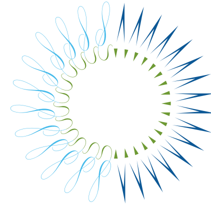

THE IMPACT OF THE FISCAL CLIFF ON THE STATES

NOVEMBER 2012

The Pew Center on the States is a division of The Pew Charitable Trusts that identifies and advances effective solutions to critical issues facing states. Pew is a nonprofit organization that applies a rigorous, analytical approach to improve public policy, inform the public, and stimulate civic life.

The Pew Fiscal Federalism Initiative examines the federal-state relationship and the impact of federal spending, tax policy, and regulatory decisions on the states to enrich policy debates about long-term fiscal stability at all levels of government.

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For additional information on the Pew Charitable Trusts and the Fiscal Federalism Initiative, please visit www.pewtrusts.org or email us at fiscal-federalism@pewtrusts.org.

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Executive Summary

The "fiscal cliff," a series of federal tax increases and spending cuts set to occur in January 2013, looms large in current fiscal policy debates. Discussions about the effect of the $491 billion in tax increases and spending cuts included in the fiscal cliff have focused on the national budget and economy. But federal and state finances are closely intertwined, and federal tax increases and spending cuts will have consequences for states' budgets.

There is a great deal of uncertainty about whether any or all of the policies in the fiscal cliff will be addressed temporarily or permanently, individually or as a package. Given this, it is useful to look at the different components of the fiscal cliff; examine how federal and state tax codes, revenues, budgets, and spending are linked; and provide a framework for assessing how states could be affected.

For example, almost all states have tax codes linked to the federal code. When certain expiring tax provisions within the fiscal cliff are analyzed independently, they could increase state revenues.

- For at least 25 states and the District of Columbia, lower federal deductions would mean more income being taxed at the state level, resulting in higher state tax revenues.
- At least 30 states and the District of Columbia would see revenue increases because they have tax credits based on federal credits that would be reduced.
- At least 23 states have adopted federal rules for certain deductions related to business expenses. The scheduled expiration of these provisions would mean higher taxable corporate income and hence higher state tax revenues in the near term.
- Thirty-three states would collect more revenue as a result of scheduled changes in the estate tax.

However, six states allow taxpayers to deduct their federal income taxes on their state tax returns. For these states, higher federal taxes would mean a higher state tax deduction, reducing state tax revenues.

The scheduled spending cuts also would have a significant impact on states. Federal grants to the states constitute about one-third of total state revenues, and federal spending affects states' economic activity and thus their amount of tax revenues.

- Roughly 18 percent of federal grant dollars flowing to the states would be subject to the fiscal year 2013 across-the-board cuts under the sequester, according to the Federal Funds Information for States, including funding for education programs, nutrition for low-income women and children, public housing, and other programs.
- Because states differ in the type and amount of federal grants they receive, their exposure to the grant cuts would vary. In all, the federal grants subject to sequester make up more than 10 percent of South Dakota's revenue, compared with less than 5 percent of Delaware's revenue.
- Federal spending on defense accounts for more than 3.5 percent of the total gross domestic product (GDP) of the states, but there is wide variation across the states. Federal defense spending makes up almost 15 percent of Hawaii's GDP, compared with just 1 percent of state GDP in Oregon.

There is still a lot of uncertainty about how the fiscal cliff would affect states. States might amend their own tax codes in response to the federal tax changes. How across-the-board program cuts under the sequester would actually be implemented is still unclear. In addition, the effect on individuals from the tax increases and spending cuts will vary by state, and states will face difficult choices in addressing these impacts.

Decisions will be made even amid this uncertainty. The public interest is best served by an enriched policy debate that incorporates implications for all levels of government and leads to long-term fiscal stability for the nation as a whole.

FISCAL FEDERALISM INITIATIVE

The federal-state relationship is in the spotlight because of enormous fiscal challenges facing all levels of government. Over the coming years, the federal government will consider fiscal policy changes to address the federal deficit that will undoubtedly impact the flow of federal funds to states and, thus, affect state revenues. This will have a significant effect on state budgets at a time when states have less capacity than in the past to respond to changes in federal tax and spending policies.

Federal and state policy makers require good data and thoughtful analysis to engage in a meaningful debate and truly understand the full costs and benefits to all levels of government in changing their tax and spending policies. Unfortunately, the increasing need to understand the evolving relationship between the federal and state governments coincides with reduced capacity to do so. Many government offices and committees that once reviewed federal-state issues were disbanded in the 1980s and 1990s, and the few that remain have been given other priorities.[1]

The Fiscal Federalism Initiative looks at the federal-state relationship and the impact of federal spending, tax policy, and regulatory decisions on the states. The initiative will provide data and analysis to help policy makers understand shared challenges and promising approaches. New opportunities for ongoing discussions among federal and state decision makers will enrich fiscal policy debates about solutions for long-term fiscal stability at all levels of government, benefiting the nation as a whole.

For more information, visit **www.pewstates.org/fiscal-federalism**.

The Fiscal Cliff

America is speeding toward a "fiscal cliff," a series of expiring tax policies and spending cuts set to take effect in January 2013. Decisions about whether to extend the tax provisions and repeal the spending cuts or to allow the entire or any part of the fiscal cliff to occur will have implications for an increasingly unsustainable federal deficit and debt and a fragile economic recovery. The repercussions for states and their economies are less discussed but relevant in considering the full costs and benefits of these policy choices.

The federal debt currently stands at 73 percent of GDP, the highest level since 1950.[2] Allowing the fiscal cliff to occur would achieve $491 billion in deficit reduction in fiscal year 2013[3] alone, not including the lower interest payments on the debt that would result from this amount of deficit reduction (see Table 1). In the short term, however, the Congressional Budget Office (CBO) projects that if the expiring tax policies are not extended and the scheduled spending cuts are allowed to occur, together they would be the major contributor to an overall economic decline of 0.5 percent in 2013 and an unemployment rate that would rise above 9 percent by the end of 2013.[4]

So far, the debate over the fiscal cliff has largely focused on its potential impact on the national budget and economy. But the fiscal cliff also would affect the states. The general economic slowdown that would result from all of the changes occurring at once, as projected by CBO, would significantly affect state economic activity and therefore indirectly affect state budgets. Increased unemployment, lower disposable income, and lower spending mean both lower income and sales tax revenues and an increase in the number of individuals who would qualify for state safety net programs such as Medicaid and unemployment insurance.

Individual components of the fiscal cliff also would have specific impacts on states' budgets. Because states' tax codes are linked in various ways to the federal tax code, expiring federal tax policies could directly affect revenues in many states—decreasing tax receipts in some and increasing receipts in others. The scheduled cuts in federal grants to

states, and cuts to federal spending on contracts and the federal workforce, would hit some states harder than others, depending on the make-up of each state's budget and economy. As policy makers consider each of these components when thinking about ways to address the fiscal cliff, the implications for states should be part of the discussion.

This report addresses the potential state-specific impacts of the various components of the fiscal cliff, focusing on how federal policy changes have a direct impact on state budgets. The analysis does not, however, examine the potential interactions among these changes or provide an overall assessment of how the entire fiscal cliff would affect states.

For individuals, higher federal and state taxes reduce disposable personal income, and spending cuts potentially mean lower levels of government services. These individual impacts would vary across the states, depending on how each state's tax code, budget, and economy are structured. If the scheduled tax increases and spending cuts occur as scheduled, states would face challenging decisions about how to address the individual impacts.

STABILIZING THE U.S. DEBT WILL HELP STATES IN THE LONG RUN

There is widespread agreement on the need to address annual federal budget deficits and stabilize the debt in the long term. CBO has projected that, if the current policy course proceeds unchanged, the national debt would surpass its World War II peak of 109 percent of GDP by 2026.[5] According to CBO, growing debt levels would result in lower economic growth due to higher interest rates, more borrowing from foreign countries, and less domestic investment.[6] Moreover, higher government interest payments due to rising debt levels increase the proportion of the federal budget that cannot be cut, making the task of fixing the deficit far more difficult.

States are closely intertwined with the federal government and, in the long term, they certainly would benefit from a healthier federal budget and national economy. Federal grants account for roughly one-third of total state revenues,[7] and federal spending on contracts and the federal workforce accounts for more than 5 percent of total state economic activity.[8] Achieving a more stable federal budget outlook, without jeopardizing the long-term fiscal stability of other levels of government, would help create more stable fiscal and economic conditions in the states.

This analysis does not examine the effects on individuals.

There is a great deal of uncertainty about whether any or all of the policies in the fiscal cliff will be addressed temporarily or permanently. In addition, although the Office of Management and Budget (OMB), which is responsible for implementing the automatic spending cuts, has issued guidance about how the budget cuts would affect each overall budget account, it has not yet indicated how the across-the-board cuts would be applied to each program, project, and activity within each account, as would have to be done if the sequester goes into effect. Such detail is critical to understanding the impact on individual programs. As a result, the detailed impacts on states are unclear.

TABLE 1:

DEFICIT REDUCTION RESULTING FROM THE FISCAL CLIFF

FISCAL YEAR 2013

(dollars in billions)

Scheduled revenue increases	
Expiration of 2001, 2003, and 2009 tax cuts[a]	$225
Expiration of payroll tax cut	$85
Other expiring provisions[b]	$65
Taxes included in the Affordable Care Act	$18
Subtotal, revenue increases	**$393**
Scheduled spending cuts	
Sequestration	$54
Expiration of federal unemployment insurance benefits[c]	$34
Expiration of Medicare "doc fix"	$10
Subtotal, spending cuts	**$98**
Total	**$491**

[a]Includes expirations of the Alternative Minimum Tax "patch," the corporate and estate tax provisions, and the individual income tax cuts.

[b]Includes provisions typically referred to as the tax "extenders."

[c]The majority of the decrease in spending on unemployment benefits is attributable to the expiration of federally funded benefits.

NOTE: Spending figures reflect budget outlays.

SOURCE: Congressional Budget Office, *An Update to the Budget and Economic Outlook: Fiscal Years 2012 to 2022*, August 2012 (box 2-1).

Despite the uncertainty, the fiscal cliff provides an opportunity to examine how federal and state tax codes, revenues, budgets, and spending are linked, and it provides a framework for assessing how states could be affected by changes to federal tax and spending policies. Whether the fiscal cliff provisions are addressed as a package or individually, federal policy makers can use this framework to more completely understand the full costs and benefits of their policy choices, and thereby avoid shifting fiscal problems from one level of government to another.

STATES HAVE LIMITED CAPACITY TO ABSORB FURTHER FISCAL AND ECONOMIC PRESSURES

Many states are still struggling to emerge from the Great Recession. Total state tax revenues declined from their pre-recession peak by 12 percent, or $97.9 billion in real terms, at the lowest point of the downturn.[9] Unemployment rates remain well above their pre-recession peak in most states.[10] While aggregate state revenue collections are projected to finally recover to pre-2008 levels in 2013,[11] demand for state programs and services will continue to put pressure on state budgets.

In fact, 19 states projected a combined $30.6 billion in shortfalls when developing their fiscal year 2013 budgets, absent further fiscal tightening.[12] Unlike the federal government, 49 states have a requirement to balance their budgets, and the 50th, Vermont, makes it a practice. This means states must address the budget shortfalls as they occur. However, state policy makers have mostly exhausted short-term fixes for closing budget gaps such as tapping into rainy day funds, using one-time asset sales, increasing taxes temporarily, postponing construction and other spending, or issuing debt.

States also are being squeezed by funding pressures at the local level. On average, states fund close to one-third of local government budgets.[13] Lackluster property tax receipts have strained local revenue, putting pressure on state governments to help fill the gap.[14]

The Scheduled Tax Changes

When added together, the fiscal cliff includes about $491 billion in tax increases and spending cuts in fiscal year 2013. This is roughly equivalent to the state GDP of New Jersey ($487 billion) and nearly the same amount as the combined state general revenue of the four most populous states—California, New York, Texas, and Florida ($508 billion).[15]

As shown in Table 1, $393 billion, or roughly four-fifths, of this amount would result from scheduled tax changes, with spending cuts accounting for the remaining one-fifth, or $98 billion. The tax changes[16] include the:

- expiration of the 2001, 2003, and 2009 tax cuts—which included cuts to ordinary income and capital gains taxes, the corporate income tax, and the estate tax—and the temporary "patch" of the Alternative Minimum Tax (AMT) ($225 billion);
- expiration of the payroll tax cut ($85 billion);
- expiration of various "tax extenders" such as the tax credit for research and experimentation and the enhanced deductions for certain business expenses ($65 billion); and
- implementation of new taxes included in the Affordable Care Act ($18 billion).[17]

State tax systems are linked in various ways to the federal system. This means that the expiring tax provisions included in the fiscal cliff would directly impact tax revenues in nearly all states—with some provisions increasing revenue and others reducing revenue. For example, the scheduled tax changes would have a direct impact on at least:

- 37 states and the District of Columbia that link their *personal income taxes* to the expiring federal personal income tax provisions;[18]
- 23 states that link their *corporate income taxes* to certain expiring federal corporate income tax provisions; and
- 33 states that link their *estate taxes* to the expiring federal estate tax provisions.

This analysis examines the potential *direct* impacts on state tax revenues that could occur with the fiscal cliff's changes

to specific federal tax provisions, such as rates, deductions, and credits. Although some of the federal provisions and resulting state impacts discussed in the analysis may not be large relative to other policy changes within the fiscal cliff, they do illustrate how policy changes at the federal level can affect state budgets.

This analysis does not account for interaction effects, possible state policy changes in response to the federal changes, or any potential taxpayer behavioral responses. It also is important to note that this analysis does not address the negative indirect revenue impacts on states resulting from the general economic slowdown that CBO and most economists project would occur if the full fiscal cliff were to take effect, which could be so significant that the individual impacts discussed below are negated. Finally, this analysis also does not address the impact of the federal tax changes on individual taxpayers' federal or state tax bills.

Six states that allow a deduction for federal income taxes would see reduced revenues.

If the scheduled federal personal income tax changes take effect, they would result in higher federal income taxes for most taxpayers.[19] A handful of states—Alabama, Iowa, Louisiana, Missouri, Montana, and

FEDERAL UNCERTAINTY COMPLICATES STATES' ABILITY TO PLAN

The uncertainty the fiscal cliff causes at the federal level brings significant challenges to state decision makers, due to the various ways in which states' tax codes and budgets are tied to federal tax and spending decisions. These linkages complicate the business of revenue forecasting and budget planning at the state level. State tax administrators and budget officers must plan for different federal scenarios that could affect state revenues and spending pressures in myriad ways. Short-term federal tax extensions and changes pose challenges for long-term state revenue forecasts, and final-hour decisions at the federal level sometimes require state legislatures to call special sessions to amend their tax codes and budgets.

States that link their tax codes to the federal tax code could choose to avoid any direct impact of federal tax changes by rewriting their tax codes. However, amending the state tax code in a timely way in response to federal changes may not always be feasible, particularly given that federal changes often are enacted after the end of state legislative sessions. More importantly, such an approach could introduce complexity into state tax codes and create costs and operational challenges involved in issuing new forms and guidance.

Oregon—allow taxpayers to deduct their federal income taxes on their state tax returns.[20] For these six states, higher federal taxes would mean higher deductions on state tax returns, which would reduce state tax revenues (see Table 2).

At least 25 states and the District of Columbia that link to certain federal deductions would see increased revenues.

Generally, of the 43 states and the District of Columbia that levy a personal income tax, most link their tax to the federal revenue code in some way by adopting various federal definitions of income or various federal deductions.[21] Some of these deductions were temporarily enacted or expanded as part of the 2001, 2003, or 2009 tax cuts and have already expired, are due to expire, or are due to revert back to their pre-expansion status.[22] The scheduled changes include, for example, the reinstatement of limits on some deductions for high-income taxpayers (estimated to increase 2013 federal revenues by $6.1 billion[23]) and the elimination of the deduction for higher education tuition and fees ($0.9 billion).[24]

Reducing or eliminating federal deductions results in more income being taxed at the federal level. Depending on how a state's tax code is written, lower federal deductions could automatically result in more income being taxed at the state level as well, which would increase state revenue. For example, the scheduled elimination of the higher education tuition deduction would increase federal taxable income, and hence federal taxes. For states that adopt this federal deduction, the impact would be the same: increased taxable income and increased state tax revenues. This is the case in at least 25 states and the District of Columbia, which would automatically see higher revenues as a result of lower federal deduction amounts (see Table 2).[25] Some of the remaining 18 states with income taxes do not link to federal deductions, and therefore would be unaffected by the scheduled federal changes. In other states that do link to federal deductions, changes to federal law, including the scheduled changes in the fiscal cliff, may not be automatically adopted into state law absent legislative action.

At least 30 states and the District of Columbia that link to certain federal credits would see increased revenues.

States that link to federal credits that would be reduced or eliminated under the expiring tax provisions would see increased revenues. Many states have tax credits that are similar to federal tax credits and, in most cases, actually base their credit amount on the federal credit amount. Two such examples include the Child and Dependent Care Credit

(CDCC) and the Earned Income Tax Credit (EITC) for low- and moderate-income workers.[26]

As of 2011, 30 states and the District of Columbia had either a child care tax credit or deduction or a state-level EITC that linked to the corresponding federal credit (see Table 2).[27] Both of these federal tax credits were expanded in recent years (the CDCC in 2001 and the EITC in 2001 and again in 2009), but both are scheduled to return to their previous, lower levels when the expansions expire at the end of 2012. The expiration of the CDCC expansion is estimated to increase federal revenues by $0.3 billion in 2013, while the expiration of EITC expansion is estimated to increase federal revenues by $0.2 billion in fiscal year 2013.[28] If these credits were reduced or eliminated, the 30 states and the District of Columbia that link to them would see increased state tax revenue.

At least 23 states that link to certain federal corporate income tax deductions would see increased revenues.

In the same way that state individual income taxes are linked to the federal system, some states link their corporate income taxes to the federal corporate tax. For example, at least 23 states have adopted federal rules for certain deductions related to business expenses (see Table 2).[29] Specifically, these states adopt the "enhanced expensing" rules, the federal "bonus depreciation" rules, or both. These temporary provisions, which were extended several times over the past decade, allow businesses to speed up the normal depreciation schedule under which deductions from business income for the cost of business property are spread over many years.[30] They are set to expire at the end of 2012, resulting in an estimated $41.7 billion increase in federal revenues in 2013.[31] Under this change, the 23 states that link to the federal corporate rules would see higher taxable corporate income and hence higher tax revenues in the near term.[32]

Thirty-three states that link to certain federal estate tax provisions would see increased revenues.

The federal estate tax is a tax on the value of a deceased person's estate, including assets such as cash, real estate, business interests, and insurance proceeds. The estate tax has undergone a number of temporary modifications since the early 2000s. As a result of these changes, the current tax rates are lower, the untaxed portion of the estate's value (the exclusion) is higher ($5 million compared with $1 million), and the federal credit for estate taxes paid at the state level is temporarily eliminated. These changes are scheduled to expire at the end of 2012, resulting in an increase in federal revenues in 2013 of around $4 billion.[33]

In 30 states the very existence of the state estate tax is tied to the existence of the federal credit, meaning that when the credit was temporarily eliminated, the estate tax in those states was automatically rendered inactive.[34] The scheduled return of the federal credit would reactivate the estate tax in these states. An additional three states link their estate taxes to the federal exclusion amount. In these 33 states, the scheduled federal estate tax changes would mean higher state estate taxes as well, thereby increasing state revenues.[35]

Some tax components of the fiscal cliff would not directly impact state revenues.

At the end of each year, Congress is faced with addressing an average of at least 50 business and personal income tax cuts that were enacted on a temporary, short-term basis and are therefore expiring or already expired. These provisions often are referred to as the "tax extenders" because, while technically temporary, Congress routinely extends them for a year or more at a time. One group of extenders, for example, includes tax benefits that are geographically targeted. Private entities in the District of Columbia, for instance, receive special tax incentives to encourage economic development. Private entities in Gulf Coast states have access to tax-exempt financing to reduce the cost of borrowing for certain activities in the aftermath of Hurricane Katrina.

Changes to the federal tax code would have both direct and indirect impacts on state finances.

The fiscal cliff includes dozens of such "extenders"—their expiration would increase federal revenues by an estimated $65 billion in fiscal year 2013 (see Table 1).[36] The expiration of tax extenders that are not linked to state tax codes would not have a direct impact on state revenues. However, the expiration of some of the extenders could affect economic activity in individual states, potentially depressing it in states that currently benefit and potentially increasing it in states that currently do not benefit from the extenders. It is unclear what the economic impact would be in each state, or how any potential economic impact could indirectly affect state revenues. As noted earlier, this analysis focuses on the direct impacts on state revenues of the scheduled federal tax changes.

Net impacts from federal tax changes are uncertain.

Changes to the federal tax code would have both direct and indirect impacts on state finances. For the handful of states that allow taxpayers to deduct their federal income taxes, the tax increases would directly reduce state tax revenues. Conversely, all of the other potential direct revenue impacts discussed above would, on their own, increase state tax revenues. The specific effects and net result of the various direct impacts of the different tax elements within the fiscal cliff, including any potential interactions among them, are unclear and would vary by state. However, the general drag on the overall economy that would result if all of the tax increases were allowed to take effect[37] could indirectly reduce state revenues so significantly as to overwhelm any of the direct impacts discussed here.

Despite the uncertainty, it is important for federal policy makers to be aware that tax decisions at the federal level often affect state revenues, and these impacts should be considered as part of the decision making process.

TABLE 2:

DIRECT IMPACT OF THE FISCAL CLIFF ON STATE TAX REVENUES

Tax Categories:	Personal Income Tax[a]				Corporate Income Tax[e]	Estate Tax
Federal changes under the fiscal cliff:	Increase total federal tax liability	Reduce certain federal personal deductions	Reduce certain federal credits		Reduce certain federal business deductions	Reduce federal exclusion and reinstate federal credit
State linkage to federal policy:	State allows deduction for federal income taxes[b]	State linked to those deductions[c]	State linked to the Earned Income Tax Credit[d]	State linked to the Child and Dependent Care Credit[d]	State linked to those deductions[f]	State linked to those changes[g]
Alabama	▼				▲	▲
Alaska						▲
Arizona		▲				
Arkansas						▲
California				▲		▲
Colorado		▲		▲	▲	▲
Connecticut		▲	▲		▲	
Delaware		▲	▲	▲	▲	▲
District of Columbia		▲	▲	▲		
Florida						▲
Georgia		▲		▲		▲
Hawaii						▲
Idaho				▲		▲
Illinois		▲	▲		▲	
Indiana		▲	▲			▲
Iowa	▼		▲	▲		▲
Kansas		▲	▲	▲	▲	
Kentucky				▲		▲
Louisiana	▼	▲	▲	▲	▲	▲
Maine		▲	▲	▲		
Maryland		▲	▲	▲		
Massachusetts			▲		▲	
Michigan		▲	▲		▲	▲
Minnesota		▲	▲	▲	▲	
Mississippi					▲	▲
Missouri	▼	▲			▲	▲

▲ indicates an expected increase in state revenue ▼ indicates an expected decrease in state revenue

(continued)

TABLE 2:
DIRECT IMPACT OF THE FISCAL CLIFF ON STATE TAX REVENUES *(continued)*

Tax Categories:	Personal Income Tax[a]				Corporate Income Tax[e]	Estate Tax
Federal changes under the fiscal cliff:	Increase total federal tax liability	Reduce certain federal personal deductions	Reduce certain federal credits		Reduce certain federal business deductions	Reduce federal exclusion and reinstate federal credit
State linkage to federal policy:	State allows deduction for federal income taxes[b]	State linked to those deductions[c]	State linked to the Earned Income Tax Credit[d]	State linked to the Child and Dependent Care Credit[d]	State linked to those deductions[f]	State linked to those changes[g]
Montana	▼	▲			▲	▲
Nebraska		▲	▲	▲	▲	
Nevada						▲
New Hampshire						▲
New Jersey			▲			
New Mexico		▲	▲	▼†	▲	▲
New York		▲	▲	▲	▲	
North Carolina			▲	▲		▲
North Dakota		▲			▲	▲
Ohio				▲		
Oklahoma		▲	▲	▲	▲	
Oregon	▼	▲	▲	▲		
Pennsylvania						▲
Rhode Island		▲	▲	▲		
South Carolina				▲	▲	▲
South Dakota						▲
Tennessee						▲
Texas						▲
Utah		▲			▲	▲
Vermont		▲	▲	▲	▲	
Virginia			▲	▲	▲	▲
Washington						
West Virginia		▲			▲	▲
Wisconsin			▲			▲
Wyoming						▲

▲ indicates an expected increase in state revenue ▼ indicates an expected decrease in state revenue

TABLE 2: NOTES & SOURCES

[a] The following states do not levy a personal income tax: Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming.

[b] Tax revenue impact in states that allow taxpayers to deduct federal income taxes. Increased federal taxes would lead to higher deductions on the state tax return, and thus lower tax revenue, in these states.

[c] Tax revenue impact in states that are automatically linked to one or more of the various "above-the-line" and "below-the-line" federal deductions that are scheduled to be reduced or eliminated. Lower deductions would lead to higher state taxable personal income, and thus higher tax revenue, in these states. Some states without arrows may be impacted by the scheduled changes. Based on Pew analysis of available sources, the potential impact could not be identified at the time of writing. See *The Impact of the Fiscal Cliff on the States*, endnote 25.

[d] Tax revenue impact in states that are automatically linked to this credit. The scheduled reduction of this credit would lead to higher state taxable personal income, and thus higher tax revenue, in these states. Two additional states had state EITCs in law but the credit was suspended (Colorado) or not yet implemented (Washington) as of 2011. States may be affected by linkages to other federal tax credits scheduled to change under the fiscal cliff that are not addressed in this analysis.

[e] The following states do not levy a corporate net income tax: Nevada, Ohio, South Dakota, Texas, Washington, and Wyoming.

[f] Tax revenue impact in states that are automatically linked to either: 1) federal bonus depreciation rules, or 2) enhanced expensing rules. The scheduled expiration of these provisions would lead to higher state taxable corporate income, and thus higher tax revenue, in the near term in these states. Some states without arrows may be impacted by the scheduled changes. Based on Pew analysis of available sources, the potential impact could not be identified at the time of writing. States may be affected by linkages to other federal corporate income tax provisions scheduled to change under the fiscal cliff that are not addressed in this analysis.

[g] Tax revenue impact in states that are automatically linked to either: 1) the exclusion amount, or 2) the federal credit for state estate taxes. The scheduled reduction in the exclusion amount would lead to an increase in the taxable value of estates, and thus higher tax revenue, in the states linked to the exclusion amount. The scheduled return of the credit would lead to the automatic reinstatement of state estate taxes, and thus higher tax revenue, in the states linked to the credit.

[†] New Mexico's allowable credit is reduced by the amount of the federal credit claimed. Thus, the scheduled federal reduction of this credit would lead to higher state credit amounts claimed, and thus lower tax revenue, in New Mexico.

SOURCES: Institute on Taxation and Economic Policy, *Why States That Offer the Deduction for Federal Income Taxes Paid Get It Wrong*, August 2011; Federation of Tax Administrators, *State Personal Income Taxes: Federal Starting Points*, January 2012, and *Range of State Corporate Income Tax Rates*, February 2012; Tax Credits for Working Families, *States with EITCs*; National Women's Law Center, *Making Care Less Taxing: Improving State Child and Dependent Care Tax Provisions*, April 2011, and February 2012 memorandum, *Developments in Federal and State Child and Dependent Care Provisions in 2011*; Commerce Clearinghouse, *2012 State Tax Handbook*, Chicago, IL: CCH, 2011; Urban-Brookings Tax Policy Center, *Back from the Dead: State Estate Taxes After the Fiscal Cliff*, November 2012.

The Scheduled Spending Changes

Together, the scheduled spending cuts account for $98 billion, or about one-fifth, of the total federal budget impact of the fiscal cliff. These include cuts due to the:

- sequester required under the Budget Control Act (BCA) of 2011 ($54 billion);
- expiration of federal unemployment insurance benefits ($34 billion); and
- expiration of the Medicare "doc fix" ($10 billion).[38]

Sequestration of federal grants would have a direct impact on state budgets. Sequestration of federal spending on procurement, salaries, and wages would reduce economic activity in the states and reduce state taxable income and thus tax revenues, and is therefore included in the analysis. This analysis does not account for interaction effects, possible state policy changes in response to the federal changes, or other indirect impacts that may occur as a result of the scheduled spending cuts, nor does it address the negative indirect impacts on state budgets resulting from the general economic drag of the entire fiscal cliff. Finally, this analysis does not address the potential impact of the spending cuts on programs or individuals.

The Sequester

Federal grants to states constitute about one-third of total state revenues,[39] and about 18 percent of these grant funds would be subject to the across-the-board cuts—the sequester—required by the BCA scheduled to take effect in January 2013.[40] (Some of the largest grants to states are exempt from the sequester, including Medicaid.) These cuts to federal spending would have a direct impact on state budgets. Because most states are not permitted to run a deficit, states either would have to replace the loss in federal revenues with state funds or implement budget cuts.[41]

In addition, federal spending on contracts, salaries, and wages makes up 5.3 percent of the U.S. economy.[42] The reductions in this spending required under sequestration—in both the defense and nondefense sectors—would not directly affect state budgets, but they would affect general economic activity in the states, particularly in states where more federal spending occurs.[43]

TABLE 3:

ESTIMATED CUTS RESULTING FROM SEQUESTRATION

FISCAL YEAR 2013

(dollars in billions)

Budget account	Estimated cut (budget authority)	Estimated percentage cut	Estimated cut (budget outlays)
Defense	$55	**	$24
Mandatory	___*	10.0%	___*
Discretionary	$55	9.4%	$24
Nondefense	$55	**	$30
Mandatory	$17	**	$9
Medicare	$11	2.0%	$4
Other mandatory	$6	7.6%	$5
Discretionary	$38	8.2%	$21
Total	**$109**	**	**$54**

*Defense sequestration cuts will come almost entirely from discretionary spending. OMB estimates that $150 million will be cut from mandatory defense accounts through 2021.

**Percentage cuts not specified.

NOTE: Totals may not add due to rounding.

SOURCES: Office of Management and Budget data; Pew analysis of Congressional Budget Office estimates made prior to September 14, 2012, release of OMB report on sequestration.

The 2011 BCA included two rounds of cuts that would reduce the federal budget deficit by at least $2.1 trillion over 10 years.[44] The first phase imposed caps on discretionary spending (such as funding for low-income school districts or highways and state grants) for fiscal years 2012 through 2021, reducing spending by roughly $900 billion over 10 years relative to what spending would have been without the caps.[45] As a result, federal spending in the states has already been cut in 2012 relative to spending levels under prior law.[46] The second phase of the BCA was triggered when Congress was unable to reach agreement on additional spending reductions, resulting in required automatic spending cuts of $1.2 trillion over nine years, scheduled to take effect beginning in January 2013.[47] This second round of cuts also would affect states.

For fiscal year 2013, the automatic spending reductions would occur through sequestration,[48] resulting in about $109 billion in cuts split evenly between defense and nondefense spending, for reductions of roughly $55 billion in each category (see Table 3).[49] Given the lag in timing between

appropriations and expenditures, CBO estimates that the actual impact of sequestration on federal spending in fiscal year 2013 would be savings of a total of $54 billion (see Table 3).[50]

OMB has calculated that the required savings specified under the BCA sequester for fiscal year 2013 as compared with fiscal year 2012[51] would amount to a:

- **9.4 percent cut** to discretionary defense spending (for example, funding for overseas operations and weapon systems);[52]
- **8.2 percent cut** to nondefense discretionary spending (for example, funding for Head Start and low-income home heating and cooling assistance);
- **7.6 percent cut** to nondefense mandatory spending (for example, funding for the Social Services Block Grant and the U.S. Forest Service; does not include cuts to exempt programs such as Medicaid and the Supplemental Nutrition Assistance Program, or SNAP);[53] and a
- **2 percent cut** to Medicare spending (see Table 3).[54]

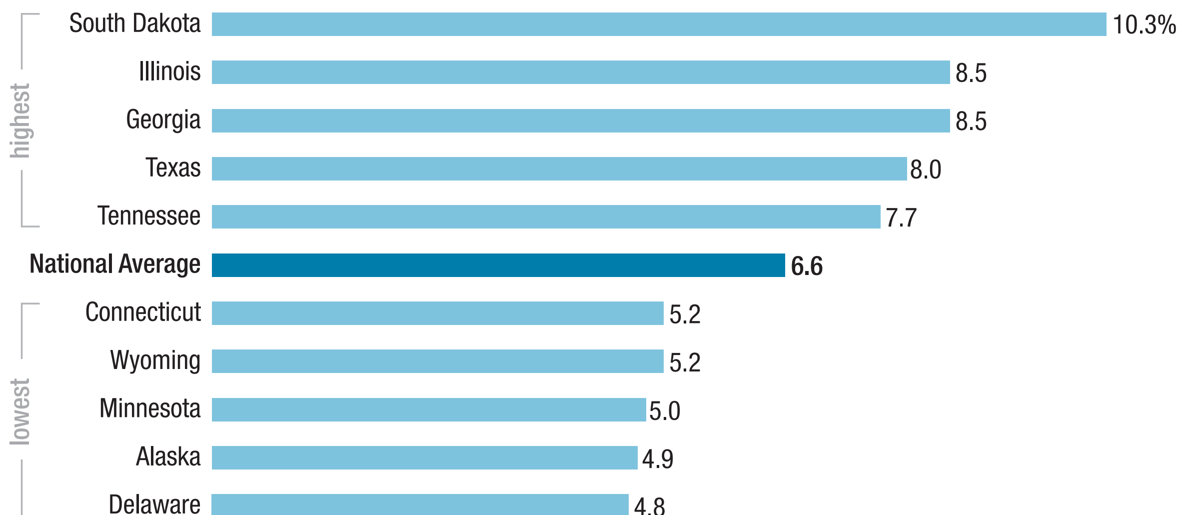
The scheduled cuts in federal grants would directly affect state budgets, while the scheduled cuts in federal spending on procurement, salaries, and wages would affect state economies and thereby have an indirect effect on state budgets.

State budgets are vulnerable to cuts in federal grants.

According to calculations by the Federal Funds Information for States (FFIS), roughly 18 percent of federal grant dollars flowing to the states would be subject to the across-the-board cuts in fiscal year 2013, including funding for education programs, nutrition for low-income women and children, public housing, and other programs.[55] The largest federal grants, including Medicaid and major income support programs, are exempt from sequestration.

Based on OMB estimates of the across-the-board percentage cuts that would be applied to all nonexempt, nondefense mandatory and discretionary programs, FFIS estimates that sequestration would result in cuts totaling about $7.5 billion, or roughly 7 percent of federal nonexempt, nondefense grants to states compared with fiscal year 2012 funding levels.[56] Because these cuts would not take effect until January 2013, three months into the federal fiscal year, the impact of the cuts could be greater than they would be if they were spread over a full 12 months. Moreover, the actual final cuts to state grants could be even larger than estimated because, as state budget experts note, experience has shown that relatively small cuts at the agency level often translate into larger cuts to the funding available within those agencies for state grants.[57] For

FIGURE 1:
FEDERAL GRANTS SUBJECT TO SEQUESTER AS A PERCENTAGE OF STATE REVENUE
FISCAL YEAR 2010



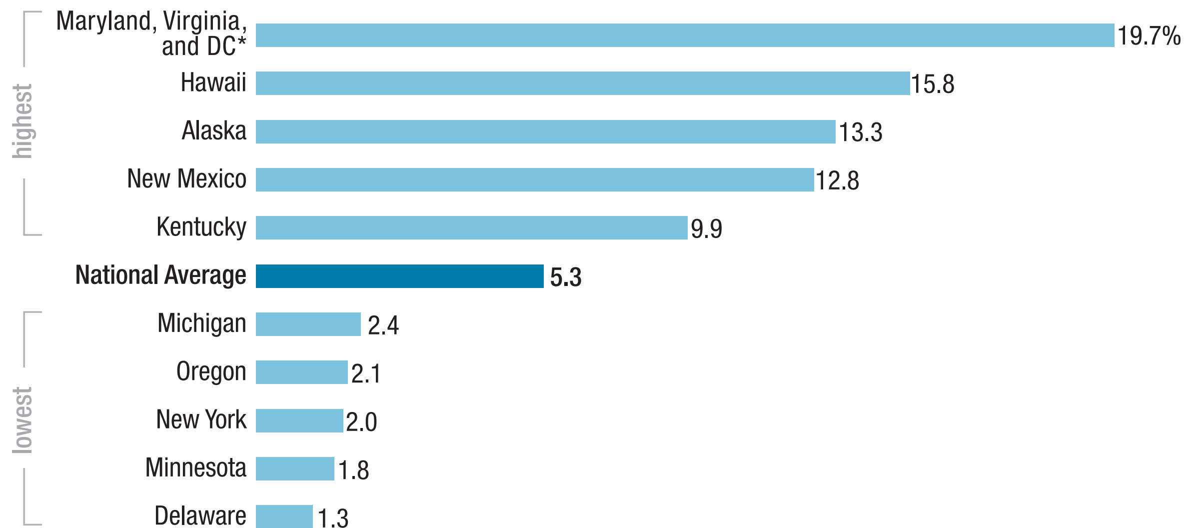
NOTE: Grants calculations exclude funds that would be sequestered in FY 2013 but would be disbursed October 1, 2013, at the start of FY 2014. FY 2010 is the most recent year for which state revenue data are available. See endnote 59 for more information.

SOURCE: Pew analysis of Federal Funds Information for States and Census Bureau State Government Finances data.

example, the House-passed fiscal year 2012 U.S. Department of Homeland Security spending bill proposed an overall spending reduction for the agency of 2.6 percent, but reduced funding for the Federal Emergency Management Agency's state and local programs by 57 percent.[58]

Because states differ in the type and amount of federal grants they receive, their exposure to general across-the-board cuts differs significantly. In all, total federal grants subject to sequester made up more than 10 percent of South Dakota's revenue, compared with less than 5 percent of Delaware's revenue in 2010, the most recent year for which complete data are available (see Figure 1 and Table 4).[59] Because federal funding for specific program areas accounts for varying shares of each state's total revenue, cuts in a given program could affect some states more than others. For example, in 2010, almost 5 percent of South Dakota's total state revenue came from federal education programs subject to the sequester, while these programs accounted for less than 2 percent of Delaware's state revenue that year.[60]

FIGURE 2:
TOTAL FEDERAL SPENDING ON PROCUREMENT, SALARIES, AND WAGES AS A PERCENTAGE OF STATE GDP
FISCAL YEAR 2010



*Maryland, Virginia, and the District of Columbia are combined due to the high percentage of commuters in the area.
NOTE: Figures do not include U.S. Postal Service, as only a small share of its spending is supported by the federal budget.
SOURCE: Pew analysis of Census Bureau *Consolidated Federal Funds Report* and Bureau of Economic Analysis data.

State economies are vulnerable to cuts in federal spending on procurement, salaries, and wages.

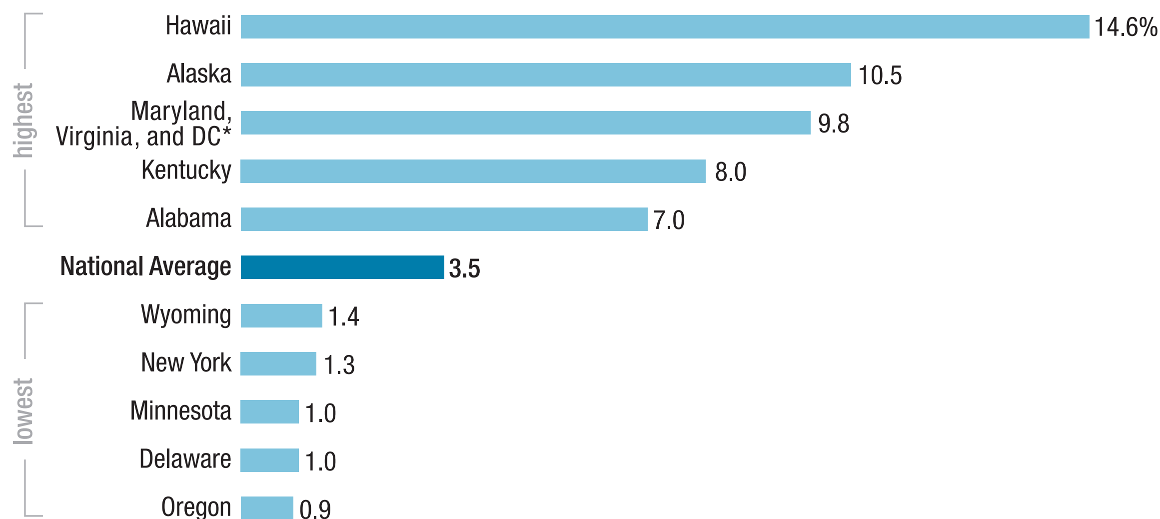
Cuts in federal procurement and salaries and wages could slow economic activity, and thereby adversely affect state finances by reducing state personal income and sales tax revenues and increasing demand for state-funded income support programs. Again, the effects on states would vary, based on the level of such federal spending in the state. Total federal spending on procurement, salaries, and wages accounted for almost 20 percent of the combined state GDP of Maryland, Virginia, and the District of Columbia, compared with just over 1 percent of Delaware GDP (see Figure 2 and Table 4).[61]

Defense cuts. Defense is the largest area of total federal spending on procurement, salaries, and wages[62] and, in 2010, it accounted for more than 3.5 percent of the total GDP of the states.[63] There is wide variation across the states in the contribution of this federal defense spending to state economies. For instance, in 2010, federal defense spending on procurement, salaries, and wages made up almost 15 percent of

FIGURE 3:

FEDERAL DEFENSE SPENDING ON PROCUREMENT, SALARIES, AND WAGES AS A PERCENTAGE OF STATE GDP

FISCAL YEAR 2010



*Maryland, Virginia, and the District of Columbia are combined due to the high percentage of commuters in the area.

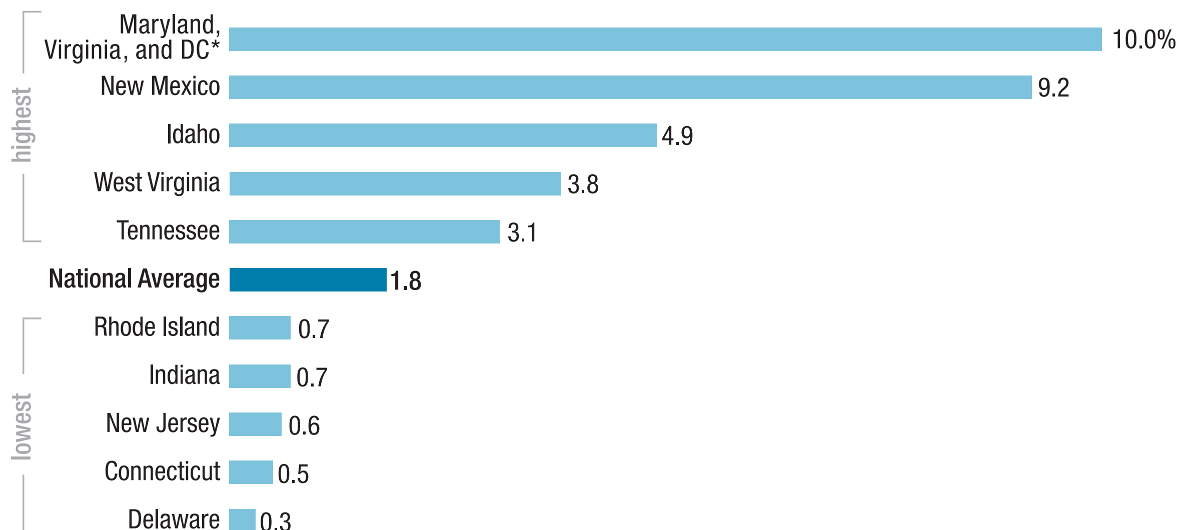
SOURCE: Pew analysis of Census Bureau *Consolidated Federal Funds Report* (CFFR) and Bureau of Economic Analysis data.The CFFR defense spending categories are based on major agency codes, while the BCA sequester applies to the budget function code for defense. While there are differences, this chart uses CFFR data for purposes of showing the comparative importance of defense spending overall to state economies. FY 2010 is the most recent year for which CFFR and state GDP data are available.

Hawaii GDP (see Figure 3 and Table 4).[64] By contrast, this spending was only 1 percent of the state GDPs of Oregon, Delaware, and Minnesota.[65] In general, states in which such spending accounts for a relatively high share of economic activity would be the most vulnerable to the scheduled defense cuts.

Nondefense cuts. In 2010, federal nondefense spending on procurement, salaries, and wages accounted for 1.8 percent of the total GDP of the states. As with federal defense spending on these items, there is significant variation in the contribution of this type of federal nondefense spending to state economic activity. In 2010, federal nondefense spending on procurement, salaries, and wages accounted for about 10 percent of the combined state GDP of Maryland, Virginia, and the District of Columbia, compared to 0.3 percent of Delaware GDP (see Figure 4 and Table 4).[66]

Nondefense workforce. States with the greatest share of federal nondefense workers would be vulnerable to potential cuts in federal salaries and wages. For example, Maryland, Virginia, and the

FIGURE 4:
FEDERAL NONDEFENSE SPENDING ON PROCUREMENT, SALARIES, AND WAGES AS A PERCENTAGE OF STATE GDP
FISCAL YEAR 2010



*Maryland, Virginia, and the District of Columbia are combined due to the high percentage of commuters in the area.
NOTE: Figures do not include U.S. Postal Service, as only a small share of its spending is supported by the federal budget.
SOURCE: Pew analysis of Census Bureau *Consolidated Federal Funds Report* and Bureau of Economic Analysis data.

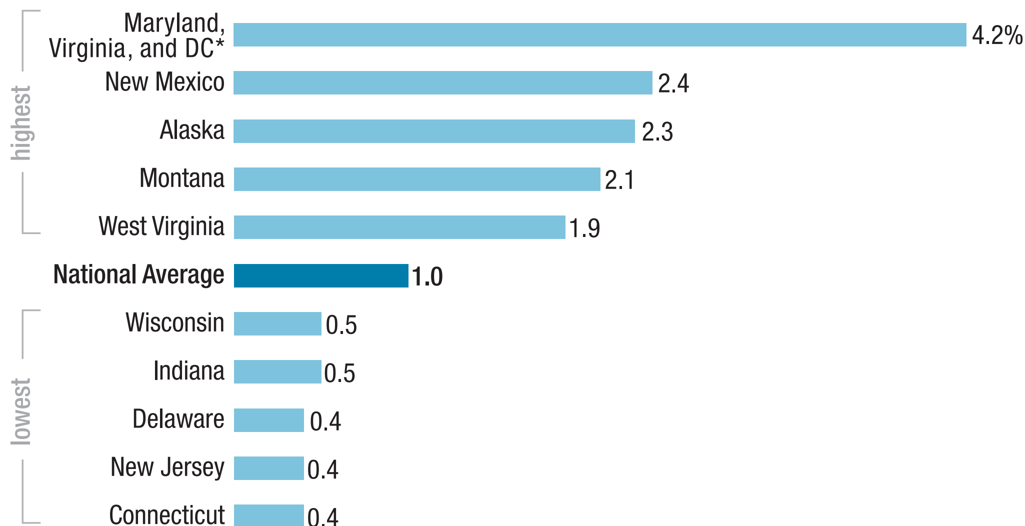
District of Columbia together account for more than 20 percent of the total federal nondefense workforce. Together, the more than 293,000 federal nondefense employees in these jurisdictions represent more than 4 percent of the area's workers (see Figure 5).[67] Yet even for some states with relatively low numbers of federal nondefense workers, such as Alaska, the federal nondefense workforce constitutes a disproportionately large share of the state's total nondefense workforce.[68] For example, Alaska has about 7,500 federal nondefense employees, but these employees represent 2.3 percent of the state's total nondefense workforce (see Figure 5 and Table 4).[69]

Expiration of Federal Unemployment Insurance Benefits could have a direct impact on state budgets.

The scheduled expiration of federally funded unemployment insurance benefits at the end of 2012 is estimated to reduce the deficit by $34 billion in fiscal year 2013.[70]

Unemployment Compensation (UC)—The standard mechanism for providing unemployment compensation is the federal-state UC program, which provides unemployment insurance for a

FIGURE 5:
FEDERAL NONDEFENSE WORKFORCE AS A PERCENTAGE OF TOTAL EMPLOYED IN STATE
FISCAL YEAR 2012



*Maryland, Virginia, and the District of Columbia are combined due to the high percentage of commuters in the area.
SOURCE: Pew analysis of Bureau of Labor Statistics and Office of Personnel Management data.

maximum of 26 weeks in most states.[71] State UI taxes levied on employers pay for most of these benefits.

Extended Benefits (EB)—Individuals in states meeting certain unemployment rate "triggers" may qualify for up to 20 additional weeks of benefits under the EB program.[72] Under permanent law, states pay for half of this program with UI taxes, and the federal government covers the other half using revenue from Federal Unemployment Taxes.[73] The Middle Class Tax Relief and Job Creation Act of 2012 (enacted in February 2012) required the federal government to continue to pay 100 percent of the EB program through the end of 2012 (with a phase-out).[74]

Emergency Unemployment Compensation (EUC)—EUC is a temporary federal program created in 2008 to provide up to 53 weeks of unemployment benefits. The Middle Class Tax Relief and Job Creation Act of 2012 extended the temporary federal EUC program to January 2013.[75]

Availability of EB and EUC benefits has been phasing out during 2012. By the beginning of 2013, EUC is scheduled to expire completely, and EB is scheduled to revert back to its permanent status of being funded equally by the federal and state governments.[76] Currently, of the 50 states and the District of Columbia, only New York meets the EB triggers.[77]

It is unclear whether New York would continue to meet the triggers in 2013.[78] Generally, the loss of the additional federal unemployment funding would not result in a significant immediate direct budget impact on states.

Expiration of Medicare "doc fix" would not have a direct impact on state budgets.

The scheduled cuts in Medicare physician payment rates are estimated to reduce the deficit by $10 billion in fiscal year 2013.[79] In January 2013, Medicare physician payment rates are scheduled to go down by 27 percent when the current "doc fix" expires.[80] This is a result of a series of so-called "doc fixes" implemented since 2003, in which Congress overrode statutorily required automatic cuts in Medicare physician payment rates. In addition, as of February 2013, provider rates are scheduled to be cut by an additional 2 percent as part of sequestration of mandatory spending specified in the BCA.[81]

Medicare is a federal health insurance program for individuals 65 years and older, and most permanently disabled individuals under age 65. Because it is funded entirely by the federal government, state budgets would not experience any direct impact from the scheduled rate cuts.

The public interest is best served by an enriched policy debate that recognizes implications for all levels of government and leads to long-term fiscal stability for the nation as a whole.

Conclusion

Decisions regarding whether to extend tax policies or repeal scheduled spending cuts are particularly challenging given the current federal deficit and fragile economic recovery. Understanding how these decisions also may impact states adds an extra degree of complexity to an already difficult task. These implications are nonetheless real and should be considered as federal policy makers evaluate all the costs and benefits of these choices. The public interest is best served by an enriched policy debate that recognizes implications for all levels of government and leads to long-term fiscal stability for the nation as a whole.

TABLE 4:

SELECTED INDICATORS OF STATES' POTENTIAL VULNERABILITIES TO SPENDING CUTS IN THE FISCAL CLIFF

	Federal Grants Subject to Sequester as a Percentage of State Revenue (2010)**	Federal Spending on Procurement, Salaries, and Wages as a Percentage of State GDP (2010)	Defense Spending on Procurement, Salaries, and Wages as a Percentage of State GDP (2010)	Nondefense Spending on Procurement, Salaries, and Wages as a Percentage of State GDP (2010)	Federal Nondefense Workforce as a Percentage of Total Employed in State (2012)
NATIONAL AVERAGE	**6.6%**	**5.3%**	**3.5%**	**1.8%**	**1.0%**
AL	7.5	8.9	7.0	1.9	0.8
AK	4.9	13.3	10.5	2.8	2.3
AZ	7.7	6.7	5.2	1.4	1.3
AR	6.2	3.4	2.4	1.0	0.9
CA	6.1	4.0	2.8	1.2	0.8
CO	7.3	7.0	4.4	2.6	1.2
CT	5.2	5.8	5.3	0.5	0.4
DE	4.8	1.3	1.0	0.3	0.4
DC	5.9	19.7*	9.8*	10.0*	4.2*
FL	7.2	3.6	2.5	1.1	0.8
GA	8.5	6.9	5.2	1.7	1.1
HI	5.4	15.8	14.6	1.2	1.1
ID	7.2	6.4	1.4	4.9	1.2
IL	8.5	2.5	1.5	1.0	0.6
IN	6.4	3.1	2.5	0.7	0.5
IA	5.3	2.4	1.7	0.7	0.5
KS	6.0	6.3	5.1	1.2	0.7
KY	6.8	9.9	8.0	1.9	0.9
LA	6.6	4.7	3.8	1.0	0.7
ME	6.7	4.8	3.7	1.1	0.7
MD	5.4	19.7*	9.8*	10.0*	4.2*
MA	5.5	4.9	3.7	1.2	0.7
MI	6.7	2.4	1.5	0.9	0.5
MN	5.0	1.8	1.0	0.8	0.6
MS	7.6	5.4	3.8	1.6	0.9
MO	7.2	7.6	5.9	1.7	1.2
MT	7.5	4.8	2.1	2.7	2.1
NE	7.0	2.8	2.0	0.9	0.7
NV	6.7	3.0	1.8	1.2	0.9
NH	6.8	3.1	2.2	0.9	0.6
NJ	5.8	2.7	2.1	0.6	0.4
NM	6.1	12.8	3.6	9.2	2.4
NY	6.6	2.0	1.3	0.7	0.6
NC	6.3	4.5	3.7	0.8	0.6
ND	6.6	4.4	2.6	1.8	1.2
OH	6.7	2.8	1.9	0.8	0.5
OK	6.3	5.5	4.3	1.2	1.0
OR	6.6	2.1	0.9	1.1	1.1
PA	6.8	4.4	2.7	1.7	0.7
RI	7.0	3.4	2.8	0.7	0.6
SC	6.9	7.4	4.8	2.6	0.6
SD	10.3	4.4	2.7	1.7	1.8
TN	7.7	4.9	1.8	3.1	0.8
TX	8.0	5.4	4.1	1.3	0.9
UT	6.9	5.3	3.7	1.6	1.3
VT	6.0	5.7	4.1	1.7	1.3
VA	5.6	19.7*	9.8*	10.0*	4.2*
WA	6.1	5.9	4.0	2.0	1.0
WV	6.7	5.2	1.5	3.8	1.9
WI	5.5	4.6	3.9	0.7	0.5
WY	5.2	3.2	1.4	1.8	1.6

**Grants calculations exclude funds that would be sequestered in FY 2013 but would be disbursed October 1, 2013, at the start of FY 2014.
*The data for Maryland, Virginia, and the District of Columbia, are combined due to the high percentage of commuters in the area.

SOURCES: Pew analysis of Federal Funds Information for States, Census Bureau State and Local Government Finance Survey, Bureau of Labor Statistics, Office of Personnel Management, Census Bureau Consolidated Federal Funds Report, and Bureau of Economic Analysis data.

Endnotes

1 Bruce D. McDowell, "Advisory Commission on Intergovernmental Relations in 1996: The End of an Era," *Publius* (Spring 1997): pp. 111—127. The Advisory Commission on Intergovernmental Relations and units in the Office of Management and Budget, the Government Accountability Office, and the Office of Personnel Management were disbanded in the 1980s and 1990s. The House and Senate intergovernmental relations subcommittees have been given other substantial responsibilities. The Census Bureau recently decided to discontinue two significant sources of uniform data for federal-state fiscal information. The two reports, the *Consolidated Federal Funds Report* and the *Federal Aid to States* report, are no longer being published, although their historical data can be accessed online.

2 Congressional Budget Office, *An Update to the Budget and Economic Outlook: Fiscal Years 2012 to 2022* (August 2012), http://cbo.gov/sites/default/files/cbofiles/attachments/43539-08-22-2012-Update_One-Col.pdf.

3 Ibid, Box 2-1.

4 The Congressional Budget Office estimates that under current law the unemployment rate will rise to 9.1 percent in the fourth quarter of 2013, averaging 8.8 percent for the calendar year; Congressional Budget Office, *An Update to the Budget and Economic Outlook: Fiscal Years 2012 to 2022*, August 2012. CBO's estimates are based on the total fiscal restraint that is scheduled to occur in 2013. Without economic feedback effects incorporated, more than four-fifths of the estimated fiscal restraint is attributable to tax and spending provisions specific to the fiscal cliff, with less than one-fifth due to other provisions in tax law and spending rules that would increase revenues and lower federal spending outside of the fiscal cliff; Congressional Budget Office, *Economic Effects of Reducing the Fiscal Restraint That Is Scheduled to Occur in 2013* (May 2012), http://www.cbo.gov/sites/default/files/cbofiles/attachments/05-22-FiscalRestraint_ScreenFriendly.pdf.

5 Congressional Budget Office, *The 2012 Long-Term Budget Outlook* (June 2012), http://cbo.gov/sites/default/files/cbofiles/attachments/LTBO_One-Col_2_1.pdf. These projections are based upon CBO's alternative fiscal scenario, which assumes that many of the provisions in the fiscal cliff will not occur as scheduled.

6 Congressional Budget Office, *The 2012 Long-Term Budget Outlook*, June 2012.

7 From 2000 to 2010, federal grants accounted for an average 30 percent of total state revenues. In 2010, the most recent year for which data are available, federal grants accounted for about 35 percent of total state revenues, reflecting the influx of federal stimulus funds and the concurrent decline in state tax revenues. U.S. Census Bureau, *2010 Annual Survey of State Government Finances* (December 2011), http://www.census.gov/govs/state/.

8 Pew analysis of data from the U.S. Census Bureau *Consolidated Federal Funds Report for Fiscal Year 2010* (September 2011), http://www.census.gov/prod/2011pubs/cffr-10.pdf; and state gross domestic product data from the U.S. Bureau of Economic Analysis, *Regional Economic Accounts* (2012), http://bea.gov/regional/index.htm. Does not include U.S. Postal Service (USPS) as only a small share of USPS spending is supported by the federal budget.

9 Pew analysis of U.S. Census Bureau, *Annual Survey of State Government Tax Collections* (2008 and 2010), http://www.census.gov/govs/statetax/. In state fiscal year 2010, total tax revenues for all 50 state governments had declined to $701.6 billion, down from their previous peak in state fiscal year 2008 when state tax revenues totaled $799.5 billion. Note that the state tax revenue estimates are in real, inflation-adjusted terms.

10 Pew analysis of U.S. Bureau of Labor Statistics, "Local Area Unemployment Statistics" (2007), accessed October 19, 2012, http://www.bls.gov/lau/lastrk07.htm; and U.S. Bureau of Labor Statistics, "Local Area Unemployment Statistics" (September 2012), accessed October 19, 2012, http://www.bls.gov/web/laus/laumstrk.htm.

11 National Governors Association and National Association of State Budget Officers, *The Fiscal Survey of States* (Spring 2012), pp. vii-x, http://www.nasbo.org/sites/default/files/Spring%202012%20Fiscal%20Survey_1.pdf. Estimates included in these reports showing that revenues are expected to recover to pre-recession levels are not adjusted for inflation.

12 National Governors Association and National Association of State Budget Officers, *The Fiscal Survey of States*, Spring 2012, p. vii.

13 Pew analysis of U. S. Census Bureau, *2010 Annual Survey of State and Local Government Finances* (2010), http://www.census.gov/govs/estimate/.

14 Pew Center on the States, *The Local Squeeze: Falling Revenues and Growing Demand for Services Challenge Cities, Counties, and School Districts* (June 2012), http://www.pewstates.org/uploadedFiles/PCS_Assets/2012/Pew_Local_Squeeze(1).pdf.

15 Pew Analysis of U.S. Census Bureau, *2010 Annual Survey of State Government Finances*, December 2011.

16 For a list of changes to the estate tax and individual income tax provisions scheduled to occur, see Roberton Williams, Eric Toder, Donald Marron, and Hang Nguyen, *Toppling Off the Fiscal Cliff: Whose Taxes Rise and How Much?* (Urban-Brookings Tax Policy Center, October 1, 2012), http://www.taxpolicycenter.org/UploadedPDF/412666-toppling-off-the-fiscal-cliff.pdf. The estate tax provisions included in the 2001 tax cut were due to expire at the end of 2010 and were replaced with new provisions enacted in 2010. Although the AMT patch and various other provisions have already expired, these changes are included in the fiscal cliff because most taxpayers would not pay the resulting increase in 2012 tax liabilities until they file their taxes in 2013. The scheduled expiration of the individual income tax rate cuts at the end of 2012 would have a more immediate impact, as the higher rates would be reflected in the 2013 withholding schedules.

17 Congressional Budget Office, *An Update to the Budget and Economic Outlook: Fiscal Years 2012 to 2022*, August 2012.

18 This is the number of states that either (1) allow taxpayers to deduct federal taxes paid, or (2) would be affected by scheduled changes to at least one of the following: various deductions, the Child and Dependent Care Credit, the Earned Income Tax Credit, corporate income tax deduction rules, or the estate tax. See Table 2.

19 Williams et al., *Toppling Off the Fiscal Cliff*, 2012.

20 Institute on Taxation and Economic Policy, *Why States That Offer the Deduction for Federal Income Taxes Paid Get It Wrong* (August 2011), http://www.itep.org/pdf/pb51fedinc.pdf.

21 For example, 29 states begin their tax calculations by having taxpayers copy over adjusted gross income from their federal tax form, while eight states start with federal taxable income; Federation of Tax Administrators, *State Personal Income Taxes: Federal Starting Points,* January 2012. Because these federal starting points already incorporate various federal deductions, those deductions are implicitly adopted by these states as well. While states sometimes make modifications to disallow or adjust some of the federal deductions on their state tax returns, many of the deductions still impact states. Even in the few states that do not use a federal starting point, various federal deductions often are selectively adopted.

22 Certain provisions that expired at the end of 2011 are considered part of the fiscal cliff because most of the initial revenue impact from their expiration would occur in 2013, when most taxpayers file their 2012 income taxes.

23 U.S. Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals* (February 2012), Table 2, http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2013.pdf. This includes the scheduled return of two tax provisions: the limit on the value of itemized deductions for certain high-income taxpayers, often referred to as the "Pease" limitation; and the personal exemption phase-out, or PEP, which reduces and ultimately eliminates the personal exemption for high-income taxpayers.

24 Congressional Budget Office, "Effects of Extending Tax Provisions Scheduled to Expire Before 2022," supplemental table to *An Update to the Budget and Economic Outlook: Fiscal Years 2012 to 2022* (August 2012), http://www.cbo.gov/publication/43547; and U.S. Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals*, February 2012, Table 2. The deduction for higher education tuition and fees expired at the end of 2011. Tax provisions that expired at the end of 2011 affect tax calculations for tax year 2012. These provisions are considered part of the fiscal cliff because most of the initial revenue impact from their expiration would occur in 2013, when most taxpayers file their 2012 income taxes.

25 Lower federal deduction amounts would result from changes to both "above-the-line" and "below-the-line" deductions. Calculations are based on information from the Federation of Tax Administrators, *State Personal Income Taxes: Federal Starting Points*, January 2012, and Pew Center on the States interviews with Karen Jacobs, senior economist, Arizona Department of Revenue, September 18, 2012; Paul Wilson, director, Tax Research Division, Minnesota Department of Revenue, September 18, 2012; Laura Wheeler, senior research associate, Georgia State University Fiscal Research Center, September 28, 2012; Roger Cox, director, Research and Development Division, West Virginia State Tax Department, October 1, 2012; Jon Hart, senior economist, Oregon Department of Revenue, October 2, 2012; Susan Mesner, senior economist, Vermont Department of Taxes, October 3, 2012; Jim Landers, senior fiscal analyst, Indiana Legislative Services Agency, October 5, 2012; and Michael Allen, director of economic research, Maine Revenue Services, October 8, 2012.

26 The EITC is designed to reward the work of lower-income workers by offsetting federal payroll taxes and, in cases where the credit exceeds tax liability, providing cash assistance. Internal Revenue Service, *EITC—It's Easier Than Ever to Find Out if You Qualify for EITC*, accessed October 9, 2012, http://www.irs.gov/Individuals/EITC-Home-Page--It's-easier-than-ever-to-find-out-if-you-qualify-for-EITC. The CDCC helps families pay for child or dependent care needed for a parent or spouse to work or look for work. Internal Revenue Service, *Ten Things to Know About the Child and Dependent Care Credit* (March 7, 2011), http://www.irs.gov/uac/Ten-Things-to-Know-About-the-Child-and-Dependent-Care-Credit.

27 Twenty-three states and the District of Columbia have child care tax credits or deductions that are linked to the federal CDCC. Nancy Duff Campbell, Amy K. Matsui, Julie G. Vogtman, and Anne W. King, *Making Care Less Taxing: Improving State Child and Dependent Care Tax Provisions* (National Women's Law Center, April 2011), Appendix A, http://www.nwlc.org/sites/default/files/pdfs/nwlc-mclt2011-without_report_card_inside_and_bookmarked.pdf. Twenty-three states and the District of Columbia have a state-level EITC tied to the federal EITC. Two additional states had state EITCs in law but they were suspended (Colorado) or not yet implemented (Washington) as of 2011. Tax Credits for Working Families, *States with EITCs*, accessed October 1, 2012, http://www.taxcreditsforworkingfamilies.org/earned-income-tax-credit/states-with-eitcs/.

28 U.S. Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals*, February 2012, Table 2.

29 These states include Alabama, Colorado, Connecticut, Delaware, Illinois, Kansas, Louisiana, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, Montana, Nebraska, New Mexico, New York, North Dakota, Oklahoma, South Carolina, Utah, Vermont, Virginia, and West Virginia. Commerce Clearinghouse, *2012 State Tax Handbook* (2011).

30 The "enhanced expensing" rules under section 179 of the Internal Revenue Code allow businesses to deduct, or "expense," part or all of the cost of new and used qualified property in the first year, up to $125,000. Bonus depreciation allows 50 percent of the cost of qualified property to be deducted in the first year. Commerce Clearinghouse, *2012 State Tax Handbook*, 2011, pp. 424-432. For a full legislative history see Gary Guenther, *Section 179 and Bonus Depreciation Expensing Allowances: Current Law, Legislative Proposals in the 112th Congress, and Economic Effects* (Congressional Research Service, August 2, 2012), http://www.nationalaglawcenter.org/assets/crs/RL31852.pdf.

31 Congressional Budget Office, "Effects of Extending Tax Provisions Scheduled to Expire Before 2022," supplemental table to *An Update to the Budget and Economic Outlook: Fiscal Years 2012 to 2022*, August 2012.

32 The short-term revenue increase would be partially offset by future revenue losses. The corporate income rules that are set to expire have allowed businesses to front-load deductions for business expenses over a shorter period of time, making the deduction more valuable in the near term and less valuable in the long term. The expiration of these rules would require businesses to spread the deduction over a longer period, essentially limiting the deduction amount in any single year. For a description of the revenue-shifting impact of these provisions see the Urban-Brookings Tax Policy Center *Quick Facts: Bonus Depreciation and 100 Percent Expensing*, accessed October 8, 2012, http://www.taxpolicycenter.org/taxtopics/Bonus-Depreciation-and-100-Percent-Expensing.cfm#5.

33 Together, the expiring federal estate and gift taxes are estimated to increase federal revenues by a combined $4.6 billion in 2013 (and $28.0 billion in 2014). Congressional Budget Office, "Effects of Extending Tax Provisions Scheduled to Expire Before 2022," supplemental table to A*n Update to the Budget and Economic Outlook: Fiscal Years 2012 to 2022*, August 2012. This combined estimate does not break out revenues from the federal gift tax, but these generally account for a small amount of total federal estate and gift tax revenues, for example, roughly 11 percent in 2008. See Congressional Budget Office, *Federal Estate and Gift Taxes* (December 2009), http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/108xx/doc10841/12-18-estate_gifttax_brief.pdf.

34 Five states permanently eliminated their estate taxes, while 15 states and the District of Columbia either do not reference the federal estate tax credit at all or refer to the federal credit as it stood before the 2001 estate tax changes, rendering their estate tax effectively independent of future changes in the federal credit. Norton Francis, *Back From the Dead: State Estate Taxes After the Fiscal Cliff* (Urban-Brookings Tax Policy Center, November 14, 2012).

35 The federal credit allows states to levy an estate tax, up to a certain level, without increasing the combined federal and state tax burden on an estate. As a result, in the 30 states that are linked to the federal credit, the increase in state revenues would come from foregone revenues at the federal level, rather than from additional taxes imposed on an estate. Leonard Burman and Sonya Hoo, *State-Level Estate and Inheritance Taxes* (Urban-Brookings Tax Policy Center, August 28, 2006), http://www.taxpolicycenter.org/publications/url.cfm?ID=1001019.

36 Congressional Budget Office, A*n Update to the Budget and Economic Outlook: Fiscal Years 2012 to 2022*, August 2012, Box 2-1.

37 Congressional Budget Office, *An Update to the Budget and Economic Outlook: Fiscal Years 2012 to 2022*, August 2012.

38 Ibid.

39 From 2000 to 2010, federal grants accounted for an average 30 percent of total state revenues. In 2010, the most recent year for which data are available, federal grants accounted for about 35 percent of total state revenues, reflecting the influx of federal stimulus funds and the concurrent decline in state tax revenues. "Grants" is a broad term that also includes payments-in-lieu-of-taxes and reimbursements, among other provisions. U.S. Census Bureau, *2010 Annual Survey of State Government Finances*, December 2011.

40 Federal Funds Information for States, *What if the BCA Sequester Is Implemented Next January?* (July 20, 2012), http://www.ffis.org/node/2860.

41 Chris Whatley, *Sequestration and the States* (Council on State Governments, *Knowledge Center*, November 22, 2011), http://knowledgecenter.csg.org/drupal/content/sequestration-and-states.

42 Pew analysis of data from the U.S. Census *Consolidated Federal Funds Report for Fiscal Year 2010* and state gross domestic product data for 2010 from the U.S. Bureau of Economic Analysis, *Regional Economic Accounts*, 2012. Does not include U.S. Postal Service, as only a small share of USPS spending is supported by the federal budget.

43 Virtually all domestic federal spending, including payments and aid sent directly to individuals, such as Social Security benefits and cash and non-cash income support, affects economic conditions in the states. The BCA exempts such direct payments to individuals from the automatic cuts.

44 Relative to the Congressional Budget Office's March 2011 current law baseline. Congressional Budget Office, *Estimated Impact of Automatic Budget Enforcement Procedures Specified in the Budget Control Act* (September 12, 2011), http://www.cbo.gov/sites/default/files/cbofiles/attachments/09-12-BudgetControlAct.pdf.

45 Congressional Budget Office, *Estimated Impact of Automatic Budget Enforcement Procedures Specified in the Budget Control Act*, September 12, 2011.

46 Federal Funds Information for States, *What if the BCA Sequester Is Implemented Next January?* July 20, 2012.

47 Congressional Budget Office, *Estimated Impact of Automatic Budget Enforcement Procedures Specified in the Budget Control Act*, September 12, 2011. Cuts to Medicare are scheduled to go into effect in February 2013. Congressional Budget Office, *An Update to the Budget and Economic Outlook: Fiscal Years 2012 to 2022*, August 2012.

48 In general, sequestration applies the same percentage spending cut to every program, project and activity within a given budget account, but it is unclear how much flexibility agencies would have in implementing the cuts. See, for example, Karen Spar, *Budget 'Sequestration' and Selected Program Exemptions and Special Rules* (Congressional Research Service, August 9, 2012), http://www.fas.org/sgp/crs/misc/R42050.pdf.

49 Congressional Budget Office, *Estimated Impact of Automatic Budget Enforcement Procedures Specified in the Budget Control Act*, September 12, 2011.

50 Congressional Budget Office, *An Update to the Budget and Economic Outlook: Fiscal Years 2012 to 2022*, August 2012.

51 Office of Management and Budget, *OMB Report Pursuant to the Sequestration Transparency Act of 2012* (September 14, 2012), http://www.whitehouse.gov/sites/default/files/omb/assets/legislative_reports/stareport.pdf.

52 Technically, cuts under the sequester apply to budgetary resources. Defense cuts under sequestration would come almost entirely from discretionary accounts. OMB has calculated that mandatory defense spending, which would be reduced by 10 percent, would be cut by $0.1 billion. In a July 31, 2012, letter to Vice President Biden, OMB issued notice of the president's intent to exempt all military uniformed personnel accounts, which are discretionary, from sequestration (http://www.whitehouse.gov/sites/default/files/omb/legislative/letters/military-personnel-letter-biden.pdf).

53 Other nonexempt mandatory programs include student loans, vocational rehabilitation, and other smaller programs. The BCA exempts many mandatory programs from sequestration, including Medicaid, the Children's Health Insurance Program (CHIP), veterans' benefits, Temporary Assistance for Needy Families (TANF), SNAP, and other income support programs. Office of Management and Budget, *OMB Report Pursuant to the Sequestration Transparency Act of 2012*, September 14, 2012.

54 Under the BCA, cuts to Medicare and certain other programs are limited to 2 percent of the current law baseline.

55 Federal Funds Information for States, *What if the BCA Sequester Is Implemented Next January?* July 20, 2012. This figure is based on grants included in the FFIS database, which includes almost all federal grants to states.

56 Federal Funds Information for States database, updated October 10, 2012, http://www.ffis.org/database.

57 Chris Whatley, *Sequestration and the States*, November 22, 2011.

58 National Association of State Budget Officers, *Impact on States of Federal Deficit Reduction*, October 5, 2011.

59 Pew analysis of Federal Funds Information for States database and U.S. Census, *2010 Annual Survey of State Government Finances*, December 2011. Calculations exclude funds for certain programs that would be subject to sequester but for which fiscal year 2013 funds would be disbursed October 1, 2013, at the start of fiscal year 2014. These include funds from the following programs: Abandoned Mine Land Reclamation, U.S. Bureau of Land Management Payments in Lieu of Taxes, Boating Safety Financial Assistance, Coastal Impact Assistance, Crime Victim Assistance, Crime Victim Compensation, Sport Fish Restoration, Wildlife Restoration and Basic Hunter Education, U.S. Forest Service Schools and Roads—Grants to States, and the Mineral Leasing Act program.

60 Pew analysis of Federal Funds Information for States database and U.S. Census, *2010 Annual Survey of State Government Finances*, December 2011.

61 Pew analysis of U.S. Census Bureau, *Consolidated Federal Funds Report for Fiscal Year 2010*, September 2011, and state gross domestic product data from the U.S. Bureau of Economic Analysis, Regional Economic Accounts, 2012. The CFFR procurement data are allocated by place of performance. Maryland, Virginia, and the District of Columbia data are combined due to the high percentage of commuters in the area.

62 Pew analysis of U.S. Census Bureau, *Consolidated Federal Funds Report for Fiscal Year 2010*, September 2011. The Office of Management and Budget on July 31, 2012, issued notice of the president's intent to exempt all military uniformed personnel accounts, which are discretionary, from sequestration.

63 Pew analysis of U.S. Census Bureau, *Consolidated Federal Funds Report for Fiscal Year 2010*, September 2011, and state gross domestic product data from the U.S. Bureau of Economic Analysis, *Regional Economic Accounts*, 2012. The CFFR defense spending categories are based on major agency codes while the BCA sequester applies to the budget function code for defense (050). While there are differences, this analysis uses CFFR data for purposes of showing the comparative importance of defense spending overall to state economies. Fiscal year 2010 data are used as it is the most recent year for which CFFR and state GDP data are available.

64 Ibid.

65 Ibid.

66 Pew analysis of U.S. Census Bureau, *Consolidated Federal Funds Report for Fiscal Year 2010*, September 2011, and state gross domestic product data from the U.S. Bureau of Economic Analysis, *Regional Economic Accounts*, 2012. Maryland, Virginia, and the District of Columbia data are combined due to the high percentage of commuters in the area.

67 Pew analysis of U.S. Bureau of Labor Statistics, *Regional and State Employment and Unemployment* (May 2012), http://www.bls.gov/news.release/archives/laus_06152012.htm; and data from U.S. Office of Personnel Management, FedScope (March 2012), http://www.fedscope.opm.gov/employment.asp.

68 Ibid.

69 Ibid.

70 Congressional Budget Office, *An Update to the Budget and Economic Outlook: Fiscal Years 2012 to 2022*, August 2012. On net, spending on unemployment benefits will be $34 billion less in fiscal year 2013 compared with fiscal year 2012, and the majority of the change is attributable to the expiration of federally funded benefits.

71 U.S. Department of Labor, *State Unemployment Insurance Benefits*, updated January 13, 2010, http://workforcesecurity.doleta.gov/unemploy/uifactsheet.asp.

72 Ibid.

73 Julie M. Whittaker and Katelin P. Isaacs, *Unemployment Insurance: Legislative Issues in the 112th Congress* (Congressional Research Service, September 12, 2012), http://www.fas.org/sgp/crs/misc/R41662.pdf.

74 Ibid.

75 Ibid.

76 Ibid.

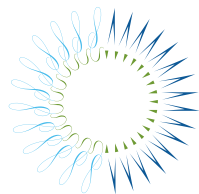
77 As of October 7, 2012. U.S. Department of Labor, Employment and Training Administration, *Trigger Notice No. 2012-38, State Extended Benefit (EB) Indicators Under P.L. 112-96*, accessed October 22, 2012, http://ows.doleta.gov/unemploy/trigger/2012/trig_100712.html.

78 At the time of writing, New York was on the EB program through the week ending December 9, 2012. Whether it continues to stay on EB past that date depends on future unemployment data.

79 Congressional Budget Office, *An Update to the Budget and Economic Outlook: Fiscal Years 2012 to 2022*, August 2012.

80 Centers for Medicare and Medicaid Services, *Estimated Sustainable Growth Rate and Conversion Factor, for Medicare Payments to Physicians in 2012* (March 2012), http://www.cms.gov/Medicare/Medicare-Fee-for-Service-Payment/SustainableGRatesConFact/Downloads/sgr2012p.pdf.

81 The 2 percent cut specified under the BCA applies to Medicare payments to Medicare Advantage plans, Part D (prescription drug) plans, and hospitals and physicians, while the “doc fix” related cut applies only to physicians.



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