JOINT ECONOMIC COMMITTEE

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Reconsidering the True Revenue Yield of the Estate Tax

A primary objection to reducing or eliminating the federal estate tax is the projected revenue loss. Although the $28 billion that the estate tax is expected to raise in 2006 is hardly insignificant, it represents just 1.2 percent of total receipts. However, the actual revenue yield of the estate tax is considerably lower. There is abundant evidence that the high compliance costs and reduced capital accumulation associated with the tax result in at least partially offsetting revenue losses to the income tax.

IMPACT OF AVOIDANCE ACTIVITIES

The individuals primarily affected by the estate tax – the wealthy – tend to be both well-educated about and willing to engage in extensive tax avoidance strategies. One way such efforts reduce income tax receipts is through the premature, tax-induced shifting of resources from parents to heirs. Research confirms that such *inter vivos* giving is highly sensitive to estate tax rates.

Tax revenue is lost whenever assets are transferred from parents in high income tax brackets to children in lower tax brackets. Income tax revenue is also lost when transfers are made to tax-exempt groups such as charities and family trusts.

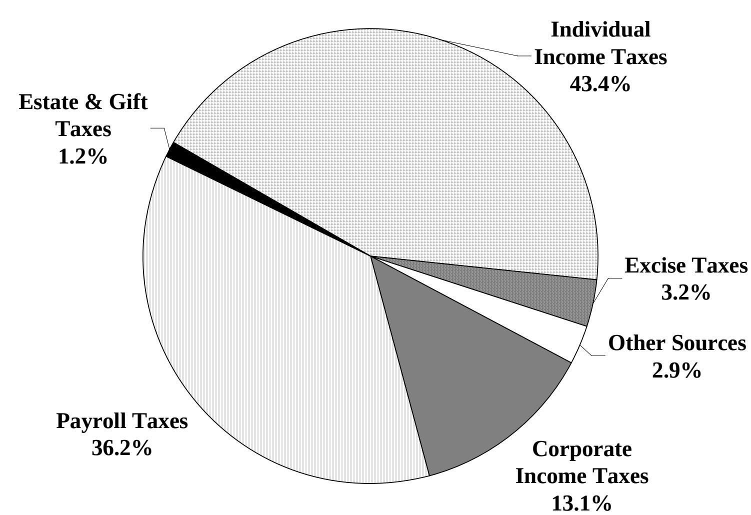
Stanford University economist Douglas Bernheim examined this dynamic through an analysis of estate tax returns under different assumptions and tax regimes. Bernheim found the income tax revenue loss associated with these factors was very large relative to the revenue raised by the estate tax, leading him to conclude:

> Although it is very difficult to estimate these effects precisely, in recent years true estate tax revenues may well have been negative.

IMPACT ON CAPITAL ACCUMULATION

In addition to the impact of tax avoidance activities, the estate tax lowers income tax revenue by reducing the amount of capital in the economy. This effect manifests as either reduced saving or increased consumption. As Joseph Stiglitz,

Figure 1. Distribution of Estimated 2006 Federal Revenues



Source: Congressional Budget Office.

chairman of President Clinton's Council of Economic Advisers, has written:

> Of course, prohibitively high inheritance tax rates generate no revenue; they simply force the individual to consume his income during his lifetime.

The estate tax also introduces inefficiencies and distortions, which in turn, reduce the amount of wealth and taxable income in the economy, thereby depressing federal tax revenue.

A growing body of research documents the effect of the estate tax on the size of estates reported to the IRS. A study from the U.S. Treasury Department found that "estate taxes have a dampening effect on the reported size of taxable estates," reducing reported estate sizes by 14 percent. Another study also found that high marginal estate tax rates are negatively related to the reported size of the largest estates. A third study found that following significant rate increases in 1941 and 1977, estate tax revenue as a share of GDP decreased. In contrast, after rates were lowered in the 1980s, revenue as a share of GDP rose. In other words, the evidence indicates that higher tax rates are associated with lower levels of taxable assets.

The Joint Economic Committee estimates that over the long run the estate tax has resulted in a cumulative loss of $847 billion in capital stock. Absent the estate tax, this lost capital would currently be serving economically productive uses. The loss of capital translates into less wealth and reduced economic activity and thus a smaller tax base for the income tax. Since most assets generate some degree of taxable income, income tax revenue is lower than it would be without the estate tax. Just as the existence of the estate tax depresses income tax collections, repeal of the estate tax would boost capital accumulation and income tax revenue.

The CONSAD Research Corporation used a simulation model to estimate the revenue impact of permanent estate tax repeal coupled with a limited step-up in basis. The CONSAD model predicts such a proposal would yield a net ***gain*** to the U.S. Treasury of $38 billion over 2003-2012.

The Joint Committee on Taxation (JCT) estimates that estate tax repeal will actually lose more revenue than the tax collects. The extra revenue loss in the JCT estimates is attributable to changes in taxpayer behavior. Over the long run, however, the increase in capital accumulation would result in greater economic activity and more capital gains realizations. Yet JCT's projection fails to account for the added revenue from these sources. Thus, the JCT revenue estimates do not accurately depict the net revenue effect over the long run of reducing or eliminating the estate tax.

CONCLUSION

The estate tax entails at least partially offsetting losses to the income tax. The actual net revenue raised by the estate tax is less than the official, static measure of its revenue yield. Although the exact magnitude of the effect is not known, the loss of capital stock, as well as the research of Bernheim and CONSAD, suggest that repeal of the estate tax may not result in a revenue loss for the federal government, and may even yield a net revenue increase.

This Research Report is based on the Joint Economic Committee study *Costs and Consequences of the Federal Estate Tax*. For a copy of this study, contact the JEC at (202) 226-3234 or visit the website www.house.gov/jec.