REPEAL OF THE ESTATE TAX: GOOD FOR THE BUDGET AS WELL AS THE COUNTRY

The federal estate and gift tax, or unified transfer tax — a.k.a. the "death tax" — is one of the most controversial features of the federal tax system. The 2001 tax cut provided for a phased reduction in the estate tax rates through 2009, and will then eliminate the estate tax in 2010, while retaining the gift tax. However, due to the sunset provision imposed on that bill by federal budget rules, the estate tax will reappear at its full pre-reform rates in 2011. The House has recently voted to make the repeal of the estate tax permanent. The Senate must still act on the matter. Some Senators and policy experts favor total repeal. Others have suggested either lowering the rate or raising the exempt amount, retaining the tax for at least some large estates.

Before deciding the issue, one should ask, what is the purpose of the tax? Is it to raise revenue? Is it to redistribute wealth to benefit people with lower incomes? If so, please note: The estate tax probably reduces total federal revenues, and certainly lowers the incomes of ordinary working people.

The estate tax reduces capital formation, and thereby lowers productivity, wages, employment, and federal revenues from the payroll and income taxes. The estate tax encourages upper bracket savers to transfer, sooner than otherwise, their assets to their lower bracket children and to tax exempt charities; the government loses a portion of the income tax revenues on the subsequent earnings of the assets and on the charitable deductions taken by the donors. Each of these reactions is enough, by itself, to offset the revenue from the estate tax. Together, they probably cost the government two dollars for every dollar the estate tax collects.

Thus, in addition to being bad for the country, the estate tax is bad for the federal budget. It is bad policy to impose a tax that places very high economic and compliance costs on the public relative to the amounts raised. It is the height of foolishness to impose a tax that actually costs the government more money than it brings in.

Terrible Economic Policy

The income tax is heavily biased against saving and investment (see below). These tax biases, of which the estate and gift tax are but one layer, are real and they have serious consequences. They have discouraged several trillion dollars in saving and investment, considerably retarding the growth of productivity, wages, and employment, and slowing the growth of individual income and wealth. The biggest losers from the heavy taxation of saving have been workers deprived of the capital they need in order to become more productive and more highly paid. Remember, taxes on capital income are substantially shifted to labor, because savers and
investors are highly sensitive to taxes, and have the option of consuming instead of creating additional capital. It is no exaggeration to suggest that the level of income in the United States could be at least 15% to 20% higher than it is today if these biases did not exist. That missing income has simply been thrown away to no good purpose. These losses could amount to as much as $4,000 to $6,000 per year for middle income working families. The current system also cripples people’s ability and incentive to save for retirement, leaving people with less retirement income than they need to be financially secure, and increasing their dependence on government programs or on their children in old age.

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Other impressive research by several scholars into the effects of the estate tax on capital formation, reaching broadly similar conclusions, is summarized in an excellent overview of estate tax issues, "The Economics of the Estate Tax" by Dan Miller. For example, he cites estimates by economists Laurence Kotlikoff and Lawrence Summers (who later became Secretary of the Treasury in the Clinton Administration) that between 41 and 66 percent of the current capital stock has been transferred either by bequests at death or through trusts and lifetime gifts. Using Kotlikoff’s and Summers’s methodology for calculating the effect of the estate tax on capital accumulation, Miller estimates that the old tax has reduced the capital stock by about one-half trillion dollars.

In a Tax Foundation study, J.D. Foster and Patrick Fleenor calculated that the combined incentive effect of the income tax and the old estate tax on marginal saving is equivalent to that of a tax system in which there is no estate tax and the income tax rate is set at 67 percent for individuals and 68 percent for corporations, about twice current levels.

Reduced capital formation. The estate tax contributes to the tax bias against saving and investment. In a study for the Institute for Policy Innovation (IPI) on the effects of the pre-2001 estate tax, Gary and Aldona Robbins estimated that full repeal of the estate tax, through its effect on capital formation, would, over the course of a decade:

- Increase annual gross domestic product by nearly a 0.9 percent. (In terms of today’s economy, by nearly $100 billion.)
- Boost the capital stock by 4.1%. (That’s about $1.7 trillion of additional investment.)
- Add 275,000 more jobs than otherwise.
- Over the ten year period, there would be about $1 trillion in additional GDP.

These figures represent the loss of potential income if there is an estate tax as compared to not having one.

Reduced work incentives. The estate tax also discourages work effort among people who are comfortably situated for retirement and are working only to add to their bequests. Leaving a bequest is one motive for continuing to work, especially for parents who have already accumulated enough money to retire. Consider the effect of the tax on the incentives of an upper-tax-bracket working couple approaching retirement age. If they have saved $15,000 a year since college, they may have accumulated over $3 million for their retirement. They may plan to live on the interest, and leave the principal, and any additional earnings from work, to their children.
Between their two salaries, however, they may be in the 28 or 33 percent tax brackets and still be paying payroll tax on their wage income, for a combined marginal tax rate of about 36 to 41 percent, or 43 to 48 percent if they are paying both the employee and employer halves of the payroll tax as self-employed workers. Throw in a few percent for the state income tax, as well, and they may face a combined marginal tax rate of about 48 to 53 percent on additional income. If, on top of that, the estate tax reappears at its old rates, any after-tax income is going to be subject to a 55 percent estate tax, and their combined tax on additional earnings will be nearly 80%. They may as well retire early and pay less tax. If this couple decides to give some of the assets to the children now to avoid tax in the future, the children may have less incentive to work as well.

Wasted resources. Estate tax planning ties up thousands of lawyers and accountants who could otherwise do more useful work. The waste of legal talent, however, is not the primary loss. The tax forces owners of family businesses to waste time, money, and effort restructuring the financial arrangements of their businesses to avoid the tax. They must also spend large sums on life insurance to prepare for the tax the business will face upon the death of the business’s founder. In many cases, the cost of the insurance is as large as the annual wage cost of one or more additional company employees.\(^5\)

Insofar as they cannot avoid the tax, many small businesses are forced to liquidate some or all of their assets. The National Federation of Independent Business reports that only about 30 percent of family farms and businesses survive the first-to-second generation transfer, and only about 4 percent survive a second-to-third generation transfer; one third of small business owners will have to sell all or part of the business to pay estate taxes; and of the businesses that fail after the death of their founder, about 90 percent of the failures can be traced to the burden of the estate tax.\(^6\) The tax leads to a dreadful waste of the entrepreneurial talent and specialized knowledge of millions of family business people who are forced to sell their businesses. Even if the assets continue to be employed by their new owners, they will often be used less efficiently when the family members who were most familiar with their operation are no longer in charge.

The impact on federal revenue.

Estate and gift taxes took in just over $29 billion in 2000, before the 2001 Tax Act trimmed the tax rate. Total federal revenue for 2000 was $2.025 trillion. Estate and gift taxes represented only about 1.4 percent of federal revenues. Under the 2001 Act, the estate tax rates began to decline. In 2002, the tax brought in $26.5 billion, while total federal tax revenue was $1.853 trillion, still a ratio of about 1.4%. A very modest reduction in the growth of federal outlays would pay for this very modest tax cut.

The estate tax actually contributes less than this apparent amount to federal revenue, however. The effect of the tax on capital formation and work incentives reduces GDP. Reduced GDP means less income for the population and lower federal payroll and income taxes. Efforts to avoid the estate tax lower income tax revenue as well. Evidence is strong that the tax is a net revenue loser for the government.

Capital formation offsets. The IPI study by Robbins and Robbins estimates that, over the first decade following repeal of the transfer tax, added growth from capital formation would generate offsetting income and payroll tax revenues equal to 78 percent of the static revenue loss. By the tenth year and thereafter, the gains from growth would
offset all of the revenue loss. Put another way, federal revenues today would be higher if the transfer taxes had never been enacted.

**Labor offsets.** The reduction in work effort described above lowers income and payroll tax collections on the foregone wages of the affected workers. Since many of the people encouraged to retire by the tax are highly experienced, the loss of their skills reduces the productivity of people who would have worked with them, further lowering wages, employment, and tax revenue. Consider the loss of jobs for nurses and office managers if a physician retires five years early.

**Estate tax planning and the income tax.** Professor B. Douglas Bernheim of Stanford University has studied the revenue effects of the transfer tax. He points out several ways in which normal estate tax planning not only reduces estate tax revenue, but reduces income tax revenue as well.7

For example, cash gifts under $11,000 per year per recipient are exempt from a donor’s taxable unified lifetime transfer. Parents may also transfer shares in a business to their children, who gain from the subsequent income of the assets. Parents in their fifties or sixties are often in higher income tax brackets than their twenty- or thirty-something children. As parents transfer assets to their children, the income tax on the subsequent earnings of the assets falls. Donations to charities are tax deductible and are not counted as part of the lifetime transfer total, and the charities do not pay tax on the subsequent earnings. People who use charitable remainder trusts get a tax deduction for the donation of the assets to the charity, while retaining a lifetime interest in the income. Some other types of trusts that shelter income from estate taxes also result in lower income taxes.

Professor Bernheim believes that the income tax offsets from efforts to avoid the estate tax may be roughly as large as the estate tax revenue. He says: "Although it is very difficult to estimate these effects precisely, in recent years true estate tax revenues may well have been negative."8

**Net revenue loser?** The IPI study estimates that the adverse effect of the estate tax on economic growth reduces income and payroll tax revenues by more than the estate tax brings in. Professor Bernheim estimates that the effect of estate tax avoidance efforts on the income tax fully offsets the revenues generated by the estate tax. If these studies are correct, the estate tax may be losing two dollars in other tax revenue for every dollar it brings in. If these two estimates are even half right, the tax raises no federal revenue. It just makes millions of people miserable. It should be abolished.

One cannot turn the estate tax from a money loser into a money raiser by scaling back the rate or by enlarging the exempt amount to reduce the number of estates subject to the tax. Each estate still affected by the tax would continue to have an incentive to avoid it by shifting assets and saving less, and the largest estates do the best job of it.

**Terrible Social Policy**

The estate tax hurts the poor as well as the rich. People can increase their productivity and labor income in three ways. They can acquire skills and training (human capital). They can buy or inherit physical capital to work with. They can seek employment that will let them work with physical
capital owned by others. By discouraging capital formation, the estate tax makes it harder for the unskilled to team up with capital, which reduces the demand for labor and lessens opportunities to get on-the-job training. It keeps the poor poor, and it keeps start-up businesses from growing to compete with older and bigger firms.

One of the worst features of the estate and gift tax is that the smallest and newest businesses, those least cash rich, are the least able to survive the tax. These include a large share of the businesses created by minorities. The estate tax makes it harder for successful minority businessmen and women to pass the business on to the next generation.9

Good social policy would focus on expanding the opportunity for everyone to get ahead, and for everyone to achieve his or her potential. It should not focus on redistributing a fixed pie (which will usually result in a shrinking pie). In fact, even if wealth redistribution is considered a desirable goal, the estate tax is a poor way to achieve it. Among the richest citizens, most wealth is earned, not inherited. One study found that, among the wealthiest 5 percent of the population, 92.5% of the wealth was from earnings and thrift, and only 7.5% from inheritance.10

According to IRS figures, the estates of the middle class lose a greater percent of their value to the estate tax than those of the super rich. (See Chart 1.) Perhaps the middle class cannot afford the most sophisticated estate planning techniques, or their assets are not of the type that can most easily be protected.

In a failing effort to equalize wealth, the estate tax may bring about a result its advocates must hate. It encourages people to spend their assets rather than leave them for posterity. The result is increased inequality in consumption. Without the estate tax, a retired couple might choose to split up a $4 million dollar fortune among four children and their spouses, and sixteen grandchildren and their spouses, which would certainly reduce the concentration of wealth and the inequality of consumption. If, instead, half of the estate has to go to the government, the grandparents may choose to spend much of the money themselves.

Dealing With Estates in a Fully Reformed Neutral Tax System

In an ideal world, the government would collect its tax revenue in a manner that least distorted economic activity, and that treated all citizens equally before the law. The current tax code does not do this. The estate tax and the taxation of dividends and capital gains in the current tax system contribute to a large anti-saving, anti-investment tax bias that is sharply reducing capital accumulation, wage growth, employment, and income. (The taxation of dividends and capital gains was improved in the 2003 tax bill, but corporate income in particular and saving in general are still tax disadvantaged compared to consumption.) The effect on the economy as a whole is serious, and for some individuals and families, it is devastating.

Tax biases on income that is saved: four layers of tax.

The income tax hits income that is saved and invested much harder than income used for consumption. The income tax is imposed on income that is saved and again on the income produced by the saving. In contrast, the income tax falls on income used for consumption but does not fall again on the consumption spending and the services and enjoyment it provides.

For example, if one uses after-tax income to buy a bond, the stream of interest payments is also taxed. If one uses after-tax income to buy a
television, there is no additional federal tax on the purchase of the TV or the stream of entertainment it provides. All taxes raise the cost of the activities being taxed, but this biased tax treatment of saving increases the cost of saving more than it raises the cost of consumption.¹¹

In addition to this basic tax bias against saving, added layers of tax are imposed. In fact, people who save and invest find their income subject to four layers of federal tax (versus one layer for consumption).

**Layer 1 — tax on earnings.** The income is taxed when first earned.

**Layer 2 — tax on interest and business income.** When the after-tax income is saved, the returns on the saving are taxed — double taxation. If the saver puts his or her income into a bond or bank account, the interest earned is taxed. If the saver invests directly in a small business, his or her investment income from the proprietorship or partnership is taxed. If the saver buys a share of corporate stock, he or she is in fact buying a share of the company, a claim to a share of its income, and his or her share of the corporate income tax on the corporate earnings.

**Layer 3 — taxes on dividends and capital gains.** Shareholders face triple taxation. In addition to the original tax on the saving and the tax paid by the corporation, shareholders must pay personal income tax on any dividends that the corporation distributes out of its after-tax income. (This is sometimes called “the double taxation of dividends”, but it is really the third layer of tax because the income used to buy the shares was taxed before it was saved.)

There is a third layer of income tax even if the corporation does not pay a dividend. If a
corporation (or other business) retains its after-tax earnings for reinvestment, the earning power and the value of the business will increase. If the owner or shareholder sells the business or the shares, the increase in value is taxed as a capital gain.

Capital gains can arise whenever a business’s prospects improve, not just because of reinvestment of previously taxed earnings. The development of a successful new product, or a discovery such as a new wonder drug or a new oil field, can boost the after-tax earnings outlook of a business and increase its current market value. \textit{The current market value of a business (and its stock) is the present (discounted) value of its expected future after-tax earnings.} If the higher expected business earnings come to pass, they will be taxed as corporate income and/or unincorporated business or personal income. To tax as well the increase in the business’s current value if the business or the shares are sold is to double-tax the future income of the business before it even occurs, and to triple-tax the initial saving. The current law income tax treatment of capital gains, whatever their source, is multiple taxation of saving.

Layer 4 — estate and gift taxes. If the saving outlives the saver, and the remaining unspent assets exceed a modest exempt amount, the federal unified transfer (estate and gift) tax imposes another layer of federal tax on the already multiply-taxed saving. This is an added layer of tax even for tax-deferred saving, which is subject to the estate tax and is taxed again as income to the heir (if not a spouse). (Contributions to Roth IRAs and non-deductible contributions to regular IRAs were subjected to the income tax before they were made.) Thus, all saving in estates has already been or will soon be taxed under the income tax, and any taxation of estates is an added layer of tax on saving. Entertainer Oprah Winfrey pegged the nature of the estate tax clearly and accurately when she complained that it is a very high-rate tax which retaxes funds that were already taxed. "I think it’s so irritating that once I die, 55 percent of my money goes to the United States government....You know why that’s so irritating? Because you have already paid nearly 50 percent [when the money was earned]."\textsuperscript{12}

Restoring neutral tax treatment between saving and consumption.

Making the tax system even-handed or neutral between saving and investment, on the one hand, and consumption on the other, requires several steps. First, excess layers of tax on capital income must be ended. The transfer tax on estates and gifts must be eliminated. Corporate income must be taxed either on individual tax returns or corporate tax returns, but not both.

Second, to measure income correctly, the basic tax treatment of saving and investment must be changed. The tax system must treat saving in one of two ways: either allow savers to deduct saving from taxable income, while including the returns, or let savers exclude the returns on saving from taxable income.\textsuperscript{13} There must be no separate, additional taxation of capital gains.\textsuperscript{14} Investments in physical capital must be deducted in the year the outlay is made (expensed) rather than depreciated over time.\textsuperscript{15} (For a description of a simple saving/consumption neutral tax system, see The Inflow-Outflow Tax, available from IRET at www.iret.org.)

Both methods of dealing with individual saving eliminate the excess tax on income that is saved compared to income that is used for consumption. Every major tax reform proposal employs one of these two treatments of saving and investment — the "Flat Tax" proposed by professors Robert Hall and Alvin Rabushka and introduced by former Representative Dick Armey (R-TX) and Senator Richard Shelby (R-AL), the individual side of the
USA Tax (Nunn-Domenici), the "Individual Investment Account" proposal (McCrery-Breaux), the national retail sales tax (Shaeffer-Tauzin), or the value added tax (the Nunn-Domenici business side).

How should estates be treated?

**Deduct saving, tax returns method.** Under the saving-deferred income tax (also called a cash flow tax), individuals would exclude their saving (including interest and principal payments) from taxable income; they would include the gross returns on their saving — interest, dividends, and sales of assets (including return of principal), plus borrowing — in taxable income, but only if the returns were withdrawn for consumption, and not reinvested. This is akin to the tax-deferred treatment allowed for limited amounts of retirement and education saving today (as with deductible IRAs, 401(k) plans, 403(b) plans, SEPs, Keogh plans, and education saving accounts), but with no restrictions on the amount of saving that could be deducted, no penalty tax on withdrawal at any age, and no forced distribution at any age.

In such a system, inherited assets received would be treated like any other saving. The decedent would have deferred tax on his saving when he bought the assets. If the heir were to sell them and spend the money, the proceeds would be taxable. If the heir were to leave the assets in saving, they would remain tax deferred, until such time as they were sold for consumption. Assets transferred during life would also remain tax deferred until the recipient sold them for consumption. IRAs and pensions are treated in this manner under current law in the case of a surviving spouse, who can roll the assets over into his or her retirement plan. Other heirs, however, are forced by law to take the inherited IRA or pension assets out of their tax deferred status, and to pay tax on any previously deferred income over a period of time.

**Tax saving, exempt returns method.** The other route to neutrality is to tax the income that is to be saved, but exempt interest, dividends, capital gains, and other returns on the saving from tax. This is akin to the tax treatment now accorded to Roth IRAs and state and local tax-exempt bonds. No deduction for buying the asset is allowed, but the returns are not taxed. The best known example of a returns-exempt income tax is the "Flat Tax".

In this system, all saving is on an after-tax basis, including the assets in an estate. Since the saving that built the assets was taxed when first earned, there would be no additional estate tax. Assets transferred during life would also be on an after-tax basis. Note that the step up in basis at death for stocks and other assets, which is still available for inherited assets as the estate tax rates are being reduced, is the proper tax treatment under this type of reform. The 2001 Tax Act will eliminate the step up when the estate tax is ended in 2010, implementing a carry-over basis (the price paid by the original investor). The assets in the estate will then be subject to the capital gains tax, but only insofar as they exceed an amount equal to the old estate tax exempt amounts. The elimination of step-up was an unfortunate policy change, as it takes one step away from fundamental tax reform while the estate tax repeal takes a step towards it.

**Conclusion**

The estate and gift tax is bad tax policy, bad economic policy, and bad social policy. It devastates small businesses and family farms. It probably even loses revenue for the federal government. The tax should be repealed at once, without regard for static revenue estimates or short term budget consequences.

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Endnotes


9. Miller, op. cit., p. 27.


11. The following example demonstrates the bias. Suppose that, if there were no income tax, one could buy $100 of consumption goods or a $100 bond paying 4% interest, or $4 a year. Now impose a 20% income tax. One would have to earn $125, and give up $25 in tax, to have $100 of after-tax income to consume. The pre-tax cost of $100 of consumption has risen 25%. To get a $4 interest stream, after taxes, one would have to earn $5 in interest, pre-tax. But $5 in interest requires a $125 bond. To buy a $125 bond, one would have to earn $156.25 and pay $31.25 in tax. The cost of the after-tax interest stream has gone up 56.25%, more than twice the increase in the cost of consumption. Put another way, if there were no income tax, obtaining a $1 stream of interest would cost the saver $25 in current consumption ($100/$4). After the income tax, it would take $156.25 to buy a $4 interest stream or $125 of consumption. Each $1 interest stream would cost $31.25 in foregone consumption ($125/$4), 25% more than in the no-tax situation. This example actually understates the bias because, for simplicity, it assumes there are only two layers of federal tax on income that is saved and does not consider the third and fourth layers.


13. These alternatives can be illustrated using the numerical example in Endnote 2. Suppose interest is exempted from tax, as with state and local tax exempt bonds. Given the 20% tax rate in the example, one would then have to earn $125 to buy a $100 bond, earning $4 with no further tax. Thus, the tax would increase the cost of saving by 20%. That is the same percentage by which the tax increases the cost of consumption. (One has to earn $125 to be able to consume $100). Because the tax increases the costs of saving and consumption by the same percentage, it does not change their relative prices and, hence, does not favor one over the other. The alternative method is to allow a
deduction for income that is saved, while taxing the returns, as with a deductible IRA. One would have to earn $125 to buy a $125 bond, earning $5 in interest pre-tax, and, after paying $1 in tax on the interest, have $4 left.

14. Under the return-exempt approach, there would obviously be no tax on capital gains, because no returns on saving would be taxable. In the deductible-saving case, the cost of the assets would be expensed, that is, deducted from the tax base (resulting in no basis for tax purposes), and all the proceeds of asset sales would be properly included in taxable income. Any gain or loss embedded in the numbers would be automatically calculated correctly for tax purposes, without any special calculations required. If the proceeds of asset sales were reinvested, any embedded gains could be rolled over, and would remain tax deferred until withdrawn for consumption. A bonus from either the return-exempt or saving-deferred approach to ending the tax bias is that capital gains would cease to be a tax issue, greatly simplifying tax forms for individual and business taxpayers and reducing disputes with the IRS.

15. Expensing is the simplest and most sensible way to provide unbiased tax treatment of direct investment in physical capital. Just as neutral treatment of saving can be accomplished by deducting saving and taxing the returns, neutral treatment of investment can be achieved by expensing investment and taxing the returns. Expensing means writing off the investment in the year it is purchased rather than the current practice of stretching out capital consumption (depreciation) allowances over an extended period of time, which reduces their value — especially for long-lived assets, which have very long stretch-out periods. The stretch-out constitutes an interest-free loan to the Treasury of the taxes that would otherwise have been saved by the deduction. Outlays for plant, equipment, buildings and other structures, land, inventory, and research and development should all be deductible in the year the outlays are made, just as for any other production input. Subsequently, all the returns on these investments, including sales of goods and services, rents, and royalties (all net of other costs), and sales of assets, should be taxed.

Note: Nothing here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before the Congress.