Protecting West Virginia's Priorities:

The Hidden Costs of Repeal or Drastic Reduction of the Federal Estate Tax

May 2006

Executive Summary

During the first week of June, the Senate will consider legislation to repeal or drastically reduce the estate tax. The House of Representatives passed a bill to repeal the tax (HR.8) in April 2005.

Repealing the estate tax would cost tens of billions of dollars annually – totaling $1 trillion in just ten years. This report demonstrates how Senator Jon Kyl's (R-AZ) proposal to lower the estate tax rate to 15 percent and raise the exemption level to $5 million ($10 million for couples) would have similarly harmful effects on the deficit and funding for vital programs.

- The President's budget this February proposed $183 billion in cuts to domestic discretionary spending over the next five years (2007-2011). The budget plan passed by the House on May 18 proposed reducing funding for domestic discretionary programs by $167 billion over five years, while the Senate passed budget plan would reduce funding by $123 billion.
- The estate tax is the most progressive way to raise the revenue our nation needs to meet its many commitments. Given that a substantial proportion of the assets of multi-million dollar estates have never been taxed before, the estate tax ensures the fairness in our tax system by guaranteeing that everyone pays their fair share.
- In 2003, the most recent year for which IRS figures are available, only 105 West Virginians – 0.5 percent of deaths that year – paid any estate tax. This report compares that figure to West Virginia's 44,000 uninsured children, West Virginia's 71,450 households that experience hunger every year, and the 2,698 estimated qualified West Virginia high school students that did not attend college due to financial cost. The needs of these three constituent groups could be addressed with revenue from the estate tax.
- Under current law, the estate tax only taxes multimillionaires. Currently, those with estates worth less than $2 million – $4 million for couples – are exempt from the estate tax. The current estate tax rate is 46 percent, which, taking into account the high exemption level, translates to an effective rate of about 20 percent.
- Sen. Kyl's proposal to lower the estate tax rate to the capital gains rate (currently 15 percent) and raise the exemption level to $5 million ($10 million per couple) would lose 84 percent of the revenue lost by full repeal.
- This report shows how the loss of revenue in one year under Kyl's proposal could alternatively be used to make up for the entire set of budget cuts proposed to agriculture, energy supply and conservation, environmental protection, health research, housing assistance, K-12 and higher education, nutrition assistance, transportation, veterans medical care, and vocational training in 2011.
- The report concludes that a drastic reduction of the estate tax would be too costly and simply unnecessary. Non-partisan Congressional Budget Office analysis shows that only a small percentage of family farms and small businesses pay the estate tax at all. Unlike the Kyl proposal, reasonable and responsible reform would not deepen the deficit, result in cuts to needed domestic spending, or shift the tax burden to working families. Balancing tax cuts for multimillionaires with severe budget cuts for vital programs and community services would reflect woefully misplaced priorities. The Senate must act to preserve the estate tax and protect America's future.

Introduction

For almost 90 years, the estate tax has helped the United States build schools, fight crime, care for the sick, and fund programs that elevate standards of living for all people nationwide. But now the nation's wealthiest heirs are lobbying their congressional allies to destroy our most progressive tax at the expense of community programs that benefit all of us.

One of the first items the Senate is expected to take up when it returns from Memorial Day recess is a House-passed bill to permanently repeal the estate tax – at a time when the federal deficit remains alarmingly high[1] (in no small part due to the 2001 and 2003 tax cuts[2]) and important community programs face major cuts. Repeal of the estate tax would cost nearly $1 trillion over the first 10 years of its full effect,[3] exploding the deficit and putting funding for many vital government services at risk.

But full repeal isn't the only danger. Some Senators, in hopes of finding a compromise, have expressed interest in a proposal offered by Sen. Jon Kyl (R-AZ) to lower the estate tax rate to the capital gains rate and raise the exemption to $5 million. This proposal is no compromise; if passed, it would lose 84 percent of the revenue lost by full repeal.[4]

As this report shows, the costs of full repeal and the Kyl proposal are nearly identical. In each case, a tiny number of West Virginians would benefit while hundreds of thousands of West Virginians could lose access to key services.

How will the Senate define our nation's priorities: more tax breaks for multimillionaires or an investment in important community services that benefit us all?

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[1] R. Kogan. "A 'Mere' $300 billion. Should a $300 Billion Deficit Be Considered a Victory?" May 22, 2006. Center on Budget and Policy Priorities. http://www.cbpp.org/5-22-06bud.htm

[2] The President's tax cuts enacted since 2001 account for nearly 48 percent of the plunge from budget surplus to deficit. All domestic programs accounted for only 15 percent of the decline. Carlitz, R. and R. Kogan. "CBO Data Show Tax Cuts Have Played Much Larger Role Than Domestic Spending Increases in Fueling the Deficit." January 31, 2005. Center on Budget and Policy Priorities. http://www.cbpp.org/1-25-05bud.htm

[3] Friedman, J. and R. Carlitz "Estate Tax Reform Could Raise Much-Needed Revenue: Some Reform Options With Low Tax Rates Raise Very Little Revenue" March 16, 2005. Center on Budget and Policy Priorities. http://www.cbpp.org/3-16-05tax.htm

[4] Ibid. and Friedman, J and R. Carlitz "New Kyl Proposal Still Calls For Applying Capital Gains Rate to Estate Tax, so Revenue Loss Would be Substantial" http://www.cbpp.org/7-27-05tax.htm

The Role of the Estate Tax

The estate tax was created for a purpose. It is one way very wealthy people pay society back for the benefits of the economic, judicial, educational, and transportation systems that helped them create their wealth. Given that a substantial proportion of the assets of multi-million dollar estates have never been taxed before, [5] the estate tax ensures the fairness in our tax system by guaranteeing that everyone pays their fair share and contributes to our nation's well-being.

The estate tax is also the most progressive way to raise the revenue our nation desperately needs to meet its many commitments. Taxing the accumulated assets of the wealthiest one percent is the fairest way to generate revenue because they are the most able to pay. Repealing the estate tax and replacing its revenue with another tax would likely place a higher burden on lower- and middle-income families with less disposable income. Under current law, estates worth less than $2 million for individuals or $4 million for couples are exempt from the estate tax.

In addition, the estate tax encourages charitable giving. Universities, museums, arts centers and other institutions rely on bequests and donations – many from wealthy estates seeking to benefit from the tax incentives – to run the social, educational, and cultural programs that benefit every community. A July 2004 CBO report estimated that if estate-tax repeal had been in effect in 2000, charitable donations would have been reduced by $13 billion to $25 billion that year.[6] The amount by which CBO finds that charitable donations would fall exceeds the total amount of corporate charitable donations in the United States, which equaled $11 billion in 2000. The amount by which charitable donations would shrink also approaches the total amount that foundations contribute for charitable causes each year.[7]

Considering the Costs: The Impact of Repeal or Drastic Reduction

The President and Congress must choose between extending tax breaks for the wealthiest one percent and safeguarding the investments we have made in our communities to protect our children's future. Repealing or drastically reducing the estate tax would cost close to $1 trillion over the first 10 years of full repeal. At the same time, the President included $183 billion in cuts to domestic discretionary programs on which our communities depend.[8] The budget plan passed by the House on May 18 proposed reducing funding for domestic discretionary programs by $167 billion over five years, while the Senate passed budget plan would reduce funding by $123 billion[9]. In exchange for a massive tax break for multimillionaires, we lose funding for services we all depend on: public education, affordable healthcare, first responders, highway maintenance

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[5] Poterba, J.M. and S. Weisbenner. "The distributional burden of taxing estates and unrealized capital gains at the time of death," 2001. National Bureau of Economic Research, No. 7811.
[6] Congressional Budget Office, The Estate Tax and Charitable Giving, July 2004. http://www.cbo.gov/ftpdocs/56xx/doc5650/07-15-CharitableGiving.pdf
[7] Kamin, D. "New CBO Study Finds that Estate Tax Repeal Would Substantially Reduce Charitable Giving" August 3, 2004. Center on Budget and Policy Priorities. http://www.cbpp.org/8-3-04tax.htm
[8] These cuts are over five years. (2007-2011) Kogan, R. et al. "The Hidden Cuts in Domestic Appropriations; OMB Data Reveal Deep Funding Cuts after 2007" February 7, 2006. Center on Budget and Policy Priorities. http://www.cbpp.org/2-9-06bud.htm
[9] Kogan, R. et al. "The House-Passed Budget Plan." May 22, 2006 Center on Budget and Policy Priorities. http://www.cbpp.org/3-29-06bud.htm

and homeland security. The choice is clear: weakening the estate tax is the wrong priority for West Virginia and the rest of the United States.

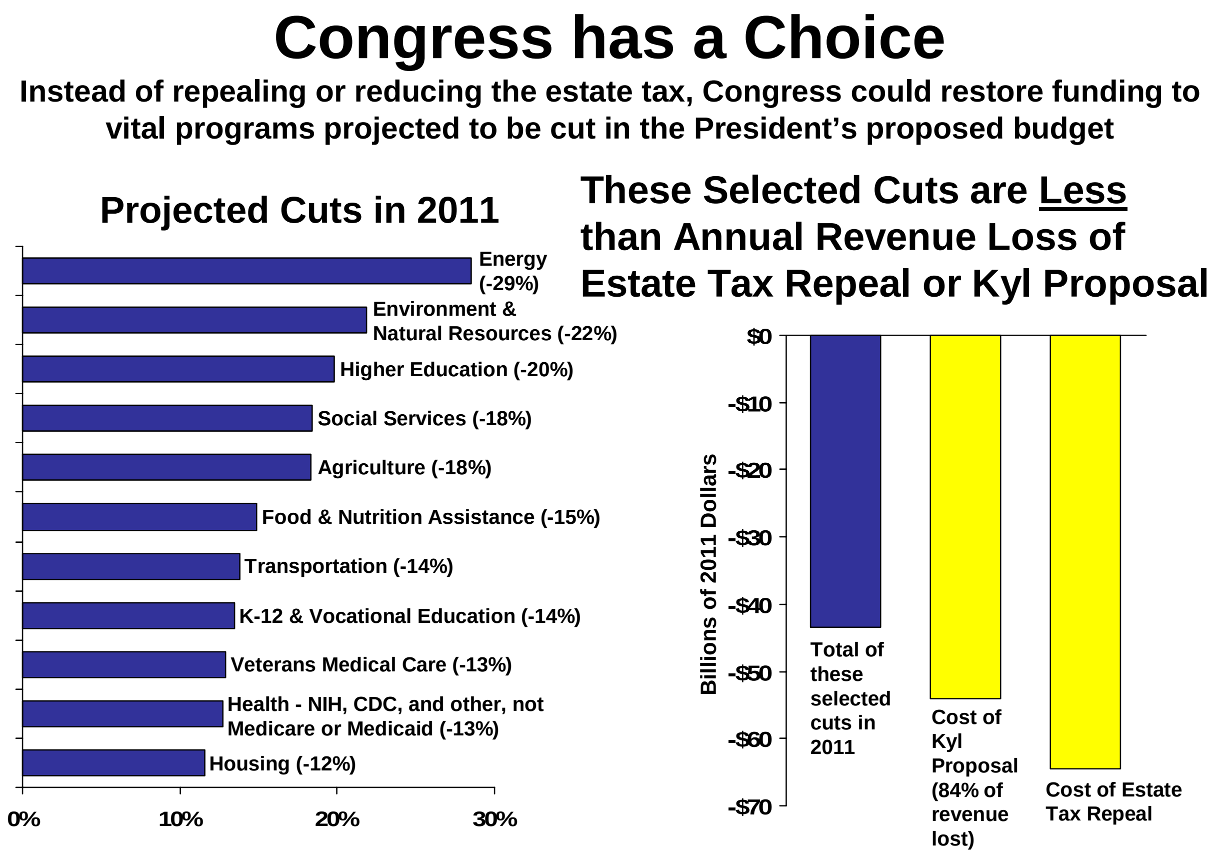
Government programs help make the American dream possible for everyone. They guarantee the promise of equal opportunity we make to all our children, every one of whom deserves a quality public education, access to health care, and the basic needs of food, shelter and safety. Cutting funding for these basic needs to pay for massive tax breaks for multimillionaires breaks the promise of the American dream. Other programs, like unemployment insurance, guarantee economic security to all Americans through difficult times such as during economic downturns or family emergencies. Jeopardizing these programs makes it more likely that if a family falls into poverty because of an emergency – like overwhelming medical bills for a loved one – they will never recover from it.

The cost of Senator Kyl's 84 percent reduction proposal as shown in Chart 1 (below)—would be nearly as detrimental to the federal budget as full repeal. Senator Kyl (R-AZ) and others are pushing proposals that would reduce the estate tax rate from 45 percent to 15 percent, which would reduce the actual rate that most estates would pay to about 6 percent (currently most estates pay an effective rate of about 20 percent).[10] Senator Kyl would also raise the exemption level to $5 million ($10 million for a couple) from the current $2 million ($4 million for a couple) and lose about 84 percent of the revenue lost by full repeal.[11] What makes the Kyl proposal so costly is lowering the estate tax rate to the capital gains rate of 15 percent (effective rate of 6 percent).

[10] Friedman, J. and R. Carlitz "Estate Tax Reform Could Raise Much-Needed Revenue: Some Reform Options With Low Tax Rates Raise Very Little Revenue" March 16, 2005. Center on Budget and Policy Priorities. http://www.cbpp.org/3-16-05tax.htm
[11] Ibid.

Chart 1- Budget Cuts vs. Revenue Lost from Estate Tax Repeal or Kyl Proposal

The following chart illustrates the choices before Congress by comparing selected budget cuts in 2011 to the revenue that would be lost in one year if the estate tax is repealed or drastically reduced.[12]



Source: CBPP analysis of OMB Data: http://www.cbpp.org/2-9-06bud-spreadsheet.pdf

Making Choices Consistent with America's Priorities

The revenue that could be lost from repeal or drastic reduction of the estate tax would be enough to cover the healthcare of all the uninsured children in the US, the food needs of all the households in the US that experience hunger and give college access to the estimated 400,000 high school seniors that forgo a four year college education due to financial cost.[13] For West

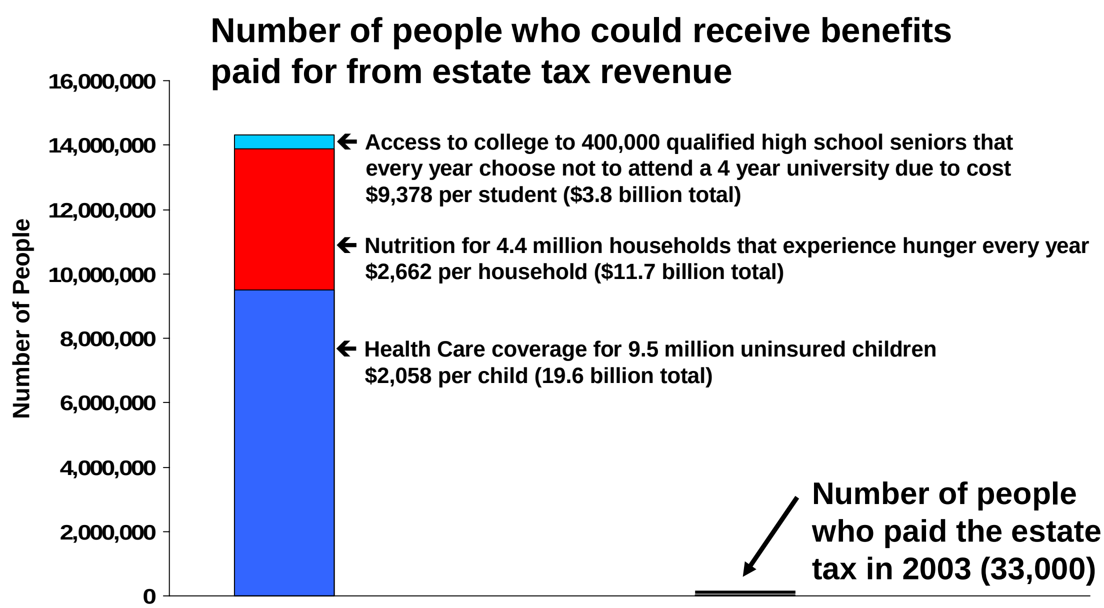
[12] The figures for the cost of estate tax repeal or Kyl's proposal in this chart represent their annual cost when in full effect, scaled to the size of the economy in 2011. This adjustment was necessary in order to make the comparison to the 2011 budget cuts accurate. Source for budget cuts in 2011 figures is the Center on Budget and Policy Priorities data on the President's 2007 budget proposal. http://www.cbpp.org/2-9-06bud-spreadsheet.pdf

[13] Note that the number of people that could receive benefits is a conservative estimate given that families that would receive nutrition aid were counted as one individual. Source for number of estates that paid estate tax is 2003 IRS Data on tax returns filed. Source for the number of uninsured children is 2003 Census data (http://www.census.gov/prod/2003pubs/p60-224.pdf)..Source for the number of households that experienced hunger was USDA http://www.ers.usda.gov/publications/err11/err11appD.pdf Source for number of seniors not attending college due to cost is the Advisory Committee on Student Financial Assistance (http://www.ed.gov/about/bdscomm/list/acsfa/emptypromises.pdf). $2,058 cost of covering one child based on Families USA data. $2,662 per household cost of providing food nutrition comes from giving an extra $20 to each person in household per week. (Avg,

Virginia this would mean enough funding to provide health care to the state's 44,000 uninsured children, food to the 71,450 households that experience hunger every year, and access to college for the 2,698 estimated qualified West Virginia high school students who do not attend college annually due to financial cost[14].

Human Face of Estate Tax Repeal

Number of people who could receive benefits from estate tax revenue compared to the number of people who paid the tax in 2003.



Fiscally Irresponsible: The Effect of Repeal on our Federal Deficit

Repealing or drastically reducing the estate tax would starve our federal budget, add stress to state budgets, and compound the problem of our spiraling national deficit. Currently, the net national debt stands at $4.8 trillion[15] and will continue to increase as long as the government continues to run annual deficits. The deficit in fiscal year 2006 is estimated to be $300 billion (2.3% of GDP) which is well above historical norms and will continue to make the debt grow faster than the economy.[16] Net interest payments on the debt alone are expected to reach $313 billion in 2010, $13 billion *more* than what the government will spend that year on education, veterans' benefits, transportation, natural resources and the environment, agriculture, and

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US household has 2.56 persons. The Household Food Security Report, 2004 calculated that food secure households spent $40 per person/per week on food, while food insecure households that experienced hunger spent $30 per person per week. http://www.ers.usda.gov/publications/err11/err11c.pdf) $9,378 per student cost of providing access to college was calculated by doubling the avg unmet need of students at public colleges with household incomes of $34,288 or less. (Source: PIRG report: http://www.pirg.org/highered/financialneed.pdf)

[14] State specific data on number of uninsured children comes from the census, and the number of food insecure households with hunger comes from USDA. State estimates of high school seniors not attending college due to cost were calculated by distributing the 400,000 national total by state based on number of state Pell Grant recipients given that Pell Grant recipients primarily come from low income households.

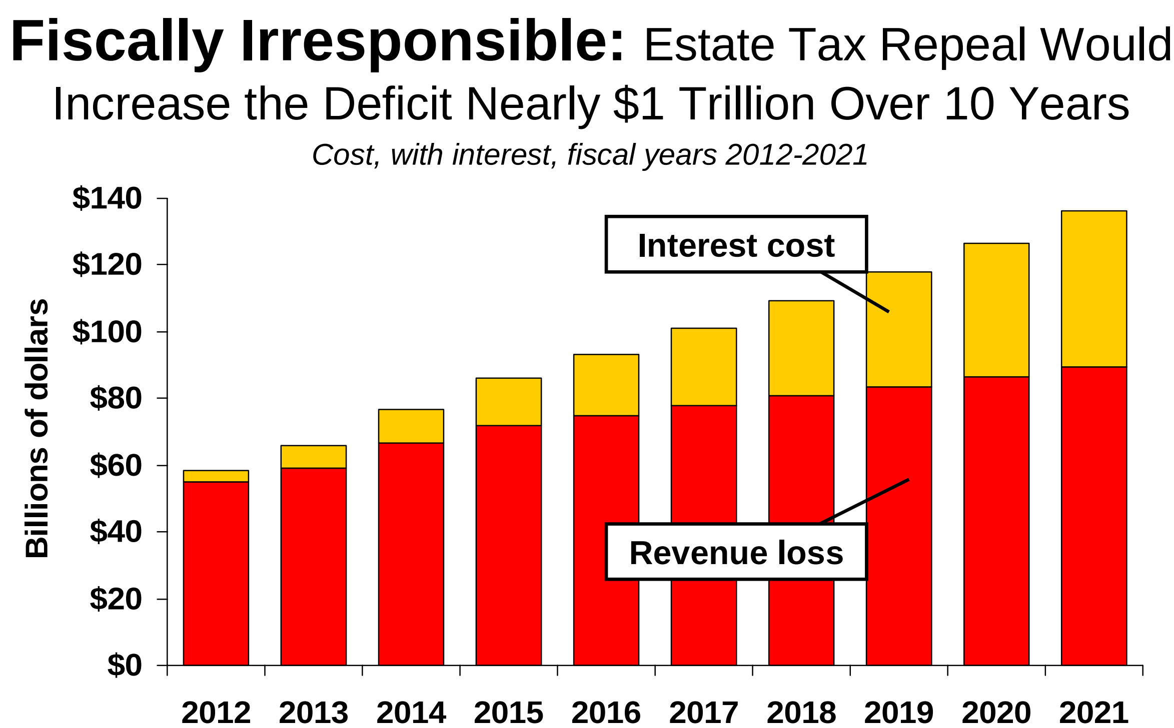
[15] Bureau of the Public Debt: Debt Outstanding by Type of Debt. http://www.publicdebt.treas.gov/opd/opdpdodt.htm

[16] R. Kogan. "A 'Mere' $300 billion. Should a $300 Billion Deficit Be Considered a Victory?" May 22, 2006. Center on Budget and Policy Priorities. http://www.cbpp.org/5-22-06bud.htm

community and regional development combined.[17] By weakening the estate tax now, we are burdening our children with increased debt in the future.

The bleak fiscal outlook at the federal level spells trouble for the budget in West Virginia and elsewhere. President Bush's proposed FY2007 budget would cut $6.7 billion from federal aid grants to states in 2007 when compared to 2006 adjusted for inflation[18]—a reduction of $48.1 million in grants to West Virginia for improved transportation and homeland security systems, education, human services, environmental protection, drug prevention and community development programs. West Virginia legislators facing these cuts will be forced to either raise state taxes or reduce services. As a result, lower- and middle-income West Virginians could face state tax increases to make up for the federal tax breaks being handed to the wealthiest one percent.

Chart 3- Estate Tax Repeal Will Increase Deficit



Source: Joint Committee on Taxation and Center on Budget and Policy Priorities

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[17] Source is Center on Budget and Policy Priorities data on the 2006 Conference Budget Agreement

[18] Lav, I. "Federal Grants to States and Localities Cut Deeply in Fiscal Year 2007 Federal Budget" February 7, 2006. Center on Budget and Policy Priorities. http://www.cbpp.org/2-7-06sfp.pdf

Drastic Reduction of the Estate Tax is Unnecessary

There is no need to drastically reduce or repeal the estate tax. At the heart of the current campaign to abolish the estate tax is a systematic distortion of the facts about who pays and who would benefit from wholesale repeal. Estate tax opponents continue to claim that it disproportionately affects farmers and small business owners, but most family farms and small businesses are already exempt.[19] In fact, only the heirs of multi-million dollar estates would see any benefit from estate tax repeal or drastic reduction. Only 105 West Virginians paid the estate tax in 2003. The taxed estates were larger than $1 million ($2 million for couples) and made up only 0.5 percent of West Virginia deaths in 2003. Nationwide, only 32,991 estates paid the tax in 2003. This was only 1.3 percent of those who died that year.[20] In 2006, just over one in 370 of all estates (0.27 percent) will pay the federal estate tax[21].

Given their reliance on many government services, most families in rural areas will be hurt if Congress weakens the estate tax. A recent report by the Congressional Budget Office put to rest the myth that the estate tax imposes a significant burden on family farms and forces many of them to sell their farms to pay the tax. In 2005, CBO found that if the current exemption level of $2 million had been in place in 2000, only 123 farm estates nationwide would have owed any estate tax.[22] In fact, one of the leading advocates for repeal, the American Farm Bureau Federation, said it could not cite a single example of a farm lost because of estate taxes.[23]

Likewise, very few small businesses are actually subject to the estate tax. If the estate tax level had been at $2 million in 2000, only 135 small businesses would have owed any estate tax at all.[24]

Unlike Senator Kyl's 84 percent reduction proposal, reasonable and responsible reform would not deepen the deficit, result in cuts to needed domestic spending, or shift the tax burden to working families. Such reform would not tie the estate tax rate to the capital gains tax rate, which would result in an enormous and unaffordable loss of revenue. Responsible reform should preserve charitable giving incentives, while protecting small farms and businesses from being unfairly taxed. Meanwhile reform should simplify the tax to make filing estate taxes less complicated and to minimize accounting costs for all taxpayers. Loopholes that exist in the tax law must be closed, and any changes to the law must not create new ways to shelter income or avoid the tax altogether.

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[19] Congressional Budget Office, "Effects of the Federal Estate Tax on Farms and Small Businesses," July 2005.

[20] Source for number of estates that paid estate tax is 2003 IRS Data on tax returns filed. Source for number of deaths is the National Center for Health Statistics mortality data.

[21] United for a Fair Economy. "Share of Estates Taxed Falls to Fraction of One Percent." January 19, 2006. http://www.faireconomy.org/press/2006/estate_tax_share_falls.html

[22] Congressional Budget Office, "Effects of the Federal Estate Tax on Farms and Small Businesses," July 2005.

[23] David Cay Johnston, "Talk of Lost Farms Reflects Muddle of Estate Tax Debate." April 8, 2001. New York Times.

[24] Congressional Budget Office, "Effects of the Federal Estate Tax on Farms and Small Businesses," July 2005.

Conclusion

The estate tax is the most progressive tool we have to raise the funds the United States needs to provide vital services to every community. But thanks to a concerted effort from the nation's wealthiest heirs and an administration that places a high priority on cutting taxes for multimillionaires, the estate tax is in danger.

Repeal or drastic reduction of the estate tax is unnecessary and dangerous, and would benefit a tiny number of West Virginia multimillionaires at the expense of education, environmental protection, community development, health care, and other services that benefit all of us. The lost revenue will compound the current deficit crisis, leaving working and middle class West Virginians to foot the bill or suffer the consequences.

The choice for Congress is clear: preserve the estate tax and protect our communities.