

# *Federal-State Fiscal Relationships In The United States: Implications for Border States*

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Donald J. Boyd, Director of Fiscal Studies

Nelson A. Rockefeller Institute of Government  
Richard P. Nathan, Director

[boydd@rockinst.org](mailto:boydd@rockinst.org) • 518-443-5284

[www.StateAndLocalGateway.rockinst.org](http://www.StateAndLocalGateway.rockinst.org)



# Key Elements of Intergovernmental Fiscal Relations

- Federal spending in the states
  - All elements of federal budget
  - Intergovernmental grants in particular
- Tax policy
- Mandates

# Economic and Demographic Backdrop

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	<b>United States</b>	<b>Arizona</b>	<b>California</b>	<b>New Mexico</b>	<b>Texas</b>
Population, 2000	281,421,906	5,130,632	33,871,648	1,819,046	20,851,820
% change from 1990	13.1%	40.0%	13.6%	20.1%	22.8%
Percent aged 65+, 2000	12.4%	13.0%	10.6%	11.7%	9.9%
% above (below) U.S. average		4.8%	(14.5%)	(5.6%)	(20.2%)
Percent aged 5-17, 2000	18.9%	19.1%	20.0%	20.8%	20.4%
% above (below) U.S. average		1.1%	5.8%	10.1%	7.9%
Percent of population of Hispanic/Latino origin, or nonwhite	30.9%	36.2%	53.3%	55.3%	47.6%
% above (below) U.S. average		17.2%	72.5%	79.0%	54.0%
Language other than English spoken at home, pct age 5+, 2000	17.9%	25.9%	39.5%	36.5%	31.2%
% above (below) U.S. average		44.7%	120.7%	103.9%	74.3%
Per capita income, 1999	21,587	20,275	22,711	17,261	19,617
% above (below) U.S. average		(6.1%)	5.2%	(20.0%)	(9.1%)
Poverty rate (2001-2003 average)	12.1%	13.9%	12.9%	18.0%	15.8%
% above (below) U.S. average		14.9%	6.6%	48.8%	30.6%
Percent of people without health insurance (2001-2003 average)	15.1%	17.3%	18.7%	21.3%	24.6%
% above (below) U.S. average		14.6%	23.8%	41.1%	62.9%

Sources: U.S. Bureau of the Census, U.S. Bureau of Economic Analysis, U.S. Bureau of Labor Statistics

# Fiscal Capacity and Need Measures

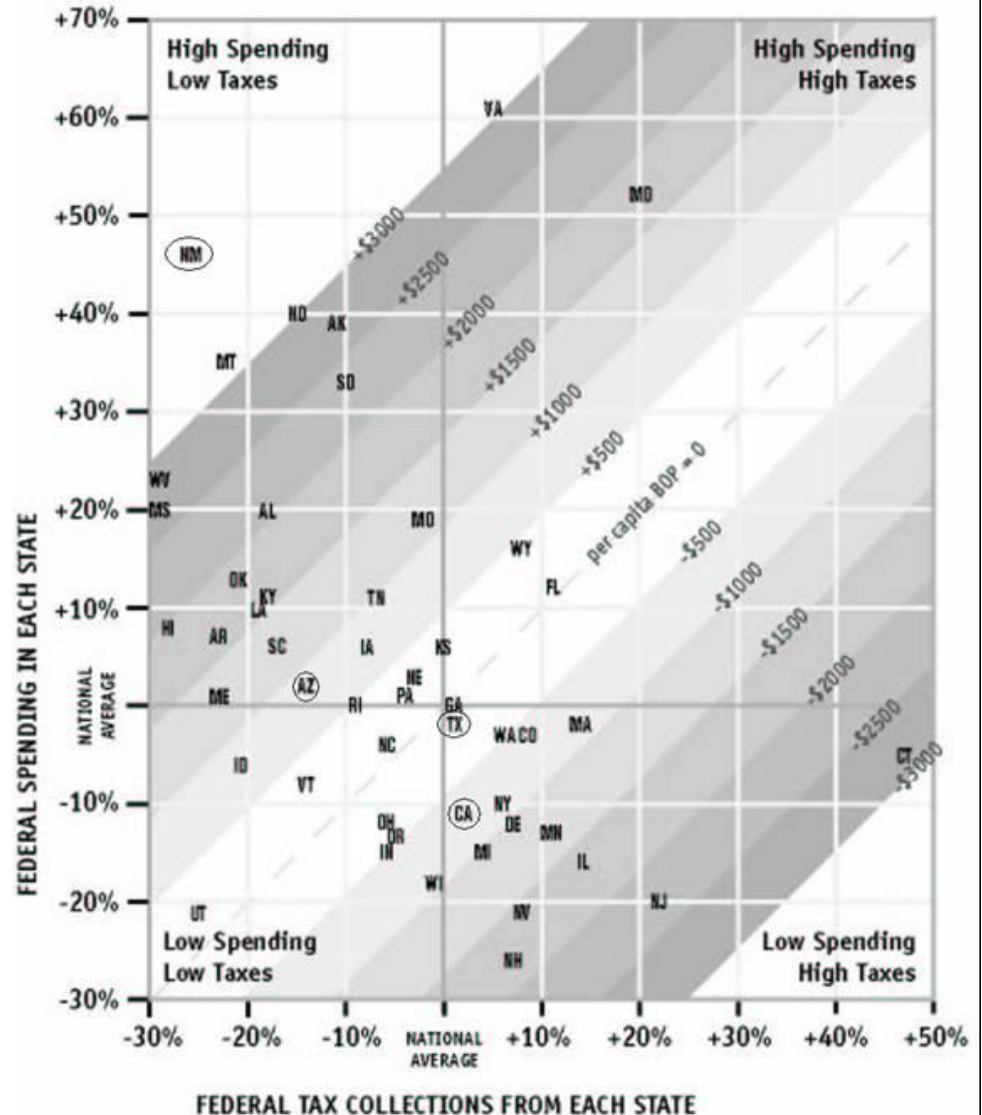
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	United States	Arizona	California	New Mexico	Texas
<b>Representative Tax and Expenditure System for 1997 (ACIR/Tannenwald)</b>					
Fiscal capacity	100	100	116	90	91
Fiscal need	100	106	109	112	107
Fiscal "comfort" (Reflects capacity and need indexes)	100	95	106	80	85
Fiscal effort	100	84	88	97	91

Source: Tannenwald, Robert; Interstate Fiscal Disparities in 1997; New England Economic Review

# Federal “Balance of Payments”

- Kennedy School researchers periodically estimate total federal spending (not just grants) in each state, and total federal taxes paid (Latest: 1999)
- NM consistently has positive “balance of payments”
- CA has slightly negative BOP; AZ, slightly positive; TX close to average



# Why do some have surpluses, some deficits?

**Arizona: Small positive “balance of payments” (“surplus”): +\$904 per capita**

- Driven primarily by lower federal taxes per capita, due to lower than average income
- Federal defense spending in AZ is 50% higher than average, but several other spending categories are lower, offsetting defense

**California: Small negative BOP (“deficit”): (\$685) per capita**

- Driven primarily by lower-than-average Social Security (younger population) and non-defense discretionary spending

**New Mexico: Huge BOP surplus: \$+3,944 per capita**

- Federal defense expenditures per capita nearly triple the US average
- Federal taxes per capita one-quarter below US average, due to relatively low income
- Nondefense discretionary spending in NM more than 50% higher than US average

**Texas: Close to neutral (small deficit): (\$189) per capita**

- Federal defense and nondiscretionary expenditures slightly above average
- Social Security lower than average (younger population)
- Other small differences yield small deficit

# Federal Grants In S&L Budgets

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- More than 1 in 5 dollars of state & local government revenue come from federal government
  - More important to states than local gov'ts
  - Particularly important in New Mexico, but important to all border states

Federal grants as percentage of state and local government general revenue, 2002

	United States	Arizona	California	New Mexico	Texas
<b>State government</b>	29.9%	30.7%	28.9%	32.5%	33.2%
<b>Local government</b>	4.3%	5.1%	4.6%	7.1%	3.5%
<b>State &amp; local gov't</b>	21.4%	22.4%	21.3%	28.7%	21.0%

Source: U.S. Bureau of the Census

# Federal Grants, Per Capita

## Federal grants to state and local government, per capita, 2003

	United States	Arizona	California	New Mexico	Texas
Total	\$1,326	\$1,259	\$1,302	\$2,009	\$1,101
Medicaid (Centers for Medicare & Medicaid Services)	575	584	497	853	466
Housing & Community Development	135	89	126	102	82
Health and Human Services other than Medicaid & TANF	119	116	141	160	102
Highway Trust Fund	98	84	77	139	117
Elementary/Secondary and Special Education	85	107	101	161	103
Nutrition Programs (USDA)	66	62	71	92	79
Temporary Assistance to Needy Families (TANF)	66	58	116	56	29
Transportation other than Highway Trust Fund	35	24	46	26	22
Employment & Training	26	20	30	32	20
Department of the Interior	13	40	6	215	3
All other	107	75	91	172	78

### Each state minus the United States average

Total		(\$67)	(\$24)	\$683	(\$225)
Medicaid (Centers for Medicare & Medicaid Services)		9	(78)	278	(109)
Housing & Community Development		(46)	(10)	(33)	(53)
Health and Human Services other than Medicaid & TANF		(3)	22	41	(17)
Highway Trust Fund		(14)	(22)	41	19
Elementary/Secondary and Special Education		22	16	76	18
Nutrition Programs (USDA)		(5)	5	26	13
Temporary Assistance to Needy Families (TANF)		(8)	51	(10)	(37)
Transportation other than Highway Trust Fund		(11)	10	(9)	(14)
Employment & Training		(6)	4	6	(6)
Department of the Interior		27	(7)	202	(10)
All other		(32)	(16)	65	(29)

Source: United States Bureau of the Census, Federal Aid to States 2003



# Selected Federal Grants, Alternative View

## Federal grants to state and local government, 2003

	United States	Arizona	California	New Mexico	Texas	
Estimated poverty population, 2003, millions	35.19	0.78	4.58	0.34	3.49	
Children under 19 at or below 200% of poverty level, millions	29.28	0.68	4.17	0.28	3.13	
Medicaid (Centers for Medicare & Medicaid Services)	4,754	4,200	3,854	4,739	2,949	per poor person
Housing & Community Development	1,119	643	976	568	521	per poor person
Health and Human Services other than Medicaid & TANF	1,182	948	1,201	1,085	721	per child <=200% poverty
Elementary/Secondary and Special Education	842	874	859	1,088	729	per child <=200% poverty
Nutrition Programs (USDA)	657	504	606	625	560	per child <=200% poverty
Temporary Assistance to Needy Families (TANF)	654	474	991	377	201	per child <=200% poverty
Employment & Training	216	145	232	180	128	per poor person

## Each state minus the United States average

Medicaid (Centers for Medicare & Medicaid Services)	(554)	(900)	(16)	(1,805)	per poor person
Housing & Community Development	(476)	(143)	(552)	(598)	per poor person
Health and Human Services other than Medicaid & TANF	(234)	19	(97)	(461)	per child <=200% poverty
Elementary/Secondary and Special Education	32	16	246	(114)	per child <=200% poverty
Nutrition Programs (USDA)	(154)	(51)	(33)	(97)	per child <=200% poverty
Temporary Assistance to Needy Families (TANF)	(180)	337	(276)	(452)	per child <=200% poverty
Employment & Training	(71)	17	(35)	(87)	per poor person

Source: United States Bureau of the Census: Federal Aid to States 2003; Income, Poverty, and Health Insurance Coverage in the United States: 2003

# How can this be?

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- Medicaid:
  - Federal aid based on what each state actually spends on program, NO CAP
  - “FMAP” (Federal Medical Assistance Percentage) ranges from 50-77% in FFY 2005 and averages about 55-57%. FMAP is highest for low-income states:
    - AZ 67.5%
    - CA 50.0
    - NM 74.3
    - TX 60.9
  - Higher-income states often spend the most on Medicaid, and so get the greatest federal aid despite their lower reimbursement rate (FMAP)
  - Price differences across states also could be a factor
- TANF: Initial block grants were based on actual spending on AFDC and related programs, based on FMAP. Again, richer states often spent more on AFDC/... and thus received larger federal TANF block grants despite their lower reimbursement rate.
- Other aid programs could have low federal spending per poor person due to lower prices in border states than in US as a whole (e.g., lower rent)

# Grants - Upcoming Issues

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- Cuts and restructuring of federal grants are virtually inevitable:
  - Federal deficit likely to exceed \$4-5 trillion over next decade. Enormous pressure to scale back Medicaid, other grants
  - President's budget expressed commitment to major Medicaid restructuring, perhaps via waivers
  - Prior Congressional efforts to move closer to block grant for Medicaid
  - Cuts and restructuring across other grants more generally

# Tax Policy

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- **Deductibility:** S&L income, property taxes deductible from *current* federal income tax; municipal bond interest is excluded from income
- **Commerce Clause:** Internet taxation, corporate nexus rules
- **Administration:** Existence of federal income & estate taxes make collection of state & local counterparts efficient, even feasible
- **Federal tax reform:** Enormous implications for state and local governments, depending on reforms adopted

# Tax Policy – Deductibility

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- HUGE benefits of income, property tax deductibility for state and local taxpayers - more than \$50 billion annually in FFY 2000 (Joint Economic Committee)
- Not spread evenly through country. One crude indicator is state and local property and income taxes per capita, indexed to US. Table suggests AZ, NM, and TX taxpayers helped less by deductibility than other states on average.
- A live issue if serious federal tax reform discussions about federal consumption tax. S&L taxes not deductible in some variants.
- Meanwhile, NCSL was calling for Congress to restore the sales tax deduction.

**State and local taxes per capita**  
Indexed to US average, Fiscal Year 2002

	<b>Income and property taxes (currently can be deductible)</b>	<b>Sales taxes (not deductible)</b>
Arizona	70.8	139.6
California	108.4	115.9
New Mexico	56.2	123.4
Texas	68.0	109.8

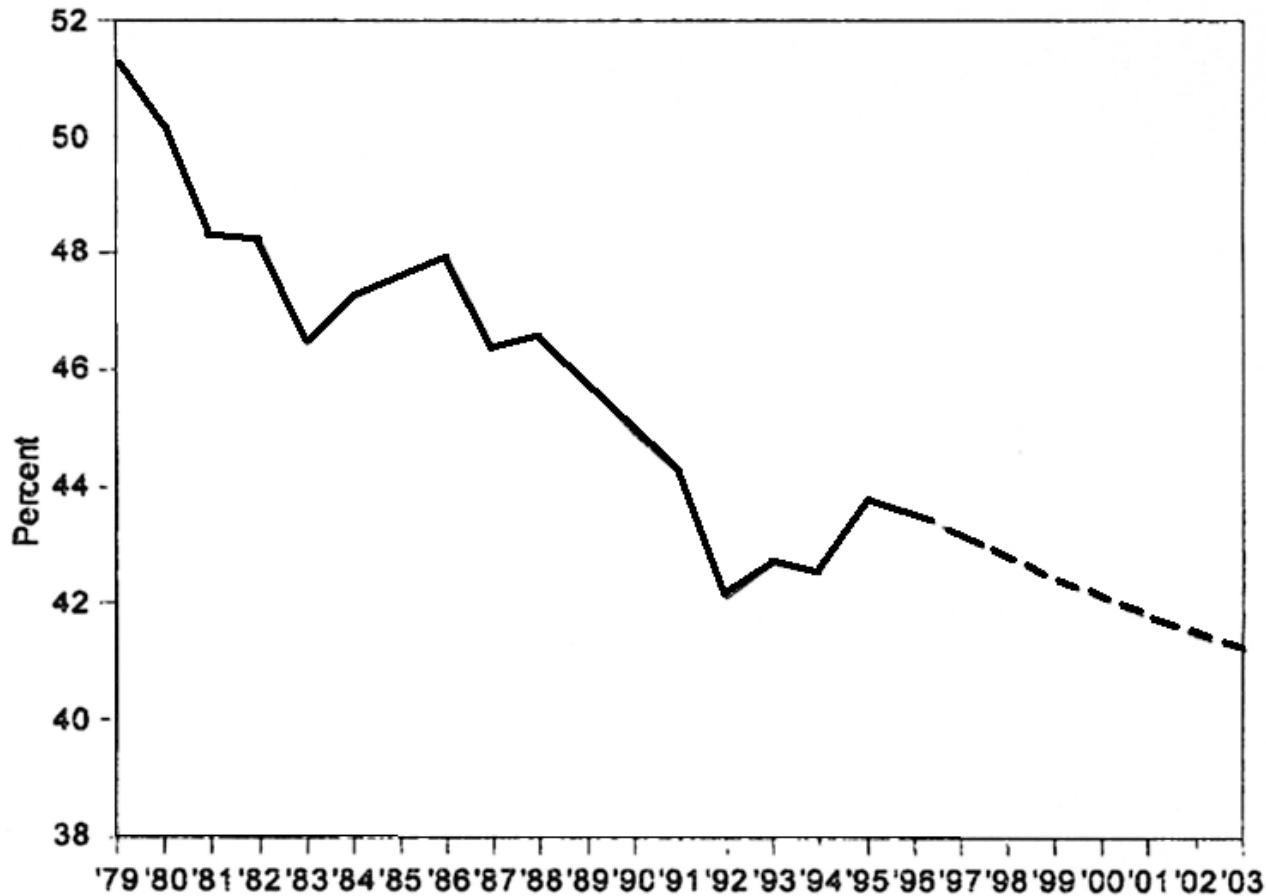
# Tax Policy – Internet Taxation

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- States generally cannot compel out-of-state vendors (no physical presence) to collect sales (use) tax:
  - Open 2 browser windows, Amazon and Barnes and Noble, and price out 2 identical sets of books – Amazon will show no tax, BN typically will have tax.
- Issue is nexus and Commerce Clause - if states simplify tax sufficiently to remove undue burden, Congress can allow states to require out of state vendors to collect use tax

# Tax Policy – Declining Sales Tax Base

Sales Tax Base as a Percent of Personal Income, 1979–2003



- E-commerce, mail order, cross-border losses. Also:
- Shift from goods to service consumption
- Exemption creep

Reproduced from Bruce, Donald and William F. Fox, "E-Commerce in the Context of Declining State Sales Tax Bases," *National Tax Journal*, 53(3,4) 2000.

# Tax Policy – E-Commerce Revenue Losses

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- Streamlined Sales and Use Tax Agreement (SSUTA) could give states authority to require collection of tax from out-of-state vendors. Requires federal action after states act.
- E-Commerce revenue losses are large, especially in AZ and TX

## Projected 2008 State Revenue Losses From E-Commerce As % of 2003 State Total Tax Collections

	Midpoint of Low and High Estimates
Arizona	6.0%
California	3.8%
New Mexico	5.0%
Texas	7.3%
United States	5.0%

Source: Bruce & Fox, 2004, Table 6



# Tax Policy – Federal Tax Reform

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- Potentially huge impacts on state and local governments, but depends on specific provisions. S&L govts tend to be an afterthought.
- Some versions of consumption tax could:
  - Eliminate deductibility of property, income taxes (possibly relative advantage for border states)
  - Eliminate interest exclusion for new state & local debt
  - Usurp S&L gov'ts' traditional role as levy-ers of sales taxes
  - Even make it difficult/impossible to administer traditional income taxes (as has happened with estate and gift taxes)

# Mandates – What is a mandate?

- Unfunded Mandates Reform Act of 1995 (UMRA), generally defines mandate as:
  - any provision in legislation, statute, or regulation that would impose an enforceable duty on state, local, or tribal governments or the private sector, or that would reduce or eliminate the amount of funding authorized to cover the costs of existing mandates
- This is far narrower than what states consider mandate. For example, does not cover actions that:
  - Make grant aid contingent on state action
  - Reduce funding but do not reduce state requirements
  - Extend or expand existing mandates
  - Create national expectations – e.g., homeland security
- As a result, UMRA did not cover:
  - *No Child Left Behind*: (voluntary – conditions for grant funds)
  - 2001 Tax Act, which phased out estate tax, making state estate taxes impractical, with revenue loss to states: (no enforceable duty on state and local governments)

## Mandates – Defined

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- Only 3 laws since 1995 exceed UMRA thresholds
  - Minimum wage increase (1996)
  - Reduction in Food Stamps administrative funds (1997)
  - Pre-emption of state taxes on prescription drug premiums
- NCSL – Currently tracking a broader concept of “cost shifts”

# Mandates – NCSL “Cost Shifts”

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## NCSL Estimates of Cost Shifts

	<b>FFY 2005</b> (\$ billions)
<i>No Child Left Behind</i>	\$10.0
Individuals with Disabilities Education Act (IDEA)	9.0
State Drug Costs for Dual-Eligibles	6.6
Medicaid Intergovernmental Transfers (IGTs) limits, other	1.9
Environment	1.5
Homeland security items	1.3
State Criminal Alien Assistance Program (SCAAP)	0.3
Food Stamps administration	0.2
Other	1.2
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Total	\$30.7

Source: National Conference of State Legislatures, *Mandate Monitor*, July 2004

# Mandates – NCSL “Cost Shifts”

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**NCSL State-By-State Cost-Shift Estimates, Selected Items  
FFY 2005, \$ Millions**

	<b>United States</b>	<b>Arizona</b>	<b>California</b>	<b>New Mexico</b>	<b>Texas</b>
<i>No Child Left Behind, Title I grants</i>	\$6,834	\$131	\$982	\$66	\$624
Individuals with Disabilities Education Act (IDEA)	9,511	145	1,028	79	795
State Drug Costs for Dual-Eligibles	6,553	37	936	14	304
Other	755	14	123	5	39
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Total of above	\$23,653	\$328	\$3,069	\$164	\$1,762

Source: National Conference of State Legislatures, *Mandate Monitor*, July 2004

# Mandates

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- Even the NCSL “Cost Shift” concept is narrower than what states may feel compelled to do, even if they are not mandated to do it.
- For example, achieving the goals articulated in NCLB may require considerable expenditure. One analysis suggests doing this in Texas could require a doubling of state aid to school districts. (All estimates of this sort are fraught with uncertainty.) (See Reschovsky and Imazeki.)

# Conclusions

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- Border states will have many federal-state fiscal issues to contend with in coming years:
  - Protecting Medicaid reimbursements and perhaps making relative gains, in a period in which federal government will need to make cuts
  - Protecting other grant revenue from likely federal cuts
  - Looking out for state-local interests during a potential tax-reform debate
  - Dealing effectively with NCLB and other federal “quasi-mandates”

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