

Why Taxing Fairly Means Not Taxing Inheritances

By N. Gregory Mankiw

Does it make sense to tax inheritances and, if so, how much? The answer to this question is a perennial political football.

President George W. Bush, to whom I was an adviser, pushed for the elimination of the estate tax. He succeeded, but only briefly. In 2001, he signed legislation that phased out the tax and eliminated it in 2010. But the tax was back in 2011.

Today, the federal government imposes a tax of 40 percent on estates over \$5.45 million (\$10.9 million for married couples). And many states take a piece of the action as well. The state of New York, for instance, has a top estate tax rate of 16 percent.

Now, Hillary Clinton wants to increase the tax by reducing the threshold to \$3.5 million and raising the rate to 45 percent. Donald J. Trump wants to eliminate it again.

It is easy to understand the appeal of the estate tax. We live in a time of great economic inequality, and the tax is levied only on the very wealthy. The tax helps fund government programs (though it raised only \$19 billion last year, 0.6 percent of federal receipts).

But the estate tax is only one of many policy tools that can be used to make sure those at the top pay their fair share. Another would be to limit itemized deductions, as the Bowles-Simpson commission appointed by President Obama proposed in 2010. We could also reform the tax treatment of carried interest, which hedge fund managers use to reduce their tax burden to extraordinarily low levels.

From my perspective, the estate tax is a bad way to tax the rich because it violates a principle that economists call horizontal equity. The basic idea is that similar people should face similar tax burdens.

Consider the story of two couples. Both start family businesses when they are young. They work hard, and their businesses prosper beyond anything they expected. When they reach retirement age, both couples sell their businesses. After

paying taxes on the sale, they are each left with a sizable nest egg of, say, \$20 million, which they plan to enjoy during their golden years.

Then the stories diverge. One couple, whom I'll call the Frugals, live modestly. Mr. and Mrs. Frugal don't scrimp, but they watch their spending. They recognize how lucky they have been, and they want to share their success with their children, grandchildren, nephews and nieces.

The other couple, whom I'll call the Profligates, have a different view of their wealth. They earned it, and they want to enjoy every penny of it themselves. Mr. and Mrs. Profligate eat at top restaurants, drink rare wines, drive flashy cars and maintain several homes. They spend their time sailing the Caribbean in their opulent yacht and flying their private jet from one luxury resort to the next.

So here's the question: How should the tax burdens of the two couples compare? Under an income tax, the couples would pay the same, because they earned the same income. Under a consumption tax, Mr. and Mrs. Profligate would pay more because of their lavish living (though the Frugals' descendants would also pay when they spend their inheritance). But under our current system, which combines an income tax and an estate tax, the Frugal family has the higher tax burden. To me, this does not seem right.

I recognize, however, that not all economists share my judgments about the estate tax. That is largely because issues of fairness transcend economics and thrust us into the realm of political philosophy, where agreement is all the more difficult.

But there is one thing that everyone can agree on: The estate tax you owe should not depend substantially on the exact moment you happen to expire. A person who died in 2010 paid no estate tax, no matter how wealthy he or she was. A year earlier or later, things would have been very different.

To avoid this particular unfairness, we need more stability in the tax code than we have had in the past. This stability is possible only if those with opposing points of view reach a compromise that, while not perfect from either perspective, is acceptable enough for everyone to live with. Neither Mrs. Clinton's proposal of 45 percent nor Mr. Trump's proposal of zero passes this test.

International comparisons are a natural benchmark. Over all, the United States is a low-tax country compared with many of our developed-nation peers. But that is not true when it comes to the estate tax.

Many countries do not tax inheritance at all, including Australia, Canada and Sweden. Most do, but the tax rates are usually much lower than what we impose in the United States. Among the nations in the Organization for Economic Cooperation and Development, the average for the top estate tax rate is 15 percent. The median is only 7 percent, which is the rate in Switzerland.

If the United States were ever to adopt such a low estate tax rate, it would surely put a lot of the estate planning industry out of business. Hiring expensive legal talent may make sense when the rate is 40 or 45 percent, but not when it is 7 or 15 percent. Yet that would be a good thing. The time those lawyers spend helping the rich skirt the estate tax is, from an economic standpoint, pure waste.