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Fiscal Danger Ahead:

Why Oregon must decouple from the bonus depreciation business tax break to save $100 million and protect public services

Imagine you're driving down the road and see a large pothole up ahead. Would you run over it and risk blowing a tire or cracking the axle? Or would you avoid the hazard and continue on your way?

There's a large pothole ahead on the state's fiscal highway. Oregon legislators must avoid hitting it lest they regret the painful consequences.

The federal Economic Stimulus Act of 2008 contains a tax break primarily used by large businesses that will cost Oregon $100 million because the state automatically connects to changes in the federal definition of taxable income.[1]

Unless the Legislative Assembly chooses to decouple (or "disconnect") from the provision, legislators will be staring at a budget shortfall and the unpleasant task of doling out pain to Oregonians in the form of cuts to vital public services.

Why decouple if Oregon isn't currently projecting a revenue shortfall?

Because the state's most recent revenue forecast did not take into account the cost of bonus depreciation, and even then it pegged Oregon as dangerously close to having a shortfall. Oregon's most recent revenue forecast projects our two-year, $14 billion general fund budget as having an ending balance of only $29 million, down from $184 million in the close of session forecast. [2] Thus, the $100 million cost of staying coupled to bonus depreciation will push Oregon into the red.

One hundred million dollars is not insignificant. For the 2007-09 biennium, it is more than the state will spend in General Fund dollars on the Departments of Justice and Forestry combined. It is more than five times the General Fund budget of the Department of Housing and Community Services. It is more than twice the General Fund budgets of all the agencies in the Economic and Community Development and Consumer and Business Services program areas.[3]

If the economic downturn gets nastier, Congress might extend bonus depreciation another year, making it even costlier to Oregon. Decoupling today could protect Oregon against future losses as well.

Will bonus depreciation stimulate Oregon's economy?

No. The best thing you can say about bonus depreciation is that it is temporary. Mark Zandi, chief economist at Moody's Economy.com, has calculated that the depreciation tax break will return only 27 cents to the economy for every dollar spent on the break.[4] The Congressional Budget Office has also noted that the provision is not likely to be very effective.[5] As reported in the *Wall Street Journal*, a "near-identical" tax cut in 2002 did not cause businesses to speed up equipment purchases significantly. Instead, studies show that "most of the tax breaks went to companies that were planning to make purchases anyway." [6]

Claims that the tax break will stimulate new investment are belied by its very structure. The tax break is retroactive to January 1, 2008, not a future date that would tie the tax break to new investment decisions.[7] Thus, many of the qualifying investments were already in the decision pipeline before the legislation passed. Put another way, it is rewarding decisions already made, not stimulating only new investment decisions. And from studies of past experience with a similar tax break, economists have found little support for the claim that bonus depreciation boosts economic activity.[8]

If stimulating Oregon's economy is the goal, then avoiding a budget shortfall would be good start. According to Zandi, each dollar spent mitigating state budget shortfalls could yield $1.36 in increased economic growth. That's why decoupling, which for now would keep Oregon in the plus column, is the smartest move legislators can make.

Isn't bonus depreciation just a timing shift with no net cost to Oregon?

No, and that claim is a red herring that's being made to distract attention from the current budget situation. It offers little solace to the legislators needing to keep this biennium's budget in balance.

It is true that most of the revenue lost to bonus depreciation will be recouped in future years, as businesses gradually depreciate the amount paid. That's why the short-term cost is higher than the long-term cost. But not all of it will be recouped.

More importantly, Oregon needs revenue in this two-year budget period, not 10 or 15 years from now. Tax payments years down the road won't help balance the budget in this troubled biennium or next. Those pointing to later tax payments are ignoring today's fiscal condition.

The *Wall Street Journal* recently reported that the total cost of the tax break to the federal government when the time value of money is factored in will be nearly triple the official estimate.[9] Immediate deductions essentially give businesses an interest-free loan while at the same time the federal government must borrow more and pay higher interest payments to cover the cost of the tax break.

Will decoupling be difficult to administer or to comply with?

No. It does add an additional step to tax preparation for businesses, but modern accounting software makes it fairly straightforward. A majority of states decoupled from the same provision in 2001-04, with no great outcry about compliance and administration.

Will decoupling from bonus depreciation hurt small businesses?

No. No one is hurt by decoupling. Small businesses generally do not depreciate their equipment purchases, because they can take advantage of the more generous Section 179 "expensing" provision. Section 179 currently allows 100 percent immediate deductions of qualifying equipment purchases below $128,000. The share that can be immediately expensed gradually phases out as expenses reach $510,000. The stimulus package raises the lower limit from $128,000 to $250,000 and increases the upper phase-out limit from $510,000 to $800,000.

Should Oregon also decouple from the Section 179 expensing increase?

Not necessarily. The cost to Oregon of the increase in Section 179 expensing is about $6 million, a relatively small revenue loss.[10]

Is the American Electronics Association correct in implying that bonus depreciation benefits small businesses?

No. The American Electronics Association is confusing the Section 179 immediate expensing provision with bonus depreciation.[11] Bonus depreciation generally benefits large corporations that, unlike small businesses, typically cannot expense their equipment purchases under Section 179.

Don't other provisions in the federal stimulus bill fully offset the $100 million cost?

Probably not. The state would receive additional revenue from the majority of itemizers who will see their state taxes increase due to receipt of the federal rebate checks.[12] Past practice, however, suggests that the legislature likely will forego that extra revenue. The 2001 Legislative Assembly allowed taxpayers to ignore their rebates when calculating Oregon taxable income.[13] In other words, the legislature chose to treat all itemizers and non-itemizers equally with regard to the rebate.

If legislators reject the path that they took in 2001 and in effect require the majority of itemizers to pay state income taxes on their federal rebate, the state would collect roughly an additional $50 million.[14] Even this additional revenue would not prevent the state from slipping into a shortfall.

Has Oregon always automatically followed the federal definition of taxable income?

No. Oregon's Constitution prohibits the state Legislative Assembly from delegating lawmaking authority to Congress, except with regard to the income tax. That exception was carved out by a 1969 constitutional amendment that authorized, but did not require, the Legislative Assembly to automatically connect to changes in the definition of federal taxable income. Following that amendment, the Legislature automatically connected to federal tax code changes, a practice known as "rolling" or "automatic" reconnect. Thus, whenever Congress changed the definition of taxable income, the change automatically applied in Oregon. That practice, however, was short lived.

In 1971, after the Legislative Assembly adjourned, Congress enacted changes that created a budget deficit in Oregon, necessitating a special session later that year. Having been burned by automatic reconnect, the Legislative Assembly subsequently removed it from the statutes and returned to picking and choosing which federal tax law changes Oregon would adopt.

Unaware of or indifferent to the problems created when Oregon previously experimented with rolling reconnect, the 1997 Legislative Assembly again chose to connect automatically to federal tax code changes. After the fiscal problems of the 2001-03 biennium, the 2003 Legislative Assembly partially suspended the automatic reconnect scheme adopted in 1997, through December 31, 2005.[15] The 2005 Legislative Assembly chose not to extend the suspension. As a result, Congressional changes in the definition of taxable income now automatically apply in Oregon, unless the Legislative Assembly affirmatively decouples from them.

Conclusion

Bonus depreciation is not only an ineffectual stimulus measure, it is a fiscal hazard that threatens to damage Oregon's coffers by $100 million. Absent decoupling from the federal legislation, bonus depreciation will trigger a revenue shortfall and necessitate a round of painful cuts to vital public services.

Endnotes:

[1] Nicholas Johnson, *New Federal Law Could Worsen State Budget Problems: States can protect revenues by "decoupling,"* Center on Budget and Policy Priorities, February 13, 2008.

[2] Office of Economic Analysis, *Oregon Economic and Revenue Forecast,* February 2008. available at www.oregon.gov/das/oea.

[3] Legislative Fiscal Office, Budget Highlights: 2007-09 Legislatively Adopted Budget, September 2007.

[4] Mark Zandi, "Washington Throws the Economy a Rope," *Dismal Scientist,* www.economy.com, January 22, 2008, available at

[5] See, for example, "Options for Responding to Short-Term Economic Weakness," statement of Peter R. Orzag, Director, Congressional Budget Office, before the Committee on Finance, U.S. Senate, January 22, 2008, available at www.cbo.gov.

[6] Jesse Druker, "Cost of Business Tax Cuts Underestimated," *Wall Street Journal,* February 11, 2006, p. A6.

[7] Some argue that a future date would discourage investments today. This dilemma points to the difficulty in designing a depreciation tax credit for new investments. Even setting an expiration date doesn't seem to help make the tax break an effective stimulus measure. See "Options for Responding to Short-Term Economic Weakness."

[8] Id. See also William Gale and Benjamin Harris, "The Bush Tax Cuts: How Did They Affect Corporate Investment?" *A Citizens' Guide for the 2008 Election, and Beyond,* Tax Policy Center, last updated January 23, 2008, www.taxpolicycenter.org/briefing-book/background/bush-tax-cuts/corporate.cfm.

[9] Druker, "Cost of Business Tax Cuts Underestimated."

[10] Nicholas Johnson and Iris Lav, *Business Tax Cuts in Stimulus Package Would Cost States Billions of Dollars,* Center on Budget and Policy Priorities, revised January 30, 2008.

[11] Testimony of Jim Craven, American Electronics Association, before the Senate Revenue and Finance Committee, February 6, 2006, available at http://www.leg.state.or.us/listn/archive/archive.08ss1/SFR-200802061259.ram.

[12] The rebate will reduce the amount of federal tax liability that itemizers can subtract in calculating their Oregon taxable income. Approximately three-quarters of itemizers will see their taxes increase because their Oregon taxable income will increase due to having less federal tax liability to subtract.

[13] HB 2550, 2001 session.

[14] Analysis by the Institute on Taxation and Economic Policy for the Oregon Center for Public Policy.

[15] HB 2186, 2003 session.

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