Executive Summary

Perhaps no section of the tax code does as much societal damage while generating relatively little revenue as the estate tax.

- Estate taxes generate less than one percent of federal revenues.
- Estate tax compliance costs the economy almost as much as the revenue raised. Such compliance costs are a deadweight loss to society.
- High marginal estate tax rates (from 37% to 55%) often force heirs to sell family farms or businesses just to pay the estate tax bill.
- Estate taxes strike families when they are at their most vulnerable: along with the family member, families can lose what the family member built.
- High marginal estate tax rates also discourage savings and investment, reducing economic growth.

Further, there is neither social nor economic justification for the estate tax.

- Estate taxes today are far out of line with historical precedent. Throughout most of U.S. history, estate taxes were temporary measures during wartime, and were eliminated when hostilities ceased.
- The largest estates do not even pay the highest tax rates. Typically, owners of small businesses and family farms who amass wealth through a lifetime of hard work and thrift pay significantly higher marginal estate tax rates than the very rich, particularly those who inherited their wealth.

Today, estate taxes reach much more deeply into the middle class than ever before.

- Today, estates over $650,000 are taxed, compared to $9 million (in today's asset dollars) in 1916.
- Although tax schedules give the impression that the estate tax begins at 18 percent, in fact, most people begin paying at a marginal rate of 37 percent on the first dollar of taxable estate.

Eliminating the estate tax altogether would eliminate all these complexities and injustices with no revenue loss to the Treasury. In fact, after ten years, eliminating the estate tax would produce sizeable economic gains, actually increasing federal revenues above the current baseline, according to the analysis in this study.

In the 105th Congress, more than 50 bills dealing with estate taxes were introduced. Proposals ranged from relief directed to specific groups of taxpayers, such as farmers and closely-held businesses, to the outright elimination of estate and gift taxes. More proposals have already been introduced during the 106th Congress.

In order to reduce compliance costs, social injustice, and hinderances to economic growth, Congress should make estate tax policy a priority for action. Serious reduction or outright elimination of estate taxes would be one of the best legacies that the 106th Congress could leave future generations.

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The Case for Burying the Estate Tax

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Introduction

Estate taxation is one of the most arcane and obscure parts of the federal tax code. Until recently it was the almost exclusive headache of the super rich, their tax attorneys and their estate planners. However, a strong economy, an ever-widening distribution of wealth – both positive developments – coupled with short-sighted tax policy are extending the reach of estate taxes. About 2.8 percent of those who died in 1992 left estates large enough to file an estate tax return. That percentage should at least double by 2002.

Estate taxes even threaten the middle class. Average Americans who purchased homes 20 or 30 years ago, own a farm or built up a family business could find their estates large enough to be taxed. And high marginal tax rates (37% on estates over $650,000 up to 55% on estates over $3 million) often force heirs to liquidate assets to pay the estate tax bill.

"Over 50 bills dealing with estate taxes were introduced during the 105th Congress."

Not surprisingly, the plight of family farms and businesses has caught the attention of policy makers. Over 50 bills dealing with estate taxes were introduced during the 105th Congress. Proposals ranged from relief directed to specific groups of taxpayers, such as farmers and closely-held businesses, to increasing the size of estates exempt from tax, to the outright elimination of estate and gift taxes. More proposals will undoubtedly be considered during the 106th Congress.

The purpose of this study is to shed some light on this little understood and extremely complex tax. The first section traces the development of federal estate taxes in the United States from colonial times to the present. Next comes a discussion of today's estate tax, including who pays it. The third section examines how estate taxes affect the economy, and the last section presents estimates of how eliminating the estate tax would affect the economy and federal budget.

U.S. Estate Taxes: An Historical Perspective

Death taxes date back almost three thousand years. As early as 700 B.C., there appears to have been a 10 percent tax on the transfer of property at death in Egypt.[1] In the first century A.D., Augustus Caesar imposed a tax on successions and legacies to all but close relatives.

Transfer taxes during the Middle Ages grew out of the fact that the sovereign or the state owned all assets. Although the king owned all real property in feudal England, he did grant its use to certain individuals during their lifetimes. When they died, the king would let the estate retain the property upon payment of an estate tax.[2]

Of course, the principle of sovereign ownership is diametrically opposed to a system of individual property rights, as we have today in the United States, and is no longer the basis for taxing transfers of wealth. But other rationales have taken its place. What follows is a brief history of U.S. estate taxation. The discussion centers around three periods: early federal estate taxes (1797 to 1915); the development of the modern estate tax (1916-1975) and the restructuring of federal estate taxes (1976 to the present). Tables 1, 2 and 3 summarize major features of estate tax legislation from these three periods.

Early Federal Estate Taxes: 1797 to 1915

In the United States, the tradition of taxing assets at death began with the Stamp Act of 1797. While the first Stamp Act on tea helped precipitate the Revolutionary War, the second was far less dramatic. Revenues from requiring a federal stamp on wills in probate

Table 1
Early Federal Estate Taxes 1797 to 1915

Sources: Martha Britton Eller, "Federal Taxation of Wealth Transfers, 1992-1995," *SOI Bulletin*, Winter 1996-97 and John R. Luckey, "A History of Federal Estate, Gift and Generation-skipping Taxes," Congressional Research Service, March 16, 1995.

Early Federal Estate Taxes 1797 to 1915

Legislation/ Court Rulings	Description	Purpose/ Importance
Stamp Act of 1797	Federal stamps required on receipts and discharges from legacies and intestate shares.	To finance undeclared naval war with France
1802	Stamp Act repealed.	
Revenue Act of 1862	Tax on legacies and distributive shares of personal property from estates over $1,000; rates ranged from 0% for surviving spouse bequests to 0.75% for distributions to ancestors, lineal descendants and siblings to 5% for those to distant relations and unrelated persons.	To finance Civil War
Internal Revenue Law of 1864	Added a succession tax, a tax on bequests of real property; increased legacy tax rates on personal property transfers; first gift tax applied to real property transfers of less than adequate consideration made during decedent's life. Also introduced an exemption for small estates; special treatment for surviving spouse bequests; tax deductions for bequests to charitable organizations.	To finance Civil War
1870	1864 tax repealed .	
1874 Supreme Court Ruling *(Scholey v. Roe)*	The Court disagreed with the taxpayer's contention that death taxes were direct taxes that must be apportioned according to the census.	Upheld the constitutionality of legacy and succession taxes.
Income Tax Act of 1894	Treated gifts and inheritances as income and taxed them as such.	
1895 Supreme Court Ruling *(Pollock v. Farmers' Loan and Trust Company)*	The Court ruled the Income Tax Act of 1894 unconstitutional because it taxed gains from real estate, thereby constituting a direct tax which had to be apportioned among the states according to the census.	Set the stage for passage of the 16th Amendment to the Constitution which expressly authorizes the federal government to impose an income tax without census apportionment.
War Revenue Act of 1898	Death tax applied to value of personal property in a gross estate (after a $10,000 exemption) instead of bequests; property going to a surviving spouse excluded from tax; rates graduated from 0.74% to 15%.	To finance the Spanish American War
1900 Supreme Court Ruling *(Knowlton v. Moore)*	The Court reaffirmed its earlier decision that the estate tax was an indirect tax and rejected the contention that death taxes were the exclusive prerogative of the states.	
1902	1898 tax repealed.	

were used to pay off debts incurred during the 1794, undeclared naval war with France. Congress repealed the Stamp Act in 1802.

Not until the Civil War did the federal government again turn to death taxes for revenue. Unlike the previous documentary stamp tax, the Tax Act of 1862 imposed a federal *inheritance* tax. Heirs who received legacies and personal property from estates worth more than $1,000 (roughly $1 million in today's dollars) had to pay a graduated tax based on family relationship.[3] Rates ranged from 0.75 percent for ancestors, lineal descendants and siblings up to 5 percent for distant relations and unrelated persons.

To help pay mounting Civil War costs, Congress increased the inheritance tax rates and added a succession tax in 1864.[4] When the need for added revenue subsided after the war, the inheritance tax was repealed in 1870.[5]

In 1874, a taxpayer challenged the legality of the Civil War death taxes, arguing they were direct taxes which, under the Constitution, must be apportioned among the states according to the census. The Supreme Court disagreed saying that direct taxes pertained to capitation (head) taxes and taxes on land, houses and other permanent real estate.[6]

Another legal decision bearing on, but not directly related to, death taxes concerned The Income Tax Act of 1894, which included gift and inheritances as income subject to tax. The Supreme Court struck down the whole bill because the tax was imposed on, among other things, real estate gains and, therefore, considered a direct tax.[7] This decision is particularly notable because it set the stage for the Sixteenth Amendment which, in short, allows the federal government to tax any thing it wants, any time it wants, any way it wants.

Financing for the Spanish-American War gave rise to another death tax in 1898. A tax, ranging from 0.74% to 15%, was imposed on the value of personal property in a gross estate. Estates under $10,000 (roughly $6 million in today's dollars) and property passing to surviving spouses were excluded.[8]

The Supreme Court upheld the 1898 Act by ruling that estate taxes, like inheritance taxes, were not direct taxes and did not have to be apportioned among the states.[9] Congress repealed the estate tax in 1902.

Evolution of the Modern Estate Tax: 1916 to 1975

Another form of death tax did not appear until 1916. As worldwide conflict cut into trade tariffs, Congress turned to another revenue source—the income tax —made possible by the Sixteenth Amendment to the Constitution.

The Revenue Act of 1916, which introduced the modern day income tax, also contained an estate tax with many features of today's system. Graduated tax rates were applied to the *net estate*, that is, *gross estate* less deductions. Gross estate included personal and real property, life insurance payable to the estate, and certain transfers that could occur during a person's life or after death. Jointly-owned property was part of the estate unless the surviving co-owner could prove he or she had helped pay for its acquisition. Deductions were allowed for administrative costs, debts, claims, funeral costs and support of decedent's dependents during administration of the estate. After an exemption of $50,000 (almost $9 million in today's dollars), tax rates started at 1% and climbed to 10% on estates over $5 million. [See Table 4 for a summary of estate tax exemptions and tax rates since 1916.]

Defense demands after the U.S. entered World War I required even more revenue. In 1917, estate tax rates were more than doubled and two more brackets were added.

In 1918, Congress reduced the tax rates on estates under $1 million and added charitable contributions to the list of allowable deductions. But the estate tax base was expanded by including the value of a spouse's dowery and life insurance proceeds over $40 million going to the estate.

Table 2
Development of Modern Estate Tax, 1916 to 1975

Sources: Martha Britton Eller, "Federal Taxation of Wealth Transfers, 1992-1995," *SOI Bulletin*, Winter 1996-97 and John R. Luckey, "A History of Federal Estate, Gift and Generation-skipping Taxes," Congressional Research Service, March 16, 1995.

Development of Modern Estate Tax, 1916 to 1975

Legislation	Description	Purpose/ Importance
Revenue Act of 1916	Introduced modern estate tax which applied to net estate (gross estate minus deductions); tax rates started at 1% of the first $50,000 of net estate to 10% on estates exceeding $5 million; gross estate included personal and real property, life insurance payable to estate, certain lifetime transfers and transfers which took affect on or after death; all joint property was included unless there was evidence that the co-owner gave support; deductions allowed for administrative costs, debts, claims, funeral costs and support of decedent's dependents during estate's administration .	To help offset revenue shortages caused by reduced U.S. trade tariffs due to World War I.
Revenue Act of 1917	Increased rates and added two brackets; estate tax rates went from 2% on net estates below $50,000, to 22% on net estates between $8 and $10 million, and 25% on those above $10 million. Estates of those who died in military service were not taxed.	To help offset defense costs of World War I.
Revenue Act of 1918	Reduced rates on estates under $1 million; expanded estate tax base by including spouse's dower rights and life insurance proceeds over $40,000; allowed a deduction for charitable contributions.	Compromise in debate between and House and Senate between cutting rates versus replacing estate tax with an inheritance tax.
Revenue Act of 1924	Increased top rate to 40% on estates over $10 million; allowed credit against federal estate taxes for state death tax of up to 25% of federal liability; expanded estate tax base by including revokable transfers; added a gift tax with same rate schedule along with exclusions of $50,000 over lifetime and $500 a year for each donee.	
Revenue Act of 1926	Repealed gift tax; lowered top rate to 20% on estates over $10 million; increased exemption to $100,000; increased the maximum credit for state death taxes to 80% of Federal liability.	Response to stiff opposition toward estate and gift taxes.
1929 Supreme Court Ruling *(Bromley v. McCaughn)*	Court held that gift tax was an excise tax which fell in the category of indirect taxes.	
Revenue Act of 1932	Raised almost every estate tax rate; added two new brackets; dropped estate exemption from $100,000 to $50,000; reintroduced gift tax with rates 75% those of estate taxes; set lifetime gift exclusion at $50,000 and annual exclusion of $5,000 per donee.	To increase federal revenues that had been reduced by the Depression.
Revenue Act of 1934	Raised top estate tax rate to 60% on estates over $10 million.	Extension of social policies that aimed to redistribute income.
Revenue Act of 1935	Raised top estate tax rate to 70% on estates over $50 million; reduced estate and gift lifetime exclusions to $40,000.	Extension of social policies that aimed to redistribute income.
Revenue Act of 1940	Added a 10% surtax to income, estate and gift taxes.	To pay for increased military preparedness as war broke out in Europe.
Revenue Act of 1941	Increase in estate tax rates range from 3% on net estates under $40,000 up to 77% on estates over $10 million.	
Revenue Act of 1942	Created a $60,000 estate tax exemption and gift tax exclusions of $30,000 lifetime and $3,000 annually; expanded estate tax base through inclusion of insurance paid for by decedent; excluded community property from gross estate only to the extent that the surviving spouse could be shown to have contributed.	Tried to correct the perceived inequity between community property and noncommunity property states.
Revenue Act of 1948	Allowed a marital deduction equal to the value of all property passing to a surviving spouse up to a maximum ½ of the adjusted gross estate in noncommunity property states.	Replaced 1942 community property rules that were complex and unsuccessful.
Internal Revenue Code of 1954	Changed estate taxation of life insurance to include most proceeds.	

Increases in estate taxes made in 1924 were, for the first time in U.S. history, not related to war. Despite sizable budget surpluses, Congress hiked the top rate from 25% to 40% on estates over $10 million and introduced a *gift tax*. Like the estate tax, the gift tax is a levy on the transfer of property from one person to another. While the estate tax aims at transfers after death, the gift tax applies to transfers during the donor's lifetime. The 1924 gift tax had the same rate schedule as the estate tax, a lifetime exclusion of $50,000 and an annual exclusion of $500 for each donee. Gifts over $500 required the donor to file a return.[10]

Growing resistance to estate and gift taxes prodded Congress to reduce estate tax rates, double the exemption to $100,000 (almost $9 million in today's dollars) and repeal the gift tax in 1926. Even so, the Supreme Court still responded to an earlier challenge by ruling in 1929 that the gift tax was an indirect tax and, therefore, constitutional.[11]

As the Great Depression cut into federal revenues, Congress reintroduced the gift tax, increased estate tax rates, reduced the exemption to $50,000 and added two new brackets in 1932. Gift tax rates were set at three-fourths those of estate taxes, a ratio maintained until 1976. Continuing economic woes coupled with socialistic policies of the era led to more increases in death taxes. By 1935, the top estate tax rate hit 70% on estates over $50 million.

Still more increases came with the onset of World War II. A 10% surtax on income, estate and gift taxes was added in 1940. In 1941, estate tax rates were increased, with the top rate hitting 77% on estates over $10 million.

Differences between *community property* and *noncommunity property* states created a new wrinkle that preoccupied estate tax policy for the rest of the decade. By law, each spouse owned one-half of all property acquired during marriage in community property states. When one spouse died, only half the community property would be subject to estate tax. In noncommunity property states, however, a spouse owned property only to the extent that he or she helped acquire it and only that portion could be excluded from the estate.

"Increases in estate taxes made in 1924 were, for the first time in U.S. history, not related to war."

Congress first tried to fix this inequity in 1942 by applying noncommunity property rules to estates in community property states. That is, only jointly-owned property to which the surviving spouse contributed could be excluded from an estate. But, the resulting backlash forced Congress to move in the other direction with a marital deduction that treated jointly-owned property as community property states did. Starting in 1948, surviving spouses in noncommunity property states could deduct up to half the value of all property passing to them from the gross estate.

While the Internal Revenue Code of 1954 overhauled the federal income tax, it made a seemingly minor structural change to estate taxation. Specifically, it expanded the tax base to include most life insurance proceeds, which could substantially raise an estate's tax bill.

Retooling Federal Transfer Taxes: 1976 to the Present

The next major change to federal transfer taxes came twenty-two years later when the Tax Reform Act of 1976 unified estate and gift taxes. Gifts, which had been taxed at 75 percent of estate tax rates, were made subject to the same, graduated rate structure. That is, transfers made at death were treated as the last taxable gift of the deceased donor. The gift tax continued to be cumulative, that is, each successive gift was added to earlier gifts which could push the transfer into a higher tax bracket. The new rate structure started at 18% for transfers over $10,000 (about $50,000 in today's dollars) and rose to 70% for those over $5 million (about $24 million in today's dollars).

The 1976 Act also combined the previously-separate exemptions for estate and gift taxes into a single, *unified estate and gift tax credit*. The credit could be used to offset gift tax liability during the donor's lifetime. Whatever remained at death would offset the estate tax liability. The unified credit was set at $29,800 for transfers before 1978, rising to $46,800

Table 3
Restructuring Federal Transfer Taxes 1976 to Present

Sources: Martha Britton Eller, "Federal Taxation of Wealth Transfers, 1992-1995," *SOI Bulletin*, Winter 1996-97, Joint Committee on Taxation, "Summary of Revenue Provisions of H.R. 2014 ("Taxpayer Relief Act of 1997"), August 1, 1997 and John R. Luckey, "A History of Federal Estate, Gift and Generation-skipping Taxes," Congressional Research Service, March 16, 1995.

Restructuring Federal Transfer Taxes 1976 to Present

Legislation	Description	Purpose/Importance
Tax Reform Act of 1976	Unified estate and gift tax with one graduated rate of tax and a single estate and gift tax credit; rates were graduated up to 70% on taxable estates over $5 million; the credit was $42,500 (same as $161,000 exemption) for transfers made in 1980 and $46,800 ($175,000) thereafter; added new tax on generation skipping transfers (GST); set up a carryover basis rule for inherited property so that the basis for the heir(s) was the asset's value at the donor's date of death after adjustments; special valuation and payment rules for small businesses and farms; increased marital deduction to ½ adjusted gross estate or $250,000.	Biggest structural change was unification of estate and gift taxes.
Revenue Act of 1978	Suspended the effective date of carryover basis rules until 1980; set up rules so that surviving spouse who "materially participated" in operating a family farm or business could treat some of appreciated value as cash contributed by spouse.	
Crude Oil Windfall Profits Tax Act of 1980	Repealed 1976 carryover basis rules retroactive to effective date.	Added as amendment to tax bill.
Economic Recovery Tax Act of 1981	Increased unified credit to $192,800 ($600,000 exemption); cut the top rate from 70% to 50%, phased in over 3 years, on transfers over $2.5 million; allowed unlimited marital deduction; included only ½ joint property in otherwise fully-valued pension benefits; simplified and liberalized rules on closely held businesses and family farms; increased annual gift exclusion to $10,000; repealed orphan deduction; delayed effective date of GST rules another year.	Changes reduced the number of taxable estates.
Deficit Reduction Act of 1984	Froze top transfer tax rate at 55% until 1988; liberalized rules on estates containing closely held businesses.	To raise revenue for deficit reduction.
Tax Reform Act of 1986	Repealed GST tax retroactive to 6/1/76 and replaced it with a single rate set at the top estate tax rate (then 55%); introduced 50% exclusion for employee stock ownership plans (ESOP)	
Omnibus Budget Reconciliation Act of 1987	Froze top transfer tax rate at 55% until 1993; phased out graduated rates and unified credit for estates over $10 million; closed a perceived loophole whereby an estate could reduce its tax liability through a series of ESOP sales and purchases; "estate freeze" transactions provisions caused the total value of transferred property to be included in gross estate as property in which the decedent retained an interest.	To raise revenue for deficit reduction.
Technical and Miscellaneous Revenue Act of 1988	Removed marital deduction when spouse is not a U.S. citizen unless the transfer uses a qualified domestic trust; expanded and clarified estate freeze rules; amended alternate valuation rules for family farms.	
Revenue Reconciliation of 1989	Amended provisions dealing with GST and noncitizen spouses; dropped ESOP exclusion.	
Omnibus Reconciliation Act of 1990	Retroactively repealed "estate freeze" rules from 1987 and 1988; added new rules regarding whether a transfer constituted a gift.	To raise revenue for deficit reduction.
Omnibus Reconciliation Act of 1993	Restored the top two transfer tax rates to 53% and 55% retroactive to 12/31/92.	To raise revenue for deficit reduction.
Taxpayer Relief Act of 1997	Increased unified credit so that exemption is $625,000 in 1998, rising to $1 million in 2006 and after; lowered estate taxes on closely held businesses and family farms.	First general estate tax relief since 1981.

for transfers after 1980. These credit amounts translated into exemptions of $120,000 and $175,000, respectively. This also marked the first increase in the $60,000 exemption since 1954. Donors could still make annual gifts of up to $3,000 without paying tax.

Capital gains treatment of inherited property also was substantially changed. Before 1976, the *basis*, or acquisition cost, of inherited property, such as stock or real estate, was the fair market value at the time of transfer. An heir immediately selling the property would have no capital gains consequences because the acquisition and sales price would be the same. However, the 1976 Act contained a *carryover basis* rule which meant that the heir's basis was the same as the decedent's. On top of estate taxes, which could take between 18 and 70 percent, heirs also could incur a potentially large capital gains tax bill where there had been none.[12]

Another major change was a new tax on *generation-skipping transfers*. These transfers allow one generation, usually the donor's children, to use the property during their lifetime but give ownership to another generation, usually the donor's grandchildren. Before 1976, estate taxes usually were imposed on the second transfer (ownership) but not on the first. Tax reform added complicated rules that taxed both transfers.[13]

The Tax Reform Act of 1976 did provide some relief from estate taxes through an increase in the marital deduction to $250,000[14] and special rules for *closely-held businesses* or family farms.[15]

In the face of ever-rising tax burdens and economic stagflation, the Congress lowered tax rates for individuals and corporations in the Revenue Act of 1978. The bill also suspended the effective date of the estate tax rules on carryover basis until 1980 and gave some relief to surviving spouses who helped operate the family business or farm.[16] Carryover basis rules were finally repealed in 1980.

More estate tax relief came with the Economic Recovery Tax Act of 1981 (ERTA). A phased-in increase of the unified estate and gift tax credit from $46,800 (same as an exemption of $175,000) to $192,800 ($600,000) removed a lot of estates from the tax rolls.[17] A cut in the top estate, gift and generation-skipping transfer tax rates from 70 to 50 percent, phased in over three years, lowered the tax bill on estates and other transfers. ERTA also allowed an unlimited marital deduction and increased the annual gift exclusion from $3,000 to $10,000. Rules affecting family businesses or farms were made simpler and more liberal.

Between 1984 and 1993, seven tax bills essentially tinkered with the estate and gift tax system. The most significant structural change occurred with the Tax Reform Act of 1986 which revamped generation-skipping transfer taxes. Other changes were designed as "revenue raisers" to help close the federal budget deficit. For example, the Deficit Reduction Act of 1984 froze the top transfer rate at 55 percent until 1988, instead of letting it drop to 50 percent in 1985. The Omnibus Budget Reconciliation Act (OBRA) of 1987 further delayed the drop until after December 31, 1992. While the reduction in the top rate did take effect at the start of 1993, the budget bill of 1993 retroactively restored the top two rates.

After more than a decade of bills that largely increased estate taxes, Congress recently provided some relief with the first increase in the unified credit since 1987. Beginning in 1998, the unified credit is set to increase from $600,000 to $1 million by 2006.

Table 4
Estate Tax Filing Requirements and Tax Rates, 1916-2006

1 Adjusted for the change in wealth, as measured by gross domestic product, between 1916 through 1998. Nominal GDP is assumed to increase by 6 percent a year thereafter.

2 Refers to the top rate on the supplemental estate tax in place from 1932 to 1953.

3 Refers to the top bracket amount on the supplemental estate tax in place from 1932 to 1953.

Estate Tax Filing Requirements and Tax Rates, 1916-2006						
Year	Exemption Amount				Top Bracket Amount[3]	
	Statutory	1998 Wealth[1]	Initial Rate	Top Rate[2]	Statutory[3]	1998 Wealth[1]
1916	50,000	8,845,267	1%	10%	5,000,000	884,526,749
1917	50,000	7,070,395	2%	25%	10,000,000	1,414,078,947
1918	50,000	5,590,117	1%	25%	10,000,000	1,118,023,407
1919	50,000	5,081,324	1%	25%	10,000,000	1,016,264,775
1920	50,000	4,662,473	1%	25%	10,000,000	932,494,577
1921	50,000	6,132,382	1%	25%	10,000,000	1,226,476,462
1922	50,000	5,762,466	1%	25%	10,000,000	1,152,493,298
1923	50,000	5,016,103	1%	25%	10,000,000	1,003,220,537
1924	50,000	5,039,625	1%	40%	10,000,000	1,007,924,971
1925	50,000	4,582,942	1%	40%	10,000,000	916,588,486
1926	100,000	8,800,000	1%	20%	10,000,000	880,000,000
1927	100,000	8,993,305	1%	20%	10,000,000	899,330,544
1928	100,000	8,800,000	1%	20%	10,000,000	880,000,000
1929	100,000	8,282,852	1%	20%	10,000,000	828,285,164
1930	100,000	9,437,541	1%	20%	10,000,000	943,754,116
1931	100,000	11,253,403	1%	20%	10,000,000	1,125,340,314
1932	50,000	7,335,836	1%	45%	10,000,000	1,467,167,235
1933	50,000	7,649,110	1%	45%	10,000,000	1,529,822,064
1934	50,000	6,523,217	1%	60%	10,000,000	1,304,643,399
1935	40,000	4,704,569	2%	70%	50,000,000	5,880,711,354
1936	40,000	4,113,684	2%	70%	50,000,000	5,142,105,263
1937	40,000	3,746,231	2%	70%	50,000,000	4,682,788,671
1938	40,000	4,003,539	2%	70%	50,000,000	5,004,423,749
1939	40,000	3,742,155	2%	70%	50,000,000	4,677,693,145
1940	40,000	3,398,261	2%	70%	50,000,000	4,247,826,087
1941	40,000	2,714,317	3%	77%	10,000,000	678,579,321
1942	60,000	3,192,178	3%	77%	10,000,000	532,029,703
1943	60,000	2,601,392	3%	77%	10,000,000	433,565,305
1944	60,000	2,348,002	3%	77%	10,000,000	391,333,637
1945	60,000	2,311,183	3%	77%	10,000,000	385,197,133
1946	60,000	2,317,412	3%	77%	10,000,000	386,235,400
1947	60,000	2,108,978	3%	77%	10,000,000	351,496,321
1948	60,000	1,912,703	3%	77%	10,000,000	318,783,834
1949	60,000	1,926,273	3%	77%	10,000,000	321,045,556
1950	60,000	1,751,039	3%	77%	10,000,000	291,839,783
1951	60,000	1,518,563	3%	77%	10,000,000	253,093,906
1952	60,000	1,438,528	3%	77%	10,000,000	239,754,601
1953	60,000	1,358,588	3%	77%	10,000,000	226,431,393
1954	60,000	1,352,887	3%	77%	10,000,000	225,481,248
1955	60,000	1,242,727	3%	77%	10,000,000	207,121,176
1956	60,000	1,177,753	3%	77%	10,000,000	196,292,237
1957	60,000	1,118,993	3%	77%	10,000,000	186,498,915
1958	60,000	1,103,908	3%	77%	10,000,000	183,984,592
1959	60,000	1,017,066	3%	77%	10,000,000	169,511,041
1960	60,000	979,597	3%	77%	10,000,000	163,266,236
1961	60,000	946,872	3%	77%	10,000,000	157,812,041
1962	60,000	881,504	3%	77%	10,000,000	146,917,293
1963	60,000	835,530	3%	77%	10,000,000	139,254,940
1964	60,000	778,063	3%	77%	10,000,000	129,677,225
1965	60,000	717,363	3%	77%	10,000,000	119,560,562
1966	60,000	654,806	3%	77%	10,000,000	109,134,298
1967	60,000	618,829	3%	77%	10,000,000	103,138,196
1968	60,000	566,501	3%	77%	10,000,000	94,416,868
1969	60,000	525,205	3%	77%	10,000,000	87,534,107
1970	60,000	498,123	3%	77%	10,000,000	83,020,471
1971	60,000	458,376	3%	77%	10,000,000	76,395,948

Estate Tax Filing Requirements and Tax Rates, 1916-2006						
Year	Exemption Amount				Top Bracket Amount[3]	
	Statutory	1998 Wealth[1]	Initial Rate	Top Rate[2]	Statutory[3]	1998 Wealth[1]
1972	60,000	416,921	3%	77%	10,000,000	69,486,786
1973	60,000	373,106	3%	77%	10,000,000	62,184,290
1974	60,000	344,616	3%	77%	10,000,000	57,436,034
1975	60,000	316,360	3%	77%	10,000,000	52,726,604
1976	60,000	283,593	3%	77%	10,000,000	47,265,531
1977	120,000	509,010	18%	70%	5,000,000	21,208,742
1978	134,000	502,784	18%	70%	5,000,000	18,760,583
1979	147,000	494,173	18%	70%	5,000,000	16,808,602
1980	161,000	497,167	18%	70%	5,000,000	15,439,983
1981	175,000	482,872	18%	70%	5,000,000	13,796,335
1982	225,000	596,669	18%	65%	4,000,000	10,607,446
1983	275,000	672,739	18%	60%	3,500,000	8,562,128
1984	325,000	716,026	18%	55%	3,000,000	6,609,471
1985	400,000	822,599	18%	55%	3,000,000	6,169,493
1986	500,000	972,095	18%	55%	3,000,000	5,832,572
1987	600,000	1,099,367	18%	55%	3,000,000	5,496,835
1988	600,000	1,021,578	18%	55%	3,000,000	5,107,890
1989	600,000	948,491	18%	55%	3,000,000	4,742,457
1990	600,000	898,109	18%	55%	3,000,000	4,490,546
1991	600,000	871,864	18%	55%	3,000,000	4,359,322
1992	600,000	826,110	18%	55%	3,000,000	4,130,549
1993	600,000	786,594	18%	55%	3,000,000	3,932,968
1994	600,000	742,559	18%	55%	3,000,000	3,712,797
1995	600,000	709,607	18%	55%	3,000,000	3,548,036
1996	600,000	673,301	18%	55%	3,000,000	3,366,503
1997	600,000	636,003	18%	55%	3,000,000	3,180,017
1998	625,000	625,000	18%	55%	3,000,000	3,000,000
1999	650,000	613,205	18%	55%	3,000,000	2,830,175
2000	675,000	600,745	18%	55%	3,000,000	2,669,979
2001	675,000	566,742	18%	55%	3,000,000	2,518,853
2002	700,000	554,464	18%	55%	3,000,000	2,376,275
2003	700,000	523,077	18%	55%	3,000,000	2,241,761
2004	850,000	599,214	18%	55%	3,000,000	2,114,875
2005	950,000	631,800	18%	55%	3,000,000	1,995,158
2006	1,000,000	627,406	18%	55%	3,000,000	1,882,219

Table 4 (Continued)
Estate Tax Filing Requirements and Tax Rates, 1916-2006

[1] Adjusted for the change in wealth, as measured by gross domestic product, between 1916 through 1998. Nominal GDP is assumed to increase by 6 percent a year thereafter.

[2] Refers to the top rate on the supplemental estate tax in place from 1932 to 1953.

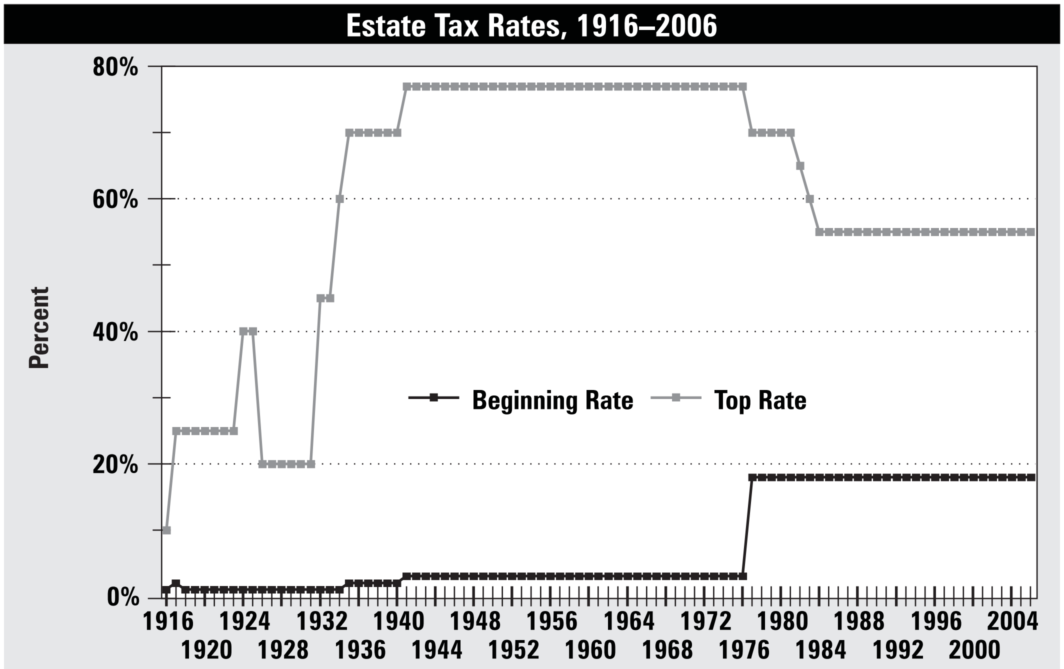
[3] Refers to the top bracket amount on the supplemental estate tax in place from 1932 to 1953.

Summary of U.S. Estate Taxation

Several main points emerge from the history of estate taxation in the United States:

- Until the 1920s, estate taxes were used as a sporadic, and temporary, way to finance wars. When hostilities ceased, the tax was repealed.
- From the 1920s through the 1940s, estate taxes became another weapon in the arsenal to redistribute income. Confiscatory tax rates of up to 77 percent on the largest estates were supposed to prevent wealth from becoming increasingly concentrated in the hands of a few. [See Figure 1 and Table 4 for the starting and top estate tax rates since 1916.]
- Loophole closing preoccupied tax reformers during the late 1960s and early 1970s. Their efforts culminated in a 1976 tax bill that overhauled estate taxation. Unification of estate and gift taxes, carryover basis rules and a new generation-skipping transfer tax were supposed to make it more difficult for people to avoid estate taxes.
- Lower income tax rates enacted in 1981 were extended to estate taxes and the exemption was increased to remove smaller estates from the tax rolls.

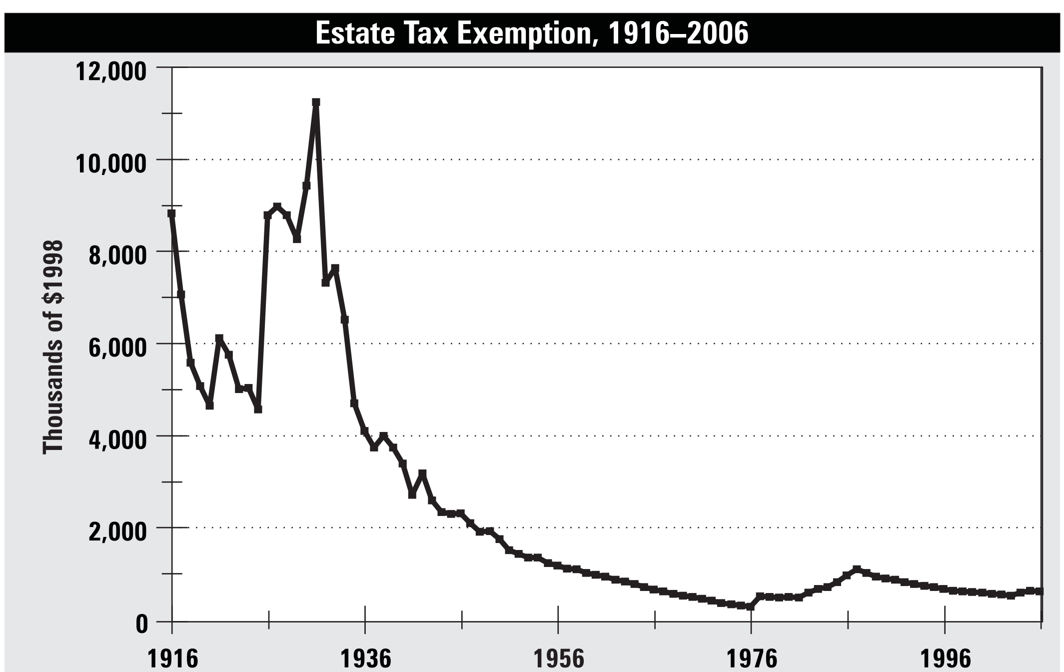
Figure 1
Estate Tax Rates, 1915–2006



Since then, estate taxes have been on the rise, this time a weapon in the arsenal to fight federal deficits. Time has seriously eroded the value of the estate tax exemption. In 1916, estates under $9 million (in today's dollars) would not have been taxed. Contrast that with the $600,000 exemption in place since 1987. As a result, increasing numbers of middle income Americans face the prospect of having their heirs presented with an estate tax bill. [See Figure 2 for the estate tax exemption in today's dollars since 1916.]

As has happened with the income tax, high marginal tax rates on estates have produced an extremely complex tax system as rules and regulations concerning what is and is not taxable or special dispensation for favored groups continually creep into the code.

Figure 2
Estate Tax Exemption, 1915–2006
Adjusted for Economic Growth



The Estate Tax Today

How exactly does the estate tax work today? Table 5 contains the tax schedule (rates and bracket amounts) that apply to the taxable estates of people who died in 1997. *Taxable estate* is gross estate less deductions. Nominally, tax rates start at 18 percent on taxable estates of less than $10,000 and rise to 55 percent on taxable estates over $3 million. In the thirteen years since this schedule was put in place, asset values have more than tripled. But, because bracket amounts are not indexed, more estates hit the top tax bracket today than did ten or fifteen years ago.

Table 5
Estate Tax Rates and Bracket Amounts, 1997

Estate Tax Rates and Bracket Amounts, 1997			
Taxable Estate		**Base Tax**	
Over	**But Less Than**	**Rate**	**Amount**
0	10,000	18%	0
10,000	20,000	20%	1,800
20,000	40,000	22%	3,800
40,000	60,000	24%	8,200
60,000	80,000	26%	13,000
80,000	100,000	28%	18,200
100,000	150,000	30%	23,800
150,000	250,000	32%	38,800
250,000	500,000	34%	70,800
500,000	750,000	37%	155,800
750,000	1,000,000	39%	248,300
1,000,000	1,250,000	41%	345,800
1,250,000	1,500,000	43%	448,300
1,500,000	2,000,000	45%	555,800
2,000,000	2,500,000	49%	780,800
2,500,000	3,000,000	53%	1,025,800
3,000,000	999,999,999	55%	1,290,800
Unified Credit[1]	**192,800**		
Exemption[2]	**600,000**		

[1] Same rate schedule has been in place since 1984. Changes in unified credit are as follows: $96,300 ($325,000) in 1984; $121,800 ($400,000) in 1985; $155,800 ($500,000) in 1986 and $192,800 ($600,000) since 1986. Equivalent exemption amounts shown in parentheses.

[2] Tax calculation for an estate of $600,000:

Base tax on $500,000	155,800
Plus	
Tax rate on estates between $500,000 and $750,00	0.37
Times	
600,000 minus 500,000	100,000
Equals	
Estate Tax	192,800

The unified credit of $192,800 translates into an exemption amount of $600,000. Here's how it works. Remember that the credit reduces taxes on gifts and estates. If the individual did not have occasion to use the credit for gifts in excess of $10,000 – as is the case for most people – the credit would offset up to $192,800 in estate tax liability. Reading from the tax schedule, a $500,000 estate would owe $155,800 in tax. Another $100,000 of estate would be taxed at a marginal rate of 37 percent, bringing the total tax on a $600,000 estate to $192,800. Although the tax schedule gives the impression that the estate tax starts at 18 percent, in fact, the unified credit means that most people will begin paying at a marginal rate of 37 percent on the first dollar of taxable estate.

"The unified credit means that most people will begin paying at a marginal rate of 37 percent on the first dollar of taxable estate."

Who Pays Estate Taxes?

In 1995, 69,722 estates exceeded the $600,000 exemption and were required to file an estate tax return. Over half (53.5%) of those returns reported the size of gross estate to be under $1 million and 96.3 percent were under $5 million. Although only 300 returns (0.4%) had estates worth over $20 million, they accounted for a much larger share (13.1%) of gross estate than those under $5 million (70.3%). [See Table 6 for estate tax returns filed in 1995 by size of gross estate.]

Table 6
Estate Tax Returns Filed in 1995: Gross Estate and Estate Tax by Size of Gross Estate

Estate Tax Returns Filed in 1995: Gross Estate and Estate Tax by Size of Gross Estate
[All figures are estimates based on samples—money amounts are in thousands of dollars]

Size of gross estate	Gross estate, tax purposes[1]				Net estate tax	
	Number	% of total	Amount	% of total	Amount	% of total
All returns, total	**69,772**	**100.0%**	**117,735,156**	**100.0%**	**11,841,034**	**NA**
$600,000 under $1,000,000	37,329	53.5%	28,556,829	24.3%	651,160	NA
$1,000,000 under $2,500,000	24,558	35.2%	36,077,544	30.6%	2,999,760	NA
$2,500,000 under $5,000,000	5,331	7.6%	18,105,550	15.4%	2,748,165	NA
$5,000,000 under $10,000,000	1,683	2.4%	11,654,534	9.9%	2,053,433	NA
$10,000,000 under $20,000,000	571	0.8%	7,862,146	6.7%	1,384,768	NA
$20,000,000 or more	300	0.4%	15,478,551	13.1%	2,003,748	NA
Taxable returns, total	**31,564**	**100.0%**	**67,183,128**	**100.0%**	**11,841,034**	**100.0%**
$600,000 under $1,000,000	13,830	43.8%	11,195,554	16.7%	651,160	5.5%
$1,000,000 under $2,500,000	12,710	40.3%	18,845,531	28.1%	2,999,760	25.3%
$2,500,000 under $5,000,000	3,298	10.4%	11,288,768	16.8%	2,748,165	23.2%
$5,000,000 under $10,000,000	1,105	3.5%	7,769,030	11.6%	2,053,433	17.3%
$10,000,000 under $20,000,000	390	1.2%	5,366,395	8.0%	1,384,768	11.7%
$20,000,000 or more	231	0.7%	12,717,850	18.9%	2,003,748	16.9%
Nontaxable returns, total	**38,207**	**100.0%**	**50,552,028**	**100.0%**	**NA**	**NA**
$600,000 under $1,000,000	23,498	61.5%	17,361,275	34.3%	NA	NA
$1,000,000 under $2,500,000	11,849	31.0%	17,232,013	34.1%	NA	NA
$2,500,000 under $5,000,000	2,032	5.3%	6,816,782	13.5%	NA	NA
$5,000,000 under $10,000,000	578	1.5%	3,885,505	7.7%	NA	NA
$10,000,000 under $20,000,000	182	0.5%	2,495,751	4.9%	NA	NA
$20,000,000 or more	68	0.2%	2,760,702	5.5%	NA	NA

[1] Gross estate is shown at the value used to determine estate tax liability. The value could be determined as of date-of-death or six months thereafter (i.e., alternate valuation method).

Note: Detail may not add to totals because of rounding.

Source: Internal Revenue Service, *SOI Bulletin*, Publication 1136 (Rev. 2-97).

"While the U.S. population quintupled in the last fifty years, estate tax returns increased tenfold."

Less than half (45.2%) the estates filing returns owed tax. Over half (54 percent) of the $11.8 billion in tax was collected from estates valued at less than $5 million. Estates worth between $5 and $20 million paid 29 percent of the tax while those over $20 million paid 16.9 percent.

Changes between 1945 and 1995

The distribution of estate tax returns looked different fifty years ago. Estates under $100,000 ($3.3 million in 1995 dollars), although generally exempt from tax, accounted for 43.6 percent of estate tax returns.[18] Estates between $100,000 and $500,000 ($16.3 million in 1995 dollars) accounted for 50.1 percent of returns. Estates over $500,000 made up the remaining 6.3 percent. [See Table 7 for estate tax returns filed in 1945 by size of gross estate.]

"Smaller estates (under $2.5 million in 1995 dollars) make up a much larger share of total returns today than in 1945 (88.7% versus 33.4%)."

Of the 19,000 returns filed, 86.2 percent paid tax totalling $597,177 ($19 million in 1995 dollars). Almost all the tax (94%) was paid by estates over $150,000 ($4.9 million in 1995 dollars). The largest estates (over $1 million, or $32.6 million in 1995 dollars) paid about half (47.5%).

Estate Tax Returns Filed in 1945: Gross Estate and Estate Tax, by Size of Gross Estate						
Size of gross estate[1]	Gross estate				Estate tax	
	Number	%	Amount	%	Amount	%
All returns, total	**19,000**	**100.0%**	**3,934,976**	**100.0%**	**NA**	**NA**
Under $100,000	8,276	43.6%	644,747	16.4%	NA	NA
$100,000 under $150,000	4,482	23.6%	543,532	13.8%	NA	NA
$150,000 under $250,000	3,067	16.1%	583,296	14.8%	NA	NA
$250,000 under $500,000	1,973	10.4%	668,175	17.0%	NA	NA
$500,000 under $1,000,000	780	4.1%	541,997	13.8%	NA	NA
$1,000,000 or more	422	2.2%	953,231	24.2%	NA	NA
Taxable returns, total	**16,374**	**100.0%**	**NA**	**NA**	**597,177**	**100.0%**
Under $100,000	6,192	37.8%	NA	NA	7,243	1.2%
$100,000 under $150,000	4,187	25.4%	NA	NA	28,496	4.8%
$150,000 under $250,000	2,931	17.9%	NA	NA	63,533	10.6%
$250,000 under $500,000	1,890	11.5%	NA	NA	105,769	17.7%
$500,000 under $1,000,000	761	4.6%	NA	NA	108,247	18.1%
$1,000,000 or more	413	2.5%	NA	NA	283,889	47.5%
Nontaxable returns, total	**2,626**	**100.0%**	**NA**	**NA**	**NA**	**NA**
Under $100,000	2,084	79.4%	NA	NA	NA	NA
$100,000 under $150,000	315	12.0%	NA	NA	NA	NA
$150,000 under $250,000	136	5.2%	NA	NA	NA	NA
$250,000 under $500,000	83	3.2%	NA	NA	NA	NA
$500,000 under $1,000,000	19	0.7%	NA	NA	NA	NA
$1,000,000 or more	9	0.3%	NA	NA	NA	NA

Table 7
Estate Tax Returns Filed in 1945: Gross Estate and Estate Tax, by Size of Gross Estate

Source: Janet G. McCubbin, "The Intergenerational Wealth Study: Basic Estate Data, 1916-1945," Internal Revenue Service, *SOI Bulletin*, Spring 1990.

[1] Bracket amounts for 1945 translated into 1995 dollars using the change in GDP between those two years are as follows:

Nominal	$1995
100,000	3,256,989
150,000	4,885,484
250,000	8,142,473
500,000	16,284,946
1,000,000	32,569,892

While the U.S. population quintupled in the last fifty years, estate tax returns increased tenfold. As a result, smaller estates (under $2.5 million in 1995 dollars) make up a much larger share of total returns today than in 1945 (88.7% versus 33.4%). Because exemption levels have not kept up with asset values, more and more small estates must file returns. [See Table 8 for the change in estate tax returns between 1945 and 1995 and Figure 3 for a comparison between the growth in returns and population.]

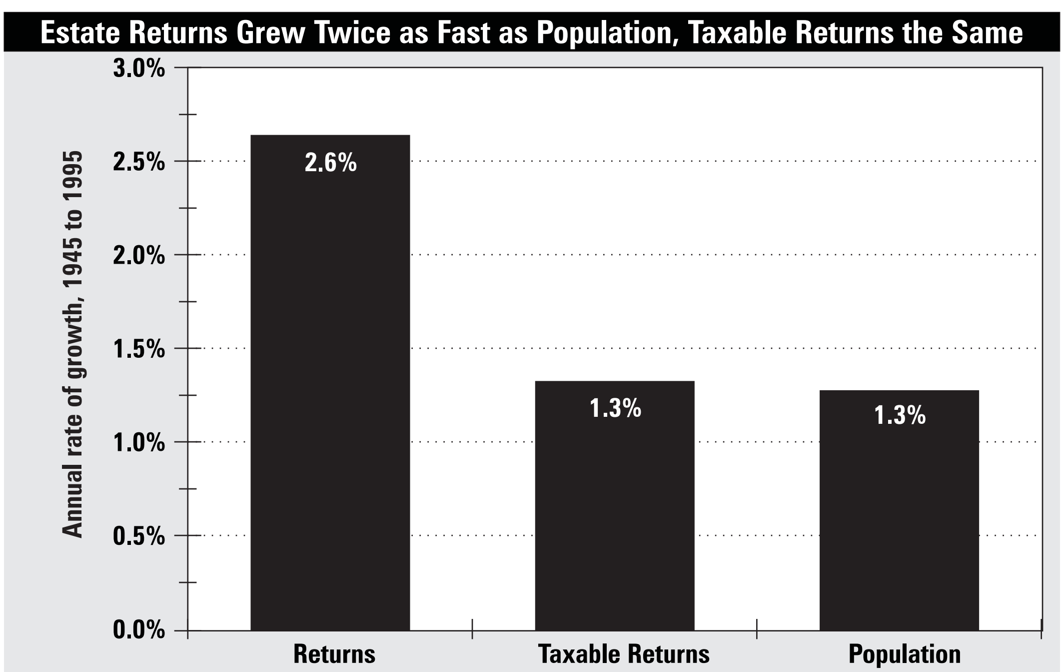


Figure 3
Estate Returns Grew Twice as Fast as Population, Taxable Returns the Same

Table 8
Change in Estate Tax Returns, 1945 to 1995

Basic data for 1945 come from Janet G. McCubbin, "The Intergenerational Wealth Study: Basic Estate Data, 1916-1945," Internal Revenue Service, *SOI Bulletin*, Spring 1990.

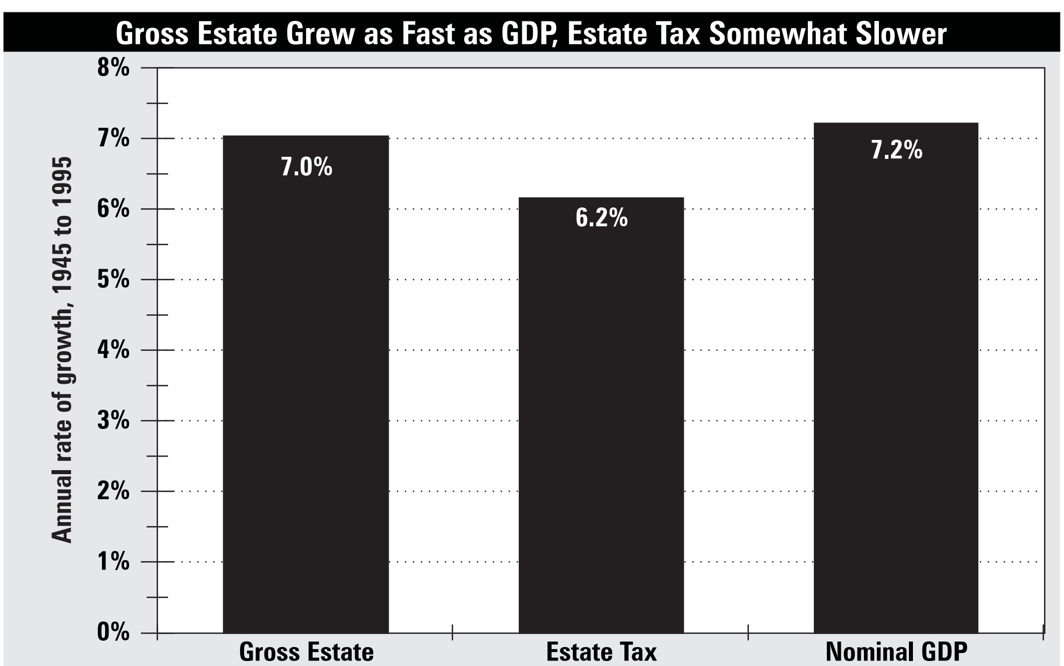
Basic data for 1995 come from Internal Revenue Service, *SOI Bulletin*, Publication 1136 (Rev. 2-97).

Change in Estate Tax Returns, 1945 to 1995

Size of gross estate ($1995)[1]	1945		1995	
	Number or Amount	Distribution	Number or Amount	Distribution
Returns filing estate tax return				
Under $2,500,000	6,352	33.4%	61,887	88.7%
$2,500,000 under $5,000,000	8,289	43.6%	5,331	7.6%
$5,000,000 under $10,000,000	2,395	12.6%	1,683	2.4%
$10,000,000 under $20,000,000	1,240	6.5%	571	0.8%
$20,000,000 or more	723	3.8%	300	0.4%
Total	**19,000**	**100.00%**	**69,772**	**100.0%**
Taxable Returns				
Under $2,500,000	4,753	29.0%	26,540	84.1%
$2,500,000 under $5,000,000	7,426	45.4%	3,298	10.4%
$5,000,000 under $10,000,000	2,292	14.0%	1,105	3.5%
$10,000,000 under $20,000,000	1,197	7.3%	390	1.2%
$20,000,000 or more	707	4.3%	231	0.7%
Total	**16,374**	**100.0%**	**31,564**	**100.0%**
Net Estate Tax (in thousands of nominal $)				
Under $2,500,000	5,560	0.9%	3,650,920	30.8%
$2,500,000 under $5,000,000	69,193	11.6%	2,748,165	23.2%
$5,000,000 under $10,000,000	89,469	15.0%	2,053,433	17.3%
$10,000,000 under $20,000,000	107,291	18.0%	1,384,768	11.7%
$20,000,000 or more	325,665	54.5%	2,003,748	16.9%
Total	**597,177**	**100.0%**	**11,841,034**	**100.0%**

Although more estates file returns today, the number which owe tax has not grown faster than the population. Although the total size of gross estate has kept pace with the economy, estate tax revenues have grown more slowly than GDP, due to a drop in the top tax rate from 77 percent in 1945 to 55 percent in 1995 and the rapid growth in estate tax planning. [See Figure 4 for comparison of growth in estate size, estate taxes and GDP.]

Figure 4
Gross Estate Grew as Fast as GDP, Estate Tax Somewhat Slower



In short, estate taxes are more likely to affect small to medium-sized estates today than fifty years ago. While the top tax rate is lower today, it hits much sooner, subjecting relatively small estates to high marginal rates.

How Estate Taxes Affect the Economy

People save for two reasons—either to consume in the future or make bequests. Estate and gift taxes hit the latter directly.

Lawrence Summers, now Deputy Secretary of the Treasury, has estimated that about half of all saving is directed toward bequests.[19] As shown earlier, estates today face marginal tax rates between 37 and 55 percent. Because of the huge part that bequests play in saving, these high estate tax rates discourage saving which, in turn, leads to less investment, slower economic growth and lower tax revenues.[20]

Why Estate Tax Rates Matter

Taxes affect growth by changing the aftertax returns to the factors of production – capital and labor. If taxes are cut, the aftertax return on the *next dollar of invested capital* goes up, and investors supply more capital. Similarly, if the aftertax wage rate on the *next hour of work* goes up, workers supply more labor. The reverse happens if taxes are raised. Because estate taxes are tied to asset values, they act primarily on capital, with higher tax rates raising the cost of capital and lower tax rates reducing the cost.

"Estate taxes are more likely to affect small to medium-sized estates today than fifty years ago."

Notice that the aftertax return refers to the next dollar invested or the next hour worked. Because economic decisions usually involve adjustments – up or down – from the status quo, or equilibrium, it is *marginal*, not average, tax rates that matter. Marginal tax rates that are higher than the average tend to dampen growth because the added return from investing another dollar or working another hour is lower than the average return. Put another way, for the economy to produce the most output at the lowest cost, average and marginal tax rates must equal each other.[21]

Marginal estate tax rates are much higher than average rates. On average, federal estate taxes currently take 8 cents for every $100 in the stock of U.S. capital. That is down from 17 cents in 1972 but up from 5 cents through much of the 1980s. Adding estate taxes at the state and local level raises the average tax rate to 11 cents. [See Figure 5 for average estate tax rates from 1954 to 1997.]

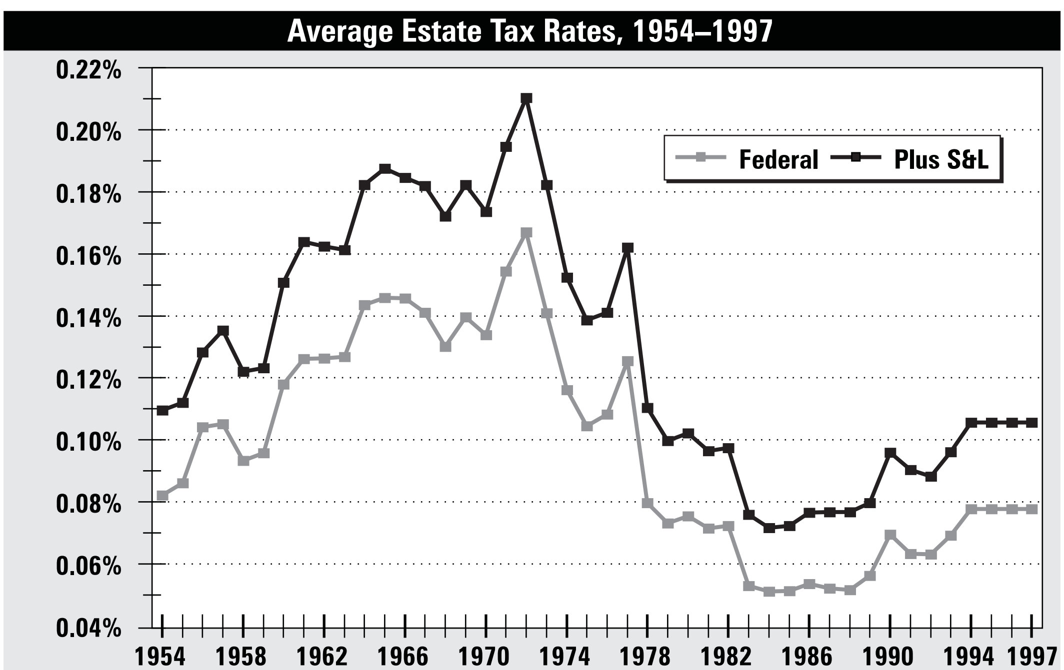
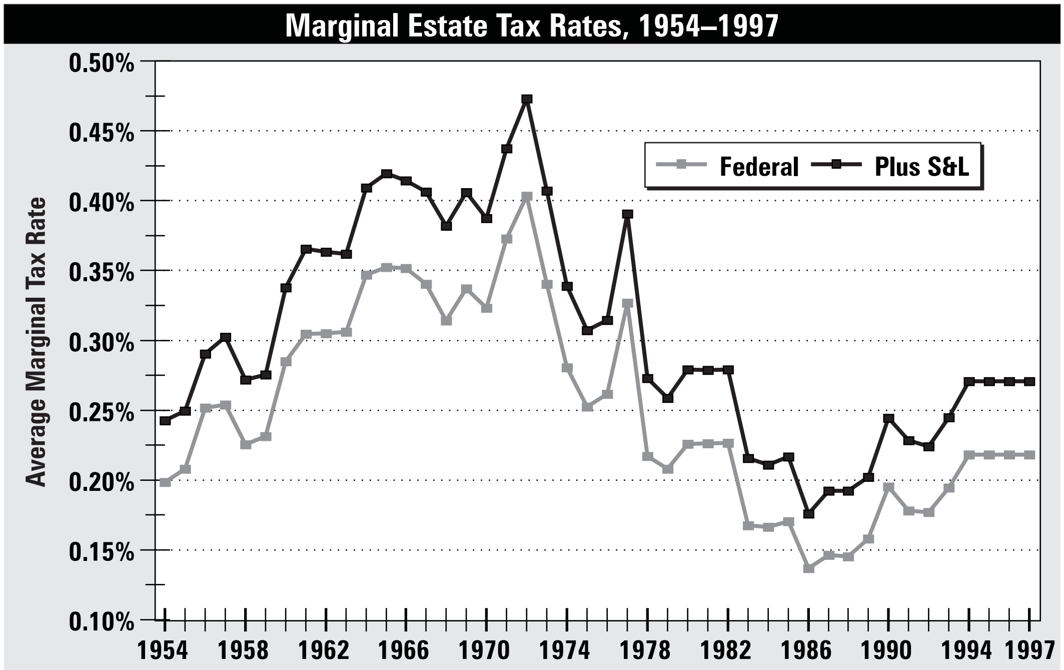


Figure 5
Average Estate Tax Rates, 1954–1997
On a $ of Economy- wide Capital

Figure 6
Marginal Estate Tax Rates, 1954–1997
On Next $ of Economy-wide Capital



However, federal estate taxes claim 22 cents out of an *additional* $100 in capital stock. While lower than the 40 cents in 1972, it is more than the 14 cents in 1986. Including state and local estate taxes raises the marginal tax rate to 27 cents. [See Figure 6 for marginal estate tax rates from 1954 to 1997.]

"All taxes are really income taxes that ultimately fall on the earnings of capital and labor."

Table 9 shows how estate tax rates affect capital. Suppose the initial price of an asset was $100. Assuming a 6 percent return, the asset should generate $6 in income each year. But, because federal estate taxes will claim 22 cents of the asset, its real cost is $100.22. Even though nominally levied on assets in the estate, the tax gets paid out of income generated by the assets. The same principle applies to property taxes, corporate taxes, sales taxes and so forth. Whatever the label, people pay taxes out of income they earn through work, saving or investing. In other words, all taxes are really income taxes that ultimately fall on the earnings of capital and labor.

Going back to the example, because the asset cost $100.22, not $100.00, its annual return is really only $5.99, not $6. Including state and local taxes raises the asset price to $100.27 and lowers the annual return to $5.98.

Table 9
How Estate Taxes Raise the Cost of Capital, Lower Its Return

[1] Asset price times one plus estate tax rate.

[2] Annual income times one minus estate tax rate.

How Estate Taxes Raise the Cost of Capital, Lower Its Return	
Effect on Cost of Asset	
Initial asset price	$100.00
Estate Tax Rate	
Federal	0.22%
Plus State & Local	0.27%
Tax-inclusive cost of asset[1]	
Federal	$100.22
Plus State & Local	$100.27
Effect on Income from Asset	
Expected annual income	$6.00
Income aftertax estate tax[2]	
Federal	$5.99
Plus State & Local	$5.98

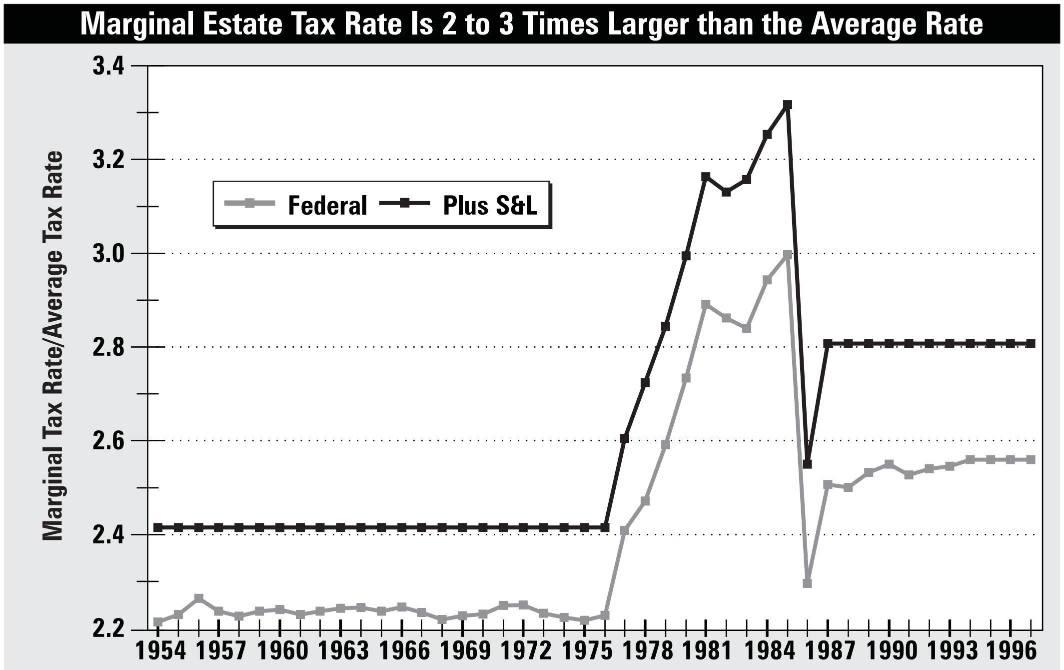


Figure 7
Marginal Estate Tax Rate is 2 to 3 Times Larger than the Average Rate

Economy-wide, the marginal federal estate tax rate is 2.8 times higher than the average rate while that for state and local governments is 1.9 times higher. Putting the two together, the marginal estate tax rate on U.S. capital is 2.6 times higher than the average rate. Because marginal estate tax rates are much higher than average rates, economic efficiency suffers. [See Figure 7 for the ratio of marginal to average estate tax rates from 1954 to 1997.]

"The largest estates do not pay the highest tax rates."

Medium-sized Estates Pay the Highest Tax Rates

An earlier section showed estate taxes are more likely to affect small and medium-sized estates today than fifty years ago. What is more, the largest estates do not pay the highest tax rates. In 1995, estates over $20 million paid an average tax rate of 12.5 percent. But the highest average rate – 17.4 percent – fell on estates between $5 and $10 million. Close behind, estates between $10 and $20 million paid an average rate of 17 percent. [See Table 10 and Figure 8 for average tax rates by size of estate.]

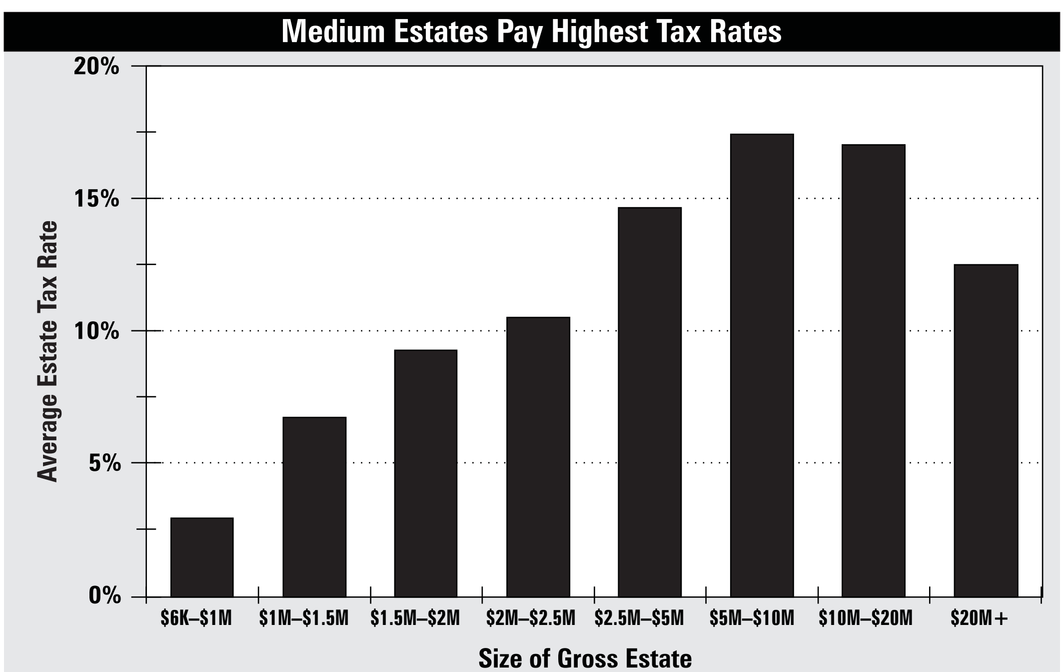


Figure 8
Medium Estates Pay Highest Tax Rates

Table 10
Average Estate Tax Rates for 1995

Estimated from Fiscal Associates Estate Tax Model. Based on all returns.

Average Estate Tax Rates for 1995 (Amounts in dollars)					
Size of gross estate	Gross Estate		Estate Tax After Credit		
	Number of Returns	Average Amount	Number of Returns	Average Amount	Average Tax Rate
$100,000-$199,999	356,747	150,956	0	0	0.0%
$200,000-$299,999	153,793	250,950	0	0	0.0%
$300,000-$399,999	69,481	350,944	0	0	0.0%
$400,000-$499,999	34,298	450,953	0	0	0.0%
$500,000-$599,999	20,761	550,948	0	0	0.0%
$600,000-$699,999	13,526	649,614	2,219	2,838	0.4%
$700,000-$799,999	10,140	747,302	5,418	11,772	1.6%
$800,000-$899,999	7,438	846,242	3,386	25,526	3.0%
$900,000-$999,999	6,225	947,496	3,612	46,657	4.9%
$1,000,000-$1,249,999	8,895	1,118,787	4,263	68,208	6.1%
$1,250,000-$1,499,999	6,277	1,366,945	3,095	101,243	7.4%
$1,500,000-$1,749,999	3,888	1,610,206	2,075	132,371	8.2%
$1,750,000-$1,999,999	2,555	1,863,180	1,296	199,746	10.7%
$2,000,000-$2,249,999	1,714	2,110,025	925	226,713	10.7%
$2,250,000-$2,499,999	1,229	2,366,258	684	240,527	10.2%
$2,500,000-$4,999,999	5,330	3,396,914	3,350	497,469	14.6%
$5,000,000-$9,999,999	1,683	6,924,857	1,101	1,205,657	17.4%
$10,000,000-19,999,999	572	13,745,010	425	2,338,663	17.0%
$20,000,000 or more	299	51,767,732	234	6,464,009	12.5%

Who are most likely to have medium-sized estates that pay the highest tax rates? Typically they are owners of small businesses and family farms who amass wealth during their lifetimes through hard work and thrift. Because wealth is often unexpected, these people may not be aware of, or take full advantage of, ways to reduce estate taxes. As a result, those who come late, or not at all, to estate planning end up paying most of the tax. In contrast, the very rich, particularly those with inherited wealth, routinely plan ways to mitigate the death tax and pay lower estate tax rates.

All told, estate taxes are detrimental to the economy. Added to income taxes, estate taxes can bring the total tax rate on new investment to 100 percent.[22] Small businesses – which have fueled much of the current expansion – are hit particularly hard. Not only are they likely to pay the highest estate rates, heirs may have to sell some or all of the enterprise to pay the tax bill.[23]

What Estate Taxes Cost Society

Estate taxes discourage saving and investment, thereby damaging the economy. What would happen if federal estate taxes were eliminated? Answering that question requires two steps: (1) measuring the extent to which estate taxes raise taxes on capital, discouraging saving and investment and (2) estimating the macroeconomic effects on capital formation, employment and output if estate taxes were eliminated.

Addressing the first question requires a special estate tax model that includes the latest estate tax return data available from the Internal Revenue Service. Using this estate tax calculator, we estimate that eliminating the federal estate tax would reduce the average, economy-wide marginal tax rate on all U.S. capital by 0.25 percent. This lower tax on capital would raise the return to savers and investors. For example, doing away with estate taxes would initially raise the real, aftertax rate of return on corporate capital by almost

5 percent, inducing more saving and investment. This faster rate of capital formation would continue until the aftertax return is driven down to its long-run level.[24]

To assess the macroeconomic effects from eliminating the federal estate tax, we used our neoclassical, general equilibrium model of the U.S. economy.[25] Our results are expressed as changes from a *baseline*, that is, a forecast of how the economy would perform if there were no change in policy. At present our baseline, which is similar to those of the Congressional Budget Office and the Office of Management and Budget, projects the U.S. economy will grow at 2.5 percent a year after inflation over the next decade.

Eliminating the federal estate tax in 1999 would cause the economy to grow faster than in the baseline, mainly due to a more rapid expansion of the U.S. stock of capital. [See Table 11a for a summary of the economic effects expressed as a percent change from the baseline and Table 11b for differences from the baseline.] By the year 2010:

- Annual gross domestic product would be $117.3 billion, or 0.9 percent, above the baseline.
- The stock of U.S. capital would be higher by almost $1.5 trillion, or 4.1 percent above the baseline.
- The economy would have created almost 236,000 more jobs than in the baseline.
- Between 1999 and 2008, the economy would have produced over $700 billion more in GDP than otherwise.

Table 11
Economic Effects from Eliminating the Estate Tax in 1999

Estimated using the Fiscal Associates Tax Model.

Economic Effects from Eliminating the Estate Tax in 1999

A: Percent change from baseline forecast

Year	Real GDP	Jobs	Stock of Capital	Real Growth
1999	0.39%	0.01%	2.31%	0.0002%
2000	0.41%	0.04%	2.72%	0.0002%
2001	0.39%	0.02%	2.99%	0.0002%
2002	0.50%	0.02%	3.30%	0.0003%
2003	0.56%	0.03%	3.55%	0.0003%
2004	0.66%	0.08%	3.68%	0.0003%
2005	0.75%	0.14%	3.82%	0.0004%
2006	0.81%	0.17%	3.94%	0.0004%
2007	0.82%	0.17%	4.02%	0.0004%
2008	0.86%	0.17%	4.07%	0.0004%

B: Difference from baseline forecast

Year	GDP ($bil)	Jobs	Stock of Capital ($bil)
1999	34.0	15,144	562. 6
2000	37.5	45,243	694.3
2001	37.5	23,002	796.9
2002	50.9	24,189	920.7
2003	59.4	39,789	1,034.7
2004	73.2	102,897	1,121.8
2005	87.6	179,214	1,219.5
2006	100.0	229,288	1,314.3
2007	106.4	229,911	1,404.8
2008	117.3	235,850	1,485.9
	Sum	**Average**	
1999-2003	219.3	29,473	801.9
1999-2008	703.8	112,453	1,055.6

Boost to Growth Would Ultimately Benefit the Treasury

One major protest against eliminating the estate tax will undoubtedly be the loss of revenue to the federal Treasury. However, there are several reasons why this argument doesn't hold water.

First, estate taxes are a minor source of federal revenue. In 1995, the $11.8 billion in estate taxes amounted to less than one percent of federal revenues.[26]

Second, the estate tax imposes extremely high compliance costs – about as much as the tax raises.[27] In contrast, compliance costs associated with another tax nightmare, the alternative minimum tax (AMT) – amount to roughly a third of the AMT tax take.[28] Compliance costs are a deadweight loss to society because tax compliance adds nothing to output and diverts resources away from productive activities that do.

Third, the damage that estate taxes do to capital formation further magnifies the loss to society. Doing away with estate taxes would produce positive economic growth effects large enough to offset most of the static revenue loss. [See Table 12 for the static and dynamic revenue effects.]

- Between 1999 and 2008, eliminating the estate tax would cost the Treasury $191.5 billion.
- But the over $700 billion in additional GDP would yield $148.7 billion in higher income, payroll, excise and other federal taxes.
- In other words, higher growth would offset 78 percent of the static revenue loss over the first ten years.
- By 2006, the dynamic revenue gain from eliminating the estate tax would be enough to offset the annual static revenue loss completely.

Table 12
Static and Dynamic Revenue Effects from Eliminating the Estate Tax in 1999

Estimated using the Fiscal Associates Tax Model.

[1] Personal, corporate, payroll, excise tax revenue collected on added GDP shown in Table 11.

Static and Dynamic Revenue Effects from Eliminating the Estate Tax in 1999
(in $billions)

Year	Static Federal Tax Loss	Dynamic Federal Tax Gain[1]	Growth Offset of Static Loss	Net Effect on Federal Revenue	Net Effect on All Govt. Revenue
1999	-16.4	6.9	42%	-9.4	-1.8
2000	-16.9	8.9	53%	-7.9	2.3
2001	-18.1	8.0	44%	-10.2	0.9
2002	-18.7	10.5	56%	-8.2	5.1
2003	-20.1	18.4	92%	-1.6	15.1
2004	-19.0	14.8	78%	-4.3	12.9
2005	-18.9	17.6	93%	-1.3	18.0
2006	-19.7	20.0	102%	0.3	21.6
2007	-21.1	20.8	98%	-0.3	22.3
2008	-22.6	22.8	101%	0.2	24.5
1999-2003	-90.2	52.8	59%	-37.4	21.6
2004-2008	-101.3	95.9	95%	-5.4	99.4
1999-2008	-191.5	148.7	78%	-42.8	120.9

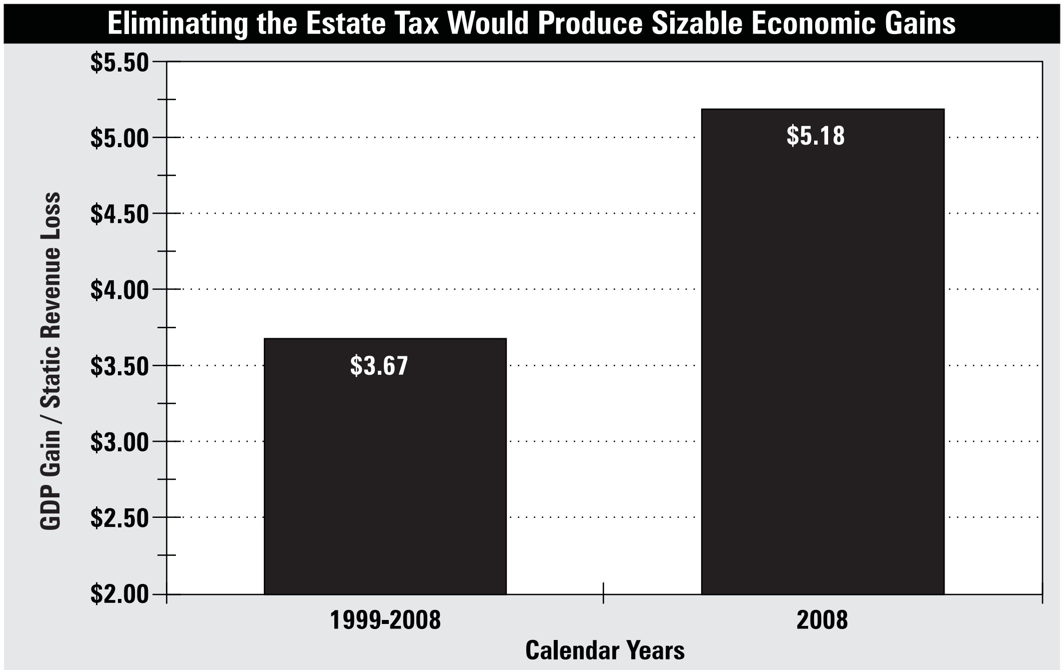


Figure 9
Eliminating the Estate Tax Would Produce Sizable Economic Gains

Bang for the Buck

Reducing estate taxes would generate sizable economic gains with little revenue loss. Over the next ten years, doing away with the estate tax would produce $3.67 in output for every dollar of static revenue loss. Longer run, the relative gains from the faster rate of capital formation would be even higher. In 2008, the ratio of GDP gain to static revenue loss would rise to $5.18. [See Figure 9.]

The high economic payoff makes reducing the estate tax an excellent candidate for a pro-growth tax cut. And elimination of the estate tax should be one element of any broad-based tax reform that aims to reduce the double taxation of saving and investment.

Conclusions

Once reserved for the rich, estate taxes are increasingly reaching into middle-class America over the last several decades. Much of the blame rests with tax policy that has not allowed the estate tax exemption to keep up with rising asset values.

While the estate tax purportedly aims to prevent wealth from becoming concentrated in the hands of a few, it is ironic that the largest estates do not pay the highest tax rates. That dubious honor falls on medium-sized estates, often belonging to people who have started and shepherded successful businesses. But, because they did not anticipate their success, they were unable to take advantage of estate planning.

Apart from fairness issues, estate taxation hurts the economy. Its sheer complexity results in high compliance costs – as much as estate taxes raise by one estimate. Compliance adds nothing to economic output while diverting resources from better uses.

Estate taxes have hit small businesses – which have fueled much of the economic expansion – particularly hard. Heirs sometimes must liquidate at least part of a successful enterprise just to pay the estate tax bill.

Because bequests are a primary motive behind saving, high marginal tax rates on estate assets raise capital costs and depress saving and investment. Because capital is so important to the economy, almost any move to reduce estate taxes should more than pay for itself through higher growth.

All in all, American taxpayers, the economy and government would be better off without estate taxes. Serious reduction or outright elimination of estate taxes might be one of the best legacies that the 106th Congress could leave future generations.

Endnotes

1 John R. Luckey, "A History of Federal Estate, Gift and Generation-skipping Taxes," Congressional Research Service, March 16, 1995.
2 Martha Britton Eller, "Federal Taxation of Wealth Transfers, 1992-1995," *SOI Bulletin*, Winter 1996-97.
3 Between 1869 and 1997, growth in nominal GDP has averaged about 5.6 percent a year. GDP for 1869 is from the U.S. Department of Commerce, *Historical Statistics of the United States, Colonial Times to 1970*, September 1975, Series F 1-5.
4 Between 1860 and 1865, federal budget expenditures increased almost twenty-fold, from $63 million to $1.3 billion. Budget receipts quintupled from $56 million to $334 million. See *Historical Statistics of the United States,* Series Y 335-338.
5 Between 1866 and 1870, federal surpluses amounted to $348 million. See *Historical Statistics of the United States,* Series Y 335-338.
6 *Scholey v. Rew*, 23 Wall. (90 U.S.) 331 (1874).
7 *Pollock v. Farmers' Loan and Trust Company,* 158 U.S. 429 (1895).
8 Between 1898 and 1997, growth in nominal GDP has averaged about 6.6 percent a year. GDP for 1898 is from *Historical Statistics of the United States,* Series F 1-5 .
9 *Knowlton v. Moore*, 178 U.S. 41(900).
10 A return was required for gifts of property located in the U.S. made by individuals, corporations, associations, partnerships, trusts or estates, if total gifts exceeded the sum of authorized deductions for exemption, charitable gifts and previously taxed property, and if the total exceeded $500 to any one donee. *Historical Statistics of the United States, Part 2,* p. 1096.
11 *Bromley v. McCaughn*, 280 U.S. 124 (1929).
12 There were adjustments for appreciation before 1977, estate taxes paid on the property and state death taxes. Heirs also could increase the basis in all the decedent's property to a minimum of $60,000.
13 Estate taxes that would have applied if the first transfer had been ownership were owed in addition to those on the second transfer.
14 Previously, the marital exemption was limited to one-half the adjusted gross estate. When combined with the unified credit, estates of up to $425,625 could pass to the surviving spouse without tax.
15 If certain requirements were met, real estate used in the farm or business was valued at its present rather than "highest and best" use. This could reduce the size of gross estate by up to $500,000 provided that the decedent's family continued the farm or business for at least 15 years. Estate taxes attributable to the business also could be deferred for five years, except for interest, and paid over up to ten years thereafter.
16 Part of the appreciated value of the business could be considered a contribution of the surviving spouse and, therefore, not subject to estate taxes.
17 The phase-in was as follows: $47,000 ($175,625) in 1981; $62,800 ($225,000) in 1982; $79,300 ($275,000) in 1983; $96,300 ($325,000) in 1984; $121,800 ($400,000) in 1985; $155,800 ($500,000) in 1986 and $192,800 ($600,000) in 1987.
18 If the decedent had made gifts during his or her life, even estates below the exempt amount would have had to file a return.
19 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. 53-56. Kotlikoff and Summers estimate that between 41 and 66 percent of current wealth is due to transfers from one generation to another, with an average of 53 percent.
20 For more on the relationship between saving and tax rates, see Gary and Aldona Robbins, *Eating Out Our Substance: How Taxation Affects Saving,* Institute for Policy Innovation, TaxAction Analysis, Policy Report No. 131, August 1995.
21 Refers to any given level of taxation.
22 The top estate tax rate (55%) plus the top federal income tax rate (39.6%) equal 94.6 percent. Adding state and local income and estate taxes could easily bring the total rate to 100 percent or more.
23 While tax law provides for what is, in essence, a loan from the government, heirs still must give half of the business' value to the government.
24 The real aftertax rate of return to capital tends to remain around 3.5 percent. After a shock, such as a change in taxes on capital, we have found that historically it has taken about five years for 90 percent of the capital adjustment to occur that will bring the return back to its equilibrium value. For more see Aldona and Gary Robbins, *Eating Out Our Substance (II): How Taxation Affects Investment* , Institute for Policy Innovation, TaxAction Analysis, Policy Report No. 134, November 1995.
25 The Fiscal Associates Model incorporates taxes through their effects on the returns to labor and capital. A tax cut that allows workers to keep more of the next dollar earned will increase the amount of labor they are willing to supply. Similarly, an increase in the aftertax return to capital, at the margin, will bring forth more saving and investment. Increases in the amount of capital and labor available to the economy will lead to more output, income and growth. For more on the Model see Gary and Aldona Robbins, *Accounting for Growth: Incorporating Dynamic Analysis into Revenue Estimation*, Lewisville, TX: Institute for Policy Innovation, Policy Report No. 138, July 1996.
26 The estate tax amount comes from Internal Revenue Service data for estate returns filed in 1995. According to budget documents, estate and gift taxes amounted to $14.8 billion out of a total $1,351 billion in federal revenues for fiscal 1995.
27 Alicia H. Munnell, "Wealth Transfer Taxation: The Relative Role for Estate and Income Taxes," *New England Economic Review*, Federal Reserve Bank of Boston, November/December 1988, pp. 3-28 and Henry J. Aaron and Alicia H. Munnell, "Reassessing the Role for Wealth Transfer Taxes," *National Tax Journal*, vol. 45, no. 2, Fall 1997, pp. 173-194.
28 Compliance costs for the alternative minimum tax amount to at least 30 percent of revenue collected. See Gary and Aldona Robbins, *Complicating the Federal Tax Code: A Look at the Alternative Minimum Tax (AMT),* Institute for Policy Innovation, TaxAction Analysis, Policy Report No. 145, March 1998.

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