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The Politics of Estate Tax Reform

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If it seems as if Congress has been wrangling over the estate tax for decades, that is because it has. Though majorities in both houses of Congress have supported repeal and the law has been changed frequently, the death tax just will not die. Why not? The short answer is: because politicians like seeing the tax languish on its deathbed.

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The explanation for this seemingly morbid desire is straight-forward, but usually ignored.

Politicians as a Special Interest Group. In *The Logic of Collective Action* (1965), economist and political scientist Mancur Olson pointed out that organizing to get government benefits is costly. Potential members of a group have an incentive to sit on the sidelines and "free ride" while others do the work — and pay the costs. Olson concluded that collective action involving small groups with high stakes can reap benefits that outweigh the "cost" of policing free riders. These groups have come to be known as "special interests."

Linda Cohen and I developed a hypothesis: Politicians *like* special interests because they like money, and they need organized interests to pay them. Politicians thus proactively create or frame issues of high stakes to small groups. Once politicians have these issues, they have little interest in resolving them. The debate itself is a continuing opportunity on all sides of the issue to raise campaign contributions. Estate tax repeal is a perfect example.

Rich families pay to get rid of the tax; investment banks, insurance companies, large nonprofits and others pay to keep it. According to a study published by the pro-estate tax groups Public Citizen and United for a Fair Economy, a group of 18 families, spending at least $27.7 *million* of their own money, orchestrated an effort aimed at repeal that totaled almost $500 million in lobbying expenditures between 1998 and 2004 alone. Nice work if you can get it, and Congress got it.

There are similar incentives on the other side. In 1986, Congress instituted a generation-skipping tax (GST) on top of the estate tax to prevent multigenerational asset transfers designed to escape the estate tax. Following the law of unintended consequences, the GST simply led to the repeal of the hallowed rule against perpetuities and the rise of dynasty trusts. By 2003, some $100 billion worth of assets had moved into long-lived dynasty trusts, largely in South Dakota, a state whose revised laws welcomed the strange creatures from all over America. Even a small piece of that enormous pie as fiduciary or other fees for assets under management would give some small groups high stakes to keep the estate tax alive.

As long as there are votes that threaten to resolve the issue to either side's advantage, there is money to be had. And so, we predict, Congress will vote on the matter over and over, avoiding a final resolution.

Recent Estate Tax History. In the past decade, there have been multiple votes to abolish estate taxation. The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) gradually reduced estate tax rates and repealed the tax for a single year (2010). The tax is scheduled to return in 2011, at pre-2001 rates.

One might think that merely makes the heirs of those who die in 2010 particularly lucky, but that is not the case. EGTRRA created another huge incentive for Congress to act by subjecting the sale of estate assets to a "carryover basis" regime in 2010. Instead of valuing the assets for income tax purposes at the fair market value at the time they are inherited (called "stepped-up basis"), carryover basis requires heirs to pay income tax on the increase in value (capital gain) from the original purchase date of the asset decades before. Thus, although there is no estate tax at the moment, heirs of small businesses may end up paying more in income taxes than their estate tax liability would have been.

Carryover basis raises the effective tax rate and is extremely difficult to calculate. Adding this provision further ensures that accountants, estate lawyers and heirs will demand Congress act — now! That is just what Congress wants. It is also precisely what happened when the Tax Reform Act of 1976 instituted carryover basis. Four years later it was repealed — retroactive to the date it became effective!

"Politicians benefit from the death tax debate."

Not Quite Repealing the Estate Tax. In 2001, there were enough votes for permanent repeal of the estate tax. There were ample resources in the $1.3 trillion surplus left for the incoming president, George W. Bush, who had sworn death to death taxes repeatedly on the campaign trail. But instead of repeal, EGTRRA was passed.

Since EGTRRA, Congress has voted on the issue repeatedly, coming up just short of the 60 votes needed for outright repeal in the Senate. Far more than 60 sitting Senators voted to repeal on multiple occasions — but not at the same time. Senators, including many prominent Democrats, simply flipped back and forth.

Furthermore, when the "Byrd Rule" — which in effect requires a 60-vote Senate majority to permanently repeal a tax — expired in October 2002, Republicans could have killed the estate tax with 50 votes in the Senate. Instead, they quietly renewed the Byrd Rule.

All of this proves what the present state of the tax shows full well — Congress, including Republicans, wants a sick but not yet dead tax: the better to vote on, my dear.

Conclusion. Higher exemption levels and rates preserve the game: they keep the estate tax a matter of high stakes (because of the rates) to small groups (because of the exemption levels). Thus I expect Congress to reinstitute the estate tax at 2009 levels, with a $3.5 million per person exemption and 45 percent rates, retroactive to January 1, 2010. This is after all what President Obama called for, and what a vast majority of Congress and sensible observers would support. Just do not expect it anytime too fast: that would be good lawmaking, not good fundraising. And one more thing: As the country recovers from the current economic troubles and more families exceed those numbers, anticipate another round of votes on estate tax repeal in a few years.

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