The Economic Effects of the Estate Tax

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I am David Logan, an economist with the Tax Foundation. I am honored to speak to you today about the economic consequences of Pennsylvania's state inheritance tax.

Founded in 1937, the Tax Foundation is the nation's oldest non-partisan, non-profit organization dedicated to promoting economically sound tax policy at all levels of government. The Tax Foundation's work is guided by the principles of sound tax policy, which require that taxes be neutral to economic decision making; that they be simple, transparent, and stable; and that they promote economic growth.

Though Pennsylvania administers an inheritance tax, it differs from an estate tax merely in administrative aspects. My remarks will focus on the large body of literature on the estate tax and its similarities to the inheritance tax. Pennsylvania's inheritance tax distorts economic decision making, increases overall tax compliance costs, is overly complex, and hinders economic growth.

Introduction

Estate and inheritance taxes have been written into public policy since 1797 at various levels of government. However, the absence of a state inheritance or estate tax has many long-term, pro-growth benefits, which include but are not limited to: a massive reduction in compliance and avoidance costs, a more efficient allocation of useful economic resources that would otherwise be diverted away from productive investment, migration of benefactors to a state which does not levy estate taxes, and a decrease in wealth inequality.

Proponents of the tax generally cite three reasons for their support. They claim that the estate tax:

1. Is a useful tool to break up large concentrations of wealth, thereby reducing inequality.
2. Raises a good deal of revenue (with the underlying assumption that the tax affects no other aspects of the economy).
3. Increases charitable giving due to the allowable deduction from estate tax liability.

Such claims are undermined by an overwhelming amount of academic literature examining theoretical behavioral responses and hard empirical data which support the idea that the tax does not accomplish any of its well intended goals. Even Roberton Williams—a longtime proponent of the estate tax—has conceded that it has failed to meet its original goals.[1]

Estate Taxes Are Ineffective at Breaking up Dynastic Wealth

There is an intuitive reason that these taxes do not break up concentrated wealth: the inherent nature of leaving one's estate to various entities already breaks up wealth built by an individual over time. If an individual with a total worth of $100,000 leaves the estate to three children, this wealth has been split three ways, regardless of the levying of an estate or inheritance tax.

The economic reasoning is put more succinctly by Edward McCaffery, who says that the estate tax fails even from a liberal perspective. The reasoning is that this tax can be avoided in large part by *inter vivos* gifting, and the benefactor can reduce the size of their estate by consuming more of it or by working and saving less. In this sense, the estate tax is a "virtue tax," a tax discouraging behavior most feel is virtuous and beneficial to the economy.

A noteworthy flaw in this "substitution of leisure for labor" argument has been pointed out by Leonard E. Burman, William G. Gale and Jeffrey Rohaly of the Urban-Brookings Tax Policy Center, who claim, "The tax may discourage work and saving for people subject to it, but it has the opposite effect on heirs who—expecting smaller bequests—choose to work harder and save more."[2] If the heirs face absolute uncertainty, this argument logically holds. The more certain the bequest, however, the less one would expect the heir to work and save--no matter the size or time delay of its deliverance

Estate Tax Revenues Are Offset by Compliance Costs and Misallocation of Resources

One study found that compliance costs associated with the estate tax were approximately equal to the amount of federal revenue gained by the tax itself.[3] In Pennsylvania, this would imply that $805.2 million was lost due to efforts to comply with the state's inheritance tax.[4]

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[1] Roberton Williams, "It's Not About Economic Equality," Urban Institute Commentary, December 2010.
[2] Leonard E. Burman, William G. Gale, and Jeffrey Rohaly, "Options to Reform the Estate Tax," *Tax Policy Issues and Options*, No. 10, Urban-Brookings Tax Policy Center, March 2005.
[3] Alicia H. Munnell, "Wealth Transfer Taxation: The Relative Role for Estate and Income Taxes," *New England Economic Review*, Federal Reserve Bank of Boston (November/December 1988): 19; Aaron and Munnell, 139.

In a seminal study, B. Douglas Bernheim concluded that lost income tax revenue alone can offset all of the revenues collected by the estate tax.[5] Individuals who would potentially pay the most in inheritance taxes have traditionally been the best equipped at avoiding a great deal of the tax by using extensive estate planning. However, low-cost estate planning techniques have proliferated in the current electronic age, and the ability to avoid the tax has been extended to lower-wealth individuals. As these advantages are realized by the average benefactor and heir, one would expect estate tax revenues to decline further, even as unemployment decreases.

These compliance cost measures take only the monetary costs of compliance and avoidance into account. However, another critical asset, time, must also be taken into consideration; time is misallocated by benefactors and estate planners, diverted from productive investment.

Does the Estate Tax Decrease Income and Wealth Inequality?

It is widely claimed that there is, at best, a very weak correlation between income and wealth.[6] One of the most influential studies on the main causes of income inequality was conducted by Alan Blinder, a former member of the Federal Reserve Board appointed by Bill Clinton. A particularly salient finding of Blinder's is that only about 2 percent of income inequality is attributable to inherited wealth.[7] Another prominent study concluded that taxes on wealth transfers may even cause an increase of income inequality.[8] Two later studies undertaken by Stiglitz resulted in his explicit conclusion that "it would seem clear that inheritances are unambiguously equality increasing."[9]

With regard to wealth mobility, inheritances are actually extremely important in helping families move up from the middle and lower quintiles of wealth. In this sense, every extra dollar helps upward mobility of low- and middle-quintile individuals, in terms of wealth. In addition, when wealthy investors were polled, only 7 percent indicated that inheritance was a source of any of their wealth. 85 percent of millionaires in particular are the product of self-made success.[10]

Avoidance by Migration

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[4] Pennsylvania Department of Revenue Monthly Report, June 2011.

[5] B. Douglas Bernheim. "Does the Estate Tax Raise Revenues?" *Tax Policy and the Economy*, Vol. 1, pp. 113-128. Cambridge, MA: MIT Press, 1987.

[6] Joint Economic Committee Study. "The Economics of the Estate Tax," December 1998.

[7] Alan S. Blinder, "Toward an Economic Theory of Income Distribution." Cambridge, MA: MIT Press, Vol. 123, pp. 137-139. 1974.

[8] Joseph E. Stiglitz, "Notes on Estate Taxes, Redistribution, and the Concept of Balanced Growth Path Incidence," *Journal of Political Economy*, Vol. 86, no. 2, 1978.

[9] Joseph E. Stiglitz, "Equality, Taxation and Inheritance," in *Personal Income Distribution: Proceedings of a Conference Held by the International Economic Association, Noordwijk aan Zee, Netherlands,* April 18-23, 1977.

[10] Thomas J. Stanley and William D. Danko, *The Millionaire Next Door: The Surprising Secrets of America's Wealthy.* Atlanta, GA: Longstreet Press. 1996.

Unlike the federal estate tax, the mobility of the decedent prior to death can be an effective avoidance tactic. Though I do not have the exact statistics on the rate of state migration in anticipation of death, I know from several documented stories that the rate is greater than zero. In one article, author Julie Garber states, "[I]n my 16 years of experience as an estate planning attorney, I'm going to estimate that at least half of my clients have changed their primary residence from a state that collects an income tax and/or an estate tax -- such as Illinois, Maryland, New Jersey, New York, Ohio or Pennsylvania -- to a state like Florida that doesn't collect an income tax or an estate tax."[11]

The result is intuitive. Because state estate taxes are based on where the decedent resided upon death (some restrictions notwithstanding), moving to a state which levies no estate tax can be extremely beneficial to the after-tax value of the estate.

In addition, the state estate tax is actually more regressive than its federal compliment because, based on World Bank data (showing that poorer workers are less mobile) and using international labor mobility as a proxy, low-wealth individuals are less mobile than those with a higher net worth.[12]

Effect on Charitable Giving

An objection to the elimination of the estate tax is the negative impact it may have on charitable giving. However, because of provisions allowing deductions for charitable giving in the individual income tax code, these tax incentives are much greater during one's life than at death.

After the rate cuts of the 1981 Economic Recovery Tax Act (ERTA), total charitable bequests increased by 23 percent in real terms and as a percentage of GDP. In 2003, experts predicted a drop in charitable contributions of between 22 percent and 37 percent if the federal estate tax were repealed,[13] but IRS data since then contradict these forecasts.

After 2003, even as the federal exemption continued to climb during the phase-out of the federal estate tax, charitable contributions remained steady for charitable organizations and increased for private foundations, even when adjusted for inflation.[14]

Conclusion

Though the original goals of wealth transfer taxes were well intended, they have not been achieved. Indeed, most of the academic literature suggests that forgoing an estate tax would help decrease income inequality, provide the state with at least the same amount of tax revenue, and

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[11] Julie Garber, "Readers Respond: Would You Move to Avoid State Estate Taxes." http://wills.about.com/u/ua/understandingestatetaxes/movetoavoidestatetaxes.htm

[12] The World Bank, "Labor Mobility for the Poor: Is it Really Possible?" *Economic Premise*, No. 45. January 2011.

[13] Jon M. Bakija and William G. Gale, "Effects of Estate Tax Reform on Charitable Giving," *Tax Policy Issues and Options*, No. 6, Urban-Brookings Tax Policy Center, July 2003.

[14] http://www.irs.gov/taxstats/article/0,,id=175876,00.html

allocate resources more productively into the economy at a time when it needs them most, all without decreasing charitable giving.

Thank you. I would be happy to answer any questions you may have.