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# MANY FEDERAL "STIMULUS" TAX CUTS UNDER CONSIDERATION WOULD BE COSTLY FOR STATES

by Iris J. Lav

The Bush Administration has repeatedly said in recent days that additional tax breaks are necessary to further stimulate the economy. The Administration plans to unveil a package of new tax cuts it will call a "growth package" later this month or early in January. Congress is expected to move fast in considering a new "stimulus" or "growth" package. Among the new tax breaks that the Administration is reported to be very seriously considering for inclusion in this package are the following:

- Eliminating the "double taxation" of corporate dividends, probably by allowing individuals to exclude any dividends they receive from their income.
- Increasing the amount of money individuals can deposit tax-free into IRA, 401(k) or other retirement plans — possibly by accelerating or expanding the tax law changes made in 2001, which are phasing in over time.
- Increasing the amount of capital investment expenses a small business can deduct from income immediately, rather than deduct as depreciation over the life of the asset.
- Increasing the amount of "bonus depreciation" that companies can take in the first year an asset is put in service, over and above the bonus depreciation provisions enacted in March 2002.

In addition to the large amount of federal funds that such new tax provisions would cost, all of these tax breaks would reduce *state* revenues because of the linkages between the state tax codes and federal taxes. These state revenue reductions would come at a time when many states have already cut spending and raised taxes to close deficits of approximately $50 billion for their 2003 fiscal year, and face additional gaps of at least $17 billion that must be closed during FY 2003. Early projections suggest that deficits for fiscal year 2004 could be in the range of $60 billion to $85 billion. Needless to say, tax increases and spending cuts are under consideration in nearly all states.

Because virtually all states must balance their budgets, new federal tax cuts that flow through to state revenues and cause state revenue losses — such as those the Bush Administration is considering — will force states to make additional budget cuts and/or raise additional taxes. If these new tax breaks are enacted, states will be in the untenable position of

### States Cannot Afford Additional Revenue Losses

States faced budget deficits of approximately $50 billion as they enacted their state fiscal year 2003 budgets, on top of an approximately $40 billion gap in fiscal year 2002. State revenues have declined for five consecutive quarters through September, 2002; largely as a result of this revenue decline, one-quarter of all states had deficits exceeding 10 percent of their budgets for fiscal year 2003. States managed to balance their budgets with a combination of depleting their reserves, some revenue increases, and sharp reduction in programs. In 16 states, spending growth was negative; these states appropriated fewer dollars for fiscal year 2003 than they spent in fiscal year 2002. Health insurance for low-income families and child care subsidies for working families have been cut, while many middle-income families have been affected by reductions in higher education spending that has driven up tuition at state schools.

Despite some recovery in the economy, state revenue collections and fiscal conditions have worsened over the last several months. According to the National Conference of State Legislatures, revenue collections through October are below forecast in 33 states, and new deficits of $17.5 billion that must be closed during fiscal year 2003 have developed. An informal survey suggests that budget deficits will continue for fiscal year 2004, and will likely be between $60 billion and $85 billion in that year.

As new state deficits open, states will have to consider additional measures to balance their budgets for the remainder of 2003 at the same time they are considering strategies to deal with the looming deficits for FY 2004. Since states already have used many or most of the one-time sources of revenues available to them, new rounds of tax increases and budget cuts are all but inevitable. Any additional revenue losses as a result of federal tax changes will increase the magnitude of tax increases and/or the depth of budget cuts that states will have to make in coming months.

giving unintended large tax breaks to some of their wealthiest residents while in many cases raising taxes on middle-income families and cutting programs for low-income households.

The states that stand to lose revenue if these tax breaks are enacted are described below.[1]

- If individuals are allowed to exclude a specified amount of dividends from income, it is likely that 43 states and the District of Columbia would lose revenue. This includes all states with a broad based income tax as well as Tennessee and New Hampshire, which tax dividends and interest.

[1] In some states, the revenue loss would be automatic because the state tax code automatically conforms to the current federal tax code for the specified provisions. In other states, legislation must be enacted each year to update the state code references to the federal tax code. Such legislation generally is routine. Although approximately 30 states did decline to conform to the temporary bonus depreciation provision in the stimulus legislation, it is unlikely that states would be willing to "decouple" from permanent changes in the income tax code or substantially increase the number of provisions for which their state tax codes diverge from the federal.

**States Already Have Been Hurt**
**By Federal Tax Actions Of The Past Two Years**

Federal tax reductions included in the stimulus package earlier this year and in the 2001 Economic Growth and Tax Relief Reconciliation Act have led to unplanned and — given the current fiscal crisis — undesirable revenue reductions in most states.

Among the changes that have reduced state revenues are the following.

- The economic stimulus legislation enacted in March 2002 allows firms to claim an immediate federal tax deduction of up to 30 percent of the cost of new equipment purchases, rather than depreciating the cost gradually over several years as under prior law. The vast majority of states historically have used federal depreciation rules for computing state business taxes, and so would be forced to give businesses an additional tax break — on top of the federal break — unless they "decoupled" their state taxes from the federal change. While 30 states have decoupled, the other states continue to suffer a revenue loss of $4 billion through September 2004.

- The 2001 tax law included repeal over the next four years (2002-2005) of the federal estate tax credit to which all state estate taxes are tied. The elimination of the credit will effectively repeal most state estate taxes, unless states change the way they link to the federal law. While 17 states and the District of Columbia have decoupled from the federal estate tax changes, the remaining states stand to lose $16 billion in the period from fiscal year 2003 to 2007. (Some states have constitutional bars to decoupling; others will not be able to do so for other reasons.)

- The 2001 tax law made a number of other changes that result in states losing revenues automatically. They include the liberalization of pension rules, the increase in the contribution limits to IRAs and 401(k), and the additional tax breaks for education.

- All states with an income tax *except* Pennsylvania and Arkansas would lose revenue if the contribution limits for retirement plans are increased.

- If the amount of capital investment small businesses can deduct immediately as an expense — a provision technically known as Section 179 expensing — is increased, all states *except* California and Michigan could lose revenue.

- After the bonus depreciation provisions were enacted in March, 2002, some 30 states chose to "decouple" from the new federal provision and maintain their own depreciation rules as they had been before the new federal law. Most of these states would be protected from revenue losses from further expansions of bonus depreciation, although a few might have to revisit their decoupling actions to account for additional federal changes. By contrast, the states that have not decoupled — AL, AK (for non-oil and gas companies), CO, DE, FL, KS, LA, ME, MI, NM, NY, OR, UT, MT, ND, and WV — would experience revenue losses.