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Repealing the Estate Tax Will Not Promote Economic Growth

Proponents of estate tax repeal argue that eliminating the tax would significantly reduce taxes on capital, encourage saving and investment, reward entrepreneurship, and promote economic growth. This paper discusses why these claims are greatly exaggerated and even misleading:

Repeal would affect few families and have little impact on total capital accumulation. The estate tax is simply not a factor for most Americans. Very few estates are large enough to require the filing of an estate tax return; an even smaller number are large enough to owe any taxes. The tax itself is very small relative to family net worth. Repealing a tax with such limited scope will not make much difference in an economy with a capital stock as large as that of the United States.

Repeal would have a small and uncertain effect on private saving. There is no convincing evidence that repeal of the estate tax would increase private saving; economic theory provides plausible reasons why repeal might even decrease saving.

Repeal will reduce national saving and hurt economic growth. The loss of federal and state revenues from repeal of the estate tax would cause a reduction in public saving that would be larger than any increase in private saving. With no offsetting budget changes, national saving would fall; in the long run this would reduce the nation's capital stock and national income.

Repeal would have little impact on family-owned businesses and farms. Most family-owned businesses and farms are too small to owe any estate tax, and evidence is scant that estate tax considerations play an important role in entrepreneurial decisions.

Repeal will not provide substantial compliance cost savings. Arguments that the administrative and compliance costs of the estate tax are large and burdensome are greatly exaggerated, and repeal would provide no significant savings.

Repeal would affect few families and have little impact on total capital accumulation.

Very few estates need to file an estate tax return, and even fewer estates owe any tax. About 100,000 estate tax returns were filed in 1999 and fewer than 50,000 estates incurred any tax. Only about 2.2 percent of adult deaths in 1999 produced taxable estates (Table 1).

Most Americans leave modest estates when they die. Current rules for the estate tax exempt all but the largest estates. As of 2002, only estates valued in excess of $1 million need to file an estate tax return. Many estates that exceed the filing threshold still will not owe any tax. Current law allows an unlimited exemption for transfers to a surviving spouse or gifts to charities, and exempts the first $1 million of the remaining net estate after deducting debts, funeral expenses, and administrative expenses.

Under the provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), the estate tax exemption is scheduled to increase to $1.5 million in 2004, $2 million in 2006, and $3.5 million in 2009. In 2010 the tax is repealed, but it is reinstated in its pre-EGTRRA form in 2011.

Because the exemption applies separately to the estate of each spouse in a married couple, couples who do some simple planning can transfer $2 million (rising to $7 million in 2009) to their heirs without incurring any estate tax.

In addition to these tax-exempt bequests, individuals can make substantial tax-free transfers while they are still living. Gifts of up to $11,000 per recipient per year do not incur estate or gift tax. Thus a couple with two children could transfer $44,000 tax-free each year ($11,000 per parent to each child), and considerably more if they also made transfers to their grandchildren and their children's spouses.

Among taxable estates, those with the highest gross value pay most of the tax. Of the $23 billion paid in estate taxes in 1999, more than 50 percent of the tax was paid by the 6.6 percent of estates with gross values in excess of $5 million (Table 2). The 0.9 percent of taxable estates valued at more than $20 million paid taxes of $5.5 billion, nearly one-quarter of the total.

Total estate taxes paid in any year represent a very small fraction of household net worth. The total net worth of the household sector exceeded $41.6 trillion in 1999.[1] The gross value of taxable estates was $119.2 billion in that year, less than 0.3 percent of household net worth. The estate tax itself claimed less than 0.06 percent of household net worth.

Among taxable estates, the average tax was less than 20 percent of the gross value of the estate (Table 3). The average tax rate was only 5 percent for estates with gross value of less than $1 million. The average tax rate was lower for estates valued at more than $20 million than it was for estates valued between $2.5 million and $20 million. This reflected proportionately much larger charitable deductions for the highest-valued estates.

Repeal would have a small and uncertain effect on private saving.

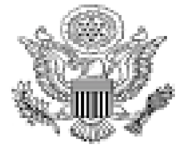
If the estate tax were repealed, people planning to leave a bequest might save either more or less than before, depending upon their reasons for saving. But the repeal of the tax would generally cause those receiving an inheritance to save less.

The reasons people leave bequests are complex and not well understood. For those who plan to leave a bequest there is some incentive to save more because each dollar saved contributes more to the eventual bequest. However, because it is no longer necessary to save as much to leave the same size bequest as before (or even a larger bequest), people may end up saving less, particularly if they have a target amount that they wish to bequeath.

But not all bequests are planned. Some people leave bequests by "accident" simply because they accumulate more than they need to meet their needs in old age. For these accidental savers, repeal of the estate tax should have no impact on saving.

While the effect of repealing the estate tax is uncertain for people leaving a bequest, the effect on recipients is clear. As a number of studies have documented, an increase in or even the anticipation of receiving wealth encourages less work and saving among inheritors, particularly those receiving large inheritances.[2] That is, people who receive inheritances can work less and save less while enjoying the same or higher standard of living.

It is sometimes argued that the estate tax discourages saving because it taxes wealth that has already been subject to the income tax. However, a significant portion of the value of estates consists of increases in the value of assets that has occurred since the time they were



acquired. Such unrealized capital gains were not subject to income taxes during the person's lifetime. Moreover, under current law, most wealth passed onto heirs will escape the income tax entirely, because the tax basis for any assets with unrealized capital gains is "stepped-up" to the current value of the asset. This eliminates any income tax on appreciation of the asset that occurred prior to the transfer. Thus, heirs are subject to a capital gains tax on these assets only if they later realize the gains (sell the assets), at which point the capital tax applies only to the appreciation that has occurred since the inheritance.

Under the current provisions for estate tax repeal in 2010, accrued but unrealized capital gains would no longer automatically escape taxation, because the tax basis would no longer change when the assets are transferred to heirs. Instead, inherited assets would retain their original basis. The law, however, provides a $1.3 million exemption to this carry-over basis rule with an additional $3 million exemption for transfers to a surviving spouse. Those amounts will be added to the basis of existing assets when they are transferred. The exemption ensures that most people will still pay no tax on the unrealized capital gains in the wealth they inherit. In some cases, where the estate consists of very large accrued capital gains and/or substantial debt, the tax on capital gains with carry-over basis could exceed the tax that would have been paid under the estate tax.

A recent study estimated that 36 percent of wealth in all taxable estates was in the form of unrealized capital gains that were not subject to the individual income tax.[3] For estates that exceeded $10 million, the figure was 56 percent. Small businesses and farms were even less likely than taxable estates in general to have paid capital gains taxes. The study found that 82 percent of all business and farm assets within estates larger than $10 million were unrealized capital gains. In other words, the value of the majority of large estates and the vast majority of large farm estates has never been taxed by the income tax system.

Repeal will reduce national saving and hurt economic growth.

Economic analysis of the effects of tax changes on economic growth are often based on revenue-neutral exercises, in which any revenue loss from the estate tax is assumed to be offset by a revenue gain somewhere else that leaves public saving unchanged. However, to the extent that repealing the estate tax is an alternative to debt reduction, this analysis is incomplete. The loss in national saving due to less debt reduction or larger deficits is very likely to exceed any gain from the repeal of the estate tax.

The ten-year cost of the estate tax provisions in last year's tax cut mask the permanent cost of repeal. The estate tax is not fully repealed until 2010, and then is reinstated in 2011. The Joint Committee on Taxation (JCT) estimated that the estate tax provisions of the 2001 Tax Act will cost $138 billion between 2002 and 2011, but that the cost of permanent repeal would be $56 billion in 2012 alone. If the annual cost of permanent repeal were to grow only at the same rate as the economy, the revenue loss in the decade after repeal would be in the neighborhood of three-quarters of a trillion dollars.

Federal estate tax repeal would hurt state budgets, too. Current federal law provides a credit for state estate and inheritance taxes that allows estates to reduce their federal estate tax liability dollar for dollar, up to a certain percentage of the federal liability (16 percent for estates over about $10 million). Most states collect a "pick up" tax on the estate based on the dollar amount of the federal credit, as reported on the federal estate tax return. Some states levy their own inheritance tax and collect an additional tax to absorb any remaining federal credit. The 2001 Tax Act gradually phases out the credit for state estate and inheritance taxes beginning in 2002, replacing it with a deduction beginning in 2005; this occurs while the

federal estate tax is reduced and eventually repealed. Thus, the 2001 Tax Act will effectively eliminate estate and inheritance taxes for most states as well.

State revenue from "pick-up" and independent estate taxes amounted to $7.5 billion in fiscal year 1999. In most states this revenue is 1 to 3 percent of their total tax revenue. According to one estimate, the revenue loss for the states could be as much as $18.5 billion per year when the federal estate tax is repealed in 2010.[4] Most of that loss would come from the loss of the federal credit for state estate and inheritance taxes, with the remainder due to the likely pressure there would be for states to repeal their own supplemental estate or inheritance taxes.

These losses in government saving are huge relative to any plausible estimate of the stimulus to private saving from repeal of the estate tax. On balance, the net effect of repealing the estate tax will almost surely be a decline in national saving that would hurt capital formation and growth.

Repeal would have little impact on family-owned businesses and farms.

Farms and family-owned businesses already get special treatment under the estate tax through three main channels: a higher effective exemption, tax deferral, and preferential valuation of assets. Qualified family-owned business can deduct an additional $675,000 in addition to other deductions and exemptions. The family-owned business deduction is repealed in 2004 when the exemption amount applicable to all estates rises to $1.5 million. Family-owned businesses can pay the estate tax in installments over 10 years, after deferring payments for up to 5 years. The estate pays only interest for the first five years, with a low interest rate of 2 percent applying to approximately the first $1 million in taxable value. Finally, family farms and certain other businesses can value their land at its value in current use rather than fair market value. To qualify for current-use valuation, heirs must continue to use the land in its current use for at least 10 years.

Most taxable estates are not farms or family-owned businesses. In 1999, only 642 taxable estates—or only 1.4 percent of the 47,482 taxable estates—had farm assets equal to at least half of the gross estate value (Table 4). These farm estates paid an even smaller share of total estate taxes (0.7 percent). Only 1.1 percent of taxable estates had significant small-business assets (with closely held-stock or non-corporate business assets equal to half or more of the gross estate), and these businesses paid just under 4 percent of total estate taxes.

Very few of the farm-owner and business-owner heirs who pay estate taxes lack enough liquid assets to pay the tax. Even without accounting for the special exemptions granted to these family-owned businesses and farms, only 3 to 4 percent of all estates would be at risk of lacking enough liquid assets. Given the larger exemption available to small businesses and farms under current law, a Congressional Research Service analysis concludes that the fraction of these businesses that would be forced to liquidate to pay the tax is "almost certainly no more than a percent or so."[5]

Even if few small businesses actually pay the estate tax, it is sometimes argued that the tax could inhibit business expansion. For example, a 1999 analysis examined a sample of business owners and found a negative correlation between potential estate tax liability (based on the owners' current level of wealth) and employment growth in those businesses.[6] But as other researchers have pointed out, this analysis did not control for the effect of the owner's age and may simply be picking up the natural "life cycle" of businesses.[7] In other words, older owners are more likely to have higher wealth, but they are also more likely to own businesses that have reached a stable size (due to the age of the business rather than the burden of potential es-

tate taxes). In fact, one interpretation of this analysis is that the causation runs the other way: it is not that potential estate tax liability causes firms to grow more slowly, but rather that the fastest-growing, "entrepreneurial" businesses are *not* the ones that would face the estate tax at all.

Repeal will not provide substantial compliance cost savings.

It is sometimes argued that the economic costs of complying with the estate tax are greater than the revenue raised by the tax, suggesting that we would be better off without the tax. But the size of these compliance and administrative costs, and the implications for the economy, have been greatly exaggerated and mischaracterized.

Compliance costs are a small fraction of estate taxes collected. For example, one study combined IRS 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.[8] Although the range of estimates in the literature as a whole is very broad (in fact reaching up to 100 percent of revenues), the more reliable estimates—given data sources and methodology—are on the lower end of the range.[9] But whatever the number, these are estimates of the entirety of estate tax compliance costs, most of which goes toward the incomes of lawyers, financial planners, and IRS employees. For the most part, these represent redistribution within the economy but not a net loss to the economy.

Most of these costs would not disappear if the estate tax were repealed. Estates would still need to be settled and income taxes filed. The study cited above concludes that the process and effort going into estate planning "would not be substantially different if there were no estate tax." Other estate tax attorneys have said 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. In fact, because of the way EGTRRA changes the treatment of capital gains in return for repeal of the estate tax, the reporting requirements and associated compliance costs will not be reduced. Instead, the emphasis of the IRS will merely shift from determining the value of the taxable estate of the decedent to establishing the "carryover basis" for assets transferred at death.[10] Thus, suggestions that the variety of compliance costs associated with the estate tax would simply disappear if the tax were repealed are extremely unrealistic.

Table 1: Taxable Estate Tax Returns as a Percentage of Adult Deaths, 1990-1999

	Total Adult Deaths	Taxable Estate Tax Returns	Taxable Returns as a Percentage of Adult Deaths
1990	2,079,034	24,456	1.18
1991	2,101,746	26,277	1.25
1992	2,111,617	27,243	1.29
1993	2,168,120	32,002	1.48
1994	2,216,736	32,471	1.46
1995	2,252,471	36,620	1.63
1996	2,314,254	41,331	1.79
1997	2,391,399	42,901	1.79
1998	2,337,256	47,483	2.03
1999	2,314,245	49,870	2.15

Source: Data for 1990 –1996 are from Internal Revenue Service, Estate Tax Returns as a Percentage of Adult Deaths, Selected Years of Death, 1934-1996. SOI Bulletin, Spring 2001. Data for later years are from Internal Revenue Service, Statistics of Income Divisions, unpublished data, and Center for Disease control and Prevention, National Center for Health Statistics, Vital Statistics for the United States, volume 49, Number 8.

Table 2: Taxable Estate Tax Returns Filed in 1999: Distribution of Gross Estate and Estate Tax, by Size of Gross Estate

(Money amounts in thousands of dollars)

Size of Gross Estate	Returns	Gross Values	Net Estate Tax	Total Transfer Tax (1)
All Taxable Returns	49,870	119,176,309	22,950,126	30,209,768
Percent of Total				
0.6 million to 1 million	38.4	13.3	3.5	4.0
1 million to 2.5 million	44.6	27.8	23.3	22.2
2.5 million to 5 million	10.5	14.9	19.9	18.7
5 million to 10 million	4.1	11.8	17.0	16.3
10 million to 20 million	1.5	8.8	12.5	12.6
Over 20 million	0.9	23.3	23.9	26.2

Source: Internal Revenue Service, Statistics of Income Divisions, unpublished data. Revised May 2001.

(1) Net estate tax plus credits for federal gift taxes previously paid, state death taxes, and foreign death taxes.

Table 3: Taxable Estate Tax Returns Filed in 1999: Average Gross Estate, Estate Tax, and Tax Rate, by Size of Gross Estate (Money amount in dollars)

Size of Gross Estate	Average Gross Estate	Average Net Estate Tax	Average Transfer Tax (1)	Net Estate Tax Rate (percent)	Transfer Tax Rate (percent)
All Taxable Returns	2,389,740	459,598	605,770	19.2	25.3
0.6 million to 1 million	827,694	42,015	63,462	5.1	7.7
1 million to 2.5 million	1,491,742	239,732	301,141	16.1	20.2
2.5 million to 5 million	3,409,645	876,323	1,081,936	25.7	31.7
5 million to 10 million	6,854,102	1,902,819	2,402,748	27.8	35.1
10 million to 20 million	13,691,073	3,706,864	4,950,883	27.1	36.2
Over 20 million	59,567,291	11,706,552	16,975,197	19.7	28.5

Source: Internal Revenue Service, Statistics of Income Divisions, unpublished data. Revised May 2001.

(1) Net estate tax plus credits for federal gift taxes previously paid, state death taxes, and foreign death taxes.

Table 4: Taxable Estate Tax Returns Filed in 1998: Gross Estate and Estates with Farm or Business Assets Equal to at Least Half of Gross Estate (Money amounts in thousands of dollars)

Size of Gross Estate	Number of Returns	Gross Estate	Net Estate Tax	Percent of Returns	Percent of Gross Estate	Percent of Net Estate Tax
All Taxable Returns	47,482	103,020,298	20,349,840	100	100	100
Returns with Farm Assets Equal to at Least Half of Gross Estate (1)	642	939,120	150,873	1.4	0.9	0.7
Returns With Business Assets Equal to at Least Half of Gross Estate (2)	521	4,138,873	791,459	1.1	4	3.9
Returns With Business and Partnership Assets Equal to at Least Half of Gross Estate (3)	776	5,614,943	1,061,468	1.6	5.5	5.2

Source: U.S. Treasury, Office of Tax Analysis, unpublished tabulations.

(1) Farm and farm real estate assets equal to at least half of gross estate.

(2) Closely held stock and non-corporate business assets equal to at least half of gross estate.

(3) Closely held stock, non-corporate business, and partnership assets equal to at least half of gross estate.

[1] Board of Governors of the Federal Reserve System, "Flow of Funds Accounts of the United States; Annual Flows and Outstandings: 1995-2001." Washington, D.C., June 6, 2002.

[2] Brown, Jeffrey R., and Scott J. Weisbenner, "Is a Bird in the Hand Worth More than a Bird in the Bush? Intergenerational Transfers and Saving Behavior." National Bureau of Economic Research working paper 8753. February 2002; Holtz-Eakin, Douglas, David Joulfaian, and Harvey Rosen, "The Carnegie Conjecture: Some Empirical Evidence." *Quarterly Journal of Economics*, vol. 108,May 1994. pp. 413-35; and Weil, David N, "The Saving of the Elderly in Micro and Macro Data." *Quarterly Journal of Economics*, vol. 109. February 1994, pp. 55-81.

[3] Poterba, James M. and Scott Weisbenner, "The Distributional Burden of Taxing Estates and Unrealized Capital Gains at Death," in *Rethinking Estate and Gift Taxation*, William G. Gale, James R. Hines, Jr., and Joel Slemrod, eds. Brookings Institutions Press, 2001.

[4] Citizens for Tax Justice, "The Effects of the Bush Tax Cuts on State Tax Revenues," May 2001.

[5] Gravelle, Jane G. and Steven Maguire, "Estate and Gift Taxes: Economic Issues," Congressional Research Service Report for Congress, #RL30600, April 9, 2001.

[6] Holtz-Eakin, Douglas, "The Death Tax: Investments, Employment, and Entrepreneurs," *Tax Notes* 84(5), pp. 782-92, August 2, 1999.

[7] Gale, William G. 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.

[8] Davenport, Charles and Jay A. Soled, "Enlivening the Death-Tax Death-Talk," *Tax Notes*, July 26, 1999, pp. 591-631.

[9] See Gale and Slemrod, "Rethinking the Estate and Gift Tax: Overview."

[10] Noto, Nonna A., "Estate and Gift Tax Law: Changes Under the Economic Growth and Tax Relief Reconciliation Act of 2001," CRS Report for Congress, RL31061, updated January 29, 2002.