



**LEARNING FROM HISTORY
PART II:**

**ESTATE TAX REPEAL
WILL HAVE NO EFFECT
ON THE BUDGET DEFICIT**

**Daniel Clifton
May 2006**

Summary

The Joint Committee on Taxation's (JCT) cost estimate of permanent estate tax repeal should not be viewed as a definitive number. This study finds three major effects lead to an overestimation of the cost estimates. First, the underestimation of Gross Domestic Product (GDP) by the Congressional Budget Office (CBO) leads to a severe underestimation of tax revenues. Second, the failure to incorporate increases in economic growth resulting from estate tax repeal further underestimates future tax revenue growth. And third, normative assumptions made by JCT staff in determining the static score leads to an overestimation of lost tax revenue. Evidence suggests under each one of these effects estate tax repeal can be revenue neutral to the federal government. Case studies are provided of previous experiences for each of these effects. Clearly, when all three are combined, estate tax repeal will have no effect on the budget deficit.

- CBO is currently underestimating economic growth by at least 1.6 percent over the next 10 years. Using CBO's own numbers this would generate additional tax revenue, currently not in the forecast, which more than covers the cost of estate tax repeal.
- Even a more conservative estimate of 1 percent GDP underestimation over 10 years would cover 75 percent of the "cost" to repeal the estate tax.
- Since January 1997 the federal government has cut taxes \$1.24 trillion and experienced a recession and revenues will finish FY 2006 \$800 billion higher than forecasted in 1997 due to CBO underestimating real GDP by 120 basis points *per year*.
- At the same time, Joint Committee on Taxation's failure to incorporate macroeconomic effects from tax cuts is leading to a wide overestimation of the impact permanent estate tax repeal will have on tax revenues.
- Recent history with similar tax cuts demonstrates tax reductions on capital are drastically overestimated. The 2003 capital gains tax reduction (which is similar to estate tax repeal) has paid for itself 16 times over. Further, all of the tax cuts enacted since 2003 have produced a total feedback effect of 42 percent over three fiscal years.
- Static estimates produced by JCT have been wrong, most recently, the 2004 Invest in USA Act which generated more the double the amount of repatriations than the initial forecast. As such the provision was a net gain for the Federal Treasury, rather than a loss as forecast by JCT.
- Combining the GDP underestimation with the errors of static scoring and the dynamic economic effects from repeal will be more than enough to cover the "cost" of repealing the estate tax.

Table of Contents

Introduction	4
CBO's 1997 10-Year Forecast v. Actual Results	5
The Impact of Economic Growth on Tax Revenues	6
Alternative Growth Scenarios and Estate Tax Repeal	7
Dynamic Analysis Omissions	8
Learning from Capital Gains Tax Cuts	10
Static Scoring Problems	13
Conclusion and Recommendations	14

*Daniel Clifton is a Fellow with the American Family Business Institute
& is Executive Director of the American Shareholders Association*

Estate Tax Repeal Will Have No Effect on Deficit

Erroneous GDP Forecast and Dynamic Effects More Than Lift Tax Revenue

Key Points:

- The US Senate is set to vote on Estate Tax repeal this month.
- The latest “cost” estimate suggests permanent repeal results in a \$358 billion increase in the federal budget deficit over 10 years.
- However, this number is not an accurate representation for three interrelated reasons.
- First, CBO underestimates economic growth and small changes in GDP over 10 years significantly increase tax revenue.
- Second, JCT static revenue estimates are historically wrong and should be not viewed as what will happen in reality.
- Third, JCT fails to consider the economic growth effects from tax cuts which increase tax revenues.
- Since 1997, the federal government has cut taxes \$1.24 trillion and will collect more revenue in FY 2006 than forecasted in 1997 with no tax cuts incorporated in the forecast.
- This is because CBO underestimated real GDP growth by 130 basis points *per year*, or roughly \$1.2 trillion nominal dollars in 2006.
- CBO is underestimating GDP growth over 10 years by 1 to 1.6 percent of GDP which covers 75 to 125 percent of the “cost” of repeal.
- Further, when combined with the static errors and the failure to incorporate macroeconomic effects, estate tax repeal will have no effect on the deficit and will actually increase tax revenues to the federal government.
- Based on the overwhelming evidence in this paper, the deficit should not be a factor in the debate over repealing the estate tax.

Earlier this year, Senate Majority Leader Frist announced the United States Senate will vote on legislation to permanently repeal the estate tax in May.

This will be the second attempt in the Senate seeking to permanently repeal the tax since President Bush signed into law the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). EGTRRA gradually reduced the estate tax in the years 2002-2009 and temporarily abolished the tax in 2010. Without legislation making abolition permanent the estate tax will come back at pre-EGTRRA levels starting in 2011.

The first Senate vote to repeal the estate tax occurred in June 2002. The vote to proceed on the legislation failed to garner the 60 votes (54-44, 2 not present) required to consider the legislation.

Driving the floor debate during the 2002 vote was the tax revenue impact of the legislation. Opponents of estate tax repeal charged the legislation would dramatically increase the deficit. Conversely, proponents claimed increases in economic growth resulting from the change will minimize any impact on the deficit.

We believe a similar debate will take place when the vote takes place. The Joint Committee on Taxation (JCT) suggests estate tax repeal will reduce federal tax revenues government \$290 billion over the next 10 years if repeal was enacted in 2005.ⁱ A more recent estimate put forward by the Congressional Budget Office (CBO) suggests repeal will lose \$358 billion over 10 years if enacted this year.ⁱⁱ

Opponents of repeal have seized on this information to make their case that repeal will increase the deficit. Yet, the numbers are overly inflated based on three interrelated reasons including: 1) CBO underestimates economic growth over 10 years and hence tax revenues; 2) JCT static scoring is never correct; and 3) Dynamic economic effects from repealing the tax.

Estate Tax Repeal Will Have No Effect on Deficit

Low GDP Forecast and Dynamic Effects More Than Lift Tax Revenue

This paper provides an update to a previous American Family Business Institute (AFBI) report issued last July which detailed the large historical inaccuracies of JCT scoring, both static and dynamic, and concluded the cost of estate tax repeal to be inflated. The report can be accessed at: <http://www.nodeathtax.org/ECONOMICREPORTS/050713JCT.pdf>

This update compares the Congressional Budget Office's (CBO) first 10-year economic and tax revenue forecast with the actual results. From this test we can learn three important points: 1) Measure the accuracy of the 10 year forecast; 2) Compare the forecasts with real time risks, such as the bursting of the tech bubble and the 2001 recession; and 3) Determine how \$1.24 trillion of tax cuts fit into the 10-year tax revenue forecast, even though the forecast never considered taxes would be cut.

CBO's 10-year economic forecast purposely underestimates economic growth (as a form of "risk management" to hedge for unexpected economic downturns and policy changes) over 10-year periods. As the economy expands above the baseline forecast, tax revenues also adjust upward leaving higher levels of tax revenue than initially forecasted.

To fully grasp just how large the forecasting error was, both in terms of economic growth and tax revenues, and how it relates to estate tax repeal requires us to go back 10 years in time knowing exactly what policy choices would be made.

Just imagine the response from opponents of tax cuts if the House and Senate leadership stood on the steps of the U.S. Capitol in January 1997 and announced a plan to cut taxes by \$1.24 trillion over the next 10 years in the exact manner this occurred over the past decade.

The response to this initiative would have been the same as the talking points Senators will deliver on the floor of the Senate when debate begins on estate tax repeal.

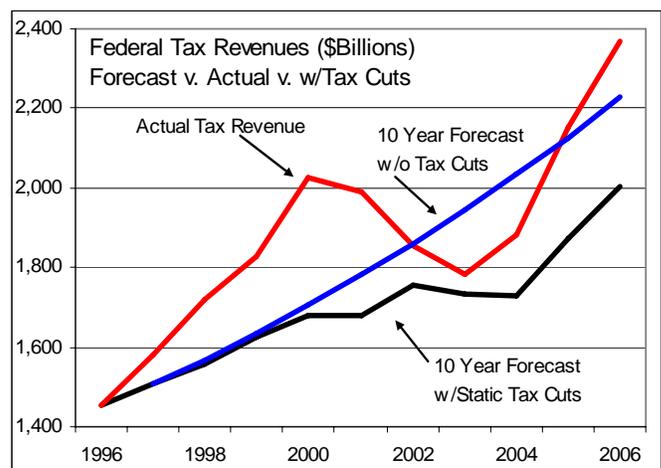
The Senators opposed to the these tax cuts would have been armed with a "static" score from the Joint Committee on Taxation claiming the cost of these tax cuts would be substantial. Furthermore, these static estimates would have been based on the January 1997 forecast for tax revenues from CBO which underestimates growth and hence tax revenues. Finally, the estimates would suggest the tax cuts provided no macroeconomic impact and hence no additional tax revenue feedback.

But what actually occurred is much different than what government revenue estimators would have suggested. CBO's forecast over the 10-year period estimated GDP to increase 2.1 percent per year. However, GDP increased an astonishing 120 basis points more *per year* over the 10-year period.ⁱⁱⁱ As such, nominal GDP in 2006 will be \$1.3 trillion higher than CBO's January 1997 forecast.^{iv}

As a result, CBO underestimated tax revenues by a cumulative \$800 billion. However, this forecasting error becomes even larger given the fact that the federal government cut taxes by a cumulative amount of \$1.24 trillion in that time, with not one cent of tax cuts incorporated into the forecast.^v

At the same time, the economy experienced a number of negative economic shocks, which the low GDP forecast attempts to take into account, and revenues still remained much higher than initially forecasted.^{vi}

Tax Revenues Soar Above CBO Baseline



Estate Tax Repeal Will Have No Effect on Deficit

Low GDP Forecast and Dynamic Effects More Than Lift Tax Revenue

CBO’s underestimation of GDP provided enough cushion in the budget to cut taxes \$1.24 trillion and survive a number of negative exogenous economic shocks and tax revenues still came in higher than initially forecasted by \$800 billion.

Over the 10-year period, CBO expected total cumulative tax collections to come in at \$18.4 trillion when actual tax collections were \$800 billion more at \$19.2 trillion. As a result, tax revenues in fiscal year 2006 will be higher than initially forecasted in 1997 without accounting for the tax cut costs.

Tax revenue collections as a percentage of GDP in Fiscal Year 2006 were forecasted to finish the year at 18.8 percent of GDP, while collections will likely finish FY 2006 at 18.1 percent. This is not because tax revenues are down; it reflects the \$1.3 trillion of additional nominal GDP above the forecast, which is good for the U.S. economy.

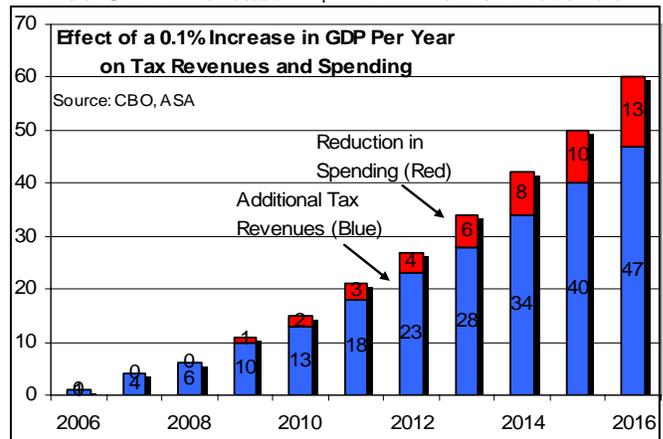
Cumulative tax revenue collections came in \$2.04 trillion higher than the static tax cut cost estimates would suggest over the 10-year period. If the static tax cuts were included in the original GDP forecast, tax revenues would have been 16.9 percent of GDP in FY 2006, 110 basis points less than the actual result.

Similarly, CBO’s current 10-year forecast underestimates GDP enough that estate tax repeal will easily fall into the budget window and have no effect on the deficit, holding spending constant.

Tax revenues are affected by changes in economic conditions. Small upward revisions in economic growth can have a profound effect on tax revenues by producing a larger tax base.

For example, each year, CBO produces estimates for tax revenues and spending if growth increases or decreases relative to their baseline by 1 percentage point over ten years. The baseline growth estimates are actually much lower than historical averages in order to manage risk from overestimating tax revenues in future years.

1% GDP Increase = \$271 Billion of Revenue



CBO Forecast v. Actual Results

<u>Real GDP</u>	
Forecast: 2.1%	Actual: 3.3% (E)
<u>Nominal GDP 2006 (\$Trillions)</u>	
Forecast: \$11.969	Actual: \$13.262 (E)
<u>Unemployment Rate</u>	
Forecast: 5.9%	Actual: 4.8% (E)
<u>Cumulative Tax Collections (\$Trillions)</u>	
Forecast: \$18.384	Actual: \$19.185
<u>Cumulative Tax Collections w/Static Tax Cuts</u>	
Forecast: \$17.144	Actual: \$19.185
<u>Tax Revenue % of GDP</u>	
Forecast: 18.8%	Actual: 18.1% (E)

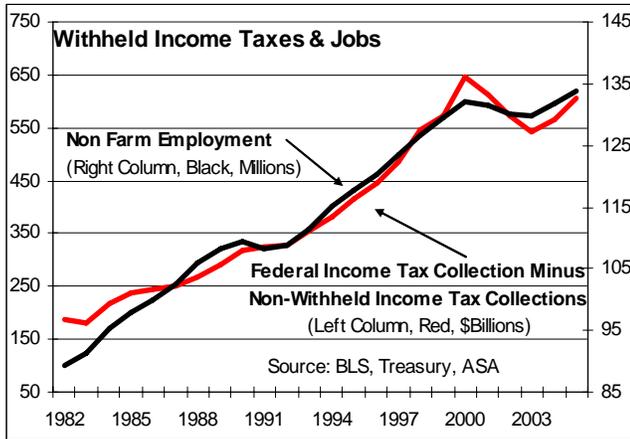
As a result of these conservative estimates, a small change in economic growth results in a strong upward revision to tax revenues. CBO’s analysis of a 0.1 percent increase in GDP growth per year above the baseline results in a higher tax base and therefore provides an additional \$224 billion of new tax revenues to the federal government over 10 years.^{vii}

At the same time, lower debt costs leads to a reduction in spending of \$47 billion over ten years. In total, the government gains an additional \$271 billion over ten years from a small change in economic growth.^{viii}

Estate Tax Repeal Will Have No Effect on Deficit

Low GDP Forecast and Dynamic Effects More Than Lift Tax Revenue

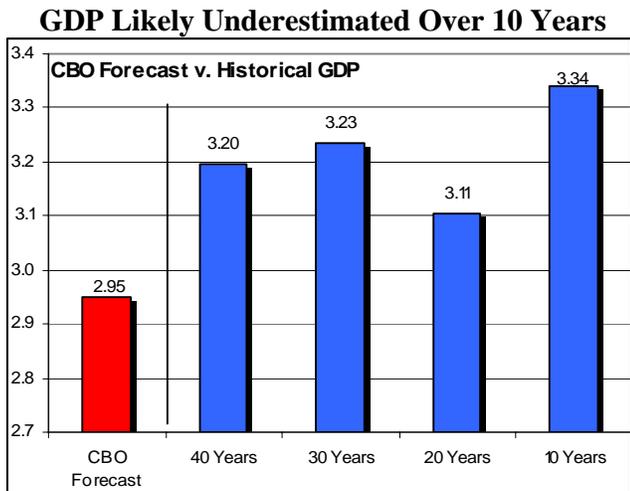
More Jobs = More Tax Revenue



CBO’s economic growth forecast is relevant to the estate tax debate since a 1 percent underestimation of GDP covers 75 percent of the “cost” of repeal.

CBO assumes over the next 10 years, real GDP growth will average 2.95 percent per year. The CBO forecast encompasses a 3.6 percent estimate for 2006 and then averages 2.9 percent from 2007-2016.^{ix} This 2.95 percent forecast is an underestimation of historical averages and a 1 percent increase of GDP over ten years is more than plausible.

For example, the past 40 year average of GDP growth is 3.20 percent, the 30 year average is 3.23 percent, the 20 year average is 3.11 percent, and the past 10 year average is 3.34.^x



Even assuming a 0.1 percent per year increase in GDP growth above the CBO baseline results in an average of 3.05 percent growth, which is below any of the averages provided above. Using the past twenty year average, 3.11 percent (which included two recessions), would suggest CBO’s real GDP forecast is underestimated by 0.16 percent per year.

The same CBO document which provided the estimates for changes in GDP also provides a static revenue estimate of making estate tax repeal permanent starting in 2010. The CBO revenue score finds estate tax repeal to reduce tax revenues \$358 billion through 2016.^{xi}

Matching up the CBO estate tax repeal score with CBO’s underestimation of GDP growth estimate (0.1% per year) reveals a revenue loss of \$87 billion over 10 years. **This covers more than 75 percent of the entire repeal static cost.** However, GDP is more likely to be off by 0.16 percent per year and in this case, estate tax repeal static tax revenue loss will be fully covered by the increase in economic growth with \$50 billion left over.

Impact of 0.1% Per Year Increase in GDP Above the CBO Baseline Compared to Death Tax Repeal (\$Billions)											
Year	07	08	09	10	11	12	13	14	15	16	06-16
GDP	4	6	11	15	21	27	34	42	50	60	\$271
Tax Loss	2	2	2	2	30	54	60	65	69	73	\$358
Total	2	4	9	13	9	27	26	23	19	13	-\$87

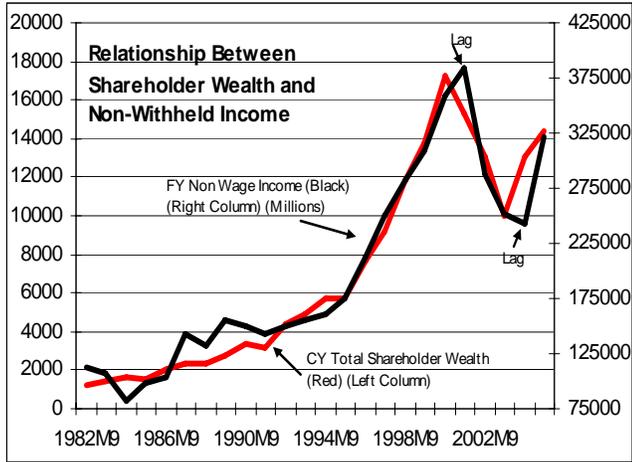
Source: CBO, ASA.
Numbers May Not Add Up Due to Rounding.
Red Denotes Negative Number.

Moreover, we believe the CBO “rule of thumb” estimates may even underestimate the true impact of these increased tax revenues due to shifting nature of federal tax collections. CBO’s estimates are in the aggregate and the widespread increase in shareholder wealth, faster than GDP, will also increase tax revenues faster than GDP. This is because non-withheld income tax collections will become a larger part of tax collections over the next 10 years.

Estate Tax Repeal Will Have No Effect on Deficit

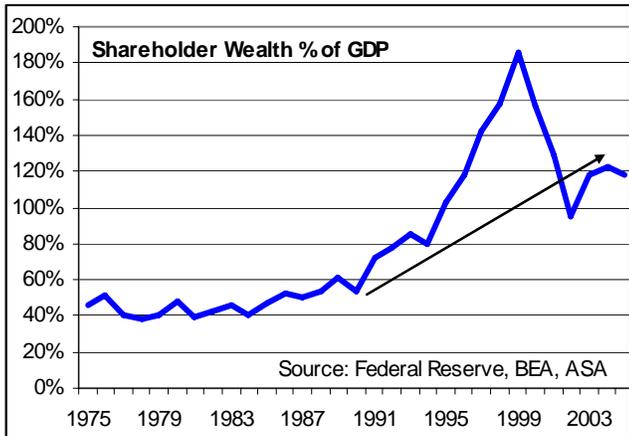
Low GDP Forecast and Dynamic Effects More Than Lift Tax Revenue

Non-Withheld Taxes and Wealth Correlated



As the chart above demonstrates, non-withheld income tax collections, which includes revenue sources such as capital gains, dividends, stock options, bonuses and small business quarterly payments, are correlated with shareholder wealth (with a one-year lag at the turning point of business cycles). And shareholder wealth is increasing faster than GDP, indicating higher tax revenues.

Shareholder Wealth Rising Faster Than GDP



Clearly, CBO’s underestimation of GDP provides enough cushion in the budget to cover 75-125 percent of the “cost.” This analysis ignores any of the additional economic effects and the subsequent tax revenue feedback from the tax cut. Combined with the dynamic effects, more than enough revenue will be generated to cover the cost of estate tax repeal without adding to the deficit.

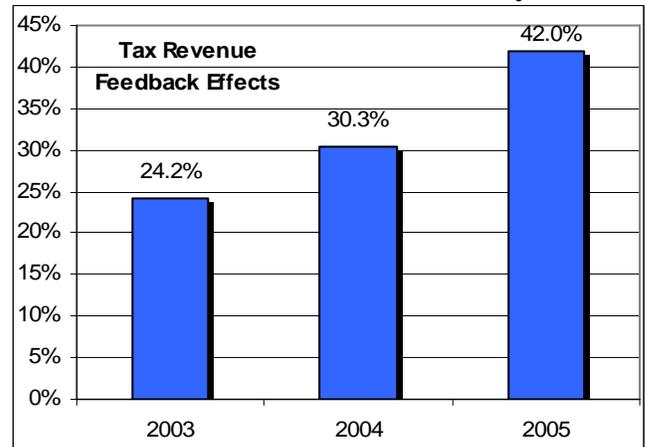
Dynamic Analysis Omissions

In addition to the underestimation of economic growth, JCT’s method of scoring tax cuts is inherently inaccurate, a claim borne out by both historical experience and economic theory.

While we believe GDP growth alone can provide enough cushion in the budget to absorb the “cost” of estate tax repeal, when combined with the static scoring errors and the failure not to incorporate macroeconomic growth from the reduction in taxes, estate tax repeal will clearly more than pay for itself.

In fact, the 2003 and 2004 tax cuts, which were a combination of reducing the double tax on savings and investment (which boosts growth) and targeted tax cuts (no effect on growth), has produced a “feedback effect” of 42 percent in slightly more than two years. In other words, the JCT overestimated the “cost” of the tax cut by 42 percent for fiscal years 2003-2005. This is a very large error.

JCT Static Revenue Estimate Off by 42%



JCT estimated the combined static tax cut cost of the 2003 and 2004 tax cuts would equal \$296 billion for fiscal years 2003 – 2005. However, tax revenues finished fiscal year 2005 \$124 billion above the adjusted baseline. As such, 42 percent of the revenue loss had been recouped and the number is growing larger each fiscal year.

Estate Tax Repeal Will Have No Effect on Deficit

Low GDP Forecast and Dynamic Effects More Than Lift Tax Revenue

We believe estate tax repeal will have an even larger effect on growth than the 2003 and 2004 tax cuts and hence an even larger impact on tax revenues.

Under the current proposal, the estate tax will be repealed, not cut like the 2003 tax cuts. Second, estate tax repeal is 100 percent pro-growth and not mixed in with relatively expensive proposals such as the child credit and marriage penalty which provide very little bang for the buck.

Third, the compliance cost is much greater for the estate tax than the previous tax cuts. While only 30,627 estates paid taxes in 2003, over twice this number were required to file all the required tax paperwork.^{xii} Estate planning has several levels of complexity, and one survey showed that an average family which engages in this effort spends between \$30,000 and \$150,000.^{xiii}

Numerous academic and empirical studies have concluded compliance costs are roughly equal to the revenue raised by the estate tax, thus making the tax the most inefficient tax in the entire federal tax code. Hence, eliminating this tax frees up greater resources which will be put to better productive uses over the long-term.

Fourth, the estate tax currently reduces the after tax return which discourages savings and increases consumption. This leads to a lower capital stock than if the tax was not in place. A recent study by the Joint Economic Committee (JEC) estimates the estate tax has reduced America's capital stock 3.8 percent, or \$847 billion. To put this in perspective, the tax itself generated just \$761 billion (inflation – adjusted) over the same course of time. This suggests that the tax is providing a substantial drag on economic growth.

Repealing the estate tax would provide real and considerable economic benefits. Dr. William Beach from the Heritage Foundation found that repeal would result in between 170,000 and 250,000 additional jobs per year.^{xiv}

Additionally, an econometric model designed by Alfredo Goyburu showed that had the estate tax been repealed in 2003, GDP would be \$10.6 billion higher, investment capital would have increased by \$25.2 billion, and 104,000 jobs would have been created each year.^{xv}

Removal of this harmful tax will clearly improve economic efficiency by reducing the corresponding deadweight loss and freeing up resources to be put towards more productive uses. Moreover, the benefits will be enjoyed by all Americans.

As a result, repealing the estate tax will increase growth, investment, employment, and asset values which in turn increase tax revenues.

Yet, despite the historical inaccuracies and the overwhelming evidence of tax cuts impact on growth, JCT does not take any of these factors into consideration which results in an inflated estimate of estate tax repeals impact on tax revenue.

Under current procedures, only microeconomic feedback effects are included in the models for revenue estimation.^{xvi} While JCT does attempt to model for behavioral effects, (a step in the right direction) historical evidence demonstrates even these forecasts are not always accurate.

Macroeconomic feedback effects are not considered, despite the fact that tax cuts on capital, such as estate tax repeal, clearly have macroeconomic implications.

National income increases expand the tax base producing a “feedback effect,” which recoups a portion of the static revenue loss and leads to an increase in the out year baseline projections. As a result of this expansion, static revenue estimates overstate the magnitude of the revenue loss to the federal treasury by failing to consider these factors.

Academic and empirical evidence shows that a tax cut on capital, such as the estate tax, will provide a “feedback” effect at roughly half the static estimate of the tax cut.^{xvii}

Estate Tax Repeal Will Have No Effect on Deficit

Low GDP Forecast and Dynamic Effects More Than Lift Tax Revenue

Other estimates show the estate tax itself loses tax revenue to the government in the form of deadweight loss due to an inefficient allocation of resources and lost savings. As a result, repealing the estate tax may actually increase tax revenues to the federal government.

Failing to consider these economic effects consistently results in JCT overestimating the cost of cutting taxes and provides an incomplete picture to elected officials of the consequences of their vote.

Within the context of Congressional debate on the estate tax, the numbers produced by JCT have a large impact on the final product of legislation. Legislators and their staff have viewed the JCT numbers as a *fait accompli* and the number sets the framework for if and how legislation is passed.

Yet, evidence from the two latest tax cuts on capital gains and the 2004 Invest in USA Act demonstrates the JCT estimates of estate tax repeal is unconscionably overstated.

Comparing the estimates JCT made in considering major tax changes with the actual results including the 1997 and 2003 tax reductions demonstrates current scoring methods overestimate the loss of government revenue from tax cuts both on a microeconomic and macroeconomic level.

Capital gains tax reductions hold similar properties as estate tax changes. Both are taxes on savings which impose an additional layer of taxation on a dollar that has been taxed once already. Further, both taxes reduce the after tax rate of return on investment. Thus, when the tax is lowered on capital more capital is produced resulting in a larger tax base. As such, the static revenue loss is partially, if not fully, offset with the dynamic economic growth effects.

This point was echoed by former Federal Reserve Chairman Alan Greenspan in remarks to the Senate Banking Committee.

“If the capital gains tax were eliminated, that we would presumably, over time, see increased economic growth which would raise revenues for personal and corporate taxes as well as other taxes that we have... ...[the] major impact [of a capital gains], as best I can judge, is to impeded entrepreneurial activity and capital formation...I argued that the appropriate capital gains tax rate was zero...”^{xviii}

This should come as no surprise to analysts who have studied capital gains tax rate changes. History has shown that cutting capital gains taxes is one of the few tax changes that actually *raises revenue*.

To many, these results may seem counterintuitive. It seems almost obvious that lowering taxes lowers government revenues. However, these sorts of static models fail to take into account three distinct changes in behavior that a capital gains tax cut brings about: 1) the unlocking effect; 2) the dynamic effect; and 3) increasing asset values. Estate tax repeal will experience the same effects.

When capital gains taxes are cut, the “lock-in” effect is eliminated and many assets are sold that would otherwise have remained locked-in by savvy investors seeking to avoid the tax. The selling triggers the tax which is then paid by the investor usually at tax season time.

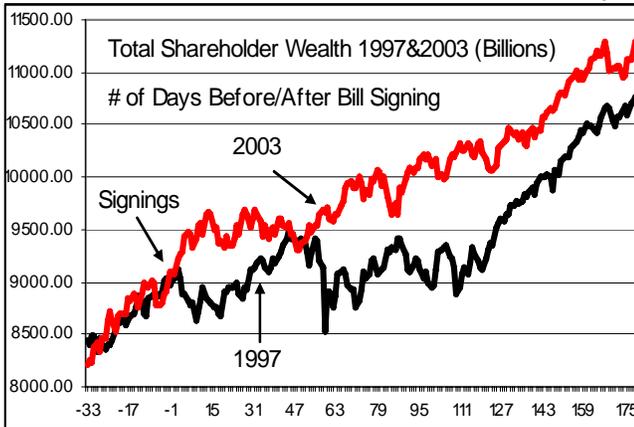
At the same time, a capital gains tax cut spurs the growth of new businesses, increases the wage of workers, enhances consumer purchasing power, and grows the economy at large, resulting in more overall gains to be taxed. When capital is taxed at a lower rate, any revenue losses are offset because there is more overall capital being produced, and thus more total revenue being generated.

Finally, the change in the after tax return makes equities more attractive relative to other assets. Following the 1997 and 2003 tax cuts on capital gains a nearly identical situation occurred – shareholder wealth increased by \$2 trillion in the first 180 days of trading. These gains are then later taxed and that is leading to the current surge in non-wage income tax collections.

Repeal Will Have No Effect on Deficit

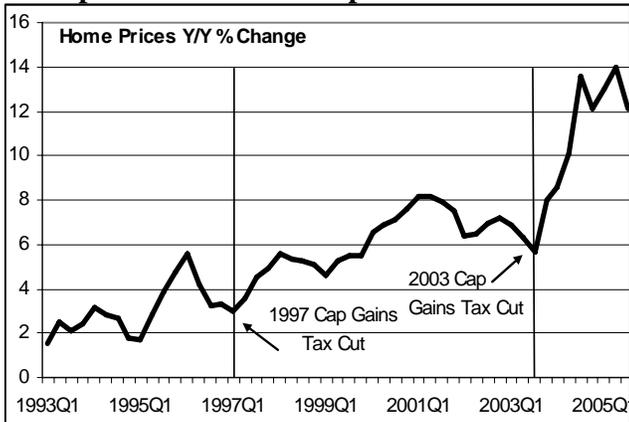
Low GDP Forecast and Dynamic Effects More Than Lift Tax Revenue

\$2 Trillion of Shareholder Wealth in 180 Days



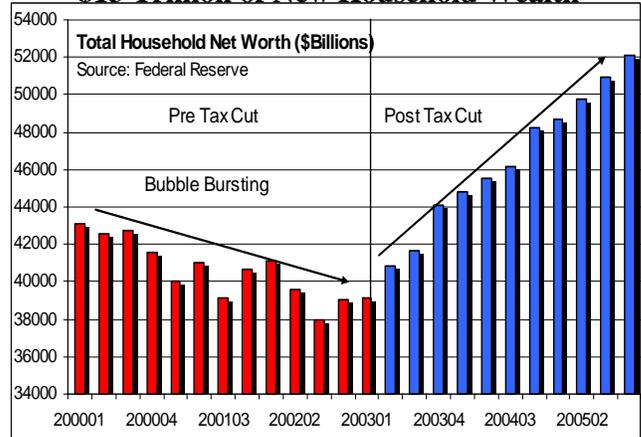
Similarly, capital gains tax reductions in 1997 and 2003 correlated with higher home prices. The 1997 capital gains reduction provided for a lower capital gains tax rate and a larger home sale exemption. This enabled the housing market to operate more efficiently and increase home sales and new construction. Subsequently, the 2003 tax cut further reduced the capital gains tax rate which was followed with a historic increase in home prices and household net worth.

Cap Gains Tax Cut Helps Boost Home Prices



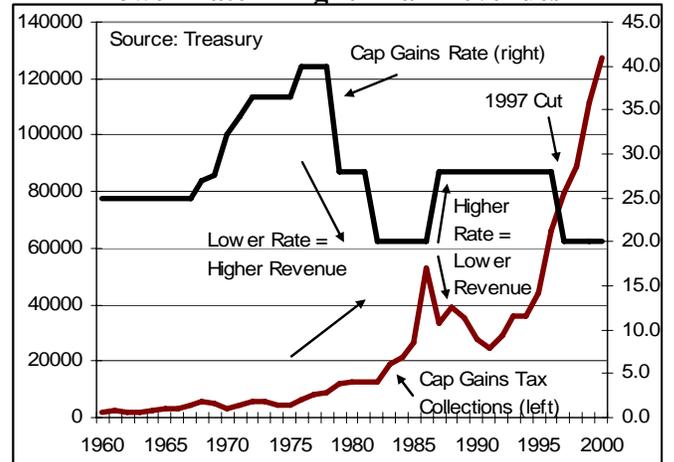
Rising equity prices coupled with soaring home values has led to an unprecedented increase in household net worth. From the tax cut signing in 2003 until the end of 2005 (2.5 years) household net worth increased \$13 trillion, or 33 percent. More importantly, the tax cut reversed the \$4.5 trillion slide in household net worth that began with the bursting of the tech bubble in March 2000.

\$13 Trillion of New Household Wealth



As a result of increasing equity and house price gains, the larger tax base increases tax revenue to the government. After capital gain tax rate cuts in 1978, 1981 and 1997 capital gains revenue increased. Conversely, when rates were increased, capital gains tax revenue decreased.

Lower Rate = Higher Tax Revenues



The best example is the Tax Reform Act of 1986, which increased the rate on capital gains from 20 percent to 28 percent. Taxpayers had some time to realize their gains before the higher rate took effect, which led to a dramatic spike of capital gains revenue in 1986 and the drop off in 1987 which followed for 7 more years. Yet, revenue estimators believed that raising the tax would generate more revenue, which misses the fact that less capital was being employed in the economy.

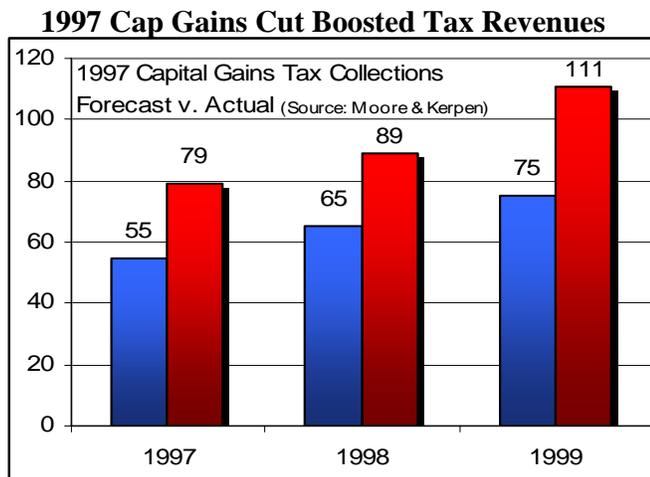
Estate Tax Repeal Will Have No Effect on Deficit

Low GDP Forecast and Dynamic Effects More Than Lift Tax Revenue

JCT attempts to take into consideration behavioral effects from the capital gains tax reductions as investors unlock their gains to take advantage of the lower rate, but fail to take into account the substantial positive economic effects associated with the lower rates.

As a result, JCT estimated the 1997 capital gains tax reduction would net a gain of \$7.8 billion to the federal treasury for the one month left in FY 1997 through FY 1999. Over the ten year period, however, JCT estimated the reduction would result in an overall \$21 billion loss to the government coffers.

Yet, Moore and Kerpen concluded JCT missed the forecast by \$24 billion in '97 and '98 and \$36 billion in '99.^{xix} The static models cannot account for the unlocking, dynamic, and asset value effects. Thus, JCT estimates appear to have a larger effect on the deficit than in reality.



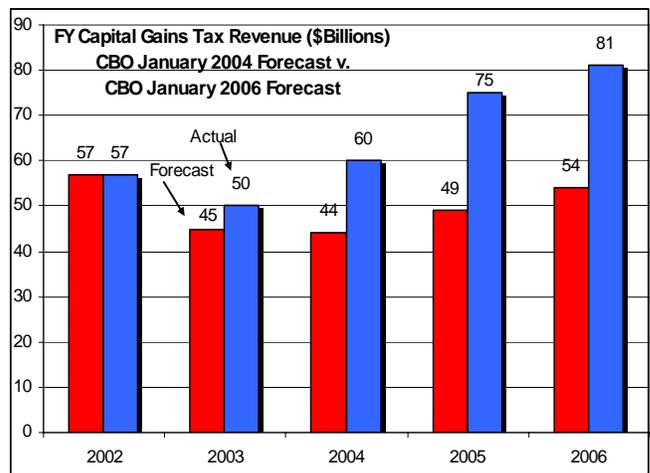
Capital gains and dividend tax revenue have a two year lag before we can see the actual results. But given the preliminary data available the same effect from 1997 is happening right now following the 2003 tax cut.

With the release of CBO's annual Budget and Economic Outlook in January, a new set of estimates for capital gains revenue showed the original JCT forecast was completely wrong and the tax cut has paid for itself, 16 times over!

At the time of the 2003 tax cut, JCT forecasted the capital gains tax reduction would lose \$3 billion from FY 2003-2005. Accordingly, the CBO forecast (after the tax cut was passed) was for the government to collect \$45 billion, \$44 billion, and \$49 billion in fiscal years 2003, 2004, and 2005 respectively.

Yet, the new data shows the government collected \$50 billion, \$60 billion, and \$75 billion in fiscal years 2003, 2004, and 2005. As a result, the government did not lose \$3 billion it collected \$45 billion, a swing of \$48 billion, and a 16 fold increase.

Cap Gains Tax Cut More Than Paid For Itself



Interestingly, the change in after tax return of assets lifted asset values, which subsequently, has forced CBO to upgrade their forecast of estate tax revenues. Estate tax revenues are now \$24 billion above the January 2002 baseline. Hence estate tax repeal will lift asset values and subsequently increase capital gains tax collections.

Year	01	02	03	04	05	06	07	08	09	10	01-10
Baseline	28	26	28	29	29	29	32	35	38	40	\$314
Tax Cut	28	26	24	25	22	25	22	23	25	16	\$236
Actual	28	27	22	25	25	28	26	28	29	22	\$260
Total	0	1	2	0	3	3	4	5	4	6	\$ 24

Source: CBO, ASA.
Numbers May Not Add Up Due to Rounding.
Red Denotes Negative Number.

Estate Tax Repeal Will Have No Effect on Deficit

Low GDP Forecast and Dynamic Effects More Than Lift Tax Revenue

Rising asset values have lifted estate tax revenues above the original baseline. As a result, the static estimate has overestimated the cost of the small estate tax changes that have been made to date by 26 percent due to rising asset values. By the end of 2010, more than 30 percent of the static tax cut cost will be paid for by rising asset values. And with household wealth surging, this number could be even larger by that time.

However, since revenues are surging, the next “static” forecast of estate tax repeal will be even larger. As the Senate vote nears it is more than likely that the JCT score will be the most inflated yet. And clearly, the numbers will not reflect a shred of reality but will be viewed as the official record.

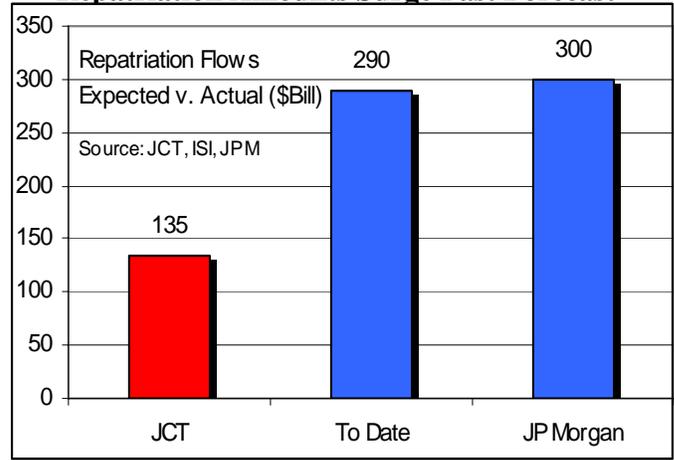
Static Errors

Even with economic growth underestimated and the dynamic analysis omissions, not even the static scores produced by JCT are correct. As mentioned, JCT attempts to take into consideration behavioral effects stemming from tax changes. We tend to view this as a positive if done correctly. However, many of the behavioral decisions tend to be taxpayers seeking to minimize their tax burden without examining the positive changes such as changes in asset allocations in response to lower taxes on capital. This omission drives up the score and makes tax cuts more difficult.

Furthermore, the JCT scoring process is highly subjective and often leads to bad forecasts. A recent Tax Notes article exposed how the JCT process was manipulated by a former director who understood old data would be used and was able to turn a tax subsidy into a revenue raiser so it could be included in legislation.^{xx} The process is clearly broken and should not be relied upon by Senators in determining their estate tax votes.

From a practical perspective, the Invest in USA Act provides a clear example of JCT missing the behavioral effects. Tax revenue estimates prior to

Repatriation Amounts Surge Past Forecast



enactment suggested this provision would actually lose money to the federal government. However, during the one year of a special tax rate, companies announced more than \$300 billion for repatriation, more than doubling the initial forecast.

As a result of the missed forecast in repatriations, JCT severely underestimated the amount of tax revenue entering the Federal Treasury. JCT expected revenues to increase \$2.8 billion in FY 2005, lose \$2.2 billion in FY 2006, and then lose money in the following eight years for a total \$3.2 billion loss over 10 years.^{xxi}

Based on the estimated \$325 billion of repatriations, ASA is expecting this provision to generate slightly more than \$17 billion in corporate tax revenues for fiscal year 2005 and 2006 combined. This indicates the government revenue forecast missed by \$16.4 billion in the first two years, which more than wipes out the expected \$3.2 billion, 10-year “loss” to the federal treasury that JCT expected.

Furthermore, the JCT analysis underestimates tax revenue collections by ignoring economic growth effects as the cash is put to use for investment, employment, share repurchases, dividends, and M&A activity. Although less quantifiable, we believe this impact could be just as high as the direct impact.

Estate Tax Repeal Will Have No Effect on Deficit

Low GDP Forecast and Dynamic Effects More Than Lift Tax Revenue

Similarly, a 2003 study by CONSAD research found that the change to a limited step-up in basis resulting from estate tax repeal will generate more than enough capital gains tax collections to cover the static revenue loss. In fact, the study found that tax collections will generate a cumulative net \$38 billion, not a static loss of \$193 billion.²²

Yet, the JCT will not include any additional capital gains tax collections in their score even though this is what will happen by the change to a step-up in basis. Moreover, this does not include the capital gain tax collection increase from a dynamic perspective as asset values increase from the change in after tax return.

No matter how it is examined, the combined JCT and CBO revenue and economic forecasts are wrong and biased against tax cuts. The cost of repeal can easily fit into the budget window when examining the CBO growth forecast, the dynamic effects of estate tax repeal, and static errors.

Conclusion

Academic, empirical, and practical experience all demonstrate tax reductions on savings and investment boost economic growth. At the same time, small changes in the economy can have a large effect on tax revenues. Yet, given this to be the case, the Joint Committee on Taxation still produces incorrect revenue estimates by only taking into consideration behavioral and not macroeconomic factors.

With the estate tax debate heating up, it is imperative that Senators took a look at the historical inaccuracy of JCT revenue scores and CBO growth projections. In fact, going back the last twenty-five years shows both organizations continually miss the mark.

Thus, the official JCT estimate should not be viewed as an accurate number. In fact, it should be looked at as a worst case scenario, one in which, the economy falls in to a deep recession prior to

estate tax repeal. As such, it is better to view the JCT score as a very high ceiling and not a floor.

The case studies provided in this paper overwhelmingly demonstrate that JCT's failure to take into account macroeconomic factors results in wide overestimations of tax revenue losses associated with tax cuts.

All of this could have been eliminated if JCT adopted a similar model used by the Council of Economic Advisors, which correctly predicted economic growth, unemployment, and tax revenue feedbacks from the 2003 tax cut. This would have provided a much clearer picture for policymakers to make such wide ranging tax changes.

With such strong evidence demonstrating the incorrect nature of the scoring process, Senators should ignore the estate tax score.

The combination of GDP's underestimation, dynamic effects being omitted, and JCT's static scoring errors provides enough cushion that estate tax repeal will not increase the deficit. Conversely, the measure could increase tax revenue while accelerating the U.S. economy's long-run growth potential. Thus, if the estate tax is repealed all Americans standard of living rises.

Endnotes

- ⁱ Joint Committee on Taxation, “Estimated Revenue Effects of H.R. 8,” April 13, 2005
<http://www.house.gov/jct/x-20-05.pdf>
- ⁱⁱ Congressional Budget Office, Budget and Economic Outlook 2007-2016, Effects of Expiring Tax Provisions
<http://www.cbo.gov/ftpdocs/70xx/doc7027/01-26-BudgetOutlook.pdf>
- ⁱⁱⁱ American Shareholders Association, Analysis of CBO’s January 1997 forecast with actual results.
- ^{iv} *Ibid*
- ^v ASA calculation of static tax cut estimates of major tax legislation enacted from January 1997-present.
- ^{vi} The economy experienced a number of exogenous shocks such as the bursting of the stock market bubble, a recession, the horrific attacks of September 11th, and two wars.
- ^{vii} Congressional Budget Office, Budget and Economic Outlook 2007-2016, Appendix C, Table C 1
<http://www.cbo.gov/ftpdocs/70xx/doc7027/01-26-BudgetOutlook.pdf>
- ^{viii} *Ibid*
- ^{ix} Congressional Budget Office, Budget and Economic Outlook 2007-2016, Economic Outlook
- ^x Bureau of Economic Analysis historic GDP data, Tabulation by American Shareholders Association
- ^{xi} Congressional Budget Office, Budget and Economic Outlook 2007-2016, Effects of Expiring Tax Provisions
<http://www.cbo.gov/ftpdocs/70xx/doc7027/01-26-BudgetOutlook.pdf>
- ^{xii} IRS, Statistics of Income Division, “Table 1 – Estate Tax Returns Filed in 2003: Gross Estate by Type of Property, Deductions, Taxable Estate, Estate Tax, and Tax Credits, by Size of Gross Estate,” unpublished data, October 2004, <www.irs.gov/pub/irs-soi/03es01tp.xls>.
- ^{xiii} American International Automobile Dealers Survey, May 2003
- ^{xiv} Beach, William W. “Now is (Still) the Time to Permanently Repeal Federal Death Taxes,” Heritage Foundation, *WebMemo*, No. 720, April 12, 2005, p. 2, www.heritage.org/Research/Taxes/wm720.cfm
- ^{xv} Goyburu, Alfredo B. “The Economic and Fiscal Effects of Repealing the Federal Estate, Gift, and Generation-Skipping Taxes,” Center for Data Analysis, Heritage Foundation, Report #02-08, November 15, 2002, pp. 7-8,
www.heritage.org/Research/Taxes?CDA02-08.cfm
- ^{xvi} Alan J Auerbach. “Dynamic Revenue Estimation.” *Journal of Economic Perspectives*, Vol. 10, No. 1, Winter 1996, 141-157.
- ^{xvii} Gregory N. Mankiw, and Matthew Weinzierl. “Dynamic Scoring: A Back-of-the-Envelope Guide. NBER Working Paper. 7 April 2005 (revised).
- ^{xviii} Alan Greenspan, testimony before the Senate Banking Committee on February 25, 1997
- ^{xix} Steve Moore and Phil Kerpen, “Capital Gains Tax Cut: The Key to Economic Recovery,” Institute for Policy Innovation, October 2001
- ^{xx} Martin Sullivan, Former JCT Chief Turns Loser into a 'Winner', Tax Notes, March 7, 2006.
- ^{xxi} Joint Committee on Taxation, Estimated Budget Effects of AJCA, <http://www.house.gov/jct/x-55-03.pdf>
- ²² Wilbur A. Steger and Fredrick H. Reuter, “The Effects on Government Revenues from Repealing the Federal Estate Tax and Limiting the Step-Up in Basis for Taxing Capital Gains,” 2003.