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Death and Taxes

By Edward C. Presscott

YOU CAN'T take it with you. Too bad, because it would sure be convenient to set up an eternal rollover account for financial assets. Just think of all the time and resources that would be saved if people didn't have to hire expensive lawyers and clever accountants to get around the government's attempt to grab a share of their earthly bounty. Not to mention the better use of those accountants' and lawyers' time.

And while we're at it, our public employees have better things to do than construct estate tax codes, design Web sites with FAQs and answer phones to explain how those taxes work, and then penalize those who unwittingly or otherwise skirt the law. Those costs are real and must be part of the equation when considering the efficacy of estate taxes.

These and other issues loom large as Congress grapples with how to deal with coming changes in estate tax law. Under the Economic Growth and Tax Relief Reconciliation Act of 2001, the estate tax is slated to expire in 2010 — for one year — and return in 2011 with personal exclusion rates that are below current levels. Today, Americans can transfer $2 million to beneficiaries federal tax free, with that rate increasing to $3.5 million in 2009 before the big switch in 2010. The House has already passed a bill to make the repeal of estate taxes permanent and the ball is now in the Senate's court.

Putting aside the inefficiencies of such inconsistent rule making, the point remains that people cannot take their IRAs with them, and the fundamental question is this: Who gets it? It's a simple question that deserves a simple answer, but when a certain little word — tax — gets involved, things are never very easy.

Economists like simplicity. It's one of our most endearing traits. As soon as you complicate things by getting between a man and his intentions you create all sorts of distortions that are often suboptimal (and are the devil to model). Taxes excel at these shenanigans. And those distortions don't end when the grim reaper comes calling. Ashes to ashes, dust to trust.

In the end, though, all those opportunity costs — both private and public — would be worth absorbing if we were really getting a good return on our estate taxes. From what I can tell, there are two main arguments in favor of an estate tax: the increased revenue that government receives to go about the people's business; and the desire to somehow balance life's unfairness by limiting the amount of capital assets that "the rich" can leave their kids.

On the second point, there is little to say except that what's fair for one is often penalty for another. What is fair, for example, about telling someone that he will be unable to distribute his hard-earned money, which has already been taxed once, to his heirs as he sees fit? Such a person has zero incentive to accept an estate tax for which he sees no justification. He will do his best to try to avoid this tax through every legal means necessary, after which he may be inclined to consume more than he otherwise would, or just quit working sooner than otherwise. And while there's nothing wrong with consuming one's assets, if such consumption comes at the expense of capital that would otherwise be put to better use, such consumption is suboptimal. Recent empirical work on the disincentive effects of estate taxes has proven these phenomena true.

And that gets to our first point about the supposed budgetary benefits of such a tax. Since an estate tax is really just another name for a tax on capital income, then there is certainly no justification for such a tax. I, and others, have written before in these pages about the inefficiency of capital income taxes, and there's no need to revive those arguments here, except to say that we can only grip the neck of our vibrant economic goose so tightly before it eventually dies and quits laying those golden eggs. And many of those golden eggs come in the form of capital that allows descendents to keep family businesses intact, or to begin new businesses that fuel our economy.

Besides, even if estate taxes were not inefficient and could be construed as fair, they would still do little to address the budget deficit. In 2003, net estate taxes accounted for $20.7 billion, a drop in the bucket of an $11 trillion economy. Clearly, we are not going to balance the budget by grave robbing.

Yet what about all the money that is left in bequests to fund university alumni buildings, art museum wings and public broadcasting? If we abolish the death tax, won't charitable organizations be hurt? I admit to a soft spot for this argument, but the fact is that people will still give to charity. In 2003, charitable contributions reported on 1040 income tax forms totaled $145 billion, which is roughly 10 times the $14.6 billion charitable contributions reported on the estate tax forms. This indicates that people are motivated to give to their favorite causes for a variety of reasons and will not cease such philanthropy if estate taxes are abolished; also, fundraisers will not lose their incentives.

The old maxim says that there are only two things in life that we can't avoid, death and taxes, but why pile on by combining the two? The Senate should join the House in permanently repealing the estate tax. ■

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