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PASSING DOWN THE DEFICIT: FEDERAL POLICIES CONTRIBUTE TO THE SEVERITY OF THE STATE FISCAL CRISIS

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Executive Summary

The state fiscal crisis has been deep and prolonged. States have struggled to close deficits that have totaled approximately $190 billion over the past three years. And, as states debate and enact budgets for fiscal year 2005 (which, in most states, begins on July 1, 2004), they are facing deficits of roughly another $40 billion for that year.

Federal policies, which have reduced state revenues and imposed additional costs on states, have played a significant role in enlarging these deficits and are impeding states' fiscal recovery. These federal policies have contributed significantly to the need for states and localities to make expenditure cuts and enact tax increases to bring their budgets into balance.

- Federal policies have cost states and localities more than $175 billion over the four-year course of the state fiscal crisis, from state fiscal year 2002 through fiscal year 2005.
- These costs have averaged 8.4 percent of total state general fund budgets during that time, a large amount.
- The federal government provided $20 billion in federal fiscal relief to the states in 2003. This $20 billion helped states avoid some budget cuts and tax increases, but it pales in comparison to the magnitude of the state fiscal crisis and to the more than $175 billion in state costs and forgone revenues over the 2002-2005 period that are attributable to federal policies. (See Figure 1.)

In seven states, the net cost of these federal policies — the total cost less the offsetting fiscal relief — exceeds $5 billion over the course of the fiscal crisis. The states with the largest net losses from federal policies are **California** ($23 billion), **New York** ($13 billion), **Texas** ($12 billion), **Florida** ($11 billion), **Illinois** ($6 billion), **Michigan** ($6 billion), and **Pennsylvania** ($5 billion).

The net loss relative to the size of state budgets varies substantially by state, from a low of 1.4 percent of the general fund budget in Alaska to a high of 13.3 percent in Florida. The 11 states in which federal policies have imposed the greatest net costs, averaging at least 10 percent

of their general fund budgets over the course of the fiscal crisis, are **Florida**, **Nevada**, **Missouri**, **Mississippi**, **Louisiana**, **Arkansas**, **Colorado, South Carolina**, **Texas, Oklahoma,** and **South Dakota.**

- The states bearing the greatest relative cost of federal policies tend to be among the least affluent states in the country, as measured by per capita income and poverty rate. **Arkansas, Louisiana, Mississippi, Oklahoma,** and **South Carolina** are among the ten states with the lowest average per capita incomes and highest poverty rates in the country. They also are among the states most harmed by federal policies.

  Eight of the 10 poorest states — **Arkansas, Mississippi, West Virginia, Louisiana, Alabama, Oklahoma, South Carolina,** and **Arizona** — are among the 20 states with the most severe losses resulting from federal policies.

- States that have a relatively heavy reliance on federal funding for their budgets also are among those that have been hardest hit. Of the 11 states with the greatest losses as a share of their budgets, six — **Missouri, Mississippi, Louisiana, Arkansas, South Carolina,** and **South Dakota** — are among the 20 states that derive the highest proportion of their revenues from federal funds.

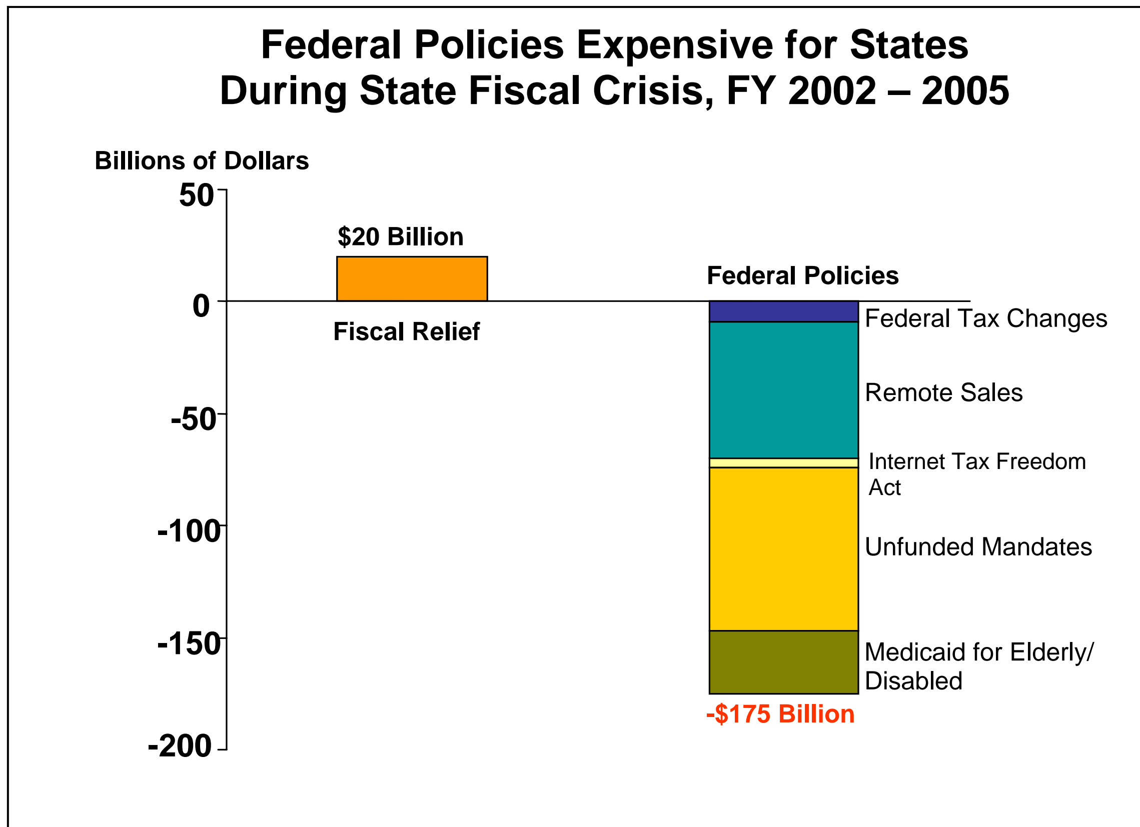
- States that are most reliant on raising revenues through a sales tax are another group that is bearing a high cost of federal policies. Among the 11 states with the greatest loss from federal policies relative to their budgets, **Florida, Nevada, Mississippi, Texas, and South Dakota** are also among the 10 states with the greatest reliance on sales taxes for revenues. As described below, federal policies that bar states from levying or effectively collecting sales taxes on certain items or transactions are among the most costly of the federal provisions affecting states.

- Finally, five of the 11 states with the greatest relative loss from federal policies have lost a significant amount of revenue as a result of the federal tax changes of the past three years. **Florida, Missouri, Louisiana, Colorado, and Oklahoma** all fall into this category due to their failure to decouple their tax codes from these federal changes.

At least five areas of federal policies have contributed to these monetary losses and to the fiscal distress of the states: federal tax policy, federal preemption of state and local taxing authority, the failure of Congress to address Supreme Court rulings that prevent states and localities from collecting taxes owed to them, mandates that require states to spend funds for particular purposes, and federal Medicare and Medicaid policies that have become expensive for states.

- Some of the federal tax cuts enacted in 2001, 2002 and 2003 are reducing *state* revenues because of linkages between the federal and state tax codes. While some states have "decoupled" their tax systems from some of these federal tax

Figure 1



cuts, others have not. The states that have not decoupled are losing approximately $9 billion during the four-year course of the fiscal crisis.

- Federal policies bar states from imposing normal state taxes on certain types of transactions. One example is the federal Internet Tax Freedom Act, first enacted in 1998, which bars states from placing taxes on the access fees that people pay for their Internet service. Just this one preemption of state taxing authority is costing states over $4 billion during the fiscal crisis.

- Two Supreme Court cases prevent state and local governments from collecting sales taxes on most items that their residents buy through catalogs or over the Internet, even though sales taxes apply when the very same items are purchased in retail stores. The Supreme Court noted that Congress has the authority to enact legislation that enables states that elect to do so to exercise their normal authority to impose sales tax on such purchases. Although federal legislation has been introduced to correct this problem, it has not garnered significant support from Congress or the Administration, and its passage is not expected anytime soon. Research suggests that state and local governments are losing at least $61 billion during the fiscal crisis as a result of the federal government's lack of action to resolve this problem.

- The federal government has placed an assortment of demands and requirements on state and local governments without adequately funding them. These so-called unfunded mandates or underfunded obligations include requirements in the areas of election reform, education of disabled children, and the No Child Left Behind law. Total funding for these programs is $73 billion below promised funding levels.

- Finally, there is the failure of the federal government to cover the cost of prescription medications for low-income elderly and disabled individuals who are eligible for both Medicare, which is a federal program, and Medicaid, a program for which states bear an average of 43 percent of the costs. For all other services covered by both Medicare and Medicaid, Medicare is the primary payer. Nevertheless, the federal government for many years failed to act to cover prescription drugs under Medicare — despite enormous shifts in medical practice in recent decades that have made drug therapies central to the provision of health care.

  This has been a particular problem for states during the fiscal crisis, during which time the cost to Medicaid of providing prescription drugs to the population eligible for both Medicare and Medicaid has been rising at double-digit rates each year. As a result, states (and the few localities that contribute to Medicaid) are spending about $28 billion in state and local funds during the course of the fiscal crisis to provide prescription drugs to low-income elderly and disabled beneficiaries who are eligible for both Medicare and Medicaid.[1]

In addition to the negative impact of specific federal policies, there is the question of whether the federal government has taken sufficient action to alleviate the severity of the state fiscal crisis. The federal government is the only level of government that can — and arguably should — run temporary deficits during an economic downturn. It makes sense for the federal government to use this power to run temporary deficits to stimulate the economy when it is weak, and to do so by — along with other steps — providing sufficient temporary fiscal assistance to states to avert some of the more severe types of measures that states have had to institute in the past few years to balance their budgets. Congress did provide $20 billion in fiscal relief to states in 2003, and that relief has proved important to states, but it pales in comparison to the size of the problem. Even after taking fiscal relief into account, the cost to states of federal policy has averaged 7.4 percent of total state general fund budgets since the fiscal crisis began.

If the federal deficit were not mounting at an alarming rate in part because of costly tax cuts heavily geared toward high-income households, the federal government could afford to do

[1] It should be noted that the new Medicare law enacted in 2003 will cover under Medicare some of the cost of prescription drugs for all Medicare beneficiaries beginning in 2006. The new law includes an unprecedented provision, however, that will require states to reimburse the federal government for most of the cost of prescription drug coverage for individuals who are eligible for Medicaid as well as Medicare.

Table 1
Total Costs and Net Costs of Federal Policies
In Millions of Dollars

	Total Costs	% of Budget	Net Costs	% of Budget
Florida	$12,177	14.4%	$11,229	13.3%
Nevada	1,207	13.8%	1,102	12.6%
Missouri	3,721	13.4%	3,345	12.0%
Mississippi	1,835	13.2%	1,625	11.7%
Louisiana	3,058	11.6%	2,749	10.4%
Arkansas	1,634	11.6%	1,458	10.4%
Colorado	2,568	11.4%	2,329	10.3%
South Carolina	2,300	11.4%	2,044	10.1%
Texas	13,345	11.2%	12,067	10.1%
Oklahoma	2,122	11.2%	1,904	10.0%
South Dakota	433	12.0%	361	10.0%
Wyoming	353	12.1%	286	9.8%
Alabama	2,391	10.7%	2,126	9.5%
Vermont	413	11.6%	330	9.2%
Tennessee	3,426	10.4%	3,003	9.1%
North Dakota	390	11.0%	318	9.0%
West Virginia	1,190	9.9%	1,065	8.9%
Kansas	1,693	9.6%	1,539	8.8%
Arizona	2,569	9.9%	2,224	8.6%
Nebraska	955	9.0%	847	8.0%
Kentucky	2,546	8.8%	2,270	7.9%
New Hampshire	480	9.5%	396	7.8%
New York	14,827	9.1%	12,663	7.8%
New Mexico	1,433	8.5%	1,297	7.7%
Washington	3,810	8.3%	3,409	7.4%
Georgia	4,997	8.1%	4,479	7.3%
Utah	1,148	7.9%	1,031	7.0%
Michigan	6,200	7.7%	5,545	6.9%
California	23,426	7.6%	20,987	6.8%
Illinois	6,890	7.5%	6,120	6.7%
North Carolina	4,416	7.6%	3,864	6.7%
Idaho	599	7.5%	514	6.4%
Indiana	3,093	7.2%	2,718	6.3%
Pennsylvania	6,228	7.3%	5,328	6.3%
Maine	764	7.3%	649	6.2%
Virginia	3,290	6.6%	2,875	5.8%
Iowa	1,222	6.6%	1,037	5.6%
Ohio	5,767	6.2%	4,996	5.4%
Oregon	1,284	6.5%	1,068	5.4%
Wisconsin	2,738	6.1%	2,385	5.3%
Maryland	2,539	5.9%	2,206	5.2%
Rhode Island	665	6.0%	564	5.1%
Hawaii	849	5.5%	768	5.0%
Minnesota	3,048	5.6%	2,686	4.9%
Montana	323	6.2%	250	4.8%
New Jersey	4,720	5.0%	4,159	4.4%
Connecticut	2,352	4.8%	2,102	4.2%
Delaware	441	4.3%	367	3.5%
Massachusetts	3,780	4.1%	3,231	3.5%
DC	597	3.9%	504	3.3%
Alaska	206	2.2%	129	1.4%
Territories and Unallocated Funds	3,019	N/A	3,008	N/A
U.S.	**$175,479**	**8.4%**	**$155,386**	**7.4%**

Total costs exclude federal fiscal relief funds; net costs include these funds.

more to help states avert substantial cuts in education and health care and significant state tax increases. Such actions by states have constituted a drag on a weak economy and also can have decidedly negative human consequences.

Analysis by the Urban Institute-Brookings Tax Policy Center shows that two-thirds of the federal tax cuts being provided this year as a result of the tax-cut measures enacted since 2001 are going to households in the top fifth of the population. Moreover, households making over $1 million a year are receiving an average tax cut in 2004 of $123,600 each.[2] At the same time, many states are raising taxes and fees that fall heavily on low- and middle-income families; more than three-fifths of the state revenue raised through tax increases so far during the fiscal crisis has come through hikes in regressive fees and taxes such as sales and excise taxes, which consume a larger share of the income of lower-income households than of more affluent ones. In addition, as described below, states are cutting back on important services on which many low- and middle-income families rely — cutting child care and health care programs, raising college tuitions, and the like.

The federal government could play a more positive role in alleviating the pain caused by the state fiscal crisis. If the federal government does not change its policies, the low- and middle-income families that are subject to the state tax increases and service cuts will, in essence, be paying for the very generous federal tax cuts for the highest-income Americans.

Federal Policies

There are a number of ways in which federal policies have made the state fiscal crisis deeper and more prolonged. These include specific federal policies that have: a) reduced state revenue directly; b) prevented states from raising revenue; c) reduced funding for programs that states and localities operate; and d) imposed new costs on states. Although the $20 billion in federal fiscal relief has certainly helped to avert some severe budget cuts, particularly in Medicaid, the federal government could have helped states avert more of the damaging budget cuts and regressive tax increases they have been forced to institute.

Federal Policies Reduce State Revenue

A number of provisions in the three federal tax cuts enacted in 2001, 2002, and 2003 have reduced state as well as federal revenues, because state tax systems are tied to the federal tax code in a number of ways. One such federal tax cut is the phase-out over four years (2002 – 2005) of the federal estate tax credit that reduces the federal estate tax by a dollar for each dollar paid in *state* estate taxes. Every state in the nation levied a state estate tax that was tied to this federal credit, with most states' laws simply setting their own estate tax at a level equal to the federal tax credit; as a result, the change in federal tax law that is eliminating the federal credit effectively eliminates state estate taxes in most states. Some 17 states and the District of

[2] Isaac Shapiro and Joel Friedman, *Tax Returns: A Comprehensive Assessment of the Bush Administration's Record on Cutting Taxes*, Center on Budget and Policy Priorities, April 23, 2004.

Columbia have managed to "decouple" their estate taxes from this change in federal law and thereby to maintain their own estate taxes. But the remaining states stand to lose $6 billion through fiscal year 2005 and $14 billion through fiscal year 2007 as a result of this federal policy action.

Another federal tax cut that is causing states to lose state revenue is a business tax cut known as "bonus depreciation." As originally enacted in 2002, the federal "bonus depreciation" tax cut allowed businesses to deduct immediately 30 percent of the cost of equipment they purchase, rather than writing off the cost of the equipment in a more even manner over the equipment's useful life (i.e., over a number of years). Most states tie their depreciation tax rules to the federal depreciation rules. As a result, they would have experienced a revenue loss totaling approximately $14 billion over the period from 2002 through September 2004 (the period over which the federal depreciation tax cut was initially slated to be in effect). The majority of states, however, were reluctant to piggyback on this temporary federal tax cut during a period when state revenues were declining, and 34 states have "decoupled" and maintained their prior tax treatment of depreciation rather than adopting the new, very generous federal provision.

In 2003, Congress and the Administration made the federal depreciation tax cut even more generous, allowing firms to deduct immediately *50 percent* of the cost of equipment they purchase and extending this tax cut through December 2004. This is resulting in further state revenue losses in those states that have not decoupled from this federal tax cut. The non-decoupled states are losing approximately $4 billion through fiscal year 2005.

Federal policies also have prevented states from raising revenues in certain areas. The Internet Tax Freedom Act has barred states from collecting taxes on Internet access fees. These access fees are the monthly charges that Internet users pay to companies such as AOL for their Internet accounts.

This ban is costing states more than $4 billion over the four years of the state fiscal crisis from state fiscal year 2002 through 2005.[3] Furthermore, legislation that the House of Representatives passed at the end of 2003, and that is pending conference with the Senate version of the ban, would expand the types of Internet-related services that states are barred from taxing — thereby reducing state revenues to a much greater extent. The Multistate Tax Commission, a joint agency of state governments, estimates that the recently passed House legislation could cost states and localities an additional $4 billion to $8.75 billion per year by 2006.

A larger example is the failure of the federal government to empower states to collect sales taxes on items purchased over the Internet and through catalogs. When a person buys a product in a state, he or she pays sales tax at the time of purchase. If the person buys the same item over the Internet or from a catalog, however, the state generally cannot compel the out-of-state seller to collect and remit the sales tax to the state. This is because two Supreme Court

[3] The ban expired at the end of November 2003, and as of this writing, Congress continues to debate the form in which it will be extended. Even though there is a hiatus in the ban, it is very likely to be extended, and states and localities are acting as if it is still in place.

decisions have barred states from requiring sales taxes to be remitted when the vendor does not have a physical presence in the state. This hurts small businesses and in-state retailers, which become less competitive with Internet and catalogue sellers, and also prevents states and localities from collecting significant amounts of revenue that otherwise would be due to them.

One of the Supreme Court decisions, the 1992 *Quill* decision, made clear that Congress *can* pass legislation to empower states to tax sales made to state residents by vendors not physically present in the state. Legislation has been introduced to this end in almost every session of Congress, but it has consistently been blocked by a coalition of federal legislators, whether out of general anti-tax ideology or in response to strong pressure from the politically potent direct marketing and electronic commerce industries.

In the past, an argument against federal action to enable states to collect sales tax on catalog and Internet sales has been that as a result of differences among state sales tax systems, a requirement to collect and remit sales tax would impose too great a burden on the out-of-state vendors. In the last few years, however, states have made substantial progress under their "Streamlined Sales Tax Project" in harmonizing state sales tax systems in ways that will substantially reduce the burden of collecting these sales taxes. The time thus is ripe for Congress to enact a solution to this problem and thereby to stem the hemorrhage of state and local revenues. So far, Congress shows no sign of doing so.

Donald Bruce and William Fox of the University of Tennessee estimate that inability to collect tax on Internet purchases last year cost states about $15 billion to $16 billion in lost revenue. During the fiscal year 2002 through 2005 period — i.e., during the state fiscal crisis — the estimated revenue loss is roughly $64 billion to $71 billion, depending on exactly how fast the E-commerce sector is growing over this period. It is unclear how much of this amount could actually have been collected by the states under a politically feasible solution to this problem. At a minimum, states would have to provide some compensation to vendors for collecting the tax, and there would have to be some exemptions from the requirement of collecting the tax to protect small vendors. A reasonable estimate is that the failure of the federal government to resolve this problem is costing states at least $61 billion over the four-year course of the state fiscal crisis..[4]

Beyond the Internet Tax Freedom Act and the E-commerce problem, there are many other examples of federal preemption of state taxing authority, although the other examples tend to be harder to quantify.[5]

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[4] Donald Bruce and William F. Fox, State and Local Sales Tax Revenue Losses from E-Commerce: Estimates as of July 2004, University of Tennessee Center for Business and Economic Research.

[5] For example, federal law prohibits state and local governments from taxing airline and bus tickets purchased for interstate travel. Were states able to apply their sales taxes to such tickets, the revenue gain would be 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

Federal Mandates Increase State Costs

Over time, the federal government has placed an assortment of demands and requirements on state and local governments without providing adequate funding. Many of these unfunded mandates, or underfunded obligations, are difficult to quantify, such as new responsibilities of state and local governments in the realm of homeland security. (See the box below.) For illustrative purposes, we focus on three areas: the education of disabled children, the Leave No Child Behind law, and new election reform requirements.

- The Individuals with Disabilities Education Act (IDEA), enacted in 1975, was most recently amended in 1997. It guarantees each disabled child an assessment and an individualized education plan. When the law was enacted, the federal government promised it would fund 40 percent of the additional costs that the law requires states to incur. Federal funding to meet this goal has fallen short by close to $40 billion over four years.[6]

- The No Child Left Behind Act requires schools to take a variety of specific steps with respect to the educational testing of children. The federal government, however, has not provided the promised level of support. During the four years of the state fiscal crisis, funding has been approximately $32 billion below the levels authorized in the Act. Moreover, this is a conservative estimate, because it is unclear how much it will cost states and localities to meet all of the new mandates in this law. For example, the law 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.

- The Help America Vote Act was intended to provide federal guidelines — and resources — for local precincts to update their voting technologies. Although the federal government has made a substantial commitment to fund new election equipment in 2004, minimal funding is expected in 2005, despite the slim likelihood that all problems will be resolved by then. Overall, the funding shortfall is about $1 billion over four years.

In the past, the federal government has often placed mandates on states and localities without providing adequate funding to meet those mandates. Recently, the confluence of the state fiscal crisis and both new and old mandates has made it more difficult for state and local governments to meet these requirements. New federal requirements related to the No Child Left Behind Act are growing in cost now, at a time when states have few resources to cover such new costs. The new costs are on top of the ongoing costs of special education for children with

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be temporary. However, it has never been repealed, and over the years, it has shielded tremendous amounts of corporate profits from state taxation.

[6] These and other estimates of spending and shortfalls in funding mandates are derived from data compiled by Federal Funds Information to States (FFIS), a joint service of the National Governors Association and the National Conference of State Legislatures that tracks and reports on the fiscal impact of federal budget and policy decisions on state budgets and programs. For details on sources and methodology, see Appendix 4.

Homeland Security

Ever since the tragedy of September 11, 2001, states and localities have become subject to a host of new mandates intended to improve preparedness, strengthen food and agriculture security, upgrade communications between agencies, and safeguard the water supply. To help meet the additional costs, the federal government has increased some grants to states and localities and created new grant programs.

To this date, there has been no comprehensive study of the new homeland security initiatives undertaken by state and local governments relative to the federal aid they have received. Some estimates indicate that substantial new federal aid would be needed to meet national goals in several homeland security areas, such as telecommunications, water systems, and airport security. However, there is no consensus regarding the appropriate division of responsibility among federal, state, and local governments for providing funding for the desired upgrades.

In the absence of data assessing each state's specific homeland security needs, we have excluded homeland security costs from this analysis.

disabilities, for which the federal government has never met its promise to pay 40 percent of the tab.

The National Conference of State Legislatures recently estimated that unfunded mandates are costing states $29 billion in the current year.[7] This report considers a narrower set of mandates and finds the *four*-year cost, during the state fiscal crisis, to be approximately $73 billion.

Rising State Medicaid Costs: The Federal Role

Another issue is Medicaid. Much has been made of the rate of growth of Medicaid costs, which reflects, in large part, the rapid growth of health care costs in the economy generally. However, a portion of the growth in state Medicaid costs is due to another factor: a gradual shift in the cost of caring for low-income elderly and disabled people from the federal government to the states.

Over the last several years, an increasing share of the cost of health care for low-income elderly and disabled people who are enrolled in both Medicare and Medicaid has been shifting from Medicare, a federal program, to Medicaid, a program in which states bear an average of 43 percent of the costs. This has occurred in part because the duration of hospital stays has decreased, with greater reliance being placed on outpatient services and pharmaceuticals to

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[7] National Conference of State Legislatures, *The Mandate Monitor*, March 31, 2004. We use a more conservative estimate of the federal funding gap than NCSL uses for its study. For example, NCSL includes delays in releasing already-appropriated election reform funds and sanctions to states that do not comply with federal drunk-driving standards; those costs are not included here. NCSL also includes national estimates of state costs of meeting water quality standards for which state-by-state estimates are not available; those also are not included in this report. And, NCSL counts costs associated with health care for individuals who are dually-eligible for Medicare and Medicaid, an issue handled separately in this report.

manage health conditions. For beneficiaries covered by both Medicare and Medicaid — also known as "dual eligibles" — the Medicare program is the primary payer for hospital stays. By contrast, Medicare currently does not generally cover outpatient prescription drugs; only Medicaid does. (Medicaid also is the only payer for long-term care.)

As a result, when changes in the provision of health care lead to shorter hospital stays and greater reliance on outpatient pharmaceutical therapies, costs shift from the federal Medicare program to the federal/state Medicaid program, and hence from the federal government to the states. This shift is quite significant, since at least 35 percent of all Medicaid expenditures are made on behalf of low-income elderly and disabled individuals who are enrolled in both Medicare and Medicaid. The cost to states for outpatient prescription drugs for this population is approximately $28 billion over the four-year fiscal crisis period.

The recently enacted Medicare drug bill will leave states responsible for the large majority of these drug costs even in years after 2005, when the new Medicare prescription drug benefit takes effect. Under the drug bill, seniors and disabled individuals eligible for both Medicare and Medicaid will receive drug coverage through Medicare beginning in 2006. But, while this will produce significant savings for state Medicaid programs, states will be required to return the bulk of these savings to the federal government in perpetuity.[8] Moreover, states face new, unreimbursed costs of $1.2 billion over the next three years for implementing the new Medicare law.

Impact on State Budgets Is Large and Growing

The federal policies discussed above are costing states more than $175 billion over the four-year period of the state fiscal crisis, from state fiscal year 2002 through 2005. Over these four years, these costs to states are growing from $34 billion in 2002 to an estimated $55 billion in 2005. Two areas have particularly contributed to the rise in cost: the growth in Internet sales, and the increase in the cost of prescription drug spending for seniors and disabled individuals who are eligible for both Medicare and Medicaid. Internet sales are estimated to more than double from 2002 to 2005, while the cost of prescription drugs is expected to grow by about three-fifths.

With state general fund expenditures declining in real terms over the course of the state fiscal crisis, these federal policies have put an increasing squeeze on state governments. When measured against state budgets, these costs have been significant. Federal policies are costing an

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[8] This would mark the first time states were required to finance a portion of a new Medicare benefit. Through the so-called "clawback" mechanism, the federal government would recoup a large portion of the money saved by state Medicaid programs as a result of Medicare taking over responsibility for providing drug coverage to the dual eligibles. Starting in 2006, when the new Medicare law takes effect, states would have to pay back 90 percent of such savings. This percentage would phase down to 75 percent by 2015.

[10] All states maintain other funds in addition to the general fund. Special funds tend to have dedicated revenue sources that must be spent for narrowly defined purposes. The general fund is the part of a state's budget over which policymakers have the most discretion; therefore, this report focuses on the state general funds.

amount equal to 8.4 percent of total state general fund expenditures, or 7.4 percent if the offsetting federal fiscal relief funds are considered.[10]

The costs of federal policies during the fiscal crisis equal or exceed five percent of general fund budgets in 46 states. In 16 of these states, the costs equal or exceed ten percent of general fund budgets. Even if the offsetting fiscal relief is included, net costs still equal or exceed five percent of general fund budgets in 43 states and equal or exceed ten percent in eleven states. (See Table 1.)

- Total costs as a percentage of state budgets vary from a high of 14.4 percent in Florida to a low of 2.2 percent in Alaska, with the cost in most states falling between 6.5 percent and 11.2 percent.

- When the fiscal relief is factored in, the net costs vary from a high of 13.3 percent in Florida to 1.4 percent in Alaska, with the cost in most states falling between 5.4 percent and 9.5 percent of state budgets.

Impact Varies by State Characteristics

The states that are particularly hard hit by the federal policies described above include the poorest states and states that tend to be more reliant on federal funds for funding programs. In addition, states in which federal policies have been particularly costly include those with tax systems that are particularly dependent on sales taxes, and those that have lost significant revenues because of recent federal tax actions.

The Poorest States

The poorest states — those in which the population has the greatest need for a variety of government services and those with the least ability to raise their own funds to pay for those services — are among those most affected by the federal policies discussed in this report. Table 2 shows the ten states that are top-ranked on both of two measures of relative poverty: having a high overall poverty rate and having low per capita income.[11] Eight of the 10 poorest states — Arkansas, Mississippi, West Virginia, Louisiana, Alabama, Oklahoma, South Carolina, and Arizona — are among the 20 states with the most severe losses resulting from federal policies.

In the ten states with the highest rates of poverty and lowest per capita incomes, the net cost of the federal policies described here averages 9.2 percent of their state general fund budgets, as compared to an average of seven percent of budgets for all other states.[12]

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[11] These ten states are each among the top thirteen states in terms of both highest poverty rates and lowest per capita incomes. States are listed in order of average rank in both categories.

[12] In this analysis, we use the arithmetic average of the cost of the federal policies in each state as a percentage of that state's general fund budget. The results do not differ significantly when looking at a weighted average or at the median-state cost as a percentage of state general fund budgets.

Table 2
Ten States With High Poverty
And Low Per Capita Income

State	Poverty Rate	Per Capita Income	Net Cost of Federal Policies as Percent of General Fund Budget
Arkansas	19.8%	$23,512	10.4%
Mississippi	18.4%	$22,372	11.7%
New Mexico	17.9%	$23,941	7.7%
West Virginia	16.8%	$23,688	8.9%
Louisiana	17.5%	$25,446	10.4%
Alabama	14.5%	$25,128	9.5%
Montana	13.7%	$25,020	4.8%
Oklahoma	14.7%	$25,575	10.0%
South Carolina	14.3%	$25,400	10.1%
Arizona	13.3%	$26,183	8.6%
Top Ten Average	**15.6%**	**$24,627**	**9.2%**
All Other States	**10.3%**	**$31,207**	**7.0%**

The disparate impact of recent federal policies on high-poverty states appears to result from several factors. The underfunding of No Child Left Behind and IDEA disproportionately affects poorer states, because those programs include poverty weights in their distribution formulas and also represent a higher share of these states' overall spending. In addition, a high prevalence of elderly poor contributes to increased costs in providing prescription drugs under Medicaid.

States With Higher Reliance on Federal Funds

The states that are most dependent on federal funding appear to be disproportionately affected by the failure to adequately fund mandates and prescription drug costs. There is significant variability in the degree to which states are reliant on federal funding. According to the Census Bureau, federal aid on average provides about 20 percent of total state and local government general revenue. The 10 states with the highest reliance, however, each derive more than 24 percent of their state and local government general revenue from the federal government.

As Table 3 indicates, the ten states with the heaviest reliance on federal dollars have faced a cost from these and other federal policies that averages 8.8 percent of their state budgets, compared to an average cost of 7.1 percent for all other states. Eight of the 10 states most reliant on federal funds are among the 20 states that are experiencing the most negative impacts from the federal policies.

A number of factors affect the degree of reliance on federal funds. They include the size and the wealth of the state (factors often embedded in federal grant formulas) and the amount of revenue the state itself raises through its tax system. According to Census Bureau data, public assistance programs (primarily Medicaid) and education programs are the two largest sources of federal aid; each of the ten states that are most reliant on federal funds are among the ten states

Table 3
Ten States Most Reliant on Federal Funds

State	Reliance on Federal Funds*	Shortfall in Funding for Mandates and Prescription Drugs	Net Cost of Federal Policies as Percent of General Fund Budget
North Dakota	28.8%	5.8%	9.0%
West Virginia	27.5%	5.5%	8.9%
Montana	26.9%	6.0%	4.8%
Mississippi	26.0%	8.1%	11.7%
Vermont	25.8%	8.0%	9.2%
Tennessee	25.5%	5.0%	9.1%
Wyoming	25.1%	7.3%	9.8%
Oregon	25.0%	5.5%	5.4%
South Dakota	24.9%	6.3%	10.0%
Arkansas	24.4%	6.5%	10.4%
Top Ten Avg.	**26.0%**	**6.4%**	**8.8%**
All Other States	**18.9%**	**4.6%**	**7.1%**

*Funding to state and local governments as a percentage of state and local government general revenue, in 2000. (Census Bureau)

that receive the most funding in at least one of these program categories, as a share of state and local general revenue.

Sales Tax Reliant States

Federal policy has significantly restricted the ability of states to raise revenue through their sales taxes. Both the failure to solve the problem of how to collect taxes on sales made over the Internet and through catalogs, and the barring of taxation of Internet access fees, affect state and local sales tax revenues. States that rely heavily on their sales tax to raise revenue are more affected by these federal restrictions than those with a more diverse revenue base. The inability of states and localities to collect sales taxes on remote sales is the largest single cost to states imposed by federal policy, accounting for $1 for every $3 in total costs considered in this report.

Sales tax reliance is especially heavy in the seven states that have a sales tax but no broad personal income tax: Florida, Nevada, South Dakota, Tennessee, Texas, Washington, and Wyoming each gain at least 48 percent of their revenue from the sales tax, according to the Rockefeller Institute of Government. Four of these seven states are among the 11 states in which the cost of federal policies equals at least 10 percent of general fund revenue over the course of the fiscal crisis.

Table 4 shows the ten states that are most reliant on sales tax revenue. For these ten, the net cost of federal policies has averaged 9.8 percent of their budgets, as contrasted with an average of 6.9 percent for all other states.

Other states with large revenue losses due to federal sales tax restrictions include Arizona, Arkansas, Colorado, Louisiana, and Oklahoma. Each of these states has lost revenue

Table 4
Ten States Most Reliant on Sales Tax Revenue

State	Sales Tax Reliance*	Cost of Sales Tax Tax Policy	Net Cost of Federal Policies as Percent of General Fund Budget
Nevada	86%	7.1%	12.6%
Florida	73%	5.4%	13.3%
South Dakota	71%	5.0%	10.0%
Tennessee	64%	5.3%	9.1%
Texas	59%	4.8%	10.1%
Washington	57%	4.5%	7.4%
Hawaii	56%	3.1%	5.0%
Arizona	51%	4.5%	8.6%
Wyoming	48%	4.3%	9.8%
Mississippi	48%	4.7%	11.7%
Top Ten Avg.	**61%**	**4.9%**	**9.8%**
All Other States	**32%**	**2.7%**	**6.9%**

*As percent of state tax revenue, based on Rockefeller Institute for 2003.

equal to 4 percent or more of their budgets as a result of federal sales tax policy. (See Appendix 2.)

By contrast, the five states with no sales tax — Alaska, Delaware, Montana, New Hampshire, and Oregon — are immune to the effect of federal sales tax restrictions. In addition, the District of Columbia, Massachusetts, New York, and Virginia each gain less then 25 percent of their revenue from the sales tax. For seven of these nine states, the net cost of federal policies total less than 6 percent of their general fund budgets; for the other two of these states, the total net cost has been less than 8 percent.[13]

States with Tax Losses Related to Federal Policies

Most states have lost revenue due to the manner in which their state tax codes are tied to federal law. The revenue loss from the 2001, 2002, and 2003 federal tax law changes cost nine states an amount equal to or greater than one percent of their budgets. These states are Colorado, Delaware, Florida, Kansas, Missouri, New Mexico, North Dakota, Oregon, and West Virginia. The ten states with the greatest revenue loss from federal tax changes faced a net cost of federal policy averaging 8.7 percent of their budgets, compared to an average of 7.2 percent of budgets for all other states. (See Table 5.)

[13] Some states were "grandfathered" into the Internet Tax Freedom Act and retain sales taxes on consumer Internet access fees that other states are barred from imposing. These states include Hawaii, New Mexico, North Dakota, South Dakota, and Wisconsin. All other states have lost revenue that on average equals approximately 0.2 percent of their budgets, with Nevada bearing the greatest loss at 0.4 percent.

In response to the federal tax cuts, many states "decoupled" elements of their tax code to minimize the degree that state revenue would be affected.[14]

A large majority of the potential revenue loss stems from the estate tax and the bonus depreciation provisions. In addition to the District of Columbia, fourteen states — Illinois, Maine, Maryland, Massachusetts, Minnesota, Nebraska, New Jersey, New York, North Carolina, Ohio, Rhode Island, Virginia, Washington, and Wisconsin — have decoupled from both of the two large revenue-losing provisions. These decoupled states have faced a net cost of federal policies well below the national average, amounting to an average of 5.7 percent of their general fund budgets. (See Table 6.)

Table 5
Ten States That Lost the Most Revenue From Federal Tax Changes

State	Net Cost of Tax Changes	Net Cost of Federal Policies as Percent of General Fund Budget
Florida	2.2%	13.3%
Colorado	1.8%	10.3%
North Dakota	1.8%	9.0%
Delaware	1.7%	3.5%
West Virginia	1.6%	8.9%
New Mexico	1.2%	7.7%
Missouri	1.1%	12.0%
Kansas	1.1%	8.8%
Oregon	1.0%	5.4%
New Hampshire	0.9%	7.8%
Average	**1.4%**	**8.7%**
All Other States	**0.2%**	**7.2%**

The Fiscal Crisis

The costs stemming from these federal policies have added to the other forces creating the state fiscal crisis, including the economic slowdown, the stock market decline, and the lack of job growth during the recovery. Federal policies have contributed substantially to the depth of the state fiscal crisis and are impeding the ability of states to recover their fiscal health.

States began to fall into fiscal crisis in state fiscal year 2002. Over the past three years — 2002 to 2004 — states have closed combined deficits of about $190 billion. States now face additional deficits of approximately $40 billion for state fiscal year 2005.

These deficits have *not*, as some assert, stemmed primarily from a state spending spree in the 1990s. State spending growth in the 1990s (adjusted for inflation and population changes), was low by historical standards; it was lower than or equal to spending growth in every other decade since World War II. (See Figure 2.) Furthermore, most of the growth in state spending that did occur during the 1990s was in education, health care, and corrections — areas where

[14] Nine states — Alabama, Iowa, Louisiana, Missouri, Montana, North Dakota, Oklahoma, Oregon, and Utah — have actually gained some revenue as a result of the federal tax changes, because they allow taxpayers to deduct federal incomes taxes paid; smaller federal tax bills have meant smaller state deductions and higher state tax bills. Such revenue gains are factored into this analysis. Only three of the states, Iowa, Louisiana, and Oklahoma, gained more revenue than they lost from other changes in tax law.

costs were rising, need was growing, and/or voters were demanding improvements. *Nine out of ten* new state dollars (adjusted for inflation) went into these three areas.[15]

Nor did states fail to prepare for the downturn. States built up their rainy day funds during the 1990s, raising total reserves to their highest level in 20 years. By the end of fiscal year 2000, states had total year-end balances (including both general-fund balances and rainy-day funds) of almost $50 billion, or 10.4 percent of expenditures. Prior to the recession of the early 1990s, states had total balances of only $12.5 billion, or 4.8 percent of expenditures. As a result, states were better prepared for this economic downturn than they were for the recession of the early 1990s. But those reserves have largely been depleted as a result of the unusually large state revenue declines of the past few years.

Table 6
States That Decoupled from Estate Tax and Bonus Depreciation Changes

State	Net Cost of Tax Changes	Net Cost of Federal Policies as Percent of General Fund Budgets
D.C.	0.0%	3.3%
Rhode Island	0.0%	5.1%
Maryland	0.0%	5.2%
Wisconsin	0.0%	5.3%
Ohio	0.0%	5.4%
Virginia	0.0%	5.8%
Maine	0.0%	6.2%
Washington*	0.0%	7.4%
Nebraska	0.0%	8.0%
New Jersey	0.1%	4.4%
Massachusetts	0.1%	3.5%
Illinois	0.1%	6.7%
North Carolina	0.1%	6.7%
Minnesota	0.2%	4.9%
New York	0.7%	7.8%
Average	**0.1%**	**5.7%**
All Other States	**0.6%**	**8.2%**

*Washington has no corporate income tax and was therefore unaffected by the federal changes in bonus depreciation.

State revenues, adjusted for inflation and policy changes, declined for eight consecutive quarters during this fiscal crisis. Total state tax collections for the 12 months ending in June 2003 (the period that corresponds to fiscal year 2003 in most states) were about $21.6 billion less, in nominal terms, than for the 12-month period ending in June 2001, according to the U.S. Census Bureau. When adjusted to compensate for inflation and population growth, revenues in this 12-month period were $56.9 billion lower than in 2001. State taxes made up a smaller share of the economy in the last fiscal year than at any time in the previous thirty years, with the exception of the double-dip recession of the early 1980s. Revenues have begun to grow again in fiscal year 2004, but growth is not yet strong.[16]

States dealt with the revenue decline in large part by cutting their budgets. Total state spending in fiscal year 2004 is about $73 billion less than it would have been if real per-capita spending during 2001-2004 had continued to grow at the same rate it did during the 1990s. (During the 1990s, real per-capita spending grew about 2 percent annually, a lower rate than in previous decades.) Real per-capita spending will be 5.4 percent lower in fiscal year 2004 than in

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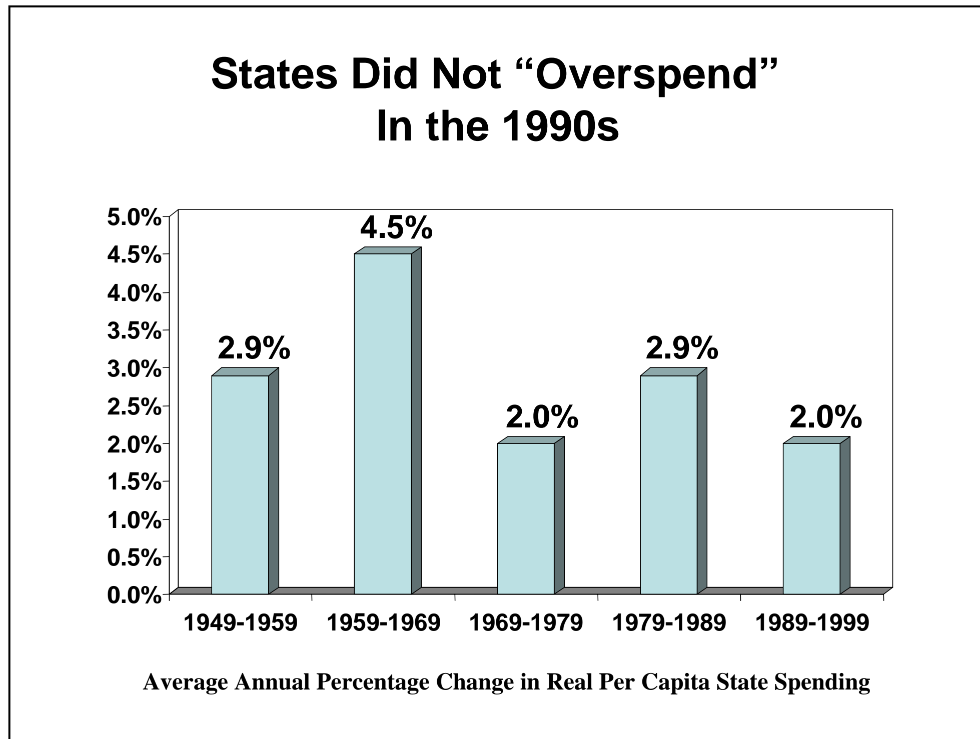
[15] John Springer, *Did States Spend their Way into this Fiscal Crisis?* Center on Budget and Policy Priorities, August 1, 2003. Liz McNichol, *Fiscal Crisis Is Shrinking State Budgets,* Center on Budget and Policy Priorities, February 25, 2004.

[16] Nicholas W. Jenny, *Growth Finally Stronger at End of 2003*, Rockefeller Institute of Government, March 2004.

Figure 2



2001. Total state spending as a share of GDP is projected to be the lowest in over fifteen years.[17] This has been achieved through cuts in a range of programs.

Some 34 states have cut eligibility for public health insurance, primarily through cuts in Medicaid and/or the State Children's Health Insurance Program. Between 1.2 million and 1.6 million people are losing coverage, about half of whom are children. Most of these cuts involved measures to scale back health care coverage for children and parents in families in which the parents work at low-wage jobs. For example, cutbacks in Texas will end coverage for nearly 170,000 children in low-income working families, while Connecticut reduced Medicaid eligibility for about 19,000 parents with incomes between 100 percent and 150 percent of the poverty line.

In addition, at least 32 states have cut eligibility for child care subsidies targeted on low- and moderate-income families or otherwise limited such families' access to child care. In 20 states, child care assistance is no longer available to low-income working families newly applying for such help; such families go on waiting lists instead.[18] At the end of last year, for example, 48,000 children were on the child care waiting list in Florida. Tennessee no longer

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[17] Elizabeth McNichol and Makeda Harris. *Many States Cut Budgets as Fiscal Squeeze Continues*, Center on Budget and Policy Priorities, April 26, 2004.
[18] Danielle Ewen and Katherine Hart, *State Budget Cuts Create A Growing Child Care Crisis For Low-Income Working Families*, Children's Defense Fund, March 2003.

even accepts child care applications from families not receiving TANF cash assistance. Yet in many cases, a child care subsidy is necessary for a low-income parent to work.

Although states usually show great reluctance to cut K-12 education, a substantial number of states have instituted cuts. Per-pupil K-12 education spending, adjusted for inflation, dropped in 34 states between 2002 and 2004.[19] This has resulted in the imposition of new or higher fees for textbooks and courses, shorter school days, reduced personnel, reduced transportation, and a variety of other types of cutbacks. States throughout the country also are cutting higher education — leading to double-digit increases in public college and university tuition and significantly reduced course offerings. The tuition increases are creating barriers to higher education for a number of low- and moderate-income families.

In addition to these cuts enacted over the past three years, further budget cuts have been proposed for fiscal year 2005. At least five states have proposed additional reductions in eligibility for health care programs. Thirteen states are developing budgets that will cut funding for K-12 education and related programs below the level needed to maintain current services, and ten are expected to cut higher education funding and/or require significant increases in tuition and fees at public colleges and universities. Eight states have proposed measures that would restrict eligibility for child care programs for the upcoming year.

Federal Policies Could Help

As federal budgets are written for the next several years, many programs are likely to be squeezed. The federal tax cuts enacted in the past three years have added substantially to the federal budget deficit. (The tax cuts will cost $275 billion in 2004 alone, of which $85 billion will go to the one percent of Americans with the highest incomes.) So have increases in defense spending, the decline in the economy, and other factors. The deficit is now expected to be $477 billion in fiscal year 2004, according to the Congressional Budget Office. If the tax cuts are extended and other anticipated policies (including reform to the Alternative Minimum Tax) are implemented, federal deficits are expected to remain above $340 billion every year in the coming decade and to total approximately $4.6 trillion over the decade.[20] (See Figure 3.)

These high budget deficits increasingly will constrain the ability of the federal government to fund other priorities, including grants-in-aid to states. The Administration has proposed reducing the total buying power of federal grants to states and localities for purposes other than Medicaid — including grants for education, transportation, environmental protection, and other program areas — by 3.5 percent, or approximately $6 billion, in fiscal year 2005. This would hamper the ability of states and localities to recover from the fiscal crisis.

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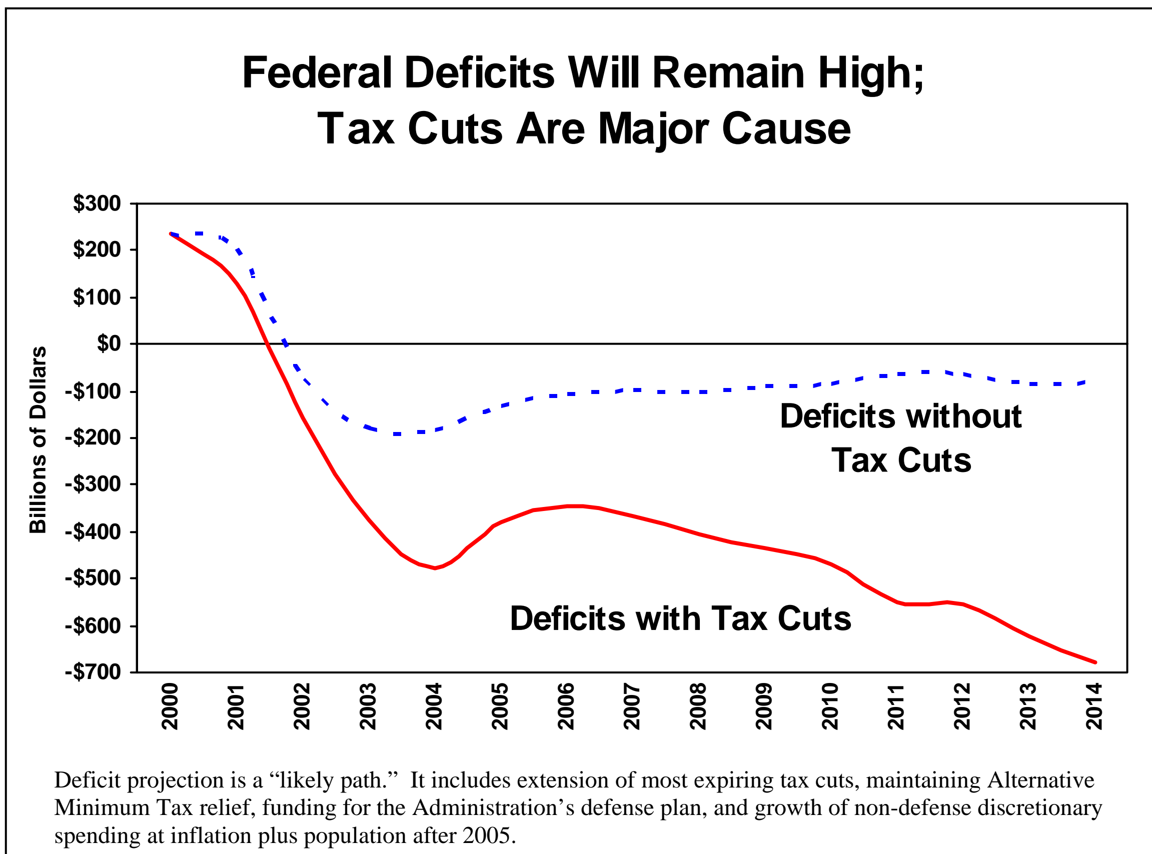
[19] Andrew Reschovsky, "The Impact of State Government Fiscal Crises on Local Governments and Schools", *State and Local Government Review*, Spring 2004 (forthcoming).
[20] Isaac Shapiro and Joel Friedman, *Tax Returns: A Comprehensive Assessment of the Bush Administration's Record on Cutting Taxes*, Center on Budget and Policy Priorities, April 23, 2004.

Figure 3



Deficit projection is a "likely path." It includes extension of most expiring tax cuts, maintaining Alternative Minimum Tax relief, funding for the Administration's defense plan, and growth of non-defense discretionary spending at inflation plus population after 2005.

While the $20 billion in federal fiscal relief that was enacted in mid-2003 has been very helpful in averting some damaging state budget cuts, this amount falls far short of the relief that the federal government could — and should — be providing to states during the current period of economic sluggishness and state fiscal crisis. Most states are required to balance their operating budgets even in economic downturns. The budget cuts and tax increases they enact during such times pull money out of the economy, thereby slowing the economy even more and causing a loss of jobs.

Only the federal government can remedy this problem. It need not balance its budget in a recession; it can run deficits. (Running large persistent federal budget deficits when the economy is healthy can ultimately harm the economy, but running deficits during economic slumps is helpful. It puts more money into the economy and stimulates it.) It therefore makes sense for the federal government to provide significant fiscal relief to states when the economy is weak. Even though the economy has begun to recover, state fiscal conditions remain weak. There is still need for federal assistance.

It also makes sense for the federal government to assist states to a greater degree with the cost of providing health care to lower-income elderly and disabled people and thereby to cushion the fiscal effects of the recent changes in health care practice that have shifted costs from the federal government to the states. And it makes sense for the federal government to fund more adequately the mandates it imposes on state and local governments and to resolve the problems

associated with federal preemption of state tax bases. With the exception of the preemption issues, addressing these matters would require federal funds.

There thus is a choice for federal policymakers. It is a choice between maintaining in full the extremely generous federal tax cuts for high-income households and moderating those tax cuts and instituting more equitable policies toward states that help state and local governments to preserve important endeavors in areas such as health care, child care, and education — areas on which low- and middle-income state residents rely — and avert regressive tax and fee increases. At bottom, this is a question of which course represents the higher priority for the nation.

Appendix 1
Cost to States of Federal Policy
(in Millions of Dollars)

	Federal Tax Changes	Internet Sales	Internet Access	Special Education	No Child Left Behind	Election Reform	Prescription Drugs	**Total Costs**	Fiscal Relief	**Net Costs**
Alabama	$90	$814	$57	$625	$500	$10	$295	$2,391	-$266	$2,126
Alaska	8	0	0	111	32	3	51	206	-76	129
Arizona	115	1,069	91	608	515	11	160	2,569	-346	2,224
Arkansas	33	658	34	391	309	6	203	1,634	-176	1,458
California	2,253	8,018	822	4,050	4,237	73	3,973	23,426	-2,439	20,987
Colorado	408	922	67	497	315	9	348	2,568	-239	2,329
Connecticut	198	874	63	460	259	8	490	2,352	-250	2,102
DC	0	167	8	67	309	3	44	597	-94	504
Delaware	176	0	0	106	97	3	59	441	-75	367
Florida	1,826	4,304	248	2,290	1,444	37	2,028	12,177	-948	11,229
Georgia	192	2,030	134	1,081	932	18	610	4,997	-518	4,479
Hawaii	57	483	0	151	84	3	69	849	-80	768
Idaho	22	204	21	184	125	3	40	599	-85	514
Illinois	69	2,429	209	1,850	1,268	27	1,038	6,890	-770	6,120
Indiana	56	984	84	978	414	13	564	3,093	-375	2,718
Iowa	-200	506	38	452	192	7	227	1,222	-185	1,037
Kansas	198	612	42	385	239	6	212	1,693	-154	1,539
Kentucky	82	724	44	593	474	9	620	2,546	-276	2,270
Louisiana	-28	1,370	69	617	647	10	373	3,058	-309	2,749
Maine	0	197	20	223	149	3	172	764	-115	649
Maryland	0	893	70	698	417	12	450	2,539	-333	2,206
Massachusetts	55	920	100	1,012	682	14	998	3,780	-549	3,231
Michigan	474	2,293	145	1,379	1,088	22	798	6,200	-655	5,545
Minnesota	115	1,240	77	686	344	11	575	3,048	-362	2,686
Mississippi	53	624	37	391	416	6	308	1,835	-211	1,625
Missouri	320	1,194	83	858	469	12	784	3,721	-376	3,345
Montana	10	0	0	120	145	3	45	323	-73	250
Nebraska	0	323	26	267	173	4	163	955	-109	847
Nevada	71	588	36	241	187	4	81	1,207	-105	1,102
New Hampshire	45	0	0	185	118	3	129	480	-84	396
New Jersey	54	1,549	130	1,385	648	19	936	4,720	-561	4,159
New Mexico	195	592	0	326	251	4	65	1,433	-136	1,297
New York	1,068	4,815	363	2,771	2,937	42	2,831	14,827	-2,164	12,663
North Carolina	49	1,354	113	1,120	746	18	1,015	4,416	-552	3,864
North Dakota	63	119	0	86	73	3	45	390	-71	318
Ohio	0	2,034	175	1,494	1,034	25	1,005	5,767	-771	4,996
Oklahoma	-16	915	61	537	439	8	179	2,122	-218	1,904
Oregon	191	0	0	462	308	8	315	1,284	-217	1,068
Pennsylvania	139	2,034	197	1,509	1,094	28	1,227	6,228	-900	5,328
Rhode Island	0	168	23	192	133	3	146	665	-102	564
South Carolina	118	705	52	669	452	9	294	2,300	-255	2,044
South Dakota	25	180	0	106	69	3	50	433	-72	361
Tennessee	38	1,668	88	786	476	13	357	3,426	-424	3,003
Texas	508	5,328	375	3,075	2,670	44	1,345	13,345	-1,278	12,067
Utah	70	482	37	340	135	4	80	1,148	-117	1,031
Vermont	18	96	11	94	86	3	104	413	-83	330
Virginia	0	1,097	84	1,047	458	16	588	3,290	-415	2,875
Washington	0	1,916	132	746	408	13	594	3,810	-401	3,409
West Virginia	187	317	20	315	253	4	94	1,190	-125	1,065
Wisconsin	0	975	0	784	404	12	564	2,738	-352	2,385
Wyoming	16	117	7	83	97	3	30	353	-67	286
Territories and Unallocated Funds				512	2,505	3		3,019	-11	3,008
TOTAL	**$9,421**	**$60,900**	**$4,491**	**$39,994**	**$32,257**	**$639**	**$27,777**	**$175,479**	**-$20,092**	**$155,386**

Appendix 2
Costs to States of Federal Policy
(as a Percentage of General Fund Budgets)

	Federal Tax Changes	Internet Sales	Internet Access	Special Education	No Child Left Behind	Election Reform	Prescription Drugs	**Total Costs**	Fiscal Relief	**Net Costs**
Florida	2.2%	5.1%	0.3%	2.7%	1.7%	0.0%	2.4%	14.4%	-1.1%	13.3%
Nevada	0.8%	6.7%	0.4%	2.8%	2.1%	0.1%	0.9%	13.8%	-1.2%	12.6%
Missouri	1.1%	4.3%	0.3%	3.1%	1.7%	0.0%	2.8%	13.4%	-1.4%	12.0%
Mississippi	0.4%	4.5%	0.3%	2.8%	3.0%	0.0%	2.2%	13.2%	-1.5%	11.7%
Louisiana	-0.1%	5.2%	0.3%	2.3%	2.5%	0.0%	1.4%	11.6%	-1.2%	10.4%
Arkansas	0.2%	4.7%	0.2%	2.8%	2.2%	0.0%	1.4%	11.6%	-1.3%	10.4%
Colorado	1.8%	4.1%	0.3%	2.2%	1.4%	0.0%	1.5%	11.4%	-1.1%	10.3%
South Carolina	0.6%	3.5%	0.3%	3.3%	2.2%	0.0%	1.5%	11.4%	-1.3%	10.1%
Texas	0.4%	4.5%	0.3%	2.6%	2.2%	0.0%	1.1%	11.2%	-1.1%	10.1%
Oklahoma	-0.1%	4.8%	0.3%	2.8%	2.3%	0.0%	0.9%	11.2%	-1.1%	10.0%
South Dakota	0.7%	5.0%	0.0%	2.9%	1.9%	0.1%	1.4%	12.0%	-2.0%	10.0%
Wyoming	0.5%	4.0%	0.2%	2.8%	3.3%	0.1%	1.0%	12.1%	-2.3%	9.8%
Alabama	0.4%	3.7%	0.3%	2.8%	2.2%	0.0%	1.3%	10.7%	-1.2%	9.5%
Vermont	0.5%	2.7%	0.3%	2.6%	2.4%	0.1%	2.9%	11.6%	-2.3%	9.2%
Tennessee	0.1%	5.1%	0.3%	2.4%	1.4%	0.0%	1.1%	10.4%	-1.3%	9.1%
North Dakota	1.8%	3.4%	0.0%	2.4%	2.1%	0.1%	1.3%	11.0%	-2.0%	9.0%
West Virginia	1.6%	2.6%	0.2%	2.6%	2.1%	0.0%	0.8%	9.9%	-1.0%	8.9%
Kansas	1.1%	3.5%	0.2%	2.2%	1.4%	0.0%	1.2%	9.6%	-0.9%	8.8%
Arizona	0.4%	4.1%	0.3%	2.3%	2.0%	0.0%	0.6%	9.9%	-1.3%	8.6%
Nebraska	0.0%	3.1%	0.2%	2.5%	1.6%	0.0%	1.5%	9.0%	-1.0%	8.0%
Kentucky	0.3%	2.5%	0.2%	2.1%	1.6%	0.0%	2.2%	8.8%	-1.0%	7.9%
New Hampshire	0.9%	0.0%	0.0%	3.7%	2.3%	0.1%	2.5%	9.5%	-1.7%	7.8%
New York	0.7%	2.9%	0.2%	1.7%	1.8%	0.0%	1.7%	9.1%	-1.3%	7.8%
New Mexico	1.2%	3.5%	0.0%	1.9%	1.5%	0.0%	0.4%	8.5%	-0.8%	7.7%
Washington	0.0%	4.2%	0.3%	1.6%	0.9%	0.0%	1.3%	8.3%	-0.9%	7.4%
Georgia	0.3%	3.3%	0.2%	1.8%	1.5%	0.0%	1.0%	8.1%	-0.8%	7.3%
Utah	0.5%	3.3%	0.3%	2.3%	0.9%	0.0%	0.6%	7.9%	-0.8%	7.0%
Michigan	0.6%	2.9%	0.2%	1.7%	1.4%	0.0%	1.0%	7.7%	-0.8%	6.9%
California	0.7%	2.6%	0.3%	1.3%	1.4%	0.0%	1.3%	7.6%	-0.8%	6.8%
Illinois	0.1%	2.7%	0.2%	2.0%	1.4%	0.0%	1.1%	7.5%	-0.8%	6.7%
North Carolina	0.1%	2.3%	0.2%	1.9%	1.3%	0.0%	1.8%	7.6%	-1.0%	6.7%
Idaho	0.3%	2.6%	0.3%	2.3%	1.6%	0.0%	0.5%	7.5%	-1.1%	6.4%
Indiana	0.1%	2.3%	0.2%	2.3%	1.0%	0.0%	1.3%	7.2%	-0.9%	6.3%
Pennsylvania	0.2%	2.4%	0.2%	1.8%	1.3%	0.0%	1.4%	7.3%	-1.1%	6.3%
Maine	0.0%	1.9%	0.2%	2.1%	1.4%	0.0%	1.7%	7.3%	-1.1%	6.2%
Virginia	0.0%	2.2%	0.2%	2.1%	0.9%	0.0%	1.2%	6.6%	-0.8%	5.8%
Iowa	-1.1%	2.8%	0.2%	2.5%	1.0%	0.0%	1.2%	6.6%	-1.0%	5.6%
Ohio	0.0%	2.2%	0.2%	1.6%	1.1%	0.0%	1.1%	6.2%	-0.8%	5.4%
Oregon	1.0%	0.0%	0.0%	2.3%	1.6%	0.0%	1.6%	6.5%	-1.1%	5.4%
Wisconsin	0.0%	2.2%	0.0%	1.8%	0.9%	0.0%	1.3%	6.1%	-0.8%	5.3%
Maryland	0.0%	2.1%	0.2%	1.6%	1.0%	0.0%	1.1%	5.9%	-0.8%	5.2%
Rhode Island	0.0%	1.5%	0.2%	1.7%	1.2%	0.0%	1.3%	6.0%	-0.9%	5.1%
Hawaii	0.4%	3.1%	0.0%	1.0%	0.5%	0.0%	0.5%	5.5%	-0.5%	5.0%
Minnesota	0.2%	2.3%	0.1%	1.3%	0.6%	0.0%	1.1%	5.6%	-0.7%	4.9%
Montana	0.2%	0.0%	0.0%	2.3%	2.8%	0.1%	0.9%	6.2%	-1.4%	4.8%
New Jersey	0.1%	1.6%	0.1%	1.5%	0.7%	0.0%	1.0%	5.0%	-0.6%	4.4%
Connecticut	0.4%	1.8%	0.1%	0.9%	0.5%	0.0%	1.0%	4.8%	-0.5%	4.2%
Delaware	1.7%	0.0%	0.0%	1.0%	0.9%	0.0%	0.6%	4.3%	-0.7%	3.5%
Massachusetts	0.1%	1.0%	0.1%	1.1%	0.7%	0.0%	1.1%	4.1%	-0.6%	3.5%
DC	0.0%	1.1%	0.1%	0.4%	2.0%	0.0%	0.3%	3.9%	-0.6%	3.3%
Alaska	0.1%	0.0%	0.0%	1.2%	0.3%	0.0%	0.5%	2.2%	-0.8%	1.4%
TOTAL	**0.5%**	**2.9%**	**0.2%**	**1.9%**	**1.5%**	**0.0%**	**1.3%**	**8.4%**	**-1.0%**	**7.4%**

Appendix 3
Total Costs to State by Year
(in Millions of Dollars)

	2002	*2003*	*2004*	*2005*	***2002-2005***
Alabama	$451	$519	$721	$700	$2,391
Alaska	46	48	50	62	206
Arizona	487	578	700	804	2,569
Arkansas	314	366	442	513	1,634
California	4,023	5,097	6,501	7,806	23,426
Colorado	454	589	758	767	2,568
Connecticut	416	495	658	782	2,352
DC	155	165	171	106	597
Delaware	63	84	158	137	441
Florida	2,133	2,660	3,497	3,887	12,177
Georgia	923	1,105	1,353	1,616	4,997
Hawaii	147	188	234	279	849
Idaho	116	134	162	187	599
Illinois	1,362	1,559	1,846	2,122	6,890
Indiana	631	716	818	928	3,093
Iowa	273	297	296	355	1,222
Kansas	322	403	488	480	1,693
Kentucky	503	582	673	788	2,546
Louisiana	567	692	870	928	3,058
Maine	162	183	197	222	764
Maryland	508	580	673	778	2,539
Massachusetts	777	874	1,016	1,113	3,780
Michigan	1,134	1,412	1,739	1,914	6,200
Minnesota	579	675	861	933	3,048
Mississippi	343	404	503	586	1,835
Missouri	682	781	1,105	1,153	3,721
Montana	71	84	90	78	323
Nebraska	192	220	254	289	955
Nevada	214	270	331	392	1,207
New Hampshire	101	113	121	145	480
New Jersey	963	1,093	1,251	1,413	4,720
New Mexico	256	328	424	426	1,433
New York	3,624	3,098	3,733	4,372	14,827
North Carolina	877	1,008	1,181	1,350	4,416
North Dakota	71	91	114	113	390
Ohio	1,132	1,300	1,547	1,788	5,767
Oklahoma	417	483	581	641	2,122
Oregon	260	325	389	310	1,284
Pennsylvania	1,212	1,399	1,662	1,955	6,228
Rhode Island	142	161	170	193	665
South Carolina	452	522	620	706	2,300
South Dakota	81	101	117	133	433
Tennessee	633	759	940	1,094	3,426
Texas	2,404	2,905	3,723	4,313	13,345
Utah	213	249	347	339	1,148
Vermont	80	95	113	126	413
Virginia	682	769	859	981	3,290
Washington	711	850	1,040	1,209	3,810
West Virginia	229	279	347	335	1,190
Wisconsin	556	634	720	827	2,738
Wyoming	65	79	94	114	353
Territories and Unallocated Funds	581	716	786	936	3,019
TOTAL	**$33,793**	**$39,116**	**$48,045**	**$54,524**	**$175,479**

Appendix 4
Notes on Sources and Methodology

The data for this analysis were derived from a variety of sources.

Federal Tax Changes. Wherever possible, estimates from state revenue departments or legislative fiscal offices were used. Where in-state estimates were unavailable, estimates were computed using data from a number of official sources. For the estate tax, we used actual state fiscal year 2002 collections and Congressional Budget Office projections to estimate estate tax revenue prior to the enactment of the federal tax cut. We then made adjustments based on enacted changes to the federal estate tax and the state estate tax credit, using state-by-state data from the Internal Revenue Service on estates subject to tax. For bonus depreciation, a Congressional Research Service estimate of total state revenue impact was adjusted using revenue data from the Joint Committee on Taxation and state-by-state personal income tax and corporate income tax revenue data from the Census Bureau. For Section 179 expensing, estimates were derived from Joint Committee on Taxation estimates of federal revenue loss, also using state-by-state data from the Census Bureau.[21] For states that gained revenue due to a state deduction of federal income taxes paid, estimates were obtained from the Iowa Department of Revenue, the Oregon Legislative Revenue Office, and the Institute for Taxation and Economic Policy model.

Internet Sales. Figures were based on Bruce and Fox (2001) estimates of total sales tax revenue loss from E-Commerce for 2002-2005, apportioned to the states using their state-by-state estimates for 2001 and 2006.[22]

Internet Tax Freedom Act. Internet usage estimates were based on Jupiter Research projections of U.S. households with broadband and dial-up Internet access.[23] These data were then adjusted based on regional usage data from the Pew Internet and American Life Project to produce estimates of dial-up and broadband usage by state.[24] Revenue loss estimates assume that state and local governments all would have applied their general sales tax rate to consumer Internet access charges. In states where local sales tax rates varied across the state, an average local sales tax rate was estimated using Census data on sales tax revenue. We use a conservative estimate of average Internet access fees, $15 per month for dial-up access and $35 per month for broadband access, though several of the most popular services, such as America Online for dial-up and cable modem providers for broadband, generally charge more.

Unfunded Mandates. For special education and the No Child Left Behind programs, state and local data were compiled by Federal Funds Information to States (FFIS), a joint service

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[21] For more information on these calculations, see Elizabeth C. McNichol, Iris J. Lav and Joseph Llobrera, *States Can Retain Their Estate Taxes Even as the Federal Estate Tax Is Phased Ou*", February 4, 2003; Nicholas Johnson, *States Can Avoid Substantial Revenue Loss by Decoupling from New Federal Tax Provision*, April 29, 2002; and Nicholas Johnson, *Federal Tax Changes Likely to Cost States Billions of Dollars in Coming Years*, June 5, 2003.

[22] Donald Bruce and William F. Fox, *State and Local Sales Tax Revenue Losses from E-commerce: Updated Estimates,* September 2001.

[23] Robyn Greenspan, "Broadband's Reach Gets Broader," February 7, 2003, published at http://www.clickz.com/stats/markets/broadband/article.php/10099_1580601.

[24] Pew Internet and American Life Project, "Internet Use by Region in the United States", August 27, 2003.

of the National Governors Association and the National Conference of State Legislatures that tracks and reports on the fiscal impact of federal budget and policy decisions on state budgets and programs, based on information from the Department of Education. Estimates for No Child Left Behind exclude programs funded by the Fund for Improvement of Education, the composition of which has changed since the law was enacted; programs that do not directly affect state and local education spending; and programs without a specifically authorized funding level. Election reform funding estimates are also compiled by FFIS, based on state allocations set out in the Help America Vote Act of 2002.

For all of these programs, some funds were allocated to territories such as Puerto Rico or to tribes, or not allocated at all. We assume that part of the overall shortfall for these programs would be attributable to these purposes, and include estimates for these categories under "Territories and Unallocated Funds" in the tables.

Medicaid Dual Eligibles. Estimates of prescription drug spending in 2002 were obtained from the Kaiser Commission on Medicaid and the Uninsured.[25] Estimates for 2003 to 2005 were calculated by adjusting the Kaiser estimates for 2002, using Congressional Budget Office projections of spending and enrollment growth from 2002 to 2005 as reflected in CBO's March 2003 baseline, adjusted by Census Bureau estimates of the growth of the elderly population in each state. Data for states with large numbers of beneficiaries enrolled in managed care, such as Arizona and Tennessee, may not be accurate because states do not collect detailed spending data from managed care organizations.

To determine the current size of state general fund budgets, we obtained the most recently available information from publications, public officials, or other analysts in each state. Historical data were obtained from the National Association of State Budget Officers.[26] For states that have not enacted a fiscal year 2005 budget, we use governors' proposed budgets. For some states, such as Alabama and Michigan, state budget figures were adjusted to include special fund spending on education spending that, in other states, would normally be part of the general fund.

Finally, all data were adjusted where necessary to reflect the fiscal year for each state. Most state fiscal years run from July to June, except for New York (April to March), Texas (September to August), and Alabama and Michigan (both October to September).

In all tables, totals may not add due to rounding.

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[25] Brian Bruen and John Holahan, *Shifting the Cost of Dual Eligibles: Implications for States and the Federal Government*, November 2003; and Kaiser Commission on Medicaid and the Uninsured, *Dual Eligibles: Enrollment and Spending, by State, 2002*, February 2004.
[26] National Governors Association and National Association of State Budget Officers, "The Fiscal Survey of States", December 2003.