



REPUBLICAN STAFF COMMENTARY

Cost and Consequences of the Federal Estate Tax

An Update

July 25, 2012

The art of taxation consists in so plucking the goose as to get the most feathers with the least hissing.

-- Jean Baptiste Colbert, Minister of Finance to Louis XIV of France

Effective taxation requires efficiency to achieve the greatest amount of revenue, but at the least distortion of output, employment, and growth. The estate tax fails on both counts. The estate tax is intended as a tool of redistribution, but generates the least amount of federal revenue of any source, yielding very little to redistribute. There are extensive costs associated with the estate tax in terms of the dissolution of family businesses, slower growth of the capital stock, and the resulting loss of output and income over time.

The estate tax impedes economic growth because it discourages savings and capital accumulation. The estate tax has reduced the amount of capital stock in the economy as described in previous Joint Economic Committee studies.¹

As of 2008, the estate tax has cumulatively reduced the amount of capital stock in the U.S. economy by roughly \$1.1 trillion since its introduction as a permanent tax in 1916, equivalent to 3.2 percent of the total capital stock; this is nearly the total estate tax revenue raised since 1916—the year of the estate tax's inception—\$1.2 trillion in real 2008 dollars.

Compounding this problem, the estate tax raises a negligible amount of revenue. Since its inception nearly 100 years ago, the estate tax has raised in total revenue nearly equal the amount of the \$1.3 trillion U.S. federal deficit for fiscal year 2011 alone. Figure 1 demonstrates the estate and gift tax rates are not related to the amount of revenue raised. Historically, the estate and gift tax has never raised more than

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Estate Taxes and Revenue

Gray bars indicate recessions, 1916-2010

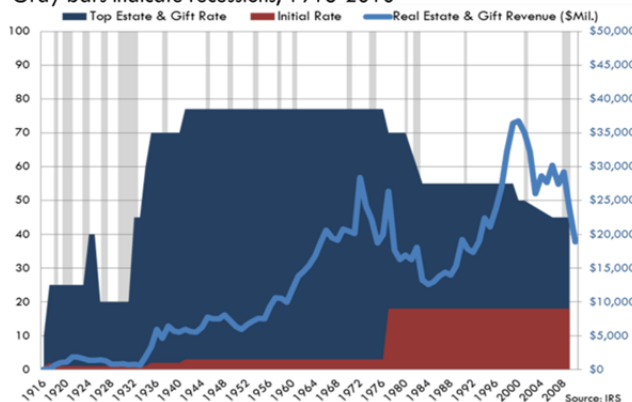


Figure 1 – The top and initial estate and gift tax rates are not correlated with the real estate and gift revenue, shown above adjusted for inflation.

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approximately \$37 billion (in real 2011 dollars) of tax revenue in any given year despite the highest rates reaching 77 percent.

The Estate Tax Remains Ineffective at Decreasing Income Inequality

In addition to its failure to provide ample revenue to redistribute, the estate tax is ineffective at decreasing inequality because most wealthy households did not acquire their wealth through inheritances. As an example, a look at *Forbes'* 2011 list of the 400 richest people in America, measured by net worth, indicates that approximately 70 percent of the richest individuals in America were, in fact, self-made.²

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There are many factors affecting the distribution of income and wealth among U.S. households over time. Without an accurate and comprehensive picture of income and wealth mobility over time, a snapshot of the distribution of income and wealth at any particular moment may actually be quite misleading. As an example, an updated article from the Federal Reserve Bank of Minneapolis' *Quarterly Review* in February 2011 found that many low-income households continue to hold substantial amounts of wealth, and many wealthy households have very little or negative income.³

According to a 2006 study from the National Center for Policy Analysis examining wealth, inheritance, and the estate tax, if every dollar resulting from inheritances was taxed away, it would reduce the top one percent's share of the nation's total wealth by only four percentage points; of the top five percent, it would reduce their share of wealth by only seven percentage points. Furthermore, only one in five children of wealthy families will be rich themselves upon retirement, while well above half the children of parents in the bottom half of the wealth distribution will end up in the top half by the time they retire.⁴ Rather, inheritances may decrease inequality because they redistribute income within families and thus decrease inequality in lifetime consumption.

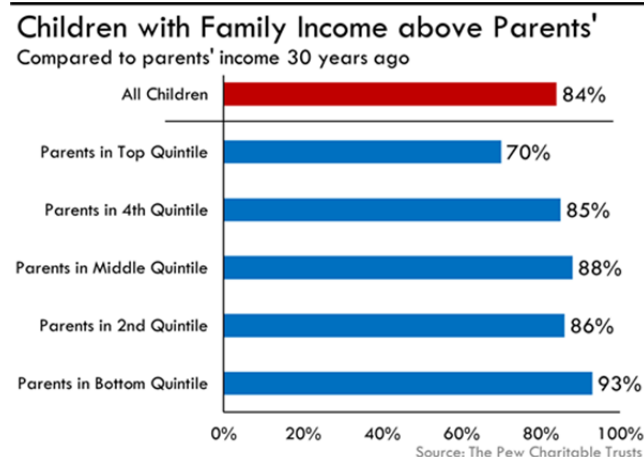


Figure 2 – The percent of the children with family income above their parents' income ranking shows that 84 percent of all children will achieve income above that of their parents.

According to a recent study by Pew Charitable Trusts, as shown in Figure 2, more than four out of five Americans have higher absolute family incomes today than their own parents had approximately 30 years ago, and children born to parents in the bottom quintile are more likely to surpass their parents' income than children from any other quintile.⁵

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Not only is income mobility probable between generations, but also within an individual's lifetime. In an examination of IRS data, the 400 highest earning tax returns filed between 1992 and 2008 included only four people who appeared in the top 400 filers continuously; however, one-timers

abounded: 39 percent of the top 400 filers appeared in that category only once over the 17-year period.⁶ When taking into account income inequality and income mobility, the Treasury states:

The degree of relative income mobility among income groups over the 1996 to 2005 period is very similar to that over the prior decade (1987 to 1996). To the extent that increasing income inequality widened income gaps, this was offset by increased absolute income mobility so that relative income mobility has neither increased nor decreased over the past 20 years.⁷

The different reasons for wealth and income inequality call into question the justification as well as the likely efficacy of government redistribution efforts.

Estate Tax Creates a Barrier to Income and Wealth Mobility

Perversely, the estate tax creates a barrier to income and wealth mobility. The estate tax motivates wealth holders to reduce savings and increase consumption, thus increasing the inequality of consumption. Thus, when faced with a potential 55 percent marginal tax rate (the top marginal estate tax rate expected after 2012), it costs \$2.22 for a decedent to give a \$1 of pre-tax assets as a result of estate and gift taxes, whereas the decedents could instead consume significantly more of that \$2.22 for personal benefit.

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The estate tax is a significant hindrance to entrepreneurial activity because many family businesses lack sufficient liquid assets to pay estate tax liabilities. In addition, economic inefficiencies due to the distortionary effects of the estate tax are burdensome, and the costs of compliance associated with the estate tax add to the paperwork and time necessary to comply with other taxes. The Tax Foundation produced a study which estimated a compliance cost of \$88.2 million and 2.3 million hours of compliance effort for estate taxes in the year 2005. The gift tax required an additional \$66.0 million and 1.7 million hours to comply.⁸

Abolition of the Estate Tax Could Raise Revenue

Many studies have indicated that abolition of the estate tax would actually increase overall federal tax revenue in at least two ways: (1) the estate tax robs additional federal tax revenues from the collection of other taxes like the income tax, and (2) a larger total capital stock could increase income tax revenue. In a recent study by former Deputy Assistant Secretary for Economic Policy at the Department of the Treasury, Stephen J. Entin, the increase in other federal government tax revenue would exceed the revenue lost from repeal of the estate tax by \$89 billion cumulatively through 2021.⁹

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The estate tax accomplishes little at great economic cost. Policymakers should consider reforming the estate tax to lessen its adverse effects or repealing it altogether.

¹ Dan Miller, “The Economics of the Estate Tax,” Joint Economic Committee Study, U.S. Congress, December 1998, http://jec.senate.gov/republicans/public/?a=Files.Serve&File_id=a96b5a38-b22d-4c49-b22c-4cec067f25aa; see also: Dan Miller, “Costs and Consequences of the Federal Estate Tax,” Joint Economic Committee Study, U.S. Congress, May 2006, http://jec.senate.gov/republicans/public/?a=Files.Serve&File_id=e7def412-d6d8-4770-b7b8-ad75eb2ed30e.

² “The Forbes 400: Richest People in America,” *Forbes*, September 2011, <http://www.forbes.com/forbes-400/list>.

³ Javier Diaz-Gimenez, Andy Glover, and Jose-Victor Rios-Rull, “Facts on the Distributions of Earnings, Income, and Wealth in the United States: 2007 Update,” *Federal Reserve Bank of Minneapolis Quarterly Review* 34, No. 1, February 2011: 2-31, <http://www.minneapolisfed.org/research/qr/qr3411.pdf>.

⁴ Jagadeesh Gokhale and Pamela Villarreal, “Wealth, Inheritance and the Estate Tax,” *NCPA Policy Report* 289, National Center for Policy Analysis, September 2006, <http://www.ncpa.org/pdfs/st289.pdf>.

⁵ Susan K. Urahn, and Erin Currier, et. al., “Pursuing the American Dream: Economic Mobility Across Generations,” Economic Mobility Project, Pew Charitable Trusts, July 2, 2012, http://www.pewtrusts.org/uploadedFiles/wwwpewtrustsorg/Reports/Economic_Mobility/Pursuing_American_Dream.pdf.

⁶ “Debunking the Obama-Buffett Myth on Taxes,” Republican Staff Commentary, Joint Economic Committee, September 28, 2011, http://jec.senate.gov/republicans/public/?a=Files.Serve&File_id=47934277-72c5-4933-9e4a-72ae8c9085f2.

⁷ “Income Mobility in the U.S. from 1996 to 2005,” Report of the Department of the Treasury, November 13, 2007, <http://www.treasury.gov/resource-center/tax-policy/Documents/incomemobilitystudy03-08revise.pdf>.

⁸ J. Scott Moody, Wendy P. Warcholik, and Scott A. Hodge, “The Rising Cost of Complying with the Federal Income Tax,” *Tax Foundation Special Report* 138, December 2005, <http://www.taxfoundation.org/files/sr138.pdf>.

⁹ Stephen J. Entin, “A Score of the Death Tax Repeal Permanency Act,” American Family Business Foundation, April 5, 2011, http://www.nodeathtax.org/uploads/view/2502/a_score_of_the_death_tax_repeal_permanency_act.pdf.