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REPORTS CALLING FOR ESTATE TAX REPEAL SERIOUSLY FLAWED

Repeal Would Increase Deficits and Likely Slow Economic Growth as a Result

by Chye-Ching Huang, Gillian Brunet, and Chuck Marr[1]

Despite questionable reports to the contrary, repealing the estate tax would weaken the economy by adding nearly $800 billion to budget deficits over 10 years, thus reducing national saving and leaving fewer funds for investment that leads to higher productivity in the long run.

Two recent reports from the American Family Business Foundation, a group funded by wealthy families that stand to receive large windfalls if Congress repeals the estate tax, implausibly claim that repeal would create 1.5 million jobs at literally no cost. The more noteworthy of those two reports, coauthored by former Congressional Budget Office director and McCain presidential campaign advisor Douglas Holtz-Eakin and Cameron T. Smith, claims that repeal would induce wealthy donors to save and work more, thereby boosting investment, job creation, and growth.[2] The report — which, according to the Urban Institute–Brookings Institution Tax Policy Center, "gets the economics all wrong" and "relies on back-of-the-envelope analysis rather than empirical data"[3] (see box on page 5) — suffers from two fundamental flaws:

KEY FINDINGS

- Two recent reports from the American Family Business Foundation ("AFBF"), a group funded by wealthy families advocating for elimination of their estate taxes, make highly implausible claims about the impact of repealing the tax.
- One report, by former CBO director Douglas Holtz-Eakin and Cameron T. Smith, ignores the fact that repeal would expand deficits by $798 billion in the first decade alone unless offset by other tax increases. Those larger deficits would likely slow long-term economic growth by reducing the amount of funds available for investments that boost productivity.
- This report also overstates the evidence that repeal would increase saving by individuals. Studies suggest that cutting the estate tax would increase private saving only modestly at best — and by nowhere near enough to offset the large public "dissaving" and adverse economic effects caused by increased deficits.
- The other AFBF report, by longstanding tax-cut advocate Stephen Entin, claims that repealing the estate tax would actually *increase* government revenues. Its own dubious assumptions and opaque methodology underscore the implausibility of this claim.

[1] Significant research was contributed by Erin Scharff.

[2] Douglas Holtz-Eakin and Cameron T. Smith, "Changing Views of the Estate Tax: Implications for Legislative Options," Feb, 2009, report prepared for the American Family Business Foundation. For a discussion of the other AFBF report, "Economic Impact of the Estate Tax," see the text box on page 8.

[3] Ben Harris, "The Estate Tax and the Economy," TaxVox Blog, Urban-Brookings Tax Policy Center, June 18, 2009, http://taxvox.taxpolicycenter.org/blog/_archives/2009/6/18/4226020.html.

- **It ignores the increased deficits that would result from repealing the estate tax (unless the cost of doing so were offset), which would likely weaken economic growth over the long term.** These increased deficits would lower *national saving*, which is the sum of private and public (i.e., government) saving. When the federal government runs a deficit, it pays for the shortfall by borrowing money from the private sector; this consumes a portion of private saving and thus lowers national saving. (As a result, when the government runs a deficit, it is said to "dissave.") National saving is a key factor in long-term economic growth: increases in national saving make more funds available for investments that boost workers' productivity, which in turn expands the economy and raises living standards.

  Relative to extending the estate tax in its 2009 form, as President Obama has proposed, repeal of the tax would add $798 billion to deficits over the first decade in which its effects would be fully felt (2012-2021), decreasing federal revenues by $630 billion[4] and increasing interest payments on the national debt by $168 billion. Unless offsetting policy changes were made, that $798 billion increase in deficits would translate into a reduction in national saving.[5] That, in turn, would reduce the amount of domestic capital available for investment, likely slowing future growth in productivity and GDP.[6]

- **The report overstates the evidence that repeal would boost private saving.** Studies suggest that the net impact of estate-tax repeal on individuals' work and saving rates is likely to be small and might even be negative. Donors simply do not alter their work or saving rates much in response to estate taxes. Moreover, studies on the potential impact on *heirs* — including an earlier study by Holtz-Eakin himself[7] — suggest that heirs would likely work and save somewhat *less* if the estate tax were reduced (since they would acquire more wealth without having to work or save as much).

  Even under the most optimistic reading of the evidence, cutting the estate tax would increase private saving by only a small amount. In any event, the increase in government deficits (or public "dissaving") from an unpaid-for reduction in the estate tax would *more than offset* any increase in private saving. The Congressional Research Service (CRS) has explained:

  > "[I]t appears difficult to argue for repeal of the estate tax to increase private saving. Even if the responsiveness to the estate and gift tax is as large as the largest empirical estimates … the effect on savings and output would be negligible and more than offset by public dissaving. Indeed, if the only objective

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[4] Based on estimates from the Joint Committee on Taxation, April 2009. These estimates include all federal revenue losses resulting from repeal.

[5] See detailed discussion on page 3 below.

[6] See Aviva Aron-Dine, "Estate Tax Repeal Would Decrease National Saving," Center on Budget and Policy Priorities, June 8, 2006, http://www.cbpp.org/cms/index.cfm?fa=view&id=352.

[7] Douglas Holtz-Eakin, David Joulfaian, and Harvey S. Rosen, "The Carnegie Conjecture: Some Empirical Evidence," *Quarterly Journal of Economics*, May 1993.

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."[8]

Repeal Would Add Considerably to Deficits, Weakening Economic Growth

The harmful impact on the deficit is the "elephant in the room" for advocates of estate tax repeal. Holtz-Eakin and Smith attempt to dismiss the issue, stating that due to "the relatively small overall contribution of the estate and gift taxes to overall federal revenues — less than 2 percent … any changes in estate tax revenue may be relatively easily offset with changes to the remainder of the revenue structure."[9] Yet the report proposes no such offsets, and members of Congress who push repeal have rarely, if ever, proposed specific measures to pay for it.

Furthermore, Holtz-Eakin and Smith's general suggestion to raise other taxes to offset the cost of estate tax repeal would almost certainly shift the overall tax burden away from the nation's wealthiest families and toward the less affluent, since the estate tax is the nation's most progressive tax. Currently, the estates of 99.75 percent of Americans who die are entirely tax-free, according to the Tax Policy Center. Increasing other, less progressive taxes to offset estate tax repeal would effectively mean that Americans of more modest means would be paying for a tax cut for the wealthiest estates.

Perhaps for this reason, proponents of eliminating most or all of the estate tax generally avoid proposing specific offsets. For example, Senators Blanche Lincoln and Jon Kyl have suggested no offsets to cover the cost of their recent proposal to slash the tax,[10] which would add nearly $118 billion to deficits over the 2012-2021 period, compared to making the 2009 law permanent. (The deficit would be increased by $91 billion in revenue losses and by $27 billion in increased interest payments on the debt).[11]

Estate-tax repeal would be even more expensive. Over 2012-2021, repeal would, as noted, cost the public $798 billion compared to continuing the current tax — $630 billion in lost revenues plus $168 billion in interest payments.

Effect on National Saving

By substantially increasing deficits, repeal of the estate tax would lower national saving. As noted, national saving has two components: private saving and public (or government) saving. When policymakers cut taxes but do not offset the cost, the resulting deficits decrease public saving (that is, they result in public "dissaving"). When this reduction in public saving is not fully offset by

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[8] Jane G. Gravelle and Donald J. Marples, "Estate and Gift Taxes, Economic Issues," Congressional Research Service, March 19, 2008, http://wikileaks.org/leak/crs/RL30600.pdf.

[9] Holtz-Eakin and Smith.

[10] The proposal would raise the estate tax exemption to $10 million per couple, lower the top tax rate on the portion of an estate that is taxable from 45 percent to 35 percent, and weaken the tax in other ways. For an analysis of the proposal see Chuck Marr and Jason Levitis, "Lincoln-Kyl Estate Tax Amendment is Both Unnecessary and Unaffordable," Center on Budget and Policy Priorities, April 10, 2009, http://www.cbpp.org/cms/index.cfm?fa=view&id=2759.

[11] Center on Budget and Policy Priorities calculations based on estimates from the Joint Committee on Taxation.

increases in the saving of domestic businesses and households,[12] overall national saving declines. As explained below, there is nothing special about the estate tax that makes it plausible that cutting this particular tax would lead to an increase in private domestic saving anywhere near large enough to offset the decrease in public saving.

A decline in national saving hurts the economy in the long run by: (1) making fewer funds available to invest in productive assets within the United States, which causes the productivity of U.S. workers to be lower than it otherwise would be; and (2) requiring the United States to borrow more from other countries, which reduces future national income since the income earned on investments made by foreign lenders is sent abroad. A combination of the two effects is the most likely scenario.[13]

Report Overstates Potential Increase in Private Saving

The Holtz-Eakin and Smith report claims that eliminating the estate tax would increase the amount of private saving available for investment by a startling $1.6 trillion, resulting in the creation of 1.5 million jobs. This claim is based on highly unrealistic assumptions that do not withstand scrutiny. In fact, cutting the estate tax likely has a mix of positive and negative impacts on private saving; the net impact is uncertain and probably small in any event. The Congressional Research Service (CRS) has reported, "the effects of cutting the estate and gift tax on savings would not be large and would not even necessarily be positive."[14]

The Effect of Repeal on Donors Is Ambiguous

The Holtz-Eakin and Smith report relies heavily on two studies — one by David Joulfaian, the other by Wojciech Kopczuk and Joel Slemrod — that found that donors reduced their saving rates in response to estate taxes.[15] However, both studies emphasized that donors may report smaller bequests to the IRS when estate taxes are higher *not* because they actually have bequeathed less wealth, but because they have used more aggressive tax avoidance and tax planning techniques to hide their wealth from the IRS. Kopczuk and Slemrod noted that their evidence was "suggestive rather than definite."[16] As the CRS observed, "the authors stress[ed] the many limitations of their results."[17] But Holtz-Eakin and Smith ignore these important caveats.

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[12] Deficits would not reduce national saving if, when the government ran a deficit, households increased their own saving by enough to fully offset the government dissaving. But such an effect is not plausible; the empirical evidence suggests a far more limited private response, including in the case of deficit-financed tax cuts. See D. Andrew Austin, "Running Deficits: Positives and Pitfalls," Congressional Research Service, September 20, 2006. See also Aviva Aron-Dine and Robert Greenstein, "The Economic Effects of a Pay-As-You Go Budget Rule," Center on Budget and Policy Priorities, March 19, 2007, www.cbpp.org/files/3-19-07bud.pdf/.

[13] See Aron-Dine and Greenstein.

[14] Gravelle and Marples.

[15] David Joulfaian, "The Behavioral Response of Wealth Accumulation to Estate Taxation: Time Series Evidence," *National Tax Journal,* June 2006; Wojciech Kopczuk and Joel Slemrod, "The Impact of the Estate Tax on the Wealth Accumulation and Avoidance Behavior of Donors," *Rethinking Estate and Gift Taxation,* eds. William G. Gale, James R. Hines, Jr., and Joel Slemrod (Washington, DC: Brookings Institution Press 2001).

[16] Kopczuk and Slemrod

[17] Gravelle and Marples.

Urban Institute–Brookings Institution Tax Policy Center
Skewers Holtz-Eakin and Smith Study[a]

In a commentary on Holtz-Eakin and Smith's paper on estate tax repeal issued on June 18, the Urban Institute–Brookings Institution Tax Policy Center (TPC) observed that "the paper — perhaps because it relies on back-of-the-envelope analysis rather than empirical data — gets the economics all wrong."

TPC noted that Holtz-Eakin and Smith claim that estate tax repeal would increase small business payrolls by 1.5 million jobs and reduce the unemployment rate by a full percentage point. TPC noted "These are fairly remarkable claims for a tax that directly falls on only 0.2 percent of decedents, or 6,000 estates."

TPC added, "The estate tax can't have much effect on hiring by small businesses because hardly any owners ever face the estate tax. Most small businesses are worth far less than the exemption level (currently set at $7 million per couple, and higher for many small business owners who value their firms at below market price). We estimate that only 100 small businesses and family farms will pay any tax in 2009…"

TPC also notes that the report "fail[s] to account for the net effects of repealing the estate tax" — that is, for the effects of the large increases in deficits (or in other taxes) that could result. TPC concludes that "Depending on how this other revenue is generated — or if it's collected at all — the estate tax repeal could depress future economic growth."

[a] See Ben Harris "The Estate Tax and the Economy," Tax Policy Center, June 18, 2009
http://taxvox.taxpolicycenter.org/blog/_archives/2009/6/18/4226020.html

The evidence that cutting the estate tax would, in fact, lead donors to work or save more is extremely limited. A survey of the empirical literature by New York University tax expert Lily Batchelder concludes, "[t]o date, there is not firm evidence that potential donors actually decide to reduce their level of work, saving, and giving because of the potential bite of the estate tax."[18]

As Batchelder observes, the studies by Joulfaian and by Kopczuk and Slemrod "have found that the magnitude of reported wealth transfers is only slightly responsive to the wealth transfer tax rate."[19] That is, cutting the estate tax would produce only modest increases in donor work and saving at best. Moreover, even these potential gains are questionable because the studies' results "are fragile and may be the product of tax avoidance responses rather than real changes in the amount of wealth transferred."[20] Similarly, a CRS analysis noted that the changes Kopczuk and Slemrod found in donor work and saving were small and did not persist with changes in the data sets and specifications.[21]

It should also be noted that Holtz-Eakin and Smith's estimates of the gains in saving and jobs

[18] Lily L. Batchelder, "Taxing Privilege More Effectively: Replacing the Estate Tax with an Inheritance Tax," Brookings Institution, Hamilton Project Discussion Paper, June 2007.

[19] Lily L. Batchelder and Surachai Khitatrakun, "Dead or Alive: An Investigation of the Incidence of Estate and Inheritance Taxes," October 28, 2008, available at SSRN: http://ssrn.com/abstract=1134113.

[20] Batchelder and Khitatrakun.

[21] Gravelle and Marples.

from estate-tax repeal reflect the assumption that in repealing the tax, Congress would not alter the current preferential treatment of bequests under the capital gains tax. Under current law, if heirs sell an asset they have been bequeathed, they pay capital gains tax only on the difference between the sale price of the asset and its value at the time of the decedent's death. But most proposals to repeal the estate tax — including the 2001 tax law, which repeals the estate tax for one year in 2010 — also eliminate the preferential capital-gains treatment of bequests. They require that heirs who sell an inherited asset pay capital gains tax on the full amount by which the sale price exceeds the asset's value when the decedent *originally acquired it*. (If estate-tax repeal proposals did not include this feature, their budgetary cost would be even greater.) If Holtz-Eakin and Smith had modeled this situation, they likely would have found significantly smaller benefits from estate-tax repeal.

Finally, studies indicate that the saving behavior of most donors is not very responsive to changes in estate tax rates. As a result, experts generally consider the tax a relatively efficient source of revenue[22] — i.e., one that alters people's behavior (and thus burdens the economy) less than other taxes.[23]

Repeal Would Likely Reduce Heirs' Work Effort and Perhaps Saving

Any increase in donor saving from cutting the estate tax must be weighed against the impact on *heirs'* saving and work effort. Studies on this issue — one of which Holtz-Eakin himself co-authored — indicate that heirs would *reduce* their work and saving rates if the tax were cut because they would then inherit (or expect to inherit) larger amounts.[24]

- A 1992 study by Holtz-Eakin, David Joulfaian, and Harvey S. Rosen found "results consistent with Andrew Carnegie's century-old assertion that large inheritances decrease a person's labor force participation. For example, a single person who receives an inheritance of over $150,000 is roughly four times more likely to leave the labor force than a person with an inheritance below $25,000."[25]

- A more recent study found that "receiving an inheritance increases the probability of retiring earlier than expected by … 12 percent."[26]

- Joulfaian, a Treasury Department economist, found that "when people inherit more than $150,000 (in 1989 dollars), their labor force participation falls on average by 9 percentage points

[22] See Batchelder and Khitatraken, and Batchelder 2007. This assumes that the rates and amount of tax raised do not change for other reasons.

[23] Lily L. Batchelder, "Estate Tax Reform: Issues and Options," *Tax Notes,* February 2, 2009.

[24] This intuition is sometimes referred to as "the Carnegie Conjecture." Carnegie observed that "the parent who leaves his son an enormous wealth generally deadens the talents and energies of the son, and tempts him to lead a less useful and worthy life than he otherwise would," quoted in David Joulfaian, "Inheritance and Saving," October 2006, NBER Working Paper 12569. Carnegie strongly supported a progressive inheritance tax.

[25] Douglas Holtz-Eakin, David Joulfaian, and Harvey S. Rosen, "The Carnegie Conjecture: Some Empirical Evidence," *Quarterly Journal of Economics*, May 1993, p. 413. Amounts cited are in 1982 dollars.

[26] Jeffrey R. Brown, Courtney C. Coile, and Scott J. Weisbenner, "The Effect of Inheritance Receipt on Retirement," NBER Working Paper No. 12386, July 2006.

and their labor earnings by 12 percent."[27] His study tentatively concluded that "large inheritances depress [heirs'] saving."[28]

- Another study, looking at the role of inheritance in the overall economy, suggests that expectations of inheritance reduce the national savings rate.[29]

Thus, to the extent that repeal or reduction of the estate tax would increase the size of the inheritances that heirs receive, it would be expected to decrease their work effort[30] and (somewhat more tentatively) to reduce their saving rates. The Holtz-Eakin and Smith report claiming that estate tax repeal would increase jobs and investment ignores this factor.

In sum, there is only fragile evidence that the estate tax has *any* negative impact on *donor* saving, and evidence suggests that the tax likely encourages work among *heirs* and may encourage heirs to save more than they would in the absence of the tax. Once these impacts are netted out, *it remains highly uncertain whether the tax has a positive or negative impact on private saving and work effort.* In any event, the magnitude of any effect is likely small. Claims that cutting the tax would have large and positive impacts on private saving go far beyond the available evidence.

Conclusion

Contrary to Holtz-Eakin and Smith's claims, it is far from clear that the estate tax reduces private saving and investment. It is crystal clear, however, that the estate tax is an important source of federal revenue and that repealing it or reducing it beyond its current level would significantly increase deficits and reduce public saving. Given the nation's serious long-term deficit problems, such a step would be irresponsible.

[27] Batchelder 2007, citing Joulfaian, October 2006.

[28] Joulfaian, October 2006.

[29] David N. Wei, "The Saving of the Elderly in Micro and Macro Data," *The Quarterly Journal of Economics,* Feb. 1994.

[30] Batchelder 2007. Batchelder cites several studies supporting this conclusion, including Brown, Coile, and Weisbenner 2006; Joulfaian, October 2006; and Holtz-Eakin, Joulfaian, and Rosen, 1993.

Study Claiming Repeal Would Pay for Itself Is Fundamentally Flawed

The other recent report sponsored by the American Family Business Foundation, authored by Stephen Entin,* claims that repealing the estate tax would actually *increase* government revenues.** The report fails entirely to support this claim:

- The report's methodology is opaque. The report fails to describe the crucial data, models, and assumptions upon which it is based.

- Some of the report's apparent assumptions are dubious. For example, it essentially assumes that donor savings behavior is highly sensitive to the amount of after-tax wealth that donors can leave their heirs; there is little evidence for this assumption (see the main text of this paper). In addition, the report seems to assume that all bequests originated as income that was subject to the income tax, ignoring evidence that a large proportion of these assets consist of unrealized — and therefore untaxed — capital gains.

- The paper is inconsistent. It claims that estate tax avoidance is widespread, meaning that estates actually pay far less than the statutory tax rate of 45 percent on the portions of the estates that should be subject to tax. However, the paper then contradicts this observation, by arguing that the estate tax stymies investment because the statutory marginal rate of 45 percent is so high. If avoidance is that prevalent, then the effective tax rate must be much lower than the stated rate of 45 percent—and the impact on investment consequently would likely be smaller.

- It also is highly unlikely that small business owners are as sensitive to the marginal estate tax rate as Entin suggests. Donors who are primarily concerned with the estate they will pass on to their heirs would likely want to pursue a sounder investment strategy than concentrating all their wealth in the family farm or closely-held business. And those donors who are primarily concerned with the success of their family farm or business are unlikely to be influenced much by the estate tax rate — since the overwhelmingly majority of farms and small businesses are entirely exempt from the estate tax. As a recent Tax Policy Center commentary indicates, the estate tax cannot have much effect on business decisions by small business owners "because hardly any owners face the estate tax."***

* Stephen J. Entin, "Economic Impact of the Estate Tax," American Family Business Foundation, June 2009, http://www.nodeathtax.org/files/AFBF_Entin_2009.pdf.

** Entin has previously argued that taxes depress saving more than they decrease consumption and that increased government saving (i.e., government budget surpluses) does *not* increase national saving. These arguments are at odds with the consensus of mainstream economists. See Stephen J. Entin, "Fixing the Saving Problem: How the Tax System Depresses Savings and What to Do about It," Aug. 6, 2001, available at http://iret.org/pub/BLTN-85.PDF for examples of this argument.

*** See Ben Harris "The Estate Tax and the Economy," Tax Policy Center, June 18, 2009
http://taxvox.taxpolicycenter.org/blog/_archives/2009/6/18/4226020.html