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STATES COULD LOSE UP TO $8 BILLION DURING CURRENT FISCAL CRISIS AS A RESULT OF SENATE FINANCE COMMITTEE PROPOSAL

The Senate Finance Committee "mark" issued today by Chairman Charles Grassley essentially includes the President's proposal for excluding dividends received by individuals from taxation. The cost of the proposal is held down by phasing in the exclusion: one-third in 2003, two-thirds in 2004, and full exclusion after 2005, and by having the provision sunset at the end of 2005.

Even though it is phased in, this proposal would be costly for states at a time of grave fiscal crisis – depriving states of nearly $8 billion in revenue between tax year 2003 and 2005.

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.

Some 37 states and the District of Columbia use federal definitions of income in their own tax systems. These states, with a few exceptions such as California, would automatically exclude dividends from state taxable income if they were excluded from federal taxable income. 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 Finance Committee proposal, states would lose $1.3 billion because of this conformity in tax year 2003. In 2004, states would lose $2.7 billion. They would lose another $4 in 2005 when it is fully in effect, bringing the total loss over the course of the fiscal crisis to $8 billion. (Note that the Congressional Research Service, using a somewhat different methodology, found that the dividend proposal would cost $4.3 billion when fully in effect, so the cost to states could be even greater than $8 billion.)

It might be argued that states could decouple from the federal dividend exclusion. While a few states might be able to do so, many likely could not. One problem is timing. Most states are nearing the end of their legislative sessions for 2003; others already have adjourned. It would be difficult to take action on the change. Another problem is the general difficulty of decoupling from federal provisions. Although 30 states did decouple from the federal "bonus depreciation" provisions enacted in 2002, 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."

A dividend exclusion also is likely to increase the interest rates that states and localities have to pay on the bonds they issue. This is particularly true if the exclusion is continued beyond 2005 or made permanent, as would be likely to occur. To compete for investor dollars with stocks paying dividends that are fully exempt from taxation, state and local governments that issue bonds would have to offer higher interest rates. The California Treasurer's office suggests that the proposal would result in relative increases in state and local bond interest rates of between 0.25 percent and 0.50 percent (25 to 50 basis points).

Table 1
Estimates of State Revenue Loss Resulting From Federal Dividend Exclusion Tax Years 2003 - 2005

(in thousands of dollars)

	Revenue Loss		Revenue Loss
Alabama	*$78,000*	Missouri	172,000
Arizona	94,000	Montana	46,000
Arkansas	*80,000*	Nebraska	60,000
California	2,366,000	New Hampshire	40,000
Colorado	150,000	*New Jersey*	*234,000*
Connecticut	180,000	New Mexico	40,000
Delaware	36,000	New York	1,048,000
Georgia	240,000	North Carolina	264,000
Hawaii	46,000	North Dakota	10,000
Idaho	44,000	Ohio	304,000
Illinois	264,000	Oklahoma	72,000
Indiana	84,000	Oregon	182,000
Iowa	114,000	*Pennsylvania*	*194,000*
Kansas	90,000	Rhode Island	44,000
Kentucky	88,000	South Carolina	114,000
Louisiana	88,000	*Tennessee*	*106,000*
Maine	62,000	Utah	58,000
Maryland	174,000	Vermont	32,000
Massachusetts	350,000	Virginia	258,000
Michigan	222,000	West Virginia	32,000
Minnesota	220,000	Wisconsin	194,000
Mississippi	*34,000*	District of Columbia	62,000
Total: States that currently use federal taxes as basis for taxing dividends			**$8,066,000**
Total: All states that tax dividends			**$8,670,000**

Notes:

States in italics tax dividends, but do not derive the amount of dividends to be taxed from the federal tax form. Some other states, such as California tax dividends based on the federal tax forms but would not automatically conform to changes in the federal law.

The estimate uses information on taxable dividend income by state from the Internal Revenue Service, *Statistics of Income Bulletin*, Spring 2001. 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. The estimate reflects the Administration's proposal to exempt dividends only if the issuing corporation has paid federal income tax, as well as the "deemed dividends" proposal that will reduce capital gains taxes.

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