Joint Economic Committee Democrats

Senator Jack Reed (D-RI) – Ranking Democrat

Economic Policy Brief

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Who Will Pay for Repealing the Estate Tax?

Advocates of repealing or substantially scaling back the federal estate tax fail to address two inconvenient truths. First, cutting the estate tax will cost the federal government revenue at a time when the budget deficit is already too large. Second, any effort to offset the revenue loss from reducing or eliminating the most progressive component of the federal tax system will impose sacrifices on working families, shifting the burden from the super-wealthy to those who are substantially less well off.

If a good case could be made that the estate tax is particularly inefficient or unfair and that repealing it would produce substantial and widespread economic benefits, those advantages would have to be weighed against the costs. But the case against the estate tax is weak. Rather than a sweeping tax that affects everyone, the estate tax targets the wealthiest estates. It has no discernible effect on saving and economic growth, generates reasonably small compliance costs, and affects very few family farms and small businesses.

Background on the Estate Tax

The estate tax is levied on the assets of very wealthy individuals before their estate is passed on to heirs. Current law allows for an unlimited exemption for transfers to a surviving spouse or gifts to charities, and exempts the first $2 million ($3.5 million in 2009) of the remaining estate after deducting debts and certain other expenses. Because the exemption applies separately to the estate of each spouse, couples can transfer $4 million (rising to $7 million in 2009) to their heirs without incurring any estate tax. Under the provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), the estate tax is scheduled to be repealed for one year in 2010 and then revert back to pre-EGTRRA rates and exemptions.

The number of taxable estates in 2004 represented less than 1.3 percent of people who died in the previous year.[1] The exemption for most of the estate tax returns filed in 2004 was $1 million, reflecting deaths in 2003. The percentage of estates that owe any estate tax is projected to drop to less than 0.5 percent as the estate tax exemption climbs to $3.5 million in 2009.[2] The tax is expected to generate about $28 billion in federal revenue in 2006.[3]

The Estate Tax is the Most Progressive Component of the Federal Tax System

Because it exempts almost 99 percent of the people who die each year and taxes only the very largest estates, the estate tax is highly progressive. The estate tax is thus a way to collect federal revenue exclusively from those with the greatest ability to pay. Compensating for the lost revenue caused by repeal of the tax would mean shifting the financial burden from the super-wealthy to working families.

Effective tax rates on estates (that is, net estate taxes divided by the gross value of the estate) are relatively small for most taxable estates and generally increase with the size of the estate.[4] Almost two-thirds of taxable estates had a gross value of between $1 million and $2.5 million in 2004 and the effective tax rate on those estates was 11 percent.[5] None of those estates would have paid any tax under the higher exemption scheduled for 2009.

During the first full decade of repeal, the federal government would lose nearly $800 billion in revenue and would pay an additional $200 billion in increased debt service costs if repeal were financed by borrowing.[6] To compensate for the revenues lost by repealing the estate tax, income taxes would have to be raised, spending would have to be cut, or the national debt would increase. As a result, people whose income is generated from wealth would most likely see their tax liability decline while people whose income comes from work would most likely see their taxes increase or their government services decline.

Critics of the estate tax argue that it is unfair because it taxes wealth that has already been subject to the income tax. This argument is flawed, however, because more than one-third of wealth in all taxable estates and more than half of the wealth in estates exceeding $10 million consists of capital gains—that is, increases in the value of assets that has occurred since the time they were acquired—that have never been taxed.[7]

Repeal Would Reduce National Saving

Repeal of the estate tax would have no discernible effect on private saving, but repeal would likely decrease public saving by increasing federal deficits. The net effect would be a decline in national saving.

It is not plausible that repeal of the estate tax would have a noticeable impact on private saving because the tax affects such a minute fraction of total net worth. The gross value of taxable estates in 2004 was only *two-tenths of one percent* (0.2 percent) of the total net worth of the household sector, and the estate tax itself claimed less than *four one-hundredths of one percent* (0.04 percent).[8]

Moreover, economic theory suggests that the effect of estate tax repeal on private saving is uncertain and could even be negative.[9] People may save either more or less than before repeal, depending on their reasons for saving. For example, someone who wished to leave an after-tax bequest of a fixed dollar amount would need to save less to reach that target. While the overall effect of repeal on saving by those leaving a bequest can be negative or positive, the effect on heirs' saving is unambiguously negative in almost all circumstances. An increase in or even the anticipation of receiving wealth encourages greater consumption out of current income.[10]

While the effect of estate tax repeal on private saving is uncertain, repeal would have a negative effect on national saving if it results in higher federal deficits. Only by increasing other taxes or cutting federal spending could higher deficits be avoided. But those actions are precisely what shifts the costs of repeal onto working families.

Repeal Would Not Substantially Reduce Compliance Costs

Contrary to popular perceptions and the arguments of estate tax opponents, the costs of complying with the estate tax are relatively small. Furthermore, significant estate planning and tax avoidance costs would remain even in the absence of an estate tax.

Although the range of estimates in the literature as a whole is very broad (ranging from 6 percent up to 100 percent of revenues), the more reliable estimates—given data sources and methodology—are on the lower end of the range.[11] For example, one study combined Internal Revenue Service estimates of the costs of administering gift and estate taxes with survey information from tax and estate practitioners, in order to estimate the combined cost of administration, planning, and compliance. That study concludes that the total cost of all these activities is only 6 to 9 percent of revenues.[12] This compares favorably with the compliance costs of the income tax which have been estimated to be about 14.5 percent of revenue.[13]

Most of the costs of estate planning and settlement would remain if the estate tax were repealed. Estates would still need to be settled and income taxes filed. Estate tax attorneys have argued convincingly that many *new* types of tax-avoidance schemes would emerge upon repeal of estate and gift taxes, with the focus shifting toward the income tax system and ways to reduce or avoid capital gains taxes. Thus, suggestions that repealing the estate tax would free up a significant amount of resources currently devoted to compliance are extremely unrealistic.

Repeal Would Have Little Impact on Family-Owned Businesses and Farms

Much of the debate surrounding the estate tax involves the impact of the tax on family farms and small businesses. Nonpartisan analyses suggest that very few family farms and small businesses are affected by the tax and that the majority of those have enough liquid assets to pay the tax. There appears to be no evidence to support claims that the tax results in the dissolution of many farms and businesses.

Family-owned businesses and farms already get special treatment under the estate tax through two main channels: tax deferral and preferential valuation of assets. As a result, a very small fraction of farmers and small business owners have estate tax liability.

In 2006, of the projected 12,600 estates with tax liability, only 350 taxable estates (3 percent) will comprise primarily farm or business assets.[14] Only a small fraction of family farmers and small business owners are subject to the estate tax, and the overwhelming majority of those who are have enough liquid assets to pay the tax without selling the farm or business.[15]

Conclusion

The estate tax is the most progressive component of the federal tax system and it raises revenue in a way that is efficient and fair with a minimal impact on family farms and small businesses. Eliminating or substantially curtailing the tax would lose revenue at a time when the country is already facing large deficits. Replacing that lost revenue would mean increasing other, less progressive taxes or cutting government services, in effect prioritizing the needs of the super-wealthy and their heirs over the needs of working families.

Endnotes

[1] Jane G. Gravelle and Steven Maguire, "Estate and Gift Taxes: Economic Issues," Congressional Research Service, RL30600, updated January 19, 2006, p.6.
[2] Joel Friedman and Aviva Aron-Dine, "The State of the Estate Tax as of 2006," Center on Budget and Policy Priorities, May 31, 2006, Figure 1.
[3] Congressional Budget Office, *Budget and Economic Outlook: Fiscal Years 2007 to 2016*, January 2006, Table 4-2.
[4] The very largest estates (those with gross assets of $20 million or more) have a lower effective tax rate than estates with between $2.5 million and $20 million in gross assets. This difference arises because the richest estates qualify for much higher deductions, mainly associated with their charitable bequests.
[5] Internal Revenue Service, Estate Tax Returns Filed in 2004 with Total Gross Estate Greater than $1 Million: Gross Estate by Type of Property, Deductions, Taxable Estate, Estate Tax and Tax Credits, by Size of Gross Estate," available at http://www.irs.gov/pub/irs-soi/04es01tc.xls.
[6] Joel Friedman, "The High Cost of Estate Tax Repeal," Center on Budget and Policy Priorities, June 5, 2006, p.1.
[7] James Poterba and Scott Weisbenner, "The Distributional Burden of Taxing Estates and Unrealized Capital Gains at Death," in eds. William G. Gale, James R. Hines Jr., and Joel Slemrod, *Rethinking Estate and Gift Taxation*, Washington, DC: Brookings Institution Press, 2001, p.439.
[8] Internal Revenue Service and Board of Governors of the Federal Reserve System, *Flow of Funds Accounts of the United States, 1995-2005*, Table B.100, available at http://www.federalreserve.gov/RELEASES/z1/current/annuals/a1995-2005.pdf.
[9] Gravelle and Maguire, pp.8-11, and William G. Gale and Joel Slemrod, "Rhetoric and Economics in the Estate Tax Debate," paper prepared for presentation at the National Tax Association Spring Symposium, Washington, DC, May 7-8, 2001.
[10] Gravelle and Maguire, pp.8-11.
[11] William G. Gale and Joel Slemrod, "Rethinking the Estate and Gift Tax: Overview," in *Rethinking Estate and Gift Taxation*, William G. Gale, James R. Hines, Jr., and Joel Slemrod, eds., Brookings Institution Press, 2001.
[12] Charles Davenport and Jay A. Soled, "Enlivening the Death-tax Death-Talk," *Tax Notes*, July 26, 1999, Table 14.
[13] Joel Slemrod, "Testimony before the Committee on Ways and Means Hearing on Tax Reform," June 8, 2005.
[14] Urban Institute-Brookings Tax Policy Center, Tables T06-0020 and T-06-022.
[15] See Gravelle and Maguire, p.13 and Congressional Budget Office, "Effects of the Federal Estate Tax on Farms and Small Businesses," July 2005, pp.12-13.