

July 2004

Whose Bonus?

No Rationale for Iowa Adopting Federal Depreciation Options

By Charles Bruner and Peter Fisher

In an effort to boost the economy, Congress in 2002 enacted bonus depreciation options for businesses, allowing them to have quicker write-offs for investments of new equipment. The bonus depreciation options have been made available for the period from September 12, 2001, through December 31, 2004, when they will expire without further Congressional action. Congressional estimates were that bonus depreciation would result in short-term reductions in corporate tax collections of \$54 billion, but that most of this would eventually be recovered through reduced deductions for depreciation in future years (with \$45 billion recovered over a 10-year period).

Most states, including Iowa, did not adopt the federal bonus depreciation options for state income taxes. Now, however, the Governor and Republican legislative leaders are considering providing this tax break by conforming to the federal bonus depreciation rule, just six months before it is scheduled to expire. This is one part of a compromise proposed to restore the Grow Iowa Values Fund, left in limbo by a recent Iowa Supreme Court decision.

Initial estimates of cost to Iowa of coupling with the federal tax provision were \$70 million through fiscal year 2005. Revised estimates are not available, but it appears that the only proposal that is on the table is simply to couple with federal law, which means that the bonus depreciation would apply retroactively for Iowa taxes. Businesses would file amended returns claiming the deductions for investments undertaken as far back as September 2001 and get refunds this year. A reasonable assumption is that all of the \$70 million hit would thus be felt in the fiscal year 2005 budget. While most of that amount eventually will be collected at a later date, some will simply be lost permanently to the state. Most importantly, the revenue loss occurs during the current fiscal year, when the state budget is already strained.

It is doubtful that there will be any public benefit from the adoption of bonus depreciation now. Virtually all of the value will go back to corporate income tax filers for purchasing decisions

they have already made – it will not stimulate any new purchasing activity. Bonus depreciation is available only for investments placed in service by the end of 2004 (with the exception of some real estate projects and passenger transportation equipment, where the deadline is the end of 2005).

Thus, even if the Legislature were to enact bonus depreciation in August, firms would

have only a few months to plan and complete new purchases to take advantage of it. Nor is this enough time to undertake any significant building project that would be completed by the end of 2005, unless it were already in the works. That is why we argue that the stimulus ef-

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fect is minimal, or non-existent. Businesses will simply get a tax break for investments already made or committed to. Further, most of these benefits are likely to go to large, multi-state corporations, with little reason to believe that any multiplier effects from using these tax refunds will actually occur in Iowa.

Many questioned the value of the bonus depreciation provisions as economic stimuli at the time they were enacted, one reason less than a third of the states with corporate income taxes adopted them at that time. Even if they would have provided some stimulus then, however, granting these tax benefits now and applying them retroactively is nothing more than an un-earned bonus to businesses financed by the rest of Iowa taxpayers. "Bonus depreciation" is Christmas in July.

Another business tax cut is also on the table: conforming to new federal limits on "section 179 expensing." Under this federal tax rule, a business can "expense" purchases of equipment and facilities up to \$100,000 per year through the end of 2005. (Expensing is deducting the entire cost in the year purchased, instead of deducting a portion of the cost each year as depreciation, over a period of years.) Iowa currently allows expensing, but only up to the old limit of \$25,000 per year. Conforming to the new federal ceiling of \$100,000 would cost the state about \$4 million per year over the next three years. Unlike the bonus depreciation provision, this would target small businesses, since the expensing option is phased out for firms making total capital expenditures in that year of over \$400,000. It would also provide some investment incentive (it is available for purchases made through December 2005), wouldn't cost the state much, and is less of a giveaway this year (it presumably would reward investment decisions made since January 1, 2004, not going back to 2001.)

If these were state appropriations, they would be under intense scrutiny. The fact that it is a tax expenditure, however, makes it much less subject to review, even though the effect on the rest of the state budget is the same — a loss of funds. Moreover, while the Department of Revenue can estimate its impact, it can only make an estimate, and estimates can be wrong.

In recent years, the General Assembly enacted other tax expenditures that were thought to be relatively modest in their impacts on the treasury. One was an exemption of non-profit hospitals from paying sales tax on purchases they made. The annual revenue loss was originally estimated at no more than \$15 million annually, and probably much less, but has turned out instead to exceed \$50 million. Another was the refundable research tax credit for corporations; proponents estimated at the time the bill was passed that this would cost just \$3 million annually, but in actuality it cost the treasury over \$24 million in the last fiscal year. These tax cuts exacerbated the shortfalls in revenue the state has experienced over the last several years; had their actual cost been known, they might not have been enacted.

Tax expenditures should undergo the same type of scrutiny that appropriations do in balancing the state budget. There are many other ways that \$70 million could be used to benefit the state, ones that have much stronger justifications than any laid out to date for adopting bonus depreciation. Before the General Assembly and Governor decide to establish bonus depreciation or expensing options, they need to examine how these contribute to Iowa's economic growth and Iowa's financial stability. It appears that bonus depreciation does nothing for growth and puts a large hole in this year's budget.