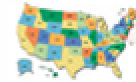
Center on Budget and Policy Priorities

820 First Street NE, Suite 510
Washington, DC 20002

Tel: 202-408-1080
Fax: 202-408-1056

center@cbpp.org
www.cbpp.org

SPECIAL SERIES | Dealing with Deficits: How States Can Respond 

Revised February 28, 2008

NEW FEDERAL LAW COULD WORSEN STATE BUDGET PROBLEMS

States Can Protect Revenues by "Decoupling"

By Nicholas Johnson

The federal "economic stimulus" package enacted on February 13 not only cuts federal taxes, but also threatens to reduce many *states'* corporate and personal income tax revenue this year and next year.

The potential revenue loss comes at a particularly problematic time for states, because about half the states are already facing budget shortfalls for the current year, the upcoming year, or both; more states will be in trouble if the economic downturn worsens. Some states are already enacting cuts in K-12 education, higher education, health care and human services, among other areas in order to balance their budgets.

The revenue loss results from a provision of the stimulus package known as "bonus depreciation." Bonus depreciation allows a business to claim an immediate federal tax deduction of up to 50 percent of the cost of new equipment purchases, rather than following the standard accounting approach of depreciating the full cost gradually over the several year useful life of the equipment. Most states' personal and corporate income taxes are based on federal law. So tax cuts at the federal level that reduce federal taxable income normally reduce state taxable income as well and therefore cost states money.

Because the bonus depreciation provision is retroactive to January 1, 2008, affected states will experience immediate revenue loss in the current fiscal year and the upcoming fiscal year. We estimate that under current state law, some 23 states stand to lose an estimated $1.7 billion in corporate and individual tax revenue in the current and upcoming fiscal years.

There is a way states can protect themselves from this immediate and large revenue loss. States can, at their own option, pass a statute to "decouple" their business depreciation rules from the section of the federal tax code that allows bonus depreciation. During the 2001-04 period, when a similar bonus depreciation provision was in effect, over 30 states fully or partially decoupled from it, with minimal adverse consequences.

The amount of revenue potentially at stake in each state is shown in the accompanying table.

TABLE 1: POTENTIAL STATE REVENUE LOSSES FROM BONUS DEPRECIATION CONFORMITY (APPROXIMATE – DOLLARS IN MILLIONS)			
State	**Revenue loss**	**State**	**Revenue loss**
Alabama	$85	New Mexico	27
Alaska	15	North Carolina	282
Colorado	*75*	North Dakota	16
Delaware	42	Oklahoma	66
Florida	217	Oregon	*86*
Kansas	85	Rhode Island	29
Louisiana	81	South Dakota	7
Maine	29	Utah	69
Michigan	166	Vermont	7
Missouri	98	West Virginia	*28 to 37*
Montana	27	District of Columbia	40
Nebraska	41	**Total**	**$1.7 billion**

Amounts shown are for those states that conform automatically or routinely to federal depreciation law and therefore will likely lose revenue without legislative action.
Methodology: The identification of states as to whether they are conformed automatically to federal bonus depreciation was based on a review of available documents, including the CCH Corporate Tax Guide, state statutes, tax department publications, and communications with state tax departments. Amounts were determined as follows: The estimated federal revenue loss of $49.5 billion, approximately 70 percent of which is likely to be in the corporate income tax and 30 percent of which is in the personal income tax, was scaled to the individual state level based on federal and state corporate and personal tax collections for fiscal year 2007. Adjustment was made for states with artificially high 2007 corporate tax collections due to oil and gas profits. Note that this methodology is approximate at best; in many cases, state tax research departments or legislative research units may be able to make better estimates based on data not publicly available. Where available, such estimates were used in this table. (Numbers received from state tax departments are indicated in italics.)

The remainder of this analysis addresses the following questions:

- What is bonus depreciation?
- Why do some states face revenue loss from bonus depreciation, but others do not?
- How can states decouple from bonus depreciation?
- What are the short- and long-term revenue implications of decoupling?
- What are the economic implications of decoupling?

What Is Bonus Depreciation?

"Bonus depreciation" is a change to the way businesses subtract from their taxable income the cost of purchasing machinery or equipment. Normally, when a business purchases a piece of machinery or equipment, the tax deduction for the cost of the purchase must be spread out over time — up to 20 years, depending on the type of product. (Equipment that is likely to break down or become obsolete more quickly is more rapidly depreciated than more durable equipment. Real estate has an even longer depreciation schedule, and is not eligible for bonus depreciation.) Contrary to the general accounting rules that match the deductions to the approximate useful life of the machine or equipment,, "bonus depreciation" allows businesses that purchase machinery or equipment in 2008 to deduct 50 percent of the cost right away. The remaining 50 percent is then depreciated over the normal depreciation schedule.[1]

The "bonus" applies to machinery and equipment placed in service anytime in calendar year 2008, meaning that businesses can begin immediately to claim the deduction in their estimated tax payments. It expires December 31, 2008, by which time it will have reduced federal taxes on profitable businesses by an estimated $49.5 billion.

[1] Section 168(k) of the Internal Revenue Code, as amended by the stimulus package signed by President Bush on February 13.

Why Are Some States Affected, and Others Are Not?

A state might lose revenue due to the new federal "bonus depreciation" law for either of two reasons.

- A state's tax code might be written in such a way that it automatically reflects any change in federal tax law. This is sometimes called "rolling conformity." (Note that some states in this category decoupled from bonus depreciation in 2001-04, but the legislation to decouple was written so narrowly that it does not automatically apply to the 2008 bonus depreciation.)

- A state's tax code might be written in such a way that it reflects the federal tax code as it existed on a particular date, but the practice in the state is that the date is routinely moved forward to incorporate federal tax changes. Specifically, if the state moved the date forward in order to conform to "bonus depreciation" in 2001-04, it is reasonable to expect that — absent specific efforts to "decouple" — the state will incorporate bonus depreciation now and hence lose revenue.

States in either of those categories are shown in Table 1, along with the potential revenue loss.

Other states are protected automatically from revenue loss due to "bonus depreciation." In most cases, this is either because they have fixed-date conformity for their tax code as a whole (or for depreciation provisions in particular), or because they have a specific provision that requires businesses to "add-back" any benefit they receive from Section 168(k) — the section of the federal tax law that allows bonus depreciation.

Such states are *not* shown in Table 1 because they are assumed to face no revenue loss. However, it is possible that some of those states might consider enacting legislation that would bring their codes into conformity with the new federal stimulus law and hence lead to lost revenue. Table 2 at the end of this paper provides the *potential* revenue loss were *all* states to choose to conform — an unlikely scenario in most states, but perhaps plausible in a few.

How Can States Decouple from Bonus Depreciation?

The last time the federal government enacted "bonus depreciation," in 2002-2004, over 30 states amended their state laws to prevent revenue loss. (Then, as now, states were facing significant budget shortfalls due to an economic slowdown, and could not afford additional loss of revenues.)

The state statutes to decouple from 2002-04 bonus depreciation typically were quite simple: They merely required businesses to calculate their taxable income as if bonus depreciation had not been enacted. Some are more detailed about the steps involved, requiring businesses to add back to their federal taxable income the amount of the bonus depreciation deduction, and then allowing them to subtract the amount of depreciation they would normally have claimed. A few states use variations on the latter approach, for instance requiring that the "bonus depreciation" deduction be spread out over a number of years, which roughly mirrors the normal depreciation law. There is no obvious advantage to any one of these approaches.

However, states *should* decouple in such a way that the decoupling applies to any future bonus depreciation beyond 2008 — or even better in such a way that the decoupling applies to any future

changes in any part of the federal tax law. This would prevent any future federal tax law change from automatically reducing state revenues.

Not all states can decouple easily. Colorado, for instance, has a constitutional provision known as "TABOR" under which decoupling probably would require a costly statewide referendum. In a few other states, such as Oregon, decoupling requires a supermajority vote of the legislature, so a small minority of legislators in either house can block it. Most of the states shown in Table 1, however, can decouple with a simple majority in each house of the legislature and the governor's signature.

What Are the Short-Term and Long-Term Revenue Implications of Decoupling from Bonus Depreciation?

The federal government expects to lose $49.5 billion in federal fiscal years 2008 and 2009 (combined) as a result of bonus depreciation. If the affected states face a proportionately equivalent revenue loss, as it is reasonable to expect they would, this represents potential revenue loss of approximately $1.7 billion, as shown in Table 1.[2] It is somewhat unclear what portion of this revenue would fall in state fiscal year 2008 and what portion would fall in state fiscal year 2009. But in most states the distinction is not very important, because any shortfall in 2008 would have to be made up in 2009.

If the federal government allows bonus depreciation to expire on December 31, 2008, as it is now scheduled to do, then no revenue loss would be expected to occur after 2009. However, there is no guarantee that bonus depreciation will expire on schedule. In the early 2000s, for instance, bonus depreciation was enacted and then a year later extended; in the end bonus depreciation was in effect for more than three years. Moreover, 2008 is an election year, so additional "stimulus" tax cuts (such as an extension of bonus depreciation) are entirely possible, especially if the economy does not recover rapidly.

Some proponents of conforming to bonus depreciation may argue that bonus depreciation is merely a timing shift. A state that loses money from bonus depreciation in 2008 and 2009 might expect to begin recouping a portion of the revenue loss beginning in 2010, because of the way bonus depreciation interacts with the regular depreciation schedule. Since more of the purchase cost is depreciated in the first year, less is depreciated in subsequent years.

This timing shift is likely to be of little solace to states facing budget problems now. Moreover, even in the longer term, states should be suspicious of the "recoupment" argument for the following reasons:

- As noted above, it is not clear whether in fact the federal government will allow bonus depreciation to expire as scheduled. If it does not, recoupment would be substantially delayed.

- Although the recoupment of revenue could begin as early as 2010, the bulk of it would occur after 2011. (Some of it could be recouped as far into the future as 19 years from now, or perhaps never, if corporations go out of business before making up the lost revenue.) This is of little help to states that are legally required to balance their budgets in 2008, 2009, and 2010 as well as all subsequent years, as nearly all states are.

---

[2] Note that this amount is a substantial revision from Center on Budget and Policy Priorities estimates published earlier this year. The primary reason for the revision is that the new bonus depreciation law was drafted in such a way that several large states that initially seemed likely would lose revenue automatically in fact will be protected; these states include Connecticut, Illinois, Massachusetts, New York, Ohio, Pennsylvania and (in part) Vermont.

- Allowing corporations to pay less taxes now, based on the premise that they will pay an equivalent amount in increased taxes five, ten or 15 years into the future, is equivalent to giving those corporations an interest-free loans. Like any interest-free loan that gets repaid, there is a hidden cost to the borrower, in this case the state. (As a recent Wall Street Journal article noted, the cost of this "interest-free loan" that results from bonus depreciation is not reflected in the official Congressional cost estimate due to a loophole in federal budget rules.[3])

What Are the Economic Implications for a State of Decoupling from Bonus Depreciation?

Of the measures considered by Congress to stimulate the economy, bonus depreciation is one of the least effective, according to the Congressional Budget Office. Moody's Economy.com found that for every dollar spent on bonus depreciation, the economy would grow by just 27 cents. Part of the reason this stimulus strategy is considered relatively ineffective is that studies of the 2001-04 bonus depreciation program found that it did little to stimulate business investment. Most of the benefit went to firms that were planning to buy new equipment anyway.

A better approach to stimulating a state economy would be for a state to decouple from the federal change and use the revenue to balance the budget — thereby reducing the need for the state to cut spending or raise new revenues. In contrast to the relatively weak stimulus effect of bonus depreciation, Moody's found that each dollar spent mitigating state budget shortfalls could yield $1.36 in increased economic growth.

Another wise use for states of the revenue saved by decoupling could be to invest in education, infrastructure, or other areas of state spending that have been shown to increase long-term economic growth.

It is worth noting that state decoupling will not impair a corporation's ability to benefit from the *federal* bonus depreciation provision. In other words, regardless of state action, corporations will receive a very generous investment incentive through their federal tax returns. Since federal tax rates are higher than state rates, the federal deduction for bonus depreciation is far more valuable than any state deduction would be.

There is reason to question state conformity to the bonus depreciation rule on economic grounds: states that fail to decouple will suffer substantial revenue loss to subsidize investments *made by multi-state corporations in other states*. The reason is as follows. Multi-state corporations pay tax to each state in which they operate. The tax is based on total U.S. income minus total U.S. expenses, including depreciation (bonus and otherwise). The amount that each corporation pays to each state is based on a formula that reflects the relative degree of that corporation's operation in the state relative to its entire U.S. operation — not on where their expenses occur. In fact, the U.S. Constitution's Commerce Clause has been held by courts to find that states cannot treat out-of-state equipment purchases less favorably than in-state purchases. No matter where a piece of equipment is purchased, taxable income is reduced in *every* state where a corporation is paying taxes. Thus, if a corporation replaces a piece of equipment at a factory out of state, it would receive the exact same bonus depreciation deduction as it would for replacing a piece of equipment within the state. Since multi-state corporations represent a large portion of most states' corporate tax bases, much of the cost of conforming to the temporary depreciation rule would subsidize out-of-state investments. Conforming to bonus depreciation is not likely to materially improve any state's economic performance or cushion its economic downturn.

---

[3] Jesse Drucker, "Cost of Business Tax Cuts Underestimated," *The Wall Street Journal*, February 11, 2008.

TABLE 2: POTENTIAL REVENUE LOSS IN EACH STATE IF THAT STATE WERE TO CONFORM FULLY TO BONUS DEPRECIATION (APPROXIMATE – DOLLARS IN MILLIONS)		
State	Revenue Loss Under Current Law	Revenue Loss If State Chose to Conform
Alabama	$85	-
Alaska	15	12
Arizona	-	129
Arkansas	-	62
California	-	1,675
Colorado	*75*	-
Connecticut	-	155
Delaware	42	-
Florida	217	-
Georgia	-	213
Hawaii	-	30
Idaho	-	35
Illinois	-	390
Indiana	-	152
Iowa	-	59
Kansas	85	-
Kentucky	-	120
Louisiana	107	-
Maine	29	-
Maryland	-	153
Massachusetts	-	333
Michigan	166	-
Minnesota	-	*151*
Mississippi	-	55
Missouri	98	-
Montana	27	-
Nebraska	41	-
Nevada	-	-
New Hampshire	-	56
New Jersey	-	418
New Mexico	27	-
New York	-	820
North Carolina	282	-
North Dakota	16	-
Ohio	-	201
Oklahoma	66	-
Oregon	*86*	-
Pennsylvania	-	335
Rhode Island	29	-
South Carolina	-	71
South Dakota	7	-
Tennessee	-	109
Texas	-	-
Utah	69	-
Vermont	7	8
Virginia	-	247
Washington	-	-
West Virginia	*28 - 37*	-
Wisconsin	-	162
Wyoming	-	-
District of Columbia	40	-

The first two columns of this table are the same as those in Table 1. The third column reflects the potential revenue loss for states that are decoupled from federal law on bonus depreciation, in the unlikely event that they were to conform. Alaska and Vermont are partially, not fully, decoupled under current law. Nevada, Texas, Washington and Wyoming lack both corporate and personal income taxes.