, vary considerably. *Id.* at 173-75 (attributing range of elasticity to factors including wealth, type of charity, marital status, age, and sex). Joulfaian suggests that the sensitivity of charitable contributions to the estate tax depends on the nature of the recipient. He found that bequests to religious organizations and schools are the most sensitive to the presence of the estate tax, while bequests to foundations and the arts and humanities are the least sensitive. *Id.* at 174-75.

<sup>189</sup> Columns 4 and 6 are the author's calculations. Columns 1, 2, 3, and 5 are from Johnson & Mikow, *supra* note 187, at 103-06 tbl.1c.

<sup>190</sup> Joulfaian, *supra* note 168, at 6.

dren. The study found that the average income of children of decedents with gross estates over \$10 million at the time the decedents died was \$271,254, measured in 1981 dollars.<sup>191</sup> The children of decedents who died in 1982 with more modest estates, between \$2.5 million and \$10 million, had an average adjusted gross income of \$123,452 the year before their parent's death, again measured in 1981 dollars.<sup>192</sup>

The difficulty with a wealth transfer tax is that it is a blunt instrument to curb wealth concentration. The tax is based upon the amount of wealth transferred by the transferor, not the amount received by the transferee. Thus, the transferor pays the same tax whether the transfer is to one person or several persons.<sup>193</sup> A device such as an accessions tax could be much more focused, because it determines liability based upon amounts received by each transferee. Despite the blunt nature of the estate tax, however, it is helping to check wealth concentration.

### C. *Effect on Savings*

The major criticism of taxing wealth transfers is that it reduces social welfare because it discourages savings.<sup>194</sup> The effect of our current estate tax on savings is an important issue since, as stated earlier, bequests and gifts account for approximately fifty percent of all wealth accumulation in the United States.<sup>195</sup> As discussed below, however, this assertion is not supported by theory or by the empirical evidence. Theory does not predict the effect of a tax on savings, and the majority of the statistical studies indicate that taxes have little or no impact.

#### 1. *Theory*

Economic theory proposes two opposite effects about how savings may respond to taxes. The first, the income effect, occurs where taxpayers increase savings to offset the effect of the tax.<sup>196</sup> The second, the substitution effect, occurs where taxpayers reduce savings and increase current consumption in response to a tax.<sup>197</sup> The result

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<sup>191</sup> *Id.* at 11.

<sup>192</sup> *Id.* at 42.

<sup>193</sup> An important exception to this rule is contained in I.R.C. § 2503(b) (1994 & West Supp. 2000), which exempts annual gifts of \$10,000 or less per donee.

<sup>194</sup> E.g., McCaffery, *supra* note 24, at 320 (“[F]or the very wealthy, economic effects of any estate tax regime favor consumption over savings . . .”).

<sup>195</sup> See *supra* note 182 and accompanying text.

<sup>196</sup> B. Douglas Bernheim, *Taxation and Saving 5* (Nat'l Bureau of Econ. Res., Working Paper No. 7061, Mar. 1999).

<sup>197</sup> *Id.*

of these opposing theories is that it is difficult to predict a priori what the effect of a tax will be on savings and investment.<sup>198</sup>

Further complicating the analysis is uncertainty about what motivates taxpayers to make bequests and gifts. There are several potential explanations that likely apply to some taxpayers some of the time. In the accident bequest model, taxpayers save for retirement and to meet unexpected contingencies.<sup>199</sup> Only unexpended amounts which remain because of the uncertainties of life result in bequests. In the altruistic model, parents make bequests solely to help their children.<sup>200</sup> Alternatively, in the strategic bequest model, parents make bequests and gifts as rewards for service obtained from their children.<sup>201</sup> Lastly, some have argued that individuals save, not to make bequests, but to obtain the power associated with wealth.<sup>202</sup> In that model, the transfer of wealth at death is merely a consequence of the decedent's unwillingness to give up this power.

If bequests merely represent amounts left over because the decedent expected to live longer or because the decedent was saving for contingencies, estate taxes will have minimal impact on savings.<sup>203</sup> Alternatively, if a taxpayer is accumulating wealth in order to exercise the power that wealth confers during his life, or if the decedent is saving to confer some form of benefit on heirs or to reward them for services, the estate tax may have an impact. But it is not clear

<sup>198</sup> E.g., *id.* ("There is no theoretical presumption that either effect dominates.").

<sup>199</sup> William G. Gale & Maria G. Perozek, *Do Estate Taxes Reduce Saving?*, in *Rethinking Estate and Gift Taxation* (forthcoming 2001) (manuscript at 6, on file with *New York University Law Review*); see also Michael D. Hurd, *Mortality Risk and Bequests*, 57 *Econometrica* 779, 797-802 (1989) (finding that most bequests "are accidental, the result of mortality risk").

<sup>200</sup> E.g., Gary S. Becker, *A Theory of Social Interactions*, 82 *J. Pol. Econ.* 1063, 1079 (1974) ("[A] 'family's' utility function is the same as that of one of its members not because this member has dictatorial power over other members, but because he (or she!) cares sufficiently about all other members to transfer resources voluntarily to them.").

<sup>201</sup> E.g., B. Douglas Bernheim, Andrei Shleifer & Lawrence H. Summers, *The Strategic Bequest Motive*, 93 *J. Pol. Econ.* 1045, 1046 (1985) ("[T]estators use bequests to influence the behavior of potential beneficiaries. Such influence may be overt, as when parents threaten to disinherit miscreant offspring, or more subtle, as when parents reward more attentive children with family heirlooms.").

<sup>202</sup> Lester C. Thurow, *Generating Inequality: Mechanisms of Distribution in the U.S. Economy* 141 (1975) (arguing that economic power helps explain "why more individuals do not use the tax loophole of transferring their assets before death"); Christopher D. Carroll, *Why Do the Rich Save So Much?*, in *Does Atlas Shrug? The Economic Consequences of Taxing the Rich* 465, 466 (Joel B. Slemrod ed., 2000) (concluding that "direct wealth accumulation motive is indispensable in explaining at least some of the observed [saving] behavior of the very wealthy").

<sup>203</sup> Bernheim, *supra* note 196, at 29-31.

whether that tax will cause taxpayers to increase savings to counteract the tax or decrease savings in response to the tax.<sup>204</sup>

Note that the foregoing analysis dealt with the effect of transfer taxes on the transferor. What is the effect on aggregate savings if the transferee is also included in the analysis? Some economists have developed models indicating that in situations where transferors reduce bequests in response to taxes, the transferees may increase savings to offset the shortfall.<sup>205</sup> The result is that "estate tax changes will typically generate opposing impacts on the donor and the recipient," and, therefore, will not harm savings.<sup>206</sup>

Finally, it is important to recall that the tax is being collected to fund governmental activities. Even if there is a net decrease in saving when the responses of the transferor and transferee are considered together, there may not be a decline in aggregate saving if the government uses the tax revenues to invest in a public good such as education or, alternatively, transfers the revenues to low-income individuals who in turn invest in education.<sup>207</sup>

## 2. *Empirical Analysis*

Only two studies have examined the effect of estate taxes directly. Perhaps reflecting the theoretical ambiguity about the impact on savings, the studies reached opposite conclusions. In a 1966 study, Seymour Fiekowsky found no evidence that the sharp increase in estate tax rates that occurred in the 1930s and early 1940s resulted in a decrease in the size of estates.<sup>208</sup> Another more recent study, however, has found some evidence that the estate tax may affect the size of estates reported by decedents on their estate tax returns.<sup>209</sup> The study's findings suggest that the wealthiest taxpayers at age forty-five respond to an estate tax rate of fifty percent by adjusting their reportable net worth in such a way that the amount they will report at death is 11.1% less than what it would have been without the tax.<sup>210</sup>

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<sup>204</sup> *Id.* In this regard it should be noted, however, that in the 1992 Survey of Consumer Finance, only two percent of wealthy households stated that providing an inheritance was the most important reason to save, and only four percent of wealthy households indicated that providing an inheritance was among the top five reasons for saving. Carroll, *supra* note 202, at 472.

<sup>205</sup> Gale & Perozek, *supra* note 199, at 21-28.

<sup>206</sup> *Id.* at 32.

<sup>207</sup> Becker, *supra* note 200, at 1077; Gale & Perozek, *supra* note 199, at 32.

<sup>208</sup> Seymour Fiekowsky, *The Effect on Saving of the United States Estate and Gift Tax, in Federal Estate and Gift Taxes* 228, 234-35 (Carl S. Shoup ed., 1966).

<sup>209</sup> Wojciech Kopczuk & Joel Slemrod, *The Impact of the Estate Tax on the Wealth Accumulation and Avoidance Behavior of Donors*, in *Rethinking Estate and Gift Taxation* (forthcoming 2001) (manuscript at 16-21, on file with *New York University Law Review*).

<sup>210</sup> *Id.* at 32.

It is not clear whether this observed impact is the result of actual decreased saving by taxpayers or the taxpayers' use of valuation techniques designed to reduce the value of reported assets.<sup>211</sup> Some valuation devices, such as family limited partnerships, routinely result in discounts in the reported value of assets by forty percent.<sup>212</sup> In an analogous area, many studies of the effect of the income tax indicate that high-income taxpayers would not reduce their economic income in response to increased rates but rather would shift the income into tax-preferred forms.<sup>213</sup> Similarly, studies on the effect of tax incentives for savings found that such incentives do not increase aggregate savings but rather cause taxpayers to switch saving into tax favored vehicles (such as 401(k) plans) from taxable investments.<sup>214</sup>

Indeed, most studies that have examined the effect of income taxes on savings have found zero or minimal impact.<sup>215</sup> After reviewing the failure of taxpayer savings to respond to income tax rate

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<sup>211</sup> For descriptions of various techniques to reduce value, see, for example, Cunningham, *supra* note 155, at 1461-62 (discussing how wealth can disappear through use of family limited partnerships); Alan L. Feld, *The Implications of Minority Interest and Stock Restrictions in Valuing Closely-Held Shares*, 122 U. Pa. L. Rev. 934 (1974) (discussing discounts available for minority stock interests and shares subject to transfer restrictions); Mary Louise Fellows & William H. Painter, *Valuing Close Corporations for Federal Wealth Transfer Taxes: A Statutory Solution to the Disappearing Wealth Syndrome*, 30 Stan. L. Rev. 895 (1978) (explaining transfer of minority shares of close corporations as tax avoidance strategy).

<sup>212</sup> Cunningham, *supra* note 155, at 1464-65.

<sup>213</sup> See, e.g., Alan J. Auerback & Joel Slemrod, *The Economic Effects of the Tax Reform Act of 1986*, 35 J. Econ. Literature 589, 615-18 (1997) (discussing evidence of income shifting rather than income creation); Nada Eissa, *Tax Reforms and Labor Supply*, in 10 *Tax Policy and the Economy* 119, 147 (James M. Poterba ed., 1996) (explaining that "income response observed in the tax return data is due more to factors other than labor market participation, such as shifting of income and compensation decisions"); Joel B. Slemrod, *The Economics of Taxing The Rich*, in *Does Atlas Shrug?*, *supra* note 202, at 17-18 (discussing "substantial evidence" of timing, financial, and accounting responses).

<sup>214</sup> See, e.g., Eric M. Engen, William G. Gale & John Karl Scholz, *The Effects of Tax-Based Saving Incentives on Saving and Wealth* 46 (Nat'l Bureau of Econ. Res., Working Paper No. 5759, Sept. 1996) (finding that "less than ten percent of 401(k) contributions represent new saving"); Auerback & Slemrod, *supra* note 213, at 603-04 (finding low saving response to high after-tax rate of return).

<sup>215</sup> Engen et al., *supra* note 214, at 45-48 (concluding that tax incentives for savings have little or no effect on level of saving); Jonathan Skinner & Daniel Feenberg, *The Impact of the 1986 Tax Reform on Personal Saving*, in *Do Taxes Matter? The Impact of the Tax Reform Act of 1986*, at 50, 72-73 (Joel Slemrod ed., 1990) (concluding that "link between the aftertax rate of return and personal saving is weak" and finding tax effects on types of saving instead); see also Bernheim, *supra* note 196, at 47-48 (providing excellent survey of studies); E. Philip Howrey & Saul M. Hymans, *The Measurement and Determination of Loanable-Funds Saving*, in 3 *Brookings Papers on Economic Activity* 662, 663-67 (Arthur M. Okin & George L. Perry eds., 1978) (demonstrating that one study's finding of "positive and significant saving elasticity . . . [was] extremely sensitive" to sample period and modeling features). But see Michael J. Boskin, *Taxation, Saving, and the Rate of Interest*, 86 J. Pol. Econ. S3 (1978) (finding that income tax rates influence saving).

changes in 1981 and 1986, two authors concluded that "the historical record seems quite clear in indicating little effect on saving of the aftertax real interest rate."<sup>216</sup>

Other studies have sought to measure indirectly the taxpayer's response to an income tax on savings by examining changes in consumption. Again, the studies are ambiguous.<sup>217</sup> Those that have used aggregate data have found no response in consumption to changes in after-tax return.<sup>218</sup> However, some have argued that aggregate data tends to mask changes.<sup>219</sup> Other studies that have examined the data on individual households have found that the rate of savings responds to changes in income tax rates.<sup>220</sup> The magnitude of the responses varies widely, periods for which the households were studied are

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<sup>216</sup> Skinner & Feenberg, *supra* note 215, at 72.

<sup>217</sup> See Bernheim, *supra* note 196, at 50 ("[T]he assumptions required for valid aggregation are extremely restrictive."); Robin Broadway & David Wildasin, *Taxation and Savings*, in *The Economics of Tax Policy* 55, 73 (Michael P. Devereaux ed., 1996) ("Overall, it would be fair to say that empirical analysis of aggregate consumption data has been inconclusive in its findings about the effects of interest rates on savings.").

<sup>218</sup> Alan S. Blinder, *Distribution Effects and the Aggregate Consumption Function*, 83 *J. Pol. Econ.* 447, 472 (1975) (finding that greater income equalization will have little or no effect on aggregate consumption); John Y. Campbell & N. Gregory Mankiw, *Consumption, Income, and Interest Rates: Reinterpreting the Time Series Evidence*, in *NBER Macroeconomics Annual 1989*, at 185, 186 (Olivier Jean Blanchard & Stanley Fisher eds., 1989) (finding that "predictable movements . . . in consumption cannot be explained as a rational response to movements in real interest rates"); Robert E. Hall, *Intertemporal Substitution in Consumption*, 96 *J. Pol. Econ.* 339, 350-51 (1988) (explaining that "consumption growth has generally stuck fairly close to its average value no matter what has happened to real interest rates").

<sup>219</sup> E.g., Orazio P. Attanasio & Guglielmo Weber, *Consumption Growth, the Interest Rate and Aggregation*, 60 *Rev. Econ. Stud.* 631, 632 (1993) (identifying sources of aggregation bias and finding "substantial differences between estimates of intertemporal substitution obtained from aggregate and average cohort data").

<sup>220</sup> Bernheim, *supra* note 196, at 50. For examples of studies using household data, see Orazio P. Attanasio & Martin Browning, *Consumption over the Life Cycle and over the Business Cycle*, 85 *Am. Econ. Rev.* 1118, 1119 (1995) (concluding that household-specific factors "have an important influence on intertemporal-allocation decisions"); Orazio P. Attanasio & Karen E. Dynan, *How Prudent Are Consumers?*, 101 *J. Pol. Econ.* 1104, 1109 (1993) (finding little evidence of "precautionary motive" in consumer saving behavior); Attanasio & Weber, *supra* note 219, at 647 (finding higher elasticity of intertemporal substitution using average cohort data rather than aggregate data); Emily C. Lawrance, *Poverty and the Rate of Time Preference: Evidence from Panel Data*, 99 *J. Pol. Econ.* 54, 72 (1991) (finding strong differential effects based on household income and time preference rates); David E. Runkle, *Liquidity Constraints and the Permanent-Income Hypothesis: Evidence from Panel Data*, 27 *J. Monetary Econ.* 73, 90-91 (1991) (arguing that panel data model supports permanent-income hypothesis); Matthew D. Shapiro, *The Permanent Income Hypothesis and the Real Interest Rate: Some Evidence from Panel Data*, 14 *Econ. Letters* 93, 98-99 (1984) (explaining rejection of permanent income hypothesis as problem of liquidity constraints); Stephen P. Zeldes, *Consumption and Liquidity Constraints: An Empirical Investigation*, 97 *J. Pol. Econ.* 305, 338 (1989) (finding that borrowing constraints affect consumption).

short, and many studies only analyzed isolated components of consumption (such as consumption of food).<sup>221</sup>

There is a strong argument that a tax on wealth transfers should have less of an impact than a tax on income. The estate tax differs from the income tax in two significant ways. First, death, which is the triggering event for the estate tax, is something that most people spend the majority of their lives denying.<sup>222</sup> While the reasons for the denial of death are debated, it seems well accepted that we tend to ignore our mortality in conducting our daily lives.<sup>223</sup> The propensity to ignore our mortality may mean that taxpayers also ignore the estate tax for a significant portion of their lives. To prove this assertion, ask yourself if your decision to work or make an investment today was influenced by the thought of your mortality. Probably not. Also, how many businesses include the effective estate tax rate in their yield calculations? I am not aware of any. In contrast, the triggering event for the income tax, the recognition of taxable income, is something on which most people regularly focus. The result may be that people respond more strongly to income tax changes than to estate tax changes. Joseph Pechman has explained:

Opinions about death taxes vary greatly in a society relying on private incentives for economic growth. Some believe that these taxes hurt economic incentives, reduce saving, and undermine the economic system. But even they would concede that death taxes have less adverse effects on incentives than do income taxes of equal yield. Income taxes reduce the return from effort and risk taking as income is earned, whereas death taxes are paid only after a lifetime of work and accumulation and are likely to be given less weight by individuals in their work, saving, and investment decisions.<sup>224</sup>

The second reason that the effect of a tax on wealth transfers may be less harmful than the effect of a tax on income as it is realized is

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<sup>221</sup> Bernheim, *supra* note 196, at 50.

<sup>222</sup> See, e.g., Sheldon Solomon et al., *A Terror Management Theory of Social Behavior: The Psychological Functions of Self-Esteem and Cultural Worldviews*, in 24 *Advances in Experimental Social Psychology* 93, 101-02 (Mark P. Zanna ed., 1991) (describing cultural strategies that help repress anxiety about one's mortality).

<sup>223</sup> See, e.g., Sigmund Freud, *Thoughts for the Times on War and Death* (1915), reprinted in 4 *Collected Papers* 288, 304 (Ernest Jones ed., Joan Riviere trans., 1959) (describing attitude toward death as "unmistakable tendency to 'shelve' death, to eliminate it from life"); Avery D. Weisman, *On Dying and Denying: A Psychiatric Study of Terminality* 13 (1972) ("The primary paradox is that while man recognizes that death is universal, he cannot imagine his own death. The belief is illogical, but persistent . . ."). Economists also have noted that people tend heavily to discount future events. David I. Laibson et al., *Self-Control and Saving for Retirement*, in 1 *Brookings Papers on Economic Activity* 91 (William C. Brainard & George L. Perry eds., 1998).

<sup>224</sup> Joseph A. Pechman, *Federal Tax Policy* 234-35 (5th ed. 1987).

that, in any given year, the expected value of the estate tax is a function of the probability of death occurring in that year. This means that during taxpayers' most productive years, the effective estate tax rate is minimal. James Poterba explored this in a paper that attempted "to place the estate tax in context so that it could be considered, along with taxes on interest, dividends, and capital gains, as an investor-level tax on capital income."<sup>225</sup> To calculate the estate tax's effective rate on capital income, he estimated the expected value of net federal estate tax liabilities for taxpayers of different ages in the 1995 Survey of Consumer Finances. The expected value was a function of the probability that the taxpayer would die during the year based upon actuarial tables. He then divided the expected value of the tax liability by an estimate of the return on household net worth to calculate the effective tax rate. Assuming an average annual real return of six percent, he found the effective estate tax rate on capital income for persons in different age groups to be as set forth in Table 5.

| TABLE 5 <sup>226</sup>   |                                   |
|--------------------------|-----------------------------------|
| Age of Household Head    | Effective Federal Estate Tax Rate |
| A. Population Life Table |                                   |
| <50                      | 0.1%                              |
| 50-59                    | 0.3%                              |
| 60-69                    | 1.0%                              |
| 70-79                    | 2.7%                              |
| >80                      | 19.0%                             |
| B. Annuitant Life Table  |                                   |
| <50                      | 0.1%                              |
| 50-59                    | 0.2%                              |
| 60-69                    | 0.5%                              |
| 70-79                    | 1.7%                              |
| >80                      | 13.9%                             |

Table 5 presents two sets of estimates. The first set is the estimated effective tax rate for different age groups using actuarial statistics from the Population Life Table, which is reported by the Social Security Administration Office of the Actuary.<sup>227</sup> The second set uses actuarial statistics from the Individual Annuitant Life Table, which describes the mortality experience of individuals who purchase single-premium annuities from life insurance companies.<sup>228</sup> Poterba suggests that the probabilities in the Individual Annuitant Life Table may be

<sup>225</sup> James M. Poterba, *The Estate Tax and After-Tax Investment Returns*, in *Does Atlas Shrug?*, *supra* note 202, at 330.

<sup>226</sup> Poterba, *supra* note 225, at 339 tbl.10.6.

<sup>227</sup> *Id.*

<sup>228</sup> *Id.*

more accurate for individuals likely to pay an estate tax, because that table reflects life expectancies of individuals affluent enough to purchase a single-premium annuity.<sup>229</sup>

Note that using the Individual Annuitant Life Table, the effective estate tax rates are quite small for taxpayers under age seventy. The rates are 0.1% for taxpayers under age fifty, 0.2% for taxpayers between ages fifty and sixty, and 0.5% for taxpayers between ages sixty and sixty-nine. These figures suggest that the failure of taxpayers to factor in the estate tax liability in their younger years may be based on more than the irrational denial of death. It also may be a reaction to the low expected value of the effective rates at the time the taxpayers are generating wealth. The greatest distortive impact of the estate tax would be on persons who are focusing on passing wealth to their families upon their death at the same time they are generating the wealth. But the number of these persons is likely to be small. Persons generating wealth are likely to be under age seventy and therefore subject to a low effective estate tax rate. Moreover, younger persons are more likely to deny their mortality.<sup>230</sup> Although survey information often can be misleading, it is interesting to note that in the 1992 Survey of Consumer Finance, only two percent of wealthy households stated that providing an inheritance was the most important reason to save and only four percent of wealthy households indicated that providing an inheritance was among the top five reasons for saving.<sup>231</sup>

Further supporting the view that the estate tax tends not to influence day-to-day behavior are responses in the 1997 Arthur Andersen/MassMutual American Family Business Survey (1997 Family Business Survey).<sup>232</sup> When asked by the 1997 Family Business Survey to list the top three governmental regulatory burdens to their businesses, most owners of family businesses regarded *income* tax regulations as most burdensome, followed by environmental, Occupational Safety and Health Administration, employment benefits, and payroll tax regulations.<sup>233</sup>

To summarize, tax theory is ambiguous about whether an estate tax will affect savings. Most of the empirical evidence, which primarily examines the effects of the income tax, suggests that it does not.

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<sup>229</sup> Id. at 338.

<sup>230</sup> Stephen F. Davis & Joseph J. Palladino, *Psychology* 457 (2d ed. 1997) (observing that young adults "rarely think of their own death," while older adults do).

<sup>231</sup> Carroll, *supra* note 202, at 472.

<sup>232</sup> See 1997 Research Findings: The Arthur Andersen/MassMutual American Family Business Survey '97 [hereinafter 1997 Family Business Survey], at <http://www.massmutual.com/fbn> (last visited Apr. 12, 2001) (reporting that 23.8% of respondents have only "some" or no understanding of estate tax due upon their deaths).

<sup>233</sup> Id.

Moreover, there is a strong argument that the estate tax has less of an impact on savings than the income tax.

#### *D. Effect on Small Family Businesses*

Another major criticism of the estate tax is that it imposes financial burdens on family businesses.<sup>234</sup> Paying premiums for insurance to fund an estate tax liability reduces the cash available for investment in the business. Moreover, to the extent that insurance is inadequate to pay the estate tax, heirs may be forced to sell part of the business to fund the tax.<sup>235</sup>

Most family business owners surveyed in the 1997 Family Business Survey stated that they rely on life insurance to pay the estate tax.<sup>236</sup> A study has concluded, however, that businesses may not carry sufficient insurance to pay the entire estate tax.<sup>237</sup> The study estimated the estate tax liability for owners of family businesses and compared the estimated tax liability to the amount of life insurance held on the owners' lives and other liquid assets held by the owner.<sup>238</sup> It found that the mean gap between estimated estate tax liability on the one hand, and life insurance and liquid assets on the other hand, ranges from twelve to eighteen percent.<sup>239</sup> The study also noted, however, that the gap might be attributable to the owners' expectations that various avoidance techniques, such as valuation discounts or favorable statutory provisions, will be used to reduce the estate tax liability.<sup>240</sup>

The estate tax should have a minimal impact on most small businesses because of the numerous provisions, discussed below, that currently provide relief to family businesses and farms. The difficulty is that current provisions are complex and require sophisticated advice before a taxpayer can benefit fully.

Internal Revenue Code § 2057 allows an estate to deduct a maximum amount of \$675,000 with respect to a qualified family busi-

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<sup>234</sup> See Douglas Holtz-Eakin et al., *Estate Taxes, Life Insurance, and Small Business 1-2* (Nat'l Bureau of Econ. Res., Working Paper No. 7360, Sept. 1999) (summarizing criticisms).

<sup>235</sup> *Id.*

<sup>236</sup> 1997 Family Business Survey, *supra* note 232 (noting that sixty-seven percent of respondents reported that life insurance represents primary source of funds to cover estate taxes).

<sup>237</sup> Holtz-Eakin et al., *supra* note 234, at 23.

<sup>238</sup> *Id.* at 8.

<sup>239</sup> *Id.* at 8, 10-11. The percentage rate varied depending on how "liquid assets" were defined. *Id.* at tbl.1.

<sup>240</sup> *Id.* at 9, 25 n.16 (noting that "there are many ways to avoid estate tax" and describing provisions for tax deferral and "phenomenon" of businesses being undervalued when passing through probate).

ness.<sup>241</sup> The applicable unified credit exclusion amount in 2000 was \$625,000,<sup>242</sup> effectively allowing up to \$1.3 million in reductions on the estate.<sup>243</sup> Therefore, if two persons hold interest in the business, they effectively can transfer up to \$2.6 million in value of the business without incurring an estate tax by using their respective unified credits and the § 2057 deductions. This allows many family businesses to escape tax entirely.<sup>244</sup> Table 6 sets forth the average value of closely held stock per 1997 estate tax return that paid an estate tax. Note that the § 2057 credit, combined with the unified credit amount, would on average have permitted the closely held stock of gross estates with a value under \$5 million to escape tax entirely. Indeed, on average, most of the closely held stock owned by estates with a gross value between \$5 million and \$10 million also would have escaped tax, since the average amount held by gross estates in that size range was \$1.5 million.

| Average Value Per Return of Closely Held Stock<br>Reported in 1997 Tax Returns |                                  |
|--|----------------------------------|
| Size of Gross Estate   | Average Value Per Taxable Return |
| \$600,000 under \$100,000  | \$206,269                        |
| \$1,000,000 under \$2,500,000  | \$317,042                        |
| \$2,500,000 under \$5,000,000  | \$802,809                        |
| \$5,000,000 under \$10,000,000   | \$1,510,943                      |
| \$10,000,000 under \$20,000,000  | \$3,189,447                      |
| \$20,000,000 or more   | \$30,094,271                     |

In addition to § 2057, the Internal Revenue Code provides other benefits to family-owned businesses and farms. Section 2032A allows a formula price to be used for real estate instead of fair market value where the real estate is used in a family-owned business.<sup>246</sup> The formula price is intended to approximate the value of the land where the land's use is limited to farming or to the family-owned business. Section 2032A can result in significant savings because it permits a discount of up to \$750,000 from the land's actual fair market value.<sup>247</sup>

<sup>241</sup> I.R.C. § 2057(a)(1)-(2) (1994 & Supp. IV 1998).

<sup>242</sup> Id. §§ 2010 (1994 & Supp. IV 1998), 2057(a)(3)(A) (West 2000).

<sup>243</sup> I.R.C. § 2057(a)(3)(A) limits the unified credit exclusion amount to a maximum deduction of \$625,000 where the maximum deduction of \$675,000 is claimed under I.R.C. § 2057. Id. § 2057(a)(3)(A) (West 2000).

<sup>244</sup> Leonard E. Burman, *Estate Taxes and the Angel of Death Loophole*, 76 *Tax Notes* 675, 675 (1997) ("The estate tax is an exclusive tax, directly affecting fewer than 2 percent of decedents. Most owners of small businesses . . . do not pay it . . .").

<sup>245</sup> Author's calculations based on Johnson & Mikow, *supra* note 187, at 102-06 tbl.1c.

<sup>246</sup> I.R.C. § 2032A (1994 & Supp. IV 1998).

<sup>247</sup> Id. § 2032A(a)(2). For estates in which decedents died after 1998, the \$750,000 may be adjusted for inflation. Id. § 2032A(a)(3).

Table 7 shows the reduction in value that resulted under § 2032A for the estate of persons who died in 1995. Note that the reported fair market value of the real estate, \$349,807,313, was adjusted down to a value of \$178,465,062, representing a discount of 49%.<sup>248</sup>

Sections 2032A and 2057 can be applied together. Thus, the reduced value of real estate will reduce the value of the business, which in turn may escape taxation entirely under § 2057.

| Estates of 1995 Decedents Electing § 2032A Special Use Valuation |                   |                   |                |                    |
|--|-------------------|-------------------|----------------|--------------------|
| Size of Gross Estate   | Number of Returns | Fair Market Value | Adjusted Value | Reduction in Value |
| \$600,000-\$1,000,000  | 260               | 172,782,587       | 73,946,990     | 98,835,597         |
| \$1,000,000 or more  | 196               | 177,024,726       | 104,518,072    | 72,506,654         |
| Total  | 456               | 349,897,313       | 178,465,062    | 171,342,251        |

Finally, § 6166 permits an estate to pay the estate tax attributable to a qualifying closely held business in installments for up to fourteen years (annual interest payments for the first five years, followed by up to ten annual installments of principal and interest).<sup>250</sup> A very low 2% interest rate applies to the deferred estate tax attributable to the first \$1 million of the business interest in excess of the unified credit amount.<sup>251</sup> The interest rate applicable to the excess is 45% of the annual rate applicable to underpayments of tax.<sup>252</sup> During 1992, 2.6% of estates with tax liability elected to use § 6166, deferring \$519 million of estate tax.<sup>253</sup>

In addition to the substantial benefits conferred by statutory provisions, courts also have allowed significant discounts in valuing minority interests in businesses to reflect lack of control and lack of liquidity.<sup>254</sup> Partial interests in real estate similarly are discounted to reflect the costs that an owner would incur in partitioning the land.<sup>255</sup>

Although these provisions provide significant relief, they are complex. They create an equity problem because they provide the

<sup>248</sup> Despite the benefit of § 2032A, it is interesting to note that in 1995 only 0.6% of all returns for decedents used § 2032A. Johnson & Mikow, *supra* note 187, at 79. It is also interesting that only 0.4% of the gross assets reported in all 1997 estate tax returns were farm assets. *Id.* at 102 tbl.1c.

<sup>249</sup> Johnson & Mikow, *supra* note 187, at 79 fig.1.

<sup>250</sup> I.R.C. § 6166 (Supp. IV 1998).

<sup>251</sup> *Id.* § 6601(j)(1)(A), (j)(2) (1994 & Supp. IV 1998).

<sup>252</sup> *Id.* § 6601(j)(1)(B).

<sup>253</sup> Martha Britton Eller, *Federal Taxation of Wealth Transfers, 1992-1995*, in *IRS Bulletin*, *supra* note 158, at 8, 15.

<sup>254</sup> James R. Repetti, *Minority Discounts: The Alchemy in Estate and Gift Taxation*, 50 *Tax L. Rev.* 415, 424-25, 427, 429 (1995).

<sup>255</sup> *Id.* at 428-29.

greatest benefit to those who seek sophisticated tax advice. To the extent that the estate tax does impose an unacceptable burden, policy-makers need to identify the benefits provided by small businesses and family farms and to determine the best way to target tax relief to those companies providing the benefits. Family businesses normally have a low return on assets.<sup>256</sup> However, the family business and farm may play an important humanizing role in a society where larger corporations are guided primarily by profit maximization. The family business or farm may contribute to the richness of community life through its willingness to help neighbors and the community in a way that does not maximize profits, but that nevertheless improves quality of life. As the business grows, however, these values may be lost as the use of the profit-maximizing formula becomes necessary to coordinate the activity of many participants. The task for policymakers is to identify the level at which this occurs so that tax relief is simple and does not require sophisticated planning.

For example, since Internal Revenue Service (IRS) data indicate that farm assets only account for 0.4% of the assets reported on all 1997 estate tax returns,<sup>257</sup> it may be possible to exempt all family farms from the estate tax with no revenue effect. Similarly, small businesses could continue to be exempted. However, once a business has a certain number of employees or reaches a certain size, measured in asset value, it becomes difficult for the owner to participate in all decisions. At that point, the social benefits of the small business begin to decrease, and the estate tax should apply. Whatever criteria are adopted for identifying which businesses qualify for the exemption, however, they should be simple and apply automatically to all similarly situated taxpayers so that less sophisticated taxpayers will not suffer.

### *E. Cost of Administration and Compliance*

The final criticism of our current estate tax is that the costs of administration and compliance are high.<sup>258</sup> The IRS incurs costs in administering the estate tax, and taxpayers incur costs in complying with it. Although the current estate and gift tax is full of loopholes and complex provisions,<sup>259</sup> the costs to the IRS in administering the tax appear to be proportional to the amount of revenues generated.<sup>260</sup>

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<sup>256</sup> Davenport & Soled, *supra* note 10, at 614.

<sup>257</sup> Johnson & Mikow, *supra* note 187, at 102, 104 tbl.1c.

<sup>258</sup> E.g., Holtz-Eakin, *supra* note 27, at 790 (concluding that "substantial evidence suggests the estate tax imposes considerable compliance and administrative costs").

<sup>259</sup> See *supra* notes 155, 211-12 and accompanying text.

<sup>260</sup> Davenport & Soled, *supra* note 10, at 619.

The costs of taxpayer compliance are much more controversial. It is difficult to distinguish between the costs incurred by the taxpayers that are necessary to plan for an orderly succession of property under applicable state law and costs that are necessary to minimize the federal estate tax.<sup>261</sup> The result is that the estimates of taxpayers' compliance have varied widely.<sup>262</sup>

Professors Joseph Astrachan and Roger Tutterow surveyed 1003 businesses to determine the expenses incurred with respect to transfer tax planning (A&T Survey).<sup>263</sup> They found that businesses, on average, spent \$16,113 for attorneys, \$14,632 on accountants, and \$2392 on financial planners in connection with estate planning.<sup>264</sup> The A&T Survey did not attempt, however, to allocate these costs between planning that any well-managed family business should engage in to assure an orderly transfer of the business and additional costs that are attributable solely to the tax.

This is a very important point because any well-organized family business should be planning for succession of the business from the older generation to the younger generation. Transitions in management in any business can be difficult, but they are particularly difficult in a family business where relationships continue after the transition. The failure to plan properly for management succession in family businesses is thought to be the primary cause of failure in subsequent generations.<sup>265</sup> Many of the expenses reported in the A&T Survey might be attributable to costs incurred in normal succession planning. For example, to insure that the older generation has a secure income and that the younger generation is economically rewarded for its efforts, a recapitalization may occur, where the older generation exchanges its common stock for preferred stock and debt. Also, to compensate children with whom the successor does not want to share

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<sup>261</sup> *Id.* at 621 ("Determining the amount that could possibly be attributed to the estate tax is difficult."); see also Alicia H. Munnell & C. Nicole Ernsberger, *Wealth Transfer Taxation: The Relative Role for Estate and Income Taxes*, *New Eng. Econ. Rev.*, Nov./Dec. 1988, at 3, 19 (attempting to estimate compliance costs).

<sup>262</sup> See, e.g., Davenport & Soled, *supra* note 10, at 622-24 (comparing their own research estimate that estate tax compliance costs equal \$6000 per person with another study finding average spending of \$19,908 in legal fees, \$11,940 in accounting fees, and \$11,212 on other advisers for estate planning).

<sup>263</sup> Joseph H. Astrachan & Roger Tutterow, *The Effect of Estate Taxes on Family Business: Survey Results*, 9 *Fam. Bus. Rev.* 303, 303, 304 (1998).

<sup>264</sup> *Id.* at 306 *tbl.2*.

<sup>265</sup> See, e.g., Craig Aronoff & John Ward, *Succession: The Final Test of Greatness 1* (1992) ("[S]uccession planning is the most critical task to secure the future of private enterprise in America. . . . [T]he failure to plan for succession is the greatest current threat to the survival of family business."); see also Ivan Lansberg, *Succeeding Generations: Realizing the Dreams of Families in Business 1-9* (1999) (explaining generally importance of planning in successful leadership transitions).

ownership, life insurance may be purchased. Lastly, appraisals will be required for the bequests and also perhaps for stockholder agreements that might be negotiated.

To estimate roughly the various fees that taxpayers might be incurring, I conducted a simple survey of sixteen tax and trusts and estates partners of several prominent Boston firms.<sup>266</sup> My survey asked what the average legal cost is for clients who are recapitalizing a closely held business in connection with an estate plan. The responses are in Table 8.

| Question: In your experience, what is the average legal cost to clients in recapitalizing a closely held business in connection with an estate plan? |                     |
|--|---------------------|
|  | Number of Responses |
| a) less than \$5000  | 1                   |
| b) \$5,000 to \$10,000   | 3                   |
| c) \$10,000 to \$25,000  | 8                   |
| d) \$25,000 to \$50,000  | 2                   |
| e) more than \$50,000  | 0                   |

The majority of the fourteen partners who responded to this question indicated that the costs would be in the \$10,000 to \$25,000 range. This corresponds to the figures cited in the A&T Survey.<sup>267</sup> But note that in a well-managed business, these costs could be incurred in any event to have a smooth succession of the business to the younger generation.

Alternatively, the costs also may be attributable to attempts to use family partnerships to reduce the value of the closely held business,<sup>268</sup> or they may reflect the desire to use an entity that escapes the corporate double tax. In my survey, I asked what the average legal costs were for planning and creating a family limited partnership or limited liability company. Table 9 sets forth the responses.

<sup>266</sup> Most of the practitioners are members of a luncheon group in Boston that meets monthly at the Boston Union Club to discuss issues in tax law and estate planning.

<sup>267</sup> See *supra* note 264 and accompanying text.

<sup>268</sup> The way that family limited partnerships result in low valuations is quite simple. An asset placed into a partnership normally has a reduced value because each partner's access to, and control over, the asset is limited by the existence of the partnership. This is particularly true for limited partners who have little voice in the conduct of the partnership. Of course, all partners acting in concert could eliminate obstacles to access and control. But our current method of valuation does not permit the identity of co-owners or the likelihood that they will cooperate with one another to be considered in valuing the assets that are placed into a partnership. Repetti, *supra* note 254, at 444, 452. The result is that placing a business into a family limited partnership can reduce significantly the value of its real estate for estate tax purposes. *Id.* at 452.

**TABLE 9**  
**FAMILY PARTNERSHIPS FOR CLOSELY HELD BUSINESSES**

| Question: In your experience, what is the average legal cost to clients for planning and creating a family limited partnership or limited liability company that will hold interests in a closely held business? |                     |
|--|---------------------|
|  | Number of Responses |
| a) less than \$5000  | 2                   |
| b) \$5000 to \$10,000  | 6                   |
| c) \$10,000 to \$25,000  | 7                   |
| d) \$25,000 to \$50,000  | 0                   |
| e) more than \$50,000  | 1                   |

Thirteen of the sixteen respondents to this question selected the ranges \$5000 to \$10,000 or \$10,000 to \$25,000. One respondent also stated in a written note on the survey that the costs of obtaining an appraisal often exceed the legal costs.

To the extent that the A&T Survey's figures reflect the costs of creating family partnerships, these costs might be incurred regardless of whether there is an estate tax because of the family's desire to avoid the double tax on corporate income. The estate tax, however, could motivate some, who otherwise might not be so inclined, to create family partnerships to reduce the value reported in their gross estates and lifetime taxable gifts.<sup>269</sup> The incurrence of these costs would be discouraged by eliminating a loophole that encourages the use of family partnerships to claim a minority discount in valuing interests in the partnership. The loophole is the failure of the transfer tax to value a transferred interest by reference to the interests already held by the transferee or transferee's family.<sup>270</sup> If the method of valuing a transferred interest accounted for interests already held by the transferee and transferee's family, the availability of minority discounts in valuing family partnerships would be curtailed significantly where the transferee and transferee's family controlled the partnership.<sup>271</sup>

<sup>269</sup> See *supra* notes 211-212 and accompanying text for a description of how family limited partnerships reduce the value of assets placed therein.

<sup>270</sup> See *Estate of Bright v. United States*, 658 F.2d 999, 1005 (5th Cir. 1981) (en banc) (holding that "family attribution should not apply to lump a decedent's stock with that of related parties for estate tax valuation purposes"); Rev. Rul. 93-12, 1993-1 C.B. 202, 203 (ruling that "a minority discount will not be disallowed solely because a transferred interest, when aggregated with interests held by family members, would be part of a controlling interest").

<sup>271</sup> See Repetti, *supra* note 254, at 485-86 (arguing for tax provision that includes value of control in valuing certain minority interests in assets).

### *F. Summary*

In summary, Part II has used the U.S. tax system as an example to determine whether a tax on wealth can be used to raise revenues and help check the growth of wealth concentration without significantly affecting savings. It has shown that the current U.S. transfer tax does raise revenues and help curb wealth concentration without significantly influencing savings. The transfer tax need not harm farms or small businesses. All farms could be exempted with minimal revenue impact. Provisions to protect small businesses should be drafted clearly so that sophisticated advice is not required. Finally, valuation rules which allow taxpayers to decrease the value of assets subject to the tax should be eliminated.

### CONCLUSION

This Article demonstrates why wealth concentration matters and why the tax system should be used to help control wealth concentration. It shows that wealth concentration appears to be related to slow productivity growth because of the lack of opportunities for the poor, and also related to excessive power vested in the wealthy. It argues that because inheritances represent approximately fifty percent of wealth, wealth transfers should be taxed so long as the tax provides benefits that outweigh any associated harms. Having used the current federal wealth transfer tax as a case study, the Article concludes that a wealth transfer tax raises significant revenues and helps curb upwardly spiraling wealth concentration. Contrary to what commonly has been asserted, empirical studies generally show that the tax does not discourage savings.

This does not mean that the current wealth transfer tax is perfect, however. For example, provisions intended to help family businesses and farms need to be simplified. Loopholes in valuation rules need to be eliminated. But the current imperfect tax is making a positive contribution. President Roosevelt's declaration that wealth should be taxed is correct today, and should guide policy initiatives in the future.