National Center for Policy Analysis

BRIEF ANALYSIS
No. 347
For immediate release:
Wednesday, February 14, 2001

Repeal the Grave-Robbing Tax

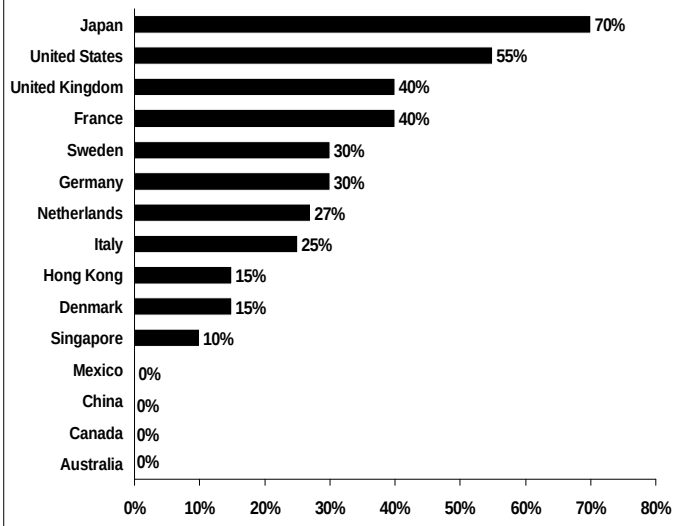
By Stephen Moore

A key component of President Bush's tax plan is eliminating the gift and estate tax, also known as the "death tax." This tax hits estates of more than $1 million in net assets with rates as high as 55 percent. The death tax raises very little revenue, yet it does significant harm to the economy, imposes very high compliance costs and fails to curtail the transmission of wealth from one generation to the next. It is arguably the most counterproductive tax in the entire Internal Revenue Code.

President Bush and congressional Republicans successfully campaigned on the issue. Polls show that about two of every three Americans support the idea. But there are serious doubts as to whether the GOP plan would ever really eliminate the death tax. The plan that passed last year (known as the Dunn-Tanner bill) and that was ultimately vetoed by President Bill Clinton would have phased it out over 10 years. But the reductions in the first few years were modest and future Congresses could easily suspend the scheduled phase-out. Meanwhile, many Democrats want to raise the current $1 million estate tax deduction, but leave in place the lofty tax rates that severely distort saving behavior.

These are undesirable options that would not alleviate the adverse economic impact and unfairness of the death tax. The core problem is that the confiscatory *rates* penalize saving and investment and unjustly force the breakup of thousands of closely held family-owned businesses, farms, ranches and other properties. The tax also causes the misallocation of tens of billions of dollars a year away from the highest wealth-producing investments into unproductive tax shelters.

International Comparison of Top Marginal Estate Tax Rates



Source: Arthur Andersen LLP survey for ACCF Center for Policy Research.

The Death Tax: Bad Economics. There are four major arguments against the death tax. First, it is fiscally irrelevant.

- Throughout the past 40 years, the tax has consistently raised only between 1 percent and 2 percent of total federal revenues.
- In 2000 it raised roughly $22 billion out of just under $2 trillion in total federal tax receipts.

Because the death tax slows economic growth and thus reduces other tax receipts, the actual net revenues raised by the federal government are well below 1 percent of total receipts. In a 1995 study, economist Dick Wagner of George Mason University calculated that the death tax may actually cost the federal government more money than it raises.

Rewarding Vice, Punishing Virtue. Take the example of two hypothetical successful people — Jerry and Mary — each of whom has worked and paid taxes on their income and has now accumulated $10 million by starting and growing family businesses. Jerry sells his company and spends all his money eating, drinking, gambling, entertaining lady friends and otherwise living high on the hog. He dies broke after 15 years of self-indulgence and leaves his children not a penny. Meanwhile, Mary lives thriftily. She continues to work to expand the business with the help of her two children, and the firm's value grows to $20 million. She wants to leave this business, her legacy, to her children and grandchildren. Mary has clearly engaged in what most people would view as a more virtuous lifestyle, but her estate is clobbered with a hefty tax at death, while Jerry's estate pays not a penny. Very few Americans would regard this situation as just or fair.

Note also that Mary has already been taxed on her earnings, and when she goes to her grave her estate pays

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up to 55 percent on the 50 percent that was not already taxed away. Hence, for every dollar that she is able to pass to her children, the government keeps up to $4. Taxing the same income twice is simply unfair.

Reducing Global Competitiveness. The table indicates that the U.S. now has the second highest death tax in the world, topped only by that of Japan. Many nations have begun eliminating their death taxes, recognizing them as a powerful disincentive for saving, investment and accumulating wealth. It is also noteworthy that the death tax is the only federal tax with a rate exceeding 50 percent. The U.S. Joint Economic Committee estimates that the death tax has reduced U.S. wealth creation by $500 billion.

An Inefficient Tax. The estate tax imposes huge compliance costs that make collection economically inefficient. A study published in the *Seton Hall Law Review* indicated that in one recent year, 1992, the compliance costs were more than half the total amount raised by the tax. The National Federation of Independent Business estimated that the government and individuals collectively spend 65 cents on enforcement, compliance and legal bills for every dollar the government eventually collects. After the burden of complying with the paperwork and reporting requirements, fewer than half of the estates actually pay even a nickel of the tax. These small estates sometimes are forced to spend tens of thousands of dollars to comply with a tax that they don't even owe. No wonder estate lawyers and tax accountants love this tax.

Failing to Break Up Concentrated Wealth. Defenders of the tax argue that its costs are worth absorbing because it helps break up hoards of wealth accumulated by those few whose fortunes come by birthright, not by hard work or individual initiative. But recent research by Professor Edward McCaffery of the University of Southern California Law School concludes that "if breaking up large concentrations of wealth is the intention of the death tax, then it is a miserable failure." The wealthiest families tend to invest heavily in estate tax planning that inoculates them from paying this tax at all. For example, two of America's wealthiest families, the Kennedys and the Rockefellers, have paid very little estate tax over the past several generations, thanks to careful and clever estate planning by hordes of lawyers and accountants. Statistics show the medium-sized estates to be the most heavily and adversely impacted.

- In 1997 two-thirds of all estates that paid the tax had a net worth of less than $10 million.
- A recent study estimates that two-thirds of the wealth of the nation's richest families goes untaxed.

Repeal and Tax Fairness. It's quite possible that death tax repeal is now the most popular public policy issue in America — outpolling even prescription drug benefits for seniors and education reform as a priority issue for Congress. A September McLaughlin poll found that 83 percent of voters believe the death tax is unfair and only 10 percent think it is fair.

Congress and President Bush must recognize that the ideal solution to restore tax fairness is to eliminate the tax entirely and immediately, as Rep. Chris Cox of California has proposed. Once a hated tax is completely extinguished, the chances of its being reimplemented are remote.

If the tax cannot be immediately eliminated, Congress should concentrate on cutting the rates as dramatically as possible. Even the liberal Charles Rangel, the ranking Democrat on the influential tax-writing House Ways and Means Committee, has endorsed an immediate 20 percent reduction in rates — which would lower the top rate in 2002 to 44 percent. The flawed Republican approach would take five years to achieve that rate. A more logical first step would be to cut the death tax rate to the capital gains rate of 20 percent.

Steve Forbes said it best: in the United States we should have a policy of "no taxation without respiration."

Stephen Moore is president of the Club for Growth and is a former Senior Economist with the Joint Economic Committee of Congress.