file: taxplan
to Ann O'Leary

# CENTER ON BUDGET AND POLICY PRIORITIES

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Center on Budget and Policy Priorities

From the desk of...
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Date June 6, 2000

Re: Estate Tax and tax cuts

Enclosed are two Center papers: The first is on the Republican bill to gradually repeal the estate tax. The vote on the bill is either Thursday or Friday.

Also attached please find a new CBPP paper that finds that the cost of tax cuts passed by the House, the Senate, or both chambers would consume $649 billion over 10 years.

CENTER ON BUDGET AND POLICY PRIORITIES

June 2, 2000

# ESTATE TAX REPEAL: A WINDFALL FOR THE WEALTHIEST AMERICANS

by Iris J. Lav and James Sly


## Summary

On May 25 the House Ways and Means Committee passed legislation introduced by Chairman Bill Archer that would repeal the federal estate, gift, and generation-skipping transfer tax by 2010.

Repealing the estate tax would provide a massive windfall for some of the country's wealthiest families.

- In 1997, the estates of fewer than 43,000 people — fewer than 1.9 percent of the 2.3 million people who died that year — had to pay any estate tax. The Joint Committee on Taxation projects that the percentage of people who die whose estates will be subject to estate tax will remain at about two percent for the foreseeable future. In other words, *98 of every 100 people who die face no estate tax whatsoever.*

- To be subject to tax, the size of an estate must exceed $675,000 in 2000. The estate tax exemption is rising to $1 million by 2006. Note that an estate of *any* size may be bequeathed to a spouse free of estate tax.

- Each member of a married couple is entitled to the basic $675,000 exemption. Thus, a couple can effectively exempt $1.35 million from the estate tax in 2000, rising to $2 million by 2006.

- The vast bulk of estate taxes are paid on very large estates. In 1997, some 2,400 estates — the largest five percent of estates that were of sufficient size to be taxable — paid nearly *half* of all estate taxes. These were estates with assets exceeding $5 million. This means about half of the estate tax was paid by the estates of the wealthiest one of every 1,000 people who died.

- If the estate tax had been repealed, each of these 2,400 estates with assets exceeding $5 million would have received a tax-cut windfall in 1997 that averaged more than $3.4 million.


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As these statistics make clear, the estates of a tiny fraction of the people who die each year — those with very large amounts of wealth — pay the bulk of all estate taxes. Moreover, a recent Treasury Department study shows that most of the estate taxes are paid on the estates of people who, in addition to having very substantial wealth, still had high incomes around the time they died. The study found that 91 percent of all estate taxes are paid by people whose annual incomes exceeded $190,000 around the time of their death.

## Small Businesses and Family Farms

It often is claimed that repeal of the estate tax is necessary to save family businesses and farms — that is, to assure they do not have to be liquidated to pay estate taxes. In reality, only a small fraction of the estate tax is paid on small family businesses and farms. Current estate tax law already includes sizable special tax breaks for family businesses and farms.

Moreover, to the extent that problems may remain in the taxation of small family-owned businesses and farms under the estate tax, those problems could be specifically identified and addressed at a modest cost to Treasury. Wholesale repeal of the estate tax is not needed for this purpose.

- Farms and family-owned business assets account for *less than four percent* of all assets in taxable estates valued at less than $5 million. Only a small fraction of the estate tax is paid on the value of farms and small family businesses.

- Family-owned businesses and farms are eligible for special treatment under current law, including a higher exemption. The total exemption for most estates that include a family-owned business is $1.3 million in 2000, rather than $675,000. There also is a special way to value family-owned businesses and farms for purposes of the estate tax, which can reduce the value placed on them for estate tax purposes by as much as $770,000. Still another feature of current law allows deferral of estate tax payments for up to 14 years, with interest charged at rates substantially below market rates.

- If policymakers wish to do so, they can change the law to exempt from the estate tax a substantially larger amount of assets related to family-owned farms or businesses, without repealing or making other sweeping changes in the estate tax. For example, a targeted proposal put forth by some Members of Congress in 1999 would have provided very substantial estate tax relief to family-owned farms and small businesses at a cost of approximately $1 billion a year.

## Effective Estate Tax Rates Much Lower than Marginal Rates

The estate tax is levied at graduated rates depending on the size of the estate; the highest tax rate is 55 percent. This sometimes leads people to conclude that when someone dies, half of their estate will go to the government.

It normally is not the case that half of an estate is taxed away, however, because effective tax rates for estates of all sizes are much lower than the marginal tax rate of 55 percent. On average for all taxable estates in 1997, estate taxes represented 17 percent of the gross value of the estate. In other words, a combination of permitted exemptions, deductions, and credits, together with estate planning strategies, reduced the effective tax rate to less than one-third of the 55 percent top marginal tax rate.

**Repeal of the Estate Tax Carries A High Cost**

Repealing the estate tax would be very costly. According to the Joint Committee on Taxation, the Archer proposal would cost $105 billion over the first 10 years, as it phased in slowly. Once the proposal was fully in effect — and the estate tax had been repealed — the proposal would cost about $50 billion a year. The cost of the proposal in the second 10 years — zfrom 2011 to 2020 — would be nearly six times the cost for 2001 - 2010.

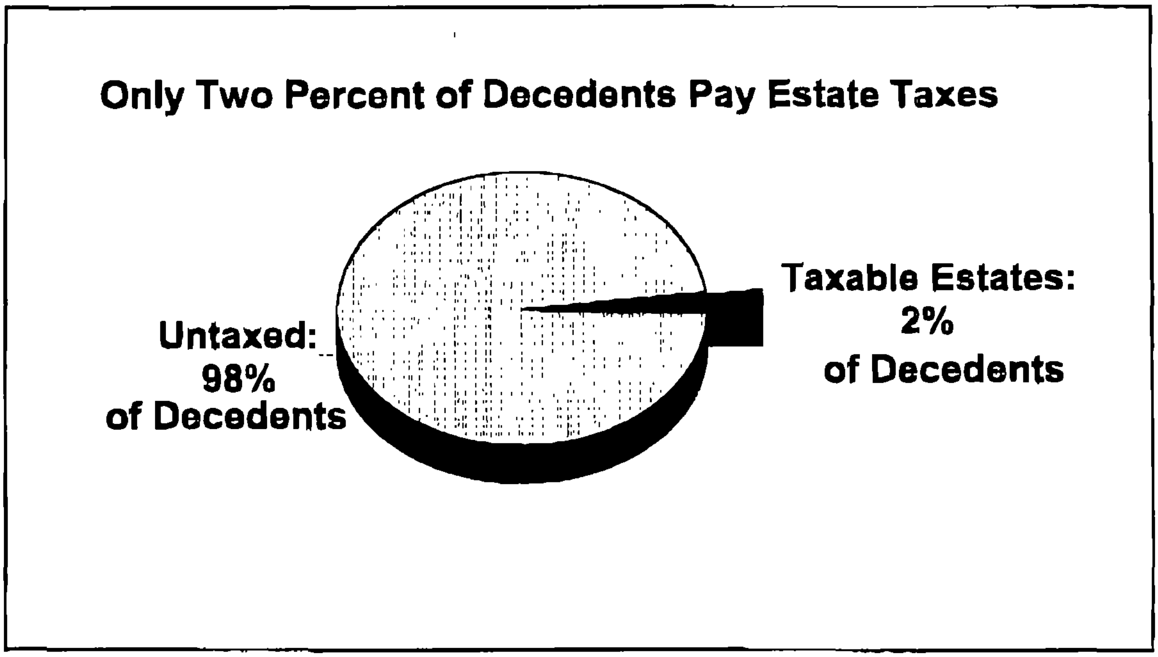
- Under Chairman Archer's proposal, the estate tax would be reduced gradually over the next decade, leading to full repeal in calendar year 2010.[1] Under current law, CBO projects the estate tax will bring in $48 billion a year by 2010.

- In the 10 years between 2011 and 2020, the estate tax likely would bring in at least $620 billion under current law. The Archer proposal includes a provision, relating to the valuation of capital assets when a person dies, that would offset a small portion of the revenue loss from repeal of the estate tax. The offsetting revenue gain is likely to be in the range of $5 billion to $10 billion a year.

  The net effect of the Archer proposal when fully phased in thus would be a revenue loss likely *exceeding half a trillion dollars over 10 years.*

The very high cost of repeal would be felt fully in the second decade of this century. That is the period when the baby boomers begin to retire in large numbers, substantially increasing the costs of programs such as Social Security, Medicare, and Medicaid. As a result of those increased costs, and the relatively slow growth in the labor force that is anticipated, the Congressional Budget Office has projected that total budget surpluses will begin to decline during this period and eventually turn into large and rapidly growing deficits even if there are no changes in current policies — that is, even if there are no additional tax cuts. Those deficits will ultimately generate pressure for reductions in Social Security, Medicare, and Medicaid benefits and limit the funds available to meet high priority needs such as improving educational opportunities, expanding health insurance coverage, and reducing child poverty. Repealing the estate tax would significantly increase those pressures.

[1] The full revenue effects of the repeal would not be felt until 2012 or 2013, because there is a lag for settlement of estates and collection of tax.




**Most Estate Taxes Are Paid by Large Estates**

Most estate taxes are paid by large estates rather than by small family-owned farms and businesses. As noted above, the first $675,000 of an estate is exempt from taxation in 2000, with the exemption scheduled to rise to $1 million by 2006. In addition, an unlimited amount of property can be bequeathed to a spouse free of estate tax.

Moreover, each member of a married couple is entitled to the basic $675,000 exemption. A number of simple estate planning devices are available under the law, the net effect of which is to double the amount a couple can exempt from estate taxation. Thus, a couple can effectively exempt $1.35 million from estate tax in 2000, rising to $2 million by 2006.

As a result of these exemptions and other provisions, such as unlimited deductions for charitable giving, only about two percent of all deaths result in estate tax liability. Of the 2.3 million people who died in 1997, for example, fewer than 43,000 had to pay any estate tax.[2]

Of those estates that are taxable, it is the largest estates that pay most of the estate tax. An analysis by IRS of the 42,901 taxable estates filing in 1997 showed that the 5.4 percent of taxable estates with gross value exceeding $5 million paid 49 percent of total estate taxes. In other words, about half the estate tax was paid by the estates of just 2,400 people — about one

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[2] Joint Committee on Taxation, *Present Law and Background on Federal Tax Provisions Relating to Retirement Savings Incentives, Health and Long-Term Care, and Estate and Gift Taxes* (JCX-29-99), June 15, 1999. As noted in the JCT report, the number of taxable estates filing tax estate tax returns in 1997 is compared to the number of decedents in 1997. In fact, tax returns are not necessarily filed in the year of death.

out of every 1,000 people who died. The 15 percent of taxable estates with gross value exceeding $2.5 million paid nearly 70 percent of total estate taxes.[3]

The average estate tax payment for the 2,400 taxable estates with assets exceeding $5 million in 1997 was $3.47 million. Thus, if the estate tax had been fully repealed for 1997 filers, fewer than 2,400 of the wealthiest people who died would have received a tax-cut windfall averaging more than $3.4 million each. A few hundred of the very wealthiest people who left estates exceeding $20 million would have received a tax-cut windfall of more than $10 million each.

## Estate Tax Payers Also are High-Income

A new analysis by the Treasury Department looks at the annual *income* of decedents who pay estate taxes. The Treasury analysis finds that virtually all estate taxes — 99 percent — are paid on the estates of people who were in the highest 20 percent of the income distribution at the time of their death. Some 91 percent of all estate taxes are paid decedents with annual incomes exceeding $190,000 around the time of their death.[4]

## Tax Share of Estates Far Lower than Marginal Rates

It often is claimed that estate tax rates are too high and that the government should not be taking as much as half of a person's lifetime savings when he or she dies. The assertion that the government takes half of a person's estate stems from the fact that the estate tax is levied at graduated rates, with the highest marginal rate of 55 percent applying to estates with a value exceeding $3 million.[5]

Data on estate taxes actually paid, however, show that estate taxes represent one-sixth the value of the average estate, not one-half. As shown in Table 1, estate taxes paid equaled 17 percent of the gross value of taxable estates for which estate tax returns were filed in 1997. The smallest and the largest estates had the lowest effective tax rates.[6] In estates valued between $2.5

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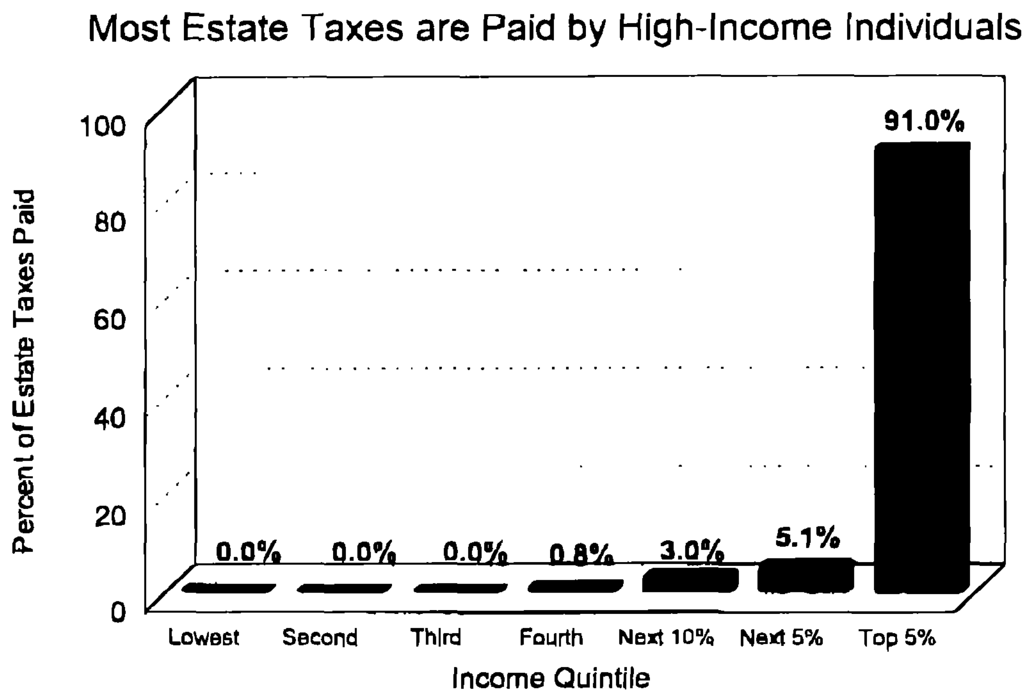
[3] Internal Revenue Service, *SOI Bulletin*, Summer 1999.

[4] Julie-Anne Cronin, *U.S. Treasury Distributional Analysis Methodology*, OTA Paper 85, September 1999. For most decedents, this income is measured after retirement, when income may be lower than earlier in life.

[5] For estates valued between $10 million and approximately $17 million there is a surcharge that phases out the value of the lower marginal rates, which brings the marginal tax rate to 60 percent for estates in that value range. Estates valued at more than approximately $17 million are taxed at a flat rate of 55 percent.

[6] The fact that the largest estates have an effective tax rate below all size estates except the smallest may suggest that the largest estates make greater use of estate tax planning and estate tax avoidance techniques. There may be significant opportunity to curb tax avoidance by large estates and use the additional revenues to lower estate tax rates for all estates.




Distribution of Estate Taxes by Family Economic Income under Current Law in 2000. US Department of Treasury, Office of Tax Analysis, September 1999.

million and $20 million, the effective tax rate was approximately one-quarter of the amount of the gross estate.

## Small Businesses and Farms Make up Only a Small Fraction of Taxable Estates

IRS data show that farms and small, family-owned businesses make up only a small proportion of taxable estates. Farm property, regardless of size, accounted for *about one-quarter of one percent* of all assets included in taxable estates in 1997. Family-owned business assets, such as closely-held stocks, limited partnerships, and non-corporate businesses, accounted for *less than four percent* of the value of all taxable estates of less than $5 million.

Farm and family-owned business assets together accounted for about 10 percent of all assets included in all estates, and less than four percent of the value of all taxable estates of less than $5 million.

**Table 1**
**Estate Tax Returns Filed in 1997**

| Size of Estate | Number of Taxable Filers | Amount of Gross Estate (millions) | Estate Tax After Credits (millions) | Effective Tax Rate |
|---|---|---|---|---|
| $600,000 - $1 million | 19,006 | 15,315 | 835 | 5.45% |
| $1 million - $2.5 million | 17,606 | 26,066 | 4,294 | 16.47% |
| $2.5 million - $5 million | 3,954 | 13,567 | 3,409 | 25.13% |
| $5 million - $10 million | 1,414 | 9,954 | 2,669 | 26.81% |
| $10 million - $20 million | 592 | 8,097 | 1,966 | 24.28% |
| $20 million or more | 329 | 24,649 | 3,465 | 14.06% |
| Total | 42,901 | 97,650 | 16,637 | 17.04% |

Source: Internal Revenue Service, *SOI Bulletin*, Summer 1999.

## Smaller, Family-Owned Business Already Eligible for Favorable Treatment

Family-owned businesses and farms already are eligible for special treatment under current law.

- Under current law, family-owned businesses and farms may be valued in a special way that reflects the current use to which the property is put, rather than its market value. This provision generally reduces the value that is counted for purposes of estate tax; the reduction in value can be as much as $770,000 in 2000. (As a result of the 1997 tax law changes, this maximum reduction in value is indexed annually for inflation.)

  To use the special valuation, the decedent or other family members must have participated in the business for a number of years before the decedent's death, and family members must continue to operate the business or farm for the following 10 years. These conditions, along with the $770,000 cap on the value of property subject to the special-use valuation, assure that the benefit goes to relatively smaller businesses and farms that are family owned and operated.

- The amount of an estate that is exempt from taxation is higher for family-owned businesses and farms than for other types of estates. Instead of the $675,000 exemption (rising to $1 million in 2006), the 1997 tax law increased the total exemption for most estates that include family-owned businesses to $1.3 million.

- In addition, when the value of a family-owned business or farm accounts for at least 35 percent of an estate, current law allows deferral of taxation. The tax payable on such an estate may be stretched over up to 14 years, including deferral of annual interest payments for five years, followed by up to 10 annual installments of principal and interest.[7]

If payments are deferred and paid over time in installments, a below-market interest rate of just two percent applies to the tax attributable to the first $1,030,000 in value of a closely held (family) farm or business. There also is a preferential rate on the tax attributed to the remaining value of the family farm or business.

## Estate Tax Relief for Family Farms and Small Businesses Can Have Modest Cost

There are a number of ways the estate tax burden could be substantially relieved for these family businesses and farms without repealing or making fundamental changes in the rest of the estate tax. A proposal that Representatives Charles Rangel and others made earlier this year is a case in point.

- The proposal would have raised the exclusion for family-owned farms and small businesses from $1.3 million to $2 million. It also would have allowed the transfer of any unused portion of the exclusion between spouses. As a result, a married couple with a farm or small business interest would receive a $4 million exclusion. (Under current law, a couple can receive a $2.6 million exclusion for a farm or small business interest if they engage in some estate tax planning. The Rangel provision would have provided the $4 million exclusion *without* the need for estate tax planning.)

- This type of substantial additional tax relief for family owned farms and businesses carries a cost that is only a tiny fraction of the cost of fully repealing the estate tax. This provision would cost about $1 billion a year, compared to the approximately $50 billion-a-year cost of the Archer proposal when fully in effect.

## Cost of Repealing Estate Tax is High and Unaffordable

The Joint Committee on Taxation estimates that the Archer proposal to reduce and then repeal the estate tax would cost $104.5 billion over the 10-year period from 2001 through 2010. Full repeal of the estate tax would be effective for people who die in 2010. The full revenue effect from repeal, however, would not be felt until two to three years after that. This is because estate taxes are rarely paid in the year of death; it takes two to three years to settle an estate and file the estate tax return. As a result, the revenue effect of the proposed legislation is not

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[7] The executor of an estate can elect to defer paying the estate tax liability for five years and then pay the deferred taxes in 10 installments. The first installment and the last year of the deferral period coincide, meaning that the maximum extension is 14 years.

reflected for any year within the 10-year period for which the revenue loss is estimated by the Joint Committee.

Under current law, CBO projects the estate tax will bring in $48 billion a year by 2010. In the 10 years between 2011 and 2020, the estate tax likely would bring in at least $620 billion under the provisions of current law. Full repeal would result in the loss of the entire $620 billion over the 10-year period. The Archer proposal also includes a provision relating to the valuation of capital assets when a person dies that would offset a small portion of the revenue loss from repeal of the estate tax; the offsetting revenue gain is likely to be in the range of $5 billion to $10 billion a year.[8] Thus, the net effect of the Archer proposal when fully phased in would be a revenue loss likely to exceed half a trillion dollars over the 10-year period from 2011 through 2020.

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[8] Capital gains income — the income from the appreciation of assets such as stocks, bonds, and real estate — is not taxed until the income is "realized" — that is, until the assets are sold. If an asset is held until the owner dies, the gain in the value of the asset is never subject to capital gains taxation. The heirs inherit the assets valued at the market price at the time of death and are not required to pay tax on any appreciation that took place during the life of the decedent. The Archer proposal would, for large estates, require heirs to value assets for purposes of capital gains taxation at the original price of the asset. Thus, some additional capital gains taxes would be collected if and when the heirs ultimately sold the assets.

CENTER ON BUDGET AND POLICY PRIORITIES

*Revised June 2, 2000*

# COST OF TAX CUTS THE HOUSE OR SENATE HAS PASSED OR ARE EXPECTED TO PASS SOON TOTAL $649 BILLION

Congress has already staked a claim on a substantial portion of the non-Social Security surplus anticipated over the next decade. If the Senate passes the "marriage-penalty" legislation the Finance Committee has proposed and the House passes the Ways and Means Committee-approved repeal of the estate tax, tax cuts the House, the Senate, or both chambers have approved this year would consume $649 billion over 10 years. These tax cuts include:

- $248 billion in tax cuts over 10 years included in the "marriage-penalty" tax bill the Senate Finance Committee reported (the House passed a somewhat less expensive version of the bill earlier this year);

- $104 billion in tax cuts from a phased-in repeal of the estate tax, which was approved by the House Ways and Means Committee on May 25 and may be considered by the full House as early as the week of June 5. (The cost of the bill in 2001 through 2010 greatly understates the true effects of the legislation because the estate tax repeal is phased in slowly. In 2011 through 2020, the legislation is likely to reduce revenues by *more than $500 billion*.)

- $122 billion in tax cuts in a bill the House passed March 9 that was portrayed as a measure to offset the cost of a higher minimum wage to small business, although the majority of the bill's tax cuts are estate tax reductions that have little to do with small business (and would be superceded by the estate tax repeal reported by the Ways and Means Committee);

- $103 billion in tax cuts contained in bankruptcy legislation the Senate passed in early February, which Congressional leaders are seeking to reconcile with a bankruptcy bill the House passed last year;

- $51 billion in excise tax cuts from the repeal of the telephone tax passed by the House on May 25;

- $21 billion in education-related tax cuts the Senate approved March 2; and

- $4 billion in reduced revenues resulting from the extension of duty-free and quota free treatment of specified products imported into the U.S. from certain sub-Saharan African and Carribean Basin nations.

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When duplication among the bills is eliminated, the aggregate revenue loss from their tax cuts equals $531 billion over 10 years and $154 billion over five years, with much of that amount consumed by tax cuts predominately oriented toward higher-income individuals. The budget resolution allows for additional tax cuts that could bring the five-year reduction in revenues to at least $175 billion. As the cuts passed by the House or Senate would absorb money that otherwise would be available for paying down debt, they would result in higher interest payments on the debt. The increased interest payments would amount to $118 billion over 10 years. The total cost of the tax cut proposals that have won approval this year thus would be $649 billion over 10 years, and $171 billion over five years.

Committing the federal government to these tax cuts would mean that $649 billion over the next decade would not be available for other purposes. The passage of these tax bills reflects a decision to give tax cuts precedence over other potential needs, such as paying down debt and bolstering the Medicare trust fund.

# CENTER ON BUDGET AND POLICY PRIORITIES

**To:** Gene Sperling, Jack Lew, Bruce Reed, Larry Summers, Barbara Chow, Melanne Verveer

**From:** Bob Greenstein

**Subject:** One Further Idea Related to Mid-session Review

**Date:** June 4, 2000

In the memo I sent you last week, I noted that the general income exclusion in the SSI program had not been adjusted for inflation since being set at $20 a month in 1972, with the result that combined Social Security/SSI benefits for poor elderly and disabled individuals and couples who receive modest Social Security payments have declined. I suggested that consideration be given to proposing an increase in this exclusion.

In writing the memo, I overlooked the fact that there also is a second SSI income exclusion that has not been adjusted for inflation since 1972 and in which an increase should be considered — the SSI earned income exclusion. To encourage work, Congress structured SSI (when it created the program in 1972) so that SSI beneficiaries who work would have higher incomes than those who did not. This was accomplished by excluding the first $65 a month in earnings, plus half of remaining earnings.

This $65 amount has never been adjusted for inflation. Had it been adjusted regularly, this exclusion would now be $260. Looked at another way, the $65 exclusion today is worth the same amount as a $16 exclusion would have been when the program was created.

This has created problems. When Congress established the exclusion, fewer than half of SSI beneficiaries who worked had earned income of more than $65 a month. Now, a far larger number do. Indeed, just *13 hours of work a month* (about three hours a week) at the $5.15-an-hour minimum wage produces earnings above the $65 level.

In addition to penalizing very modest work effort, the failure to adjust the $65 level also has increased program complexity and imposed burdens both on elderly and disabled beneficiaries and on SSA. A substantial number of SSI beneficiaries have earnings of more than $65 a month; they must report small amounts of earnings frequently, often on a monthly basis. A recent report from the Social Security Administration notes that the low level of the $65 threshold results in "burden on beneficiaries to report insignificant earnings and on SSI field office employees to adjust monthly payments of almost 300,000 beneficiaries" and "imposes increasing administrative costs and complexities."

This can be addressed by raising the $65 threshold and indexing it. According to the SSA report, raising it to $200 (still below its real 1972 level) and indexing it would raise SSI costs $4 billion over 10 years. A more modest option — raising it to $100 and indexing it — would raise

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SSI costs by $1.1 billion over 10 years. (There also would be Medicaid costs so the total cost is higher.) This proposal could be presented as addressing an erosion in the program's work incentives, as well as in the real income of low-income elderly and disabled people, and as being in keeping with the philosophy that led Congress to eliminate the Social Security earnings test for those who have reached the "normal retirement age."

**SSI Benefit Changes That Can Be Made Administratively Also Are Needed**

The recent SSA report that contains information on the erosion of these exclusions also reveals that a number of highly restrictive SSI criteria that are set administratively have not been adjusted for inflation since the late 1970s and have eroded badly. Adjustments are needed in some of these areas. You can make these adjustments administratively. It would be useful to make room now in the baseline for this. A few examples:

- Household goods and personal effects count against the SSI assets limit, to the extent these items exceed $2,000 in value. Furniture and appliances count; only wedding and engagement rings are exempt. This is extremely harsh and unlike virtually any other means-tested program; the other programs fully exclude household goods and personal effects.

  The law requires a dollar limit on household goods and personal effects but leaves it up to the executive branch to set the limit. This limit was placed at $2,000 in 1979 and has never been adjusted since. The Clinton Administration should not let eight years go by without any adjustment here.

- The limit on the value of a vehicle that is excluded is $4,500. This, too, is up to the executive branch to set. The limit was placed at $4,500 in 1979 to match the food stamp vehicle limit. The administration has worked for the past seven years to secure legislation raising the food stamp vehicle limit, which now is $4,650. (The Administration succeeded in securing an increase in the food stamp vehicle limit in 1993, but the 1993 provision was largely repealed in 1996.) Meanwhile, the SSI vehicle limit — which can be changed through administrative action — remains stuck at $4,500.

These are just two examples. Various other aspects of the SSI eligibility and benefit structure that are determined administratively also have eroded badly to inflation and need some adjustment, include the substantial gainful activity amount (which affects work among disabled beneficiaries and is particularly important), the trial work period services amount, and the student earned income exclusion. All of these items relate to encouraging work.

I understand that the current OMB baseline already includes the amount needed to adjust the substantial gainful activity amount, the most costly of these items. The additional items that can be addressed administratively are less expensive; for some additional amount — probably not more than $500 million over 10 years — you could make long-overdue adjustments in these areas. This should be done before the Administration leaves office.

file: tax proposals

Ana O'Leary

# CENTER ON BUDGET AND POLICY PRIORITIES

# FAX

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**Date**

**Re:** **ESTATE TAX AND MINIMUM WAGE**

Please find attached to this three new pieces we released today:

- The first analyzes the negative impact repealing the estate tax would have on state revenue collections. Our web site has 50 nice one-page fact sheets on each state that are easier to use.

- The second two-pager highlights three problems with the Hastert proposal on minimum wage.

- The third examines the most significant problem on the tax side with the Hastert proposal, the new deduction for health insurance premiums.

Sorry for length of the fax, but hope this is helpful.

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*August 30, 2000*

# REPEAL OF THE FEDERAL ESTATE TAX WOULD COST STATE GOVERNMENTS BILLIONS IN REVENUE

by Elizabeth C. McNichol, Iris J. Lav and Daniel Tenny

Congress has passed and sent to the White House legislation that would repeal the federal estate, gift, and generation-skipping transfer tax by 2010. Under this legislation, the estate tax would be reduced gradually over the next decade, leading to full repeal in calendar year 2010. Once the proposal was fully in effect — and the estate tax had been repealed — the proposal would cost the federal government about $50 billion a year.

State governments also receive revenue through the federal estate tax. Under the current provisions of the federal estate tax, taxpayers receive a dollar-for-dollar credit against their federal estate tax liability for state estate and inheritance tax payments up to a specified amount. The maximum amount of the credit varies by the size of the estate.

- Currently, every state has a tax on estates equal to at least the value of the credit that can be taken against federal liability. In most states, the estate and inheritance taxes are designed in such a way that states would face either a full or partial loss of revenues if the federal estate tax were repealed. Approximately two-thirds of the states could face total loss of estate tax revenue as a result of the federal repeal.

- The amount of revenue lost to states would be substantial. Information gathered from state budgets and state revenue officials suggests that states together would have lost approximately $5.5 billion in revenue in fiscal year 2000 if estate tax repeal had already been in effect. By 2010, when the estate tax repeal would be fully effective under the proposed legislation, the state revenue loss would approach $9 billion.

- The amount of potential revenue loss for each individual state varies depending on the design of the state's specific inheritance and estate tax. The impact would be greatest in the 35 states that rely entirely on the state credit against the federal tax for their estate tax revenues.

## States Share in the Federal Estate Tax

Thirty-five of the 50 states currently have an estate tax that equals the amount of the state credit, with there being *no other* state estate or inheritance tax. In these states, the state law refers specifically to the amount allowed as a credit against the federal estate tax. This is commonly referred to as a "pickup" tax. A pickup tax provides revenue to the state but does not increase the federal estate tax payment the heirs must make. Instead, the estate's federal estate tax liability is reduced by the amount of the state tax payment.

Some 15 states also have their own inheritance or estate taxes, a portion of which qualifies as a pickup tax. In all of these 15 states, the state laws specify that if the amount of the state tax is less than the credit allowed against federal taxes, the state tax is increased to the amount of the credit. In cases where the state liability is greater than the credit, federal estate taxpayers receive a credit for the portion of their state tax that equals the maximum allowable credit. Two of these 15 states are phasing out their separate tax and will rely only on the pickup tax in the future. [1] Table 1 shows the estate and inheritance tax provisions of the states.

The repeal of the federal estate tax would negate a compromise reached between the federal government and the states many years ago when the federal estate tax was first enacted. The federal estate tax was established in the early 1900s. Until that time, the taxation of estates and inheritances was considered the prerogative of the states. States objected to the establishment of a federal estate tax because they felt it infringed on one of their traditional tax bases. As a compromise, Congress included the state credit in the federal tax, thereby guaranteeing states a portion of the estate tax base.

In recent years, a number of states have changed their own estate and inheritance taxes to rely solely on a pickup tax equal to the maximum federal credit. This has left them vulnerable. If the federal estate tax — and therefore the federal credit — are repealed, the action would repeal automatically the estate taxes of most of these states. Other states that have retained some version of their own estate or inheritance tax are likely to lose some, but not all, of their revenues from this source.

While it could be argued that states could retain this revenue by reinstating a state estate or inheritance tax, in many states, this would be unlikely to occur. It would require the passage of new legislation in each state establishing what would be labeled a new tax. This could be very difficult to accomplish in the current political climate. (As noted, in states with pickup taxes, the pickup tax does not increase the amount of tax levied on an estate but simply shifts some of the revenue from the federal government to the state. If the federal estate tax is repealed, any action by these states to impose an estate tax would likely be attacked as constituting an increase in tax burdens.)

## Most States with only a Pickup Tax Would Lose This Revenue if the Federal Estate Tax Were Repealed

In most states with only a "pickup" estate tax — that is, an estate tax that is set to equal the amount of the federal credit — repeal of the federal estate tax would automatically repeal the state estate tax.[2]

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[1] In addition to state estate and inheritance taxes, four states — Connecticut, Louisiana, North Carolina and Tennessee — levy taxes on gifts of money or property that exceed a specific level. These state gift taxes do not affect the revenue collected from the state's pickup of the federal estate tax and would not be affected by the repeal of the federal estate tax.

[2] Among the states with only a pickup tax, there are a few exceptions such as Virginia and the District of Columbia where the state estate tax statute refers to the federal estate tax law as of a particular date. In these states, the amount of state estate tax owed would be calculated based on the amount of the federal credit prior to its repeal. However, even in these states, the intent of the state estate taxes appear to be the same as in the other pickup tax states. In addition, in order to continue collecting this tax, these states would have to take over the administration of the tax and require estates to file a form similar to the

(continued...)

**Table 1**
**Estate, Inheritance and Gift Tax Provisions as of July 2000**

| STATE | Pickup Tax Only | Inheritance + Pickup Tax | Estate + Pickup Tax |
|---|---|---|---|
| Alabama | X | | |
| Alaska | X | | |
| Arizona | X | | |
| Arkansas | X | | |
| California | X | | |
| Colorado | X | | |
| Connecticut[1] | | X[1] | |
| Delaware | X | | |
| Florida | X | | |
| Georgia | X | | |
| Hawaii | X | | |
| Idaho | X | | |
| Illinois | X | | |
| Indiana | | X | |
| Iowa | | X | |
| Kansas | X | | |
| Kentucky | | X | |
| Louisiana[1] | | X[1] | |
| Maine | X | | |
| Maryland | | X | |
| Massachusetts | X | | |
| Michigan | X | | |
| Minnesota | X | | |
| Mississippi | X | | |
| Missouri | X | | |
| Montana | | X | |
| Nebraska | | X | |
| Nevada | X | | |
| New Hampshire | | X | |
| New Jersey | | X | |
| New Mexico | X | | |
| New York | X | | |
| North Carolina | X | | |
| North Dakota | X | | |
| Ohio | | | X |
| Oklahoma | | | X |
| Oregon | X | | |
| Pennsylvania | | X | |
| Rhode Island | X | | |
| South Carolina | X | | |
| South Dakota | | X | |
| Tennessee | | X | |
| Texas | X | | |
| Utah | X | | |
| Vermont | X | | |
| Virginia | X | | |
| Washington | X | | |
| West Virginia | X | | |
| Wisconsin | X | | |
| Wyoming | X | | |
| TOTALS | 35 | 13 | 2 |

1 Connecticut and Louisiana are phasing out their inheritance taxes.

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[2](...continued)
current federal form. As a result, there is a strong likelihood that these states would act to repeal their estate taxes when the pickup taxes in other states were eliminated.

It is difficult to determine precisely the revenue loss to states from the repeal of the federal estate tax. There are no state-specific projections available on the amount of revenue that would be lost to states if the federal estate tax were phased out over a period of time. However, there are data from the IRS on the amount of the state credit for recent years and data from states on their estate and inheritance tax collections. These can be used to estimate the expected magnitude of the revenue loss to states of the repeal of the federal tax.

For states that have only a pickup tax, Table 2 shows two amounts. The first column shows the average annual amount of state taxes credited against the federal estate tax for each state between 1995 and 1997, the most recent years that federal data on the amount of the state credit by state are available. For states with only a pickup tax, this amount is approximately equal to the average annual amount of state estate taxes collected in those years.[3] A three-year average is shown because estate tax revenue at the state level can fluctuate significantly from year to year; in smaller states in particular, the death of one highly wealthy individual can produce unusually high revenues for a single year. (The source of these data are the *Statistics of Income* bulletin of the Internal Revenue Service.) The second column shows each state's estimate of estate tax collections for state fiscal year 2000. This information, from budget documents and discussions with state revenue officials, provides more recent information on the amount of revenue a state collects in estate taxes. Since these are states that have only a pickup tax, all of these revenues are a result of the state credit on the federal estate tax.

For example, Table 2 shows that Michigan received approximately $80 million a year from the pickup tax from 1995 to 1997. Had the estate tax repeal been in effect in those years, Michigan would have lost approximately $80 million in revenue a year. More recently, estate tax collections have increased in Michigan to an estimated $187 million in fiscal year 2000, all of which would have been lost had the federal estate tax been repealed.

Together, the states relying solely on the pickup tax would have lost $4.4 billion in revenue had the federal estate tax been repealed in fiscal year 2000.[4]

## States with Separate Estate or Inheritance Taxes Would Also Lose Substantial Revenue

States that levy their own estate or inheritance taxes in addition to the pickup tax would continue to collect those taxes if the federal tax was repealed. However, as noted above, all these states provide that if the amount of the state tax is less than the credit allowed against federal taxes, the state tax is increased to the amount of the credit. As a result, these states would also lose revenue if the federal estate tax — and thus the credit — were repealed.

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[3]Note that state data on estate tax collections may not match IRS data because of different fiscal years and because the timing of state and federal estate tax payments may vary for the same estate.

[4]As Table 2 shows, the amount of revenue that states collect through the pickup tax has increased significantly in recent years as federal estate tax collections have grown. Revenues from the federal estate and gift taxes are projected to increase from an average of $17.2 billion from 1995 to 1997 to $30 billion in 2000.

**Table 2**
**State Revenue from Credit**
**Against the Federal Estate Tax For State Taxes Paid**
(for states with a pickup tax only)

| State | Average Federal Credit, Calendar Years 1995-1997 (millions of dollars) | FY 2000 State Estate Tax Revenues (millions of dollars) |
|---|---|---|
| Alabama | $35.6 | $68.0* |
| Alaska | 1.2 | 1.8* |
| Arizona | 51.7 | 80.6 |
| Arkansas | 54.7 | 21.6 |
| California | 590.6 | 937.0* |
| Colorado | 28.6 | 65.1 |
| Delaware | 11.9 | 41.0 |
| Florida | 429.3 | 779.1* |
| Georgia | 62.7 | 155.0 |
| Hawaii | 16.1 | 22.8 |
| Idaho | 7.2 | 11.1 |
| Illinois | 181.9 | 360.0* |
| Kansas | 32.8 | 62.9 |
| Maine[1] | 22.1 | 45.8 |
| Massachusetts | 88.3 | 166.5 |
| Michigan | 80.1 | 187.0* |
| Minnesota | 48.3 | 82.5 |
| Missouri | 66.0 | 132.7 |
| Nevada[2] | 29.7 | 76.7 |
| New Mexico | 11.9 | 16.1 |
| North Carolina[3] | 67.0 | 152.7* |
| North Dakota | 3.7 | 6.1 |
| Oregon | 34.0 | 47.8 |
| Rhode Island | 9.8 | 34.2 |
| South Carolina | 21.4 | 42.7 |
| Texas | 201.3 | 249.1 |
| Utah[4] | 14.6 | 65.1 |
| Vermont | 11.7 | 13.6 |
| Virginia | 83.0 | 165.6* |
| Washington | 62.1 | 86.9 |
| West Virginia | 11.9 | 21.1 |
| Wisconsin | 47.3 | 133.5 |
| Wyoming[5] | 3.6 | 50.8 |
| **Total** | **$2,422.3** | **$4,382.4** |

*Projection

Sources: Average federal credit: *Statistics of Income Bulletin*, Internal Revenue Service, Summer 1999. FY 2000 Revenues: CBPP survey of state revenue officials.

Notes:

1. The Maine revenue figure has been adjusted downward by $13 million to correct the effects of one-time accounting changes in fiscal year 2000.
2. Nevada's FY 2000 estate tax revenue was unusually high. The FY 1999 revenue, which is more typical, was 24.2 million dollars.
3. North Carolina's inheritance tax has been repealed, but continued to generate revenue in fiscal year 2000. The number above is the projected revenue for fiscal year 2001, which does not include any inheritance tax revenue.
4. Utah's FY 2000 estate tax revenue was unusually high. The FY 1999 revenue, which is more typical, was 8.9 million dollars.
5. Wyoming's FY 2000 estate tax revenue was unusually high. The projection for fiscal year 2000 was 7.5 million dollars; the actual revenue was the figure given above.

It is more difficult to identify the specific amount of the revenue loss in these states because of the interactions between the state inheritance and estate taxes and the federal credit. Table 3 shows the amount of the state credit against the federal estate tax for each of these states. However, the revenue a state would lose as the result of the repeal of the federal estate tax is less than the total amount of the credit in states with separate taxes. Table 3 also includes estimates of the incremental amount of state revenue raised as a result of the pickup provisions of the estate tax. The latter information was collected through survey of revenue officials in each of these states. If the federal estate tax had been repealed in fiscal year 2000, each state would have lost approximately the amount of revenue shown in the second column of Table 3.

Together, these states with their own estate or inheritance taxes in addition to the pickup tax would have lost approximately $1.1 billion in revenue in fiscal year 2000.

## Total State Revenue Loss

The total revenue loss for all states, had the federal estate tax been repealed for fiscal year 2000, would have been approximately $5.5 billion — $4.4 billion for the states solely relying on the pickup tax and $1.1 billion for the states using the pickup tax along with their own estate or inheritance taxes.

Estate tax revenues are expected to grow by approximately 60 percent between now and 2010, when estate tax repeal would be fully in effect in the legislation Congress has passed. State pickup tax revenues would likely grow in tandem with the federal revenues. Thus, the revenue loss to states when the repeal would be fully in effect in 2010 would approach $9 billion a year.[5]

## Repeal of the Estate Tax Would Benefit the Wealthiest Taxpayers While Reducing the Amount of Revenue for Services for All State Residents

The federal estate tax — and thus the state pickup tax that is part of the federal tax — is paid solely by the wealthiest two percent of people who die each year.

- In 1997, the estates of fewer than 43,000 people — fewer than 1.9 percent of the 2.3 million people who died that year — had to pay any estate tax. The Joint Committee on Taxation projects that the percentage of people who die whose estates will be subject to estate tax will remain at about two percent for the foreseeable future. In other words, 98 of every 100 people who die face no estate tax whatsoever.

- To be subject to the federal estate tax, the size of an estate must exceed $675,000 in 2000. The estate tax exemption is rising to $1 million by 2006. The vast bulk of estate taxes are paid on very large estates. In 1997, some 2,400 estates — the

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[5]Both the federal and state revenue projections included here present growth in nominal terms — that is, they are not adjusted for inflation.

**Table 3**
**State Revenue from Credit**
**Against the Federal Estate Tax For State Taxes Paid**
(for states with their own inheritance or estate taxes)

| STATE | Average Federal Credit, Calendar Years 1995-1997 (millions of dollars) | Estimated Revenue from Pickup of Federal Credit, FY 2000 (millions of dollars) |
|---|---|---|
| Connecticut | $85 | $140 |
| Indiana | 47 | 21 |
| Iowa | 28 | 35 |
| Kentucky | 41 | 37 |
| Louisiana | 43 | 50 |
| Maryland | 70 | 78 |
| Mississippi | 11 | 22 |
| Montana | 5 | 6 |
| Nebraska | 17 | 20 |
| New Hampshire | 12 | 25 |
| New Jersey | 126 | 158 |
| New York | 418 | 450 |
| Ohio | 132 | 38 |
| Oklahoma | 41 | 0 |
| Pennsylvania | 141 | 30 |
| South Dakota | 3 | 1 |
| Tennessee | 41 | 11 |
| Total | $1,262 | $1,122 |

Sources: Average federal credit: *Statistics of Income Bulletin*, Internal Revenue Service. FY 2000 revenue: CBPP survey of state revenue officials.

State Notes

**Connecticut** - Connecticut is phasing out its inheritance tax. The actual revenue from succession taxes in fiscal year 2000 was $30 million dollars from the estate tax and $198 million dollars from the inheritance tax. The number above is an estimate of the amount of revenue the estate tax would have generated in fiscal year 2000 had the inheritance tax not been in place based on revenue numbers from recent years and the projected fiscal impact of the inheritance tax phase-out.

**Louisiana** - Louisiana is phasing out its inheritance tax. The actual revenue from inheritance and estate taxes combined was projected to be $79 million in fiscal year 2000. The number above is an estimate of the amount of revenue the estate tax would have generated in fiscal year 2000 had the inheritance tax not been in place based on the 2000 revenue estimates and estimates for the period during which the inheritance tax is being phased out.

**Maryland** - Maryland's inheritance tax rate is being reduced over the next two years, causing Maryland's estate tax revenue to increase somewhat. In FY 2002, Maryland revenue from the pickup to the federal credit is projected to be $81 million.

**Mississippi** - Mississippi's non-pickup estate tax has been repealed, but continues to generate a small amount of revenue. The non-pickup estate tax is estimated to have added less than $200,000 to FY 2000 revenue.

**New Jersey** - New Jersey's estate tax revenue has fluctuated in recent years. The number above represents the average for fiscal years 1998 through 2000.

**New York** - New York's estate tax has been repealed, but it continues to generate revenue.The number above is an estimate of the amount of revenue the estate tax would have generated in fiscal year 2000 had the non-pickup estate tax not been in place. It is based on the revenue numbers from recent years and the projected fiscal impact of the non-pickup tax repeal.

**Ohio** - Ohio's estate tax is being reduced over the next two years, but this reduction is expected to have a minimal effect on pickup tax revenues. Fiscal year 2000 data were not available for Ohio. The number above is from fiscal year 1999.

**Oklahoma** - Oklahoma's estate tax always exceeds the federal credit.

**Pennsylvania** - Pennsylvania cut inheritance tax rates in 2000. This cut will increase the amount of revenue that comes from the pickup of the federal credit, but the amount of the increase is unknown.

**South Dakota** - South Dakota's inheritance tax is being reduced over the next six years, but this reduction is expected to have a minimal effect on pickup tax revenues.

**Tennessee** - The exemption for Tennessee's separate inheritance tax is scheduled to increase along with the federal exemption. After this increase takes effect, a much higher proportion of Tennessee's estate tax revenue will come from the pickup to the federal credit. By the time the exemption reaches $1million, almost all of Tennessee's estate tax revenue will come from the pickup tax. A state official estimates that when the exemption reaches $1 million, Tennessee will receive approximately $50 to $60 million in revenue from the pickup tax.

largest five percent of estates that were of sufficient size to be taxable — paid nearly *half* of all estate taxes. These were estates with assets exceeding $5 million. This means about half of the estate tax was paid by the estates of the wealthiest one of every 1,000 people who died. The average tax cut these estates would receive from repeal of the estate tax would exceed $3 million.

As these statistics make clear, the estates of a tiny fraction of the people who die each year — those with very large amounts of wealth — pay the bulk of all federal estate taxes.

Moreover, a recent Treasury Department study shows that almost no estate tax is paid by middle-income people. Most of the estate taxes are paid on the estates of people who, in addition to having very substantial wealth, still had high incomes around the time they died. The study found that 91 percent of all estate taxes are paid by the estates of people whose annual incomes exceeded $190,000 around the time of their death. Less than one percent of estate taxes are paid by the lowest-income 80 percent of the population, those with incomes below $100,000.

Thus, the elimination of state estate taxes through the repeal of the federal estate tax would benefit the wealthiest taxpayers in the state. At the same time it would reduce the amount of revenue available to finance services for all state residents.

**Appendix Table 1**
**Amount of Credit for State Taxes Paid Against the Federal Estate Tax**
(Figures are in thousands of dollars)

| STATE | CY 1995 | CY 1996 | CY 1997 | Average |
|---|---|---|---|---|
| Alabama | 30,025 | 40,798 | 35,924 | 35,582 |
| Alaska | 1,718 | 717 | 1,075 | 1,170 |
| Arizona | 43,970 | 43,106 | 68,024 | 51,700 |
| Arkansas | 25,146 | 114,065 | 24,942 | 54,718 |
| California | 479,486 | 565,750 | 726,541 | 590,592 |
| Colorado | 23,762 | 33,402 | 28,713 | 28,626 |
| Connecticut | 58,555 | 113,275 | 82,020 | 84,617 |
| Delaware | 7,730 | 7,057 | 20,985 | 11,924 |
| Florida | 360,205 | 451,137 | 476,649 | 429,330 |
| Georgia | 62,704 | 68,912 | 56,562 | 62,726 |
| Hawaii | 15,727 | 12,268 | 20,405 | 16,133 |
| Idaho | 10,004 | 5,419 | 6,124 | 7,182 |
| Illinois | 140,624 | 190,531 | 214,521 | 181,892 |
| Indiana | 29,406 | 48,605 | 61,674 | 46,562 |
| Iowa | 20,581 | 32,976 | 31,763 | 28,440 |
| Kansas | 20,815 | 41,793 | 35,702 | 32,770 |
| Kentucky | 22,721 | 34,427 | 64,520 | 40,556 |
| Louisiana | 50,510 | 31,666 | 48,266 | 43,481 |
| Maine | 17,216 | 10,947 | 38,100 | 22,088 |
| Maryland | 62,091 | 73,056 | 74,459 | 69,869 |
| Massachusetts | 54,780 | 108,112 | 102,149 | 88,347 |
| Michigan | 78,632 | 85,330 | 76,480 | 80,147 |
| Minnesota | 34,442 | 54,263 | 56,050 | 48,252 |
| Mississippi | 12,165 | 11,183 | 11,019 | 11,456 |
| Missouri | 37,164 | 72,098 | 88,730 | 65,997 |
| Montana | 3,957 | 6,284 | 4,900 | 5,047 |
| Nebraska | 16,154 | 18,632 | 17,228 | 17,338 |
| Nevada | 39,628 | 25,190 | 24,419 | 29,746 |
| New Hampshire | 6,456 | 14,604 | 15,719 | 12,260 |
| New Jersey | 99,791 | 125,748 | 151,775 | 125,771 |
| New Mexico | 8,627 | 14,368 | 12,724 | 11,906 |
| New York | 355,515 | 398,672 | 499,702 | 417,963 |
| North Carolina | 80,230 | 57,449 | 63,243 | 66,974 |
| North Dakota | 4,139 | 3,574 | 3,522 | 3,745 |
| Ohio | 112,580 | 145,174 | 139,688 | 132,481 |
| Oklahoma | 41,599 | 49,079 | 32,834 | 41,171 |
| Oregon | 33,099 | 32,098 | 36,685 | 33,961 |
| Pennsylvania | 114,320 | 133,466 | 174,767 | 140,851 |
| Rhode Island | 7,309 | 6,959 | 15,264 | 9,844 |
| South Carolina | 17,653 | 20,287 | 26,275 | 21,405 |
| South Dakota | 1,309 | 4,129 | 4,385 | 3,274 |
| Tennessee | 24,942 | 52,328 | 46,567 | 41,279 |
| Texas | 162,303 | 171,964 | 269,653 | 201,307 |
| Utah | 25,296 | 7,395 | 10,976 | 14,556 |
| Vermont | 2,846 | 17,737 | 14,482 | 11,688 |
| Virginia | 78,859 | 61,065 | 109,085 | 83,003 |
| Washington | 29,406 | 68,029 | 88,977 | 62,137 |
| West Virginia | 8,757 | 14,531 | 12,377 | 11,888 |
| Wisconsin | 21,408 | 48,327 | 72,303 | 47,346 |
| Wyoming | 6,588 | 1,885 | 2,377 | 3,617 |
| Total | 3,002,950 | 3,749,867 | 4,301,324 | 3,684,714 |

Source: *Statistics of Income Bulletin*, Internal Revenue Services, Summer 1999.

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*August 30, 2000*

## Tax Package Proposed as Accompaniment to Minimum Wage Bill Contains Troubling Proposals

On August 28, 2000, House Speaker Dennis Hastert wrote to President Clinton proposing that they work to pass a package that would include a minimum-wage increase, a series of changes in the Fair Labor Standards Act (some of which could exempt certain firms and employers from minimum wage and overtime rules), and a package of tax cuts. The minimum-wage and FSLA changes are beyond the scope of this short analysis. Its purpose is to highlight three problematic aspects of the proposed tax package.

- One of the largest tax proposals in the package would provide a costly new "above-the line" deduction for health insurance premiums paid by individuals who purchase their own insurance or whose employers subsidize less than 50 percent of the cost of health insurance premiums. This provision is likely to do little to make health insurance affordable for most of the nation's uninsured, 93 percent of whom either owe no federal income taxes or are in the 15 percent bracket and thus would at most receive a subsidy of 15 cents for every dollar spent on health insurance. Moreover, because the deduction would provide a far deeper percentage subsidy for purchasing health insurance to higher-paid business owners and executives than to lower-wage earners, it could encourage some small business owners to drop group coverage (or not to institute it in the first place) and to rely on the deduction for their own coverage. To the extent this occurs, the ranks of the uninsured and underinsured among low- and moderate-wage workers could increase. This proposal is discussed in more detail in an attached short analysis.

- The package would repeal the modest unemployment insurance surtax (equal to 0.2 percent of the first $7,000 in an employee's wages) that employers pay *without* making any needed improvements in the unemployment insurance system. Representative of business, labor, state governments, and the Department of Labor (DOL) recently reached agreement on an unemployment insurance reform package that would repeal this surtax, provide additional administrative funding and flexibility to states in operating the UI program, and make some modest but long-overdue improvements in the unemployment insurance program to improve the program's coverage rate among certain types of workers, particularly women, lower-paid workers and workers whose regular unemployment benefits are exhausted during recessions. Little more than one-third of unemployed workers receive unemployment insurance in an average month. A blue-ribbon Congressionally-chartered panel that studied the UI program in the mid-1990s and was chaired by Janet Norwood, the highly respected former Commissioner of the Bureau of Labor Statistics, recommended a more extensive set of benefit and coverage improvements.

Repealing the UI surtax without approving the other elements of the business-labor-state-DOL reform proposal would unravel the agreement and undermine prospects for passing the rest of the proposal. A strong case can be made for including the full UI reform proposal in the minimum wage package. If inclusion of the full proposal is not possible, repeal of the surtax should not be part of the minimum-wage package.

- The package does not include certain other tax items that would be a more appropriate complement to minimum-wage legislation than some of the tax cuts the Speaker has proposed. In particular, the package does not include any improvements in the Earned Income Tax Credit for low-income working families with children. Bipartisan legislation introduced in July by Senators Rockefeller, Jeffords, and Breaux, as well as separate tax legislation introduced this year by Senator Hatch, would improve the EITC in various ways and thereby better support low-income working families with children. The Administration's budget also contains a set of EITC improvements. Such proposals recognize that to support families earning low wages, a combination of a higher minimum wage and a stronger EITC is needed.

One other point bears mention. Speaker Hastert's letter describes the tax cuts in the package as reflecting "our desire to help alleviate the burdens on small businesses that would shoulder the costs of [the minimum wage] increase." However, a number of the provisions that make up the tax package (especially the health insurance deduction) bear little relationship to any possible effects of a minimum-wage increase on small business.

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*August 30, 2000*

## Health Insurance Deduction of Little Help to the Uninsured

One of the principal tax proposals that Speaker Hastert has recommended be part of a minimum-wage package would create a new tax deduction for the purchase of health insurance and other heath expenses by people who pay at least 50 percent of the cost of their health insurance premiums. At first glance, such a deduction may seem an attractive idea if it could help the uninsured to obtain coverage or help small businesses to cover their employees. Closer examination indicates, however, that this deduction — which would cost $11 billion a year when fully in effect — would be unsound policy.

- It would provide little help to most of those who lack insurance and do little to reduce the ranks of the uninsured.

- Because the deduction provides a far deeper percentage subsidy for the purchase of insurance to higher-income business owners and executives than to lower-income wage earners, it could encourage small business owners to drop, or fail to institute, group coverage and rely instead on this deduction to help defray the cost of their own coverage. As a result, some workers could be forced to buy more costly and less comprehensive insurance on the individual market, and the ranks of the uninsured and underinsured could increase.

### Deduction Would Do Little to Help the Uninsured

The deduction would provide little subsidy to most workers who currently are uninsured and most workers for whom employers pay inadequate shares of premiums to make insurance affordable. Census data show that 93 percent of all uninsured individuals either have incomes too low to incur income tax liability or pay income tax at the 15 percent marginal rate.[1] These individuals would at most get a subsidy of 15 percent of the cost of purchasing health insurance, too little to enable most of them become insured. For low- and moderate-income families and individuals without employer-sponsored coverage, a 15 percent subsidy — which would leave

[1] These data show that 18 million uninsured individuals — 43 percent of all of the non-elderly uninsured — owe no income tax; their earnings are too low for them to incur an income tax liability. These uninsured individuals would receive no benefit from a tax deduction; a deduction would do nothing to make health insurance more affordable for them. Another 20 million uninsured individuals — 50 percent of the non-elderly people without health insurance — pay income tax at a 15 percent marginal tax rate. A deduction would provide these taxpayers with a subsidy equal to 15 percent of the cost of insurance not covered by an employer. General Accounting Office, Letter to The Honorable Daniel Patrick Moynihan, June 10, 1998, GAO/HEHS-98-190R, Enclosure II. The analysis is based on the 1996 Current Population Survey.

them with the other 85 percent of the premium cost — is too small subsidy to make insurance affordable.

Rather than helping uninsured workers who cannot afford the premiums required to obtain adequate health coverage, such a deduction would, by and large, provide its principal benefits to individuals in higher tax brackets who already purchase individual insurance. The deduction would offset a much-larger share of the cost of individually purchased insurance for individuals in the 31 percent, 36 percent, or 39.6 percent tax brackets. Yet such individuals generally can afford insurance without a deduction.

- For a family earning $35,000 whose employer does not offer insurance, the proposed deduction would reduce the cost of a typical family health insurance policy from $7,350 to $6,250, or from 21 percent of income to 18 percent of income.[2]

- Few families that have forgone health coverage because they cannot afford to spend 21 percent of income on it would find coverage affordable because a tax deduction had lowered its cost to 18 percent of income. It may be noted that the child health block grant established in 1997 set a limit on the premiums and co-payments that can be charged under programs receiving block grant funds, with the limit being *five* percent of income for families above 150 percent of the poverty line and smaller amounts for poorer families.

This provision might be of modest help to some moderate-income families whose employer pays half or nearly half of the premium costs, since the deduction would be in addition to the employer subsidy. Even families whose employers pay 50 percent of the premium, however, would receive only very modest help from the deduction. The deduction would reduce the proportion of the premium these families must pay from 50 percent of the premium to 42.5 percent. While that might help some families afford insurance, the number of such families likely would be small.

In addition, the deduction could induce some employers currently paying more than 50 percent of premium costs to scale back their contribution to 50 percent or less. Also, as noted above, some employers may drop coverage altogether.

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[2] A General Accounting Office study found that in 1998, health insurance premiums for family coverage purchased in the individual, non-group market range from $3,180 to $14,233 per year, depending on factors such as age, health status, and region of the country. The GAO identifies a "medium" premium cost for a family of four as $7,352. U.S. General Accounting Office, *Private Health Insurance: Potential Tax Benefit of a Health Insurance Deduction Proposed in H.R. 2990* (GAO/HEHS-00-104R), April 21, 2000. It should be noted that in addition to premium costs, health insurance policies typically have substantial deductibles and copayments. Families would have to come up with additional funds, over and above the family share of the premium, to cover these costs. While these costs would be deductible under the proposal, a family in the 15 percent tax bracket would still have to bear 85 percent of them.

The group that would appear to benefit most from this deduction would be higher-income taxpayers who purchase insurance as individuals. A health insurance deduction is worth more than twice as much to individuals in the top tax brackets than to moderate- and middle-income families in the 15 percent bracket.

**Deduction Could Cause Some Erosion in Employer-Based Coverage**

While few low- and moderate-income workers would benefit, some could be harmed by the proposal. The proposed new health insurance deduction would allow small business owners or more highly-paid employees to purchase insurance for themselves, using the more generous subsidy the deduction provides for those in higher tax brackets, without the necessity of providing coverage for lower-paid employees. As a result, the deduction could provide an incentive for some small business employers to drop group coverage, or for some owners newly launching small businesses to decline to offer such coverage. To the extent this occurs, it would adversely affect some of the same workers the minimum-wage legislation is supposed to help.