Quick Study

A Policy Report Summary by the Institute for Policy Innovation

# The Case for Burying the Estate Tax

**A Summary of IPI Policy Report # 150**

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Until recently, estate taxes were the 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 grab of estate taxes.

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 (from 37% up to 55%) often force heirs to liquidate assets to pay the estate tax bill.

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 the elimination of estate and gift taxes. More proposals will undoubtedly be considered during the 106th Congress.

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 When hostilities ceased, the tax was repealed.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 becoming increasingly concentrated in the hands of a few. [See Figure 1.]

Loophole closing preoccupied tax reformers during the late 1960s and early 1970s.

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.

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.]

## The Estate Tax Today

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

**Figure 1**

**Estate Tax Rates, 1916–2006**

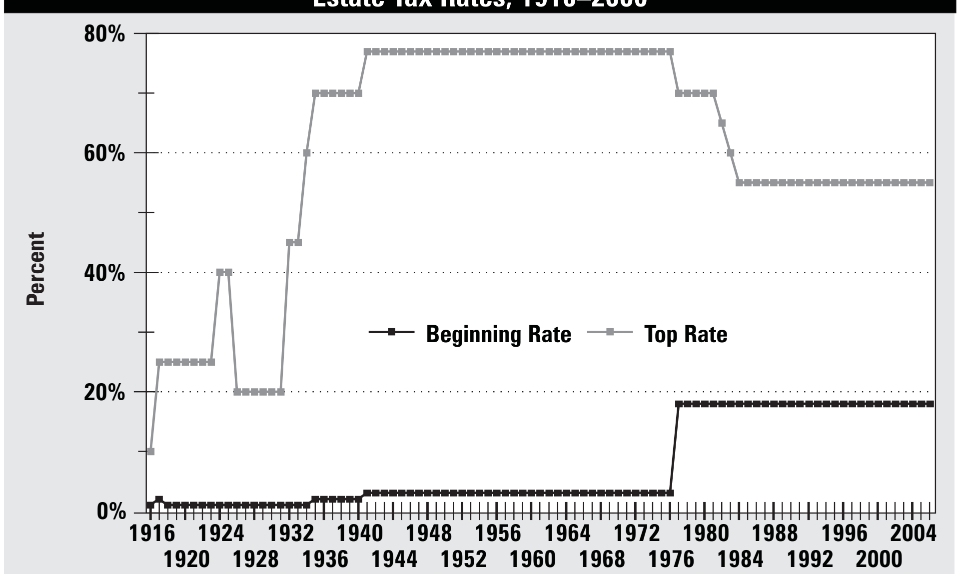


Figure 2

Estate Tax Exemption, 1916–2006


amounts are not indexed, more estates hit the top tax bracket today than ten or fifteen years ago.

The unified credit of $192,800 translates into an exemption amount of $600,000. 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.

### Who Pays Estate Taxes?

In 1995, 69,722 estates were required to file an estate tax return. Almost a quarter of those returns reported the *size of gross estate* to be under $1 million. Over half reported estates under $2.5 million and 96 percent under $5 million.

Less than half 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

While the U.S. population quintupled in the last fifty years, estate tax returns increased tenfold. As a result, smaller estates 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 smaller estates must file returns.

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. 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.

### 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. 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.

*For the economy to produce the most output at the lowest cost, average and marginal tax rates should equal each other.* 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 are 2.6 times higher than the average rate. Because marginal estate tax rates are much higher than average rates, economic efficiency suffers.

### Medium-sized Estates 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 Figure 3.]

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 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. Small businesses—which have fueled much of the current expansion—are hit particularly hard.

## What Estate Taxes Cost Society

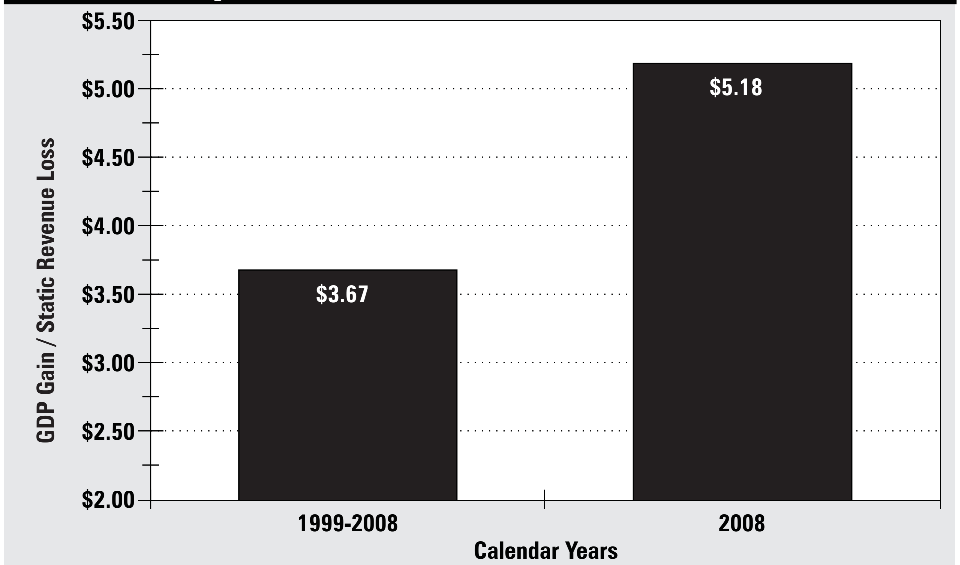
We estimate that eliminating the federal estate tax would reduce the average, economy-wide marginal tax rate on all U.S. capital by 0.25 percent. This lower tax on capital would raise the return to savers and investors.

Eliminating the federal estate tax in 1999 would cause the economy to grow faster than the baseline, mainly due to a more rapid expansion of the U.S. stock of capital. By the year 2010:

- Annual gross domestic product would be $137.2 billion, or 0.9 percent, above the baseline.
- The stock of U.S. capital would be higher by almost $1.7 trillion, or 4.1 percent above the baseline.
- The economy would have created almost 275,000 more jobs than in the baseline.
- Between 1999 and 2010, the economy would have produced almost $1 trillion more in GDP than otherwise.

Figure 4

Eliminating the Estate Tax Would Produce Sizable Economic Gains




### 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.

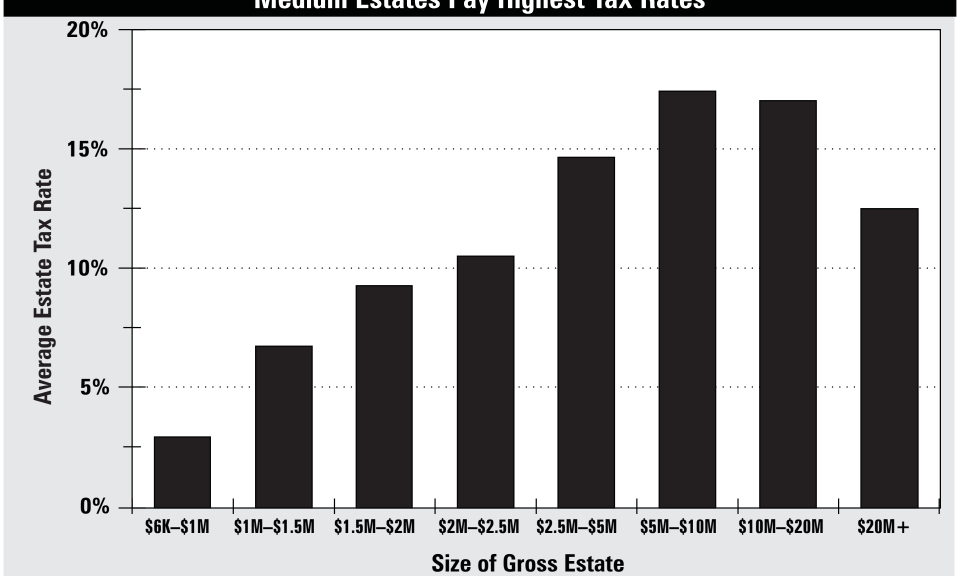
Second, the estate tax imposes extremely high compliance costs—about as much as the tax raises. Tax compliance adds nothing to output and diverts resources away from productive activities that do.

Third, doing away with estate taxes would produce positive economic growth effects large enough to offset most of the static revenue loss.

- 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 2010, the dynamic revenue gain from eliminating the estate tax would be enough to offset the annual static revenue loss completely.

Figure 3

Medium Estates Pay Highest Tax Rates




### 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. [See Figure 4.]

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

Estate taxes have increasingly reached into middle-class America over the last several decades.

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.

Estate taxation hurts the economy. Its sheer complexity results in high compliance costs—as much as estate taxes raise by one estimate.

Estate taxes have hit small businesses particularly hard. Heirs sometimes must liquidate at least part of a successful enterprise to pay the estate tax bill.

High marginal tax rates on estate assets raise capital costs and depress saving and investment. 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 would be one of the best legacies that the 106th Congress could leave future generations.

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### Want More Info?

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