The Heritage Foundation Backgrounder

No. 1091 | The Heritage Foundation • 214 Massachusetts Avenue, N.E. • Washington, D.C. 20002-4999 • (202) 546-4400 • http://www.heritage.org

The Thomas A. Roe Institute for Economic Policy Studies

August 21, 1996

THE CASE FOR REPEALING THE ESTATE TAX

William W. Beach
John M. Olin Senior Fellow in Economics

INTRODUCTION

Virtually from the beginning of government in human society, death and taxes have been closely linked as well as inevitable. The passing of well-to-do individuals has been a lucrative moment for tax collectors. Most nations today impose death, estate, and inheritance taxes, and the United States is no exception.

This ancient practice, however, is beginning to change. Motivated by mounting evidence that death-related taxes may hold back the economic well-being of the living, several countries and American states recently have repealed their taxes on estates or significantly scaled them down. The U.S. Congress also is reexamining the wisdom of these taxes. Two bills, one in the House and another in the Senate, call for outright repeal of the estate and gift tax,[1] and dozens of others in both chambers propose significant modifications that give taxpayer relief.

Support for these proposals still comes primarily from advocates of limited government. But a growing number of liberals recently have shown a keen interest in repeal. Like so many critics of the estate tax, these new critics are disturbed by the growing evidence that this tax:

✗ **Reduces** economic growth, hurting the jobs and incomes of the very people that wealth redistribution was intended to aid;

1 In the House of Representatives, H.R. 784 is sponsored by Representative Christopher Cox (R-CA). In the Senate, S. 628 is sponsored by Senator Jon Kyl (R-AZ).

✗ **Increases** the cost of capital, slowing down research and development and the use of machines that would increase worker productivity—and thus wages;

✗ **Keeps** interest rates on home loans and other major purchases higher than they should be; and

✗ **Raises** very little money—in fact, it may cost the government and the taxpayers more in administrative and compliance fees than it raises in revenue.

Current wealth taxation policy stems from the mistaken view that redistributing income leads to the redistribution of economic power. Nearly a century of wealth taxation, however, shows that well-to-do Americans (including a great number of middle-class families) simply find ways of legally avoiding the tax collector. Not only do they save less and consume more of their income, thus benefiting from the lower taxes on consumption, but they also make less productive investments, such as large life insurance policies and substantial charitable contributions, thus reducing the chances that their death will leave a large taxable estate. The policy of using the estate tax to redistribute economic power actually leads to a distorted distribution of consumption and a less productive economy. Both of these unexpected outcomes worsen the economic condition of the less economically powerful.

The Founders understood the critical importance of reducing legal barriers to economic opportunity as the best public means of allowing every citizen to achieve economic fulfillment. This understanding found a home in the original U.S. Constitution, where direct taxes on wealth and income were prohibited except in time of national emergency. But soon after the ratification of the Sixteenth Amendment (which lifted the ban on federal income taxation) in 1913, the federal government began a 60-year effort to create a more democratic economy through the forcible redistribution of wealth. That policy has imposed costs on economic growth as well as fundamental liberties.

It is time to repeal the estate, gift, and generation-skipping tax. The case for this turns on three factors: the diminishing importance of the estate tax as a federal revenue stream; the failure of the tax to achieve its public policy objectives, principally the creation of economic benefits for lower-income Americans; and the continuing damage the tax exacts on the economy in terms of jobs, output, and growth. Transcending all of these factors is the growing appreciation that wealth taxation infringes on fundamental liberties and is inconsistent with the principle of limited government.

If the estate tax were repealed, the effect on the economy would be significant. According to an econometric study conducted by Professor Richard Wagner of George Mason University, the effect of the estate tax on the cost of capital is so great that within eight years, a U.S. economy without an estate tax would be producing $80 billion more in annual output and would have created 250,000 additional jobs and a $640 billion larger capital stock.

An analysis by The Heritage Foundation using two leading econometric models also found that repealing the estate tax would have a large and beneficial effect on the economy. Specifically, the Heritage analysis found that if the tax were repealed this year, over the next nine years:

✔ The nation's economy would average as much as $11 billion per year in extra output;

- ✔ An average of 145,000 additional new jobs could be created;
- ✔ Personal income could rise by an average of $8 billion per year above current projections; and
- ✔ The deficit actually would decline, since revenues generated by extra growth would more than compensate for the meager revenues currently raised by the inefficient estate tax.

The estate tax has few friends, other than tax attorneys, and raises very little revenue at a heavy cost to the economy. It generates complex tax avoidance schemes. The hardest hit by the tax are small businesspeople who work hard to pass on an enterprise of value to their children. And its bias against saving and wealth generation is the antithesis of the American dream.

HOW WEALTH TAXES BEGAN IN AMERICA

Current public policy on the taxation of intergenerational wealth stems from roots laid down in the American Revolution and, oddly enough, in the Revolutionaries' efforts to create a society in which all citizens would be free to become as wealthy as their talents allow. As with so many principles that trace back to the Revolutionary period, the liberty to acquire and dispose of personal property became, by the 20th century, subsidiary to another element of the country's founding: the drive to create democratic equality of economic opportunity.[2]

The Early Years

Alexis de Tocqueville paid considerable attention to the views Americans held about wealth and economic opportunity when he made his famous tour of the early Republic in 1831. On the one hand, Americans had a nearly universal disdain for aristocracy and any non-republican show of wealth. But on the other hand, nearly everyone with whom Tocqueville became acquainted wanted desperately to be rich:

> I do not mean that there is any lack of wealthy individuals in the United States; I know of no country, indeed, where the love of money has taken stronger hold on the affections of men and where a profounder contempt is expressed for the theory of the permanent equality of property. But wealth circulates with inconceivable rapidity, and experience shows that it is rare to find two succeeding generations in the full enjoyment of it.[3]

Removing Barriers to Wealth. The democratization of acquiring wealth constituted the touchstone of the new civilization that the Revolutionaries sought to build. Theirs was a battle against barriers erected in the Old World to prevent the rise of the common man. For centuries, laws had been applied differently to rich and poor people. The Revolutionaries overturned this by embracing the legal principle of equality before the law, extending it to all free Americans, and giving it the sharp legal teeth of natural liberty in

---

2 For a brilliant survey of the tensions engendered in the early republic by widespread, ambiguous views of wealth, see Gordon S. Wood, *The Radicalism of the American Revolution* (New York, N.Y.: Alfred A. Knopf, 1992).

3 Alexis de Tocqueville, *Democracy in America* (New York, N.Y.: Alfred A. Knopf, 1972), Book One, p. 51.

one's life and property. They freed labor and capital from taxes, turned over to communities virtually all regulation of commerce, and tried in many other ways to remove government from everyday life. This truly was the age of the individual. Liberated from the oppressive economic and social networks that had surrounded the Crown and that prevented ordinary people from rising, the Revolutionaries emphasized the importance of allowing the marketplace rather than birth and influence to be the measure of personal worth. As Gordon Wood writes in his Pulitzer Prize-winning history of this period,

> A man was now praised for having arrived and risen "without friends," for having been "the architect of his own fortune," or for never having been "borne on the shoulders of patronage." For many Americans the ability to make money—not whom one knew, or who one's father was, or where one went to college—now became the only proper democratic means for distinguishing one man from another.[4]

Nothing epitomizes the zeal of the Revolutionaries for fundamentally altering the process of acquiring wealth better than the rapid abolition of primogeniture and the narrowing of entail. The ancient practice of primogeniture settled the entirety of an estate on the first-born male, thus leaving the remaining male children and all female children without inheritance. Primogeniture made birth order rather than merit the principal cause of wealth. Thus, dullards were as likely as commercial geniuses to end up ruling vast properties and exercising immense social and political influence. Entail nicely complemented primogeniture by making it all but impossible for real estate to leave a family, no matter how desirous a family one day might be to part with the property or how badly they managed their estate. Together, primogeniture and entail put a gigantic weight around the neck of economic progress and reduced the rate of commercial improvement to an obese creep.

Thomas Jefferson, himself initially a victim of primogeniture and then its beneficiary upon the death of his older brother, vigorously opposed both practices and saw legislation that he had written in 1777 abolishing primogeniture passed by the Virginia House of Burgesses in 1785. Within a few years, every new state government had followed Virginia's lead, and no subsequent state ever seriously considered allowing it. For Jefferson, the reform of entail and abolition of primogeniture were two of the most important actions taken in the early Republic to create "a system by which every fibre would be eradicated of ancient or future aristocracy, and a foundation laid for a government truly republican."[5]

Even a cursory reading of the Revolutionary texts underscores this unrelenting focus of the Founders on removing barriers to the wealth-creating process. Early American public policy was not aimed at redistributing wealth or at restraining its growth. Rather, the early Republic pursued a public policy of removing obstacles to entrepreneurship and economic self-improvement. If an egalitarian theme was present in early American pub-

4 Wood, *Radicalism of the American Revolution*, p. 342.

5 Thomas Jefferson, *Autobiography*, p. 51, in *The Life and Selected Writings of Thomas Jefferson*, ed. Adrienne Koch and William Peden (New York, N.Y.: Random House, 1944).

lic policy, it was the theme of equality before the law, which often meant the elimination of legal privileges that gave one class an economic advantage over another.

This attitude to wealth creation can be found in the Constitution of the United States. A straightforward reading of the following paragraph from Article I, Section 9 appears to prohibit all direct taxes, which would include a prohibition against taxes on income and wealth: "No Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken."[6]

Changing Attitudes Toward Wealth and Taxation

National Emergencies. It was generally accepted during the 19th century that Congress had extensive authority to bend the Constitution during times of national emergency. For example, the writ of *habeas corpus* could be suspended in times of war or rebellion in order to advance the public good. Thus, it appeared well within Congress's emergency powers to impose taxes on wealth and inheritance to meet the wholly unexpected revenue requirements of the federal government during dangerous times.

Congress wasted no time in testing its expansive wartime authority: Taxes on estates were imposed first during the Quasi-War with France (1797-1799), but repealed in 1802. Still, had it not been for the Civil War, it is possible that after 1802, the 19th century would have been an uninterrupted period of no estate or intergenerational wealth taxation. But the expenses of the Union government exhausted its revenue sources so quickly that President Lincoln and the war Congresses employed the emergency clauses of the Constitution to enact the first modern intergenerational wealth tax. The Revenue Act of 1862 revived the death tax of the Quasi-War Congress and recrafted it into a true inheritance tax. Congress repealed the tax on wealth in 1870.[7]

Wealth Seen As an Obstacle to Economic Opportunity. While costly national emergencies occasionally challenged the idea of unrestricted wealth creation and ownership, more important in the long run was a change of attitude in some circles toward the relationship between wealth and economic opportunity. Between 1880 and 1916, the party of Lincoln overflowed with political warriors who saw no American problem that could not be solved by righteous citizens wielding the policy tools of the newly powerful federal government. Just as they had overcome the Southern assertion of states' rights, they would be victorious over the growing concentrations of private economic power that they viewed as fundamentally threatening the bedrock American value of equal economic opportunity.

The reform Republicans created many tools for achieving their "new economic democracy," but perhaps none was so important to this project as the income tax. If the principal post-war threat to the Republic came from the great wealth that industrialization created for a few privileged people, and from the opportunities this wealth provided for corrupting political institutions, reformers needed above all else a legal means of redistributing wealth, thus diffusing the political power that great wealth provided. In 1894, Con-

6 Constitution of the United States, Article I, Section 9, paragraph 4.

7 John R. Luckey, "A History of Federal Estate, Gift, and Generation-Skipping Taxes," *CRS Report for Congress*, Congressional Research Service, March 16, 1995, p. 4.

gress took its first tentative step in this direction by passing the Income Tax Act. Significantly, the heart of the Act was a definition of gifts and inheritances as income.

The Supreme Court wasted little time in striking down the Income Tax Act. In 1895, the Court ruled[8] that the Act constituted a direct tax on certain forms of income that did not meet the Constitution's requirement of apportioning such a tax according to population. Without a change in the Constitution, the Court concluded, all such efforts at taxing income would fail to pass constitutional review.

The constitutional obstacle was removed in 1913 with ratification of the Sixteenth Amendment.[9] Congress quickly passed an income tax in 1914 that levied a 3 percent rate on all incomes above $30,000 (about $900,000 in 1996 dollars).[10] It then launched the modern period of estate and gift taxation through the Revenue Act of 1916.

The Revenue Act of 1916 established rules for valuing a decedent's estate, for capturing taxable lifetime transfers into the estate, and for determining those transfers made for inadequate consideration and those that became effective only upon death. It created exemptions and deductions that continue to be a part of estate tax law today. Most important, the Act introduced progressive taxation into estate tax policy.[11] This element clearly distinguished its public policy objective from earlier death taxes: The central mission of federal estate and gift taxation would be the redistribution of wealth.[12]

After 1916, and despite a few efforts to retreat from estate and gift taxation immediately following World War I, taxes on intergenerational wealth transfers became a permanent feature of U.S. tax policy.

The history of wealth transfer taxation between 1920 and 1976 consisted largely of expanding the tax base for estate and gift taxes and increasing the tax rates. Congress raised the top marginal rate for estate taxes to 40 percent in 1924. In 1932, the top rate rose to 45 percent and the gift tax became permanent. The imminence of hostilities in 1941 caused Congress to search for additional revenues and led to a further increase in the top rate on estates to 77 percent.[13]

Figure 1 shows the rapid increase in estate and gift tax collections after the end of World War II. Intergenerational taxes grew significantly in both amount and rate, even when adjusted for inflation. This growth probably stemmed as much from the demo-

---

8 *Pollock v. Farmers' Loan and Trust Company*, 158 U.S. 429 (1895).

9 The Sixteenth Amendment reads: "The Congress shall have power to lay and collect taxes on income, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."

10 There is little foundation for a claim that the U.S. government levied taxes on incomes in 1914 because it needed additional revenues. Federal budget surpluses in 1911 and 1912 led to a reduction in total federal debt in 1913 and 1914, and these latter two years had very small deficits of about $400,000 each. Bureau of the Census, *Historical Statistics of the United States: Colonial Times to 1970*, Part 2, 1975, p. 1104, Series Y, column 336.

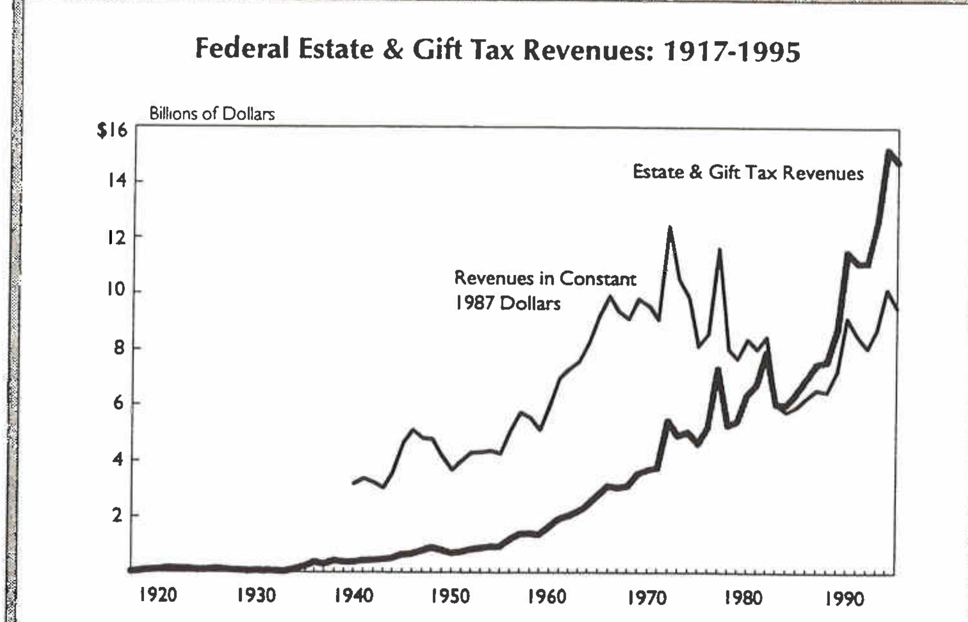
11 Congress exempted the first $50,000 and taxed the remainder of the estate at rates that ranged from 1 percent to 10 percent on values above $5,000,000. Luckey, "A History of Federal Estate, Gift, and Generation-Skipping Taxes," p. 7.

12 The Revenue Act of 1916 was, of course, challenged immediately. The U.S. Supreme Court heard the challenge and upheld the statute in 1920. See *New York Trust Company v. Eisner*, 256 U.S. 345 (1920). It perhaps is significant that the Court's majority opinion was delivered by Oliver Wendell Holmes.

13 Luckey, "A History of Federal Estate, Gift, and Generation-Skipping Taxes," pp. 9-12.

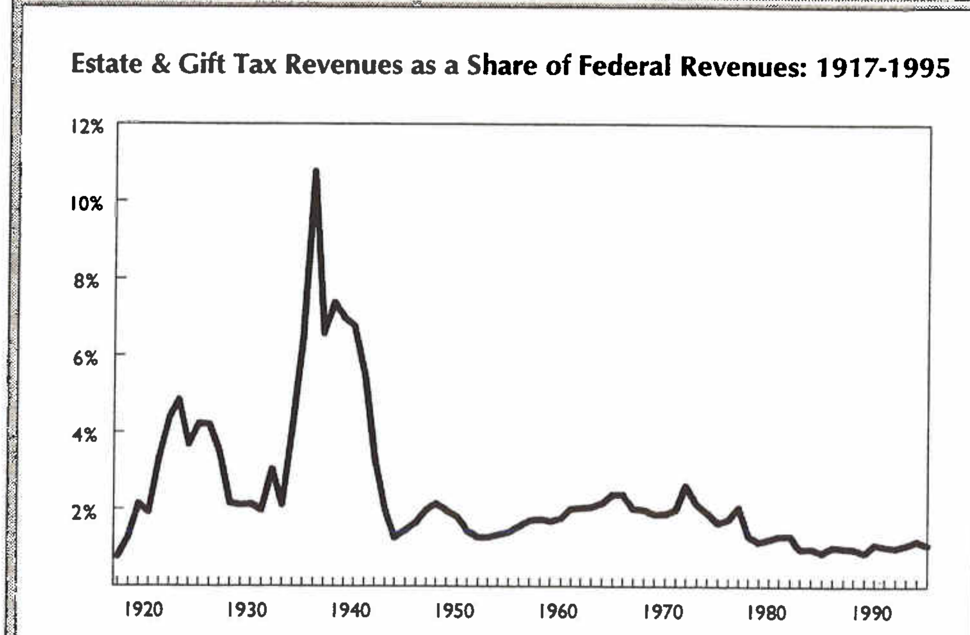
graphics of the transfer taxes as from high tax rates: The late 1960s saw the beginning of generational transfers from those Americans who had weathered the storms of depression and world war. Transfers increasingly consisted of small businesses and farms as well as stocks, bonds, and liquid assets. And as the number of taxable estates containing businesses grew, so did the pressure for estate tax relief.

Chart 1



Source: Bureau of the Census, *Historical Statistics of the United States: Colonial Times to 1970; Economic Report of the President*, 1985, 1996; and Heritage calculations.

Chart 2



Source: Bureau of the Census, *Historical Statistics of the United States: Colonial Times to 1970; Economic Report of the President*, 1985, 1996; and Heritage calculations.

Congress recognized in 1976 that a tax intended to diminish the power of great wealth more frequently ended up taxing ordinary Americans who had accumulated taxable estates through nothing more than frugality, entrepreneurship, and plain hard work. The Tax Reform Act of 1976 addressed the concerns of these people through a number of policy changes. Specifically, the Act:

- ✔ **Unified** the estate and gift tax, enabling taxpayers to apply unused gift tax allowances as deductions against their taxable estates;