Statement of

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On the Estate Tax

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Madam Chairwoman and members of the Committee, thank you for inviting me today and giving me the opportunity to discuss the detrimental impact of the estate tax on small businesses and their families. Today, I am speaking on behalf of the National Center for Policy Analysis (NCPA), a nonprofit, nonpartisan public policy research organization dedicated to developing and promoting private alternatives to government regulation and control. NCPA recently started the Family Policy Center, which focuses on finding private solutions to issues faced by women, families, and small businesses.

As you are probably aware, an estate tax was enacted in 1916 to pay for World War I, and it has remained in force since. The initial top rate was just 10 percent, suggesting that its original purpose was to raise revenue, rather than redistribute wealth. The estate tax did not become explicitly redistributive until the administration of Franklin Roosevelt. The Revenue Act of 1935, in particular, was almost solely concerned with redistribution. The top estate tax rate, which was 45 percent when Roosevelt took office, was ratcheted up to 60 percent in 1934 and 70 percent in 1935.

Today the estate tax exists almost exclusively for redistributive purposes, since the revenue yield is minuscule. In fact, the estate and gift tax is not a significant revenue source for the federal government. [Note that if the estate tax were abolished, most bequests would still be subject to capital gains taxation when assets are sold - generating offsetting revenue increases.]

Myths

Support for the estate tax is based on three major claims: 1) inheritances are a major source of wealth inequality, 2) the tax provides significant revenue for the federal government and 3) the individuals required to pay the tax can easily afford it. These are, however, all myths. Not only the rich, but lower- and middle-class Americans, especially small business owners, should be concerned if the estate tax is not repealed or maintained permanently.

Myth 1: The Estate Tax is Major Source of Inequality.

Fact: Support for the estate tax is based largely on the idea that inheritances are a major source of wealth inequality. It is commonly assumed that inheritances are a major source of wealth inequality and that the offspring of wealthy families tend to be as rich as their parents due to bequests. However, an NCPA analysis of data from the Survey of Consumer Finances found that among the wealthiest 1 percent of Americans only 17 percent of their wealth came from bequests. In fact, the contribution of inheritance is surprisingly small, and it turns out that an individual's skills and personal choices are far more important in determining household wealth.

More specifically, skills acquired through education, entrepreneurship and hard work determine whether individuals move from one wealth level to another.

To understand the reasons for wealth inequalities, it is best to look at the age range in which individuals generally accumulate their wealth. For instance, wealth accumulation tends to peak, as married households reach retirement age (60 to 69) and have accumulated all the wealth they will during their lifetimes. Studying this specific group it is easy to see that the distribution of wealth is highly unequal:

- The top 1 percent of households holds about 23 percent of all wealth.
- The top 5 percent holds 51 percent of all wealth.

However, inherited wealth is a very small portion of total wealth even for the wealthiest households. For example:

- If we could somehow tax away every single dollar of wealth due to inheritances, it would reduce the top 1 percent's share of the nation's total wealth by only 4 percentage points.
- If all the wealth due to inheritance of the top 5 percent were taxed away, it would reduce their share of the wealth by only 7 percentage points.

The principal argument for the estate tax is the notion that without it wealth would become more concentrated in the hands of financial dynasties. However, wealth is highly mobile - being raised in a wealthy family does not guarantee that these children will be rich themselves when they retire:

- Only one in five children of the wealthy will themselves be wealthy
- When they reach retirement age.
- On the other hand, more than half of the children whose parents are in the bottom half will end up in the top half by the time they retire.

Because inheritances are only a minor factor determining the wealth distribution among retirees, using the estate tax as a redistributive mechanism is unlikely to have a significant effect on that distribution. Indeed, it may be self-defeating if it slows capital formation: The resulting increase in capital returns would make the rich even richer.

Myth 2: The Estate Tax Contributes Significant Revenue for the Federal Government.

Fact: While estate tax advocates claim that it raises considerable sums for the federal government, in reality the tax makes up less than 3 percent of total federal tax proceeds and some estimates put this number at less than 1 percent. Moreover, it reduces capital formation, thereby lowering productivity, wages, employment, and federal payroll and income tax revenues. For example, the Heritage Foundation found that as a result of complete estate tax repeal:

- The U.S. economy would average as much as $11 billion per year in extra output.
- An average of 145,000 new jobs per year could be created and personal income could rise by an average of $8 billion annually above current projections.
- The federal budget deficit would decline because increased revenue generated by increased economic growth would more than compensate for estate tax revenue.

Myth 3: Heirs Can Afford the Estate Tax.

Fact: Heirs can be wealthy or poor. It is important to understand that the burden of the tax falls on the recipient, not the giver. For this reason, one cannot state with certainty what the distributional effect of the estate tax actually is. In fact, nearly two-thirds of the children of parents in the wealthiest 20 percent of families fall to a lower wealth bracket upon reaching adulthood. Therefore, contrary to the popular notion that only the rich are beneficiaries of

estates, middle-class Americans, especially small business owners, are often stuck with a burdensome estate.

A survey by the Center for the Study of Taxation found that because of the estate tax, 51 percent of family businesses would have significant difficulty surviving a principal owner's death. Fourteen percent of business owners said it would be impossible for them to survive and only 10 percent said the estate tax would have no effect.

To further explain why this is such an issue, it is important to look at what exactly the estate tax actually taxes. The estate tax taxes wealth, which is the total *stock* of assets owned by a household, and includes material possessions, as well as financial instruments such as stocks and bonds. Small business owners and family farmers generally have large investments in infrastructure, adding to their "wealth", but many don't have large capital assets that can be used to pay the tax. Therefore, many heirs have to liquidate the family farm or shut the doors on the family business to pay the estate tax.

Conclusion:

The NCPA views the estate tax as:

- ANTI-family- Does not allow a parent to pass their hard work and wealth on to their children
- ANTI-farm- Farms are especially vulnerable because they hold vast amounts of land which are subject to the estate tax as they are passed from generation to generation
- ANTI-small business- Hurts small businesses that don't enjoy the same tax shelters and benefits as large corporations

Congress is facing a tax deadline. Under legislation passed in 2001, the federal estate tax is being phased out: The tax rate is falling and the value of the property of the deceased that is exempted from the tax is rising. The tax is even scheduled to disappear in 2010, but it will return in 2011 at pre-2001 rates - up to 55 percent for estates valued in excess of $1 million.

Small business owners and other middle-class Americans must not be deceived by the misleading claims of estate tax supporters. Even if the tax is allowed to go away in 2010, the increase when it returns in 2011 will only further impede productivity. If Congress truly wants to stimulate the economy, they ought to end the estate tax permanently.

I have been involved in small business issues for more than 30 years, serving as national president of the National Association of Women Business Owners (NAWBO), owner of my own business, and today as a Distinguished Fellow for the National Center for Policy Analysis. So, on behalf of the NCPA and the many small business owners, like me, and families that might be effected by the actions of this committee, I want to thank you for accepting my testimony. I look forward to answering your questions.