# 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**.