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As Sure as Death and the Estate Tax

Death and Taxes

Antony Davies and James R. Harrigan

Perhaps sensing an opportunity to co-opt the Bernie Sanders voters who have yet to give her the time of day, Hillary Clinton has come back to class warfare, making the so-called death tax a late-entry campaign centerpiece. Her proposal is to tax estates over $10 million at 50 percent, estates over $50 million at 55 percent, and estates over $500 million at 65 percent, which would be the highest estate tax rate since 1981.

This works as class warfare precisely because the amounts involved are so high. Only the truly wealthy would be subject to the tax, and almost everyone else could rest comfortably knowing that the rich are being forced to pay their "fair share," whatever that means in practice. But as the saying goes, there is nothing as sure as death and taxes. And before we line up behind Clinton's gambit to soak the rich, we should take a careful look at what happened when politicians foisted the income tax on an unsuspecting American public 103 years ago.

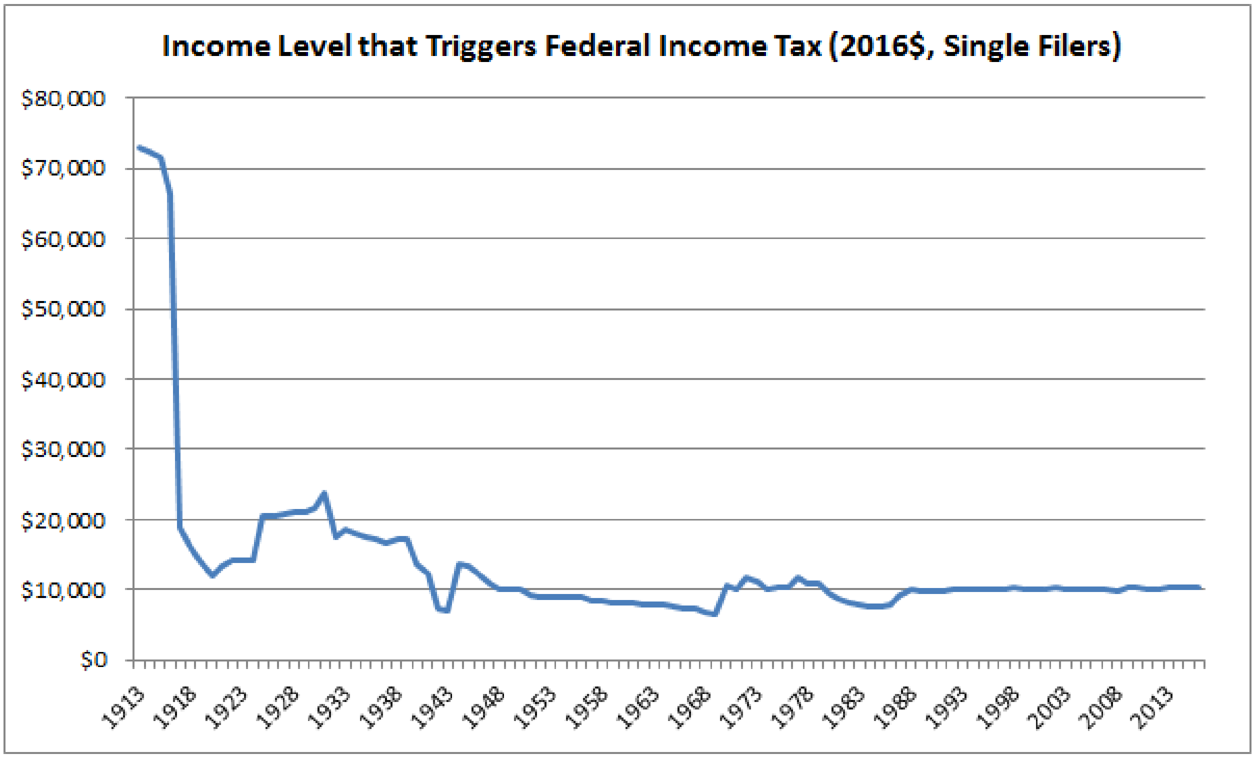
As it was written, the Constitution prohibited a federal income tax. It took the 16th Amendment to bring the tax to life when it was ratified in 1913.

Then, as now, politicians assured voters that the new federal income tax would only apply to the rich. In supporting the income tax, Representative William Sulzer of New York said the tax would make it "possible for the Government to...make idle wealth pay its just share of the ever-increasing burdens of taxation." Politicians assured poor and middle-class American voters that the income tax would only apply to the rich. And so it did. For a grand total of four years.

Originally, the federal income tax only applied to people earning over what today would be $73,000. It kicked in at 1 percent for incomes up to $487,000, and topped out at 7 percent for people earning over, in today's terms, $11 million.

But by 1917, Congress had doubled the bottom tax rate and slashed the deductions and exemptions. Just four years after it was created as a tax on the rich, the federal income tax applied to people earning as little (in today's terms) as $18,000. Of course, this was at the tail end of the first World War, so one might excuse politicians for reaching into middle-class and poor pockets. It was, after all, a national emergency.

But then as now, national emergencies create what becomes the new normal. Increased taxes somehow never return to lower levels when emergencies end. The year that World War I concluded, Congress again doubled the bottom tax rate to 4 percent and again lowered deductions and exemptions. By this point the income tax applied to people earning as little as $16,000 in today's dollars. By 1924, the bottom tax rate applied to people earning just $14,000.



In 1913, the federal income tax only applied to people earning over $73,000 (in 2016 dollars). Today, the federal income tax applies to anyone earning over $10,350. (Data sources: Tax Foundation, Bureau of Labor Statistics)

The bottom income tax rate remained at 4 percent or below until the next national emergency, World War II, at which time Congress quadrupled the bottom tax rate to over 20 percent. To leave no source of revenue untapped, Congress then applied this "tax on the rich" to people earning as little as $7,000 (in today's terms).

Today, a popular argument is that we need the estate tax to "recycle" money back into the economy. This is not true. The whole point of financial markets is to make people's savings available to others who want to borrow. Saved money is already flowing through the economy in the form of home loans, college loans, car loans, and credit card lending. Meanwhile, wealth held in the form of business assets is producing goods and services for consumers and investment income for savers. And herein lies the greatest danger of the estate tax: The estate tax erodes small businesses to the benefit of large corporations.

A recent study of federal and state inheritance and estate taxes showed that increasing these taxes slowed the growth in the number of small businesses (those with fewer than 100 employees) and accelerated the growth in the number of large businesses (those with 500 or more employees). This is because heirs who inherit small businesses must liquidate portions of those businesses to raise the money necessary to pay inheritance and estate taxes. Conversely, when heirs inherit stock in a corporation, the payment of taxes owed on the inheritance has no effect on the corporation.

While politicians claim that the estate tax is aimed only at the extremely wealthy, the extremely wealthy can afford teams of lawyers and accountants to shield their wealth. A good case in point is the approximately $400 million presently held by the Clinton Foundation. Because the Clinton Foundation is a non-profit entity, that money is exempt from the very estate tax that Hillary Clinton now peddles. And as the estate tax inevitably expands to capture the middle-class and poor who can't afford lawyers and accountants, it will be the middle-class and poor who end up being its helpless victims.

The federal tax code has become a monster that is beyond everyone's comprehension at the same time that no one is beyond its reach. Buried among its 75,000 pages of text, so incomprehensible that even the people who wrote and administer the code don't fully understand it, are myriad special provisions for favored industries - each of which buys votes for politicians, rewarding them for the complexity.

The income tax is a warning to the rest of us of what awaits us with the estate tax. Like the politicians of 1913, Hillary Clinton tells us not to fear the estate tax because it only applies to the very few who are very wealthy. That's true for now. But expect it not to remain true for long. It took politicians just four short years to expand the income tax from a "tax on the rich" to a tax on everyone. The same fate awaits us with the estate tax.

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