Center on Budget and Policy Priorities

820 First Street NE, Suite 510
Washington, DC 20002

Tel: 202-408-1080
Fax: 202-408-1056

center@cbpp.org
www.cbpp.org

June 8, 2006

# ESTATE TAX REPEAL WOULD DECREASE NATIONAL SAVING
## Long-Run Impact on Economy Negligible and Possibly Negative

By Aviva Aron-Dine

Repeal of the estate tax would add about $1 trillion to federal deficits over the first decade in which its costs would be fully felt (2012-2021). These higher deficits would reduce national savings, with the consequence that, in the long run, estate tax repeal would have at best negligible, and possibly negative, effects on the economy.

Surprisingly, however, many supporters of estate tax repeal argue that either repeal or elimination of most of the estate tax would significantly *increase* saving. They contend that, although the direct benefits of repeal would go to a small number of extremely wealthy individuals, lower tax burdens would lead these individuals to save more. This, in turn, would increase national investment and economic growth, providing widespread benefits. A recent report by the majority staff of the Joint Economic Committee, for example, asserts that the U.S. capital stock would be larger had the estate tax never existed (see box on page 3), while a recent *Washington Post* column by Senator Jeff Sessions trumpets Heritage Foundation claims that the estate tax reduces the capital stock and costs the U.S. economy hundreds of thousands of jobs per year.[1]

Such estimates rely on dubious assumptions about how individuals would react to estate tax repeal. They ignore the conclusion of the non-partisan Congressional Research Service that, given the available evidence on private saving behavior, "a reasonable expectation is that the effects of cutting the estate and gift tax on savings would not be large and would not even necessarily be positive."[2]

Even more problematic, repeal supporters appear to forget that national saving has two components: private and public (government) saving. When the federal government runs a surplus, this adds to national saving. In contrast, when the government runs a deficit, it pays for the shortfall by borrowing money from the private sector. This borrowing consumes a portion of private savings, lowering net national saving. When the government runs a deficit, it is said to "dissave."

Repeal advocates rely on estimates that simply assume that the cost of repeal will be fully offset, which enables them to ignore the crucial question of how repeal would impact government saving. In reality, since proponents of repeal have proposed no measures to pay for its large cost, repeal of

[1] Jeff Sessions, "… Or Unfair Burden on Families?" *Washington Post*, June 5, 2006.

[2] Jane Gravelle and Steven Maguire, "Estate and Gift Taxes: Economic Issues," Congressional Research Service," updated April 8, 2005.

the estate tax would lead to significantly higher deficits (that is, to public dissaving) and consequently to *reduced* national saving.

## Repeal's Effect on Private Savings Unknown

Considering the effect of estate tax repeal on national saving is important because national saving is a key determinant of investment and long-term economic growth. Increases in national saving make more funds available for investment, which increases the size of the capital stock: the total supply of equipment, buildings, and other productive capital in the economy. With more capital available, future workers are more productive, and the increased productivity yields higher national income.

According to the Congressional Research Service, "virtually no empirical evidence about the effect of estate and gift taxes [on saving behavior] exists."[3] Evidence does exist, however, regarding the effect of taxes on saving more generally. As the Congressional Budget Office has noted, most empirical evidence suggests that taxes have relatively little impact on private saving.[4]

Repeal supporters argue that the estate tax, because it imposes a tax on accumulated wealth, encourages individuals to consume rather than save; without such a tax, they contend, people would consume less and save more. But whether estate tax repeal would actually increase private saving depends on several key unknowns.

First, it depends in part on *why* people save. If an individual saved simply in order to leave larger inheritances to his heirs, then repeal of the estate tax might encourage him to save more, because each dollar saved would contribute more toward his heirs' inheritances. On the other hand, suppose that an individual hoped to leave his heirs inheritances of a particular size. In this case, he would save less if the estate tax were repealed, because he could provide the target inheritance without accumulating as much wealth (since no tax would have to be paid on the estate).

Second, it depends on what *heirs* do with their inheritances. On the one hand, heirs would inherit more wealth if the estate tax were repealed, and so would have more assets available to save and invest productively, should they choose to do so. On the other hand, if they have greater wealth to begin with, heirs might conclude that they have less need to save for the future, preferring instead to spend more of their inheritances. Studies that predict that estate tax repeal would increase private saving most often simply ignore the question of how repeal would impact saving by heirs.

Ultimately, because the answers to these questions are unknown, so is the true effect of estate tax repeal on private saving. In a detailed examination of the possible effects of the estate tax on saving, Brookings Institution economist William Gale and Federal Reserve economist Maria Perozek find that, under a number of plausible assumptions, lower estate tax rates might actually *reduce* saving (for example, if individuals save just enough to leave their target bequests, or if heirs decrease saving when they receive larger inheritances). Indeed, as noted above, the Congressional Research Service

---

[3] Jane Gravelle and Steven Maguire, "Estate and Gift Taxes: Economic Issues," Congressional Research Service," updated April 8, 2005.

[4] Congressional Budget Office, "An Analysis of the President's Budgetary Proposals for Fiscal Year 2007," March 2006.

**Joint Economic Committee Estate Tax Report Similarly Flawed**

In a recent report, the majority staff of the Joint Economic Committee asserts that the U.S. capital stock would be $847 billion larger today had the estate tax never existed.[a] This estimate has since been repeated in other articles by supporters of estate tax repeal.

The estimate, however, suffers heavily from the flaws described in this analysis. First, it relies on unsubstantiated assumptions about the responsiveness of saving and investment to the estate tax. As the Congressional Research Service notes, the true impact of eliminating the estate tax on private saving behavior is simply unknown.

Second, the estimate implicitly assumes that had the estate tax never existed, all of the revenue collected by the tax since its inception in 1916 would have been replaced by other tax revenue or offset by spending reductions. Otherwise, the loss of estate tax revenue would have added to deficits, reducing government savings and thereby offsetting the gains to national saving and the capital stock from the assumed increases in private saving.

The JEC report is misleading, in that it never mentions the tradeoff implicit in its estimate: the assumption that, in the absence of the estate tax, other taxes would have been higher or government services over the past 90 years would have been reduced. Instead, the majority JEC staff misleadingly implies that its estimate is a useful guide to the future impact of estate tax repeal. In fact, unpaid-for repeal would likely *decrease* (not increase) national saving and so would have, by the JEC report's own logic, a *negative* impact on the capital stock.

[a] Joint Economic Committee, "Costs and Consequences of the Federal Estate Tax," May 2006.

concluded based on this and other research that cutting the estate and gift tax would have a small and potentially even a negative effect on savings.

## Effect of Repeal on National Savings Is Negative

Estimates from the Joint Committee on Taxation indicate that estate tax repeal would cost $776 billion over the first decade (2012-2021) in which its budgetary effects would be fully felt. Because supporters of repeal have not proposed any measures to offset these costs, estate tax repeal would add to federal deficits and debt, leading to $213 billion in additional interest costs over the same ten-year period.[5] In total, estate tax repeal would thus add nearly $1 trillion to federal deficits between 2012 and 2021.

All else being equal, this increase in deficits — or, in other words, in government dissaving — would translate into a $1 trillion reduction in national savings over the same period. Even if highly optimistic assumptions are made about the responsiveness of private saving behavior to repeal, increased saving by households would offset only a fraction of this increase in government dissaving, meaning that the net effect of repeal would be to *decrease* national savings. The Congressional Research Service concludes: "even if the responsiveness [of private saving behavior]

[5] Interest is calculated using CBO's standard methodology for calculating the effect on debt and interest payments of tax cuts and spending increases that are not offset. For a more detailed discussion of these cost estimates, see Joel Friedman, "The High Cost of Estate Tax Repeal," Center on Budget and Policy Priorities, June 5, 2006.

to the estate and gift tax is as large as the largest [estimate of such responsiveness], the effect on savings and output would be negligible and *more than offset by public dissaving*. Indeed, if the only objective were increased savings, it would probably be more effective to simply keep the estate and gift tax and use the proceeds to reduce the national debt" [italics added].[6]

When repeal supporters highlight the crucial importance of national saving to economic growth, what they really establish is the importance of *not* adding further to deficits. Their arguments logically lead to the conclusion that estate tax revenue should be preserved, not largely or entirely eliminated.

[6] Jane Gravelle and Steven Maguire, "Estate and Gift Taxes: Economic Issues," Congressional Research Service," updated April 8, 2005.