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BUSINESS EXPENSING PROPOSAL WOULD ADD TO STATE FISCAL PROBLEMS

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President Obama's proposed temporary tax incentive to encourage business investment in machinery and equipment would cost states up to $20 billion in *state* corporate and individual income tax revenues during the current and next two state fiscal years.[1] This loss would come on top of states' record revenue losses resulting from the recession, which are creating budget shortfalls of unprecedented size; state shortfalls are likely to exceed $130 billion for state fiscal year 2012, which starts July 1, 2011 in most states. The additional state revenue losses resulting from the proposal would make it necessary for states to enact additional budget cuts or tax increases, which would reduce the proposal's overall stimulative effect.

On September 8, the President proposed that from that date through December 31, 2011, businesses should be allowed to immediately deduct from their gross income the entire cost of capital investments in machinery and equipment — a practice known as "expensing" — rather than gradually deducting or "depreciating" these costs over a period of several years, as current law generally requires. Because of linkages between the federal and state tax codes, this proposal would cost state governments significant amounts of revenue.

- States almost always use the federal definition of taxable income as the starting point for the calculation of taxable income under both their corporate and personal income taxes. As a result, when the federal government allows firms to claim more tax deductions, as the President's proposal would do, that also reduces state taxable income — and thus state tax revenues.
- Based on the Administration's estimate that expensing would cost the federal government $200 billion over the next two years, we estimate that it would cost states $20 billion in lost revenue in state fiscal years 2011, 2012, and 2013. As many as 45 states and the District of Columbia would be affected. (The exceptions are Nevada, Texas, Washington, and Wyoming, which would not be affected because they have no personal or corporate income tax, and California,

[1] The state estimates assume that at the federal and state levels, 75 percent of the revenue loss would occur in corporate income taxes and the remainder in personal income taxes. The estimates also assume that each state loses the same percentage of personal and corporate income revenues as would be forgone at the federal level. State tax revenue data come from the Nelson A. Rockefeller Institute of Government, based largely on U.S. Census quarterly figures (http://www.rockinst.org/pdf/government_finance/state_revenue_report/2010-10-19-SRR_81.pdf) and the Census Bureau. Federal tax data come from the Congressional Budget Office.

for reasons explained later in this paper.) About 85 percent of this revenue loss would be recouped in later years, because the immediate deduction of costs for purchases of machinery and equipment largely would substitute for depreciation deductions that would otherwise have been taken in later years. But this would not ease states' problems over the next few years, when they will continue to be in fiscal crisis, because states (unlike the federal government) must balance their budgets every year, including years in which the economy is in recession or otherwise very weak.

- These revenue losses would add to projected state budget shortfalls, which already are extremely large, and thus would necessitate larger state budget cuts or tax increases. Economists estimate that the budget cuts and tax increases which states are enacting in response to the budget shortfalls are slowing economic growth by one-half of a percent of GDP to three-quarters of a percent of GDP.[2]

Table 1

State Revenue Loss from Administration Expensing Proposal

State	Total Revenue Loss (in millions of dollars)	State	Total Revenue Loss (in millions of dollars)
Alabama	$291	Mississippi	$196
Alaska	294	Missouri	261
Arizona	270	Montana	70
Arkansas	256	Nebraska	128
Colorado	308	New Hampshire	231
Connecticut	454	New Jersey	1,398
Delaware	98	New Mexico	55
District of Columbia	203	New York	3,047
Florida	819	North Carolina	942
Georgia	583	North Dakota	52
Hawaii	93	Ohio	291
Idaho	86	Oklahoma	187
Illinois	1,330	Oregon	352
Indiana	422	Pennsylvania	1,113
Iowa	180	Rhode Island	94
Kansas	270	South Carolina	143
Kentucky	297	South Dakota	14
Louisiana	285	Tennessee	418
Maine	130	Utah	193
Maryland	646	Vermont	58
Massachusetts	1,223	Virginia	694
Michigan	523	West Virginia	223
Minnesota	578	Wisconsin	611
		Total	**20,410**

Note: Amounts shown are the revenue losses associated with the 24-month period for which full expensing would be in effect. The great majority of these losses would occur in state fiscal years 2012 and 2013, which for most states run from July 1, 2011 through June 30, 2012 and from July 1, 2012 through June 30, 2013.

[2] Mark Zandi, Chief Economist at Moody's Economy.com, says that state actions currently are reducing GDP growth by half a percentage point. (Communication with author.) In July 2010, Goldman-Sachs said state actions would reduce GDP growth by three-quarters of a percentage point. (Goldman-Sachs, U.S. Daily, July 21, 2010.)

States Are Coping with Large Revenue Losses

The economic downturn has caused state tax revenues to decline 13 percent below pre-recession levels. Meanwhile, the cost of providing services has risen, due both to normal population growth and to increased human need resulting from the recession. The result has been large budget gaps in nearly every state.

After accounting for the federal fiscal relief provided through the 2009 Recovery Act and the August 2010 jobs legislation, states faced (and have mostly closed) budget gaps of $101 billion for the current state fiscal year. States are facing an even larger projected gap — $134 billion — for state fiscal year 2012; the gap will be larger because the federal fiscal relief will have almost entirely expired. Preliminary data suggest that state budget shortfalls for 2013 also will approach or exceed $100 billion, assuming an economic recovery in line with what mainstream forecasters are expecting.

Because states must balance their budgets regardless of the state of the economy, they are closing these shortfalls with budget cuts and tax increases, both of which remove demand from the economy. As many economic analysts have noted, the drag on the recovery from such actions is costing hundreds of thousands of jobs. Indeed, states and localities have cut over 400,000 jobs since August 2008,[3] with ripple effects causing additional job loss in the private sector and making it more difficult for the economy to recover.

Why Expensing Reduces State Revenues Further

Forty-six states and the District of Columbia levy taxes on corporate and/or personal income where the definition of "income" is based in whole or in part on the definition in the federal Internal Revenue Code. In 24 states and the District of Columbia, this conformity is *automatic*: — when the Internal Revenue Code is amended, tax codes in these states automatically change as well to reflect the federal changes. The other 22 states conform to federal definitions of allowable deductions, taxable income, and other items *as of a particular date* but routinely update the conformity date every year to reflect the latest federal changes.

Recent history suggests that nearly all states with automatic conformity and most states with conformity as of a specified date will conform to the expensing proposal if it is enacted, and will thus lose significant revenue. Congress has enacted or expanded several types of business tax breaks over the past decade, including several rounds of expanded machinery and equipment write-offs (known as "bonus depreciation") on a temporary basis and a "domestic production deduction" that allows deductions for a variety of activities ranging from manufacturing to film-making and publishing. Last year, Congress enacted a provision that allows corporations to postpone paying federal taxes on money gained from buying back their debt at a lower price, which is known as deferral of "cancellation of debt income." Although two-thirds of the affected states chose not to conform to the first two rounds of bonus depreciation in 2001-2004, most did conform to the more recent rounds of business tax cuts in 2008 and 2009. A majority of states conformed to the domestic production deduction, and nearly all are conforming to the deferral of cancellation of debt income.

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[3] CBPP calculations from Bureau of Labor Statistics data.

Because most states have conformed to these recent federal business tax breaks, most are likely to conform to the expensing proposal if it becomes law. (The only major exception is California, which — alone among states — has long utilized depreciation rules of its own that differ from the federal rules; it is unlikely California would conform to the new expensing rules.) If the expensing proposal is enacted, economically significant corporations can be expected to bring considerable political pressure to bear on their state legislators and governors to conform state tax laws to the expanded federal deduction for equipment purchases.

State Revenue Losses Would Aggravate Fiscal Crisis

The Administration estimates that the proposal would cost the U.S. Treasury approximately $200 billion over two years. (The Joint Committee on Taxation has not yet produced an estimate.) The Administration also estimates that the federal government would then recoup $170 billion of that amount later in the decade, because the immediate write-off of equipment costs would substitute for depreciation deductions that would otherwise have reduced tax payments in those later years.

States, too, would eventually recoup most of their revenue losses. But that would not help them over the next few years when they will still be in fiscal crisis, because they — unlike the federal government — must balance their budgets in all years, including those in which the economy is weakest. The revenue losses over the next few years would likely compel further cuts in state programs and/or additional state tax increases, which would reduce demand for goods and services and partly offset the stimulus resulting from the proposal.

We estimate that if every state other than California were to conform, the $200 billion two-year federal revenue loss would translate to a $20 billion state revenue loss in corporate and personal income taxes combined. These losses would affect both the current state fiscal year (2011) and the 2012 and 2013 fiscal years. In 2011, the revenue losses would be modest and would mostly take the form of lower estimated corporate tax payments. In fiscal years 2012 and 2013, however, the losses would result from final payments made when personal and corporate tax returns are filed and would be much larger.