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HOUSE STIMULUS PACKAGE WOULD WORSEN STATE FISCAL CONDITIONS BY CAUSING STATES TO LOSE $5 BILLION A YEAR IN REVENUE FOR THE NEXT THREE YEARS

by Iris J. Lav and Kevin Carey

A provision in the stimulus package that the House Ways and Means Committee approved October 12 — and that is expected to come to the House floor the week of October 22 — would reduce state revenues by approximately $5 billion a year for the next three years. This reduction in state revenues would come at a time when a growing number of states are falling into fiscal crisis and, because of balanced budget requirements, are being forced to cut programs and/or raise taxes during the downturn. If the state revenue losses that would result from the Ways and Means bill compelled states to institute still-larger program cuts or tax increases, that would partially offset and thereby weaken the federal stimulus policies.

The single biggest tax-cut item in the Ways and Means bill is a provision that allows partial expensing of business investments. This provision would allow firms to subtract immediately 30 percent of the cost of new investments in equipment or similar business property, rather than depreciating the costs of these investments over a number of years as under current law.

- This provision, which would be in effect for the next three years, is estimated by the Joint Committee on Taxation to reduce federal revenues by $39 billion in 2002, $36 billion in 2003, and $30 billion in 2004.

- Most states use federal rules on expensing and depreciation in the calculation of their own state corporate and other business income taxes. Of the 45 states that have corporate income taxes, 44 — all but California — conform to the federal rules. As a result, 44 states and the District of Columbia would experience significant revenue losses if this provision becomes part of federal law.

- These states stand to lose an average of approximately $5 billion a year in corporate and individual income tax revenues in each of the three years the provision would be in effect as a result of their conformity to federal expensing and depreciation rules.

Some states would lose additional revenues because their tax systems conform to federal treatment of net operating losses and/or levy a corporate Alternative Minimum Tax that piggy-backs on the federal corporate AMT. The House bill makes net operating loss provisions more generous and repeals the corporate AMT.

A number of economists and fiscal experts, such as Joseph Stiglitz who was awarded the Nobel Prize in economics last week, have argued that a federal stimulus package should include the provision of significant fiscal relief to states so they do not need to cut programs or raise taxes in the middle of a recession and thereby dampen economic activity. The Ways and Means bill not only fails to provide such fiscal relief but would make the fiscal shortfalls that states face more severe and the resulting need to cut programs or raise taxes greater.

States are ill prepared to withstand this revenue loss. Some 49 states are required by their constitutions or state law to balance their budgets, and many must take remedial actions during a fiscal year to assure that they end the year with their budgets in balance. As a result, many states will have little choice but to cut spending or raise taxes to compensate for the additional revenue losses the Ways and Means legislation would engender. The weakening economy already has taken its toll on state fiscal conditions, and budget cuts are beginning to be seen throughout the country.

- Most states are experiencing revenue collections below projections. Some 15 states — Arkansas, California, Georgia, Illinois, Indiana, Iowa, Maine, Massachusetts, Michigan, Minnesota, Mississippi, North Carolina, Rhode Island, South Carolina, and Virginia — are reporting that revenue collections for the period of July through September 2001 were below revenues for the comparable period in 2000. This number is expected to increase in coming weeks as more state revenue reports are released. Moreover, the events of September 11th affected only the last two and half weeks of the July-September quarter. As the effects of the attack are fully felt, the number of states whose revenues are shrinking is virtually certain to rise.

- State officials are working to revise budget projections in the aftermath of the terrorist attacks. Early indications suggest that large budget deficits are in the offing. Among the states that already are projecting large deficits are California: $9.5 billion; New York: $9.0 billion; Arizona: $1.6 billion; New Jersey: $1.5 billion; Ohio: $1.5 billion; Florida: $1.3 billion; and Michigan: nearly $1.0 billion.[1]

- State revenue losses and budget deficits have forced many governors to order agencies to designate and/or implement significant cuts in current expenditures, even as the need for government services is increasing as a result of more people losing their jobs and their income. Budget cuts are currently being considered or have already been implemented in at least 27 states. For example, governors have

[1] Budget deficit estimates are from a variety of state sources and may vary in terms of methodology and the budget time period to which they apply. In particular, the figures for New York, Arizona, and Ohio are for this fiscal year and next.

ordered agencies to find broad-based cuts of 15 percent in California, seven percent in Indiana, and four percent in Arizona and North Carolina.[2]

- Eight states — Arizona, Indiana, Maine, Nevada, New Hampshire, New Jersey, North Carolina, and West Virginia — already have raised taxes and fees significantly as they enacted their state fiscal year 2002 budgets.

- Large numbers of states are expected to take further action to cut programs and/or raise taxes when their state legislatures convene this winter.

The $5 billion-a-year revenue loss from the partial expensing provision of the Ways and Means bill would come on top of state revenue losses that are resulting from provisions of the federal tax-cut legislation enacted in June. For example, a provision of that legislation will cause state estate tax revenues to fall, starting in 2002.[3] Under longstanding provisions of federal estate tax law, taxpayers receive a dollar-for-dollar credit against their federal estate tax liability for all *state* estate and inheritance tax payments they make up to a certain level. State estate taxes in most states are specifically tied to this federal credit. The federal tax cut enacted this spring repeals the federal estate tax in 2010, but phases out the credit on which state estate taxes rely on a much faster timetable. The legislation phases out the credit over four years, beginning in 2002. Given the way that state estate taxes are constructed, the effect of reducing and then eliminating this federal credit is to reduce and then eliminate state estate taxes in most states. The revenue loss to states as a result of the phase-out of the credit for state estate and inheritance taxes will be approximately $1.9 billion in federal fiscal year 2003 and $3.5 billion in 2004.[4]

Despite significantly reducing state revenues, the Ways and Means legislation contains no fiscal relief for states. It neither provides funding to address the mounting fiscal problems states are encountering in the face of falling revenues nor contains any measures to offset the further loss of revenues the legislation will cause states to bear. As a result, it digs states' fiscal holes deeper.

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[2] Budget reduction amounts include cuts that are being implemented or developed. The cuts may be implemented in the current fiscal year and/or proposed for the subsequent year.

[3] Other provisions in the tax legislation enacted in June will cause additional state revenue losses in many states that conform to various provisions of the federal tax code. Provisions that will induce revenue losses in some states include expansions of tax breaks for pensions, the increase in the contribution limits for Individual Retirement Accounts, enhanced tax breaks for education, the increase in the standard deduction for married couples, repeal of the provisions that phase out itemized deductions and personal exemptions for high-income taxpayers, the marriage penalty relief in the Earned Income Tax Credit, and the modest expansion of the Dependent and Child Care Credit.

[4] Although the credit is reduced by 25 percent effective January 1 2002, there will be little revenue loss until 2003. This is because estates do not file tax returns and pay taxes until at least nine months after a death occurs.

The Ways and Means bill does include a provision to speed up the transfer of $9 billion already slated to be shifted from the federal unemployment insurance trust funds to state unemployment accounts. These funds, however, could be used only for unemployment insurance purposes and do not address the shortfalls in state operating budgets. (In addition, these funds are very modest compared to the $35 billion of additional federally funded unemployment benefits, measured in 2002 dollars, that the federal government provided in the last recession.) The Ways and Means legislation also would provide states with $3 billion through the Social Service Block Grant to provide health coverage for unemployed workers. Those funds could be used solely to provide health insurance to individuals *not eligible* for Medicaid, Medicare, or SCHIP programs. The funds thus would not help states to cover existing costs or to alleviate the burdens of increases in state Medicaid expenditures being caused by the economic downturn.

Moreover, this $3 billion constitutes only a small fraction of the cost of maintaining health insurance for those who lose their jobs. Proposals to provide partial federal subsidies for COBRA health insurance premiums and to enable states to extend Medicaid coverage to low-income unemployed workers who do not qualify for Medicaid under current rules and would not be covered through COBRA are estimated to cost between $16 billion and $25 billion, or five to eight times the amount the Ways and Means bill provides.[5]

In short, the Ways and Means legislation not only contains no provisions to help states compensate for the large losses in revenue they are facing as a result of the downturn but would cause states to lose additional revenue and make state budget shortfalls larger. As a result, the legislation would increase the probability that states will have to take actions to cut programs and raise taxes — actions that undercut the effect of the fiscal stimulus the federal government is attempting to provide.

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[5] For additional discussion of the Ways and Means Package, see Joel Friedman and Robert Greenstein, *Ways and Means Package Departs from Bipartisan Principles For Effective Stimulus and Officers Little Help to the Unemployed*, Center on Budget and Policy Priorities, October 17, 2001, available at `http://www.cbpp.org/10-17-01tax.htm`