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AMENDMENT PROVIDING SECOND YEAR OF BONUS DEPRECIATION WOULD LESSEN ITS STIMULATIVE EFFECT WHILE WORSENING BOTH THE FEDERAL AND STATE BUDGET DEFICITS

by Edwin Park, Nick Johnson and Andrew Lee

Earlier today, the Senate rejected an amendment by Senator Gordon Smith (R-OR) to add a second and third year to the bonus depreciation tax cut included in the Daschle economic stimulus bill. On Tuesday, the Senate is expected to consider a similar amendment that would add a second year, but not a third year, to this business tax cut. The amendment expected on Tuesday, like the earlier Smith amendment, would render the package less effective as economic stimulus, worsen the federal budget outlook, and reduce state revenues at a time when states are already under severe budget pressures.

- **Extending this business tax cut from one year to two years would significantly reduce its effectiveness as an economic stimulus proposal according to the Congressional Budget Office and other experts, and this would be harmful.** In the recent report, "Economic Stimulus: Evaluating Proposed Changes in Tax Policy," the Congressional Budget Office warns that lengthening the effective period of this provision weakens its ability to provide stimulus: "Temporarily cutting taxes on investment can provide one-time opportunities for saving that may induce firms to advance their investment plans to the present, a step they might not take if they knew that the tax advantage would remain in place and be available to them later."

  To provide short-term economic stimulus, business tax provisions must induce immediate business investment. Lengthening the effective period, however, allows firms to delay investment decisions until after the economy is recovering and still take advantage of the tax break. Why should a firm accelerate investments into 2002 — the time the economy needs them — if it knows it can still get the same tax break if it waits to see what the economy looks like and delays the investment until 2003? Business Roundtable President John Castellani made the same point last week when he argued that, to encourage immediate business investment, it is preferable to have "higher amounts of bonus depreciation over a shorter period of time than lower amounts over a longer period of time." Numerous analyses issued by economists at the Brookings Institution make the same point.

- **Adding a second year also would increase the cost of the bonus depreciation provision and worsen the overall budget outlook.** Extending the 30 percent bonus depreciation provision to two years would cost an additional $30 billion in 2003 above the cost of the current one-year provision. Extending this provision would worsen the budget outlook in 2003 despite the fact that these substantial costs would be incurred at a time when the economy is expected to have already recovered, as well as the fact that OMB director Mitchell Daniels announced on January 23 that the Administration's budget will show an $80 billion deficit for fiscal year 2003. The recent CBO report concludes that "extending the period during which such expensing could be used would reduce the bang for the buck because it would decrease businesses' incentive to invest in the first year and increase the total revenue cost."

- **A second year of bonus depreciation would reduce state revenues by another $5 billion and force states to implement even larger tax increases and cuts in programs like Medicaid.** Because state corporate tax codes are tied to the federal code, enacting a depreciation tax cut at the federal level causes some 45 states to lose state tax revenues as well. The Congressional Research Service has found that a 30 percent depreciation provision would cost states $5.4 billion in 2002 and $5.1 billion in the following year.[1] The stimulus package on the Senate floor makes states whole by providing $5 billion to $6 billion in fiscal relief to states to help offset the $5.4 billion revenue loss in 2002. If the depreciation tax cut is extended for a second year, however, states will lose an additional $5.1 billion in 2003 with no offsetting relief from the federal government.

  Such a revenue loss would deepen what is already the worst state fiscal crisis in at least two decades. Although the recession technically may end within the next several months, most states anticipate serious fiscal difficulties to continue at least through 2003, due to lagging revenues and continued high unemployment levels. Some states, including Alabama, Florida, North Carolina and Ohio, have already enacted major budget cuts and/or tax measures that will carry over into 2003. Other states have been able to draw upon reserves and make other budget adjustments to avoid major service cuts and tax increases in 2002, but will not be able to forestall such cuts in the 2003 fiscal year. If states lose an additional $5 billion in 2003 as a result of Congress' extending the bonus depreciation provision into a second year, they will have to raise taxes and cut programs such as Medicaid to a greater degree.

  Many state legislatures are meeting now to discuss their FY 2003 budgets. Examples of tax changes that governors have proposed in the last two weeks to help balance FY 2003 budgets include increased sales, cigarette and gasoline taxes in Kansas, postponement of an income tax cut in Maryland, broadening the sales tax base in Minnesota, excise tax increases in Missouri, and rollback of an income tax reduction in Oregon.

  Many states have also already implemented or are now considering significant cuts in Medicaid and the State Children's Health Insurance Program (SCHIP) for 2003 that would affect thousands of children and elderly and disabled people. For example, Oklahoma and New Mexico may eliminate their CHIP-funded Medicaid expansions to children entirely. Tennessee has proposed cutting Medicaid eligibility for 180,000 low-income people in its TennCare program. Some states like Florida and Oregon will likely cut coverage of the "medically needy," people with catastrophic health care expenses. Other states will no longer cover disabled workers returning to work and low-income women with breast and cervical cancer. Finally, a number of states, including California, Indiana, Maine and New Jersey, are suspending measures to reach more of the uninsured until their budget situation improves.

  These budget cuts and tax increases are based on revenue forecasts that do *not* assume enactment of bonus depreciation provisions. The additional loss of revenues in 2003 that would result from lengthening the bonus depreciation period would increase the likelihood and severity of state actions to cut programs and raise taxes.

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In addition, New York City and the District of Columbia would lose revenue from their own corporate income taxes. Including those amounts, the total loss to state and local governments would be $5.8 billion in 2002 and $5.5 billion in 2003.