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Revising Estate Taxation

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Estate, gift, and inheritance tax yields (*not* counting a temporary payment speedup in effect this year) will probably exceed \$5 billion in 1971. Ten years ago the total was \$2 billion. The rise has been due, not to legislative actions, but to an increase in deaths combined with a rise in real wealth, plus inflation where graduated rates apply.

Until World War I death taxation was the province of the states. War needs led to imposition of a Federal tax. Although peace eventually brought some reduction, Congress in the mid-1920's decided against elimination of the Federal tax while granting states 80 percent of the yield (the tax credit).

Depression desires for more revenue, and then New Deal forces for modification of the economic and social structure, led during the 1930's to substantial increases in Federal rates and to the imposition of a gift tax. The states, however, got no portion of the increase. World War II brought further rate increases—to the present level, from 3 percent on the first \$5,000, 22 percent at \$40,000, 32 percent at \$250,000, and 77 percent over \$10 million. In 1948 Congress made a major structural change in adopting the marital deduction. This provision, subject to various limitations, allows the tax free transfer of half of the estate to a surviving spouse.

More than a full generation has now passed since Congress determined most of the present estate and gift tax structure. (Nor have many states given thorough study to their inheritance, estate, and gift taxes.) True, Congress has made changes from time to time but usually of specific features; though some can properly be called significant, the scope has

been rather limited. The major outlines of the taxes—and the philosophy underlying them—are essentially those of a strikingly different era, the Great Depression. Increasingly, persons familiar with the issues—a very small group—have recognized the need for thorough reexamination. Various groups have worked, in some cases over long periods, on both technical features and broad outlines.

Other tax matters, however, have generally seemed more urgent. Understandably, Congress has given higher priority to other issues. But hearings may be held. Chairman Mills of the Committee on Ways and Means has indicated that he believes a detailed examination, some “taking stock” of the present system, is needed. The taxes, and the issues they raise, are highly complex. The burdens can in fact be heavy—the rates of 77 percent do apply. Yet

This Issue in Brief

Much of the present death tax system was enacted during the depression of the 1930's, says Professor Harriss, and the entirely new situation today calls for a review of the old laws.

By reducing private holdings of wealth by \$5 billion this year, American death and gift taxes will absorb about one-tenth of personal savings, including additions in private pension funds.

Any new appraisal of the death tax system should take this factor into account, especially in view of the great need for capital formation brought about by popular aspirations for a continually rising standard of living.

in some cases—but by no means all—there is use of avoidance devices which can reduce the tax below what a “man in the street” would presumably expect the law to call for.

Moreover, another feature has become a candidate for change—the credit for state death taxes. Raising it only part of the distance to the 80 percent level set in 1926 could yield substantial *revenue sharing* from a long-established provision, and without need to institute new arrangements.

The Treasury during President Johnson’s Administration prepared detailed proposals which went to Congress early in 1969. The stated objective was to improve the equity of the Federal tax system.

Equity is a complex and perplexing concept. As applied to taxation, it has several aspects, not all of which can be in harmony. By any of the concepts of tax equity that I can think of—some being significantly different from others—estate and gift taxes as they now exist fall short of reasonable standards. Yet these taxes may also score better than others in some aspects of tax justice and equity. Here, certainly, in the goal of fairness in taxation, in these taxes themselves and as part of the whole tax structure, is a topic which warrants thoughtful analysis in a Congressional forum. However, the elements of these complex taxes deserve objective, informed review in the light of other goals of public policy.

The fact that major features have existed for a long time does not mean that they are the best possible. Perhaps somewhat unconsciously, estate planners who have gained familiarity with the present system may feel that it is about what ought to continue. Yet by whatever the standards of judgment applied, many imperfections exist.

Merely to identify estate and gift tax features which one believes should be candidates for change

will spark controversy. Some are highly technical. Most are interrelated so that what may seem best in one case will depend to some extent upon what is done to other provisions. The broader studies, done inside and outside the Treasury, have attempted to integrate proposals to develop a more rational total. Specific changes ought not to be judged as such so much as elements of a whole.

Diverse Objectives Bring Complications

Baffling difficulties in a review of alternatives result from a lack of agreement on objectives. What revenue role does one seek from for these taxes? Then, what portion of the whole should go to the states? Ought adjustment be made for inflation? Is equalization, social reform, redistribution, breaking up of large fortunes, or other such goal significant as a non-revenue objective? My sampling of opinion suggests that these social aspects carry weight. But vaguely sensed agreement is not enough. Legislators must try to make any one of them, or more, sufficiently specific to be operational, and also to be reasonably related to other goals, including equity in the distribution of burden and effects on the economy. Reaching an intellectually defensible conclusion on the application of social objectives calls for analysis which has a high degree of sophistication. I know of none. The literature I have examined does not include the thoroughness required for the practical application of criteria so often endorsed in general. Furthermore, when one begins to take account of some economic effects, to one of which I refer in a moment, the complications grow.

The fact that the issues are difficult does *not* mean that we should fail to try for improvement. The present system *does* have defects. We ought to be able to do much better. Only a few of the proposed changes can be noted here.

The high and steeply graduated rate structure calls for examination. The Treasury proposed substantial rate reduction. But, because it could not endorse revenue loss, other features had to involve burden increases (reduction of opportunities for avoidance). The chief of these would be (1) a combination of gift and estate taxes into a single levy with (2) reduction of opportunity to *skip generations* by the use of trusts. (3) Perhaps of greater concern to many taxpayers was an income tax proposal—to tax capital gains at death or to provide that the heir take over the decedent’s basis.



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Among the relief aspects, other than rate reduction, might be, as in the Treasury plan, the complete exemption of gifts and bequests between married couples. Easier payment provisions for illiquid estates, such as closely held businesses, would probably receive considerable support.

More basic changes in the type of tax also deserve consideration. For example, the estate tax form, which takes no account of the number of heirs receiving the property, certainly leaves much to be desired, at least by certain criteria of equity. Perhaps an inheritance tax would come closer to meeting general objectives. Or might we not get better results with an *accession* tax which could apply to each recipient on the basis of all gifts and bequests received from all sources? These big issues, and others less sweeping, do warrant examination.

Although the 1969 Treasury plan would not add to total tax payable, the fact of opening up these taxes for modification would invite efforts to get more revenue. The taxing of capital gains at death would be a far-reaching change. It would have much revenue potential. Why not, the questioning could run, get more revenue when people die by adding this income tax element?

Congress faces—and generates—tremendous pressure for ever-rising expenditures. How tempting to get more revenue from tax sources which in any one year directly affect only a few people! And those directly hit by added burdens would for the most part be members of wealth groups much above average. Reformers could ask, “Why not curtail the present methods of avoidance *without* adopting the rate reductions and other changes proposed by the Treasury to keep total burdens from rising?” Such argumentation might have political appeal. To meet such arguments on their basic merits, requires more than emotion, more than defensive justification of the status quo.

What would be the effects of larger taxes imposed at death? To help in answering this question, let us look at one aspect—the relation to the growth of the economy's capital.

American death and gift taxes, by reducing private holdings of wealth \$5 billion this year, will absorb about one tenth of all personal savings, including additions in private pension funds. Subjecting capital gains at death to tax would also reduce private wealth. These taxes do not, of course, directly destroy buildings or machinery or other

forms of tangible productive capacity. Nevertheless, securities and real estate are liquidated by the estate to get cash to pay death taxes. The people who use their (new) savings to buy the assets being liquidated cannot use the same dollars to pay for new capital construction (including housing), to finance job and business expansion, to buy state-local bonds, and so on. Life insurance dollars used to pay taxes are not available for capital construction.

Death taxes do reduce personal holdings of wealth. The things that such wealth finances—housing, utilities, factories, etc.—will thereby be fewer and less substantial than if the tax were lower. These taxes do more per dollar of revenue than do other taxes in curtailing the growth of capital rather than reducing consumption. True, personal income taxes, especially the upper bracket portions that impinge heavily on new savings, and to some extent corporation income taxes and various consumption taxes, also affect the growth capital.

Taxing Capital Gains Would Burden Capital

Much as someone may feel that present failure to tax capital gains unrealized at death leads to inequities, imposing such a tax would add a burden falling on capital and thus reduce the funds for net new investment. Dollars used today for government services (and the real resources they buy) are not available for capital formation.¹

No solid basis exists for determining for the economy the “best” balance between consumption and capital formation. Nevertheless, popular aspirations for consumption in the future do require capital—and on a scale which is higher than may be consistent with existing taxes. If so, *any addition* to taxes payable at death would have effects on society not intuitively obvious.

During the depression of the 1930's when much of the present death tax system was enacted, many economists feared that at high levels of national income people would tend to save more than would be spent on new capital equipment. Some funds saved and withdrawn from the income stream would be held idle because of lack of demand for investment goods. Oversaving (underinvestment) would depress the economy. This view led to the

1. Some government spending does go for what economists call “investment in human capital.” And some is for tangible things which will last many years. One aspect of a broad examination of death and gift taxation would include comparison with government spending of revenues.

belief that positively desirable results would come from reducing society's total savings and played a part in the large increase in Federal death taxes. More recently, there has been revival of the realization that savings and capital accumulation have a crucial role in enabling the economy to provide a rising income for a growing population.

In an earlier *Tax Review* (August 1969) I compared possible needs for savings and new capital facilities with the probable supplies of funds. More recent efforts to refine the estimates have not been completed. But the general indications are clear.

The supply of new capital funds will fall significantly short of what is needed to satisfy present expectations of a rising population. The persons most adversely affected will be those with low (lowest) incomes. They are the ones least able to finance their own housing. By definition, a young person with no inheritance beginning to work cannot supply the capital needed to permit him to produce enough to get the income he expects.

Let us be clear! Any one or two of the many sets of needs for capital—job expansion, state-local facilities, environmental betterment, electric utilities—could be met with the net savings which will be available. But the same does *not* apply to the whole economy, to all sets of desires for capital.

The normal rise in American aspirations, encouraged by advertising and observation of what others have, cannot be measured. But it is large. Workers have come to expect, perhaps a 3 percent, perhaps higher, rise in *real* income from year to year. Although conditions differ from industry to industry, and although data are unsatisfactory, much of the increase must come, not from longer hours or higher quality of effort but from more and better equipment per worker. When one thinks of 70 million workers each expecting hundreds of dollars a year in higher *real* income, the capital needed to provide the rise in productivity may exceed half of the total net saving of the economy.

As the labor force grows by perhaps 1,400,000 a year in much of the 1970's, huge amounts of capital will be needed for jobs with good productivity. If the job investment requirement averages \$15,000, a total of \$21 billion a year is indicated. For housing a growing population at better average standards—new housing and quality improvement—even falling short of the goal of 2,600,000 units a year, a dollar amount of \$40 billion a year would hardly suffice

(allowing only a little for cost increases). State-local needs (borrowings over debt retirement) will require many billions a year. And so on.

Total near-term annual needs of \$85 to \$90 billion (net, above funds provided by capital consumption allowances) seem to me on the low side. Low, that is, as related to *what Americans expect*. Only slight increases in the assumed level of aspirations gets the figure over \$100 billion. Inflation at recent rates would raise all of these amounts.

Probable savings are exceedingly difficult to estimate. The national income accounts show net savings—personal saving (including the growth of pension and insurance funds) plus undistributed corporate profits—at about \$69 billion in 1970; the governmental sector had a net deficit. The dollar amounts will rise, of course, as national income grows. But even with high levels of corporation profit and relatively slow increases in dividend payout ratios, the total growth of net saving will be less than will be needed to meet aspirations for rising levels of income for our expanding population.

The present tax system has elements of bias against (owners of) capital. The steeply graduated personal income tax rates obstruct the growth of savings. As pre-tax income rises from year to year—from larger output and inflationary price effects—progressively more will be taken in income taxes. Moreover, the failure of income taxes to recognize inflation means that profits taxes will continue to take as *return to* (i.e., earnings produced by) capital something that in fact is *return of capital* in the sense of purchasing power. Replacement costs go up but without recognition by a tax system which imposes Federal-state rates over 50 percent.

The Federal income tax (except for the \$100 dividend exclusion) no longer allows recognition of the probability that some of the tax on corporation earnings is not shifted to consumers. Shareholders as suppliers of capital bear the tax burden not passed to consumers. To this extent there is double taxation of dividends. The property tax often bears heavily upon investment in new buildings.

Finally, but not least, death and gift taxes absorb more than minor amounts each year of what could be the growth of privately supplied capital. Any examination of the role of these taxes in the economy should give attention to popular aspirations for a rising level of living which requires more capital, lots more.