

**A NEW STIMULUS PACKAGE?
STATES STAND TO LOSE SUBSTANTIAL ADDITIONAL REVENUE**

By Iris J. Lav

President Bush recently has said he is considering a menu of additional tax breaks to further stimulate the economy. Among the potential new tax breaks he has mentioned are:

- increasing the amount of net stock market losses that an individual can deduct in any one year;
- cutting taxes on capital gains income (the profit from the sale of stocks or other assets), possibly by allowing gains to be “indexed,” that is, adjusted for inflation, or by cutting the tax rate on capital gains income;
- cutting taxes on dividends (possibly by allowing some amount of dividends to be received by individuals free of tax, or by allowing corporations to deduct dividends paid); and/or
- 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).

In addition to the large amount of federal funds that such new tax provisions would cost, some of these tax breaks would reduce state revenues because of the linkages between the state tax codes and federal taxes. This revenue reduction would come at a time when many states have already cut spending and raised taxes to close deficits of approximately \$44 billion for their 2002 fiscal year and at least some of the \$46 billion in deficits projected for fiscal year 2003.¹ Additional tax increases and spending cuts are under consideration in a number of states.

Because virtually all states must balance their budgets, new federal tax cuts that flow through to state revenues — such as those President Bush 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 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.

States Cannot Afford Additional Revenue Losses

States had budget deficits of approximately \$44 billion in state fiscal year 2002. State deficits in 2002 were larger in percentage terms than in 1992, the worst year for state budgets in the recession of the early 1990s. These FY 2002 deficits were closed with a combination of the use of reserves and one-time measures, tax increases, and budget cuts. Some of the budget cuts, such as those in Medicaid and child care subsidies for working families, have hit low-income families particularly hard, while many middle-income families have been hurt 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 six months. State revenues were 7.9 percent below prior year collections in the first three months of 2002, and 10.9 percent below prior year collections in the second quarter of the year, according to preliminary estimates from the Rockefeller Institute of Government. As a result, the additional budget shortfalls for fiscal year 2003, which began in most states on July 1, 2002, are now estimated at \$46 billion and could go higher.

As new state deficits open, states will have to consider additional measures to balance their budgets. Some states have scheduled special legislative sessions for the fall to deal with this problem, and others are likely to do so. 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.

The states that stand to lose revenue if these tax breaks are enacted are described below.²

- At least 36 states would suffer a state revenue loss if the amount of capital losses (such as losses on the sale of stock) permitted to be deducted in the year incurred is increased. All states with an income tax *except* Alabama, Arkansas, New Jersey, Pennsylvania, Wisconsin, and possibly Hawaii would have revenue losses.
- At least 33 states would lose revenue if profits from the sale of stock or other assets were indexed for inflation. The states that stand to lose revenue include all states with an income tax *except* Alabama, Arkansas, Idaho, Iowa, New Jersey, Pennsylvania, South Carolina, Wisconsin, and possibly Hawaii.
- The states affected by reducing the taxation of dividends would depend on the method used to accomplish that end. If individuals are allowed to exclude a specified amount of dividends from income, it is likely that 36 states — all states with an income tax *except* Alabama, Arkansas, Iowa, Mississippi, New Jersey and Pennsylvania — would lose revenue. A corporate deduction for dividends paid potentially could reduce state revenues in 44 states, all *except* Arkansas, California, Nevada, South Dakota, Washington, Wyoming, and the District of Columbia.

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

¹ State budget deficit data from NCSL *State Budget And Tax Actions 2002: Preliminary Report* adjusted to allocate 50% of the \$23.7 billion FY 2002-2003 biennial budget deficit in California to FY 2002, and to include the \$1.9 billion FY 2002 budget deficit in New York. As a result of the adjustments, the total two-year deficit number used in this paper is approximately \$5 billion less than the NCSL estimate.

² 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.