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Issue Brief

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First, Stop Digging

Why the Oregon legislature must end rolling reconnect and decouple from the bonus depreciation business tax break to avoid deepening the state's fiscal hole

Facing a serious revenue shortfall, the Oregon Legislative Assembly ought to heed the first rule for when you find yourself in a hole: stop digging.

Right now, Congress is drafting economic recovery legislation that may contain a large shovel for Oregon called bonus depreciation. It's a business tax break recognized as an ineffectual economic stimulus. Because Oregon automatically follows the federal definition of taxable income (absent affirmative action by the Legislative Assembly to the contrary), the extension of bonus depreciation by the federal government will further shrink Oregon's tax revenues. OCPP estimates that the measure could cost Oregon roughly $67 million over two years, although the Legislative Revenue Office will issue an official estimate when Congress enacts the stimulus measure.

To grasp the impact of the automatic coupling to bonus depreciation that would follow from legislative inaction, the Oregon Legislative Assembly need only look back a year. In early 2008, as Oregon's fiscal situation was on the brink of falling into the red, Congress passed the Economic Stimulus Act of 2008, which contained the bonus depreciation tax break. Despite warnings about its fiscal effects and limited stimulus benefits, the Legislative Assembly chose not to decouple from the bonus depreciation provision.[1] The 2008 bonus depreciation provision cost Oregon $85.8 million this biennium.[2]

Today, the possible extension of bonus depreciation is *déjà vu* all over again for the Legislative Assembly, except that Oregon's fiscal situation is far worse. This time, Oregon finds itself deep in the hole, without the revenue needed to pay for vital public services — care for seniors and disabled Oregonians and child care subsidies for low-income working families, to name just two.

To avoid digging a deeper hole, and to eliminate the problems that come from automatically following congressional legislation, the Oregon Legislative Assembly should both disconnect from the ill-advised bonus depreciation tax cut *and* end their practice of automatically connecting to changes in the federal definition of taxable income. The Legislative Assembly could accomplish both in one fell swoop by moving swiftly to end automatic reconnect before Congress acts, likely by Presidents' Day.

Is there time to act?

Yes. Oregon's fiscal situation is dire, providing ample reasons and opportunity for the Legislative Assembly to suspend procedural rules and move quickly, as they do during special sessions and at the end of the regular legislative session. Just as the Legislative Assembly can get legislation to the Governor in a day or two during special sessions, they can and should move swiftly to protect the state's coffers from taking another significant economic hit.

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How much deeper will bonus depreciation dig Oregon's revenue hole?

The federal stimulus legislation isn't final and estimates of the cost to states of the new bonus depreciation measure are not available yet. OCPP estimates, however, that its cost will be slightly less but on the same order of magnitude as the 2008 measure. According to the Joint Committee on Taxation, the price tag for the first two years of the U.S. Senate's version of the bonus depreciation provision would be about 78 percent of what the first two years of the 2008 measure cost. Using that as a yardstick, OCPP estimates that the 2009 measure will cost Oregon roughly $67 million over two years. The Legislative Revenue Office ultimately will project a cost once the measure is enacted at the federal level.

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 definition of taxable income. 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. [3] 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 in the definition of taxable income. 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.[4] 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 or ends the automatic reconnect.

Will bonus depreciation stimulate Oregon's economy?

No. The best thing you can say about bonus depreciation is that it is temporary and gives businesses a reason to support timely passage of the federal stimulus bill. Mark Zandi, chief economist at Moody's Economy.com, estimates that the bonus depreciation tax break would return only 25 cents to the economy for every dollar spent on the break.[5] In fact, of all the components of the stimulus bill that Zandi examined, bonus depreciation had the smallest bang for the buck. He notes that its primary value is that it "expands political support for the stimulus plan and thus accelerates its adoption."[6]

The Congressional Budget Office has also noted that the provision is not likely to be very effective.[7] 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." [8]

Claims that the tax break will stimulate new investment are belied by its very structure. The tax break would be retroactive to January 1, 2009, not a future date that would tie the tax break to new investment decisions.[9] Thus, many of the qualifying investments would have already been in the decision pipeline before the legislation passed. Put another way, it rewards decisions already made instead of stimulating only new investment decisions. And from studies of similar tax breaks in the past, economists have found little support for the claim that bonus depreciation boosts economic activity.[10]

If stimulating Oregon's economy is the goal, then avoiding a budget shortfall would be a good start. According to Zandi, each dollar spent mitigating state budget shortfalls could yield $1.38 in increased economic growth.[11] 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 — if last year's debate is any indication — will be made to distract attention from the current budget situation. It offers little solace to the legislators needing to put this and next biennium's budget in balance.

It's 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 and the next, 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 ignore today's fiscal holes.

The *Wall Street Journal* reported that, when the time value of money is factored in, the total cost of the 2008 tax break to the federal government would be nearly triple the official estimate, and there is no reason to believe the 2009 version will be any different.[12] 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 the change 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. Small businesses generally do not depreciate their equipment purchases, because they can take advantage of the more generous Section 179 "expensing" provision.

Conclusion

Bonus depreciation is not only an ineffectual stimulus measure, it is a shovel that threatens to dig a deeper fiscal hole for Oregon. Absent decoupling from the federal legislation, bonus depreciation will exacerbate Oregon's revenue shortfall.

The Legislative Assembly should regain control over Oregon's fiscal condition by ending the automatic reconnect and deciding on a case-by-case basis which measures to implement in Oregon. Just as it was wrong in the early 1970s, in the recession earlier this decade and in early 2008, it is wrong today to cede control over Oregon's tax system to Congress.

Endnotes

[1] See Oregon Center for Public Policy, *Fiscal Danger Ahead: Why Oregon Must Decouple from the Bonus Depreciation Business Tax Break to Save $100 Million and Protect Public Services,* February 13, 2008, available at www.ocpp.org/cgi-bin/display.cgi?page=iss080213danger.

[2] Legislative Revenue Office, *The Economic Stimulus Act of 2008 (The Impact on Oregon)*, February 15, 2008.

[3] Section 1, Article IV, and Section 21, Article I, of the Oregon Constitution when read together prohibit the Legislative Assembly from passing a law that delegates authority to any other lawmaking body. Section 32, Article IV, allows the Legislative Assembly to refer to the definition of federal taxable income.

[4] HB 2186, 2003 session.

[5] Mark Zandi, *The Economic Impact of the American Recovery and Reinvestment Act*, Moody's Economy.com, January 21, 2009, p. 9, available at www.economy.com/mark-zandi/documents/Economic_Stimulus_House_Plan_012109.pdf.

[6] Zandi, *Economic Impact of the American Recovery and Reinvestment Act,* p. 11.

[7] See, for example, Peter R. Orszag, Director, Congressional Budget Office, statement before the Committee on Finance, U.S. Senate, "Options for Responding to Short-Term Economic Weakness," January 22, 2008, available at www.cbo.gov/ftpdocs/89xx/doc8932/01-22-TestimonyEconStimulus.pdf.

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

[9] 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 Orszag statement.

[10] Orszag statement. 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.

[11] Zandi, *Economic Impact of the American Recovery and Reinvestment Act,* p. 9.

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

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