THE BROOKINGS INSTITUTION
WASHINGTON, DC

Policy Brief

NO. 62

June 2000

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Resurrecting the Estate Tax

In June, the U.S. House of Representatives voted to phase out the estate and gift tax over the next 10 years. This is not a new idea: both the House and the Senate voted to dump the tax last year, but President Clinton vetoed the bill. What is new is that 65 Democrats joined Republicans in voting out the tax this year, enough to override a veto. This shift, along with an endorsement from presumptive Republican presidential nominee George W. Bush, makes the estate tax a live political issue.

Besides its association with the rich and the dead, the estate tax manages to touch on several other sensitive topics. The tax embodies in extreme form the trade-off between equity and efficiency that pervades government policy. It is only levied on the wealthiest households, but the tax base is linked to accumulated wealth and thus to the labor supply, effort, and saving that create wealth and are crucial to prosperity. In addition, the impact and proper role of estate taxes depends on issues as personal and sensitive as parents' rights to provide for their offspring and the nature of relations between parents and children, and issues as controversial as the true meaning of equal opportunity.

Despite all this, the estate tax has received little public airing and even less reasoned discussion. Many arguments commonly made against the tax are demonstrably specious. To the extent that any of them are valid, they suggest reform rather than abolition. Many arguments made in favor of the tax actually support maintaining some sort of levy, but not necessarily the existing version.

Estate Tax Basics

Taxes on transfers of wealth were levied as far back as the 7th century B.C., in Egypt. The first American tax on wealth transfers dates to 1797 when, faced with the expenses of dealing with French attacks on American shipping, Congress imposed a stamp duty on receipts for legacies and probates for wills. The tax was eliminated in 1802. Similar, short-lived taxes were enacted during the Civil and Spanish-American Wars. The modern estate tax also originated in a time of war preparation, if not war itself, in 1916. However, this incarnation survived World War I because it fit the dominant view of the time that federal revenue from customs and excise taxes should be replaced by more progressive tax methods.

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THE CASE FOR REFORM,

Nearly all industrialized countries levy some kind of a wealth transfer tax. But other than the United States, only New Zealand and the United Kingdom levy "pure" estate taxes; the others have an inheritance tax or a mixture of inheritance and estate taxes. Other than the U.S., only Japan and South Korea collect more than one percent of total tax revenues from wealth transfers, but many industrialized countries have annual wealth taxes, which the U.S. does not.

Under current U.S. law, the executor of an estate must file a federal estate tax return within nine months of a person's death if the gross estate exceeds $675,000. The tax base includes the decedent's gross assets plus any gifts made in excess of $10,000 per year per donee. The tax allows deductions for transfers to a surviving spouse, charitable gifts, debts, funeral expenses, and administrative fees. A tax credit exists for state-levied inheritance and estate taxes; most states now levy so-called "soak-up" taxes that fall within the credit limit, and so do not add to the total tax burden. A unified credit currently exempts taxes on the first $675,000 of lifetime taxable transfers, a figure that will rise to $1 million by 2006. For estates above those amounts, the tax rate begins at 37 percent and rises to 55 percent on taxable transfers above $3 million. In 1999, the federal estate and gift tax netted $28 billion—about 1.5 percent of federal revenue. By comparison, the gasoline tax raised $39 billion, the income tax $879 billion, and the corporate income tax $185 billion.

Estate tax liability is highly concentrated among rich families. Less than 2 percent of people who die owe any estate taxes at all. In 1997, estates with gross value over $5 million accounted for half of all estate and gift taxes, but only about 5 percent of all taxable estates and about 1 out of every 1,000 deaths. Estate taxes are much more progressive than the graduated income tax. Households in the top 5 percent of the income distribution bear 91 percent of estate taxes compared to 49 percent of income taxes. Those in the top 20 percent bear 99 percent of estate taxes and 77 percent of income taxes.

The Case Against the Estate Tax

1. Taxing at death is immoral

Opponents often view death as an illogical time to impose taxes at best, and a morally repugnant one at worst. Compounding the grief of a family with a *tax,* of all things, seems a bit heartless, and the mention of *"death tax"* evokes queasiness. As evocative as it is, this argument is seriously misleading. First, death is neither necessary nor sufficient to trigger the estate and gift tax. It is insufficient because over 98 percent of decedents pay no tax. It is unnecessary because gifts between living people can trigger a tax liability. More important, estate tax liabilities can be effectively prepaid via life insurance purchases tied to the expected tax liability or, in the case of qualified family businesses, can be delayed and

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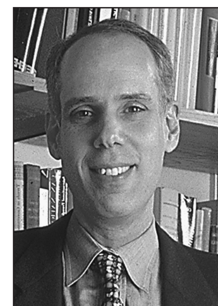

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paid over a 14-year period after the death of the owner. Thus, although death may trigger the tax liability, the payment can be remitted at any of a number of times.

Leaving the morality issue aside, death is very likely to be a convenient "tax handle." The public nature of the probate process reveals information about a family's level of affluence that is difficult to obtain in the course of enforcing the income tax, but that may be relevant for societal notions of the appropriate level of progressivity. This aspect of taxation at death likely explains why inheritance and estate taxes date back for millennia. Many economists have argued that taxes at death have smaller disincentive effects on lifetime labor supply and saving than do equivalent-revenue taxes imposed during life.

2. The estate tax stifles saving, labor supply, and economic growth
Combined with the income tax, the marginal tax disincentive to work and save created by the estate tax for the affluent can be so high as to seriously discourage work and saving. The top federal income tax rate of 39.6 percent combined with the top estate tax rate of 55 percent implies a tax penalty as high as 73 percent on a dollar earned with the intent to bequeath.

The impact of the estate tax on saving hinges on why people make bequests. For example, to the extent that bequests are unintentional, and arise out of people's unwillingness to convert their wealth to annuities, people would have wealth left over when they die, even if they would have liked to have consumed the wealth themselves. In that case, an estate tax would not discourage saving and would not be a burden to the bequeathor (although the donee would be less well off).

What if bequests are really payment for services rendered by children to parents in their later years? An estate tax, then, merely raises the purchase price of the services, so that the effect on saving depends on how responsive parents' purchases of services are to the price. Since people are likely motivated by a combination of factors in their bequests, the impact of estate taxes on saving by the estate owner is difficult to sort out.

Evidence is not much stronger than theory. The effects of income taxes on labor supply and savings appear to be relatively small. Estate taxes are levied at higher rates, which might suggest a larger effect, but they are also levied at more distant points in the future, suggesting a lesser impact. Direct evidence, however, is sparse. In years when the estate tax has been relatively high, reported estates as a fraction of national wealth were lower than other years, which is consistent with either a depressing effect on wealth accumulation and/or an encouraging effect on estate tax avoidance.

3. The estate tax hurts family-owned businesses and farms

Estate tax opponents claim that a large proportion of American businesses never make it to the second generation and assert that the estate tax is the reason why. This is surely a case of the tail wagging the dog. Farms and other small businesses represent a small fraction of estate taxes. In 1997, farm assets were reported on less than 6 percent of all taxable estates, and closely held stock on less than 10 percent. Farm assets totaled a microscopic 0.3 percent of taxable estates; closely held stock, limited partnerships, and "other noncorporate business assets" accounted for less than 10 percent. Only 3 percent of estates consist mainly of farms or small business. These figures imply that the vast majority of estate taxes are paid by people who own neither farms nor small businesses, and that scaling back or eliminating the estate tax is a very blunt instrument for dealing with the issue.

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Family farms and businesses already receive special treatment under the estate tax. Taxpayers may calculate the value of family farms and businesses on the basis of the value to family proprietors rather than market value. This can reduce gross assets by as much as $775,000. In addition, the estate tax liability due to family farms and businesses can be paid in installments over a 14-year period, with only interest payments at below-market rates due during the first five years. Legislation enacted in 1997 permits a special deduction of up to $675,000 worth of family-owned farms and businesses when they constitute at least 50 percent of an estate in which heirs materially participate. Moreover, small businesses already receive numerous income tax subsidies.

4. The estate tax discriminates unfairly against savers

Opponents claim the tax inequitably burdens families that want to provide for their children and punishes those who fail to engage in sophisticated tax planning. It's true that the estate tax does not burden people who spend every penny on themselves or charity, but hurts those who pass their fortune to their children.

The perspective, however, is crucial to this argument. From the giver's viewpoint, the tax seems to single out the altruistic for taxation. But from the perspective of the next generation, inheritance provides an advantage to some rather than others. Supporters of the tax claim that advantages derived from inheritance are unearned, unfair, and reward the "skill" of choosing affluent parents. They argue that this seriously distorts notions of equality of opportunity, and is detrimental to a widely shared understanding of fair play. Supporters note that high estate taxes do not stop parents from passing on huge amounts of human capital, family reputation and values, and large amounts of tax-free financial wealth via gifts and bequests. They say that high estate taxes provide good incentives for young people to work hard, promote fair play, and do not seriously impinge on parents' ability to provide for their offspring.

5. The estate tax is easy to avoid and creates huge compliance costs

Opponents allege that the estate tax is inefficient because avoidance and compliance costs are so high and the tax is so easy to avoid. But how high are the costs? The widely-cited claim that the costs of complying with the estate tax laws are roughly the same magnitude as the revenue raised is extremely rough at best. More recent estimates based on consultations with tax professionals produce a cost of 7 percent of revenues, a number that in our view is likely to be closer to the truth. Moreover, an unknown fraction of this may be estate planning, *inter alia* about intergenerational succession of the business, that is unrelated to taxation and thus would likely be incurred regardless of whether there was an estate tax. If there are high compliance costs, it is not clear whether that would suggest that the tax should be cut back or, alternatively, be bolstered by broadening the base, eliminating loopholes and reducing tax rates.

6. The estate tax doesn't raise much revenue, anyway

Opponents argue that the estate tax raises very little revenue, so that abolishing it would make little difference to federal revenues. This assertion is factually incorrect. Over the long-term, eliminating the estate tax could cost over $50 billion per year. But even if it is right, it begs the relevant question: should taxes be cut in this way, some other way, or not at all? A more sophisticated version of the argument is that the net effect of estate taxes is close to zero because the sheltering schemes that reduce estate taxes also tend to reduce income taxes. If this were the case, the estate tax would be difficult to justify. But the findings are highly speculative, and opponents do not act as if they believe the tax imposes no net burdens.

The Case In Favor of Transfer Taxes

1. The estate and gift tax is progressive

Progressivity has always been the primary defense of estate taxes and remains so today. It's true that the standard liberal defense of the estate tax on progressivity grounds is in part a knee-jerk resistance to a tax cut for the rich. But the standard conservative attack is also partly a knee-jerk response to any tax that is progressive, as evidenced by recent support for the flat tax and criticism of the graduated income tax and capital gains taxes. Neither liberals nor conservatives are arguing for a low-exemption, flat-rate estate tax that almost everyone would pay when they die. Instead, the policy debate concerns a tax that applies only to the rich.

It would help if opponents of the estate tax clarified whether they are advocating a large reduction in the progressivity of the tax burden, or just a change from one progressive tax instrument to another (it is the former). Likewise, it would help if supporters of the estate tax clarified whether they would support an equally progressive alternative tax, or whether there is something about taxation of wealth transfers *per se* that is essential.

Ultimately, the progressivity of the tax depends on its impact on saving and labor supply. If the estate tax discourages significant amounts of wealth accumulation, it could drive wages down by reducing the amount of capital per worker. In this case, the impact of the tax would be felt (indirectly) by workers. Because the impacts on saving and labor supply appear to be relatively small but have not been firmly established, it is appropriate to maintain the view that the estate tax is progressive until new evidence is provided. Certainly, the alignment of forces pro and con is consistent with this view.

2. *Transfer taxes serve as a backstop to the income tax*

Supporters of the estate tax often note that it serves as a backstop for the income tax by imposing taxes at death on income that previously escaped taxation. One source of such income is capital gains that have never been realized. These gains elude the income tax net and are bequeathed to inheritors with a stepped-up basis, and so are never taxed under the income tax. (Basis step-up also occurs for transfers from one spouse to another, even though such transfers are deductible from the gross estate. As a result, the estate tax contains a potentially large marriage bonus that has received little attention.) To the extent that the estate tax is meant to collect on previously accrued but unrealized capital gains, the tax should apply only to unrealized capital gains and should be capped at the highest capital gains tax rate. Clearly, this is not how the estate tax is structured.

3. *Transfer taxes reduce the concentration of wealth*

Since its enactment, the estate tax has been viewed as a counterweight to an undue concentration of wealth. Today, some opponents claim that the estate tax fails to achieve this goal. Although the concentration of wealth may not be lower now, in the era of high estate taxes, than it was before, the real question is whether concentration of wealth is lower than it would be without the tax. It is probably unrealistic to expect that a tax that in a typical year raises revenue equal to 0.3 percent of Gross Domestic Product (GDP) and 0.1 percent of household net worth would make a serious dent in overall wealth inequality. This reduces the scale of both costs and benefits, but does not resolve whether the benefits exceed the costs. In fact, the opponents' claim could be construed as an argument for increasing, rather than decreasing, the tax.

4. *Transfer taxes help the non-profit sector*

Supporters note that the deduction in the estate tax for charitable contributions generates a significant increase in contributions to the non-profit sector, especially among the wealthiest households. In 1997, of 329 taxable estates with gross assets above $20 million, 182 made charitable contributions, and those that did contributed an average of over $41 million! Transfer taxes may also encourage giving to charity during life, as a way to reduce gross estate values. Opponents say the deduction has a small effect relative to the overall funds raised by the non-profit sector, and that repealing the tax would raise wealth among the richest families, which would increase charitable contributions. This latter claim is inconsistent with their view that estate taxes do not affect the concentration of wealth.

Where Do We Go From Here?

The most radical reform would be to abolish the estate tax. This would eliminate existing problems, but may create a host of additional issues, including repealing what is by far the most progressive tax instrument in the federal tax arsenal, following a long period during which distributions of income and wealth have already become more skewed. A repeal could hurt non-profits. It would reduce federal revenues. It may not even raise saving, labor supply or growth, as its advocates hope, and it would create a gaping loophole for capital gains in the income tax. Moreover, the case for abolition appears to be backed largely by loose rhetoric about the immorality of taxing at death and the supposed impact on a tiny component of those who would benefit from it.

Elimination of the estate tax could be coupled with an extension of the capital gains tax to the gains accrued but unrealized at death. By itself, that is neither an attractive nor a likely option, as it would raise much less revenue from a quite different set of people, and would have many of the complexities of the estate tax. It would also not necessarily help small businesses and farms, since most of their wealth takes the form of unrealized capital gains.

The bill passed by the House in June tied elimination of the estate tax to another significant change in capital gains taxation, under which heirs would assume the decedent's basis for capital gains purposes—called the "carryover basis"—for transfers from estates valued at more than $1.3 million (plus a $3 million exemption on spousal transfers). This would raise even less revenue than taxing gains at death, and would be substantially more complicated, in part because records would have to be kept for longer periods of time. A similar provision passed in the late 1970s was repealed before it took effect because of anticipated implementation problems.

The best way to achieve more modest changes in the estate and gift taxes depends in large part on what the system aims to accomplish. If the goal is to help family-owned businesses and farms, the appropriate exemptions could be increased. But it may make more sense simply to raise the exempt amount for all assets, since doing so for selected forms of assets creates both horizontal equity problems and inefficient sheltering incentives.

If the goal is to chip away at an undue concentration of wealth, then the effective exemption could be raised substantially—since only the extremely wealthy are the target—and the high tax rates maintained. This could simplify the tax and greatly reduce the number of people who pay estate taxes, but it would also reduce revenues. If the goal is to improve equality of opportunity, then estate tax revenues could be earmarked for special education and training programs, or for means-tested asset accumulation subsidies.

Broadening the tax base, closing loopholes and reducing rates carried the day in the last comprehensive income tax reform in 1986 and could improve the equity, efficiency, and simplicity of the estate tax as well. Treating different assets similarly would reduce

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Brookings gratefully acknowledges the generosity of the Cabot Family Charitable Trust and B. Francis Saul II for their support of the Policy Brief series.

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sheltering opportunities and make the tax simpler and fairer. For example, legislation could address unwarranted valuation discounts and abusive trust arrangements that abound. Reducing rates would reduce the incentive to shelter or change behavior.

The historical record shows that transfer taxes can play an important role in the tax system. While many arguments against the current estate and gift tax system are specious, they contain an important undercurrent of truth. At the same time, supporters of these taxes must distinguish between the potential benefits in principle and the design problems that arise in practice. A transfer tax system that couples effective marginal tax rates of up to 73 percent with substantial opportunities to shelter funds is asking for trouble. An income tax with similar features in the 1970s was swept out in favor of a broader-base, lower-rate system in the 1980s. In light of these considerations, a package of lower rates, a higher exemption level, a thorough reform of the tax base and perhaps a judicious earmarking of estate tax revenues may well be the lifeblood of a more effective transfer tax system for the future.

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