

## The Potential Impacts of Devolution on State Government Programs and Finances

### Testimony Finances before the House Budget Committee

Steven D. Gold

*The following perspective is that of the researcher named above and does not necessarily reflect the views of the Urban Institute, its officers, trustees, or sponsors.*

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I am pleased to speak to you today about devolution and state governments. I recently assumed a position as co-director of the New Federalism Project at the Urban Institute. This new project, with initial sponsorship from the Annie E. Casey Foundation, will monitor and assess the effects of the shift of responsibility from the federal government to state governments. It will track both state government fiscal adjustments and outcomes reflecting the well-being of children and their families. We look forward to presenting our findings as they develop over the next three years, not only to the Congress and other federal officials but also to state and local officials and the public at large. My comments today, however, reflect my own views rather than those of the Urban Institute or the Annie E. Casey Foundation.

Devolution is a mixed blessing for states. The positive side of the ledger—the increased flexibility in using funds that may accompany block grants—has been widely discussed, although it is impossible to be certain about how states will take advantage of that flexibility. Less attention has been devoted to the potential disadvantages of devolution, most of which are tied to diminished federal aid. Because there should be full awareness of these possible pitfalls, my testimony will emphasize the possible downside of devolution, the risks it entails and the problems it may cause. I must stress, however, that these negatives have to be balanced against the positive aspects of devolution.

I shall emphasize three points:

- Devolution as proposed by Congress will cause significant fiscal stress for state governments. It will eventually force most states to choose between raising taxes and reducing services.
- Devolution will have impacts on most state programs, including those that are not affected directly by large reductions in federal aid. For example, both elementary-secondary school aid and higher education funding will be hurt by the intensified competition for state dollars.
- The effects of devolution will grow steadily over the years. Many states will be able to absorb aid reductions initially without great difficulty, but states will really feel the effects of block grants (a) when a recession occurs or (b) as 2002 approaches, whichever comes first.

It is difficult to discuss devolution for several reasons: First, it is inherently complicated, with numerous important effects on states and citizens and major differences in how various states will be affected. Second, as the cliché goes, the devil is in the details. Some approaches to reducing federal aid and increasing state flexibility have very different effects than others. Third, policies like those in the budget reconciliation bill would fundamentally alter the welfare and Medicaid systems, confronting state governments with new choices. There is enormous uncertainty about how they would respond. Fourth, the time horizon matters: the short-run effects of devolution are likely to differ considerably from the long-run effects.

#### Three main effects of the New Federalism

The New Federalism reforms approved last year by Congress have three major aspects affecting state and local governments:

1. They would receive less federal aid.
2. Some of the most important aid programs would be changed from matching to non-matching grants.
3. States would have more flexibility in operating programs. What is not known at this time is the size of the aid reductions in relation to the benefits from increased flexibility.

*Aid reductions.* Aid to states will bear a disproportionate share of the spending reductions needed to balance the budget because the three largest spending categories—Social Security, defense, and interest payments—are expected to be cut relatively little if at all. In the reconciliation bill vetoed by the President in late 1995, aid would have been reduced approximately 26 percent <sup>1</sup>. If there is a budget agreement, the

eventual aid reduction will be smaller than 26 percent because the size of the federal tax reduction will be less than it was in the vetoed bill and more optimistic economic assumptions have reduced the prospective deficit in 2002. But the aid reduction would still be substantial, probably on the order of 15 percent to 20 percent.

This projected reduction is from what aid would have been under past federal law. In nominal dollars, the total amount of aid would increase. The components of aid should, however, be considered separately. The entire nominal increase between 1995 and 2002 is attributable to Medicaid, which accounted for about 40 percent of total aid in 1995. Excluding Medicaid, aid would fall in nominal dollars. It is also important to recognize that the baseline from which the aid reductions are calculated does not reflect the impact of inflation on discretionary programs in some years.

Federal aid represents between a quarter and a third of state government resources <sup>2</sup>. A 15-20 percent reduction from what aid would have been in 2002 implies that, other things being equal, total state revenues (including taxes, fees, and federal aid) will be about 5 percent lower than they would have been in that year. Spreading this reduction over seven years, we can say that total revenues will grow about 0.7 percent less than they otherwise would have. Whether states can absorb this reduction without having to reduce services or increase revenues depends on how fast current-services spending and revenue are growing. If the growth rate of revenue were at least 0.7 percent higher than the growth rate of spending, states could adjust to the loss of federal aid without having to cut back spending or raise taxes and fees. However, it appears that most states are not so fortunate. Indeed, many seem to have structural deficits.

This does not imply that states face immediate fiscal catastrophe. For one thing, aid reductions will be gradually phased in. Thus, the effects of aid reductions in squeezing state budgets will probably not be particularly dramatic at first but rather will grow steadily over time.

In addition, many states currently have accumulated substantial reserve balances that can provide a cushion to help them absorb federal aid cutbacks at first. But those balances represent non-recurring revenue, and they would disappear fast if a recession occurred.

Some observers may discount long term projections in the belief that policies could be changed before 2002, resulting in smaller cutbacks. Whether or not that assumption is accurate depends in part on whether a constitutional amendment to require a balanced federal budget is adopted. If it were, it would be much more difficult to avoid large aid reductions in the out-years.

*Shift from matching to non-matching grants.* At least as important as the amount of grants is their form. By proposing a shift from open-ended matching grants to block grants for Medicaid, Aid to Families with Dependent Children, and some smaller programs, the reforms incorporated in the budget reconciliation act would have significantly decreased the incentive for states to spend their own money on the affected programs. Since 1965, the federal government has paid from 50 percent to 83 percent of the cost of Medicaid and AFDC, so it cost states only 17 cents to 50 cents to increase their spending for those programs by a dollar. Under block grants, it would cost a dollar for states to spend a dollar <sup>3</sup>. Thus, the devolution revolution would reduce not only federal spending but also state spending as well. It is really a prescription for lower government spending.

The virtual abandonment of open-ended matching grants <sup>4</sup> is inconsistent with the view that such grants are needed to stimulate the production of services that provide national benefits. It may be appropriate to reduce the high matching rates for some existing programs, but a zero match is too low to produce an efficient level of services for which benefits extend beyond a state's borders. In other words, if a majority of citizens believe that there should be a national safety net that provides a minimal level of certain services, either programs should be funded entirely by the federal government or it should provide open-ended matching grants to encourage states to spend more for such services than they otherwise would.

Another important implication of block grants is that the amount of financial aid provided by the federal government to states will not automatically increase during a recession. States usually experience serious fiscal problems when the economy contracts because tax revenue is depressed and the caseloads of programs such as Medicaid and welfare grow substantially. During the most recent recession these developments were partially offset by a large increase in federal aid. Between 1990 and 1992, federal aid to states rose 34.3 percent while state tax revenue was growing only 9.1 percent, making it much easier for states to avoid deficits or painful spending reductions and tax increases (Gold, 1995). Although some Congressional proposals include a contingency fund to augment certain block grants if unemployment rises sharply, states would not enjoy a large increase in federal aid during the next recession as they have in the past.

The automatic growth of federal aid caused by the recession of the early 1990s suggests that the full implications of switching to block grants will really not be felt until the next recession occurs. Eliminating open-ended matching grants means that the state budget crunch will be much more severe during a recession than it has been during the downturns of the past several decades.

*Enhanced Flexibility.* An important feature of the New Federalism is the freedom it would afford states to redesign programs in more efficient and effective ways. The quantitative magnitude of the benefits from increased flexibility is, however, uncertain. The reduction in paperwork and the advantages gained by consolidating many small programs are probably not worth a great deal in comparison with the loss of funding that is associated with the block grants <sup>5</sup>.

The relaxation of regulations could be more significant, but that depends on how sweeping the legislation creating the block grants turns out to be and the creativity of state governments. Some of the flexibility that

state officials seek involves allowing them to cut off beneficiaries of programs or shift costs to others (e.g., by repealing the Boren Amendment that has forced states to pay higher rates to hospitals and nursing homes than they otherwise would have). Such provisions help states fiscally but do not necessarily make programs more efficient. But freedom from the voluminous rules governing how programs must be operated could increase efficiency substantially by allowing them to design programs differently.

*Historical perspective.* The New Federalism rolls back the clock, in some ways to the Great Society and in other respects to the New Deal. By fundamentally changing Medicaid, it affects one of the major legacies of the Great Society. By abolishing AFDC, it undoes a guarantee that was established as part of the New Deal. Of course, both of these programs are ripe for reform since they have developed in ways that were not foreseen in 1965 and 1935 and because public attitudes changed. Medicaid has become much more expensive and covers many more people than was expected when it was created; no one predicted that the largest part of it would go for long-term care, or that it would become the dominant form of federal aid to states. Likewise, AFDC was originally viewed as a program for widows and orphans. It was not until the 1960s that it became an open-ended matching grant, and it was the completely unforeseen explosion in the number of single-parent families that began then that made it so controversial.

But while the New Federalism would fundamentally change the form of those programs, it does not come anywhere near returning us to where we used to be in terms of the amount of aid provided. If federal aid were cut 20 percent from its 1995 level, it would not be any lower than it was in 1992. After falling in the early 1980s and growing relatively slowly through most of the remainder of that decade, the amount of aid began to rise rapidly in 1989. Just four years later it had grown from \$124 billion to \$194 billion. Most of this increase occurred automatically, without explicit initiatives from the Bush Administration or Congress. As explained above, much of it reflected the recession that led to surging demand for services (including health, income security, and social services). Another part was caused by spending increases related to new federal mandates. But part also was the result of state actions that shifted costs to the federal government, particularly for Medicaid.

*De facto devolution.* At this time, what once seemed an irresistible march toward block grants and adoption of a balanced budget plan has become less certain. Nevertheless, it appears very likely that much of the devolution agenda will continue to advance.

Two points can be made. First, many states already have waivers permitting them to escape from a large number of the federal regulations that have governed welfare and Medicaid programs, and the administration appears ready to grant additional waivers liberally. The end of "welfare as we know it" is already occurring, and the same is true for Medicaid.

Second, if momentum toward reducing the federal budget deficit continues, aid to states will be curtailed, probably resulting in a reduction of the proportion of state revenue coming from the federal government. This amounts to de facto devolution, although it may occur more gradually than if it were compressed into seven years.

Thus, whether or not a big budget agreement is reached in 1996 or 1997, the federal system appears likely to change fundamentally. The issues are how fast it changes and how it changes. It could follow the model proposed by Congress last year, but it would also be possible to reduce the growth of federal spending substantially without essentially abandoning a national safety net for the poor and leaving states responsible for shouldering the costs of increased Medicaid and welfare caseloads during recessions.

### **The Context of the Devolution Revolution**

To project the impact of the New Federalism, one must consider the context in which it is occurring. What, then has been happening to state spending and tax policies?

Some important changes occurred in the composition of state spending between 1990 and 1994 (Gold, 1996b):<sup>6</sup>

- Medicaid rose most, growing from 9.1 percent to 12.8 percent of the budget. Among the causes of this increase were health cost inflation, the impact of the recession in raising caseloads, and the shift of other health programs into Medicaid.
- Corrections also rose sharply, from 5.2 percent to 5.9 percent of total spending, reflecting popular support for "get tough on criminals" policies such as "three strikes and you're in."
- School aid, the largest share of the budget, was stable at about 36 percent of the total. This was not a strong performance considering that enrollment rose 6.9 percent during this period. Competition from Medicaid and corrections is probably an important reason why school aid did not increase more. Real spending per pupil, including federal and local funds, rose only 2.2 percent during this four-year period and did not rebound strongly after the recession ended, as it normally did in past periods when the economy was growing.
- Higher education was the big loser in the battle for state support, falling from 14 percent to 12.5 percent of spending. States relied heavily on tuition increases to make up the difference.
- Aid to Families with Dependent Children rose slightly, from 2.5 percent to 2.8 percent. This is not much of an increase in view of the 27.5 percent caseload increase that occurred. Real benefits were reduced in most states.
- The remaining programs received a smaller share of the pie, as states focused on trimming bureaucracies, shifted some health programs into Medicaid, and provided meager increases for other programs.

What would one expect under the New Federalism? If federal aid cutbacks cause state fiscal stress, the

programs that fared badly in the early 1990s would again be losers. Support for higher education and miscellaneous programs would languish, and welfare spending would also go down. Corrections spending would surely continue to grow rapidly. School aid would have to battle hard for funds, and Medicaid would rise much more slowly than it did in the early 1990s. There would be intense competition for state funds, and education programs would probably not fare particularly well. Indirect effects would include higher property taxes for local schools and substantial tuition increases for college students and their families.

An important issue to monitor and analyze will be how widely state responses differ. Will many states sharply reduce their spending on poverty-related programs, if given the chance, as might be predicted by those who remember how backward some states were before federal programs and mandates began to expand in the 1960s? Or have states changed so much that they will maintain most services if they are not required to?

The response of states to devolution depends in part on their tax policies. If states raised taxes to offset part of the loss of federal aid, services would not have to be reduced as much. Would that happen? As of now, raising taxes is the farthest thing from the minds of most state officials. In view of the political ideologies of many recently-elected governors and legislators, it appears that state tax policy is in the process of becoming more conservative.

But it is not possible to be certain about what kind of tax policies states would pursue under devolution. Raising taxes would be a last resort, and anti-tax sentiment could waiver if the alternative is significant reductions in services. I suspect that we will see large local tax increases before we see large state tax increases, in part because state aid to localities will be depressed in a period of tight state budgets. Substantial increases in fees and charges, such as college tuition, are also likely.

Not much guidance can be obtained from analyzing recent trends. The major development in state tax policy during the past several years has been small net tax reductions. Last year, for example, approximately 30 states cut taxes, but the reductions amounted to only about 1 percent of total state tax revenue. With a few exceptions, most of the reductions were small or moderate in size. These tax cuts followed a large number of tax increases at the start of the decade. This is precisely what normally has happened for the past 20 years, with increases during recessions and decreases in their aftermath. (Gold, 1996a)

## Conclusion

If the New Federalism is adopted in something like the form proposed by Congressional Republicans, the country will be in for a grand experiment. In some important ways, state governments have changed fundamentally. Starting in the 1960s they became more representative, more competent, and much larger. If the federal government pulls back sharply, there is no precedent for telling how the states will respond.

The problem of predicting their policies is complicated by some other factors. Twenty-one states now have term limits for legislators. While the effects of these newly-enacted limitations are still indefinite, they are likely to reduce legislative expertise, increase the short-term orientation of policy making, and enhance prospects for adoption of new, untested policies. In addition, nearly half of the states have constitutional or statutory spending or revenue limits that did not exist 20 years ago. Since most of those limitations make no allowance for changes in federal aid, they could present formidable barriers to state efforts to offset reduced reliance on federal aid.

All block grants are not the same. The result of creating them depends in part on which programs they replace, whether they were entitlement or non-entitlement programs, and whether they were growing rapidly or not.

I will conclude with three questions that ought to be considered in determining whether block grants accompanied by large federal spending reductions are appropriate:

- Are the existing programs working well? That is, do they satisfy the needs they were intended to address? If they do, the case for devolving responsibility to the states is weaker.
- Is primary responsibility for the programs appropriately assigned to the federal government or to the states? The federal government is better suited to providing the bulk of the financing for programs where spending tends to soar during recessions. In addition, a strong argument can be made that the federal government should play a prominent role in funding poverty-related programs for three reasons: poor states have less fiscal capacity, uniformity of benefits reduces the incentive to migrate from low- to high-benefit states, and the entire society is concerned about alleviating poverty.
- To what extent can increased flexibility be achieved simply by reducing federal program requirements, without adopting a block grant? In many cases, creation of a block grant is unnecessary to enhance flexibility.

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## Notes

1. This estimate was prepared by the Center on Budget and Policy Priorities. For a discussion of this issue developed before the reconciliation bill was vetoed, see Lav and St. George (1996).
2. According to the U.S. Census Bureau, federal aid was approximately 26 percent of state general revenue in 1992. One component of general revenue is miscellaneous revenue, a large portion of which is dedicated to programs that are outside the scope of annual budget deliberations, such as interest received in return for loans to companies (for economic development subsidies) or to home owners (for mortgage subsidies). Excluding miscellaneous revenue raises the proportion of state resources accounted for by federal aid.
3. This is not necessarily true in all cases. Under one Medicaid block grant proposal, there would still be a price effect for low-spending states. That is, they would receive the maximum possible amount of federal aid only if they spent more than they were already spending.
4. With the exception of foster care.
5. That was the conclusion about the block grants created in 1981 according to Peterson, et al (1986).
6. The spending considered here is the sum of general fund spending plus earmarked state spending for elementary-secondary schools. This is a rough approximation of how tax dollars are spent, except that it excludes most highway-related spending. It excludes spending paid for with federal aid, user charges, or the gimmicks used to help finance Medicaid.

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