CENTER ON BUDGET AND POLICY PRIORITIES
820 First Street, NE, Suite 510, Washington, DC 20002
Tel: 202-408-1080   Fax: 202-408-1056   center@cbpp.org   http://www.cbpp.org

February 5, 2002

THE KYL AMENDMENT TO LOCK IN PERMANENT REPEAL OF THE ESTATE TAX

by Joel Friedman

Senator Jon Kyl plans to offer an amendment to the stimulus bill on the Senate floor that would permanently repeal the estate tax. Under last year's tax-cut legislation, the estate tax is repealed at the beginning of 2010, but the repeal expires at the end of that year as part of the general expiration of all provisions of the tax bill. The Kyl amendment would undo the sunset on the repeal of the estate tax.

The link between locking in repeal of the estate tax beginning in 2011 and increasing consumer spending or business investment *now* — the goal of any honest stimulus proposal — is so tenuous as to undermine completely its credibility as a legitimate effort to spur economic recovery. But while offering no benefit to the economy in the short run, the Kyl amendment has the potential to cause significant further deterioration in the long-term fiscal outlook. The Joint Committee on Taxation estimates that permanent estate tax repeal would cost $55 billion in 2011 alone. Based on the Joint Committee's estimates, repeal is expected to cost $800 billion over the following decade, from 2012 through 2021.

Permanent repeal would lock in these large revenue losses just as the baby boom generation begins to retire and the Social Security and Medicare systems come under increasing pressure. Using the stimulus package to cut revenues in the next decade and beyond when the fiscal challenges to the country are sure to be immense makes little sense, particularly since the proposal does nothing to help the country address the economic challenges it faces today. Indeed, the proposal could hamper economic recovery by causing long-term interest rates to rise. Finally, locking in estate tax repeal on a permanent basis — rather than increasing the estate tax exemption substantially, but not completely repealing the tax — could deprive the Treasury of resources that ultimately will be needed to restore long-term Social Security solvency without relying on deep Social Security benefit cuts or to finance a meaningful prescription drug benefit for seniors.

Repeal of Estate Tax Has Significant Long-Term Cost

Permanent repeal of the estate tax would be extremely costly. The Joint Committee on Taxation estimates that in 2011, permanent repeal would cost $55 billion — representing one-fifth of the cost of all the tax-cut provisions in last year's package, assuming their extension. It would be the second largest revenue loser in the package when all of the provisions are fully in effect; only the upper-bracket rate reductions would lose more revenue. In the decade after 2011, the revenue losses from extending estate tax repeal is estimated to total $800 billion.[1]

Although long-range fiscal and economic forecasts are inherently uncertain, there are some things we know with some certainty about the decade that lies ahead, when the cost of permanently extending the estate tax could be very large. Specifically, we know that the baby boom generation will begin to retire in large numbers during the second decade of this century and that the cost of Social Security, Medicare, and Medicaid long-term care will rise substantially as a result. The best projections indicate that Social Security will go from running annual cash surpluses to running annual cash deficits sometime during this decade (that is, annual Social Security tax revenues will fall below annual Social Security benefit expenditures).

- CBO Director Dan Crippen observed in testimony before the Senate Budget Committee on January 23, "long-term pressures on spending loom just over the horizon. Those pressures result from the aging of the U.S. population (large numbers of baby boomers will start becoming eligible for Social Security retirement benefits in 2008 and for Medicare in 2011), from increased life spans, and from rising costs for federal health care programs."[2]

- In the Administration's budget, in a section titled "The Threat to the Budget from the Impending Demographic Transition," it states: "In the years that follow [2008], the population over the age 62 will skyrocket, putting serious strains on the budget because of increased expenditures for Social Security and for the Government's health programs which serve the elderly — Medicare and increasingly Medicaid."[3]

Looking out over the next 75 years, the cost of permanently repealing the estate tax would be equal to an amount that is *nearly half the size of the entire shortfall in the Social Security Trust Fund*. Ironically, the Kyl amendment comes only a few weeks after the President's Social Security Commission issued a report showing it was unable to come up with options to restore long-term Social Security solvency that do not involve shifting large amounts of funding from the rest of the budget to Social Security. The President's hand-picked Commission presented three options, one of which failed to restore solvency to the Trust Fund. The other two options were able to eliminate the shortfall in the Trust Fund and restore long-term solvency only by relying both on substantial cuts in traditional Social Security benefits (cuts likely to be too large

---

[1] This estimate is based on the CBO economic assumptions and Joint Tax Committee costs estimates used at the time the tax-cut package was enacted.

[2] Dan L. Crippen, "The Budget and Economic Outlook: Fiscal Years 2003-2012," Testimony before the Senate Budget Committee, January 23, 2002.

[3] "Budget of the United States Government — Fiscal Year 2003," Analytical Perspectives, p. 39.

to be acceptable politically) *and* the transfer of trillions of dollars in revenue from the rest of the budget. Permanent extension of estate tax repeal thus would risk eliminating essential resources that ultimately will be needed if long-term Social Security solvency is to be restored without deep Social Security benefit cuts or sizeable payroll tax increases.

Very Few Would Benefit from Permanent Repeal of the Estate Tax

In a recent analysis, "Economic Stimulus: Evaluating Proposed Changes in Tax Policy," the Congressional Budget Office presented general principles for effective economic stimulus. The goal of stimulus, CBO advised, is to boost consumer spending and business investment in the short term when the economy is weak. With regard to individual tax cuts, CBO noted that "tax cuts that are targeted toward lower-income households are likely to generate more stimulus dollar for dollar of revenue loss — that is, be more cost-effective and have more bang for the buck — than those concentrated among higher-income households." Permanent repeal of the estate tax as a stimulus proposal is particularly ill-conceived, not only because the proposal would be effective at the end of the decade (years after the current recession has ended), but also because the benefits of this proposal would flow only to the most well-off.

The estate tax is a very progressive tax paid by only by the wealthiest in the country. According to Treasury Department data, 91 percent of the tax is paid by the top five percent of taxpayers.[4] Furthermore, in 1999, the latest year for which IRS data are available, only two percent of the estates of people who died were subject to the tax. In addition, more than half of all estate taxes paid in 1999 were paid by the 3,300 largest estates, all of which were valued at over $5 million. Fully half of the estate tax was paid by the estates of the wealthiest one of every 700 people who died.

Moreover, despite the myths built up around the impact of the estate tax on small family farms and businesses, only a small fraction of the estate tax is paid on these enterprises, and few small family farms or businesses are ever subject to the tax. Current estate tax law already provides sizable special tax breaks for these family farms and businesses. A Treasury Department analysis of 1998 estate tax data shows that only six in every 10,000 people who died that year left a taxable estate in which a family business or farm formed the majority of the estate.

---

[4] These Treasury estimates reflect the distribution of the estate tax burden assuming the tax is paid by the estate. Some object to this approach, claiming that the incomes of the heirs are not as high as those as the decedents. A Brookings Institution analysis concludes, however, that the progressivity of the estate tax is high whether it is based on the incomes of the decedents or the heirs because "the recipients of large inheritances tend to have very high income and (non-inheritance) wealth themselves." See William Gale and Joel Slemrod, "Overview" in William Gale, James Hines, and Joel Slemrod, eds., *Rethinking Estate and Gift Taxation* (Brookings Institution Press: Washington, 2001).

Permanent Extension of the Tax Cuts Unlikely to Benefit the Economy in Either the Short or the Long Term

Senator Kyl's amendment is part of a larger effort to make permanent all of the provisions in last year's tax-cut package. President Bush supports permanent extension of these tax cuts, and Senator Phil Gramm is to offer an amendment to the Senate stimulus legislation that would remove the 2010 sunset. Although proposals to cut taxes starting in 2011 would have little to do with stimulating the economy this year, supporters of these proposals will no doubt try to claim that making these tax cuts permanent will, in fact, have a positive economic impact. Such claims do not withstand scrutiny.

For instance, supporters may argue that making the tax cuts permanent will generate increased economic activity today, since consumers and businesses will take into account future tax savings and will increase their spending immediately. The empirical evidence does not support this contention, as Peter Orszag, the Joseph A. Pechman Senior Fellow in Tax and Fiscal Policy at the Brookings Institution, explained convincingly in testimony before the Senate Budget Committee on January 29. Orszag noted that the argument that future tax cuts have significant effects on economic activity today is belied by studies of previous tax cuts that phased in over time. Orszag reported: "These studies strongly suggest that people tend *not* to spend tax cuts prospectively; instead, they largely wait until the money is in their pockets."

Supporters of proposals to make the tax cuts permanent also may argue that doing so would have a positive long-term impact on the economy. Orszag's well-documented testimony rebuts this contention as well. He explains, based on the economic research in the field, that the marginal tax rate reductions and other provisions of the tax cut enacted in June are likely to have only a small impact in boosting long-term economic growth, and that these small positive effects are likely to be offset by the negative effects the tax cut would have in reducing national saving by depleting projected budget surpluses. Orszag observed that "any positive incentive effects from lower tax rates in the long run are offset by the adverse effects from lower national savings. The overall effect of the yet-to-be-implemented tax cuts on economic activity in the long run may, if anything, be negative."

See Peter R. Orszag, "The Budget and the Economy," Testimony before the Senate Budget Committee, January 29, 2002; and Peter Orszag and Robert Greenstein, "Future Tax Cuts and the Economy in the Short Run", Center on Budget and Policy Priorities, January 28, 2002. On the long-run economic effects of the estate tax, See William Gale and Maria Perozek, "Do Estate Taxes Reduce Saving," in William Gale, James Hines, and Joel Slemrod, eds., *Rethinking Estate and Gift Taxation* (Brookings Institution Press: Washington, 2001).

Before repeal of the estate tax occurs in 2010, the already-modest number of estates subject to the estate tax will decline quite substantially, as a result of the changes in the estate tax enacted last year. In 2001, the size of an estate had to exceed $675,000 to be subject to tax ($1.35 million for a couple). This exemption level increased to $1 million in 2002 ($2 million for a couple). It will rise to $3.5 million ($7 million for a couple) in 2009.

- In the year before repeal takes effect, only those estates valued in excess of $3.5 million — which represent fewer than *one-half of one percent* of all estates — will be taxable. The burden on family farms and businesses will be negligible.[5]

- Further, the amount of tax paid by the remaining taxable estates will be substantially less than under current law, both because the first $3.5 million of an estate ($7 million for a couple) will be exempt from the tax and because the tax law enacted last year reduces the top estate tax rate that will apply to the taxable portion of an estate from 55 percent to 45 percent.

- Maintaining the exemption at $3.5 million would lose only about half of the revenue that would be lost under full repeal. The remaining revenue could prove to be essential to help restore Social Security solvency or provide a prescription drug benefit for seniors. Policymakers need to preserve — not to foreclose prematurely — the option of stopping short of full, permanent repeal of the estate tax.

Conclusion

Senator Kyl's proposal to make estate tax repeal permanent is far removed from the goals of the stimulus legislation he seeks to amend. While the stimulus bill is intended to boost the economy in the short run and to counter the ill effects of the recession, the Kyl amendment would not take effect until the end of the decade, many years after the current recession has ended.

But the Kyl amendment is much more dangerous than simply being ineffective stimulus. Enactment of the Kyl amendment would lead to revenue losses upwards of $800 billion in the decade after 2011, precisely the time when budget first confronts the high costs of supporting the retirement of the baby boomers. The amendment should be rejected on the grounds that it offers no stimulus to the economy in the short run and starves the Treasury of revenue that may be needed for Social Security and Medicaid in coming decades (or may be needed to help avoid crushing deficits in those years), when the nation will have to address the sobering demographic realities that lie ahead.

---

[5] A Treasury Department analysis of a Senate Democratic proposal to raise the exemption to $4 million for family farms and businesses found that almost all family-owned farms and nearly three-quarters of family-owned businesses that would have paid estate tax under the 2001 estate tax law would be exempt.