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Repealing the Federal Estate Tax

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Congress is debating permanent repeal of the federal estate tax. The "death tax" is assessed at a high rate on the accumulated savings of deceased persons above a basic exemption amount. Some pundits say that repeal would be an unfair break for the wealthy, but the issue is more complicated than that. Many public finance experts believe that the estate tax causes broad harm to the economy by suppressing investment and generating unproductive tax avoidance activity. In addition, the estate tax might not raise any revenue for the government when all its effects are taken into account.

Plan for a 2010 Funeral

Tax cut legislation enacted in 2001 modestly reduced the estate tax rate and increased the exemption amount between 2002 and 2009. Currently, the top estate tax rate is 46 percent and the exemption is $2 million. Thus, if the owner of a small business with assets of $3 million passed away this year, the heirs of the estate would have to pay federal estate taxes of about $460,000.

Under the 2001 law, the estate tax is fully repealed in 2010. But the tax is then resurrected in 2011 with a top rate of 55 percent and an exemption of $1 million. If you are in poor health in 2010 and you own substantial personal or business assets, your heirs might favor your prompt departure. If Congress enacts a permanent repeal this year, many unpleasant family situations and tax planning headaches can be avoided.

Estate Taxes in Other Countries

Does the United States need an estate tax? Table 1 shows that many countries have decided that they do not. Of 50 countries surveyed by PricewaterhouseCoopers in 2005, 24 do not have an estate or inheritance tax, including Australia, Canada, New Zealand, and Sweden.[1] Of the 26 countries in the table that do have estate or inheritance taxes, the United States has the third highest rate at 46 percent.

Table 1. Top Estate Tax Rates in 50 Countries

Country	Rate (%)	Country	Rate (%)
Japan	70	Argentina	0
South Korea	50	Australia	0
United States	46	Canada	0
France	40	China	0
United Kingdom	40	Colombia	0
Spain	34	Cyprus	0
Germany	30	Czech Rep.	0
Belgium	30	Estonia	0
Netherlands	27	India	0
Venezula	25	Indonesia	0
Chile	25	Israel	0
Hungary	21	Latvia	0
Philippines	20	Lithuania	0
Norway	20	Malaysia	0
Ireland	20	Malta	0
Greece	20	Mexico	0
Luxembourg	16	New Zealand	0
Finland	16	Portugal	0
Hong Kong	15	Russia	0
Denmark	15	Slovak Rep.	0
Austria	15	Slovenia	0
Turkey	10	Sweden	0
Singapore	10	Switzerland	0
Poland	7	Thailand	0
Brazil	4		
Italy	3	Average	13

Source: American Council for Capital Formation based on a 2005 analysis by PricewaterhouseCoopers.

The High Cost of the Estate Tax

The estate tax is probably the most inefficient tax in America. It has a high marginal rate and is very difficult for the government to administer and enforce. It has also created a large and wasteful estate-planning and avoidance industry. The industry overflows with high-paid lawyers and accountants doing paperwork, litigation, asset appraisals, and creating financial structures to minimize the tax burden using trusts, life insurance, and private foundations. Alicia Munnell, a member of President Bill Clinton's Council of Economic Advisers, estimated that the resources spent on avoiding estate taxes may be as large as the amount that the tax collects.[2]

An even larger cost of the estate tax is the damage that it causes to saving, investment, and business activity. The need to pay an estate tax bill can result in heirs liquidating or selling family businesses because such businesses are often asset rich but cash poor. The estate tax damages the economy when it destroys ongoing, job-producing businesses simply to fund added government consumption.

Also, consider the impact of the estate tax on an entrepreneur who has struggled to build a small business into a larger enterprise. She may begin wondering why she should keep working so hard to grow her business if the government will take half of all the added wealth that she creates. Productive people in this situation may decide to take it easy, reduce their investment, and increase their consumption. As tax law professor Edward McCaffery notes, the death tax discourages socially beneficial savings and rewards a selfish "die-broke" ethic.[3]

Liberals who complain about "concentrations of wealth" have it wrong. Wealth accumulation by anyone and everyone is good for the economy. Frugal savers who become wealthy are great benefactors to society because their capital increases productivity and is the fuel for growth. The estate tax penalizes savers and investors who attain wealth, while rewarding wealth dissipation through private and government consumption.

The winners from estate tax repeal would be average workers who would gain from a larger capital stock and entrepreneurs' greater job creation efforts. Former chairman of President George W. Bush's Council of Economic Advisers, Greg Mankiw, noted that as a tax on capital, the estate tax likely reduces U.S. productivity and wages. He concluded that "repeal of the estate tax would stimulate growth and raise incomes for everyone."[4]

Federal Revenues May Increase with Repeal

Federal budget data indicate that estate taxes will raise $28 billion this year, accounting for 1.2 percent of total federal revenues. However, if the estate tax were repealed, income and capital gains tax revenues would increase to partly or fully offset the loss in estate tax revenues.

If the estate tax were repealed, the nation's capital stock would grow larger over time, which would produce higher incomes and thus more income tax revenues. Another effect of estate tax repeal would be to end the current tax avoidance strategy of parents shifting assets to their children, who are usually in a lower income tax bracket than the parents. All in all, the estate tax "probably reduces personal income tax revenue by more than the estate tax itself collects, causing a net decrease in total federal tax revenue," according to Harvard University's Martin Feldstein.[5]

Capital gains tax revenue would also increase under estate tax repeal.[6] That would occur as the current "step-up" in basis on assets was replaced by "carryover" basis. Much of the value in large estates consists of unrealized capital gain, which currently avoids capital gains taxes because asset basis is stepped up to market value at death. That has the effect of reducing federal revenues by more than $50 billion annually.[7] Under most estate tax repeal plans, some portion of unrealized gains would be carried over to heirs who would pay tax when they sold the assets. Thus the government would pick up a part of this $50 billion in revenue, and that would offset the revenue loss from estate tax repeal.

Conclusions

Permanently repealing the estate tax would likely spur greater savings and growth. If full repeal does not gain enough support in Congress, Sen. Jon Kyl (R-AZ) has proposed a compromise that would cut the tax rate to 15 percent and increase the exemption to $5 million. That would be a big improvement over current law. But if Greg Mankiw is correct that the estate tax "unfairly punishes frugality, undermines economic growth, reduces real wages, and raises little, if any, federal revenue," why retain any part of this damaging tax?[8]

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[1] See American Council for Capital Formation, "New International Survey Shows U.S. Death Tax Rate among Highest," July 2005. The rates in the table are for estates passed to children. Note that estate taxes are imposed on the value of estates, while inheritance taxes are imposed on each heir. Canada imposes capital gains taxes on unrealized gains at death.
[2] See a discussion of Munnell's work in Dan Miller, "Costs and Consequences of the Federal Estate Tax," Joint Economic Committee, May 2006, p. 17.
[3] Edward McCaffery, "Grave Robbers: The Moral Case against the Death Tax," Cato Institute, October 4, 1999.
[4] Gregory Mankiw, remarks at the National Press Club, Washington, November 4, 2003.
[5] Martin Feldstein, "Kill the Death Tax Now," op-ed, *Wall Street Journal*, July 14, 2000.
[6] Wilbur Steger and Frederick Rueter, "The Revenue Effects of Estate Tax Repeal and Basis Step-Up Limits," *Tax Notes*, June 6, 2005.
[7] Joint Committee on Taxation, JCS-2-06, April 25, 2006, p. 34.
[8] Mankiw.