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Death and Taxes: The Economics of the Federal Estate Tax

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In April 2005, the U.S. House of Representatives voted to permanently repeal the federal estate tax (H.R. 8). Similar legislation is currently pending before the U.S. Senate (S. 420), and lawmakers are expected to finalize this legislation soon. This *Special Report* examines the economic arguments against the estate tax, and provides a brief history of the federal transfer tax system.

I. A Critique of Arguments In Favor of Estate Taxes

The estate tax is typically defended in two ways. First, it is argued that the estate tax is “fair” because it is highly progressive and borne only by wealthy taxpayers. Second, it is argued that the estate tax is an important federal revenue source. As detailed below, a large body of economic research shows neither argument stands up to close scrutiny.

Do the Wealthy Bear the Burden of the Estate Tax?

The federal estate tax results in net tax liabilities for a small number of estates each year—typically between 1 and 2 percent of estates in recent decades. Advocates of estate taxation argue this makes the estate tax highly progressive, allowing lawmakers to efficiently redistribute wealth from rich to poor in society.

However, this logic is flawed. The assumption that the full economic burden of the estate tax falls only on wealthy estate owners is inconsistent with both the economic theory of tax incidence and empirical evidence on the effects of estate taxes.

Economists teach that, in general, taxes do not stay where lawmakers put them. Instead, some portion of taxes are generally shifted onto others. What economists call the “legal incidence” of a tax—that is, the legal requirement that certain individuals remit tax payments to the government—is largely irrelevant to understanding the economic effects of taxes. What matters instead is which individuals bear the true economic burden—what economists call the “economic incidence” of taxes.

For example, corporations are legally required to pay federal corporate income taxes on their net income. However, although they bear the legal incidence of the tax they do not bear the economic incidence. Economists widely agree that the ultimate burden of the corporate income tax is borne by individuals, not corporations. Some portion of the tax is borne by shareholders of companies, but some portion is also passed on to workers in the form of lower wages, to consumers in the form of higher prices, and to owners of other types of capital throughout the economy in the form of lower investment returns.¹

¹ Harvey S. Rosen, *Public Finance, 7th Edition*. Chapter 17 (New York: McGraw-Hill, 2005)

In the case of estate taxes, many advocates of the tax argue that the economic burden of the tax falls on wealthy estate holders. But this is clearly incorrect. Estate holders may bear the legal incidence of the estate tax, but the economic incidence is partly shifted onto others in society—many of whom are far from wealthy.

Estate holders are able to shift part of the burden of the estate tax to others through estate planning and changes in behavior during life. Because individuals are forward-looking during life, those with large estates can respond to the prospect of paying estate taxes long before death. By adjusting consumption and savings decisions during life, estate holders can pass on the burden of estate taxes to others in ways that are unintended by lawmakers.

One way estate holders shift the burden of estate taxes onto others is by saving less during life, thereby shrinking the size of taxable estates upon death. Studies regularly find that, in fact, estate taxes shrink the size of taxable estates by encouraging consumption and discouraging wealth accumulation.² In this way, part of the burden of estate taxes is shifted onto the heirs of estates.

While it is commonly assumed that estate heirs are as wealthy as decedents, studies show this is often not the case. Harvard economist N. Gregory Mankiw reports that the correlation between lifetime earnings of successive generations is between 0.4 and 0.5.³ That suggests many estate heirs are much less wealthy than decedents, making the estate tax much less progressive than its supporters believe it to be.

Also, wage and salary earners throughout the economy bear some part of the economic incidence of estate taxes. To see why, recall that the estate tax is essentially a one-time excise tax on assets accumulated throughout life. Because the estate tax penalizes these savings, many economists believe that it discourages estate holders from saving during their working lives.⁴ If estate holders save less, the pool of capital

available in the economy for business investment is smaller, resulting in fewer machines, buildings and other technology that makes workers more productive. Because wages in the economy are primarily driven by productivity—and productivity is driven by capital investment, which is driven by the level of savings—if the estate tax discourages savings it will tend to make workers less productive, and in turn, lead to lower wages.

Once the tax-shifting behavior of estate holders is taken into account, the economic incidence of the estate tax may be far less progressive than is commonly assumed. Wealthy estate holders may bear the legal incidence of the tax, but the economic incidence is borne by many other groups in society who are adversely affected by the economic distortions of the estate tax.

Do Estate Taxes Raise Revenue?

A second argument in favor of the estate tax is that, despite its harmful economic effects, it raises revenue for federal programs. However, the estate tax has never been an important federal revenue source. In recent decades it has accounted for only 1 to 2 percent of federal receipts, and many economists argue that even this tiny figure may overstate estate tax revenues. Substantial evidence suggests the estate tax may actually raise zero or even *negative* federal revenue once the full economic effects of the tax are taken into account.

One reason the estate tax is a poor revenue source is that it encourages widespread tax avoidance. This avoidance in turn causes “revenue leakage” in the tax system. During life, wealthy estate holders face incentives to engage in complex estate planning to avoid estate taxation. This may include making gifts to children in lower tax brackets, making tax-deductible charitable gifts, or selling off assets while living in order to pay the current maximum 15 percent capital gains tax rate rather than the maximum 46 percent estate tax rate if assets are held until death.

2 Joel Slemrod and Wojciech Kopczuk, “The Impact of the Estate Tax on the Wealth Accumulation and Avoidance Behavior of Donors.” *National Bureau of Economic Research Working Paper No. 7960* (October 2000).

3 M. Gregory Mankiw, “Remarks by Dr. N. Gregory Mankiw Chairman Council of Economic Advisers at the National Bureau of Economic Research Tax Policy and the Economy Meeting.” President’s Council of Economic Advisors. (November 4, 2003). Available at <http://www.whitehouse.gov/cea/NPressClub20031104.html>.

4 In theory, taxes on savings may increase or decrease savings. For a detailed discussion see Rosen, op. cit., Chapter 16.

Official estate tax revenue estimates do not take these behavioral effects of estate taxes into account. Additionally, official estimates do not account for the large tax-deductible expenses incurred during the process of estate planning. Each of these effects of the estate tax lowers federal tax revenue overall, partially or completely offsetting revenue generated by the tax.

Although economic studies show that tax cuts are not generally self-financing—that is, they normally reduce net revenue rather than increase it—the estate tax may prove to be an exception to this general rule. Because the estate tax causes revenue losses due to widespread tax-avoidance activities, many economists argue that estate tax repeal would result in small revenue losses and possibly a revenue increase.

II. Economic Arguments Against the Estate Tax

Over the years, economists have identified many economic costs of the estate tax. Two of the most harmful are outlined below: the estate tax's negative effect on entrepreneurship, and the high costs of complying with the tax.

Estate Taxes Discourage Entrepreneurship

Previous Tax Foundation research has shown the estate tax hurts the economy by discouraging entrepreneurship. A 1994 study found that the estate tax's 55 percent rate at the time had roughly the same disincentive effect as doubling an entrepreneur's top effective marginal income tax rate.⁵ Thus, because of the estate tax an entrepreneur facing a 31 percent statutory income tax rate would behave as if he or she were facing an effective 62 percent income tax rate.

As the effective tax rates facing entrepreneurs rise, each hour of extra work is worth less in terms of after-tax income. Under reasonable economic assumptions, at some point the threat of estate taxation causes entrepreneurs to become more likely to retire early rather than

continue to work.⁶ If the estate tax encourages entrepreneurs to stop working and saving, not only does this reduce federal income and payroll tax revenue, but also results in less overall wealth creation in the U.S. economy.

In a 2000 study, economists Joel Slemrod and Wojciech Kopczuk measured the incentive effect of the estate tax on wealth accumulation.⁷ Examining nearly a century of estate tax returns between 1916 and 1996 they found a strong negative relationship between estate tax rates and the size of taxable estates, suggesting that estate taxes discourage wealth accumulation. Based on Slemrod and Kopczuk's estimates, Princeton University economist Harvey Rosen calculates that overall wealth accumulation in the U.S. economy would rise by 1.5 percent if the estate tax were fully eliminated.⁸

High Compliance Burden of Estate Taxes

In addition to discouraging entrepreneurship and wealth accumulation, the estate tax imposes a staggering compliance burden on the economy. Very wealthy estate holders may be able to avoid some estate taxation through complex tax planning, but doing so is costly and economically wasteful. The estate tax also imposes high compliance costs on many individuals with smaller estates, as they are forced to file complex estate tax returns despite owing no net estate tax. These tax compliance costs represent pure economic waste burned off of the U.S. economy, on top of actual estate tax revenues.

Economic studies have found that compliance costs of the estate tax are much more burdensome per dollar of revenue generated than the federal income tax. One 1992 study by economists Henry J. Aaron and Alicia H. Munnell estimated the cost of complying with estate taxes to be \$1 for every dollar of revenue raised—nearly five times more costly per dollar of revenue than the notoriously complex federal income tax. According to the authors of the study, “[T]he ratio of excess burden to revenue of wealth transfer taxes is among the highest of

5 Patrick Fleenor and J.D. Foster, “An Analysis of the Disincentive Effects of the Estate Tax on Entrepreneurship.” *Tax Foundation Background Paper No. 9* (June 1994).

6 In theory, taxes on labor may increase or decrease work effort. For a detailed discussion see Patrick Fleenor, “A Primer on the Economic Implications of Marginal Tax Rates.” *Tax Foundation Background Paper No. 32* (November 1999).

7 Slemrod and Kopczuk, op. cit.

8 Harvey Rosen, *Public Finance, 7th Edition* (2005) p. 494.

all taxes.” Noting that this compliance burden is largely the result of widespread tax avoidance, Aaron and Munnell conclude that estate taxes are effectively “penalties imposed on those who neglect to plan ahead or who retain unskilled estate planners” rather than actual taxes.⁹

Table 1
The Long History of Federal Estate and Gift Taxes
1916-2011

Year	Estate Tax Exemption	Lifetime Gift Tax Exemption	Annual Gift Tax Exclusion	Maximum Estate Tax Rate	Maximum Gift Tax Rate
1916	\$50,000	None	None	10%	0%
1917-23	\$50,000	None	None	25%	0%
1924-25	\$50,000	\$50,000	\$500	40%	25%
1926-31	\$100,000	None	None	20%	0%
1932-33	\$50,000	\$50,000	\$5,000	45%	34%
1934	\$50,000	\$50,000	\$5,000	60%	45%
1935-37	\$40,000	\$40,000	\$5,000	70%	53%
1938-40	\$40,000	\$40,000	\$4,000	70%	53%
1941	\$40,000	\$40,000	\$4,000	77%	58%
1942-76	\$60,000	\$30,000	\$3,000	77%	58%
1977	\$120,000	\$120,000	\$3,000	70%	70%
1978	\$134,000	\$134,000	\$3,000	70%	70%
1979	\$147,000	\$147,000	\$3,000	70%	70%
1980	\$161,000	\$161,000	\$3,000	70%	70%
1981	\$175,000	\$175,000	\$3,000	70%	70%
1982	\$225,000	\$225,000	\$10,000	65%	65%
1983	\$275,000	\$275,000	\$10,000	60%	60%
1984	\$325,000	\$325,000	\$10,000	55%	55%
1985	\$400,000	\$400,000	\$10,000	55%	55%
1986	\$500,000	\$500,000	\$10,000	55%	55%
1987-97	\$600,000	\$600,000	\$10,000	55%	55%
1998	\$625,000	\$625,000	\$10,000	55%	55%
1999	\$650,000	\$650,000	\$10,000	55%	55%
2000-01	\$675,000	\$675,000	\$10,000	55%	55%
2002	\$1,000,000	\$1,000,000	\$11,000	50%	50%
2003	\$1,000,000	\$1,000,000	\$11,000	49%	49%
2004	\$1,500,000	\$1,000,000	\$11,000	48%	48%
2005	\$1,500,000	\$1,000,000	\$11,000	47%	47%
2006	\$2,000,000	\$1,000,000	\$12,000	46%	46%
2007-08	\$2,000,000	\$1,000,000	\$12,000	45%	45%
2009	\$3,500,000	\$1,000,000	\$12,000	45%	45%
2010	None	\$1,000,000	\$12,000	0%	35%
2011+	\$1,000,000	\$1,000,000	\$11,000	55%	55%

Source: Internal Revenue Service; CCH Inc.

9 Henry J. Aaron and Alicia H. Munnell, “Reassessing the Role for Wealth Transfer Taxes.” *National Tax Journal* (June 1992).

10 Douglas Holtz-Eakin and Donald Marples, “Estate Taxes, Labor Supply, and Economic Efficiency.” *Special Report*, American Council for Capital Formation (January 2001).

11 The 1916 estate tax was not the nation’s first. Estate taxes were enacted on three previous occasions as extraordinary revenue sources during wartime. Levies were passed in 1797 (repealed in 1802); 1862 (repealed in 1870); and 1898 (repealed in 1902).

A 2001 study from former Congressional Budget Office director Douglas Holtz-Eakin and Donald Marples found similarly high excess burdens associated with the estate tax. The authors estimate that the costs of economic distortions caused by the estate tax are equal to 26 percent of pre-retirement savings, or \$34 billion per year between 2001 and 2005.¹⁰

If these estimates are correct, the compliance costs of the federal estate tax alone may completely offset the revenue raised, likely reducing economic welfare in the U.S. by a large amount. For these reasons and for reasons noted above, many economists argue the federal estate tax is hard to justify on either efficiency or equity grounds.

III. Brief History of the Federal Transfer Tax System

The federal government taxes transfers of wealth in three ways: through the estate tax, the gift tax and the generation-skipping transfer tax. Together these taxes make up the federal transfer tax system.

The modern estate tax was enacted in 1916, just three years after the federal income tax.¹¹ In part to limit estate tax avoidance, Congress supplemented it with the gift tax in 1924. The gift tax was quickly repealed in 1926 but was reintroduced in 1932. Before the enactment of the gift tax, some taxpayers were able to largely avoid estate taxes by simply transferring assets while they were alive, a practice that led to widespread tax avoidance.

The federal transfer tax system was overhauled in 1976, and many provisions of the estate and gift tax were unified, considerably simplifying the system. In an effort to curb the growing use of generation-skipping trusts to avoid estate and gift taxes, the 1976 act also enacted a generation-skipping transfer tax.¹² Since 1976, the three-legged framework of the modern transfer tax system has remained essentially unchanged.

Box 1. Estate Tax Repeal Leaves Many State-Level Estate Taxes in Place

In addition to the federal estate tax, many states levy their own estate tax. Prior to the passage of the Economic Growth and Tax Relief Reconciliation Act (EGTRRA), the federal estate tax offered a credit for state-level estate taxes. As a result, every state and the District of Columbia taxed estates at least up to the federal credit amount.

EGTRRA phased out the federal credit for state-level estate taxes over four years, replacing it with a deduction in 2005. Because many state-level estate taxes “piggybacked” on the federal credit amount, EGTRRA also eliminated many state-level estate taxes in 2005.

In an attempt to preserve their estate taxes, some states have “decoupled” their taxes from federal law. Currently 25 states have allowed their state-level estate taxes to expire with the federal credit, while 25 states and the District of Columbia have retained them. As a result, even if Congress moves to permanently eliminate the federal estate tax, many state-level taxes will remain.

Although these state-level estate taxes did not increase net estate tax liabilities for estate holders—they merely absorbed a federal credit—their existence threatens to cause considerable tax complexity for estate holders once the federal tax is repealed.

Source: Congressional Budget Office.

Box 2. Will Estates Be Subject to Capital Gains Taxes in 2010?

Because increases in the value of an estate over an owner’s lifetime represent a capital gain, in theory transferred estates could be subject to both estate taxes *and* capital gains taxes.

To prevent this double taxation, current law allows transferred estates to be valued at their current market value rather than their original purchase price—the so-called “stepped-up” basis rule. By resetting an estate’s original value to its current value, the stepped-up basis shields estates from capital gains taxes.

However, when EGTRRA repeals the estate tax in 2010, it also repeals the stepped-up basis rule. Instead it establishes a “carry-over” basis similar to that used to value other assets subject to capital gains taxes.

Although EGTRRA attempts to correct this by exempting \$1.3 million of an estate’s increased value from capital gain taxes (or \$3 million for transfers to a spouse), many estates will face capital gains taxation if Congress does not repeal or further reform the estate tax.

Source: John Luckey, “A History of Federal Estate, Gift, and Generation-Skipping Taxes.” Congressional Research Service Report for Congress 95-444A (April 2003).

Relief for Small Businesses

As noted above, one of the concerns most often raised about transfer taxes is their harmful effect on entrepreneurship. In response to complaints about the tax’s harmful effects on small family businesses, the 1976 act provided some relief for small businesses and farms. It created favorable valuation rules for small businesses and farms, allowing them to be valued at their current use rather than other potentially more valuable uses. To prevent companies from being forced to sell assets to pay estate taxes, it also spread tax payments over a 15-year period.

In 1997, Congress further shielded small businesses from estate taxes by creating a provision allowing qualified family-owned businesses to shelter up to \$1.3 million from estate taxes. However, this provision was eliminated in 2004 when the applicable exclusion amount for all estates rose to \$1.5 million, superseding the lower \$1.3 million amount.

Although these provisions provide relief to many small businesses, the Congressional Budget Office estimates that a small but significant number of economically important small businesses and farms are still subject to federal estate taxes each year.¹³ Additionally, survey data show that estate taxes continue as an important reason why many family-owned businesses report they fail to survive beyond the first generation.¹⁴

The Current System

Today, the current federal estate tax—along with the generation-skipping transfer tax—exempts the first \$2 million of estates. The federal gift tax allows tax-free gifts of up to \$12,000 per year, and exempts total lifetime gifts up to \$1 million. Estates and gifts beyond these amounts are taxed at progressive marginal rates ranging from 18 percent to 46 percent. Currently there are 15 progressive estate and gift tax rates.

12 Prior to the 1976 act, trusts allowed taxpayers to avoid at least one generation of transfer taxes. Transfers of wealth into and out of trusts were taxed, but interest payments from trusts to intermediary beneficiaries—commonly children or grandchildren—were not subject to transfer taxes. This allowed taxpayers to avoid at least one generation of estate and gift taxes. The Tax Reform Act of 1986 replaced and expanded the 1976 generation-skipping transfer tax.

13 “Effects of the Federal Estate Tax on Farms and Small Businesses.” Congressional Budget Office (July 2005).

14 “Costs and Consequences of the Federal Estate Tax.” *Joint Economic Committee Study*, U.S. Congress Joint Economic Committee (May 2006).

Table 1 summarizes the full history of the estate and gift tax, listing years in which Congress enacted changes to exemption levels, exclusions or top marginal tax rates.

In 2001 the President signed the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) into law. The law began an eight year process that slowly eliminates the estate and generation-skipping transfer tax. However, the repeal is temporary. The tax is scheduled to disappear in 2010, only to reappear in 2011 at levels determined by pre-EGTRRA law—potentially drawing a large number of taxpayers into the federal transfer tax system.

Beginning in 2002, the law slowly lowers estate tax rates and raises the applicable exclusion amount through 2009. In 2010, the tax disappears completely. However, for budgetary reasons all provisions of EGTRRA expire at the end of 2010. In 2011, the federal estate tax will return at levels specified by 2001 law if left unreformed. In addition to expanding the number of estates subject to the tax, the sudden return also complicates tax planning and creates potentially disturbing economic incentives regarding the timing of death.

While EGTRRA repeals the estate tax and the generation-skipping transfer tax, it leaves the federal gift tax largely intact. Beginning in 2002 it raises the lifetime gift exemption to \$1 million, and beginning in 2006 raises the annual gift exclusion to \$12,000. From 2002 to 2007 it slowly lowers gift tax rates in tandem with estate tax rates, from 50 percent to 45 percent in one-percentage-point increments.

When the estate tax disappears in 2010, the top gift tax rate drops to the top individual income tax rate of 35 percent—its lowest level since 1933. In 2011, the maximum gift tax rate returns to 55 percent.

EGTRRA is scheduled to make the following changes to the federal transfer tax system through 2009:

- Increases the value of estates excluded from estate and generation-skipping transfer taxes to \$1 million in 2002 and 2003; \$1.5 million in 2004 and 2005; \$2 million in 2006, 2007 and 2008; and \$3.5 million in 2009. In 2010, both the estate tax and the generation-skipping transfer tax are repealed.
- Increases the lifetime generation-skipping transfer exemption by \$40,000 to \$1.1 million in 2002.
- Increases the value of lifetime gifts excluded from gift taxes to \$1 million beginning in 2002, and increases the amount that can be given tax-free each year to \$11,000. In 2006, the annual exclusion increases to \$12,000 per year.
- Reduces the top estate tax rate to 50 percent in 2002, which then drops by one percentage point per year until it reaches 45 percent in 2007, where it remains until full repeal in 2010.
- Reduces the credit for state-level estate taxes paid to 75 percent of the amount that would otherwise have been deductible in 2002, 50 percent in 2003

Table 2
Timeline of EGTRRA's Federal Estate Tax Repeal
2002-2010

Year	Maximum Estate Tax Rate	Applicable Exclusion Amount	Credit for State-Level Estate Taxes Paid	Other Major Changes
2002	50%	\$1,000,000	75% of current credit	Repeal of 5% surtax on estates between \$10 and \$17.18 million
2003	49%	\$1,000,000	50% of current credit	—
2004	48%	\$1,500,000	25% of current credit	Repeal of \$1.3 million family-owned business deduction
2005	47%	\$1,500,000	Deduction replaces credit	—
2006	46%	\$2,000,000	—	—
2007	45%	\$2,000,000	—	—
2008	45%	\$2,000,000	—	—
2009	45%	\$3,500,000	—	—
2010	Repealed	Repealed	Repealed	

Source: Congressional Research Service

of the exemption during the intervening years. As a result, many estates will be pushed into higher estate tax brackets in 2011 than they would have in 2001.

Effect on Tax Compliance Costs

One of the most important economic effects of the estate tax repeal and sudden reappearance will be sharply higher costs of tax planning and compliance. In general, large estate holders do not know when they will die, and because of EGTRRA's complex schedule of phase-outs and expirations, small differences in the date of death can lead to dramatically different tax liabilities.

For example, depending on the year of death, estate holders who are currently elderly or ill face maximum estate tax rates of 45 percent for a death in 2009, zero for 2010, or 55 percent in 2011. Each year estate holders survive requires additional spending for tax planning based on continually changing estate tax law.

Total federal income tax compliance costs are currently estimated at \$265.1 billion for

2005.¹⁵ Compliance costs are projected to reach \$482.7 billion by 2015—or 20.7 percent of federal income tax collections in that year—in part due to rising compliance costs associated with the rising number of estate and gift tax returns following 2011.

V. Conclusion

A range of economic studies suggest the federal estate tax slows entrepreneurship, imposes high tax compliance costs, and raises little or no federal revenue on a net basis. As one of the nation's most inefficient taxes per dollar raised, the current estate tax is hard to justify from the perspective of economic efficiency. However, because the economic incidence of the estate tax may be much less progressive than is commonly assumed, it is also hard to justify on equity grounds. For these reasons, lawmakers should consider fundamental reform or elimination of the federal estate tax.



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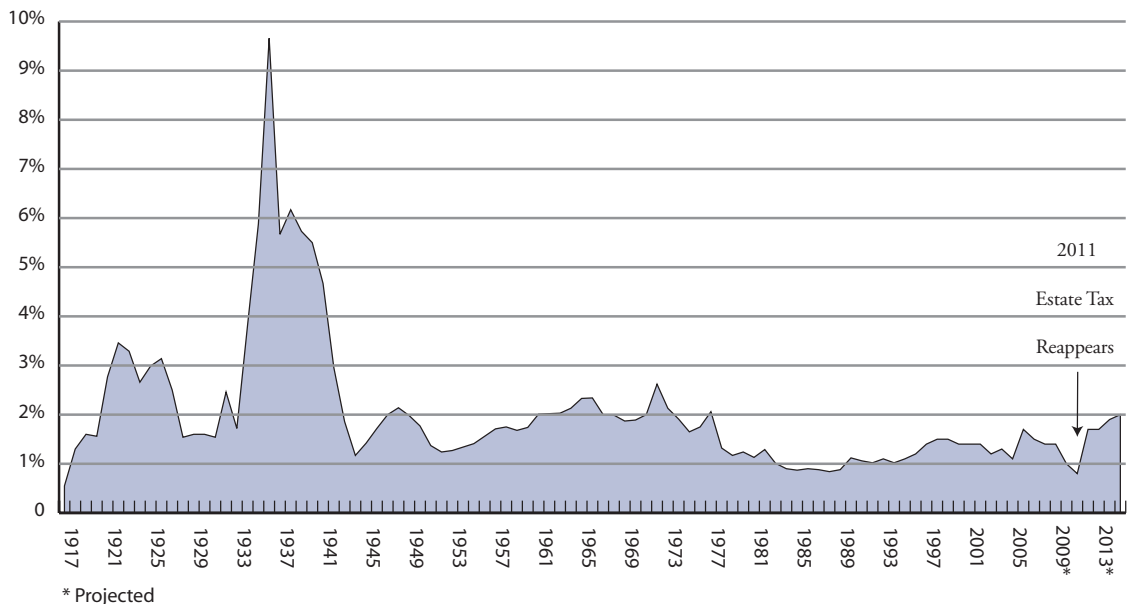
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Figure 2
Federal Transfer Tax Revenue as a Percentage of Federal Receipts, 1916–2015



Source: Internal Revenue Service; Tax Foundation calculations

15 Scott A. Hodge, J. Scott Moody and Wendy P. Warcholik, "The Rising Cost of Complying with the Federal Income Tax." *Tax Foundation Special Report No. 138* (January 2006). Estimates of federal income tax compliance costs include the compliance costs associated with filings of Internal Revenue Service Form 706 (estate tax) and Form 709 (gift tax).