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Devolution's Price

Paul E. Peterson

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Devolution's Price

Paul E. Peterson[†]

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The current political pressures on the welfare state, induced both by fiscal pressures and a Republican majority in Congress, have prompted some of its defenders to look for solutions at state and local levels. They point out that the American federal system is open, complex, and pluralist. Problems that cannot be addressed at one level are often resolved at another. Interests that cannot gain representation in Washington get heard in Albany, Springfield, and Sacramento.¹ They remind us that state and local governments filled in many programmatic gaps opened up by the Reagan Administration. Such optimism,

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1. Cf. MORTON GRODZINS, *THE AMERICAN SYSTEM: A NEW VIEW OF GOVERNMENT IN THE UNITED STATES* (Daniel J. Elazar ed., 1966) (describing complex interdependence and sharing of power between federal and state governments in American federalism).

however, is misguided. Current proposals for devolution differ markedly from those of the 1980s. While the Reagan devolution was mainly limited to the developmental or productivity policy arena, the Gingrich devolution promises to shape redistributive policy. This distinction is important because the impact of devolution varies greatly depending on the policy arena in which it occurs.

I. DEVELOPMENTAL VS. REDISTRIBUTIVE POLICY

Traditionally, states and localities have assumed primary responsibility for managing the physical and social infrastructure—roads, education, mass transit systems, public parks, police and fire services, and sanitation systems—necessary for the country's economic growth. I call these kinds of policies *developmental* because without them economic progress would be retarded. In contrast, state and local governments tend to play only a minor role in serving the needs of the disabled, the unemployed, the sick, the poor, families headed by single parents, the elderly, and others dependent on the welfare state. I refer to these policies as *redistributive* because they shift resources from the “haves” to the “have-nots.”

State and local developmental spending has always exceeded that of the national government. Even after the great growth in federal spending during the Great Society, federal expenditures were only half that of state and local governments. In 1990, states and localities were spending 10.8% of GNP on the country's developmental infrastructure, while the national government was spending only 5.2% of GNP.²

With regard to redistributive expenditures, the story is entirely different. Since 1962, the state and local share of the country's expenditures on the elderly, the poor, and the needy has steadily declined. While national government redistributive spending more than doubled, from 4.9% of GNP in 1962 to 10.3% in 1990, state and local redistributive spending edged up only slightly, from a very low 2.2% of GNP in 1962 to 3.5% in 1990.³ The modest growth in state and local spending levels is particularly striking as this was also the period in which the civil rights movement awakened the country to problems of poverty, the Great Society was introduced, and entitlements became an entrenched part of American social policy.

The reluctance of state and local governments to participate in the redistributive movement can hardly be attributed to the political climate. Over most of this period Democrats controlled at least part of state government in most states, and they held unified control in several. Differences in state and local treatment of development and redistributive policies are rooted not in

2. See PAUL E. PETERSON, *THE PRICE OF FEDERALISM* 66, 70-71 (1995).

3. *Id.*

partisan politics but in underlying features of the federal system.⁴

II. ECONOMIC DEVELOPMENT

State and local governments are efficient mechanisms for supplying most of the physical and social infrastructure needed for economic development. In providing roads, schools, sanitation systems, and public safety to their residents, state and local governments must be sensitive to local businesses and residents. If they ignore their constituencies, people will vote with their feet and move to another town. Since seventeen percent of the population changes residence each year, the effects of locational choices on property values can be quickly felt. Moreover, if a state or community makes a poor policy choice, its failure will soon become apparent and other communities will learn from the mistake. If it chooses wisely, its policy will be copied—and thus be disseminated throughout the federal system.

III. REDISTRIBUTION

For the same reason that local governments are well-suited to providing economic development—the mobility of labor and capital—they are not effective at redistributing wealth. For example, local governments avoid progressive income taxes. Only about three percent of local revenues comes from this source.⁵ Any locality making a serious attempt to tax high-income groups and give to the poor will attract more poor citizens and drive away the most productive contributors to the local economy. No amount of determination on the part of local political leaders can make redistributive efforts succeed. If no other force is able to stop their efforts, bankruptcy will.

The smaller the territorial reach of a local government, the less its capacity for redistribution. Most small suburbs in metropolitan areas have almost no capacity to meet the special needs of low-income citizens because the effects of such actions would immediately be felt in the suburb's tax rate, property values, and attractiveness to business. Big cities are somewhat better able to undertake redistribution because of their greater geographical reach and control over extremely valuable land at the heart of the nation's transportation system.

The greater territorial reach of states also makes them better at redistribution than most local governments. The costs of moving across state lines is more substantial than changing residence within a metropolitan area. As opposed to the 17% of the population who change residence every year, only 3% move across a state line.⁶ Even so, labor and capital can and do move,

4. Though partisan factors have some effects on state policy-making, economic factors are much more important. For an extended discussion, see generally PETERSON, *supra* note 2.

5. *Id.* at 20.

6. *Id.* at 30.

and states must take that possibility into account in their policymaking.

Current economic trends are further limiting state and local redistributive capacity. Capital, entrepreneurial activity, and skilled labor have become ever more mobile. State and local governments now face increasingly competitive relationships with each other and must attend ever more strictly to economic development. The result is that they are growing ever more reluctant to provide for the needy within their ranks. In 1962, states and localities accounted for 31% of the nation's redistributive expenditure; in 1990, they accounted for only 25%.⁷

IV. DIFFERENCES BETWEEN THE REAGAN AND GINGRICH DEVOLUTIONS

Reagan promised and Gingrich promises to devolve government to state and local levels; however the consequences of enacting these policies would differ gravely. Reagan devolved a good deal of responsibility for developmental policy, thereby strengthening the federal system in many important ways. Gingrich is proposing to devolve a wide range of redistributive policies. His devolution, if enacted into law, proposes to transform welfare and Medicaid entitlement programs into block grants.

A. *Reagan's Devolution*

The federal system responded well to Reagan cutbacks and retrenchments. Between 1982 and 1990, federal education aid was cut from 0.8% to 0.74% of GNP, but state and local education expenditures climbed from 4.4% to 4.9% of GNP, an increase of no less than \$83.3 billion (in constant 1990 dollars).⁸ Over this same period, total federal grants to state and local governments were downsized from 2.8% to 2.5% of GNP; yet state and local governments increased total expenditures from their own sources from 12.4% to 14.3% of GNP.⁹

A number of factors helped state and local governments plug the holes left by national policy. For example, Democrats remained the dominant force at the lower tiers of government. State revenues were not as crimped as federal ones. After federal income taxes were indexed to changes in the cost of living in 1981, the federal government could no longer enjoy silent increases in tax revenues generated by the shift of taxpayers into higher tax brackets simply as

7. *See id.* at 54. It might be argued that this change is due mainly to an increase in redistributive spending at the federal level. But one needs to explain why the federal government responded to constituent demands for increased levels of redistributive spending, while state and local governments did not. If states and local governments did not operate under a structural constraint, they should have responded in a similar manner. After all, the sum total of all state and local governments has exactly the same constituency as the national government.

8. *See id.* at 66, 70-71.

9. *Id.* at 74, 54.

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a result of inflation, a phenomenon known as "bracket creep." Most state and local governments' tax systems were not subjected to similar provisions. Although property taxes were capped in such states as California and Massachusetts, many state income tax systems, not indexed to the cost of living, retained significant bracket creep. Though tax revolts broke out, they were frequently offset by silent tax increases resulting from these bracket creeps.

Most importantly, Reagan cuts focused not on the safety net but on traditional public services. Developmental grants were cut from 1.5% to 1.1% of GNP between 1982 and 1990,¹⁰ general revenue sharing with state and local governments was entirely eliminated, and sizeable cuts were made in education and community development block grants. At the same time, welfare, food stamp, and medicaid policies were left virtually untouched. Overall, redistributive grants actually increased from 1.3% to 1.4% of GNP.¹¹

Because Reagan cuts focused on developmental policies, state and local governments responded by substituting local revenues for federal ones. Although, there was no one-for-one replacement of each federal program, states and localities had strong incentives to continue to provide the public services their constituents wanted and needed.

B. *Gingrich's Devolution*

Unlike the Reagan devolution, the Gingrich devolution has sought to make major changes in the federal government's role in the provision of a broad range of redistributive services. For example, the Congressional Budget Resolution for Fiscal Year 1996 dramatically reshaped the Aid to Families with Dependent Children (AFDC) program. Under the legislation vetoed by President Clinton, each state was to receive a block grant equivalent to the amount of funding it received in 1994. A special fund was set aside to help assist states experiencing overall population growth. The grant contained no provisions for any inflation that might occur over the next seven years. If inflation were to grow at an average rate of 3% per year, the legislation implies a 25% effective reduction—even assuming no growth in the number of needy families, an heroic assumption.

Growth in Medicaid, according to the budget resolution, is to be 7.2% in 1996, 6.8% in 1997, and 4% in the last five years of the plan. These rates fall far short of the 10% growth rate projected by the Congressional Budget Office, if current policies remain in place.

10. *Id.* at 74.

11. *Id.*

V. WELFARE POLICY: THE CURRENT RACE TO THE BOTTOM

The probable effects of the proposed block grants on state welfare and Medicaid policies can be estimated by examining state policies under the current AFDC program. The federal government sets minimum standards and pays at least half the cost of AFDC in all states. In the states with the lowest per capita income, the federal share is over 80%. But even though costs are shared, states have extensive authority to set eligibility requirements and benefit levels.

Before 1970, shared federal and state funding of AFDC did not preclude a steady rise in welfare benefits. The mean benefit paid to a family in the average state climbed from \$306 in 1940 to \$605 in 1970 (calculated in 1993 dollars).¹² This steady increase was made possible by both steady economic growth and the fact that each state could set its policies without worrying too much about what its neighbors were doing.

State AFDC policies began to change around 1970. Instead of increasing over time, they began a retreat that has accelerated over the years. By 1975, the mean cash benefit in the average state had slipped to \$512; by 1985, it had fallen to \$393; and by 1993, it reached its postwar nadir of \$349.¹³ All in all, cuts between 1970 and 1993 amounted to no less than 42%.

VI. THE WELFARE MAGNET

States vary considerably in their willingness to provide welfare benefits to low-income families. In 1991, the maximum annual combined cash and food stamp benefits for a family of four varied between \$5952 in Mississippi and \$11,898 in California.¹⁴ The variation in cash benefits among states was even greater in 1990 than it had been in 1940.¹⁵ States whose welfare benefits are relatively high have become welfare magnets—places that attract poor people because they offer higher cash benefits than other states. The higher the benefits, the more magnetic the state—as high benefits keep poor people from moving elsewhere while attracting additional poor people into the state. Professor Mark Rom and I estimate that after five years a high benefit state will have, *ceteris paribus*, a poverty rate approximately one percentage point

12. *Id.* at 109.

13. *Id.* at 110.

14. 1991 GREEN BOOK, at 1209, tbl. 11, cited in PETERSON, *supra* note 2, at 122.

15. *Id.* The aphorism, race to the bottom, should not be taken literally. It does not necessarily mean all states will some day have exactly the same low benefits. One must expect that other factors—differences in per capita income, poverty, ethnic make-up and partisan composition—will continue to shape policy. As the race continues, the differences among states could actually increase, as some states become terminator states, that is states that totally eliminate state contributions to welfare policy. Such policy decisions can be expected to put great downward pressure on the benefits provided by other states, even though they would not eliminate interstate differences.

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higher than a low benefit state.¹⁶

Before 1970, differences in state welfare policies had little magnetic effect. Numerous state laws and administrative practices were designed to make access to the welfare system difficult, and discouraged changing residences merely to improve one's welfare opportunities. Many states denied welfare benefits to anyone who had not lived in the state for a year. AFDC benefits did not open the door to food stamps and Medicaid. Thus, before 1969, states could increase their welfare benefits without becoming a more attractive place of residence for poor people in other parts of the country.

In 1969, the Supreme Court ruled in *Shapiro v. Thompson*¹⁷ that denying welfare benefits to newcomers unconstitutionally denied them equal protection before the law. This decision, along with the liberalization of many other state administrative practices and the increase in the range of benefits offered, increased the desirability of welfare benefits, reduced the stigma to which recipients were subjected, and facilitated access to the welfare rolls, especially for those moving from one state to another.

Once newcomers could obtain welfare benefits, state officials became increasingly concerned about becoming welfare magnets. Kenneth Scheve, Jr., Mark Rom, and I have estimated the effects of neighboring states benefit levels on a state's average AFDC benefits. Our estimate, based on annual data for the years 1976 to 1989, took into account interstate differences in tax capacity, the balance of political power between the two parties in the state legislature and gubernatorial office, and the state's poverty rate. We found that for every \$100 change in the benefit levels in neighboring states the preceding year, a state altered its benefits by \$30.¹⁸ Benefits were further cut if a state's poverty population was on the increase. States were acting as if they were in a competitive race with each other.

VII. INTENSIFYING THE RACE TO THE BOTTOM

These cuts in welfare benefits occurred despite the fact that the federal government paid at least half of all incremental costs. If block grants are enacted, the cost of becoming a welfare magnet will double. The block grant

16. PAUL E. PETERSON & MARK ROM, *WELFARE MAGNETS: A NEW CASE FOR A NATIONAL STANDARD* (1990). This estimate is confirmed by an out-of-sample prediction for the 1986-1990 period. See PETERSON, *supra* note 2, at 125. Though studies show that migration is also affected by job opportunities and family relationships, similar effects of welfare benefits on the residential choices of the poor are reported in Rebecca M. Blank, *The Impact of State Economic Differentials on Household Welfare and Labor Force Behavior*, 28 J. PUB. ECON. 25-58 (1985); Edward M. Gramlich & Deborah S. Laren, *Migration and Income Redistribution Responsibilities*, 19 J. HUM. RESOURCES 489 (1984); and Lawrence Southwick, Jr., *Public Welfare Programs and Recipient Migration*, 12:4 GROWTH AND CHANGE 22-32 (1981).

17. 349 U.S. 618 (1969).

18. Paul E. Peterson, et al., *State Welfare Policy: A Race to the Bottom?* (Feb. 1996) (Occasional Paper, Harvard Univ., Dep't of Gov't, Ctr. for Political Studies).

proposed under the 1996 Congressional Budget Resolution was a fixed sum of money that did not change with the number of individuals in the state eligible for assistance. If enacted, when poor people move to states with more generous benefits, these states would experience an increase in their welfare burden without any commensurate increase in federal funding. To safeguard against rapidly rising state welfare costs, generous states would come under increasing fiscal and political pressure to reduce their benefits. Eventually, all states would be engaged in the race for the bottom, each state trying to shift the cost of welfare to its neighbors.

The pressure on state budgets will be intensified by the fact that the block grant that each state receives is not scheduled to increase despite the fact that inflation has been climbing by an average of three percent a year, enough to reduce the real value of the block grant by approximately one-fourth over seven years. In addition, most states will experience overall population growth. Even if poverty rates remain constant, the raw number of potential welfare recipients will increase unless states tighten welfare eligibility standards. Some states will inevitably experience a recession, either as part of national economic slowdown or as a result of economic changes that have disproportionate regional economic impacts (such as the effects of the early 1980s collapse in energy prices on the Texas and Louisiana economies). All of the additional costs generated by inflation, population growth, and economic slowdowns will be borne entirely by state governments. To keep these costs from breaking their budgets, some states will cut benefits and eligibility standards dramatically. Poor people will have even stronger incentives to locate in higher benefit, more permissive states. High benefit states will be under intensified pressure to match cuts made elsewhere. A race to the bottom is virtually assured.

VIII. MEDICAID MAGNETS

Should Medicaid be incorporated into a block grant program, the race to the bottom could become deadly. Seventy percent of Medicaid funds are spent in providing services to a disabled and elderly population whose Medicare benefits have expired. The remaining 30% provide health care benefits to low income families. Both aspects of Medicaid have reduced inequities in the utilization of health care. Since Medicaid services have been available, low birth weight and infant mortality rates have fallen, children from poor families are more likely to use hospital facilities, and differential access between children from poor and nonpoor families has been noticeably reduced.

Like AFDC, Medicaid is currently an entitlement program. A person or family is entitled to receive Medicaid benefits if income and resource eligibility requirements are met. These eligibility requirements are set by states, subject to certain federal guidelines. The federal government pays for at least one-half the cost of Medicaid services in all states. In states with low per capita

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incomes, the federal government pays a higher share of program costs. Increases in the cost of a state's Medicaid program are borne either equally by the state and the federal government or disproportionately by the federal government.

The national framework for Medicaid has helped provide better coverage to needy groups, especially low-income pregnant women and their children. In 1986, Congress expanded coverage to all pregnant women and infants living in families with incomes below the poverty line. In 1990, Medicaid was expanded to cover all children living in poverty up to the age of nineteen. The impact of these new federal standards on state policy has been considerable. The uniform, minimum floor for coverage (for pregnant women and children) established in 1992 was two to three times higher than the coverage provided by the average state only four years earlier. As a result of both policy and demographic changes, the cost of Medicaid has increased rapidly, growing from \$31 billion in 1975 to \$73 billion in 1990. Today it is by far the largest of all safety net programs.

Despite overall growth in Medicaid and generous federal assistance which helps alleviate state Medicaid costs, states are still sensitive to the likelihood they might become a Medicaid magnet. Following procedures similar to those used to estimate competitive effects on AFDC policy, Mark Rom, Ken Scheve, and I estimated the effects of per recipient expenditures of neighboring states on a state's own Medicaid expenditures for the years 1976 and 1989. Our estimate controlled for the composition of the Medicaid population, as well for tax capacity, poverty rates, and party strength. We found that Medicaid expenditures per recipient were reduced by \$13 for every \$100 a state's benefit level the previous year had exceeded that of the average contiguous state.¹⁹ As with welfare, states take into account Medicaid benefits in neighboring states when setting their own.

The race to the bottom can be expected to increase if proposed Medicaid policies are enacted. The proposed 4% increase in the Medicaid block grant is expected to be sufficient to cover only anticipated demographic changes, such as overall population growth and increases in the size of the elderly and disabled populations (whose services account for approximately 71% of Medicaid costs). But after two years, nothing is budgeted for inflation, despite the fact that in recent years overall inflation has averaged about 3% a year and health care costs have been rising at around 6%. After two years, any increase in the cost of the program beyond 4% would be borne entirely by the state government.

19. Paul E. Peterson, et al., *State Welfare and Medicaid Policy: A Race to the Bottom?* (Paper prepared for the Nat'l Ass'n for Welfare Res. & Stat. Ann. Res. Conference, Jackson, WY, Sept. 10-13, 1995).

States will be under great fiscal pressure to race to the bottom. Medicaid is already one of the fastest growing segments of state budgets. If states are asked to bear all additional costs beyond the federal 4% increment, the burden on many states is likely to be severe. Even if health care inflation can be limited to overall rates of inflation, this increase plus demographic changes will produce a natural increase in costs of 7%. States that experience a slowdown in economic growth will face even greater demands on their Medicaid budgets, as unemployed workers apply for coverage. Demands on the program can be expected to intensify further with the drop in employer-funded health care insurance. Under extreme fiscal pressure, some states will be forced to change eligibility requirements, provider payments, and the range of covered services. Poor people in need of costly medical services will have especially large incentives to locate in places where medical benefits are more generous. As the more generous states experience a rise in their low-income, medically needy population, they will come under increasing pressure to match cuts that have occurred elsewhere. The race to the bottom could become quite deadly.

IX. THE FUTURE OF SOCIAL POLICY

If Republican proposals in Congress are enacted into law, the competitive pressures on states will certainly intensify. Yet the future of social policy will also be affected by several economic and political factors that are easier to identify than to predict.

If the economy continues to grow at its current pace, block grants, if enacted, can be implemented without creating serious budgetary crises at state and local levels. Likewise, if immediate problems do not arise, they could become a more or less permanent of the governmental landscape. This scenario is possible because moments of major change such as the country is currently experiencing are typically followed by periods of stability. The creation of the Great Society in 1965 and 1966 was followed by a period of consolidation. Reagan introduced massive tax cuts and significant spending reductions in 1981; policy initiatives for the next decade amounted to little more than modest refinements of the settlement reached in 1981. We may be in the midst of another watershed moment.

Under these circumstances, that is if block grants are enacted and steady economic growth continues, state welfare policy can be expected only to drift toward the bottom. In most states, nominal expenditures will be maintained, if only to avoid blame for cutting holes in the safety net. But benefit levels will not keep pace with the cost of living, nor will funds increase in response to the growing size of the population. Changes will not be so immediate and visible as to create a sense of national crisis. The move toward the bottom could be so much a "race" as a stately walk.

Should the economy deteriorate sharply in the near future, however,

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devolution could lead to state welfare policy crises. Economic downturns are often concentrated in particularly hard-hit regions. As state fiscal revenues falter, pressures to make sharp cuts in safety net expenditures will intensify. The movement of low-income people from one state to another in search of better social services will come to public notice. States will be forced to take measures to avoid becoming havens for the poor. The race to the bottom could quickly intensify. Demands for a national solution would escalate.

At the national level, an economic recession would cause a new budgetary crisis. Once again, members of a Congress would have to balance tax policy and senior citizen entitlements against further devolution of welfare policy. Further cuts in the safety-net for poor families would certainly be placed on the bargaining table. When looking for new places to cut, Congress could be expected to turn its attention to the inequity built into the current block-grant funding arrangements. New York and California are receiving much more aid per recipient than are poor states, such as Arkansas and Mississippi, only because in 1994 New York and California provided higher welfare benefits and more medical services to a broader population. Could this be defended as equitable? Would it be possible to further cut block grants to states receiving disproportionately large subsidies?

Answers to these questions will depend on which party is blamed for an economic recession, should it occur. The blame usually goes to the party controlling the presidency at the onset of a recession. Depending on which party gets blamed for the recession, an economic downturn could produce one of two diametrically opposite consequences for welfare policy. If Republicans get the blame, a resurgent Democratic party could halt and begin to reverse the devolution begun in 1995. But if the Democrats are blamed for a recession, the Republicans could solidify their hold on the national government and further devolve responsibility for welfare policy.

