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BUSH "GROWTH PLAN" WOULD WORSEN STATE BUDGET CRISES

By Iris J. Lav

The Bush Administration's proposal for "Economic Growth and Job Creation" provides no fiscal relief for the states, which are struggling with deficits likely to total at least $60 billion for the fiscal year beginning in July. To the contrary, preliminary estimates suggest the plan's federal tax cuts would cause states to lose more than $4 billion a year, making state budget deficits larger. Since states must balance their budgets, this new revenue loss will require states to cut state programs more deeply and/or to raise state taxes to a greater degree.

The Administration has said the plan is intended to promote economic growth and job creation. But when states must cut programs to balance their budgets, they lay off workers, reduce payments to contractors, cut reimbursements to providers, or lower benefit payments to individuals. This reduces the money people have to spend and thereby decreases demand for private sector goods and services. Tax increases have a similar effect. Far from promoting economic growth and job creation, the effect of failing to aid states *and* further increasing state deficits is economic contraction and reduction in employment.

- The largest effect on states would come from the proposed exclusion of corporate dividends from the taxable income of individuals. This dividend exclusion would reduce revenue in most of the 37 states and the District of Columbia that link their own tax systems to the federal taxation of dividends. Preliminary estimates suggest that the changes would cost these states $4 billion a year in the first year or two. The six other states that tax dividends independently could also experience revenue losses. Including these states would raise the estimate of revenue loss to $4.3 billion.

- In conjunction with the dividend exclusion, the plan would reduce capital gains taxes for investors in corporations that do not pay dividends but instead reinvest their earnings. Some 39 states and the District of Columbia would lose revenue as a result of this proposal. The modest initial cost of this provision is included in the above estimate. Over time, however, the cost of this capital gains tax break would grow substantially, so the essential loss to states is likely to exceed $4billion a year.

- Another proposal would have a small effect on state revenues. The Bush plan also would increase the amount of investments that small businesses can deduct in the year the investments are made. All states that tax business income except California and Michigan will experience some revenue loss from this change, with a potential aggregate revenue loss in the ballpark of $200 million a year.

- The federal tax reductions in the Bush plan would be permanent. They would continue to reduce state revenues for the foreseeable future.

- These new revenue losses would be on top of revenue losses that states already are feeling as a result of federal tax changes enacted in 2001 and in the 2002 stimulus package. For example, changes in the estate tax that the federal government enacted in 2001 — specifically, the phase-out of the state estate tax credit between 2002 and 2006 — will cost states $16 billion from 2003-2007 and more in years after that. New tax breaks for retirement and education savings and the bonus depreciation provision also are reducing state revenue.

- In other words, federal tax changes in 2001 and 2002 have made state budget holes deeper. Now, despite the most severe state budget crises in 50 years, the Administration is proposing measures that would make the problems still more acute.

The Proposed Tax Changes

There are three elements of the Administration plan that would reduce state revenues: the exclusion of corporate dividends from individual taxation, the reduction in taxation of capital gains income derived from investments in corporations that reinvested their earnings, and the increase in amount of investments that small businesses can write off as an expense in the year the investment is made.

Dividend Exclusion

The Administration plan would allow individuals to exclude from their federal taxable income the corporate dividends they receive from corporations that have paid federal corporate income taxes on their profits.[1] Each of the 41 states and the District of Columbia that levy an income tax includes dividends in taxable income. Two other states have limited income taxes that also tax dividend income. Many of these states would lose revenue as a result of this change.[2]

Some 37 states and the District of Columbia use federal income definitions in their own tax systems. These states, with a few exceptions, would automatically exclude dividends from

[1] The Council of Economic Adviser's description of the Administration plan notes that "…corporate income that is not taxed at the firm level would not be eligible to be excluded from the individual income tax." Corporations would have to inform the recipients of the dividends whether some or all of their dividends are eligible for exclusion from individual taxation. CEA, January 7, 2003.

[2] The states that do not levy any form of income tax, and thus would *not* lose revenue, are Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming. The states that just tax interest and dividend income are New Hampshire and Tennessee.

Aid for the Unemployed is Not State Fiscal Relief

Some $3.6 billion in the Administration's package is designated for a specific new program of "personal reemployment accounts" that would be administered through the states. States would be required to use the money to set up accounts of up to $3,000 for each unemployed worker. The accounts would be used by the workers for the expenses of job search, job training, child care or other expenses. Whatever the policy merit of these accounts, they would not provide fiscal relief. These funds could not be used to help states balance their budgets because the funds would have to be spent on the new program.

state taxable income if they were excluded from federal taxable income.[3] 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.

Even though all states would face pressure to conform with the dividend exclusion, some states might want to "decouple" from the federal change. That is, they may want to continue taxing dividend income. It is worth noting that when the "bonus depreciation" provisions were enacted in the March, 2002 stimulus package, there were 30 states that subsequently did decouple from the new federal treatment of depreciation.[4] The extent of decoupling was unprecedented; never in recent decades had so many states decided to decouple from a federal change.

The response of states to the bonus depreciation provisions is unlikely to be a model for the state response to the dividend exclusion. The bonus depreciation provision is temporary; it expires in September 2004. States that decoupled from the bonus depreciation knew that after a short period of time, their tax laws on depreciation would once again conform to federal treatment. The dividend exclusion, however, would be permanent. In the majority of states that have the tradition of conformity to federal tax law, it can be quite difficult to sustain a major difference from federal law over time. Taxpayers generally view such differences as burdensome and the same, largely upper-income taxpayers and corporations that are pushing for this change in dividend rules at the federal level would oppose decoupling. These taxpayers would be likely to push their states to follow the federal lead and exempt dividend income.

[3] The exceptions are states that do not conform unless they enact legislation to adopt new federal changes. Most such states do so routinely, but a few are less likely to adopt changes. Those that may be somewhat less likely to adopt changes include California, which maintains some differences with federal taxation, and Virginia, which recently enacted legislation stating that it will not adopt federal changes automatically.

[4] The bonus depreciation provisions allow businesses that purchase equipment between September 2001 and September 2004 to deduct immediately 30 percent of the cost of the equipment, rather than deducting the cost over the useful life of the equipment.

Standard & Poor's Raises Concerns on Effect of Proposal on States

In a January 9, 2003 release, Standard & Poor's Rating Services notes with respect to the Bush plan, "Not only is there no direct money flowing to states under the current proposal, there would also be income tax revenue erosion and cost increases in servicing the debt." It notes that this is particularly problematic at this time, when nine states already have negative rating outlooks and the ratings of six states have been downgraded in the last year. It observes that this proposal would add further uncertainty to a budget process that is just beginning.

The release also addresses the issue of whether states would be able to avoid the revenue loss from the change in taxation of dividends. It says: "State legislatures now convening to develop fiscal 2004 budgets will have to consider significant budget and tax policy issues arising from the federal stimulus package however it ultimately develops. To preserve the state revenues coming from dividends, states would be required to decouple current state income tax structures from the federal system, a step they did not take with the elimination of estate taxes in 2001." It goes on to say that despite the fiscal situation of the states, decoupling is not that likely. "State legislative changes to tax structure, even given the obvious necessity and benefit, will likely prove difficult, at best."

The Standard & Poor's analysis concludes with the following concern. "…if the proposal moves forward in its current form, fiscal pressure will be even more acute for state governments already facing estimated fiscal 2004 budget deficits totaling more than $60 billion. As a result, further credit deterioration over the next year is likely." Needless to say, lower ratings mean immediately higher interest costs for states, which will further increase fiscal stress.

Source: Standard & Poor's, *No Relief For States Under Bush Proposal; Credit Outlook Remains Bleak*, January 9, 2003.

Capital Gains Tax Reduction

In conjunction with the dividend exclusion, the plan would reduce capital gains taxes for investors in corporations that do not pay dividends but instead reinvest their earnings. This is intended to avoid disadvantaging companies that focus on reinvestment and growth rather than on paying annual dividends. According to Administration documents, the concept of a "deemed dividend" would be established. When a corporation (that pays federal corporate income taxes) retains earnings that can be used for reinvestment in the business, the shareholders would be allowed to increase the "basis" of the stock they hold in that corporation. For example, a shareholder who bought a stock for $50 a share might be able to adjust that purchase price (that is, his "basis" in the stock) upward by $1 in a year that the company retains its earning rather than pays dividends. If the corporation continued to retain its earnings in each of five years at a level that resulted in a basis adjustment of $1 a year, the shareholder's basis in the stock would be $55 a share, rather than the $50 a share for which the stock was purchased. If the shareholder then sold the shares for $60 a share, his or her capital gain that was subject to taxation would be $5 a share rather than $10 a share.

Some 39 states and the District of Columbia use federal definitions to determine the basis of an asset and the amount of capital gains income subject to taxation when an asset is sold. These states — all states with an income tax except Hawaii and Pennsylvania — would lose revenue as a result of this proposal, although the amount of loss cannot be estimated at this time.

Here too, it would be difficult for states to decouple from this type of permanent change. Taxpayers may object to decoupling because it would require them to calculate their income in very different ways for federal and state purposes. Moreover, this is a provision that would have a modest effect on state revenues initially, because the adjustments to the basis of stock values would not apply retroactively. This means that decoupling immediately would save only modest amounts of money for states. As a result, policymakers might fail to place a high priority on the need to decouple.

Over time, however, as upward adjustments would be made year after year to the basis of outstanding shares, the revenue loss would grow. The Tax Policy Center at Urban Institute and The Brookings Institution estimates that this change ultimately would eliminate 15 percent of all capital gains income.

Revenue Loss: Dividends and Capital Gains

Table 1 shows preliminary estimates of the annual revenue loss that states would incur as a result of exempting dividend income from taxation and the associated reduction in capital gains taxes. The 37 states and the District of Columbia that currently link their taxation of dividends to the federal tax treatment would together lose about $4 billion a year. If the states that independently tax dividends are included, the revenue loss rises to $4.3 billion. For example, California would lose $1.2 billion a year, and New York $524 million. Illinois would lose $132 million, Iowa $57 million, and Maine $31 million.

Expensing for Small Businesses

One other piece of the Administration plan, "expensing" for small businesses, would result in a small annual reduction in state revenue. This provision would increase the ability of small businesses to consider a portion of investments made as an expense that can be deducted immediately, rather than deducted gradually over the life of the asset. The proposal would increase the amount that can be expensed from $25,000 to $75,000. All states that tax business income except California and Michigan would likely experience some revenue reduction as a result of the increased ability of small businesses to expense investments. The revenue loss to the states is likely to be in the ballpark of $200 million a year.

Other Tax Cuts Enacted in 2001 and 2002 Also Hurt States

If enacted, the Administration's package would represent the third piece of tax legislation since the Administration took office that resulted in states losing revenue. Federal tax reductions included in the stimulus package enacted in March 2002 and in the 2001 Economic Growth and

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

States would also be hard hit by the anticipated increase in interest rates expected to result from this package. 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, the dividend proposal 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 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 — $674 billion over ten years — would enlarge long-term deficits and increase government borrowing. As government borrowing needs crowd out other borrowers, long-term interest rates can rise.

Economists Peter Orszag and William Gale at the Brookings Institution have estimated that the enlargement of the federal deficit and increase in government borrowing would, in the long run, increase interest rates by approximately one-half of one percentage point (50 basis points). No analysis currently is available that quantifies the extent to which competition for investor dollars from stocks paying tax-free dividends would push up the interest rates that state and local governments must pay on their tax-exempt bonds. It is clear, however, that the dividend proposal would put upward pressure on interest rates.

The California State Treasurer's Office surveyed the comments that had been made by experts on the subject of tax-exempt bond interest rates. For those that made estimates, the general consensus was that the Administration 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).

The Treasurer's office then estimated the cost to state and local governments of increased interest costs of this magnitude. It noted that over the past five years the average annual issuance of long-term state and local tax-exempt bonds nationwide was $170.57 billion. Assuming that this volume prevails for the next ten years, some $1.7 trillion in bonds would be issued over that period. If interest costs increased by 50 basis points, the report finds that "…the total increased interest payments by our nation's taxpayers over the life of the state and local bonds projected to be issued nationwide over the next 10 years would equal $154.96 billion." If interest costs increased by 25 basis points instead of 50 basis points, then the increased interest over the life of the bonds would equal $77 billion.

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

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 already reduced state revenues are the following.

- 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 this 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. In 2006, the first year this provision will be fully in effect, the states that are continuing to link to federal law will experience a $4.2 billion revenue loss, and the revenue loss will increase in subsequent years. (Some states have constitutional bars to decoupling; others are not able to do so for other reasons.)

- 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 tax rules regarding depreciation from the federal change. While 30 states have decoupled, the other states continue to suffer a revenue loss of $4 billion over the period bonus depreciation is in effect, through September 2004.

- 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), and the additional tax breaks for education.

None of these other tax reductions were offset with any kind of assistance to states to compensate for the revenue losses.

With the exception of bonus depreciation, all of these tax changes — including the tax changes being proposed in the Bush package — extend at least through 2010, and the tax cuts enacted in 2001 will continue beyond then if those tax cuts are made permanent. They will continue to reduce state revenue year after year.

Stimulating the Economy

One of the most effective ways to stimulate the economy at this time would be to provide significant fiscal relief that states could use to avoid budget reductions or tax increases. When states cut programs, they lay off workers, reduce the extent to which they contract for services, lower benefit payments to individuals, and cut reimbursements to providers. This reduces the money people have to spend and thereby reduces demand for private sector goods and services. Tax increases have a similar effect. In other words, the actions states take to balance their budgets contract the economy and cause a loss of jobs.

State governments have already acted to close budget deficits of approximately $50 billion for state fiscal year 2003 (which runs through June 30, 2003 in most states) and face additional deficits they must close of about $17.5 billion in 2003. In addition, states face further budget deficits of $60 billion to $85 billion for state fiscal year 2004.[5] These represent the

[5] See Iris J. Lav and Nicholas Johnson, *State Budget Deficits for Fiscal Year 2004 are Huge and Growing*, December 23, 2002. http://www.cbpp.org/12-23-02sfp.htm

largest state budget gaps in half a century. Unless they receive assistance, states will be making massive cuts in expenditures — including expenditures for education and health insurance — and increasing taxes substantially to meet their balanced budget requirements.

As Brookings Institution economist William Gale observed in a recent *Los Angeles Times* op-ed, “The best way to boost the economy right now would be to increase federal aid to the states, which are facing their worst financial crisis in decades.” Unfortunately, the Bush Administration proposal fails to include such a measure, aggravating state fiscal problems instead.

Table 1
Preliminary Estimates of State Revenue Loss Resulting From Federal Dividend Exclusion
State Fiscal Year 2004

(in thousands of dollars)

	Revenue Loss		Revenue Loss
Alabama	*$39,000*	Missouri	86,000
Arizona	47,000	Montana	23,000
Arkansas	*40,000*	Nebraska	30,000
California	1,183,000	New Hampshire	20,000
Colorado	75,000	*New Jersey*	*117,000*
Connecticut	90,000	New Mexico	20,000
Delaware	18,000	New York	524,000
Georgia	120,000	North Carolina	132,000
Hawaii	23,000	North Dakota	5,000
Idaho	22,000	Ohio	152,000
Illinois	132,000	Oklahoma	36,000
Indiana	42,000	Oregon	91,000
Iowa	57,000	*Pennsylvania*	*97,000*
Kansas	45,000	Rhode Island	22,000
Kentucky	44,000	South Carolina	57,000
Louisiana	44,000	*Tennessee*	*53,000*
Maine	31,000	Utah	29,000
Maryland	87,000	Vermont	16,000
Massachusetts	175,000	Virginia	129,000
Michigan	111,000	West Virginia	16,000
Minnesota	110,000	Wisconsin	97,000
Mississippi	*17,000*	District of Columbia	31,000
Total: States that currently use federal taxes as basis for taxing dividends			**$4,033,000**
Total: All states that tax dividends			**$4,335,000**

Notes:

States in italics tax dividends, but do not derive the amount of dividends to be taxed from the federal tax form.

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.