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Is the Estate Tax Doomed?

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Under the deal struck by President Obama and Congress to avert the "fiscal cliff," the estate tax — long targeted for elimination by Republicans — survived, but in a substantially diminished form.

In 2001, the year George W. Bush became president, individual estates over $675,000 were taxed and the top rate was 55 percent. Now, the maximum tax is 40 percent and only individual estates worth more than $5.25 million are taxed (a figure that will now be automatically adjusted for inflation).

The estate tax has a history as long and controversial as the income tax. Its first modern version appeared in the federal tax code in 1916, three years after the ratification of the 16th Amendment, which authorized the federal income tax. Advocates of the estate tax see it as a crucial tool for raising revenue and a buffer against the sharp, nearly inexorable rise in inequality over the past four decades. Opponents, who call the levy "the death tax," say it penalizes savers, harms growth and interferes with parents' ability to pass on their wealth to their children.

With income inequality at levels not seen since the 1920s, and low economic mobility, some liberals hope that in the coming years our lawmakers will face intense political pressures to maintain, and even raise, taxes on inherited wealth. In this view, economic realities are building a compelling case for a more progressive tax system.

But judging from the experience of other wealthy countries, the opposite may be true. As inequality has risen in the developed world, many governments have been dismantling — not increasing — estate taxes. Countries from Austria to Canada to Sweden have abolished estate taxes outright.

There is nothing inevitable about high estate taxation in a democracy — even in an era of fiscal inequality, and even if a country is in fiscal crisis. Estate taxes have survived when their proponents have demonstrated that they are needed to ensure shared sacrifice in a collective effort. Over the past two centuries this has most often happened during the most extreme instance of national purpose: mass warfare. In an article published last year in the American Political Science Review, we presented evidence covering estate or inheritance tax rates in 19 industrialized countries over two centuries. This analysis allowed us to see the forces that have shaped estate taxation over the long run.

In many ways, our discoveries flout the conventional wisdom on estate taxation. Consider first that across the 19 countries, estate taxes are often very old. England has had such a tax since the probate duty of 1694. As early as 1791, France adopted a universal estate tax. In most cases, estate taxes were established more than a century before an income tax. The United States federal government is an exception to this pattern, but at the state level, estate taxes commonly predated income taxes by many years. Why? For much of history, it was easier for a government to record the value of an estate than to track income on an annual basis. The lesson is clear: estate taxation first arose because it was easy, not because of concerns about inequality.

Consider next a second fact: by long-term historic standards, current estate tax rates are actually relatively high. Before 1914 it was almost unheard-of for a government to maintain a top estate-tax rate above 10 percent — well below the 40 percent rate just agreed to by President Obama and Congress. Low rates prevailed both in monarchies and democracies. This was true even though the late 19th and early 20th centuries were a period of very high wealth inequality across the industrialized world. The lesson is again clear: democracies have often taxed estates lightly even during periods of rampant and rising inequality.

What happened after 1914? Governments that conscripted their populations for the two world wars also raised top rates of estate taxation to levels previously thought unimaginable. By the end of World War II, the top marginal estate-tax rate reached 75 percent in Britain and 77 percent in the United States. In strong contrast, countries that did not mobilize their populations en masse made no such change. In 1945, the top estate-tax rate in Norway was only 35 percent, and just 9.45 percent in the Netherlands. As we have shown in other work, this same divergence between countries also held for the income tax. Perhaps this divergence is no surprise. The two world wars were costly, and it may have been urgent to increase taxes on the rich along with the rest. In fact, we found that the two world wars not only led to an overall increase in taxes, but also led to the wealthy bearing a greater share of the tax burden than ever before. In the case of the estate tax, rates on large estates increased significantly more than those on small estates. But it was not just the need for revenue that explains why taxes also became more progressive in this way.

Our research identifies the political reason that estate taxes, and taxes in general, became more progressive in countries that mobilized for war. Proponents of progressive taxation made a clear case that if the broad population was to sacrifice for the war effort, then on grounds of fairness the wealthy should make a financial sacrifice to pay for the war. During World War I this came to be known as “the conscription of wealth,” a turn of phrase arguably as impressive as “death tax,” in contemporary debates. Likewise, during World War II, President Franklin D. Roosevelt and American labor unions made use of the term “equality of sacrifice” to call for heavier taxes on the wealthy. Since war debts continued after each war’s end, these two terms retained their salience even after conflict had ceased.

A striking illustration of our fairness argument can be gleaned by using the Google Ngram Viewer. This allows users to scour the archive of full-text searchable historical documents to see the frequency of specific phrases. Since John Stuart Mill’s use of the term in 1848, “equality of sacrifice” has been one proposed criterion for judging whether a tax system is fair. By the late 19th century, many economists argued that equality of sacrifice could be assured only if the wealthy were taxed more heavily than the rest. Each dollar in taxes represented a smaller sacrifice for the rich than for the poor. Nevertheless, the Ngram's evidence shows that "equality of sacrifice" gained real salience only with the advent of the First World War, seven decades after the term's introduction. See the graph:

Wartime experiences helped to reshape societal beliefs about a fair tax system. As a result, top rates increased significantly, and the estate tax for the first time had an impact on the distribution of wealth in American society. In their work on wealth inequality over time in the United States, the economists Wojciech Kopczuk and Emmanuel Saez suggest that the 77 percent top marginal estate-tax rate that prevailed after World War II helped ensure that the share of wealth owned by those at the top of the social ladder did not return to its prewar highs. However, given the fairly high exemption levels and rate thresholds, the effect of the estate tax was felt mainly by those with the very largest fortunes, and not by the merely well-to-do. This was fitting, since wartime calls for equality of sacrifice had focused above all on the very largest fortunes.

While reference to the term "equality of sacrifice" remained frequent for a time after World War II, its use nonetheless fell into steady decline as the wartime context receded. In step with this shift, since the 1970s there has been a parallel movement away from heavy estate taxation, both in the United States and in other countries that mobilized heavily for the two world wars. Outside a wartime context, arguments that estate tax rates must remain high in order to prevent undue concentration of wealth have failed to carry the day. Some countries that took part in the war, like Canada, Australia and New Zealand, have abolished estate taxes outright. Today, with a 40 percent top estate-tax rate, the United States is actually something of an outlier. Among the other 18 countries in our study, the average top marginal rate of inheritance taxation in 2011, the most recent year for which we have comparative data, was only 18.4 percent (counting those without a tax as having a rate of zero).

The question for supporters of the federal estate tax, and for proponents of progressive taxation more generally, is how the downward trend in estate taxation might be stopped. As the United States shifts to fighting wars with precision weapons and a relatively small volunteer Army, the argument that taxation of the rich is necessary in wartime to ensure equal sacrifice will no longer be convincing. How can one ask the wealthy to sacrifice for war when much of the rest of the population isn't really sacrificing either?

We believe that the future of the federal estate tax will instead depend on its advocates' showing that it is needed to ensure shared sacrifice of a new kind in an era of more limited wars. The same can be said for progressive taxation in general. Advocates of progressive taxation cannot assume that rising inequality will create irresistible pressure for higher taxes on inherited wealth. They will need to construct a compelling narrative of shared sacrifice, but shared sacrifice for what?

Our research shows that a narrative like this cannot be constructed out of thin air. It instead requires dramatic external events providing proponents of progressive taxation with a way to recast the debate. It is always possible that economic crisis could constitute such a new event. Absent a new narrative of this sort, we expect a continued, long-run trend toward lower taxation of the rich, and as part of this, lower taxation of estates. This also implies either that federal revenues will not rise — or if they do, then new revenues will most likely come from nonprogressive sources like a national sales tax. In short, the survival of the estate tax, and of progressive taxation as we have known it, may only be temporary.

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