US ACTION
EDUCATION FUND

Setting the Right Priorities:

Why Hawaii Can't Afford Repeal or Drastic Reduction of the Federal Estate Tax

Executive Summary

In September, the U.S. 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.

Repealing the estate tax would cost tens of billions of dollars annually – totaling $1 trillion in just ten years. This report demonstrates how two proposals by Sen. John Kyl (R-AZ) that significantly lower the estate tax rate and raise exemption levels would have similarly harmful effects on the deficit and funding for vital programs.

- The FY2006 congressional budget agreement includes $31 billion in cuts to entitlement programs and $212 billion in cuts to domestic discretionary spending over five years.
- 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 97 Hawaiians– 1.2 percent of deaths that year – paid any estate tax. This report compares that figure to the estimated 10,900 Hawaiians that could lose benefits from various programs if budget cuts are addressed by reducing the number of recipients.
- Under current law, the estate tax only taxes multimillionaires. Currently, those with estates worth less than $1.5 million – $3 million for couples – are exempt from the estate tax. The current estate tax rate is 47 percent, which translates to an effective rate of about 20 percent.
- Sen. Kyl's proposals to lower the estate tax rate to the capital gains rate would remove anywhere from 80 to 93 percent of the estate tax’s revenue depending on whether the exemption level is increased to $3.5 million ($7 million for couples) or higher.
- This report shows how the loss of revenue in one year under one of Kyl's proposals could alternatively be used to make up for the entire set of budget cuts proposed to agriculture, community development, Medicaid, transportation, veterans benefits services, income security, health, environmental protection, education, training, employment and social services in 2010.
- 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 proposals, 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 our future.

This report was prepared by USAction Education Fund in August 2005.[1]

[1] Primary author was Danilo Trisi, with contributions from other USAction Education Fund staff.

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 its August recess is a House-passed bill to permanently repeal the estate tax – at a time when the federal deficit remains alarmingly high[2] (in no small part due to the 2001 and 2003 tax cuts[3]) and important community programs face major cuts. Repealing the estate tax would cost nearly $1 trillion over 10 years,[4] exploding the deficit and putting 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 proposals offered by Sen. John Kyl (R-AZ) to lower the estate tax rate to the capital gains rate. These proposals are no compromise; if passed, they would remove 80 to 93 percent of the estate tax's revenue depending on whether the exemption level is increased to $3.5 million ($7 million for couples) or higher.[5]

As this report shows, the costs of full repeal and two Kyl proposals are nearly identical. In each case, a tiny number of Hawaiians would benefit while tens of thousands of Hawaiians 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?

[2] Last year the federal deficit hit a record $412 billion. U.S. Office of Management and Budget, "Historical Tables Fiscal Year 2006" pg. 26 Available on-line at http://www.whitehouse.gov/omb/budget/fy2006/pdf/hist.pdf The Center on Budget and Policy Priorities' analysis of the August 2005 CBO Economic Update showed that projected deficits never dip below $330 billion over the next 10 years and total $4.0 trillion over the 2006-2015 period when one assumes the extension of tax cuts, continuation of current Alternative Minimum Tax relief, and a conservative estimate of future funding for the wars in Iraq and Afghanistan. http://www.cbpp.org/8-16-05bud.htm

[3] 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

[4] 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

[5] Friedman, J and R. Carlitz "New Kyl Proposal Still Calls For Applying Capital Gains Rate to Estate Tax, so Revenue Loss Would be Substantial" July 27, 2005. http://www.cbpp.org/7-27-05tax.htm and Friedman, J. and R. Carlitz "Kyl Estate Tax 'Compromise' Proposal Extremely Costly, True Cost Likely to be Masked" July 7, 2005 http://www.cbpp.org/7-7-05tax.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, [6] 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 $1.5 million – $3 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.[7] 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.[8]

Making Choices: The Impact of Repeal or Drastic Reduction

In 2006 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 eliminate close to $1 trillion over the first 10 years of full repeal. At the same time, Congress has included in its budget resolution $31 billion in cuts to entitlement programs and $212 billion in cuts to domestic discretionary programs on which our communities depend.[9] In exchange for a massive tax break for multimillionaires, we lose funding for services we all count on: public education, affordable healthcare, first responders, highway

[6] 36 percent of all estates and 56 percent of all estates larger than 10 million have never been taxed before. 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.

[7] Congressional Budget Office, The Estate Tax and Charitable Giving, July 2004. http://www.cbo.gov/ftpdocs/56xx/doc5650/07-15-CharitableGiving.pdf

[8] 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

[9] These cuts are over five years. (2006-2010) Horney, J. "Assessing the Conference Agreement on the Budget Resolution" April 28, 2005. Center on Budget and Policy Priorities. http://www.cbpp.org/4-28-05bud.htm

maintenance and homeland security. The choice is clear: weakening the estate tax is the wrong priority for Hawaii 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 reducing the estate tax—based on either of the two proposals highlighted 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 47 percent to 15 percent, which would reduce the actual rate that most estates would pay to about 5 percent (currently most estates pay an effective rate of 20 percent).[10] Proposal 1 would also raise the exemption level to $8 million ($16 million for a couple) from the current $1.5 million ($3 million for a couple) and would reduce the revenue from the estate tax by 93 percent.[11] What makes the Kyl proposals so costly is lowering the estate tax rate to the capital gains rate of 15% (effective rate of 5%). As Chart 1 below shows, even Kyl's Proposal 2 where his exemption level is raised to $3.5 million ($7 million for a couple) instead of $8 million ($16 million for a couple) would still reduce estate tax revenue by 80 percent.[12]

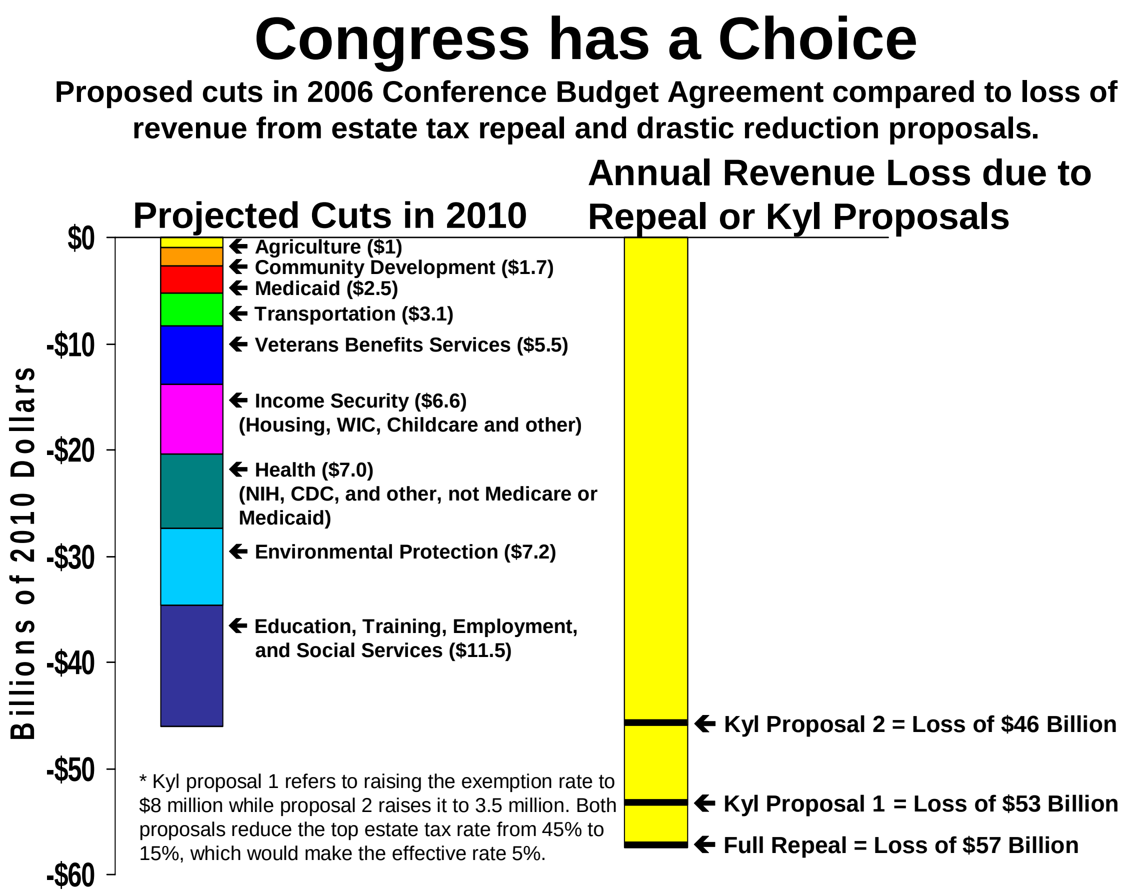
[10] Friedman, J. and R. Carlitz "Estate Tax Reform Could Raise Much-Needed Revenue: Some Reform Options With Low Tax Rates Raise Very Little Revenue" March 16, 2005. Center on Budget and Policy Priorities. http://www.cbpp.org/3-16-05tax.htm

[11] Ibid.

[12] 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

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

The following chart illustrates the choices before Congress by comparing selected budget cuts in 2010 to the revenue that would be lost in one year if the estate tax is repealed or drastically reduced.[13]



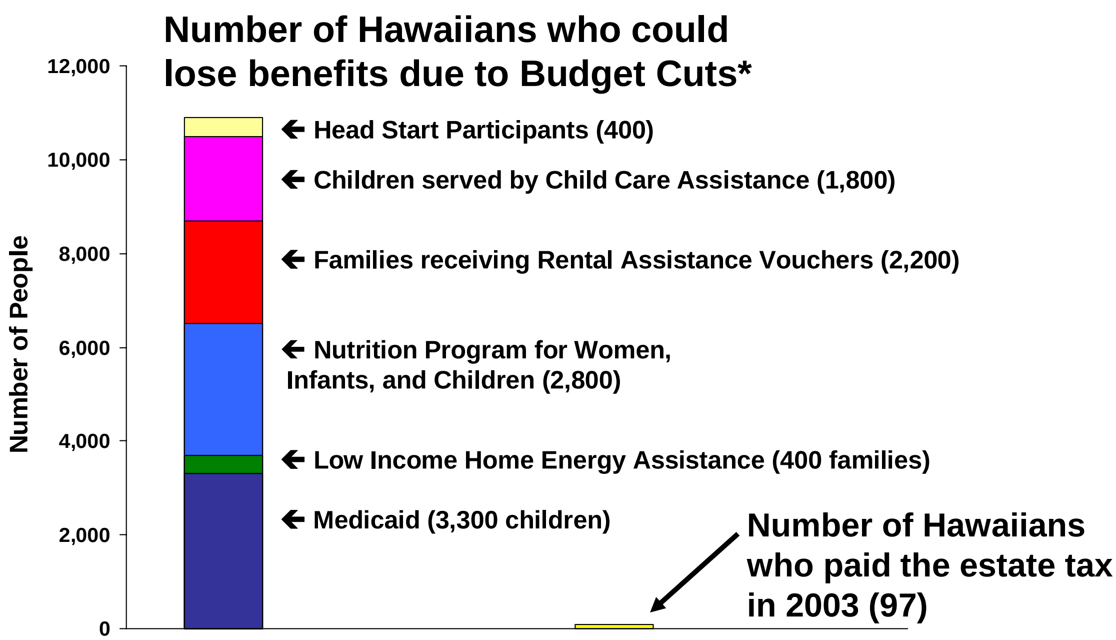
[13] Given that under current law the estate tax will be fully repealed in 2010 (to be restored in 2011), a new repeal bill or the Kyl proposals would not result in any additional revenue loss in 2010. Therefore, the figures for the cost of estate tax repeal or Kyl proposals in this chart represent their annual cost when in full effect, scaled to the size of the economy in 2010. This adjustment was necessary in order to make the comparison to the 2010 budget cuts accurate. Source for budget cuts in 2010 figures is the Center on Budget and Policy Priorities data on the 2006 Conference Budget Agreement.

Chart 2- Hawaiians That Could Lose Benefits vs. Hawaiians that Pay the Estate Tax

How do Hawaiians fare? The following chart shows the impact of proposals to repeal or reduce the estate tax on Hawaiians. It compares the number of Hawaiians who could lose services if key programs in the federal budget are cut, to the number of Hawaiians who stand to gain from repeal or reduction of the estate tax.[14]

Human Face of Estate Tax Repeal

Number of Hawaiians who could lose benefits due to budget cuts compared to number of Hawaiians who paid the tax in 2003.



***Assumes that budget shortfalls in 2010 are addressed by reducing the number of recipients (Source: CBPP, Families USA)**

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 $4.6 trillion[15] and will continue to increase as long as the

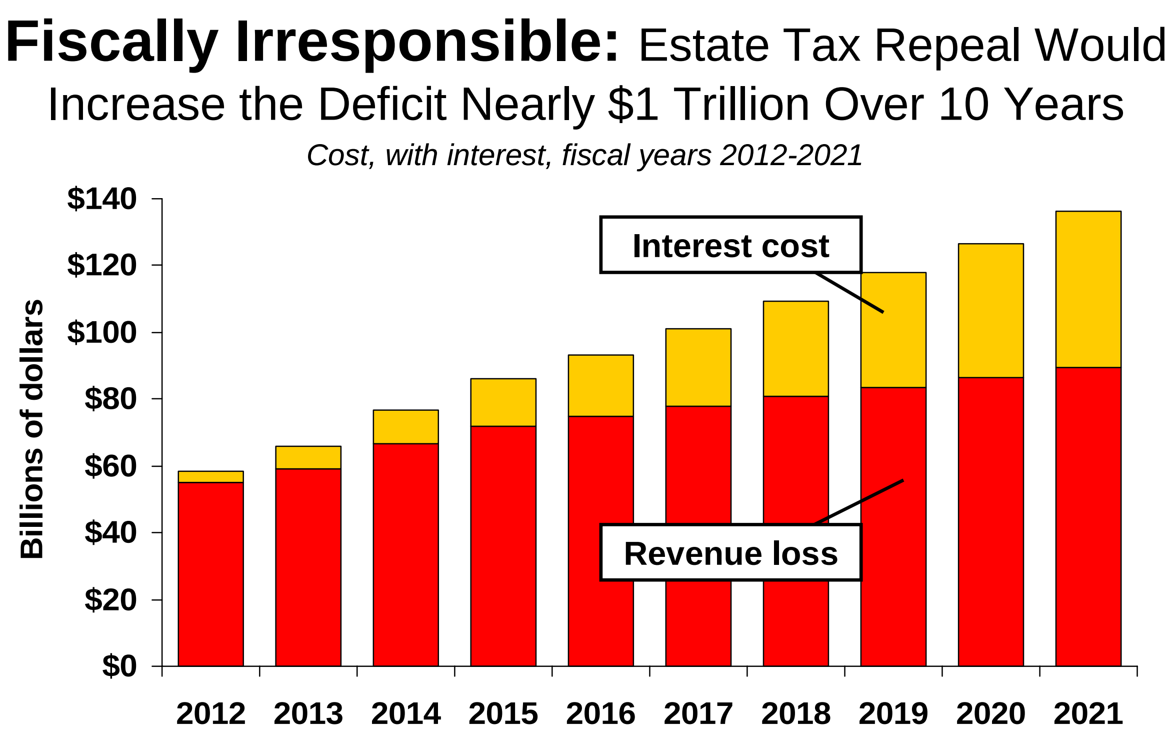
[14] Note that the number of people that could lose coverage due to budget cuts is a conservative estimate given that families that would lose rental vouchers or low income energy assistance were counted as one individual. Source for number of estates that paid estate tax is 2003 IRS Data on tax returns filed. Source for the number of people that could lose coverage due to budget cuts is Parrott, S. et al. "Where Would the Cuts be Made Under the President's Budget?" February 22, 2005. Center on Budget and Policy Priorities. http://www.cbpp.org/2-22-05bud.htm Source for number of children that could lose benefits from Medicaid is Families USA "State-level Impact of Federal Budget Agreement on Medicaid" May 9, 2005. http://www.familiesusa.org/site/DocServer/House_Senate__10_billion_1.pdf?docID=9121

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

government continues to run annual deficits. Last year's deficit was the highest ever at $412 billion. 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 community and regional development combined.[16] 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 Hawaii and elsewhere. President Bush's proposed FY2006 budget would cut at least $22 billion from federal aid grants to states in 2010[17]—a reduction of $111 million in grants to Hawaii for improved transportation and homeland security systems, education, human services, environmental protection, drug prevention and community development programs. Hawaii legislators facing these cuts will be forced to either raise state taxes or reduce services. As a result, lower- and middle-income Hawaiians could face state tax increases to make up for the federal tax breaks being handed to the wealthiest one percent.

<u>Chart 3- Estate Tax Repeal Will Increase Deficit</u>



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

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

[17] Parrott, S. et al. "Where Would the Cuts be Made Under the President's Budget?" February 22, 2005. Center on Budget and Policy Priorities. http://www.cbpp.org/2-22-05bud.htm

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.[18] In fact, only the heirs of multi-million dollar estates would see any great benefit from estate tax repeal or drastic reduction. Only 97 Hawaiians paid the estate tax in 2003. The taxed estates were larger than $1 million ($2 million for couples) and made up only 1.2 percent of Hawaii deaths in 2003. Nationwide, only 30,627 estates paid the tax in 2003. This was only 1.3 percent of those who died that year.[19]

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. CBO found that if the current exemption level of $1.5 million had been in place in 2000, only 300 farm estates nationwide would have owed any estate tax.[20] 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.[21]

Likewise, only a very small percentage of small businesses are actually subject to the estate tax. According to the U.S. Small Business Administration there were 22.9 million small businesses in the United States in 2000.[22] If the estate tax level had been at $1.5 million in 2000, only 692 estates would have filed a tax return claiming the qualified family-owned business interest reduction. Out of these, only 223 would have owed any estate tax at all.[23]

Unlike the Kyl proposals, 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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[18] Congressional Budget Office, “Effects of the Federal Estate Tax on Farms and Small Businesses,” July 2005.

[19] 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.

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

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

[22] US Small Business Administration Office of Advocacy http://www.sba.gov/advo/stats/sbfaq.html

[23] 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 Hawaii 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 Hawaiians to foot the bill or suffer the consequences.

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