Abstract - This paper pulls from a variety of data sources to estimate the positive and negative impacts of federal policies on state and local finances. For 2004, it finds that a positive federal policy impact of $467 billion is offset by at least $153 billion in negative impacts, representing a one-third reduction in positive impacts. While positive impacts grow only slowly over the next three years, the negative impacts increase rapidly. By 2007, the negative impacts reduce the positive impacts by at least 45 percent. The net value of federal grants and subsidies declines by 18 percent from 2004 to 2007.

INTRODUCTION

Most states and many local governments are struggling through a deep and prolonged fiscal crisis, during which revenues are declining or growing only slowly. There are several causes for the crisis, including the weak economy, the decline in the stock market, policy actions that states took during the 1990s to reduce taxes, and structural problems in state tax systems. This paper considers whether federal policy may also have contributed to the weakness of state and local fiscal conditions. In addition, it looks at how federal policies may affect state and local finances over the next three years, as states and localities struggle to emerge from this sustained period of fiscal distress.

Federal policy has a major effect on state finances. For much of the post World War II era, federal policies have had a substantially positive effect on states. The federal government has provided grants-in-aid to state and local governments since the 1950s for activities such as agriculture, highway construction, urban renewal and housing, education, health, and family support. In the 1970s, the federal government provided counter-cyclical assistance to states during the economic downturn, as well as general revenue sharing. Federal tax policy also has provided subsidies to states and localities. The federal itemized deduction for state and local taxes provides a subsidy to states and localities by lowering the cost of those taxes to taxpayers, thereby making the taxes more acceptable. Another subsidy is provided by exempting the interest taxpayers receive on state and local bonds from federal taxation. Until changes made in 2001, the federal gov-
ernment essentially administered the estate tax on behalf of both federal and state governments and shared the tax revenue with the states. Finally, the Jobs and Growth Tax Relief Reconciliation Act (JGTRRA) of 2003 included counter–cyclical fiscal relief for states that totals $20 billion over two years (federal fiscal years 2003 and 2004).

Over the past 10 to 15 years, this positive effect of federal policy on states and localities has been gradually eroding. Arguably, the pace of that erosion has been accelerating recently. The eroding value of federal assistance requires states and localities to replace lost federal funding, find alternative revenue sources to replace those sources federal policies have diminished or made inaccessible, or forgo providing services. The federal policies with a negative effect on states and localities include:

- The decline in grants–in–aid for all purposes other than Medicaid, and the transformation of grant programs into block grants with funding that does not increase along with program costs;
- The shifting of health care costs from the fully federally–funded Medicare program to Medicaid, for which states pay a share of the cost;
- A decline in the value of the deduction for state and local taxes as federal tax rates decline and as federal policymakers fail to deal with the growth in the number of taxpayers subject to the Alternative Minimum Tax (AMT), under which the deduction for state and local taxes is denied;
- Federal tax changes that cause states to lose tax revenues, because the federal and state tax systems are closely linked;
- Unfunded mandates and “underfunded national expectations” that the federal government imposes on states, including the Individuals with Disabilities Education Act, Leave No Child Behind, Voting Rights, and expenditures for homeland security;
- The preemption of state authority to tax certain activities, including the Internet Tax Freedom Act, the prohibition on taxing the income of certain out–of–state corporations (P.L. 86-272), the 4–R Act, and the prohibitions on taxing airline and bus tickets for interstate travel; and
- The failure of the federal government to solve problems in state finances that only it can solve, including the failure of the federal government to implement a solution that would allow the effective taxation of remote commerce under state and local sales and use taxes, and the failure to deal with international transfer pricing and tax shelters.

Table 1 shows the value to states and localities of some of the various positive and negative effects of federal policies. It shows that on balance the federal government still has a positive effect on state and local finances, but that the positive impact is not as great at it would seem to be. Moreover, the positive impact is slated to decline sharply over the next four years.

- For 2004, the gross value of federal government grants and subsidies—including grants–in–aid, the value to states of the deduction for state and local taxes and tax–exempt bonds, the estate tax sharing, and the temporary fiscal relief—totals approximately $467 billion. That is offset by $153 billion of negative effects if the minimum impact of unfunded mandates is considered, or by $212 billion if the maximum impact of unfunded mandates is used, leaving a net benefit in the range of $255 billion to $315 billion.
Piling on Problems: How Federal Policies affect State Fiscal Conditions

The negative effects of federal policies reduce the positive effects by one-third in 2004. If the upper end of the range of the cost of mandates is used, then the negative effects reduce the positive effects by more than 40 percent. Moreover, information was not available to quantify a number of the items under the categories of preemption and the failure of the federal government to solve problems. The extent to which negative impacts reduce the positive aspects of federal policies would appear to be larger if all of the negative effects could be measured.

The balance may be expected to tip even more in the negative direction in the near future. Total positive impacts are projected to rise a very modest 2.0 percent between 2004 and 2007, to $477 billion. (Even if the new fiscal relief is excluded from the 2004 total, positive impacts rise only 4.2 percent over the three–year period.) The negative items total a minimum of $220 billion in 2007. When the positive and negative impacts are offset against one another, the net value of federal grants and subsidies declines from $314 billion in 2004 to $256 billion in 2007—a decline of 18 percent.

By 2007, the negative impacts reduce the positive impacts by at least 45 percent and perhaps as much as 60 percent.

Each of these impacts, and the derivation of the cost estimates, is described in more detail in the following sections of this paper. In some cases, making quantitative estimates of these impacts required judgment calls or even subjective decisions, and it surely is possible to disagree with the assumptions or methodology used. Nevertheless, there is little question about the direction of the change. States can expect increasingly less net assistance from the federal government in the coming years. As states struggle to emerge from their fiscal crises, this withdrawal of

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**TABLE 1**

THE IMPACT OF FEDERAL POLICIES ON STATE AND LOCAL FINANCES

<table>
<thead>
<tr>
<th></th>
<th>2004</th>
<th>2007</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Positive Impacts</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Grants–in–aid</td>
<td>$392.9</td>
<td>$425.0</td>
<td></td>
</tr>
<tr>
<td>Deductibility of S/L taxes</td>
<td>36.6</td>
<td>25.9</td>
<td></td>
</tr>
<tr>
<td>Tax exemption for S/L bonds</td>
<td>24.8</td>
<td>25.7</td>
<td></td>
</tr>
<tr>
<td>Estate tax credit</td>
<td>3.2</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td>Subtotal Positive Impacts</td>
<td>$457.4</td>
<td>$476.6</td>
<td>4.2%</td>
</tr>
<tr>
<td>Fiscal relief</td>
<td>10.0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total Positive Impacts</td>
<td>$467.4</td>
<td>$476.6</td>
<td>2.0%</td>
</tr>
<tr>
<td>Negative Impacts</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Decline in non–Medicaid grants</td>
<td>−66.5</td>
<td>−105.6</td>
<td></td>
</tr>
<tr>
<td>Shift Medicare costs to Medicaid</td>
<td>−21.0</td>
<td>−34.0</td>
<td></td>
</tr>
<tr>
<td>Federal tax changes 2001–2002</td>
<td>−4.0</td>
<td>−7.0</td>
<td></td>
</tr>
<tr>
<td>Federal tax changes–2003</td>
<td>−1.8</td>
<td>???</td>
<td></td>
</tr>
<tr>
<td>Mandates (minimum)*</td>
<td>−23.5</td>
<td>−23.5</td>
<td></td>
</tr>
<tr>
<td>Preemption (ITFA only)</td>
<td>−1.7</td>
<td>−2.1</td>
<td></td>
</tr>
<tr>
<td>Failure to solve problems (E–Commerce only)</td>
<td>−35.0</td>
<td>−48.0</td>
<td></td>
</tr>
<tr>
<td>Total Negative Impacts</td>
<td>−$153.0</td>
<td>−$220.2</td>
<td>43.9%</td>
</tr>
<tr>
<td>Net impact of federal policy</td>
<td>$314.4</td>
<td>$256.4</td>
<td>−18.4%</td>
</tr>
<tr>
<td>Memo: net impact with maximum mandate est.</td>
<td>$255.4</td>
<td>$197.4</td>
<td></td>
</tr>
</tbody>
</table>

See text for details of calculations. Note that “2004” and “2007” may be, for various items, federal or state fiscal years or calendar years, depending on availability of data.

*This is the lower end of a cost range for unfunded mandates as estimated by NCSL. The upper end of the range is $82.5 billion. These cost estimates are available only for federal fiscal year 2003.
federal support is likely to increase the difficulty of fiscal recovery.

PROVISIONS WITH POSITIVE IMPACT AND HOW THE IMPACT IS CHANGING

This section considers four areas in which the federal government has had a positive impact on the finances of states and localities. They are grants–in–aid, the deductibility of state and local taxes, the tax exemption for states and local bonds, and the estate tax. It also briefly describes the temporary fiscal relief for states enacted in May, 2003.

Grants–in–Aid

Federal grants to state and local governments accounted for 12.5 percent of state and local expenditures in 1950. Grants grew in importance over time and peaked at 30 percent of state and local expenditures at the end of the 1970s, in an era when the financing of government was in some respects seen as a partnership among federal, state, and local government. In 2002, total grants of $352 billion provided 26 percent of state expenditures (See Figure 1) (OMB, 2001b; OMB, 2003b; BEA, 2003).

This modest decline in grants over the last 30 years is somewhat misleading, however, because of the overwhelming role Medicaid has played in the growth of grants–in–aid. The growth in Medicaid largely reflects the growth in health care costs over time, the aging of the population, the growth in the disabled population, and to a lesser extent the expansion of the program to cover more children and parents (Ku and Broaddus, 2003; Bruen, 2002). The participation of the federal government in supporting Medicaid health insurance on a basis that matches state spending has been very important for states, since it is unlikely that states would have been able to meet their residents' health care needs without the federal program. Nevertheless, the growth in Medicaid grants largely reflects inflation in health care costs in the public and private sectors alike over the last two decades.¹ (Moreover,

Figure 1. State and Local Grants as a Share of State and Local Expenditure

¹ In recent years, states sometimes have used certain tactics to increase their federal Medicaid reimbursements and use those increased reimbursements for other purposes. The federal government has taken action to curb these schemes when they have arisen.
costs have been transferred from the federal Medicare program to Medicaid in recent years; see discussion below.) Increases in Medicaid grants mask declines in most other areas of grants-in-aid.

A more accurate picture of the extent to which federal grants help states and localities pay for government can be seen by looking at grants-in-aid for all purposes except Medicaid as a percent of state and local budgets for all expenditures except Medicaid. Using data from the National Health Expenditures to exclude Medicaid from state and local spending, one finds that non-Medicaid grants-in-aid have shrunk from 27.5 percent of non-Medicaid state and local budgets in 1980 to an average of 17 percent during the 1990s (Department of Health and Human Services, 2003) (See Figure 2). This means that the federal government is playing a diminished role in helping states meet their obligations outside of Medicaid. If grants-in-aid other than support for Medicaid had continued to provide the same proportion of state and local budgets for purposes other than Medicaid as they did in the 15 years from 1966 through 1980—an average of 23.7 percent rather than the 18.2 percent projected for FY 2004—states and localities would be receiving approximately $66 billion more in federal assistance in 2004.2 (Note that the FY 2004 figure for federal aid includes the $5 billion in non-Medicaid fiscal relief discussed below.)

Current budget proposals would exacerbate the downward trend in aid to states and localities. The FY 2004 Congressional Budget resolution includes a cut in domestic discretionary programs, reducing those programs by $168 billion below the baseline over the next ten years (Friedman, 2003). Many grants-in-aid to states

Figure 2. Non-Medicaid Grants as a Share of State and Local Expenditure

2 The era encompassing the 1970s was used as a benchmark from which to measure the decline in federal aid because the combination of the general revenue sharing program and the counter-cyclical aid that was provided during that era makes it the high water mark in the fiscal relationship of the federal government with states and localities. In that era it was essentially decided that it made sense to collect revenues from the more progressive and elastic federal tax system and share those revenues with the states. Others may want to argue that it is more appropriate to measure the level of non-Medicaid federal aid against a different benchmark. In any case, the use of this particular benchmark does not affect the finding of a decline in federal aid between 2004 and 2007.
and localities in areas outside of Medicaid are included in domestic discretionary programs, and thus are likely to be reduced. In fact, grants to state and local governments are likely to take a disproportionately large share of cuts in domestic discretionary programs, since that category includes funding for law enforcement, courts, domestic security, education, and other areas that are unlikely to see reductions.

The likelihood of cuts is borne out by the level of non-Medicaid grants–in–aid projected for future years in the President’s FY 2004 budget. Non–Medicaid grants grow from $221.6 billion in FY 2003 (without the fiscal relief, which was not in the budget) to $226.9 billion in FY 2007; that is a total increase of only 2.4 percent over the four year period—clearly far less than the cost of state and local government is likely to rise over that period. As a result, non–Medicaid grants will fall to 16.2 percent of projected non–Medicaid state and local expenditures in 2007. If the grants had remained at their 23.7 percent level described above, states and localities would be receiving approximately $105 billion more in federal assistance in FY 2007 than they currently are projected to receive.3

Some grants–in–aid are provided to states and localities in the form of block grants, in which lump sums of funding are given to states or localities to be spent on a range of programs within broad guidelines. One problem with block grants, however, is that federal policymakers tend to disassociate the funding streams (which come from the federal level) from their programmatic uses (which are determined at the state or local level). Over time, block grants tend to have their funding frozen or have fallen behind the funding level needed to keep pace with inflation.

An analysis of 11 block grants that serve low–income people in the areas of housing, health, and social services shows that, when adjusted for inflation, funding for these programs fell by an average of 11 percent from 1982 (or the first year the program was funded as a block grant, if later) through 2003. The only two block grants that experienced substantial inflation–adjusted growth are both grants that fund child care assistance; these grants received funding increases in the late 1990s when the establishment of work requirements under the TANF program greatly increased the need for child care assistance to current and former welfare recipients. Inflation–adjusted funding for the nine block grants in areas other than child care fell by an average of 22 percent from 1982 (or the first year the program was funded as a block grant, if later) through 2003.

Again, current budget proposals could add to this problem. The Administration’s budget proposes block grants for Medicaid, Section 8 Housing, and Head Start. The House version of the TANF reauthorization legislation would authorize block grants for the food stamp program in five states. These block grants would not necessarily operate in exactly the same way as existing block grants. The Medicaid block grant, for example, would increase every year based on a formula, but it is unclear whether the formula would keep pace with the growth in the cost of the

3 State and local expenditures were projected by using the average growth rate from 1992 through 2002, which is 5.7 percent per year. National Health Expenditure projections for Medicaid spending in 2007 are subtracted from the projection for total state and local spending to derive non–Medicaid spending.

4 The block grants included in this analysis are the Child Care and Development Block Grant, Child Care Entitlement to States, Community Development Block Grant, Community Services Block Grant, HOME Investment Partnership, Low–Income Heating and Energy Assistance Program, Maternal and Child Health Block Grant, Preventive Health and Health Services, Social Services Block Grant, State Children’s Health Insurance Program, and Temporary Assistance for Needy Families.
program. It is likely that the transformation of additional programs into block grants would, over time, reduce the federal contribution to these state–run programs.

Deductibility of State and Local Taxes

State and local taxes paid by individuals have been deductible on the federal income tax since 1913, with some variation in which state and local taxes are deductible. Currently, real property taxes, personal property taxes, and state and local income taxes are deductible. (The deductibility of sales taxes was eliminated in 1986.) Deductibility is a form of federalism, because it reduces the individual’s after–federal–tax price of state and local public services. It thus makes it somewhat easier for state and local governments to raise adequate taxes. According to a Congressional Research Service report, “Some of the benefit goes to the state and local governments (because individuals are willing to pay higher taxes) and some goes to the individual taxpayer” (CRS, 2000). In addition, it is argued that deductibility reduces interstate tax competition because it narrows interstate differentials among statutory tax rates in the various states. There is some dispute, however, as to how efficient deductibility is in accomplishing these purposes, and whether it is appropriate public policy.

What is clear is that the value of deductibility to state and local governments is projected to experience a sharp decline in the coming years. Figure 3 shows projections of the tax expenditures for deductibility of state and local taxes that OMB made at the beginning of 2001, prior to the enactment of Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), and the similar projections OMB made at the beginning of 2003. For FY 2003, there is a modest difference in the cost projections: the 2001 projection was $79 billion and the 2003 projection is just under $73 billion; presumably some of that difference could be attributable to changes in economic assumptions.

![Graph of Deduction for State and Local Taxes Pre- and Post-EGTRRA](image)

Figure 3. Deduction for State and Local Taxes Pre– and Post–EGTRRA
projections for FY 2006, however, differ markedly. In 2001, deductibility was projected to cost the federal government $95 billion in FY 2006. The current projection is for a cost of $57 billion in FY 2006, a decline of 40 percent (OMB, 2001a and 2003a). There are a number of reasons for this decline, including the drop in tax rates enacted in 2001 that lessens the value of the deduction. The most important factor reducing the value of the deduction for state and local taxes, however, is the Alternative Minimum Tax.5

The Alternative Minimum Tax (AMT) is a provision of the tax code that was intended to assure that high income taxpayers could not escape taxation through the use of combinations of certain exclusions, deductions, and credits. Because the parameters of the AMT have not been regularly adjusted for inflation since 1986 and because the 2001 and 2003 legislation substantially reduces the tax rates for the regular income tax, the AMT is being transformed from a tax that affected only a few very high income taxpayers into one that will affect a broad swath of taxpayers, including many middle-class taxpayers.6 As recently as the late 1990s, fewer than 1 percent of all taxpayers were subject to the AMT. In 2002, 2.7 percent of taxpayers paid the AMT. By 2010, however, 33 percent of all taxpayers will be subject to the AMT. Prior to the changes in tax law in EGTRRA, 16 percent of taxpayers would have been subject to the AMT in 2010. While it is unlikely that policymakers will allow the AMT to expand to the point where a third of taxpayers must pay this complicated tax, it is unclear when, how, and to what extent the AMT issues will be dealt with; depending on how it is done, fixing the problem could be very expensive.

In the calculation of taxable income for AMT purposes, the deduction for state and local taxes is not allowed. Thus a taxpayer who finds himself or herself subject to the AMT will lose some or all of the state and local tax deduction. Indeed, taxpayers in higher-tax states are more likely to have to pay the AMT than other taxpayers. For all taxpayers subject to the AMT, more than half of the increases in taxable income for AMT purposes were accounted for by the denial of the deduction for state and local taxes. By 2010 the percentage of AMT adjustments attributable to state and local taxes will decline slightly, to 44 percent. (Burman et al., 2002). Thus if the AMT is allowed to continue on its current path, the value to states of the deduction for state and local taxes will be greatly eroded.

The cost to the federal government in FY 2004 of the deduction for state and local taxes is currently projected to be $73 billion, declining to $52 billion in 2007 (OMB, 2003a). As noted above, there is some question about the efficiency of the deduction. Do state and local governments capture the benefit of the deduction, primarily through being able to support public services more adequately because of an enhanced willingness to pay taxes? Or is it just a tax break for the upper-middle- and higher-income taxpayers who itemize?

In 1985, President Reagan’s proposal that was the prelude to the Tax Reform Act of 1986 estimated that state and local governments gained less than 50 cents for every dollar lost to the federal government (Executive Office of the President, 1985). While many thought that was a bit of an underestimate of the benefit to state and local government at the time, it may be accurate or even a bit high today. To

5 Note that JGTRRA accelerated the rate reductions in the 2001 tax law—which will accelerate the decline in the value of the deduction—and made a temporary change in the AMT—which will offset a portion of the additional decline from the rate cut accelerations in 2004. Updated estimates of the effect are not yet available.

6 AMT parameters were adjusted slightly in 1993 and in other pieces of legislation during this period, but not sufficiently to offset the effects of inflation on the parameters.
the extent that the benefit to state and local government comes from people’s perception that they are getting a break on their state and local taxes, a reasonable proportion of a state’s residents have to be getting the break for deductibility to be an effective subsidy. According to the Joint Committee on Taxation, the deduction for real property taxes was taken on 23.5 percent of all returns in 2002, and the deduction for state and local income and personal property taxes was taken on 24.7 percent of returns (JCT, 2002). Thus, only about one-quarter of families and individuals benefit from the deduction. Moreover, with the AMT causing great uncertainty about whether specific individuals will be able to take the deduction, its value for enhancing the ability to levy state and local taxes is likely to be further eroded in the future. Although it is impossible to assess accurately the value of the deduction to state and local governments, Table 1 shows the value as half of the federal revenue loss—$36.5 billion in 2004 and $26 billion in 2007. As noted, that may be an overestimate of its current value to states and localities.

**Tax Exemption for State and Local Bonds**

Interest received by taxpayers who purchase bonds issued by state and local government is exempt from federal taxation. This provides a subsidy for the activities states and localities support with bonds, including capital expenditures, production of housing for low- and middle-income households, improvement of water treatment facilities, providing student loans, building hospitals, and various other activities. The tax exemption provides a subsidy because the purchasers of the bonds care about the after-tax rate of return on their investment, so states and local governments can issue bonds that pay lower interest rates than issuers of taxable bonds have to pay.7

The value of the exemption to states and localities depends on the spread between the interest rate for taxable bonds and the interest rate for their tax-exempt bonds. In other words, the value to the issuing jurisdiction of the tax exemption is the difference between the interest that it would have to pay if the bond interest were taxable by the federal government and the interest it actually pays on the tax-exempt bonds it issues. Table 2 compares interest rates on corporate AAA bonds (with little risk) and state and local bonds over the last few years. Between 1999 and the present, the ratio of state and local bond interest rates to taxable bond rates has ranged from a low of 71.0 percent in September, 2001 to a high of 82.6 percent in April, 2003. Based on a top marginal tax rate of 38.6 percent that prevailed during most of this period, one would expect

| TABLE 2 | COMPARISON OF INTEREST RATES ON TAX-EXEMPT STATE AND LOCAL BONDS AND PRIVATE BONDS IN ALL INDUSTRIES |
|---------------------------------|---------------------------------|---------------------------------|---------------------------------|
| Annual average rate | State and Local | Private AAA Rating | Ratio Tax-Exempt to Taxable |
| 1999 | 5.43 | 7.04 | 77.1% |
| 2000 | 5.71 | 7.62 | 74.9 |
| 2001 | 5.15 | 7.08 | 72.7 |
| 2002 | 5.04 | 6.49 | 77.6 |
| 2003 (Jan–Apr) | 4.80 | 5.94 | 80.9 |


7 There is controversy in the literature about whether the tax exemption actually provides this subsidy or not. Both sides of this question are described in Fortune (1998). For purposes of this paper, I assume the subsidy does exist. If in reality there is no subsidy, then the positive effect of the federal government on states would be lower than this paper finds.
the ratio to be somewhat lower, closer to 65 percent. In other words, a taxpayer that has to pay a 38.6 percent rate of tax on a taxable bond should be willing to accept a tax-exempt bond with an interest rate that is just over 61.4 percent of the interest rate carried by the taxable bond—assuming the bonds are of equivalent risk. That fact that the ratios of tax-exempt to taxable bond interest rates are higher than that suggests that the high-income taxpayers are in fact capturing some of the subsidy.

The cost to the federal government of this exemption is approximately equal to the amount of interest the taxpayer receives times the taxpayer’s marginal tax rate. The federal tax expenditure for the exemption for state and local bonds of all kinds is estimated by OMB to be $33 billion in FY 2004 and just over $34 billion in FY 2007. There remains the question about how much of the revenue the federal government loses goes to subsidize state and local government projects and how much is captured by the high-income taxpayers and corporations that buy the bonds. In 1985 the President’s tax reform proposal noted, for example, that “the revenue loss to the Federal government is approximately 33–50 percent higher than the benefits received by the borrower” (Executive Office of the President, 1985). The top marginal tax rates were much higher in 1985 than they are today, so that estimate may be an overstatement with respect to the federal loss in the current circumstances. A 1996 study suggests that states and localities capture about 75 percent of the benefit, while about a quarter of the subsidy ends up as a windfall to well-off investors (McIntyre, 1996). A recent study suggests a much lower number, finding that only 35 percent of the subsidy goes to reduce the interest rates on the tax-exempt bonds, and the remainder is captured by the individual and corporate bond holders (Ettlinger, 2002).

For purposes of this paper, it is conservatively assumed that state and local governments receive 75 percent of the benefit of the exemption. Thus the value of the exemption to them is approximately $30 billion in 2004 and $31 billion in 2007.

Estate Tax

Another area of positive impact has been the federal estate tax. From 1924 until the federal tax changes made in 2001, the federal government has essentially shared the federal estate tax with the states. The federal estate tax has included a credit for state estate taxes paid. Thus an estate that paid state estate taxes would get a dollar for dollar credit against federal estate taxes owed, up to a specified maximum. This credit is being phased out over four years, between 2002 and 2006. In 2004, states still will be getting a benefit of approximately $3.2 billion from the credit. The impact of the loss of the credit is discussed below.

Fiscal Relief

Finally, the Jobs and Growth Tax Relief Reconciliation Act of 2003 included fiscal relief for states that totals $20 billion over two years, $10 billion in federal fiscal year 2003 and $10 billion in FY 2004. Half of the money is in the form of additional federal payments for the Medicaid program, and half is in the form of general revenue sharing, distributed to states on a per-capita basis.

AREAS OF NEGATIVE IMPACT

In the previous section, areas in which federal policies have a generally positive effect on state finances were discussed. Even though, as illustrated, the positive effect is declining in many of the areas, the federal government still is providing funding through these mechanisms to
help states and localities meet their responsibilities.

In this section, specific areas where the federal government is imposing costs on states are discussed. Areas in which federal policies prevent states from taking actions that could improve state finances also are included.

Medicaid

Medicaid would seem to be an area in which federal funding has, until now, kept up with need, since the federal government matches state expenditures. On average, the federal government pays about 57 percent of all Medicaid expenditures. In fact, however, there has been a subtle shift of costs over the past decade from the fully federally–financed Medicare program to the joint federal–state funded Medicaid program. This has not necessarily happened as a result of deliberate policy, but rather is a function of the way in which health care has been changing. Almost all elderly persons on Medicaid and 40 percent of disabled persons on Medicaid are also on Medicare, and about 35 percent of total Medicaid costs are spent on benefits for these “dual eligibles.” For low–income individuals fully enrolled in both programs, Medicaid pays for services that Medicare does not cover, like prescription drugs and long–term care, and also covers the deductibles, coinsurance, and premiums that Medicare assesses beneficiaries. In addition, state Medicaid programs pay some or all premiums, cost sharing, and deductibles for Medicare beneficiaries with incomes below 120 percent of the poverty line ($10,780 in annual income for a single person and $14,540 for a couple).

Changing medical practices have shortened the length of time that people are hospitalized and have increased the use of prescription drugs and ambulatory care. While these medical advances can reduce overall health care costs and improve quality of care, they have the paradoxical effect of increasing Medicaid expenditures while lowering Medicare costs. Furthermore, Medicaid covers long–term care, while Medicare does not. A majority of the Medicaid expenditures for seniors and people with disabilities are for long–term care services, such as nursing home or home health care services.

As a result of these circumstances and trends, Medicaid has been financing a growing share of health insurance costs for the aged and disabled. In 1984, Medicaid paid for 30 percent of the total public expenditures for health insurance for the aged and disabled and Medicare paid for 70 percent. By 1998, Medicaid was covering 40 percent of the public health insurance costs of the aged and disabled, with Medicare’s share having fallen to 60 percent. By 2012, Medicaid’s share is projected to rise to 45 percent, while Medicare’s share will drop to 55 percent (Ku, 2003).

In FY 2004, states are projected by CBO to spend about $182 billion on care for the aged and disabled, of which $78 billion will be state funds and the rest federal. About $260 billion will be spent for Medicare (CBO, 2003). The $182 billion Medicaid expenditure represents 41 percent of the total $442 billion cost of care for the aged and disabled through Medicare and Medicaid combined. If Medicaid were to pay only 30 percent of the total as it did in 1984, rather than the 41 percent projected for FY 2004, states would spend $57 billion of their own money for the aged and disabled rather than the projected $78 billion. The difference between a state expenditure of $78 billion and $57 billion is $21 billion, which is how much less states would have to spend in FY 2004 if Medicare still paid 70 percent of the total bill.8

8 This analysis assumes that total public health care expenditures on Medicare and Medicaid together would be the same today, with only the relative shares changing. In that case, total Medicaid expenditures would fall to $132 billion and Medicare would rise to $309 billion.
A similar analysis can be made for FY 2007. In FY 2007, states are projected by CBO to spend $244 billion for the aged and disabled in Medicaid, of which $105 billion is state funds and the remainder federal funds. This would be 44 percent of the $551 billion total public cost of health insurance for the aged and disabled in Medicaid and Medicare together. If Medicaid still paid 30 percent of the total rather than the projected 44 percent, states would spend $71 billion in state funds for the aged and disabled rather than the projected $105 billion, so states would be spending $34 billion less\(^9\) (See Figure 4).

Thus, the subtle transfer of expenses from Medicare to Medicaid is costing states $21 billion in FY 2004, rising to $34 billion in FY 2007.

**Federal Tax Changes**

Federal tax changes often affect state tax revenues, because most state–level individual, corporate, and estate taxes use federal definitions and are closely tied to their federal counterparts. In the Tax Reform Act of 1986, for example, many business and some individual deductions and loopholes were closed or curbed. At the federal level, the additional revenue that produced was used to reduce rates. The federal base broadening also broadened the base of state taxes, although many states similarly used the additional potential revenue to make rate reductions or other offsetting changes. In recent years, however, federal tax changes have reduced state tax revenues.

EGTRRA, enacted in 2001, included a change in the estate tax that is causing a major revenue loss for states. In the final negotiations over the bill, Congress was looking for ways to fit the legislation’s cost into the agreed upon amount. One way it did so was to phase out over four years (2002–2006) the credit for state estate taxes paid. Since every state levied a “pick–up tax” that was tied to this credit—and most states’ laws simply said their own estate tax was equal to the federal credit—this change effectively phased out state estate taxes as the federal credit phased out. The state revenue loss is $23 billion between 2003 and 2007. The 2004 revenue loss is

\(^9\) Total Medicaid expenditures would be $165 billion and Medicare would be $386 billion.
approximately $3.2 billion, rising to $7.0 billion in 2007.10

Other changes in EGTRRA that cause states to lose revenue include the liberalization of IRA and other pension rules and the expansion of education savings benefits. These losses, however, are difficult to quantify.

In 2002, an economic stimulus package was enacted. This legislation included a temporary “bonus depreciation” provision that allows businesses to deduct 30 percent of the cost of equipment in the year of purchase. Most states tie their depreciation rules to the federal treatment, and they would have experienced a revenue loss of approximately $14 billion over the just under three–year life of this provision. The majority of states, however, were reluctant to piggyback on this temporary provision at a time when state revenues were declining. Some 30 states “decoupled” their own treatment of depreciation from the new federal provision, reducing the actual revenue loss to approximately $3.1 billion from state fiscal years 2002 through 2004. The 2004 state revenue loss without decoupling would have been about $4 billion. Taking decoupling into account, the revenue loss is $800 million for 2004.

As described below, the 2003 tax bill, JGTRRA, extended bonus depreciation through the end of calendar year 2004. Several other tax provisions in JGTRRA sunset at the same time; many of these, such as the child tax credit increase and the marriage penalty relief, are almost certain to be extended. Thus there is a fairly high probability that the bonus depreciation provisions also will be extended and continue to cause revenue losses in years subsequent to 2004.

The new tax law enacted in 2003 includes three provisions that cause state revenue losses (See Table 3). One is an expansion of bonus depreciation to 50 percent of the cost of the equipment, and as described above, an extension of this provision through the end of 2004. Another is an increase in the amount of equipment purchases that small businesses can expense in the year of purchase, rather than depreciate over time. This provision is scheduled to sunset at the end of 2005. The third is an increase in the standard deduction for married couples, scheduled to sunset in 2004, which affects some ten states that use federal rules for this provision. If one assumes that the states that currently conform to federal treatment in these three areas continue to

<table>
<thead>
<tr>
<th>TABLE 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>ESTIMATED LOST STATE TAX REVENUE RESULTING FROM JGTRRA, BY STATE FISCAL YEAR</td>
</tr>
<tr>
<td>(In billions of dollars)</td>
</tr>
<tr>
<td>By SFY</td>
</tr>
<tr>
<td>Expansion of bonus depreciation</td>
</tr>
<tr>
<td>Section 179 expensing</td>
</tr>
<tr>
<td>Standard deduction increase</td>
</tr>
<tr>
<td>Total</td>
</tr>
</tbody>
</table>

Notes: Figures for 2004 and 2005 assume provisions expire as scheduled in the bill. Some totals do not add due to rounding. Estimates for bonus depreciation and Section 179 expensing are based on Joint Committee on Taxation estimates of federal impact and on each state’s relative personal and corporate income tax collections. Estimates for standard deduction are based on Minnesota’s estimate extrapolated to other states. All estimates assume that only those states that now follow federal rules on each provision will continue to do so.

10 To date, 18 states and the District of Columbia have decoupled from the federal estate tax change and are maintaining their estate taxes, bringing the actual revenue loss down to $15 billion between 2003 and 2007. The revenue loss will grow in subsequent years. Table 1 counts the full revenue loss rather than the loss remaining after decoupling, in part because of the uncertainly surrounding the maintenance of decoupling in several states.
do so, then the additional revenue loss in state fiscal year 2004 will be 1.8 billion. If these provisions do not sunset as scheduled and continue throughout the decade, the state revenue loss though 2012 would be over $18 billion\textsuperscript{11} (Johnson, 2003).

**Unfunded Mandates**

In the mid–1990s, there was a great deal of discussion of the problems caused when the federal government imposes unfunded mandates on states and localities. Eliminating unfunded mandates became a crusading point in the Contract with America, culminating in the passage of the Unfunded Mandates Reform Act of 1995. The law seeks to discourage the federal government from imposing mandates on state, local, and tribal governments or the private sector without paying the costs of those mandates. It does this largely by increasing the information that federal policymakers have about the effect of mandates, and by creating points of order in the House and Senate against some unfunded mandates. It does not, however, prevent mandates from being enacted. Unfunded mandates and “underfunded national expectations” continue to be an issue for states and localities.\textsuperscript{12}

There are four major areas in which states currently are experiencing increased costs as a result of unfunded or insufficiently funded mandates. They are IDEA—Special Education, No Child Left Behind, election reform (Help America Vote Act), and homeland security. In homeland security, there are both unfunded mandates and federal expectations that states and localities will partner with the federal government in various activities. The National Conference of State Legislatures (NCSL) estimates that the total annual cost to state and local governments of these mandates and expectations is currently between $23.5 billion and $82.5 billion. This section relies heavily on the NCSL analysis (NCSL, 2003).

The Individuals with Disabilities Education Act (IDEA) was enacted in 1975 and most recently amended in 1997. The law guarantees each disabled child an assessment and an individualized education plan. When the law was enacted, the federal government promised that it would fund 40 percent of the additional costs states are mandated to incur. The full funding to bring the federal share to 40 percent has never materialized. According to NCSL, it would currently require $11 billion in additional annual funding for the federal government to reach its 40 percent share of the “Part B” average per pupil expenditures that state governments currently are compelled to provide. NCSL further notes, based on work by the Center for Special Education Finance, which is funded by the U.S. Department of Education, that it would take more than $25 billion in immediate additional federal funding to meet all of the excess costs of educating children with special needs.

The No Child Left Behind Act also imposes additional costs on states and localities. The Act includes a variety of specific steps schools must take with respect to testing children. It also prescribes various remedies for schools in which test scores do not meet standards, including giving children the right to transfer to another school—even if providing that alternative would be costly. It is unclear how much it will cost states and localities to meet the mandates in this new law. NCSL suggests that the unfunded costs are likely to be in the range of $5 billion to $35 billion a year.

\textsuperscript{11} Note that the tax provisions included in the Administration’s FY 2004 budget would have reduced state revenues by about $64 billion over 10 years.

\textsuperscript{12} The term “unfunded national expectations” was coined by Michael Bird at the National Conference of State Legislatures.
According to NCSL, the authorized amounts for states to initiate implementation of the Help America Vote Act for FY 2003 and FY 2004 total $3.2 billion ($2.2 for FY 2003 and $1.2 billion for FY 2004). Some $1.5 billion was appropriated for FY 2003, and the President’s budget recommends $490 million for FY 2004. This leaves states at least $1 billion short for the first two years of implementation, although estimates of the full cost for states and local governments to implement the Help America Vote Act range as high as $15 billion. NCSL uses a range of $1 billion to $5 billion as the cost.

Homeland security is another area in which the exact amount of costs being borne by state and local governments for a wide range of activities—including emergency management and assistance, disaster relief, counterterrorism, public safety and first responder training, smallpox inoculation, public health, purchasing equipment, improving the safety of the water supply, strengthening food and agricultural security, and upgrading communications—may be impossible to calculate. There has been some federal funding, but NCSL estimates that the funding falls short by about $6.5 billion to $17.5 billion this year.

As noted above, NCSL puts the current cost at $23.5 billion to $82.5 billion. Table 1 uses the lower number in this range for 2004, with a note indicating the effect of the higher number. It is unclear how to project the cost of these four mandates to 2007. It is likely that the costs of IDEA and No Child Left Behind will continue to rise, potentially at a more rapid rate than spending generally. Expenses for election reform arguably will be completed before 2007. Expenses for homeland security are likely to continue, although some capital expenses undoubtedly are concentrated in the near term. Given all of these uncertainties and potentially counteracting trends, Table 1 of this report uses the NCSL current cost of unfunded mandates for both 2004 and 2007.

**Preemption**

The federal government also affects state and local finances when it preempts the right of states or localities to tax specific activities. For example, federal law prohibits state and local governments from taxing all airline tickets as well as bus tickets purchased for interstate travel. Were states able to apply their sales taxes to such tickets, the revenue gain would be very large. Federal law also prohibits states and localities from taxing the income of certain out-of-state corporations. P.L. 86–272 provides that neither a state nor its subdivisions can impose a corporate profits tax on an out-of-state corporation if the corporation’s only activity within the state is soliciting orders for physical goods, provided the orders are approved at an out-of-state office of the seller and the goods are shipped into the state from an out-of-state location. This allows corporations to have an unlimited number of salespeople in a state at all times, yet remain exempt from tax so long as the salespeople work out of their homes. When P.L. 86–272 was enacted in 1959, it was intended to be temporary. However, it has never been repealed; it has instead been the subject of constant litigation and it has shielded tremendous amounts of profit from state taxation.

Federal legislation enacted in 1996 bars state and local governments from taxing the pension income of non-residents, even when that income constitutes deferred income earned while the individual was a resident of the state or locality. Given the large number of people who retire to states other than the ones in which they worked, the revenue loss to the states in which the deferred income was actually earned is likely substantial. Much of the deferred income is never taxed, since Ne-
vada, Florida, and Texas—three major retirement destinations—do not tax individual incomes.

Similarly, Section 306 of the federal statute known as the “4–R Act” of 1976 bars state and local governments from taxing railroad property at a higher effective rate than general commercial and industrial property. One might accept the legitimacy of this policy goal, but in actuality the legislation has been aggressively litigated by the railroad industry and used to invalidate non–discriminatory state taxes imposed in lieu of property taxes and to obtain federal court jurisdiction of run–of–the–mill valuation disputes (despite clear legislative intent to the contrary). Analogous legislation also governs state and local property taxation of airlines and trucking companies.

A more recent preemption is the Internet Tax Freedom Act (ITFA). Enacted in 1998 and renewed for a two–year period in 2001, ITFA prohibits states and localities from taxing fees charged for Internet access—the $25 to $50 a month that people typically pay for their Internet connections. While the law grandfathered a few states that already had implemented such taxes, other states and localities were barred from doing so. The estimated cost to states of this single preemption is approximately $1.7 billion in 2004, rising to $2.1 billion in 2007.13

Finally, there are a number of other, narrower preemptions of state and local taxing authority on the books. For example, local governments have been barred from imposing their sales taxes on direct broadcast satellite TV services, the District of Columbia has been barred from taxing the income of nonresidents who work in the city, and state and local governments are barred from taxing the profits of federally–chartered corporations like the Federal National Mortgage Association (Fannie Mae).

**Failure to Act**

There are some problems in state and local finances that deprive states of revenue, yet states themselves are largely powerless to solve these problems. Federal government action is needed to solve these problems, because they involve either interstate commerce issues or international commerce issues or because the states do not have adequate tax enforcement resources. The failure of the federal government to solve these problems itself or empower the states to address them is costing states billions of dollars in foregone revenue.

For example, during the late 1970s and early 1980s there was a growing trend among states to adopt the worldwide unitary combined reporting approach to corporate taxation. States were convinced that corporations were using transfer pricing to artificially shift profits that were earned within their borders onto the books of the corporations’ overseas subsidiaries. Worldwide unitary reporting looked at the corporation’s worldwide income and apportioned an amount of that income to the state based on in–state property, payroll, and sales factors still in use for apportionment purposes today. Foreign governments, foreign and U.S.–based multinational corporations, Congress, and the Reagan Administration all brought substantial pressure to bear on the states to abandon worldwide unitary. Despite the fact that the U.S. Supreme Court twice upheld the fairness and con-

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13 This estimate is for state government revenue losses only and takes into account the grandfathering of Internet access taxes in several states. It assumes that in the absence of ITFA, all states would apply their sales taxes to Internet access services and that the grandfathered states that repealed their taxes on Internet access would reinstate them. The estimate is based on 2004 and 2007 forecasts of total Internet access accounts in the U.S. made in August 2002 by the Yankee Group and assumes that the average charges for dial–up and high–speed accounts in both years would be $25 per month and $50 per month, respectively.
stitutionality of combined reporting, the federal government ultimately convinced the states to back down to a “waters–edge” approach to apportionment that did not consider worldwide income. In return, the federal government promised to step up its efforts to prevent transfer pricing abuse, so that state corporate tax bases would not be adversely affected by the abandonment of combined reporting. However, the federal government has done a very poor job of stopping international income shifting through transfer pricing and other tax–avoidance techniques, and the corporate tax base has been shrinking at both the federal and state level as a result. Many experts now urge the federal government to eliminate an international tax system premised on enforcing “arm’s length” transfer pricing standards and to adopt combined reporting instead (McIntyre, forthcoming).

Similarly, the failure of the Internal Revenue Service to prevent aggressive tax sheltering by both corporations and individuals in recent years has had an adverse impact on state corporate and personal income tax collections because of the piggybacking of state income taxes on federal definitions of taxable income. A 2002 study by Harvard economist Mihir Desai found that as much as one-third of the discrepancy between book and federal taxable income of major corporations in 1998—some $154 billion—could not be explained by known differences in reporting requirements and might be due to tax sheltering (Desai, 2002). In turn, a study by William F. Fox and LeAnn Luna estimated that about 30 percent of the falloff in the effective state corporate income tax rate in the 1990s is attributable to the piggybacking of the state corporate tax base on the eroding federal corporate tax base (Fox and Luna, 2002).

The most striking example of failure of the federal government to act is in the area of the taxation of mail order and Internet sales under state and local sales and use taxes. State and local government organizations began seeking federal legislation reversing the 1967 National Bellas Hess decision as far back as the early 1970s. That effort was given a renewed impetus in the mid–1980s as a result of a major ACIR report highlighting the amount of revenue state and local governments were losing from untaxed catalog sales. More recently, state and local government organizations have been working virtually non–stop to achieve authority to tax remote sales since the 1992 Quill decision removed all legal question as to the ability of Congress to empower states to tax non–physically–present vendors. Legislation has been introduced to this end in almost every session of Congress but has been blocked by a coalition of legislators not wishing to help state and local governments raise additional revenue and/ or not wishing to impose the collection burden on the politically–potent direct marketing and electronic commerce industries. The mobilization of the main–street retailing industry in support of a level playing field combined with the progress of the Streamlined Sales Tax Project in harmonizing state sales tax systems makes the prospect for enactment of federal legislation reversing Quill better than it has ever been. Nonetheless, there remains a hard core of congressional op-

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14 A recent study by Tax Analysts economist Martin Sullivan found that “in 1999, subsidiaries operating in 13 tax havens accounted for 45 percent of the foreign profits generated by U.S. multinational corporations. But these countries also accounted for only 25 percent of those companies’ foreign assets, 20 percent of their foreign sales, 11 percent of their foreign property, plant, and equipment, and 10 percent of their foreign employees.” Sullivan concluded: “The magnitude of the disparities between income and other economic indicators does not prove—but does strongly suggest—that the U.S. multinationals have been successful in circumventing the arms’ length [transfer pricing] method.” “Data show Big Shift in Income to Tax Havens,” November 15, 2002.
position to changing the status quo, and it is by no means certain that such legislation will pass in the near future. In the meantime, state and local governments continue to hemorrhage sales tax revenue. According to William Fox, the state and local revenue loss from the inability to collect sales tax on e-commerce alone will be $35 billion in 2004, rising to $48 billion in 2007 (Fox and Luna, 2002).

CONCLUSION

This paper suggests that if all of the sources of negative impacts of federal policies on states and localities are considered together, the cumulative impact is far greater than is generally acknowledged. Moreover, federal policies are found to be on a path that will greatly increase the federal government’s negative impact on states and localities in the near future. The net positive impact is slated to decline by 18 percent between 2004 and 2007. By 2007, the negative impacts of federal policies reduce the positive impacts by at least 45 percent and perhaps by as much as 60 percent. Federal policies are enacted one by one, so this type of cumulative impact is never considered.

Moreover, the impact of certain types of policies on state and local governments often is not considered at all. For example, the decline in the value of the federal tax deduction for state and local taxes is a byproduct of problems in the AMT structure, not a deliberate policy decision. Nevertheless, the interest of states and localities should be considered as proposals are made to repair the AMT. Similarly, the spillover effects onto the tax systems of states that conform to federal tax rules usually are not considered when tax policy change proposals are discussed. A recent, rare exception occurred toward the end of the debate on JGTRRA, as the Senate passed its version and sent it to conference. Senate leadership made a promise on the floor of the Senate that the final form of the provision lowering the tax on dividends would not flow through to reduce state revenues. This followed a barrage of information used on the floor of Congress on the extent to which various forms of a dividend exclusion would cause state revenue losses (Lav, 2003; Johnson, 2003). In the end, for this or other reasons, the dividend provision was enacted as a rate cut that did not affect state revenues. This suggests that it is possible to have federal policy debates encompass the effect of policies on states, if sufficient information is available on the magnitude of those impacts.

States and local governments have an important role to play in providing public services. Historically, the federal government—with its more progressive tax system and its flexibility to continue to provide funding during economic downturns—has partnered with states and localities in this endeavor. That fiscal partnership is waning, but the fact of that waning is not generally understood. Additional research and dissemination of information on the positive and negative ways federal policies affect state fiscal conditions could foster debate over whether this federal withdrawal is appropriate public policy.

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