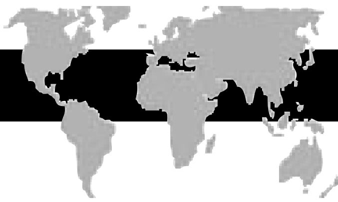

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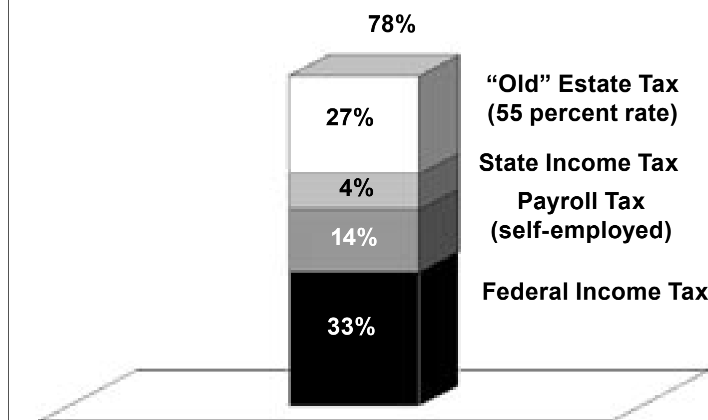
We All Pay for the Estate Tax

by Stephen J. Entin

Congress is debating repeal of the estate tax — again. The 2001 tax cuts included a gradual phase-out and full repeal of the estate tax in 2010. But due to the sunset provision imposed by federal budget rules, the estate tax will reappear at its full pre-reform rates in 2011. At that time, estates in excess of $2 million will be taxed at the old rates — up to 55 percent.

For anyone with a sizeable estate, 2010 is a good year to pass away. However, estate tax repeal is also important to people who do not have large estates. The estate tax generates little revenue for the federal government, but negatively affects every American. It reduces capital formation, and thereby lowers productivity, wages, employment and federal revenues from payroll and income taxes. It encourages upper-income-bracket savers to transfer their assets to their lower-bracket children and to tax-exempt charities sooner than they would otherwise; the government loses a portion of the income tax revenues on the subsequent earnings of the assets and on the charitable deductions taken by the donors. Together, these effects probably cost the government well over a dollar of income and payroll taxes for each dollar the estate tax collects.

How the Estate Tax Raises Marginal Taxes on Labor



Note: Marginal tax on $1.00 of income earned in retirement.
Source: Author's calculations.

Effect on Investment. The income tax is heavily biased against saving and investment, and the estate tax contributes to that tax bias. Economists Laurence Kotlikoff and Lawrence Summers estimate that between 41 percent and 66 percent of the current capital stock has been transferred either by bequests at death or through trusts and lifetime gifts. Using Kotlikoff and Summers' methodology for calculating the effect of the estate tax on capital accumulation, Dan Miller of the Joint Economic Committee of Congress estimated that the old tax reduced the capital stock by about $500 billion.

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

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

First, the income is taxed when it is earned. Second, when after-tax income is saved, the returns on the saving are taxed — double taxation. For example, if the saver puts his income into a bond or bank account, the interest earned is taxed. If the saver invests directly in a small business, his investment income from the proprietorship or partnership is taxed. If the saver buys a share of corporate stock, he must pay personal income tax on any dividends that the corporation distributes to him, and a capital gains tax on any increase in the share value (as occurs when income is retained for reinvestment) when he sells the asset.

Third, even before the shareholder receives his dividend, or the corporation retains income to reinvest, there is the corporate tax that must be paid on the corporate income, which is really the income of the shareholder.

Fourth, if any unspent assets remain above a modest exempt amount, the federal unified transfer (estate and gift) tax imposes another layer of federal tax on

the already multiple-taxed saving. This added layer of tax is also imposed on tax-deferred savings, which are subject to the estate tax and are taxed again as income to non-spousal heirs.

Thus, all saving in estates has already been or will soon be taxed under the income tax, and any taxation of estates is an added layer of tax on saving.

Effect on Wages. The estate tax discourages work by people who only want to add to their bequests. Consider the tax's effect on the incentives of an upper-tax-bracket working couple approaching retirement age. If they have saved $15,000 a year since college, they may have accumulated over $3 million for their retirement. They may plan to live on the interest and leave the principal and any additional earnings from work to their children. Their two salaries may put them in the 28 percent or 33 percent tax bracket, and when state income taxes are added, their combined marginal tax rate is about 32 percent to 37 percent. Including payroll taxes, their combined marginal tax rate on additional income can reach 46 percent to 51 percent.

If the estate tax reappears at its old rates, any after-tax income will be subject to a 55 percent estate tax, and their combined tax on additional earnings could reach 78 percent or more! [See the Figure.] They may as well retire early and pay less tax. If this couple decides to give some of the assets to their children now to avoid tax in the future, the children may have less incentive to work as well.

Effect on Federal Revenue and the Economy. Before the 2001 Tax Act trimmed the tax rate, estate and gift taxes took in just over $29 billion in 2000, accounting for only 1.4 percent of federal revenues. However, the estate tax actually contributes less than this to federal revenues because of the tax's effect on capital formation and work incentives. Prior to the 2001 act, the Heritage Foundation reported that if the estate tax were repealed:

- The U.S. economy would average as much as $11 billion per year in extra output.
- An average of 145,000 new jobs could be created, and personal income could rise by an average of $8 billion per year above current projections.
- The federal budget deficit would decline because the increased revenues generated by extra growth would more than compensate for the meager revenues raised by the death tax.

The Estate Tax Hurts the Poor as Well as the Rich. People can increase their productivity and labor by acquiring skills and training (human capital), by buying or inheriting physical capital to use with their labor, or by seeking employment that will let them work with other people's physical capital. By discouraging capital formation, the estate tax makes it harder to combine labor with capital, which reduces the demand for labor and reduces opportunities for on-the-job training. It keeps the poor poor, and it keeps start-up businesses from growing to compete with older and bigger firms.

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

Furthermore, among the richest citizens, most wealth is earned — not inherited. One study found that among the wealthiest 5 percent of the population:

- Most of the wealth (92.5 percent) was from earnings and thrift.
- Only 7.5 percent was from inheritance.

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

Solution: Permanent Repeal and Tax Fairness. Because it is an inefficient way to raise revenue and negatively affects the economy, Congress should permanently repeal the estate tax.

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