

# Repeal of the Estate Tax and Its Impact on Philanthropy

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*The estate tax has many advocates and opponents. We present a review of the primary arguments and empirical evidence promulgated in support of continuation and for repeal. Overall, we find that there are plausible theories and strong, but not definitive, empirical evidence on both sides of the issue. Further research is needed that more clearly isolates differences between the income-tax and estate-tax (that is, the after-tax cost or "price" of a donation or bequest) effects, the independent-income and wealth effects (how having higher income or wealth has an effect on giving during life and at death), and married and single estate tax filers. These differences can be best isolated using longitudinal data. Data and analyses for both the short run and long run are necessary before society can reasonably predict the impact the repeal of the estate tax will have on both giving during life and charitable bequests.*

**W**HY do we have an estate tax? Does the estate tax matter? Will its gradual repeal affect the economy and the non-profit sector? According to *Giving USA 2001* (AAFRC Trust, forthcoming), bequests to philanthropy totaled an estimated \$16 billion in 2000. What will happen to such gifts as the estate tax is repealed? Will giving increase, decrease, or remain stable? There is widespread disagreement; conflicting theories abound, and some evidence exists to support most of them. Repeal also may have many unintended consequences not yet understood, such as further concentration of wealth and political power or the possible impact on the underlying economic growth rate and the concomitant effects of growth on income at all levels.

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In the face of a sweeping national policy change, policymakers, the public, and the nonprofit sector need to better understand the pros and cons of the estate tax, the potential impact that repeal will have on giving, and the need for additional study. In the rush to action, these issues have not received the examination and thorough debate they merit.

The estate tax and the ability to leave an inheritance are important components of the American political and economic landscape, and they are likely to become even more important in the future. It is estimated that there are more than five million millionaires and 350,000 decamillionaires in the United States (Philanthropic Initiative, June 2000a). Forecasts by John Havens and Paul Schervish (1999) suggest that these numbers will grow dramatically in the next generation. Their conservative estimate is that \$41 trillion in wealth will be transferred from one generation to another between 1998 and 2052, and that at least \$6 trillion of it will go to charity. A less conservative growth estimate, but one that is still within the range of reasonable estimates of future economic growth, is that these numbers will almost double. Furthermore, William Gale and John Karl Scholz report that transfers during life (gifts) account for at least 20 percent of the wealth of recipients, on average. If bequests are included, transfers of wealth from one generation to the next constitute at least 51 percent, and possibly as much as 70 percent, of net worth. Among those who either give or receive wealth transfers, both groups are more likely to have “obtained at least half of their wealth from gifts and inheritances” (Gale and Scholz, 1994, p. 149).

Currently (given that the new legislation starts with deaths in 2002, this article refers to the prerepeal law as the current law), the head of a household can pass an unlimited amount of assets to a spouse and \$675,000 in property and other assets to heirs free from taxation under the federal estate tax law. This exemption is scheduled to increase to \$1 million by 2006 (see Joulfaian, 1998, for useful summaries of the historical and upcoming changes in the estate tax, as well as behavioral effects). Estate tax rates are relatively progressive in that they increase rapidly as the value of the estate grows, from 37 percent to a maximum of 55 percent (on taxable estates of \$3 million or more). According to the National Association of Financial and Estate Planning (1999), “more advanced planning can eliminate or painlessly handle another two or three million dollars in estate values.” That is, households that plan in advance can eliminate any estate taxes on \$3–4 million of net worth. In 1998, almost one hundred thousand estate tax returns were filed, and 17 percent claimed a charitable deduction. Charitable deductions as a percentage of total estate value averaged only 6 percent, but this percentage is reduced considerably by the large number of estates that did not leave any charitable gifts (Billitteri, 2000).

## Recent Legislative Changes

At the time this article was initially submitted, the repeal of the estate tax was one part of the overall tax package promulgated by President-elect Bush to stimulate the economy and achieve other policy objectives. On May 26, 2001, Congress passed the Economic Growth and Tax Relief Reconciliation Act of 2001. As part of the EGTRRA 2001, the estate tax will be gradually reduced (beginning with deaths in 2002) until it is repealed completely in 2010. The exemption will increase to \$1 million in 2002 and then continue to jump up substantially every two or three years (to \$1.5 million in 2004, \$2 million in 2006, and \$3.5 million in 2009). In a similar fashion, the top tax rate will drop to 50 percent in 2002 and fall incrementally to 45 percent in 2009 before its complete repeal in 2010, but the gift tax is retained at the maximum income tax rate.

One important aspect of the EGTRRA that has not received much attention is the sunset provision in 2011. This means that if nothing is done in the interim to change this provision, we return to the *status quo ante*. Hence, there would be no estate tax repeal from 2011 and beyond. This type of planned uncertainty is the worst of all worlds from a horizontal equity perspective (are like people treated the same way?) and from a planning perspective for households.

Consider three people with similarly large wealth profiles: one dies in 2009 and the estate pays a top tax rate of 45 percent with an exemption of \$3.5 million; another dies in 2010 and that estate pays no estate tax; the third person dies in 2011 and this estate pays a top tax rate of 55 percent with a \$675,000 exemption.

The new law does not eradicate the tax implications for heirs and decedents, especially capital gains taxes. Unlike the prior tax regime, which allowed a step up in tax basis at death (an asset's value at the time of inheritance, rather than the original cost or basis of the decedent, was used to calculate future capital gains when the heir sold the inherited assets), under the new law those inheriting assets also inherit the original valuation of the asset. Therefore, any inherited assets accumulate capital gains tax liability from the time the decedent purchased the asset until the beneficiary of the estate sells the asset. The total capital gains are subject to a maximum tax rate of 20 percent plus state taxes where relevant (for a useful summary of the new law versus the prior one, see Greater Milwaukee Foundation, 2001).

In addition, heirs may be affected by a decline in parental giving during life for two reasons. First, the gift tax is retained at the maximum income tax rate. Second, as Kathleen McGarry (2001) points out, giving during life may decline once bequests are no longer taxed, because there would be no tax incentive to make an early bequest. There remain other reasons for parents to support their heirs financially while the parents are still alive, but the tax motivations for doing so have changed dramatically.

Democrats in Congress were unsuccessful in their effort to modify rather than repeal the estate tax. The Democrats proposed several alternatives, including raising the estate tax exemption to \$5 million, which would leave only the wealthiest 3,283 estates owing any estate tax (as opposed to approximately 50,000 in 1999; Weisman, 2001). Ironically, the repeal passed despite the vocal opposition of more than a thousand wealthy people, including Ted Turner and Bill Gates's father. These individuals all signed a petition opposing the repeal of the estate tax as being "an unfair windfall to a tiny number of very wealthy people, forcing others less fortunate to make up the difference" (*Wall Street Journal*, 2001, p. 1).

### Arguments for Repeal

According to Howard Zaritsky (1980), the earliest known estate tax dates back to 700 B.C. in Egypt (10 percent of the transfers of property at death). In the United States, wealth taxes have existed almost as long as our country itself, dating back to 1789. The modern estate tax, created to help finance World War I, generated about 1 percent of total federal revenues during the past two decades (Gale and Slemrod, 2000). Although the current estate tax and its predecessors were created to help finance different wars, President Franklin Roosevelt argued in favor of continuing the estate tax explicitly as an effort to redistribute the increasing concentration of wealth.

Scholars have argued, however, that such an effort to redistribute is not necessary, as there has been tremendous mobility of income and wealth in the United States. In a syndicated column, Bruce Bartlett (2000) cites several studies showing movement up and down the income scale. For example, the University of Michigan found that in the period from 1971 to 1978, almost half of the top 20 percent of income earners dropped 20 percent or more in income. Conversely, there is a great deal of upward mobility, with many moving up at least 20 percent, including almost half of those who were in the bottom 20 percent of earned income. Similarly, the Treasury Department found that between 1979 and 1988, 86 percent of those in the bottom income bracket moved into a higher bracket, and 35 percent of those in the top range dropped 20 percent or more. Additional studies by the Census Bureau and the Urban Institute, as well as by the Federal Reserve Board, found similar results. These data suggest that the U.S. economy is open and dynamic enough that we may not need the estate tax to ameliorate the impact of the tendency toward concentration of income.

Another argument cited against the tax is that it collects relatively few dollars and requires disproportionate compliance costs. Henry Aaron and Alicia Munnell (1992) suggest that the total compliance and administration costs equal or exceed the revenues generated by the tax. Douglas Bernheim (1987) estimates that after taking into account the indirect effects through the impact on the

personal income tax, the “true estate tax revenues may well have been negative” (p. 135). That is, families will use available legal (and sometimes illegal) opportunities to minimize income and estate taxes. Relatively high income taxes may encourage postponing the tax and shifting the burden to the estate tax. This suggests that total social well-being would be better served without such a tax. Other scholars, such as Charles Davenport, argue that the compliance costs are actually only 7 percent of the revenues collected at most, and that the 7 percent includes some estate planning that would transpire even without an estate tax (Kessler, 2000). Furthermore, several studies have demonstrated that the increases in philanthropic giving resulting from the estate tax deduction are greater than the revenues forgone (Boskin, 1976; Joulfaian, 1999).

Among the most common rationales given for repeal are that the tax is or causes a “punishment for success,” or “double taxation,” or sale of some family farms and businesses to pay taxes. Most estate tax revenue does indeed come from the largest estates; in 1998, more than half of the total revenue came from estates valued at more than \$5 million. It is also the case that many assets subject to estate tax are previously taxed at some point along the way, and that the income used to purchase those assets originally was subject to income tax in the first place. However, it must be said that some of the assets that are subject to the estate tax have not been taxed prior to probate and that the estate tax can serve as an effective backstop to gaps in income tax (Joulfaian, 1998).

Of course, whether or not the estate tax is a punishment for success or a tax on being lucky depends on who one believes is paying the estate tax. If the wealth creator is the one paying the tax, then the estate tax might be construed as a punishment for success. However, practically the estate tax is paid by the heirs. This suggests that the tax is on the good luck of having “picked” financially successful parents. If we are concerned with equal opportunity, such a tax on luck may be a good idea.

The argument that resonates most with legislators, the media, and the American people, however, is the potential loss of small family farms and businesses. This aspect of the debate underscores the need for closer examination of the issues. To start with, very few of these are subject to the estate tax at all; cases where family farms or family businesses are the biggest part of the estate make up only about 3 percent of all estates taxed. Even those family farms and businesses that are subject to the tax have several options to help them, including protecting part of the assets through estate planning, a scheduled increase in the exemption, other special exemptions, and spreading payment of the estate tax over fourteen years.

Beyond that, changing the law to provide an even larger exemption or permitting an even longer payment period could address any remaining concerns affecting this group of taxpayers. Even one of the leading opponents of the estate tax, the American Farm Bureau

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Federation, could not find a single case of a farm lost because of estate taxes (Johnston, 2001). Contrary to the rhetoric, when family farms and businesses are sold by heirs, it is because the heirs do not want to continue the family farm or business—not because the estate tax is so punitive that they are forced to make the choice between paying the tax and keeping the farm or business.

Another reason offered for abolishing the estate tax is the theory that any tax on wealth discourages savings. Joseph Stiglitz's research (1978) raises the theoretical possibility that the estate tax discourages savings in the economy. Why save a dollar if the government takes half of it? This argument has important implications for the overall economy. If the estate tax were to diminish savings, holding everything else constant, the result would be lower capital formation, which in turn yields slower productivity growth. Productivity growth and technological change are the main determinants of growth in real (inflation-adjusted) income; therefore, savings are important to the economy and to our standard of living. This is important because Stiglitz points out the theoretical potential paradox that a tax that is designed to redistribute wealth may in economic terms actually harm low-wealth holders (and the nonwealthy) by depressing real wages. James Poterba (1997) estimates that the estate tax does raise the effective tax rate on capital (savings) and that the impact depends on the age of the wealth holder. For the relatively young (heads of household aged fifty to fifty-nine), the estate tax adds only 0.3 percentage points to the average tax rate on capital, but for "older" heads of households (between seventy and seventy-nine), the estate tax adds an additional 3 percentage points to the tax burden on capital or savings.

However, some evidence suggests that estate taxes may have a relatively small detrimental effect on savings, according to a policy brief by William G. Gale and Joel Slemrod for the Brookings Institution (2000). They point out that most of the empirical research suggests that savings by households is not very sensitive to changes in income tax rate, and that, arguably, households would be even less sensitive to changes in an estate tax. The reasons are that the estate tax is more distant in time than are income taxes, and that the estate tax, unlike the income tax, is not paid by the wealth creator (the saver).

Some observers even argue that savings can be a reason to continue the tax. That is, the estate tax can be an incentive to create more wealth and more savings for wealth holders who want to leave a certain amount to their children after taxes. For example, if parents want to leave \$1 million to each child, then, after the first child, they would have to save \$2.2 million in preestate tax dollars to bequeath \$1 million in after-estate-tax dollars. Note that with the current exemption, the first child's million is nearly tax-free and will become completely tax-free by 2006. Absent the estate tax, the parents simply save the \$1 million per child they wish to leave behind, which

would decrease total savings in the economy by approximately \$1.2 million per child, after the first child.

## Philanthropy Supply-Side Argument for Repeal

Within the nonprofit sector, one reason given for estate tax repeal is what Havens and Schervish refer to as the “supply-side,” or wealth, effect (1999). They suggest that without the estate tax, the rich and their heirs would have more after-tax and after-bequest-to-heirs wealth to give to charities. This theory is supported by their empirical research, which found that people with large final estates (those with no surviving spouse) gave away more of their wealth than did people with small final estates. For example, in 1997 smaller estates (\$1–9.99 million) bequeathed to charities an average of 5.6 percent, whereas larger final estates (\$20 million or more) gave away an average of 49 percent to charity but only 21 percent to heirs (Schervish and Havens, forthcoming). Additional support for this idea comes from research by Gerald Auten and David Joulfaian (1996), showing that when children are better off financially parents are more likely to make charitable contributions. These points suggest that ending the estate tax could ultimately increase charitable giving.

By contrast, the supply-side theory may be at least partially refuted by a study by Robert Avery and Michael Rendall (1990), which predicts that for every \$1,000 of entrepreneurial wealth, the entrepreneur gives away \$4.56, but for every \$1,000 of inherited wealth, the inheritor gives only \$0.76. In other words, those who create wealth give *six times* as much as those who inherit it. This suggests that untaxed transfer of wealth to heirs may not result in as much additional giving by heirs as the pure supply-side argument might indicate. Furthermore, given the unlimited deduction for charitable gifts in the current estate tax, wealth creators can already give as much as they want tax-free.

For Schervish and Havens’s supply-side theory to hold up empirically, at least one of three circumstances must be true. First, the wealth effect (the impact of owning more wealth) must exceed the price (tax) effect (the after-tax cost or price of a donation or bequest)—at least for high-net-worth individuals as they plan their final estates. Although the wealth effect may not have been properly specified (defined and tested) in earlier research, none of the empirical research heretofore demonstrates a wealth effect that exceeds a price effect.

Second, the wealthy must have a fairly fixed (inelastic) demand for giving to their heirs. That is, for the repeal of the estate tax to increase charitable giving, wealthy households must decide in advance to give a relatively fixed amount or (fixed share) of their estate to their heirs and the remainder to charity. Parents might find convergence in their concern for their children and their desire for their children to become philanthropic by creating a family

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foundation with a participatory role for the children in managing it. Some preliminary results by Rob McClelland (personal correspondence, June 2001) suggest that the share of final estates (widows only) going to heirs is inelastic across estates of all sizes. Those above and below \$20 million gave an average of \$0.85 of every additional dollar of wealth to their heirs; those with an estate in excess of \$50 million behaved similarly (\$0.86).

Research by McGarry (2001) suggests that parents are more likely to make lifetime gifts and that those gifts are more likely to be much larger as the income and wealth of the parents increases, but that the type of wealth also affects the outcome. For example, holding the size of wealth constant, wealthy holdings in a family farm or business decreases the probability of a transfer, but if they make a transfer during life, it is twice as large. It should be noted that life expectancy also plays a role in parents' decision to transfer gifts during life. McGarry speculates that repeal of the estate tax will have a deleterious impact on charitable bequests, because decedents can give to their heirs at the same after-tax cost as they can now give to a charity.

The third way that the repeal of the estate tax might create a net increase in philanthropy via supply-side impulses is if the heirs use the bequest to create net new wealth by creating a new business or making further investments in the family business, and then give away some of that new wealth in excess of what their parents planned to give. Earlier research by Holtz-Eakin, Joulfaian, and Rosen (1994a, 1994b) shows that inheritance may help ameliorate the problems that plague small business: liquidity and imperfect capital markets. That is, an inheritance may serve as a tool for heirs to overcome the typical problems of inadequate credit and cash flow in a new business. Holtz-Eakin and colleagues found that large inheritances are associated with a higher probability of starting a new business and of that business surviving. Of course, any cost-benefit analysis of charitable gifts and bequests from the heirs would need to discount them to present values. Future charitable bequests that are years away would have to be of much greater dollar value in the future to be of equivalent value today.

### Arguments for Continuing the Estate Tax

One reason cited for keeping an estate tax is to avoid excessive concentration of wealth in relatively few hands. Others feel that by limiting the accumulation of wealth and therefore the often-related accumulation of political power, the estate tax limits skewing of the political process. Research by Aaron and Munnell (1992) found that the United States has a highly concentrated distribution of wealth—in fact, arguably the most concentrated of the industrialized Western nations—and that it became even more concentrated during the 1980s. For example, in this country, the top 1 percent of wealth holders own 32 percent of the wealth, compared to 16 percent of wealth



in Sweden, 19 percent in France, and 20 percent in Canada. Only in the United Kingdom do the wealthiest control as large a proportion of the wealth. Similarly, the top 5 percent of wealth holders in the United States control 55 percent of the wealth, which is between 10 and 20 percentage points more than the other European countries, except the UK.

Gale and Slemrod (2000) point out that estate tax revenues equal only about 0.3 percent of gross domestic product (GDP) and about 0.1 percent of household net worth, implying that the current estate tax is likely to have little meaningful impact on the distribution of wealth. Conversely, these figures could also justify keeping the estate tax and increasing its impact by either raising the tax rates or reducing the exemption, if one wanted to increase redistribution.

Furthermore, the estate tax does increase the total tax burden on the wealthy, which increases the progressive nature of the overall tax structure (Poterba, 1997; Joulfaian, 1998). In addition, the wealthy do not act to minimize their estate taxes by way of legal transfers (gifts) to heirs while they are alive (Poterba, 1997, 1998). In fact, almost two-thirds of elderly wealth holders, who are likely to be confronted with an estate tax liability, are not making transfers (gifts) during life (Poterba, 1998). However, the wealthy are responsive to changes in tax rate and differentials between personal income tax rate and that of estate taxes (Joulfaian, 1998; Poterba, 1998). This tax rate sensitivity manifests itself in the timing of gifts during life and bequests (Joulfaian, 2000b). The wealthy seem to have a preference for holding wealth and its concomitant benefits that exceeds the goal to minimize taxes (Poterba, 1997; Joulfaian, 1999; McGarry, 2001). Joulfaian (1999) concludes that “in addition to its contribution to the nonprofit sector, charitable bequests may shed light on the savings motives of the wealthy; these transfers are perhaps inconsistent with the view that the bequest motive explains the size of the wealth amassed by the very wealthy. This gives more credence to the view that the wealthy derive utility from holding wealth during life” (p. 18). This suggests that the estate tax is unlikely to deter wealth holders from accumulating wealth during their lifetime.

For nearly one hundred years, our national social policy (through the estate tax) has had the result, intentional or not, of helping to redistribute wealth. Alternatively, the estate tax may be viewed as a mechanism to fund the government by those who benefit much from national defense (as well as other governmental expenditure, such as infrastructure expenses for roads, bridges, and so on). However, many wealthy households pay little in income taxes, as much of their income is in the form of accrued capital gains that could escape taxation until death (Joulfaian, personal correspondence, Jan. 17, 2001). Repeal may represent a major sea change in the way our society determines how a portion of wealth is given to public benefit at death—through taxes or through philanthropic giving. Regardless of one’s views on how this should be accomplished,

a decision of this magnitude should have thorough public discourse and full understanding of the consequences.

As with so many aspects of the estate tax debate, the evidence is conflicting. The estate tax does not seem to be especially effective in avoiding concentration of wealth or in taxing previously untaxed income, such as unrealized capital gains. Ninety-eight percent of all wealth holders pay no estate taxes, and those who do so pay relatively little, thanks to generous exemptions. Of the remaining top 2 percent of wealth holders, most pay an average of only about 6 percent of the estate's value in estate taxes.

These factors suggest that relatively little wealth is redistributed by government through collection of estate taxes. On the other hand, one of the reasons many wealth holders pay so little in estate taxes may be that they are not required to do so because they are already giving so much to philanthropy. In this case, it may be possible that although little wealth is being redistributed by the government, it is being redistributed through giving to charitable causes as a result of the existence of the estate tax and the incentive to give to charity to avoid paying the tax.

Another reason offered for continuing the tax is that it sends a signal to the American people that our society values individual philanthropy so highly that it offers the taxpayer a choice between giving his or her wealth to charity or giving it to the government (Mark Wilhelm, personal correspondence, Sept. 20, 2001). The deduction for philanthropy institutionalizes a national preference for the private sector, including the nonprofit sector, to do certain things the government might otherwise have to do. In other words, by encouraging individuals to support philanthropic activity, the estate tax helps to avoid government spending on some activities the American people value. Clotfelter and Salamon (1982) have applied similar reasoning to the deduction for charitable donations in the personal income tax.

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### The Price of Giving

One commonly cited reason for having an estate tax is that the existence of a tax on the wealth a person holds increases the incentive to give to charity. The idea is that potential givers respond to changes in the price of giving. The current top marginal tax rate of 55 percent on estates means that it only "costs" the estate \$0.45 to give \$1.00 for philanthropic purposes. If the estate does not give the money to charity, the heirs receive only the after-tax amount, or \$0.45 for every dollar of wealth, whereas the charity receives the entire dollar. This argues that eliminating the estate tax reduces charitable giving, since there are no savings or advantage in giving to charity rather than to heirs.

Studies by the Treasury Department's Joulfaian suggest that eliminating the estate tax would have lowered charitable bequests by

12 percent, or \$1.3 billion, in 1998. In another study done in 2000, Joulfaian found that, without the estate tax, charitable bequest giving would decline between 0 percent and 31 percent, depending on the model used to create the estimates. Former President Clinton, as part of his justification for vetoing the repeal in 2000, estimated that charitable gifts (both lifetime contributions and charitable bequests) would decrease by \$5–6 billion. A study commissioned by INDEPENDENT SECTOR argued that elimination of the estate tax would have reduced charitable bequests by \$3 billion in 1996.

Pamela Greene and Robert McClelland (2001) use data from the Health and Retirement Study for 1991 to replicate Joulfaian's work. This data set allows them to calculate an individual's life expectancy subjectively and to control for behaviors that might predict giving, such as volunteerism and religious participation, which cannot be done when using tax data. They find strong evidence that the estate tax does increase annual charitable contributions. In addition, they found that the tobit models (estimations of the probability of an independent variable affecting the dependent variable) violated some of the conditions required for such estimates. They used symmetrically trimmed least squares to adjust for the problems in the error term that the tobit results produced and found a smaller but still significant price effect from the estate tax, but they also found a much larger wealth effect than they did when using tobit. These differences may have arisen from specification errors in the tobit analyses, or from the fact that this sample looked at a "younger" population (fifty-to-sixty-year-olds). Most important from the perspective of the estate tax was the finding that the price effects of the income tax and the estate tax were larger than the income and wealth effects for giving during life. This suggests that repeal of the estate tax would have an adverse impact on giving—at least lifetime giving. These results were stable among several scenarios as to the growth rate of a household's assets.

Greene and McClelland found several other interesting results. Religious participation was associated with significantly larger contributions, as was volunteering. They also found that minorities gave significantly less than whites overall, but when the race variable was disaggregated into those who participate in some religious organization and those who do not, they found that minority religious participants gave more than whites (both religious participants and nonparticipants). Minority nonparticipants gave so little that the overall effect for minorities was negative. This bifurcation of giving among minority members was further confirmed when a regression including only religious participants found minorities to give significantly more than whites.

Bernheim's results (1987) suggest that the estate tax is an inefficient method for generating tax revenues; however, it has a large impact on charitable giving. Overall, he estimates that charitable bequests would have declined by almost 80 percent absent the

estate tax and that such gifts would disappear almost entirely for estates under \$1 million. In 1983, this would have reduced charitable bequests by an estimated \$2 billion.

Joel Slemrod and Wojciech Kopczuk (2000) found that the impact of the estate tax is more closely tied to the tax rate in effect when the wealth holder is forty-five years old than to the tax rate at the time of death. This suggests that individuals plan for the estate tax and incorporate the anticipated estate tax rate into their fiscal and estate planning. Similarly, James Poterba finds that transfers (gifts) during life are less than would be expected by models of “dynastic utility maximization,” that is, effecting the greatest satisfaction across generations within a family, but that transfers (lifetime gifts) increase with net worth, “possibly reflecting the impact of progressive estate taxes” (1998, Abstract).

The price-of-giving theory is also supported by several studies examining the impact of income taxes and donations. For example, Daniel Feenberg (1987) found that income taxes are an important determinant of charitable giving, almost regardless of how models predicting giving are structured. Using a panel data set (following the same people over several years), Charles Clotfelter (1980) found that the impact of the price of giving was similar in the panel to cross-sectional (single-year) estimates and that the tax price of giving plays an important role in explaining giving. However, William Randolph (1995) demonstrates that people adjust their giving more completely to changes in permanent (recurring) income than they do to transitory (nonrecurring) income. Clotfelter (1985) also found that the more expensive taxes become, the more income people give to charity. This was especially true for people with high incomes.

### The Role of the Financial Advisor

Research by the Philanthropic Initiative (2000b) also suggests that the estate tax is important in prompting the wealthy to give. Working with the Council of Michigan Foundations, the Philanthropic Initiative (TPI) interviewed 150 financial advisors in Michigan in 1996 and, additionally, surveyed 500 advisors. Many estate planners say minimizing the estate tax is the only way they can persuade clients to consider philanthropy. Even with the tax, many are reluctant to raise the topic for fear of driving away the client. Without it, there would be no fiscal incentive to mention philanthropy, so the advisor would be even more hesitant to discuss a charitable bequest. Of those surveyed, TPI found that almost 90 percent of estate planners were willing to mention philanthropy occasionally and 54 percent were willing to mention it with all of their high-net-worth clients. In the in-depth interviews, more than half of the advisors did not feel comfortable raising the issues surrounding philanthropy with their clients. TPI estimates that even with the current estate tax, only 5–10 percent of the senior advisors could be

termed an “initiator” with respect to philanthropic advising. Absent tax motivations, many felt that it would be inappropriate to even raise the issue. From this research, one might reasonably conclude that without current leveraging of the estate tax, philanthropic advising by financial planners would virtually disappear.

Anecdotally, this concern is felt among many professional fundraisers. In a *Chronicle of Philanthropy* article last year, Billitteri quotes Charles Collier, who is a senior fundraiser at Harvard, as saying, “I can’t tell you the number of donors to Harvard and elsewhere I know who say that, if the estate tax gets repealed, ‘I’m leaving much more to my kids and much less to charity’” (July 27, 2000).

However, not all observers perceive that the role of the financial planner with respect to philanthropic giving is based on the existence of the estate tax. In a recent survey with more than fifteen hundred respondents who were representative of the American population, the National Committee on Planned Giving found that legal and financial advisors play a larger role in such planning than they did eight years earlier (in 1992, when a similar survey was conducted). Part of this may be due to increased affluence and better financial acumen, but the committee concludes that “the desire to support charity remains the primary motivation for most donors, while tax and other financial considerations continue to be secondary” (see the Survey of Donors 2000 at their Website, [www.ncpg.org](http://www.ncpg.org)). In addition, 28 percent of those surveyed who have a charitable bequest in their will (and 68 percent of those with a charitable remainder trust) cited a financial or legal advisor as the source for the idea. Furthermore, as one anonymous referee pointed out, financial planners would still remain interested in charitable estate planning even with repeal of the estate tax, as there are tremendous fees to be earned in drafting and managing charitable trusts. On the other hand, 35 percent of those making a charitable bequest and 77 percent of those with a charitable remainder trust cited the “desire to reduce taxes” as an important factor in their decision to make a gift (National Committee on Planned Giving, 2001).

### Taxes Are *Not* the Only Reason for Giving

Although there is strong evidence to support the idea that tax incentives have some influence on giving, the complexity of the estate tax issue is demonstrated by other evidence suggesting that tax incentives are not the main motivation for making charitable contributions. Top wealth holders are responsive to the effects of the income tax, but Joulfaian (2000c) reports that for a stratified random sample of wealthy tax filers over a decade, the average actual contribution is about twice as large as the average deduction claimed. In fact, in one year during the decade under study, Joulfaian found that the average actual contribution exceeded the allowable deduction

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claimed by a factor of six. This suggests that the wealthy are willing to donate in excess of allowable tax advantages.

Still, even with the estate tax incentive, “only 20 percent of the wealthiest Americans leave anything to charity in their testamentary decisions,” according to Philanthropic Initiative (2000b). This could indicate that repeal of the estate tax incentive might not have as great an effect on philanthropic giving as some fear.

### The Need for Further Research

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*The complexity of the estate tax issue is demonstrated by evidence suggesting that tax incentives are not the main motivation for making charitable contributions*

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Although there has been much work done in this area, there is a need for further refinement and replication of more of Joulfaian’s work with additional samples to include longer panels and nonwealthy, as well as wealthy, households. We need to further disentangle how much of giving during life is prompted by a desire to minimize the impending estate tax in comparison to a desire to minimize current taxes, as well as to meet pure philanthropic desires. Similarly, further investigation is needed to determine the extent to which bequests are due to the price of giving versus the desire to give back to society versus the desire to avoid spoiling one’s heirs. Conversely, how much does the estate tax affect the intent and behavior of individuals regarding accumulation of wealth over their lifetime? These questions are further complicated by possible differences in the desire to protect the standard of living of one’s spouse following one’s death versus the standard of living of one’s children.

The Schervish and Havens finding (forthcoming) demonstrating that there is a jump in giving (both during life and at death) correlated with a jump in income and wealth suggests that future research should test whether income and wealth effects are nonlinear (that is, changing in ways that cannot be captured accurately by a straight line); however, Greene and McClelland’s research (2001) suggests that testing for the nonlinearity of wealth and finding its proper specification is rather complex. Their results suggest that more needs to be done using advanced econometric techniques and other data sets.

Most of the empirical work on how much the estate tax affects giving during one’s life is based on giving during the last year of one’s life. Arguably, the last year of life is quite anomalous. Joulfaian’s work (2000a) differentiates itself from this literature by including a panel that allows examination of giving during the last several years of life and at death. He includes approximations for the income tax effects during life and for wealth holdings, such as wealth in the form of business assets, which might affect giving during life because of liquidity constraints. Joulfaian found that lifetime giving was ten times larger than bequest giving when using the panel for several years of income and donations, as opposed to using data only about giving during the year prior to death. However, as Joulfaian points out, using several years of giving during life as one variable is subject to

aggregation bias. This panel does not track individuals over a protracted period of time, so changes in the income tax code, the estate tax, and marital status throughout one's life may affect giving during life and planning for giving at death in ways that are not captured accurately in an end-of-life study. This panel includes only the behavior of the rich, so another study is needed to address the same effects on the nonrich.

Given the progressive nature of both income and estate taxes, the tax price effect is likely to be endogenous (since the marginal income and estate tax rates increase as income and estate increase in value, it is difficult to separate out the causal relationships), so additional research to replicate Joulfaian's efforts is necessary to determine whether his results hold up with various samples. Similarly, Joulfaian found different coefficients (and levels of significance) when estimating the tax price effect and the wealth effect for the estates of married and single individuals. As one might expect, marrieds are less responsive to tax price than singles, but singles are much more likely to give as their estate grows than are married decedents. Joulfaian found that singles bequeath more than married people, but married households give more during life than single people do.

The Center on Philanthropy at Indiana University is collaborating with the University of Michigan's Panel Study of Income Dynamics (PSID) to add a philanthropy module that tracks giving and volunteering by households over time. This module will enable researchers to model donative behaviors over the course of life (and to make some assumptions at death), which should enable scholars to address several of these issues. However, additional work is still necessary to focus on high-income and high-wealth households, as they have not been oversampled in the PSID population. This is particularly important given that most of the extant research suggests a disproportionately high share of both lifetime and bequest giving comes from high-income and high-wealth holders (for example, Joulfaian, 2000c; Schervish and Havens, forthcoming; Rooney, Steinberg, and Schervish, 2001).

If further research finds that married households continue to give more during life but to give less in bequests, but bequests among final estates (singles, widows, divorced) are more responsive to changes in wealth than to the tax-price effect, then repeal of the estate tax may have a deleterious short-term impact on charitable bequests, but a positive long-term effect. This suggests that from a dynamic perspective households would take care of the needs of their heirs first but share some of their newfound "after-tax" wealth with charities. Conversely, if additional studies find that a bequest from a final estate is not responsive to a change in wealth but is responsive to a change in estate taxes, then repeal of the estate tax will have a detrimental effect on giving in both the short and long run.

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*Human behavior is complex; ultimately it is impossible to know how much giving is based on tax avoidance and how much is based on philanthropic impulses*

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## Conclusion

A good deal of information is already available to inform the estate tax debate, but more is needed. Human behavior is complex, and ultimately it is impossible to know how much giving is based on tax avoidance, how much is based on philanthropic impulses, and how much is based on a combination of the two—or those two coalesced with other factors. Many of the estimates given here are extrapolations on the basis of how giving changed in the past when marginal tax rates increased or decreased. There may be no way to know whether the loss to philanthropy will be the same if the estate tax is removed altogether, or whether repeal will result in a significant increase in giving. It does seem likely that the sources and distribution of the new total philanthropy will change. Unfortunately, it is impossible to predict precisely what the actual effect of eliminating the estate tax will be, but additional studies may help improve understanding of the issue.

The reasons for and against continuing or repealing the estate tax are complex, both theoretically and empirically. We believe these complexities call for thorough study and more exhaustive public discussion of the challenges and benefits of the tax; the potential unintended consequences of keeping, changing, or repealing it; and especially the impact on charitable giving. In the meantime, policy leaders should use this time for phased-in reduction in rates and increases in exemption for more study and debate of the issues. Major policy changes involving these complicated questions should not be addressed with a hasty or simplistic response. Nonetheless, the consistent evidence that the estate tax does increase giving to nonprofits—at least in the short run—suggests that this effect must be weighed in any cost-benefit analysis of these issues.

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