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# *An Analysis of the Disincentive Effects of the Estate Tax on Entrepreneurship*

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# EXECUTIVE SUMMARY

This paper is the second in a series of Tax Foundation studies examining federal transfer taxation. The first of these studies provided a history and overview of federal transfer taxation. This paper attempts to gauge one of the economic effects of federal transfer taxation by examining the disincentive effects of the federal estate tax on entrepreneurs.

The federal government imposes taxes on wealth transfers through its unified transfer tax system. An estate tax is paid on the contents of estates. Transfers of wealth between living persons are subject to a gift tax. Transfers to grandchildren or more distant relatives are subject to the generation skipping transfer tax. Of these, the estate tax is by far the largest generator of revenue and has the greatest effect on economic activity.

In 1994, the federal tax code includes 17 marginal transfer tax rates ranging from 18 percent on transfers of less than $10,000 to 55 percent on those in excess of $3 million. There is also a unified transfer tax credit of $192,800, which is equal to a $600,000 exemption. In addition, the benefit of the unified credit and progressive rate schedule is gradually phased out by an additional 5 percent tax on that portion of a transfer in excess of $10 million but less than $21.04 million. The effective tax rate on estates as small as $5 million is currently 44 percent. Estates over $20.04 million face an effective tax rate of 55 percent.

An individual's decision to save is part of a life-long, forward-looking process. Typically, individuals save a portion of their income during their working years so that they may consume at a comfortable level during their retirement or during periods of unemployment. People often leave bequests because there is no way of knowing when death may strike and because they wish to provide their children and grandchildren with a measure of financial security.

In many instances the nature of entrepreneurial activity also results in the accumulation of large amounts of wealth. During his or her working life, the proprietor of a relatively small manufacturing operation or family farm may accumulate millions of dollars worth of land, plant, and equipment.

Whatever motivation an individual has for accumulating wealth, his willingness to do so is affected by taxes. Perhaps the most obvious example of this is the personal income tax imposed on labor income and the returns to saving. This tax discourages productive effort and reduces the incentive to save relative to consumption.

The estate tax also discourages productive effort and saving. The effect of the tax on saving and economic activity may *vary* significantly, however, depending on the circumstances of the wealth holder.

The disincentive effect of the estate tax is especially felt by entrepreneurs. As stated above, during a lifetime it is not uncommon for the proprietor of a small business or family farm to accumulate a significant quantity of business assets and personal wealth.

This wealth is a testament to the individual's success at producing goods and services demanded by others in society. It is also a symbol of the jobs and opportunities enjoyed by others that the entrepreneur's hard work and creativity has made possible.

Because most people face sales and income taxes daily, they **have a** reasonably good sense of the effects that these taxes have on individual incentives and the economy as a whole. The effects of the estate tax, on the other hand, are more difficult to grasp since it is a tax on wealth that has been accumulated over a lifetime.

To clarify these effects, this paper presents a model of the wealth accumulation process. This model is used to compare incentives to accumulate wealth under two tax scenarios. In the first scenario, an entrepreneur's life experience of work, saving, wealth creation, and business expansion is considered in the context of current individual, corporate, and estate tax law. In the second scenario, the estate tax is eliminated and the individual and corporate income tax rates are raised until they produce the same after-tax bequest as under the first scenario. The purpose of this exercise is to develop a more intuitive feel for the dampening effects of the estate tax on entrepreneurship.

The various simulations conducted using this model showed that the estate tax has roughly the same effect on entrepreneurial incentives as a doubling of income tax rates. In other words, income tax rates would need to be nearly twice their current levels, or roughly 70 percent, to produce the same disincentive effects as the current estate tax. Furthermore, given the progressivity of the estate tax, the increase in income tax rates is greater as the size of the estate increases. Given the fact that the estate tax raises only about 1 percent of federal revenue, it is clear that the disincentive effects of the tax are well out of proportion to the revenues associated with the estate tax.

For example, consider an entrepreneur whose non-corporate business **allowed** him or her to leave an estate valued at $5.2 million, despite the disincentive effects of the estate tax. This estate under current law faces an effective estate tax rate of 44.34 percent, which is clearly a powerful disincentive facing any businessman. In fact, to achieve the same degree of disincentive it would be necessary to raise the effective individual income tax rate facing such an individual from 37 percent to over 68.21 percent.

If the business is structured as a taxable corporation and even more successful, raising the value of the entrepreneur's pre-tax bequest to $23.4 million, then the estate faces an effective estate tax rate of 55 percent. To match the disincentive effects of a 55 percent estate tax rate it is necessary to raise the effective individual and corporate tax rates from 37 and 35 percent to 72 percent and 71.66 percent, respectively.