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The Gift and Estate Tax and Economic Performance
House Ways & Means Committee Testimony

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The following testimony was presented by Dr. Foster before the House Ways & Means Committee on February 1, 1995.

Mr. Chairman and Members of the Committee, my name is J.D. Foster and I am the Executive Director and Chief Economist of the Tax Foundation. It is an honor for me to appear before your committee today on behalf of the Tax Foundation to discuss the Federal gift and estate tax.

The Tax Foundation is a non-profit, nonpartisan research and public education organization that has monitored fiscal policy at all levels of government since 1937. The Tax Foundation is neither a trade association nor a lobbying organization. We do not take positions on specific legislation or legislative proposals. Our goal is to explain as precisely and clearly as we can the current state of fiscal policy and the consequences of particular legislation in the light of established tax principles, so that you, the policy makers, may make informed decisions.

For those who have inherited wealth or who have sold their businesses after building them up, the estate tax creates a powerful incentive to consume this wealth since much of it will otherwise be lost to the federal government.

Aside from its ability to raise revenue for the federal government, the estate tax is most often justified by the need to ensure a particular sense of fairness in the overall tax system and to govern who receives the fruits of our economic system. Against this social policy are raised the questions of fairness to the individuals paying the tax and the economic costs imposed on the taxpayer and on society as a whole.

The federal gift and estate tax is a unique feature of the federal tax system. It is not a tax on income, though it can influence the incentives to earn income; it is not a tax on consumption, though it can affect lifetime consumption; nor is it a tax on a particular activity. It is a tax on the net economic product of an individual after all other economic activity has concluded. As such, analysis of the distortions it imposes on the economy are unique and these will be the subject of my testimony.

Taxes distort the allocation of resources in the economy by altering the relative prices of goods, services, and factors of production like capital and labor. In the absence of taxes and other government policies, the economy tends to allocate its resources to produce those goods and services that are most in demand. Prices are the signals that indicate where resources should flow. Goods and services that command relatively high prices in the market, such as cars and medical attention, attract a greater flow of capital and labor than do products that command relatively low prices. Taxes alter the prices that direct the allocation of resources so that resources are directed towards less productive and less valuable uses, thereby reducing the quantity and value of the economy's product.

The nature of the disincentives imposed by the estate tax varies according to the eco-

Table 1
Marginal and Effective Transfer Tax Rates (1994)

Taxable Transfer (000s)	Statutory Marginal Tax Rate	Marginal Pre-credit Tax	Cumulative Pre-credit Tax	Cumulative Tax-Unified Credit	Effective Marginal Tax Rate	Effective Average Tax Rate
$10	18%	$1,800	$1,800	$0	0%	0%
20	20	2,000	3,800	0	0	0
40	22	4,400	8,200	0	0	0
60	24	4,800	13,000	0	0	0
80	26	5,200	18,200	0	0	0
100	28	5,600	23,800	0	0	0
150	30	15,000	38,800	0	0	0
250	32	32,000	70,800	0	0	0
500	34	85,000	155,800	0	0	0
600	37	37,000	192,800	0	0	0
750	37	92,500	248,300	55,500	37	7.40
1,000	39	97,500	345,800	153,000	39	15.30
1,250	41	102,500	448,300	255,500	41	20.44
1,500	43	107,500	555,800	363,000	43	24.20
2,000	45	225,000	780,800	588,000	45	29.40
2,500	49	245,000	1,025,800	833,000	49	33.32
3,000	53	265,000	1,290,800	1,098,000	53	36.60
4,000	55	550,000	1,840,800	1,648,000	55	41.20
5,000	55	550,000	2,390,800	2,198,000	55	43.96
10,000	55	2,750,000	5,140,800	4,948,000	55	49.48
21,040	55	6,624,000	11,764,800	11,572,000	55	55.00
30,000	55	4,928,000	16,692,800	16,500,000	55	55.00
40,000	55	5,500,000	22,192,800	22,000,000	55	55.00
50,000	55	5,500,000	27,692,800	27,500,000	55	55.00
100,000	55	27,500,000	55,192,800	55,000,000	55	55.00

Source: Internal Revenue Service

nomic state of the original wealth holder. For example, for an entrepreneur seeking to build a farm or business, the greatest disincentive effect is probably on his or her labor. The value of the business is the capitalized value of the entrepreneur's past and prospective personal efforts. As the estate tax looms larger, the disincentive grows and the amount of effort spent on building the business tends to decline. For those who have inherited wealth or who have sold their businesses after building them up, the estate tax creates a powerful incentive to consume this wealth since much of it will otherwise be lost to the federal government.

The Federal Gift and Estate Tax

The federal gift and estate tax is a system of tax rates, exemptions, credits, and special rules designed to transfer wealth from families to the federal government. This policy has two underlying justifications. The first is to raise revenue for the federal fisc and the second is to inhibit the accumulation of wealth beyond a certain level.

In total, there are 17 marginal transfer tax rates ranging from 18 percent to 55 percent. There is also a unified tax credit of $192,800 applying to lifetime gifts and bequests. And there is a rule which gradually phases out the benefit of the unified credit and progressive rate schedule by imposing an additional 5 percent tax on that portion of a transfer in excess of $10 million but less than $21.04 million.

The combined effect of the unified credit, graduated rate schedule, and benefit phase out rule is to create a range of effective marginal and average transfer tax rates that differs markedly from the statutory schedule, as shown in Table 1 on page 2. For example, while the statutory marginal tax rate on transfers between $600,000 and $1 million was 37 percent, the effective average tax rate on such transfers ranged from 0 percent to 15.3 percent.

A Short History of the Tax

The nation's first transfer tax was enacted in the final years of the 18th century when strained relations with France compelled the U.S. to develop a powerful navy. This force was funded by the Stamp Act of 1797, which required that federal tax stamps be purchased when transferring property from an estate. The cost of the stamp required to transfer property depended on the value of the estate and the size of the transfer. This tax was repealed in 1802.

The federal government resorted once again to transfer taxes in the 1860s when the Civil War and subsequent reconstruction forced the Congress to look for additional federal revenue. A series of Acts passed in 1862, 1864, and 1866 created and refined the first federal inheritance tax. In 1870 Congress repealed this tax as demands for federal revenue eased. The transfer tax was once again enacted in 1898 to help finance the Spanish-American War. The tax was repealed in 1902. Prior to 1916, therefore, the federal government did not rely on transfer taxes as a permanent source of revenue, but, rather, levied the tax as a temporary source of revenue during national emergencies.

In 1916, the federal government enacted the estate tax along with the federal income tax. Sixteen years later, largely to prevent avoidance of the estate tax, the Congress enacted the gift tax. When it was enacted, the estate tax was imposed on estates in excess of $50,000 (about $650,000 in 1995) and the rate ranged from 1 percent to 10 percent.

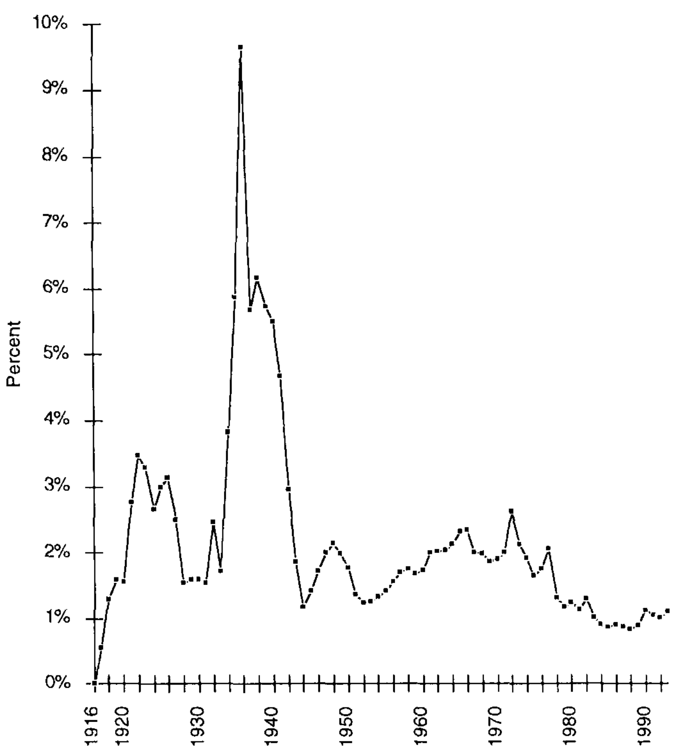
The transfer tax reached its peak as a source of federal receipts in the period from 1932 to 1941, when transfer taxes accounted for as much as 9.7 percent of total federal receipts. However, while other taxes were raised during the Second World War, the transfer tax remained unchanged so that transfer tax receipts fell to 1.4 percent of total revenue by the end of the war. See Figure 1 on page 3.

With the exception of the mid-1930s, transfer taxes have never represented a significant share of federal revenue, though the nominal value of estate and gift tax receipts has grown steadily. In 1992, the U.S. government collected $11.1 billion in transfer taxes, predominately estate taxes, representing about 1 percent of total federal revenue.

Few changes in the transfer tax were made following the war until a series of legislation passed in 1976, 1981, and 1986 overhauled and modified the federal transfer tax system. Portions of the separate estate and gift tax systems were unified and levies were imposed on generation-skipping transfers. These Acts also lowered marginal transfer tax rates and significantly reduced the number of transfer tax returns filed each year by raising the filing requirements. See Figure 2 on page 4.

Two recent tax Acts have partially reversed some of the changes made over the previous 11 years. The Omnibus Budget Reconciliation Act of 1987 extended until 1992 the top marginal rate of 55 percent. This rate had been scheduled to fall to 50 percent. By enacting an additional 5 percent tax on transfers between $10 million and $21.04 million, the Act also phased out the benefits of the unified credit and graduated rate schedule over this range. These provisions expired on December 31, 1992, but were retroactively reinstated in the Omnibus Reconciliation Act of 1993. See Figure 3 on page 5.

Figure 1
Transfer Taxes as a Percent of Federal Receipts (1916 - Present)

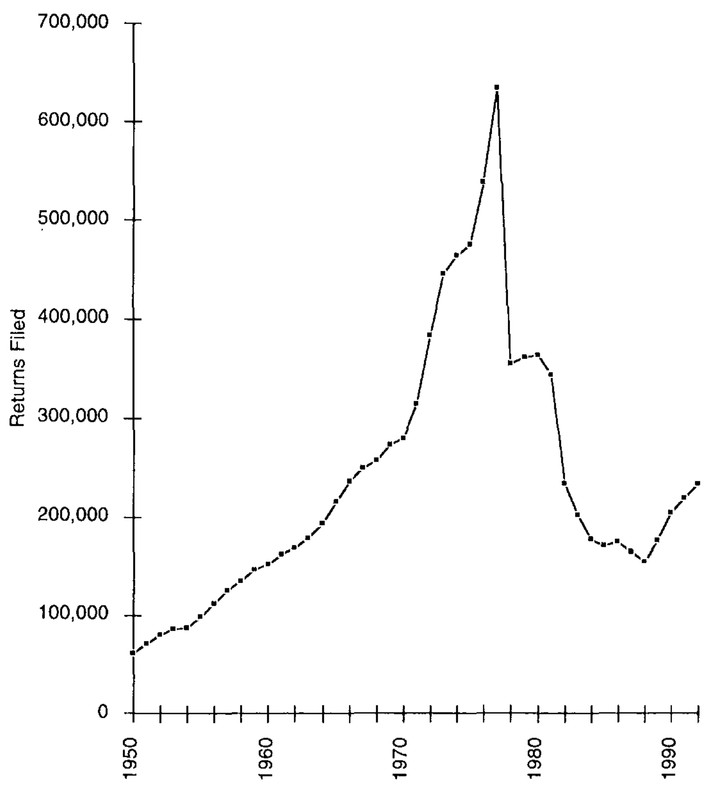


Source: Internal Revenue Service.

Who Pays the Gift and Estate Tax

The value of the wealth reported on the estate tax returns filed for 1989 decedents (the latest year for which data is available) totaled almost $87.7 billion. The lion's share of this

Figure 2
Total Transfer Tax Returns Filed (1950 - Present)



Source: Internal Revenue Service.

wealth, 31 percent, or slightly over $27.2 billion, was held by estates valued between $1 million and $2.5 million. The next largest share, 22.8 percent or $19.9 billion, was held by estates valued at between $600,000 and $1 million. Estates valued over $20 million held 14.1 percent of this wealth, or $12.3 billion. About 250 large estates (those with over $20 million in assets) file with the IRS each year. These estates are composed largely of business assets, such as closely held stock, farm assets, limited partnerships, and other non-corporate businesses. See Figure 4 on page 6.

Nearly one-half of all estate tax returns filed for 1989 decedents were for estates whose gross value exceeded $1 million. However, these estates accounted for nearly 96 percent of the total transfer tax receipts. Alternatively more than half of all returns were for $1 million or less, and these estates paid less than five percent of all estate taxes. Figure 5 on page 7 shows the distribution of federal estate tax returns for 1989 decedents by estate size. More than half of these returns, were filed for estates valued at between $600,000 and $1 million, while only 0.5 percent were filed for estates valued at $20 million or more.

The composition of estates varies significantly as the size of the estates increases. For example, as Figure 6 on page 8 shows, the percentage of the estate represented by business assets (closely held stock, farm assets, limited partnerships) grows steadily with estate size, while real estate and cash tends to decline as a share of estates as the estate size increases.

The Disincentive Effects of the Estate Tax

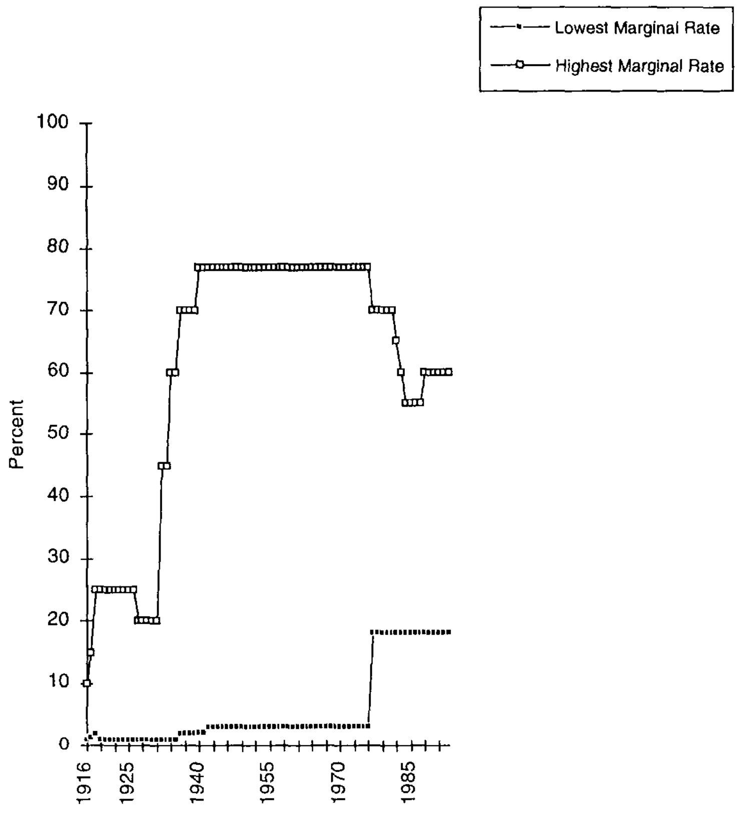
The gift and estate tax is a tax on capital and is universally recognized as a disincentive to save and invest. Anyone facing the tax has a tremendous incentive to dispose of his or her resources rather than let them be confiscated by the federal government. These dispositions may take any number of forms of personal consumption or charitable donations. While the latter may represent socially desirable behavior, increasing personal consumption to minimize the savings exacted by the federal government is a counterproductive dissipation of precious resources, particularly for a country that has such a low private saving rate.

For many taxpayers who are building up their personal wealth through their own labor, the gift and estate tax is also a powerful disincentive to the hard work and long hours associated with success. Successful businessmen at some point face the prospect that, after the federal, state, and local governments have imposed their income, property, and sales taxes on current income and assets, and the remainder is saved and plowed back into the business or other savings, the federal government will come along and take up to half of what is left through the estate tax. For individuals such as these, at some point they must surely ask themselves whether it would be better to continue to work so hard or to spend time with the family or on other, non-business related activities.

Thus, the transfer tax discourages work effort by some of the nation's most productive and gifted citizens—the dreamers and the visionaries whose hard work, skill, and luck have created new jobs and new markets. The question is, however, just how great a disincentive the estate tax is to this kind of productive activity.

This is not an easy question to answer because the estate tax is a very different type of

Figure 3
Estate Tax Marginal Rate Ranges (1916 - Present)



Source: House Ways and Means Committee, 1993.

tax than we are accustomed to examining. When a sales tax is levied, the effect is either to raise the price of the product being taxed or to shift the tax onto labor in the form of lower wages or onto capital in the form of lower after-tax earnings for a given level of pre-tax earnings. In each case, however, experience with sales taxes offers some intuitive sense of the consequences of a sales tax change of a certain size on a particular type of product.

Similarly, experience offers a relatively clear picture of the effects of income taxes on the disincentives to work. Research indicates, for example, that for males earning low to upper-middle income wages, the disincentive effect of higher marginal tax rates is fairly low, while that for all women tends to be higher. Research, in accord with common sense, also tells us that the disincentive effect of higher marginal tax rates rises rapidly once an individual's income reaches a certain level because the trade-off between the work required to earn an additional dollar of after-tax wages and enjoying the fruits of leisure quickly tilts in favor of leisure over labor.

To clarify the effects of the estate tax on the incentive to work, the Tax Foundation developed a model that allows a comparison of the disincentive effects of the estate tax and the income tax. Specifically, the model allows a calculation of how high the top income tax rate would have to rise for it to achieve the same level of disincentive effect as the current estate tax regime.

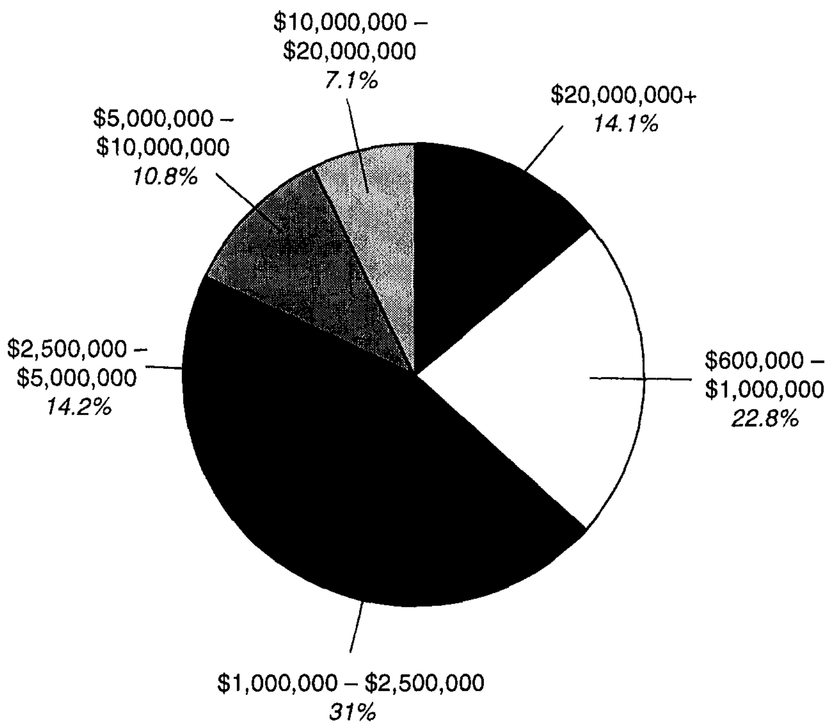
Another way to think about the model is that it allows us to compare two scenarios. In the first scenario, an entrepreneur's life experience of work, saving, wealth creation, and business expansion is considered in the context of the current individual, corporate, and estate tax law. In the second scenario, the estate tax is eliminated and the individual and corporate income tax rates are raised until they produce the same after-tax bequest as under the first scenario. (The model is described in the Appendix to this testimony.) (pages 4 through 7 of the paper)

The various simulations conducted using this model showed that the estate tax has roughly the same effect on entrepreneurial incentives as a doubling of income tax rates. In other words, federal income tax rates would need to be nearly twice their current levels to produce the same disincentive as the current estate tax. For example, consider an entrepreneur who is currently paying at the top income tax rate and whose non-corporate business is expected to allow him or her to leave an estate valued at $5.2 million. This estate under current law faces an effective marginal estate tax rate of about 44 percent. To achieve the same degree of disincentive through income taxes it would be necessary to raise the effective individual income tax rate to about 68 percent. According to this research, this pattern of implied income tax rate appears for a wide variety of estate sizes and business growth patterns.

These results indicate that the estate tax creates a powerful influence on some of society's most productive workers, those whose effort has allowed them to create jobs and opportunity for others by offering goods and services demanded by others in the economy. There is a very good reason why Adam Smith called his famous work on the power of the free market economy to create prosperity: "The Wealth of Nations". The estate tax is a tax on that wealth and, as such, is a direct levy on prosperity.

Since the Super Bowl was played just three

Figure 4
Distribution of Total Estate Wealth by Estate Size (1989 Estates)



Source: Internal Revenue Service.

days ago, a sports analogy seems appropriate. Imagine a rule that says that for every touchdown scored by an individual player, the team gets six points. And, anytime a player scores more than one touchdown, the team must give up three points at the end of the game per extra touchdown scored. Jerry Rice of the San Francisco 49ers scored three touchdowns in the Super Bowl, giving the 49ers 21 points during the game, counting the extra point kicks. But, if the NFL had a rule similar to the estate tax, at the end of the game the 49ers would have to give back three points each for every touchdown scored after the first, so they would have to give back six points. Under these rules, is Jerry Rice going to try as hard to score that second or third touchdown, particularly since he was playing with a dislocated shoulder? That is what the estate tax looks like to a successful entrepreneur.

Estate Tax Reform and the Family Business

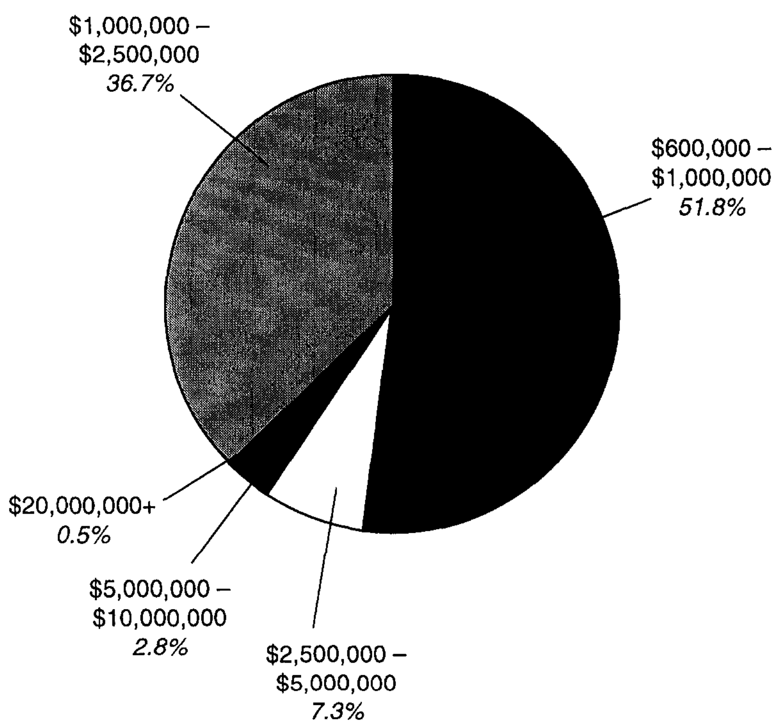
Estate tax reform that reduces the burden of the tax is a clear statement that society no longer deems the economic cost of the tax, or the unfairness of the tax to the taxpayer, to be a reasonable price to pay for the tax's social policy goals. Such reform may be made in a number of ways. The most simple would be to reduce the tax rates or to increase the amount of the unified credit, and to index all elements of the tax. All of these changes would reduce the economic cost of the tax system.

This cost may also be reduced by targeting the relief towards particular segments of society. For example, it may be suggested that the tax relief would have its greatest effect on reducing economic costs while having the least effect on society's notions of tax fairness by reducing the estate tax burden on the estates of businessmen who started or inherited businesses and developed them into larger, thriving enterprises—what I call first-generation wealth. The supposition inherent in such targeted relief is that society generally is inclined to hold it fairer that an individual who creates wealth through his or her own efforts should be allowed to keep a larger fraction of that wealth than should somebody who inherits wealth.

A narrower policy goal is to reform the estate tax so as to allow family businesses to be inherited by other family members. The estate tax can impose an enormous financial burden on a family business. Even medium-sized businesses cannot readily access the financial resources necessary to pay the tax, and certainly not without accepting financial burdens that can severely damage the viability of the firm. Consequently, the inheritors of a family business must often sell part or all of the business to outside interests. Targeted estate tax relief could dramatically improve the possibility that a family business could be inherited.

There is an important distinction, however, between a policy that would offer enough relief so that a family business could remain in the family, and relief that is so constraining as to become a policy of requiring that the family business remain in the family in order to qualify for the relief. These constraints may be politically necessary, but the price is less of a reduction of the economic cost of the tax as far as the entrepreneur is concerned in those cases whenever it is not possible or not desired that the business be passed on to other family members. If the intent of the reform is to reduce as far as possible the disincentives facing entrepreneurs in

Figure 5
Distribution of Estate Tax Returns by Size (1989 Estates)



Source: Internal Revenue Service.

the process of creating first generation wealth, then the relief will have its greatest effects if it comes with the fewest limitations and constraints as possible.

In other words, if the predominant policy goal to be attained in reform of the estate tax is to keep family businesses in the family, then limitations to the reform to that effect are appropriate. However, if the predominant goal is to reduce the disincentives facing the entrepreneur building a successful business, then these limitations can be highly counterproductive. The difference is whether the policy is to make it possible for the family business to continue as such, or to require that it do so to receive the benefits.

Comprehensive Tax Reform and Estate Tax Reform

Comprehensive tax reform is widely anticipated, motivated largely by a recognition that the federal tax system remains harmful to economic growth and international competitiveness, and that its complexity and compliance burdens go far beyond the bounds of reason. There are a number of tax reform plans, both in the Senate and in the House, that have been introduced and that together represent a rough starting point. Whatever their form these plans all have the reduction of the tax burden on saving as a key element. What is little recognized is that these plans all tend to put additional pressure on the estate tax system.

A tax principle likely to undergird any tax reform effort is that all income should be subject to tax once and only once. Since many of the tax reform proposals would only tax income when it is used for consumption, income that is saved and that ultimately becomes part of the individual estate will not be subject to tax except through the estate tax. Also, the partial or complete elimination of the tax bias against saving that tax reform promises means that individuals will increase their savings rate. This, in turn, means that estate sizes will be much larger in the future than they would have been without tax reform.

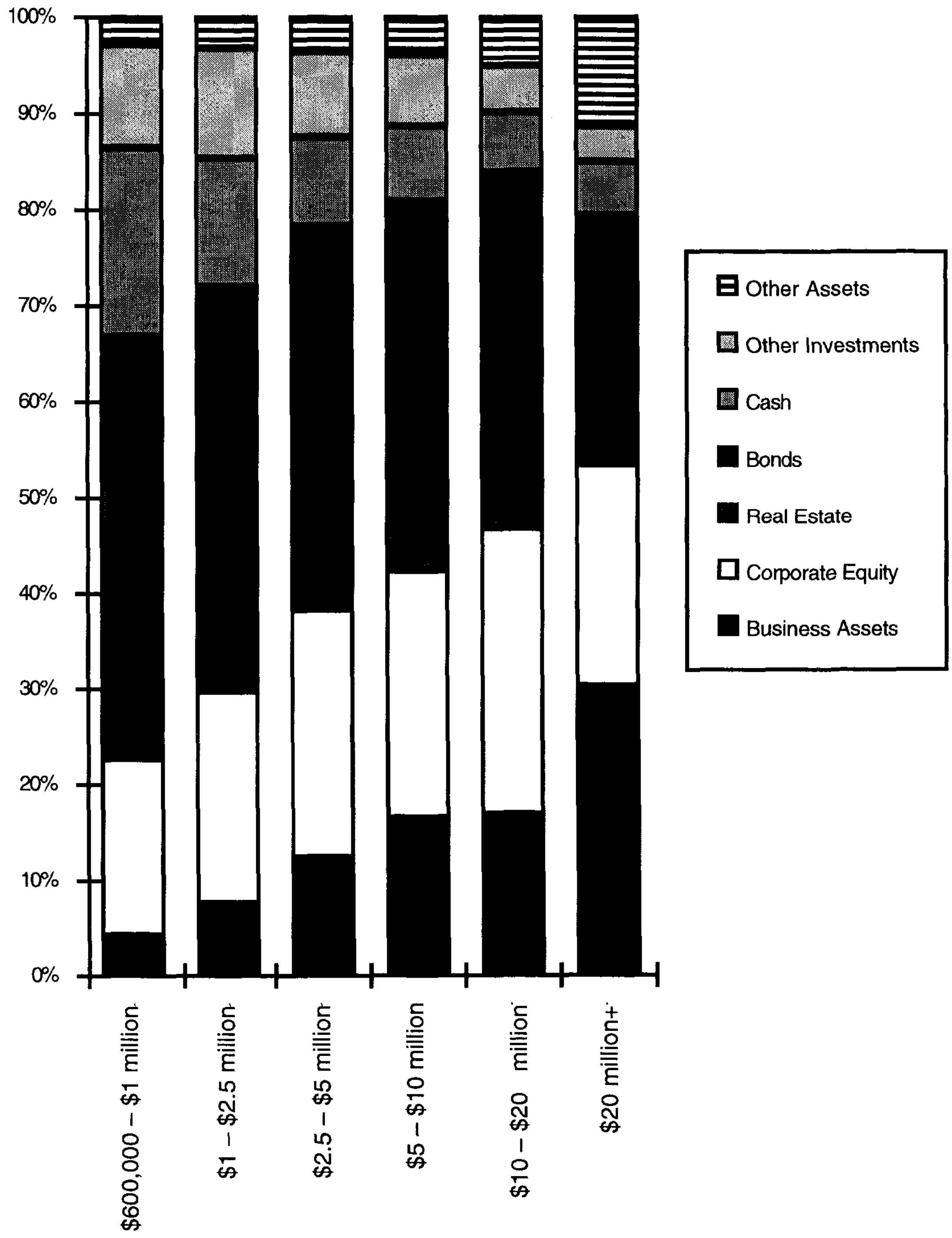
For these reasons, the estate tax is likely to play a far more integral role in the overall federal tax system following tax reform than it does today. Because of the complexity of any comprehensive tax reform effort it is likely that the estate tax would not be given the attention it needs at that time, and so it may be advisable to complete much or all of the desired reform of the estate tax prior to the reform of the federal income tax system.

Conclusion

The federal gift and estate tax lies at the crossroads between redistributionist social policy and economic policies to foster prosperity. The tax poses a tremendous disincentive to work, save, and invest. This disincentive can be acutely felt by entrepreneurs trying to build their businesses.

Estate tax reform may be either general or targeted in nature. If estate tax relief is targeted specifically to reduce the disincentives facing entrepreneurs, then the relief should include as few limitations and constraints as possible because these limitations also limit the effect of the relief. If the relief is intended to allow for businesses to remain in the family, then Congress will need to be careful in deciding between a policy of allowing the business to remain in the family versus a policy of requiring that it remain in the family to qualify for estate tax relief.

Figure 6
Composition of Estates by Estate Size (1989 Estates)



Source: Internal Revenue Service.

The Tax Foundation, a nonprofit, nonpartisan research and public education organization, has been monitoring tax and fiscal activities at all levels of government since 1937.

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