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WHAT THE VETOED TAX BILL WOULD HAVE DONE FOR ESTATES AND WHY WE STILL NEED TO DO IT*

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. It is terrible tax policy, terrible economic policy, and terrible social policy. This paper begins by describing the provisions of the recently-vetoed tax bill (the Taxpayer Refund and Relief Bill of 1999) that would have eased the tax burdens on estates. Then it explains why there is absolutely no justification in tax theory for having estate and gift taxes, why these taxes are bad economics, and why they fail to achieve any useful social objectives.

The Tax Bill Vs. Current Law

Current Law.

The federal government imposes a unified gift and estate tax (the "death tax") on the cumulative transfers made during a person's lifetime and at death to persons other than spouses. Above an exempt amount, the marginal tax rates range from 37% to 60% as the value of the transfers increase. On certain generation skipping transfers, the top rate can reach nearly 80%.

The federal estate and gift tax, or unified transfer tax — a.k.a. the "death tax" — ...is terrible tax policy, terrible economic policy, and terrible social policy.

A single graduated rate schedule is applied to cumulative taxable transfers. The bottom rate is 18% on the first $10,000 of taxable transfers, rising to a 55% rate on transfers over $3 million.

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Institute for Research on the Economics of Taxation

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There is a 5% surtax imposed at death on taxable transfers between $10 million and about $17 million; the surtax boosts the marginal tax rate to 60% on transfers within that range and phases out the benefits of the graduated rates. On transfers above that, the tax rate is a flat 55% on the entire taxable estate. (See Table 1.)

As of 1999, a unified credit exempts the first $650,000 of transfers from tax, effectively eliminating the brackets below 37%. The exempt amount will rise to $675,000 in 2000 and 2001, $700,000 in 2002 and 2003, $850,000 in 2004, $950,000 in 2005, and $1 million in 2006 and thereafter; it will not be adjusted for inflation.

An additional write-off of up to $675,000 is allowed for family businesses. The sum of this allowance and the unified credit may not exceed $1.3 million, and the heir or a member of the heir's family must materially participate in the business for five years of any eight year period within ten years following the decedent's death.

As of 1998, individuals could give $10,000 a year to any number of recipients tax free. The annual exempt amount is indexed for inflation beginning in 1999.

There is a graduated credit of up to 16% of an estate allowed against state death taxes. So long as state death taxes are less than the federal credit, the maximum combined tax rate is the statutory federal rate.

A generation-skipping transfer tax (GST) is imposed on either trusts or direct transfers to individuals more than one generation below the transferor (e.g., from grandmother to granddaughter). There is an exempt amount of $1 million (indexed beginning in 1999). The rate is the top estate tax rate of 55% on transfers in excess of the exemption. The 45% of the transfer remaining after the GST is also subject to the estate tax. In effect, under certain circumstances, the government takes 55% of the transfer or trust, and another 55% of the

Table 1: Marginal Tax Rate Schedule Of Estate And Gift Tax

If the Taxable Estate is:		The Marginal Tax Rate is
Over	But not over	
0	10,000	18
10,000	20,000	20
20,000	40,000	22
40,000	60,000	24
60,000	80,000	26
80,000	100,000	28
100,000	150,000	30
150,000	250,000	32
250,000	500,000	34
500,000	750,000	37
750,000	1,000,000	39
1,000,000	1,250,000	41
1,250,000	1,500,000	43
1,500,000	2,000,000	45
2,000,000	2,500,000	49
2,500,000	3,000,000	53
3,000,000	10,000,000	55
10,000,000	17,184,000	60*
Over 17,184,000		55

** Includes 5% Surtax due to recapture of graduated rates.*

remaining 45%, as if the assets had been taxed passing from grandmother to daughter and then from daughter to granddaughter. The combined tax rate can reach nearly 80%.

The basis of inherited assets is "stepped up" (or down) to fair market value as of the date of death. (Alternative dates of six months after death or the date the property is sold or distributed by the estate may be selected.) In effect, any capital gains or losses accrued while the decedent was alive are excluded from tax considerations. The basis of an asset acquired by gift is not "stepped-up"; it is generally the same basis as the donor's (or fair market value, whichever is less).

Inherited tax deferred saving plans such as 401(k), 403(b), and Keogh plans and SEPs and regular IRAs must be taken into taxable income by heirs other than spouses over specified time periods. Heirs must begin withdrawals from Roth IRAs (non-taxable) within specified time periods.

Above an exempt amount, the marginal tax rates [of the estate and gift tax] range from 37% to 60% as the value of the transfers increase. On certain generation skipping transfers, the top rate can reach nearly 80%.

Estate tax reform in the Taxpayer Refund and Relief Act of 1999.

The Taxpayer Refund and Relief Act of 1999, which has been vetoed by President Clinton, would have reduced estate and gift tax rates in stages through 2008, and then eliminated the federal transfer taxes entirely in 2009 and beyond. The 5% surtax and the rates in excess of 53% would have been repealed beginning in 2001, and the unified credit converted to a unified exemption. Rates above 50% would have been repealed in 2002. Remaining rates would have been reduced 1 percentage point per year from 2003 through 2006, 1.5 percentage points in 2007, and 2 percentage points in 2008.

The Taxpayer Refund and Relief Act of 1999, which has been vetoed by President Clinton, would have reduced estate and gift tax rates in stages through 2008, and then eliminated the federal transfer taxes entirely in 2009 and beyond.

As a partial offset to the estate tax relief, the step-up in basis at death for capital assets allowed under current law would have been curtailed for some assets, in effect substituting the capital gains tax for the estate tax, but this tax would be paid only if and when the assets were sold. After repeal of the transfer taxes in 2009, transfers from estates of over $2 million would bear the carryover basis (the price paid by the decedent for the asset). The carryover basis would be phased in for estates between $1.3 million and $2 million. The first $3 million of transfers to a spouse would continue

to receive step-up, and these amounts would not be counted toward the transfers subject to the phased-in carryover basis for estates over $1.3 million.

The top tax rate on long term capital gains is currently 20% (10% for people in the current 15% ordinary income tax bracket). The vetoed tax bill would have lowered that rate to 18% (8% for people in the current 15% tax bracket). These rates are far below the current effective transfer tax rates of 37% to 60%.

Table 2: Current Law Versus Vetoed Congressional Tax Bill
Assume $4 Million Estate With $2 Million Basis

	Current Law*	Congressional Tax Bill, If No Inflation	Congressional Tax Bill, If 50% Inflation	Congressional Tax Bill, If Prices Doubled
Original Basis **	$2,000,000	$2,000,000	$2,000,000	$2,000,000
Value Of Estate At Death	4,000,000	4,000,000	4,000,000	4,000,000
Estate Tax	1,495,000	0	0	0
New Basis ***	4,000,000	2,000,000	3,000,000	4,000,000
Taxable Capital Gain	0	2,000,000	1,000,000	0
Capital Gains Tax	0	360,000	180,000	0
Total Taxes	1,495,000	360,000	180,000	0
Amount Heirs Receive	2,505,000	3,640,000	3,820,000	4,000,000

** Current Law calculation assumes $1 million exempt amount has been fully phased in.*
*** Original basis is the price the decedent paid for the assets.*
**** New basis under Congressional tax bill would be the original basis (called "carryover basis") adjusted for inflation. New basis under current law is stepped up basis — the value of the assets at time of death.*

The bill also would have indexed the basis of capital assets for inflation (using the GDP deflator) beginning in 2000, for assets acquired in 2000 and beyond. Assets acquired before 2000 could obtain the indexing protection for inflation occurring in 2000 and beyond if the owner were willing to recognize (and pay tax on) accrued gains through a "deemed sale and repurchase" of the asset at market value as of January 1, 2000. Indexing with the GDP deflator is a bit less generous than

indexing with the consumer price index, which is used in most other indexing features in the tax code and for certain federal outlays; the CPI slightly overstates inflation, but it is a preferable index to use, because it is not revised once it is issued, and because it is equally bad tax policy to tax either inflationary or real capital gains.

The combined effects of the repeal of the death tax and the reduction in the capital gains tax rate and the indexing of its basis would have provided substantial relief for heirs. For example, suppose assets bought by the decedent for $2 million had grown in value to $4 million at time of death. Under current law, in 2006, the unified credit would shelter the first $1 million of the estate. The estate tax, after the credit, would be $1.495 million, leaving net assets of $2.505 million after tax. The basis of the assets would be stepped up to current market value, and there would be no capital gain if the heir sold before any additional appreciation. (See Table 2.)

As a partial offset to the estate tax relief, the step-up in basis at death for capital assets allowed under current law would have been curtailed for some assets, in effect substituting the capital gains tax for the estate tax, but this tax would be paid only if and when the assets were sold.

Under the vetoed bill, after repeal of the estate tax in 2009, the heirs of such an estate would only have owed capital gains tax on the $2 million increase in the value of the decedent's assets (assuming no inflation), collectible when they sold. If they sold immediately, before further appreciation, the tax would have been $360,000 at the new, reduced 18% capital gains rate, leaving $3.64 million after tax. If these assets had been first purchased after 2000, and inflation accounted for half of the increase in the estate value, the basis would have been $3 million, leaving $1 million taxable at 18%, for a tax of $180,000, with $3.82 million left after tax. If inflation accounted for all of the increase in value, the estate's adjusted basis would have been $4 million, and there would have been no taxable gain, and no tax.

A better idea.

Even better would have been to repeal the transfer tax immediately and retain the step-up in basis for all assets. Both the estate tax and the capital gains tax are excess layers of tax on saving, whether gains are real or due to inflation (see below). Neither tax makes good economic sense. The step-up in basis is one of the few features of the tax code that treats capital gains correctly. It would be a shame to lose that treatment.

Terrible Tax Policy: Tax Biases Against Saving And Investment[1]

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 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 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.

Even better would have been to repeal the transfer tax immediately and retain the step-up in basis for all assets. Both the estate tax and the capital gains tax are excess layers of tax on saving, whether gains are real or due to inflation...

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 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.[2]

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. ***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.]"[3]

The estate tax and the taxation of 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 effect on the economy as a whole is serious, and for some individuals and families, it is devastating.

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.[4] There must be no separate, additional taxation of capital gains.[5] Investments in physical capital must be deducted in the year the outlay is made (expensed) rather than depreciated over time.[6] (For a description of a simple saving/consumption neutral tax system, see The Inflow-Outflow Tax, available from IRET.)

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 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 allowing limited amounts of retirement saving today (as with deductible IRAs, 401(k) plans, 403(b) plans, SEPs, and Keogh plans), 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.

Terrible Economic Policy

Cost of the tax biases against saving and investment.

These tax biases 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. 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 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 their children in old age.

The costs of the estate tax alone: effect on GDP.

Reduced capital formation. The estate tax contributes to the tax bias against saving and investment. A recent study by the Institute for Policy Innovation (IPI)[7] estimated that repeal of the estate tax, through its effect on capital formation, by 2010 would:

- Increase annual gross domestic product by $137 billion (0.9 percent).
- Boost the capital stock by $1.7 trillion (4.1%).
- Add 275,000 more jobs than otherwise.
- Over the ten year period, there would be nearly $1 trillion in additional GDP.

These figures represent the loss of potential income if the estate tax is not removed.

[A]ll 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. 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).

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.[8] For example, he cites estimates by economists Laurence Kotlikoff and (now Treasury Secretary) Lawrence Summers 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.[9] Using Kotlikoff's and Summers's methodology for calculating the effect of the estate tax on capital accumulation, Miller estimates that the tax is currently reducing the capital stock by about one-half trillion dollars.

J.D. Foster and Patrick Fleenor of the Tax Foundation have calculated that the combined incentive effect of the income tax and the 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 were set at 67 percent for individuals and 68 percent for corporations, about twice current levels.[10]

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.

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.

Between their two salaries, however, they may be in the 36 percent tax bracket and still be paying payroll tax on their wage income, for a combined marginal tax rate of about 44 percent, or 52 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. They may face a combined marginal tax rate of about 55 percent on additional income. If, on top of that, any after-tax income is going to be subject to a 55 percent estate tax, 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.[11]

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 Businessmen 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 the failure of 90 percent of small businesses after the death of their founder can be traced to the burden of the inheritance tax.[12] 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 people 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 $24 billion in 1998. Total federal revenue for 1998 was $1.721 trillion. Estate and gift taxes represent only about 1.4 percent of federal revenues. A very modest reduction in the growth of federal outlays would pay for this very modest tax cut.

[Due to] the adverse effect of the estate tax on economic growth... [and] the effect of estate tax avoidance efforts on the income tax ... the estate tax may be losing two dollars in other tax revenue for every dollar it brings in.

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 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 2010 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.[13]

For example, cash gifts under $10,000 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.

[T]he 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.

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."[14]

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.

In a failing effort to equalize wealth, the estate tax ... encourages people to spend their assets rather than leave them for posterity. The result is increased inequality in consumption.

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

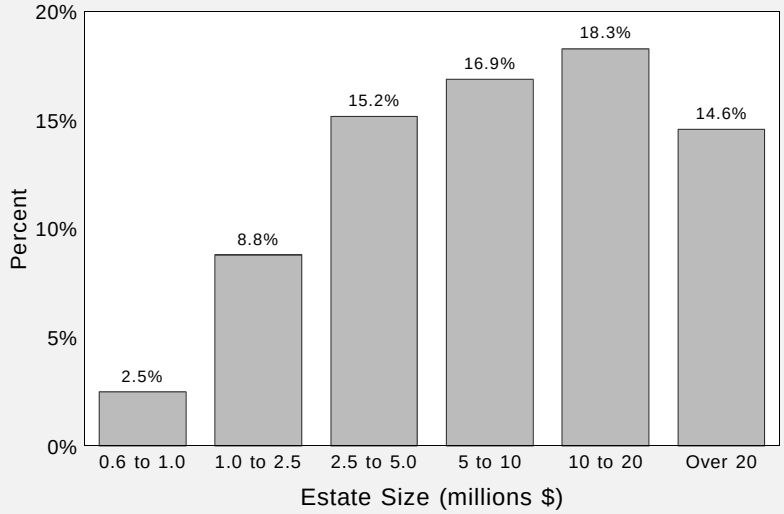
get on-the-job training. It keeps the poor poor, and it keeps start-up businesses from growing to compete with older and bigger firms.

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 minority businessmen and women to pass the business on to the next generation.[15]

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. Most wealth is earned, not inherited. A recent 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.[16]

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.

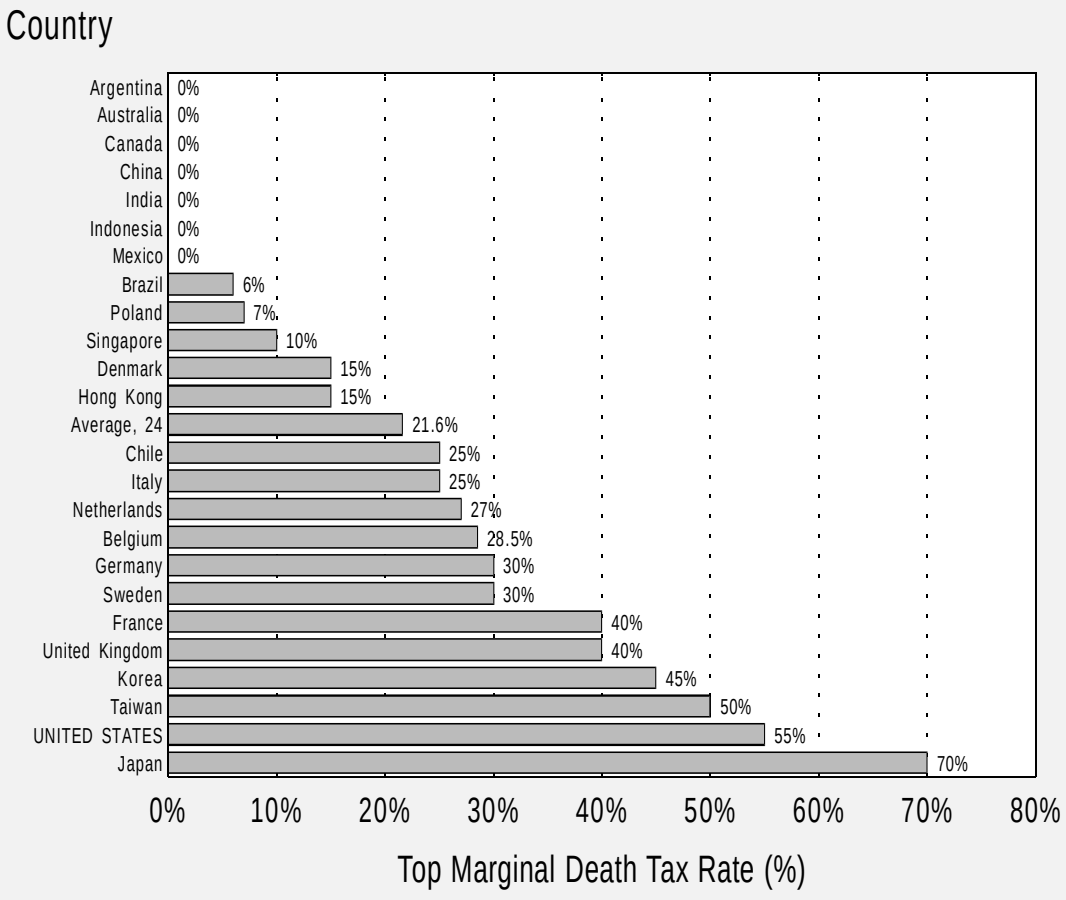
Chart 1
Estate Tax Paid As Percent Of
Gross Estate, 1996



Source: "Estate Tax Returns Filed In 1996," SOI Data, April 1998, accessed at www.irs.gov.

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.

Chart 2
International Comparison Of Top Marginal Death Tax Rates



Source: American Council For Capital Formation

All around the world, countries seeking a better future are treating saving and estates better than the United States does. According to data collected by the American Council for Capital Formation[17], the United States has the second highest estate tax rate among major nations. Only Japan's is higher, and Japan is in the process of reducing its top rates to European levels. (See Chart 2.)

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. Tax relief for estates should not be compromised by imposing carryover basis and the capital gains tax. Step-up in basis at death should be retained.

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Notes

1. Material in the next two sections was modified from the author's background papers contained in "Unleashing America's Potential," the *Report of the National Commission on Economic Growth and Tax Reform*, January 1996.

2. 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.

3. Oprah Winfrey, cited in Bruce Bartlett, "Why Death Taxes Should Be Abolished," *NCPA Policy Backgrounder* No. 150, National Center for Policy Analysis, Dallas, TX, August 1999.

4. 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.

5. 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 returns-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.

6. 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.

7. Gary and Aldona Robbins, "The Case for Burying the Estate Tax", *IPI Policy Report* No. 150, Institute for Policy Innovation, Lewisville, TX, 1999, accessed at www.ipi.org.

8. Dan Miller, "The Economics of the Estate Tax," Joint Economic Committee, U.S. Congress, Washington DC, 1998.

9. Laurence J. Kotlikoff and Lawrence H. Summers, "The Role of Intergenerational Transfers in Aggregate Capital Accumulation," *Journal of Political Economy*, vol. 89, no. 4, 1981, pp. 706-732; and Laurence J. Kotlikoff and Lawrence H. Summers, "The Contribution of Intergenerational Transfers to Total Wealth: A Reply," in *Modelling the Accumulation and Distribution of Wealth*, eds. Denis Kessler and Andre Masson (Oxford, England: Clarendon Press, 1988), pp. 53-76.

10. J.D. Foster and Patrick Fleenor, "The Estate Tax Drag on Family Business, " *Family Business Review*, Fall 1996, pp. 233-252, as cited in Miller, *op. cit.*

11. Jack Faris, "We're Not Rockefellers," *Small Business Focus*, National Federation of Independent Business, Washington, DC, February 26, 1999; and statement of Michael Coyne, "Death Taxes," before the Committee on Ways and Means, U.S. House of Representatives, Washington, DC, June 16, 1999.

12. NFIB, "Death (Estate) Tax Reform," on the Internet at www.nfibonline.com/politics/issue-archive/taxes/etib.html, cited in Bartlett, *op. cit.* The latter is an excellent overview of a number of recent surveys and writings on the effect of the estate tax on businesses.

13. B. Douglas Bernheim, "Does the Estate Tax Raise Revenue?" in *Tax Policy and the Economy*, vol. 1, ed. Lawrence H. Summers (Cambridge, MA: MIT Press, 1987), 113-138. Or see the discussion of his work and related issues in Miller, *op. cit.*

14. Bernheim, *op. cit.*, p. 135.

15. Miller, *op. cit.*, p. 27.

16. James P. Smith, *Unequal Wealth and Incentives to Save* (Santa Monica, CA: Rand Corporation, 1995), p. 16, as cited in Bartlett, *op. cit.*

17. American Council For Capital Formation, Center for Policy Research, Special Report, "An International Comparison of Death Tax Rates," Washington, DC, June, 1999.