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Repeal the Death Tax?

Critics deride efforts to repeal the Estate and Gift Tax as a "giveaway to the rich." However, the so-called "Death Tax" is remarkably ineffective in preventing undue concentrations of wealth. The economic distortions resulting from avoidance of the tax may even cost the Treasury more in lost revenue than the relatively small amount it brings in.

Three times in the Nation's history (in 1797, 1862 and 1898), estate taxes were imposed when there was a sudden need for revenue. The tax was dropped (in 1802, 1870, and 1902) when the need passed. Records of estate appraisals in probate courts provide a very convenient target for the tax collector and it would appear that the imposition of estate taxes in those instances was purely for reasons of expediency.

However, the estate tax has remained in existence in various forms ever since it was reintroduced in 1916, in preparation for World War I. Although the impetus of expediency has never really gone away—there are always those who assert that the government needs money—the tax is only a minor portion of the Treasury's receipts. During the 60 years ended in 2005, estate and gift taxes averaged 1.53 percent of Federal revenues; the high for the period was 2.62 percent in 1972, and the low was 0.84 percent in 1988. After the increases in the amount of an estate not subject to tax that were enacted in 2001, this percentage decreased from 1.43 percent to 1.15 percent in fiscal year 2005.

Advocates of the tax have kept it in place for other reasons than as a source of revenue. Ever since the "Progressive Era," the main argument for the estate tax has been the "need" to prevent the concentration of wealth. Presumably this is not only why the World War I tax was kept on the books, but also why the rates reached confiscatory levels, well above the rates of a few pennies on the dollar levied in the earlier death duties.

It may be debated whether or not it is desirable for the government to prevent the concentration of wealth. However, for the purposes of the current discussion, the more important issue is whether the estate tax is an effective means of doing so. That the tax is levied on estates, rather than inheritances, strongly suggests that revenue (rather than the dispersal of wealth) remains the primary consideration of its design. The tax on a very large estate will be the same whether it is left to twenty heirs or only one. A tax on what heirs receive, rather than what the decedent owned, would better serve the purposes of egalitarianism.

Experts, even those of a generally egalitarian persuasion, who have examined the question of the effect of inheritances on inequality, have concluded that they are not a major factor and that the taxation of estates and inheritances has little effect on inequality. One reason for this is that legacies are not a major determinant of either wealth or income. Alan Blinder, in his *Toward an Economic Theory of Income Determination,* found that the unequal distribution of inherited wealth accounted for only about two percent of income inequality. Thomas Stanley and William Danko, in their book *The Millionaire Next Door,* found that only 14 percent of millionaires cite inheritance as the source of their wealth. Most millionaires received nothing at all and 80 percent received less than 10 percent of their holdings through inheritance. These authors found that inheritances were dwarfed by more important sources of inequality of wealth, such as differences in productive effort, money management, and the extent to which individuals live within their means.

Nevertheless, estate-tax advocates often assert with satisfaction that because the estate tax only takes a big bite out of the very largest estates, the cause of equity is advanced to some extent. However, there are so many possibilities for avoidance that the estate tax is in many respects a voluntary tax.

Fairness, Simplicity and Efficiency

The three main traits that define a civilized tax system are fairness, efficiency, and simplicity. The estate tax meets none of these criteria.

Fairness in taxation has two dimensions, horizontal and vertical. The latter calls for those with more resources to pay more in tax and the former calls for those with equal resources to pay equal taxes. However, with sufficient investment of time, energy and money, a wealthy individual is capable of greatly reducing the tax or of escaping it altogether via various tax-avoidance strategies. In fact, the only reason individuals submit to the tax at all is either ignorance of the available avoidance options or their conclusion that the avoidance options are too costly.

Thus the large number of tax-avoidance strategies permitted under the estate tax means its burden is distributed unfairly among payers. Economist Alicia Munnell observed that "tax liabilities depend on the skill of the estate planner, rather than on capacity to pay."

Efficiency in taxation is measured by the cost of its collection, not only in terms of the cost of administration, but also, and far more importantly, the cost and burden placed on the taxpayer over and above the tax itself and in relation to revenue it generates. Munnell found that: "In the United States, resources spent on avoiding wealth transfer taxes are of the same general magnitude as the [revenue] yield, suggesting that the ratio of excess burden to revenue of wealth transfer taxes is among the highest of all taxes." Resources spent on the

pure mechanics of tax avoidance are resources that have been diverted from more productive uses.

Even more significantly, high estate-tax rates create perverse incentives that tend to subvert egalitarian goals in other ways. Advocates of the estate tax do not seem to have a very clear notion either of what they would like to achieve or of the incentives created by the tax. Is the goal to be greater equality of wealth or of consumption? The prospect of estate taxes at marginal rates of up to 60 percent is a powerful incentive to avoid it.

Perhaps the most important mechanism by which estate taxes on very large estates are reduced is large *inter vivos* gifts to potential heirs. In general, the larger the estate, the larger such gifts and the earlier in the heir's life they begin.* Increasing the numbers of relatively young adults enjoying resources they did not earn is unlikely to be what the egalitarians have in mind.

We doubt that larger mansions, yachts, fancier dinners, etc., are what they have in mind either. Yet, what one doesn't give away or leave one's heirs might as well be consumed—Uncle Sam will eventually pick up more than half the tab. The estate tax thus retards the long-term formation of capital by encouraging short-term consumption and because the amount paid in estate and gift taxes reduces the amount of capital in the economy as a whole. Estimates of the amount of private savings that are diverted to private or government consumption via the tax are largely conjectural, but typically run far in excess of the taxes paid. No one believes that retarding capital growth is a desirable goal—capital assets are of benefit to many besides its owners. Punishing the owners for their accumulations can affect others too, most obviously when paying the tax leads to the liquidation of a closely-held business and putting its employees out of work.

Charities

Another argument in favor of the estate tax is that it encourages charitable bequests. The notion seems to be that many individuals facing a large estate tax decide that they would rather see their money go to a charity of their selection than to Uncle Sam. But tax incentives are by no means the only or even the predominant reason people give to charities. Churches, hospitals, universities, and other charities flourished long before there was an estate tax (or an income tax).

In any event, charitable bequests amount to well under two percent of the revenues of nonprofit institutions, and fewer than one in five taxable estates include any charitable bequests at all. A relatively small number of very large estates account for most of the total bequests to charity. No doubt the heirs of such large estates were generally well provided for, and the gifts reflected factors other than the estate-tax savings.

Those who make large charitable bequests typically were not large donors when they were alive. This also suggests that tax savings are not their primary motivation. If they had donated the funds while they were still alive, they would have received income tax deductions *and* the donated funds would not be taxed in their estates.

"Carried Over" or "Stepped Up"?

A final argument for the estate tax is that it enables the government to tax the accumulated unrealized capital gains that were not taxed during a decedent's lifetime. To the extent that this argument has any merit, it reflects a "blunderbuss" approach. Estate taxes will be the same whether the estate represents highly appreciated assets or interest compounded in savings accounts.

Nevertheless, the issue of taxing capital gains is relevant to any reform of the Estate and Gift Tax. Under current rules, heirs take the value as of the decedent's death (a "stepped up" basis) as the cost of any assets they receive by bequest. If the estate tax is repealed and the "stepping up" procedure is retained, then the decedent's unrealized gains will never be taxed in any way. (Some have even suggested that, in the absence of gift taxes, it might be possible to "step up" the basis of an appreciated stock, say, by giving it to a dying relative or friend who would give it back by will).

On the other hand, if the heir's cost basis remained what the decedent paid for an asset (a "carried over" basis), two other problems arise. First, not everyone keeps detailed records and it may simply not be feasible for an executor to determine what was paid for the assets included in the estate. Second, if all asset transfers by will gave the heirs a "carried forward" basis, then large numbers of future heirs (especially heirs of estates not now subject to tax at all) could be facing potential capital gains taxes that are larger than estate taxes due under current law.

Repeal or Reform?

Repeal would end the costly and counterproductive effects of the Estate and Gift Tax. However, it is unlikely that all taxes on transfers of wealth will ever be eliminated. Simply increasing the amount of an estate not subject to tax (which is how the "Death Tax" has been cut since 2001) might reduce the distortions resulting from avoiding the tax, but many taxpayers concern themselves with estate planning even though their estates would not be subject to tax.

A comprehensive reform would be an "accessions tax," in which the total lifetime inheritances and gifts to an individual in excess of some exempt level would be taxed. Presumably, an executor would have to get the tax authority to determine the tax due, if any, on every distribution from an estate. This would necessitate a lot of very long-term record keeping. A far simpler, but less comprehensive change would be to treat gifts and legacies (again, above some exempt amount) as taxable income to the recipient in the year that they are received. Some sort of hybrid system of these two approaches might also be developed. ❑

HAS CONSTRUCTION ACTIVITY PEAKED?

Construction activity recently has decreased due to a downturn in residential construction. Although other areas of the construction industry appear to be rebounding slightly, overall activity may have peaked, and this could put a damper on economic growth.

The construction industry accounts for only about six percent of employment and about nine percent of Gross Domestic Product, but it has a disproportionate impact on the economy because many manufacturing industries, such as appliances, furniture, carpeting, etc., depend on new construction

* One of curiosities of the Unified Estate and Gift Tax is that paying a tax on a large gift removes both the gift *and the tax paid* from one's estate, whereas the tax on an estate is calculated on its value before tax.

activity for much of their sales. Construction has been an especially important ingredient in the current expansion, but there are signs that the boom may be coming to an end. In the second quarter of 2006, the constant-dollar value of total construction put in place was four percent below its peak level a year earlier—the largest decrease since the 2001 recession.

This decrease was due entirely to a retrenchment in residential construction activity, as can be seen in Chart 1. Residential construction accounts for a large share of total construction put in place, typically 40 percent and recently more than 50 percent. It is also the most cyclical. Moreover, these cycles usually foreshadow cyclical turns in the overall economy. Since 1965 there have been six recessions; residential construction activity decreased prior to every one of them, typically with a lead of two to five quarters.

Since peaking in the second quarter of 2005, the real value of private residential construction put in place has fallen by 8.7 percent. This is larger than the decrease associated with the 2001 recession (when the construction cycle was exceptionally mild), and is the sharpest decline since the economic "soft landing" of 1994-95.

The chart underscores the remarkable boom in housing construction during the current business expansion. From its 2000 low to last year's peak, real residential construction put in place soared nearly 43 percent. This increase was broad-based, with contributions from the construction of single-family and multifamily houses as well as home improvements.

Indeed, by historical standards, housing construction entered a new phase in the mid-1990s. Prior to 1994, the value of real residential construction had never exceeded $400 billion. It fluctuated cyclically in a range between $185 and $390 billion, with substantial downturns during recessions. However, in the months prior to the 2001 recession, residential construction activity dipped only briefly before it began to increase again. Over the next five years, a combination of factors, including falling mortgage rates, creative mortgage lending practices (such as zero down payments and interest-only mortgage payments), and the growth of the sub-prime mortgage market, propelled residential construction into previously uncharted territory.

The Recent Reversal

Mortgage rates began to increase about a year ago; the rate on 30-year fixed-rate mortgages has risen by a full percentage point since then. This, combined with elevated home prices in many areas of the country, has made both new and existing housing less affordable.

Recent trends in building permits, housing starts, new home sales, and other housing market indicators all point to a broad and continuing decline in housing market activity. As shown in Chart 2 on the next page, sales of new homes decreased in July to an annual rate of about one million, down from a peak rate of 1.3 million a year earlier. The inventory of unsold new homes, measured by the number of months it would take to liquidate the existing stock at the current sales rate, increased to 6.5 months in July, up from 4.2 months a year earlier. Further decreases in the sales rate and increases in inventory could lead to an additional decrease in residential construction activity.

Nonresidential Construction is Rebounding

Other areas of the construction industry, however, are holding steady or increasing. The real value of private nonresidential construction put in place, which recently has accounted for roughly a quarter of the total, appears finally to be emerging from a prolonged slump. It decreased sharply from late 2000 to late 2002 and remained flat through last fall. Since then it has steadily increased.

In particular, the real value of construction put in place in the manufacturing and health-care sectors has increased sharply since 2003, rising by 25 and 21 percent, respectively. Simultaneously, a weak recovery is underway in the office and commercial segments, both of which have risen just four percent since their 2003 bottom. All four segments continued to expand during the first half of 2006.

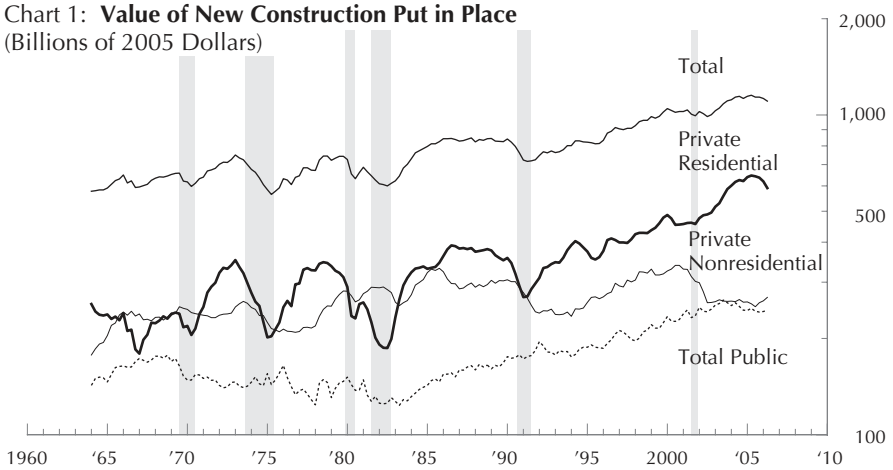
These increases have been offset by weakness in the telecom and power sectors. The real value of construction put in place in the telecom sector peaked in 1998; last year it reached an annual rate of $13 billion, less than 60 percent of that peak. This collapse is not surprising given the problems experienced by this sector since the internet bubble burst in the late 1990s; signs of a recovery are not yet apparent.

In the power industry, the real value of construction activity peaked in 2003 and then decreased by 25 percent to an annual rate of $29 billion last year. This is not unusual. Energy-related construction is a lengthy process, and future plans are often deferred while projects already underway are completed. This may account for the decline in activity in 2004 and 2005. However, a recovery in this sector appears to have begun during the first half of 2006.

The Public Sector and the New Transportation Bill

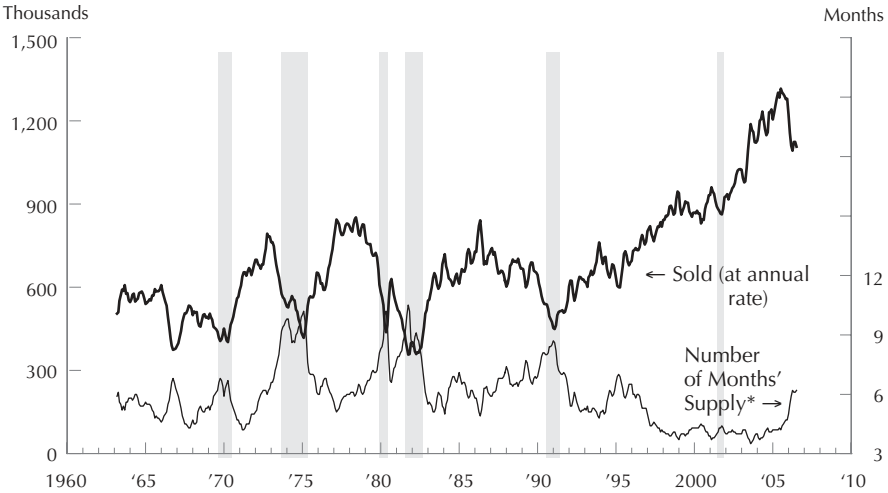
Besides private residential and nonresidential construction, the third major area of construction activity is the public sector, which accounts for about a

Chart 1: **Value of New Construction Put in Place**
(Billions of 2005 Dollars)



Note: All series are seasonally adjusted quarterly data at annual rates. Source: Commerce Department, *Current Construction Reports*.

Chart 2: **New Homes**



* Ratio of homes for sale to homes sold. Note: Both series are 3-month moving averages of seasonally adjusted data. Source: Census Bureau, *Current Construction Reports*.

fourth of the total. This sector tends to be immune to the business cycle and is largely driven by public policy. Since 1983, the real value of public construction put in place generally has trended upward. It was unaffected by the 1990-91 recession (when both housing and nonresidential construction decreased sharply) and the 2001 recession (when nonresidential activity plummeted).

However, activity in this sector has decreased for the past couple of years, having peaked in mid-2003 and fallen by eight percent through the end of last year. The decline was broad-based, with all four major segments experiencing declines in outlays. Mass-transit construction decreased the most, falling by 13 percent from its 2002 peak. Construction work on sewer and water systems, as well as highways and streets, also decreased. Even the construction of public educational buildings, normally a steadily rising segment, fell by nearly four percent last year. Combined, these four segments account for nearly three fourths of public construction put in place.

The weakness in mass transit, highways and streets was mainly attributable to the delay in Congressional reauthorization of federal transportation funding. Major highway bills are enacted every few years. The previous bill expired in 2003 and was finally reauthorized two years later, in August 2005. In the interim, 12 temporary funding measures kept money moving to state and local governments; however, funding was kept at levels no higher than those that prevailed under the old bill.

The new act, the Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy for Users (SAFETEA-LU), provides for up to $295 billion in Federal funds through 2009 for roads and mass transit, a 35 percent increase over the previous bill. Already, highway and street construction outlays have increased substantially in the first half of 2006, while mass transit posted a 4.2 percent (18 percent annualized) increase in the second quarter.

Outlays for sewer and water systems also rebounded in the first half of the year, rising by 10 percent (in real terms) from their level a year earlier. Only the construction of education buildings remains weak in the public sector, with outlays falling again in the second quarter. At $63 billion, real outlays are 14 percent below their peak in the second quarter of 2004. This is the lowest rate since the early part of the decade.

The Role of Rising Costs

The overall picture of the construction industry that we have described is very different from the one portrayed in the media and by many industry analysts. Typically, conditions are being depicted in a positive light, with double-digit growth rates often cited. How can our picture be so different?

The main difference is the role of prices. Our data are adjusted for price changes, while most others are not. (The Census Bureau no longer publishes inflation-adjusted data for the value of construction put in place, but we have deflated their current-dollar data using construction cost data similar to what it previously used). In current-dollar terms, the value of construction put in place hit a new high in the second quarter. But some of this increase was simply due to higher construction costs rather than an increase in physical quantity. Adjusting for this, the value of construction decreased over the past year.

Construction costs have increased at an accelerated rate during the past couple of years. In 2004 and 2005 they increased by nine to ten percent per year, and in the second quarter of 2006 the annual rate of increase approached 12 percent.

Given that so much of the construction boom was concentrated in the residential sector, the weakness in this sector could have a significant impact on the industry and on the overall economy. The decline in housing construction seems unlikely to be reversed any time soon. Falling affordability due to the appreciation of home values and the recent increase in mortgage rates are the principal factors in the downturn. If housing activity continues to weaken and the rest of the economy follows suit, the Federal Reserve may try to limit further interest rate increases or even reduce rates. But, given continued high prices for housing in many areas and changing expectations about the potential returns on real estate as an investment, this may be insufficient to spur a rebound. It may be a while before housing construction returns to the historic peaks seen in recent years. ❑

PRICE OF GOLD

	2004	*2005*	*—— 2006 ——*	
	Sep. 9	*Sep. 8*	*Aug. 31*	*Sep. 7*
Final fixing in London	$396.30	$448.55	$623.50	$621.50

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