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

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PROPOSED FEDERAL TAX CHANGES LIKELY TO COST STATES BILLIONS OF DOLLARS IN COMING YEARS

Amount of State Revenue Loss Will Depend on How Tax Cut Is Structured

By Nicholas Johnson

The U.S. Senate tax plan exempts from taxation 50 percent of dividends received by individuals in tax year 2003 and 100 percent of dividends in the following three tax years. It also expands a tax break known as "Section 179" that provides an immediate deduction for small and mid-size businesses that make equipment purchases.

The House of Representatives tax plan does not exempt dividends but rather reduces the individual income tax *rates* on dividends and on capital gains. It also expands and extends the "bonus depreciation" tax break for corporations, first enacted in 2002. Like the Senate plan, the House plan expands the Section 179 provision.

Either plan would reduce state revenue substantially, although the loss resulting from the Senate version is likely to be much greater than under the House version.

- In state fiscal year 2004 (which in most states begins July 1), the two provisions in the Senate bill would cost states about $2.6 billion, rising to $3.3 billion in state fiscal year 2005 and $3.5 billion in state fiscal year 2006.

- Over a ten-year period, assuming its provisions are extended as is likely, the Senate plan would cost states about $37 billion. Roughly $32 billion of the loss would occur as a result of the dividends exemption. Another $5.3 billion would come from the Section 179 provision.

- The bonus depreciation provision in the House plan would cost states an average of about $1 billion a year through 2006. Combined with the Section 179 provision, the House plan would cost states about $4.7 billion through 2006.

- Over the full ten years, assuming its provisions are extended, the House plan would cost states about $15.2 billion — $9.9 billion due to the bonus depreciation provision and $5.3 billion due to the Section 179 provision.

Some Senate leaders have indicated they will seek to structure the dividends component of the final tax bill in such a way that states are not harmed. If this occurs, the final bill could have a smaller impact on states.

Table 1
Estimated Lost State Tax Revenue Resulting from the Senate Tax Bill, by State Fiscal Year
(In billions of dollars)

	2004	**2005**	**2006**	**2003-2012** (assuming provisions are made permanent)
Exemption of dividends	2.0	2.7	2.9	32.2
Section 179 expensing	0.7	0.6	0.6	5.3
Total	**2.6**	**3.3**	**3.5**	**37.4**

Table 2
Estimated Lost State Tax Revenue Resulting from the House Tax Bill, by State Fiscal Year
(In billions of dollars)

By SFY	**2004**	**2005**	**2006**	**2003-2012** (assuming provisions are made permanent)
Expansion of bonus depreciation	0.8	1.4	0.8	9.9
Section 179 expensing	0.7	0.6	0.6	5.3
Total	**1.4**	**1.9**	**1.4**	15.2

Notes to Tables 1 and 2: Some totals do not add due to rounding. Section 179 estimates are based on preliminary Joint Committee on Taxation estimates of federal impact and the assumption that the cost to states will equal about 15 percent of the cost to the federal government. Bonus depreciation estimates reflect impacts only on states that have not decoupled, and are based on JCT estimates of federal impact and on each state's relative personal and corporate income tax collections. See notes to Table 3 for methodology for dividends estimate.

The revenue loss would occur at a particularly difficult time for states. States have closed or are in the process of closing deficits for state fiscal year 2003 that totaled nearly $80 billion, along with deficits for fiscal year 2004 that exceed $70 billion. These deficits have been closed by a combination of depleting reserves, raising taxes, and cutting needed programs such as education and health insurance for low-income families. Most observers expect state fiscal problems to continue in fiscal year 2005, and further rounds of tax increases and program cuts will be made as states struggle to meet their balanced budget requirements.

The Dividends Exemption in the Senate Bill Could Cost States $32 Billion Over Ten Years

Some 37 states and the District of Columbia use federal definitions of income in their own tax systems. These states, with a few likely exceptions such as California and Montana, would exclude dividends from state taxable income if they were excluded from federal gross income, as the Senate bill proposes. A few states — Alabama, Arkansas, Mississippi, New Jersey, Pennsylvania, and Tennessee — ask taxpayers to report directly the amount of dividends they receive rather than deriving dividend income from the federal tax return. These states would not automatically lose revenue, but would undoubtedly face pressure to conform to the federal treatment.

Under the Senate proposal to exempt dividends, states would most likely lose at least $32 billion in revenue, depending on which states conformed to the federal treatment. California, which has a tradition of allowing its tax structure to deviate from federal law, might well resist the exclusion, but most other states likely would not. Some states would conform automatically to the change. Other states, following historical practice, would update their tax codes as a matter of routine to reflect the federal change.

It is far more common for states to accept federal changes than to decouple from them. Although 30 states did decouple from the federal "bonus depreciation" provision enacted in 2002, that degree of decoupling was unprecedented. Only 17 states have decoupled from the phase-out of the estate tax credit that eliminates state estate taxes. The same pressures that are being brought to bear to push for a dividend exclusion at the federal level also exist in state capitols. For these reasons, when the dividend proposal was first released in January, Standard & Poor's commented, "State legislative changes to tax structure, even given the obvious necessity and benefit, will likely prove difficult, at best."

In state fiscal year 2004, which begins July 1 in most states, states would lose about $2.6 billion as a result of conforming to the Senate dividend exemption. The revenue loss would rise to $3.3 billion in 2005 and $3.5 billion in 2006. The Senate dividend exemption, as drafted, would expire after the 2007 tax year. Legislative leaders have made very clear, however, that they intend this provision to be extended and made permanent. If made permanent, the dividend exemption would cost states at least $32 billion over ten years. (See Table 3.)

"Bonus Depreciation" Expansion in the House Bill Would Cost States Roughly $3 Billion Over Three Years

Under normal tax law, the cost of purchases of machinery or equipment cannot be claimed fully as a business expense in the year of purchase but rather must be spread over the useful lifetime of the equipment. The 2002 federal tax bill allowed firms to deduct up to 30 percent of the cost of purchasing machinery or equipment in the first year, as long as the item was purchased between September 2001 and September 2004. The House bill expands the percentage to 50 percent and extends it to September 2005.

As noted above, a majority of states have decoupled from bonus depreciation. But some 14 states — Alabama, Colorado, Delaware, Florida, Kansas, Louisiana, Missouri, Montana, New Mexico, North Dakota, Oregon, Utah, Vermont and West Virginia — have not. (Missouri decoupled for one year only; Vermont decoupled for its corporate income tax but not its personal

Can This Revenue Loss Be Averted?

The Senate bill calls for dividends to be excluded from federal gross income. Such an exclusion would affect some 37 states that use either federal adjusted gross income (AGI) or federal taxable income as the starting point for their income tax calculations. However, the exemption for dividends could be worded in such a way as to exclude them only from taxable income, not AGI. In that way, far fewer states would be affected.

States differ in the way they piggyback on the federal tax code. The majority of states begin their calculations with the federal definition of AGI. Currently, dividend income is included in AGI, and thus excluding dividend income would reduce AGI for both federal and state purposes. An alternative approach would retain dividend income for the AGI calculation, and then have an offsetting subtraction for dividend income for purposes of calculating taxable income.

Of the 34 states that are likely to be affected adversely by the dividend exclusion, 23 conform to federal AGI and could avoid harm if the exclusion affected federal taxable income but not AGI. Some 11 states piggyback on the federal calculation for taxable income and could be affected. Of those 11 states, however, only five — Colorado, North Dakota, Oregon, Utah, and Vermont — conform automatically. (Legislation is pending in Oregon to change the conformity rules.) The other six states, Hawaii, Idaho, Minnesota, North Carolina, Rhode Island, and South Carolina, would be affected if they chose to update their code references. But there is far less precedent for conformity to changes in taxable income than changes in adjusted gross income, and therefore it is more likely that those states would decouple.

Senate leaders have indicated they will try to avert any revenue loss to states that might result from the exclusion of dividends. For instance, Senate Budget Committee Chairman Nickles was quoted in the May 15 Congressional Record as saying: "I will do all I can to ensure that any dividends language that emerges from conference does not cause states to lose tax revenues." Senate Finance Committee Chairman Grassley said: "I, too, will do all that I can in conference to ensure that state revenues are not reduced by any dividends provisions that are included in the final product."

No similar assurances were given as regards to the impacts on states of other provisions in the tax bills.

income tax.) Those states would lose an estimated $800 million in 2004 and $2.9 billion over three years.

If the federal government extends bonus depreciation this year, it is reasonable to expect it would consider further extensions in the future; the likely ten-year revenue loss for states would equal about $9.9 billion. See Table 4.

Senate and House "Section 179 Expensing" Provision Would Cost States About $5 Billion Over 10 Years

Every one of the 45 states with a personal or corporate income tax, except California, follows federal rules that allow small and mid-size firms to deduct immediately, or "expense," the cost of up to $25,000 in machinery and equipment purchases. Both the Senate and House

Further Adverse Effects on States from Exempting Dividends: Cost of State and Local Borrowing Likely to Rise

States would also be hit by the anticipated increase in interest rates expected to result from either the House or Senate plan. Higher interest rates increase the cost of borrowing for states, putting further strain on their budgets. Two factors would contribute to an increase in interest rates. First, exempting dividends from taxation, or taxing them at a much more favorable rate, would draw funds away from the bond market, as dividend-paying stocks became more attractive investments following the tax cut. To compete for investor dollars with stocks paying dividends that are fully or partially exempt from taxation, entities that issue bonds — including state and local governments — would have to offer higher interest rates. Second, the high cost of the package as a whole — an estimated $660 billion for the Senate plan and $1.1 trillion for the House plan over ten years, assuming that the artificially phased-out tax cuts are extended as Congressional and Administration leaders have said they intend — would enlarge long-term deficits and increase government borrowing. As government borrowing needs crowd out other borrowers, long-term interest rates can rise.

The California State Treasurer's Office has estimated the cost to state and local governments of increased interest payments. It found that the total increased interest payments over the life of the state and local bonds projected to be issued nationwide over the next 10 years would equal between $77 billion and $155 billion.

Source: California State Treasurer Phil Angelides, *No Dividends: How Taxpayers Lose Under the Bush Plan*, January, 2003. www.treasurer.ca.gov.

bills would increase this amount to $100,000 and make certain other changes. These changes would cause states to lose roughly $600 million to $700 million a year in the short term. If made permanent, these changes would cost states more than $5 billion over 10 years.

Other Provisions

Some other provisions of the House and Senate bills could cause some states to lose revenue. For instance, increases in the standard deduction in both bills would affect about 10 states that base their own standard deduction amount on the federal amount. Extension of the "net operating loss carryback" — a corporate tax deduction in the House bill — also could cost money to a few states that base their own NOL carryback on the federal provision.

Note that reductions in federal tax *rates* do *not* affect state tax systems.[1] Therefore, neither the acceleration in tax rates included in both bills, nor the reduction in tax rates on dividends and capital gains under the House bill, would reduce state revenues.

The Senate bill does include some measures that, if enacted, could raise new revenue for states. These provisions close corporate loopholes and eliminate a tax exemption for income earned by U.S. citizens working abroad. Because those provisions would increase taxpayers'

[1] A small number of states allow taxpayers to deduct some or all of their federal tax liability from their state taxes. In such a situation, a rate cut could lead to increased state revenues.

federal gross income, states would likely gain the ability to tax that income as well. However, it appears highly unlikely that those measures will be included in the final tax bill.

Implications for States

The likely revenue losses described in this paper — $4.3 billion under the House plan and $10 billion under the Senate plan by the end of state fiscal year 2006 — would add to significant revenue losses that states already are suffering as a result of the state fiscal crisis and the last two federal tax cuts.

- Annual state tax collections have declined by $49 billion since 2000 in inflation-adjusted terms, according to U.S. Census Bureau data. Although local tax collections have risen modestly, combined state and local tax collections remain well below their 2000 levels.

- Contributing to those revenue losses — and likely to cost states even more revenue in the next several years — are several aspects of the 2001 and 2002 tax bills. The 2001 tax law included repeal over four years (2002-2005) of the federal estate tax credit to which all state estate taxes were tied. Although several states were able to amend their tax codes to avoid negative fiscal effect from this change, 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 are not able to do so for other reasons.)

- Similarly, although a majority of states decoupled from the bonus depreciation legislation enacted in March 2002, the remaining states are losing some $3 billion over the 2002-2004 period (and stand to lose additional revenue under the House-passed expansion and extension of bonus depreciation).

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

These revenue losses are causing or contributing to significant cutbacks in education, health, human services, and other state-funded services. Such cutbacks would be worsened under the revenue losses likely to occur under the Senate or House bill.

Table 3
State Revenue Loss over 10 Years Under Senate Proposal To Exempt Dividend Income
(in millions of dollars)

Alabama	*480*	Missouri	1,080
Arizona	570	Montana	280
Arkansas	*540*	Nebraska	350
California	12,890	New Hampshire	300
Colorado	860	*New Jersey*	*1,080*
Connecticut	1,180	New Mexico	250
Delaware	250	New York	6,250
Georgia	1,450	North Carolina	1,660
Hawaii	340	North Dakota	60
Idaho	270	Ohio	1,990
Illinois	1,580	Oklahoma	450
Indiana	540	Oregon	1,090
Iowa	730	*Pennsylvania*	*1,480*
Kansas	570	Rhode Island	260
Kentucky	570	South Carolina	720
Louisiana	550	*Tennessee*	*810*
Maine	370	Utah	340
Maryland	1,060	Vermont	200
Massachusetts	1,880	Virginia	1,600
Michigan	1,420	West Virginia	210
Minnesota	1,320	Wisconsin	1,200
Mississippi	*220*	District of Columbia	250
		Total	51,650

Summary:

Total, all states that currently tax dividends:	**$51.7**	**billion**
Total, states that currently use federal taxes as basis for taxing dividends:	**$46.8**	**billion**
Total, states that currently use federal taxes except California, Montana and Virginia	**$32.3**	**billion**

Notes:
Does not include impact of Section 179 expansion (estimated at $5.3 billion nationally over 10 years).

States in italics tax dividends, but do not derive the amount of dividends to be taxed from the federal tax form. Some other states, most notably California and probably Virginia, tax dividends based on the federal tax forms but would not automatically conform to changes in the federal law. Montana has acted prospectively to decouple.

These figures are based on information on taxable dividend income by state from the Internal Revenue Service, *Statistics of Income Bulletin*, Spring 2002. The dividend income reported in the SOI was adjusted to remove interest payments from mutual funds that the IRS requires to be reported as dividends, and to include personal trust dividend income that is reported elsewhere. See William G. Gale, “About Half of Dividend Payments Do Not Face Double Taxation,” *Tax Notes*, November 11, 2002.

Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming do not levy any form of income tax and thus would not lose revenue.

Table 4
State Revenue Loss Over 10 Years
Under House Bonus Depreciation Expansion Proposal
(in millions of dollars)

Alabama	921	New Mexico	360
Colorado	768	North Dakota	127
Delaware	611	Oregon	767
Florida	2,635	Utah	390
Kansas	437	Vermont	35
Louisiana	738	West Virginia	572
Michigan	571		
Missouri	991	**Total**	**9,923**

Note: States shown conform to current federal bonus depreciation rules. Other states either do not conform to bonus depreciation or do not have income taxes. Estimates are based on Joint Committee on Taxation estimates of federal impact, CBO figures for federal tax collections, and Census Bureau data on state corporate and personal income tax collections.