Should We Have an Estate Tax?

Today's *New York Times* contains two commentaries on the estate tax. Although ostensibly presented as a debate, both commentators support the estate tax. Roberton Williams of the Tax Policy Center discusses some policy reasons for having the estate tax. Meanwhile, Yale political science professor Ian Shapiro asks, “why is the Obama administration giving hundreds of millions of dollars to that tiny sliver of the American population that constitutes the super-duper rich,” and suggests that the maximum estate tax rate should be more than 35 percent.

Williams’ commentary is the more interesting. He enumerates three reasons to have an estate tax. First, the appreciation on inherited assets might otherwise escape taxation. Second, we need the revenues so that we can reduce our deficit. Third, the estate tax encourages charitable giving.

Williams’ first argument in support of the estate tax is that it functions to tax appreciation, which otherwise has not been taxed and potentially could escape taxation. He says:

[The estate tax] taxes income that has escaped tax over a wealthy person’s lifetime. Investors pay no tax on capital gains until they sell their appreciated assets. ... Get rid of the estate tax and people will find even more ways to avoid income taxes.

We first should recognize that the estate tax taxes more than just an asset’s appreciation. A decedent’s gross estate includes an asset’s fair market value, regardless of whether the asset is appreciated.

Putting that aside, the elimination of the estate tax would not necessarily mean that appreciation would escape taxation. We could have a pure carryover basis regime (although that would be inefficient and administratively burdensome). Under that regime, there would deferral of income tax until a sale or other taxable disposition of the appreciated asset. Yes, some people would seek ways to continue deferring taxation, and, to an extent, deferral is avoidance. Nonetheless, we do not need the estate tax to tax the appreciation on an inherited asset.
If we simply are concerned with taxing the appreciation, we could design a tax that, similar to the Canadian system, generally subjects appreciation to income tax upon an individual’s death. Or, we could do as Ray D. Madoff proposes in her op-ed piece in yesterday’s New York Times, replace the estate tax with an income tax on gifts and inherited wealth. Professor Madoff’s proposal, of course, would tax more than appreciation.

Williams’ second argument in support of the estate tax is our need for revenue. He states that, even though the estate tax generates less than one percent of total federal revenues, we need that revenue to reduce our deficit. In fact, he concludes his commentary with the following remarks:

No one likes paying taxes. But our fiscal needs demand both spending cuts and increased revenue. Estate taxes fall only on the wealthiest, who have benefited most from our economy and have the greatest ability to pay. As such, it it still has an important role to play in federal tax policy.

Yes, we need to reduce our deficit, but, in and of itself, raising revenues is not a good justification for a tax. Bad taxes raises revenues. (Really bad taxes can reduce revenues.) The salient question is whether the estate tax is economically efficient and achieves desirable policy objectives.

Williams’ third argument in support of the estate tax goes to this issue of desirable policy objectives. In his commentary, Williams asserts that the estate tax promotes philanthropy. He writes:

[T]he tax encourages charitable bequests because giving away assets cuts what estates owe. One study concluded that ending the tax would reduce charitable giving by 12 percent.

It is true that there are studies that conclude that the elimination of the estate tax would reduce charitable giving. There also is a contrary view. Paul G. Schervish, who is the director of Boston College’s Center on Wealth and Philanthropy, believes that eliminating the estate tax potentially would increase wealth and, in turn, charitable giving. In a 2001 letter to the editor of the Chronicle of Philanthropy, Professor Schervish wrote:

I once was opposed to such a move [i.e., the repeal of the estate tax], counting myself among those who view the estate tax as a catalyst for charitable giving. But I now believe that philanthropy would survive—and even thrive—without the tax. ... Doing away with the estate tax would increase not only the amount of giving, but also the quality of giving. Indeed, it would be the basis for a new era of spiritual depth in philanthropy, making the voluntary act of charity more fully a work of liberty and humanitarian care, and less the windfall fruit of a convoluted tax strategy.
Promoting philanthropy is a worthy policy objective. So long as we have an estate tax, we should continue to use it as a means of encouraging charitable giving. However, should we have an estate tax solely or primarily for the reason of encouraging charitable giving? As passionate as I am about philanthropy, I am just not sure.

While supporting the estate tax, Williams acknowledges that it is imperfect and carries a significant economic cost. He writes:

But the estate tax has its downsides. People spend substantial time and money organizing their financial affairs, buying insurance policies, and constructing wills and trusts to minimize taxes on their estates, all an unproductive waste of resources.

In an article in yesterday's Wall Street Journal, Emily Maltby writes about one entrepreneur who spends about $25,000 to $50,000 every three years on legal and accounting fees relating to keeping his estate plans current. (Although it is not entirely clear from the article, the entrepreneur seems to have a gross estate that is north of $100 million.) Query whether those monies could be put to a more economically productive use.

In my experience, the estate tax is the source of a fair degree of economically inefficient activity. There, however, is one bright spot. Despite its flaws, the estate tax motivates people to plan their estates. Even people who have little or no likelihood of being subject to the tax often are motivated to undertake estate planning because of the concerns about the tax. That is not enough to justify the tax, but it is at least a curious consequence.