Federal Devolution: The View From the States

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The deficit and related federal budget issues have moved off the front page in recent months. The debate about when the budget should be balanced appears to be over, with both Congress and the President agreeing that in 2002, the budget will be balanced. As a nation, we appear to be moving toward an economic and social system that relies on a much smaller federal presence.

Some of the federal government's current activities will simply be dropped. More often, though, current federal responsibilities and some funding will be returned to the states. And, in the struggle to find the cuts necessary to balance the federal budget by 2002, no one will be surprised to find that the funding coming from the federal government is insufficient to maintain current service levels in programs delegated to the states.

None of this is really new. In the mid 1980s, there were the Gramm-Rudmann-Hollings budget restrictions. Before that, there was President Reagan's new federalism. While both of these initiatives received considerable public attention initially, interest waned as time went on.

The same could happen with the current agreement to balance the budget by the year 2002. This time, however, conditions appear different. During the past few years the American public appears to have signed on fully to the quest for a balanced budget. Unlike the situation a decade ago, eliminating the deficit now truly appears to be a priority item on the electorate's agenda.

You may notice that I am a little hesitant to make a strong declarative statement on this topic. I did not say, for example, that Americans have decided that a smaller federal government would be better, nor am I willing to assert that the federal budget *will* be balanced in 2002. The reason I am hesitant is that I am unsure everyone is aware of the probable consequences of those budget decisions. When the personal sacrifices that will accompany those budget cuts become apparent, the momentum leading us toward a balanced budget may stall, leaving the nation with a smaller deficit and smaller federal presence, but with spending still exceeding revenues. Making the cuts necessary to bring the deficit to zero may simply turn out to be politically impossible.

No matter how this eventually works out, however. . .for the relevant future—certainly for the next six years, which is a long time in the public policy arena—a declining federal sector should be part of everyone's planning. Given that major changes are expected in a key sector of each state's economy, it seems only prudent to begin to examine how those changes might affect us.

Whether the deficit is actually eliminated or not, a diminished role for the federal sector and the devolution of service responsibilities to the states and to local governments are going to have a significant impact on us, both individually and collectively. Herbert Stein, head of the Council of Economic Advisors under President Nixon, made this point well in a column in the *Wall Street Journal*, noting that all the money in the budget comes from people and that all but 1 percent goes to people and their state and local governments in this country. Some individuals and some states and localities will be affected more than others, but all will see a change. You simply cannot remove $1.3 trillion from an economy—even over seven years, as would President Clinton's budget—without affecting individual pocketbooks.

My role here this morning is to stimulate your thinking on how the expected changes are likely to affect your state. I want you to consider two kinds of impacts: (1) the impact of federal cuts on state economies and (2) the effect of devolution on state government finances. These two items are linked, because state finances depend on the strength of the state's economy. But state governments also have a particular exposure because they are one of the primary recipients of federal funds and because some of the services they provide are either partially reimbursed by federal payments or financed directly through federal grants.

Every state will face major financial challenges as federal programs are devolved in order to pare the federal budget by 2002, but balancing the federal budget will affect each state and each state economy differently. The federal government is a more important sector in some areas than in others. Federal contracts play a larger role in the markets for some items, and more of those items are produced in some states than in others. Further, states differ in their capacity to absorb programs, if not given full funding for them. Policymakers in each state will need to conduct their own examination of the likely impacts of federal devolution.

Even so, federal devolution will bring changes so fundamental that every state needs to begin planning now, to manage the financial challenges that will be created. This morning I want to provide you with some background information, so you can see how important the federal sector is in your state and identify where the pressure points are likely to be. Most state officials—painfully aware of what the future appears to have in store—have already begun to make plans for dealing with the effects of devolution. Extension public policy specialists may be able to play a role in this, as well, helping local citizens understand the forces behind particular state policy decisions. But that will be possible only if we appreciate the magnitude of the challenges facing state government.

One last preliminary item: State policymakers will have the time necessary to devise strategies for providing services in programs that have been returned to the states by the federal government. As everyone knows, the cuts currently proposed for the baseline budget grow as we go farther into the future. The largest are delayed until after the turn of the century. While this undoubtedly was the result of normal political impulses to put bad news as far into the future as possible, the gradual phasing in of these cuts will provide state and local officials time to design, test and modify new approaches to providing services, given the increased flexibility and lower funding levels expected.

Federal Expenditures, by State, in 1994

Now let me turn to some state-by-state data that illustrate the size of the challenge facing state policymakers. I have prepared two tables indicating the importance of federal payments to the states. One shows federal spending as a percentage of personal income, by state; its figures are more useful in determining the effects of federal spending on a state's economy. The second—a table of per capita federal spending, by state—is more helpful in assessing the impact of federal spending cuts on future spending by state and local governments. The tables were prepared using data from the Bureau of Census report *Federal Expenditures by State for Fiscal Year 1994.*

Nationally, federal expenditures were $4,996 per capita in fiscal 1994, but there were substantial differences among the states in the amounts that individuals, firms and institutions received. Alaska received the most on a per capita basis ($7,657) and Indiana, the least ($3,843). Other top-ranking recipient states included Maryland, Virginia, New Mexico and Hawaii—all states with substantial federal presences. North Dakota and Missouri also received more than $6,000 per capita in federal payments during fiscal 1994. And, on the other side of the ledger, Wisconsin and Utah received less than $4,000 per capita in federal expenditures.

When expenditures as a percent of personal income are examined, relatively large differences in the importance of the federal sector to state economies emerge. In seven states—Alaska, Mississippi, Montana, New Mexico, North Dakota, Virginia and West Virginia—federal expenditures were more than 30 percent of personal income in 1994, while in four states—Connecticut, Nevada, New Hampshire and New Jersey—federal spending was less than 18 percent of personal income.

Because not all federal programs are scheduled for cuts and particular federal programs differ in their importance in individual states, it is instructive to look further into the spending data. The Census Bureau separates federal spending into five major categories: (1) direct payments to individuals, (2) procurement, (3) salaries and wages, (4) grants to state and local governments, and (5) all other. State-by-state detail on these categories of spending and on three programs of particular interest—Social Security, Medicare and Medicaid—also is provided in Table 1 and Table 2.

■ ***Direct Payments to Individuals.*** More than one-half of all federal spending (52 percent) is classified as direct payments to individuals. Social Security, Medicare, and federal civilian and military pensions make up more than 80 percent of this expenditure category. With a few noticeable exceptions, states group relatively closely around the U.S. average of $2,617 per capita. States with a higher proportion of elderly receive more, while states with a younger population receive less. But most states receive relatively similar amounts in this area. Typically, Social Security is about 45 percent of direct payments or slightly less than one-quarter of all federal expenditures. Medicare is about 23 percent of direct payments to individuals or about one-eighth of all federal expenditures.

■ ***Salaries and Wages, Plus Federal Procurement.*** Salaries of federal civilian and military employees were $169 billion in 1994, about 13 percent of federal spending. About 15 percent of federal spending in that year went for procurement.

■ ***Other Expenditures.*** Skipping state and local government aids for the moment and turning to the remaining 3.5 percent, the "other" category is comprised primarily of farm program payments, research and development contracts and grants, and federal fringe benefits. In many states this category is relatively unimportant, but in states with a large commercial agriculture sector, these expenditures are significant. In fiscal 1994, commodity program payments included in the "other" category totaled $9.4 billion or some 0.7 percent of the federal budget. While the figures were slightly distorted by inclusion of disaster relief payments related to the 1993 flood in the upper Mississippi region, they still indicated farm program payments have a significant effect on some state economies.

Here, as we look out into the future, there is good news—at least up to 2002. We know what size the agricultural commodity program is likely to be; we know what will be paid and when. For the next few years, the "decoupled" farm bill should add significantly to farm incomes. States with economies dependent on agricultural commodities—particularly grains—should benefit. But there is great uncertainty about what will happen after 2002 and how those affected by this program should begin to plan for managing, in case the farm program then disappears completely.

■ ***State and Local Grants and Aids.*** Finally, let us turn to the best-known category. Federal grants and aids to state and local governments totaled $214 billion in 1994, about 16 percent of all federal spending. Much has been said and much more will be said and written about the impact of federal budget changes on state and local governments; so, it is useful to devote more time to this spending category. Many of the programs covered here are easily recognized. They include the well-known and controversial safety net programs, as well as those providing aid for education, job retraining and environmental management. In total, however, these programs are relatively small. For the entire nation, federal aid to state and local governments was only $811 per capita. Less than one-sixth of total federal spending went to programs in this category.

There is a much wider variation in the level of this category of federal dollars that goes to particular states. For example, Alaska, Wyoming, New York and Louisiana all receive at least 50 percent more, per capita, than the U.S. average.

• ***Medicaid***. Medicaid is the largest aid program for state and local governments. It provides federal reimbursement for state payments that address medical care for the poor and long-term care for the elderly. Nationally, nearly 40 percent of all federal assistance to state or local governments comes through Medicaid. Thus, cuts to the program are inevitable if the federal budget is to be balanced. Spending programs this large simply cannot be "off the table" in any credible budget-balancing plan.

State policymakers recognize the need for Medicaid cuts if the budget is to be balanced. They also recognize, however, that changes in the federal Medicaid reimbursement rate will stress state budgets. The state share of Medicaid payments currently is a large and growing portion of state general fund expenditures. In Minnesota, for example, medical assistance makes up roughly one-quarter of the state budget.

The U.S. Congressional Budget Office baseline budget shows Medicaid growing by nearly 10 percent per year between now and 2002. But, making program changes in this area will be made even more difficult by the fact that any cuts to this program will affect some of the most frail and defenseless in society. In Minnesota, Medicaid spending is split roughly 50-50 between medical assistance for the poor and nursing home care for the elderly. Given the increasing average length of stay in nursing homes and given the increased life expectancy of the elderly, we need to begin planning now, if we are to avoid either significant state tax increases or the removal of individuals from nursing homes after the turn of the century. Changes in federal reimbursement rates for Medicaid will present every state with major programmatic and financial challenges.

• ***Medicare***. The outlook for the future at the state level is further complicated by possible interactions between cuts in another federal program—Medicare—and demands for Medicaid. While Medicare spending is another entitlement that must be cut from future baseline levels if there is to be any possibility of balancing the budget, those cuts may have unfortunate side effects. One result may be an increase in the number of individuals making use of Medicaid, as low-income senior citizens accrue health care costs in excess of those covered by a stripped-down Medicare program.

Nationally, Medicare spending is slightly more than double federal spending for Medicaid. In 11 states, Medicare spending in fiscal 1994 exceeded the total of all aid to state and local governments.

The Federal Budget Outlook

Given its long-term projections, an advantage of the current federal budget process is that it provides states and localities with an early warning of potentially damaging future changes.

The President's FY 1997 budget plan contains a reasonable estimate of the size of the cuts from baseline levels of federal programs that will be necessary to balance the budget in 2002. This budget, because it contains only minor tax cuts, has the smallest impact on federal spending. The budget proposed by Congressional Republicans—which includes significant tax cuts—requires much larger federal spending cuts. Passage of the Dole-Kemp tax plan would require still larger cuts from baseline spending levels.

None of the approaches to balancing the budget by 2002 reduces Social Security spending below baseline levels. But all do reduce Medicare and Medicaid spending. While the reductions from baseline spending incorporated into the President's plan are smaller than those under either Republican alternative, those reductions are not trivial. For Medicaid, federal spending would be cut 13 percent from the 2002 baseline. Medicare would see an 11.2 percent cut. Other entitlements, including Food Stamps and AFDC, would be cut by 10 percent, while discretionary programs would be cut by an average of more than 14 percent from current baseline levels.

Although it is impossible to translate these baseline budget-cut percentages into precise bottom-line impacts on state budgets, the implications are clear. For Minnesota, a *pro rata* share of the Medicaid reduction alone (assuming no change in state law and no spillover impact from changes to Medicare) would require an additional $400 million in tax revenue or something on the order of a 3.5 percent increase in state tax revenues, to maintain services at the current level.

For nonmedical programs—for which federal spending cuts are likely to average in excess of 20 percent—the situation appears even more difficult. There is simply no way that states and localities can make up the difference between current spending levels and those that would occur should federal support be reduced to the degree indicated in the President's budget plans for 2002.

Conclusion

The outlook for states in 2002 is sobering. But this is not meant to be one of those gloom-and-doom talks for which economists are famous.

State governors have set the right tone by beginning to plan, setting things in order so that the necessary changes can be identified and managed over the next few years. The governors have made it clear that taxes will not be raised to cover all lost federal dollars. Still, most of them have not precluded tax increases for essential services. Fewer federal restrictions on state actions will help ease the problems of transition, as will the productivity enhancements that always follow budgetary pressures. States are now focusing on reordering priorities and redesigning service-delivery systems, particularly in the area of long-term care. State officials believe that they will find a way to manage through the challenges posed by federal devolution. But they also recognize that we can all manage better if we begin making plans now for those changes that surely are underway.

TABLE 1. Federal Expenditures, Dollars per Capita

(U. S. Census, 1994, by State)

STATE	TOTAL	DIR. PAY.	SOC. SEC.	M'CARE	WAGES	PURCH.	OTHER	ST/LO.AID	M'CAID
Alabama	$5,281	$2,843	$1,227	$646	$ 741	$ 797	$139	$ 761	$305
Alaska	7,657	1,525	490	171	2,256	1,662	459	1,754	290
Arizona	4,665	2,591	1,244	546	557	657	125	735	271
Arkansas	4,638	2,975	1,357	733	416	243	202	801	340
California	4,944	2,401	944	678	599	968	142	834	250
Colorado	5,194	2,185	952	464	968	1,223	243	575	177
Conn.	5,066	2,718	1,401	781	429	840	155	925	359
Delaware	4,178	2,527	1,279	585	644	237	102	669	216
Florida	5,095	3,324	1,547	896	521	595	81	575	211
Georgia	4,545	2,195	966	463	843	680	115	713	295
Hawaii	6,449	2,458	987	429	2,119	768	181	923	206
Idaho	4,382	2,224	1,095	452	539	745	187	687	207
Illinois	4,249	2,669	1,225	820	460	274	123	724	237
Indiana	3,843	2,400	1,305	613	365	291	169	618	277
Iowa	4,588	2,683	1,419	747	337	225	630	712	245
Kansas	4,897	2,707	1,276	756	741	451	346	652	236
Kentucky	4,574	2,631	1,230	588	681	345	107	809	348
Louisiana	5,022	2,470	1,092	582	495	704	142	1,213	754
Maine	5,410	2,837	1,279	732	623	825	101	1,023	487
Maryland	7,306	2,717	998	646	1,481	1,644	738	727	238
Mass.	5,856	2,925	1,293	953	515	1,094	285	1,036	348
Michigan	4,104	2,689	1,323	824	304	261	101	749	307
Minnesota	4,116	2,214	1,131	578	354	394	384	770	304
Miss.	5,272	2,738	1,158	629	577	860	159	939	400
Missouri	6,019	2,821	1,329	798	631	1,412	401	752	299

Montana	5,418	2,629	1,239	597	714	238	778	1,058	288
Nebraska	4,583	2,574	1,257	699	598	346	379	686	240
Nevada	4,189	2,340	1,121	415	524	717	62	547	131
N.Hampsh.	4,077	2,329	1,188	558	380	428	99	841	436
N.Jersey	4,723	2,870	1,353	860	473	534	66	780	308
N.Mexico	6,816	2,443	1,011	455	961	2,174	201	1,036	321
New York	4,973	2,857	1,291	888	409	338	133	1,235	623
N.Carolina	4,082	2,331	1,182	476	684	268	111	688	297
N.Dakota	6,127	2,671	1,221	855	887	329	1,139	1,100	315
Ohio	4,326	2,656	1,297	729	402	430	83	754	316
Oklahoma	4,824	2,745	1,225	675	806	351	199	724	240
Oregon	4,231	2,681	1,305	636	460	160	167	763	245
Penn.	5,063	3,252	1,491	998	481	375	149	805	332
Rhode Is.	5,489	3,118	1,418	817	643	501	123	1,103	446
S.Carolina	4,666	2,412	1,152	438	683	743	84	744	363
S.Dakota	5,290	2,563	1,243	670	750	273	698	1,004	286
Tennessee	4,842	2,601	1,209	613	516	865	98	761	348
Texas	4,315	2,235	932	546	544	699	148	689	293
Utah	3,980	1,805	833	289	775	624	142	634	213
Vermont	4,157	2,474	1,203	611	462	188	91	941	322
Virginia	7,004	2,620	996	493	1,854	1,784	260	485	154
Wash.	4,987	2,504	1,117	486	784	765	199	734	270
W.Virginia	5,241	3,295	1,530	776	432	244	81	1,189	543
Wisconsin	3,871	2,482	1,315	696	275	252	182	679	281
Wyoming	4,924	2,248	1,080	473	752	254	170	1,500	207
U.S.	4,996	2,614	1,188	688	598	735	174	804	310

TABLE 2. Federal Expenditures, Percent of Personal Income

(U.S. Census, 1994, by State)

STATE	TOTAL	DIR. PAY.	SOC. SEC.	M'CARE	WAGES	PURCH.	OTHER	ST/LO.AID	M'CAID
Alabama	29.5	15.9	6.8	3.6	4.1	4.4	0.8	4.2	1.7
Alaska	32.7	6.5	2.1	0.7	9.6	7.1	2.0	7.5	1.2
Arizona	24.4	13.5	6.5	2.9	2.9	3.4	0.7	3.8	1.4
Arkansas	27.6	17.7	8.1	4.4	2.5	1.4	1.2	4.8	2.0
California	22.1	10.7	4.2	3.0	2.7	4.3	0.6	3.7	1.1
Colorado	23.3	9.8	4.3	2.1	4.3	5.5	1.1	2.6	0.8
Conn.	17.4	9.4	4.8	2.7	1.5	2.9	0.5	3.2	1.2
Delaware	18.1	11.0	5.6	2.5	2.8	1.0	0.4	2.9	0.9
Florida	23.5	15.4	7.1	4.1	2.4	2.7	0.4	2.7	1.0
Georgia	22.5	10.9	4.8	2.3	4.2	3.4	0.6	3.5	1.5
Hawaii	26.8	10.2	4.1	1.8	8.8	3.2	0.8	3.8	0.9
Idaho	23.8	12.1	5.9	2.5	2.9	4.0	1.0	3.7	1.1
Illinois	18.0	11.3	5.2	3.5	1.9	1.2	0.5	3.1	1.0
Indiana	19.0	11.8	6.4	3.0	1.8	1.4	0.8	3.0	1.4
Iowa	22.7	13.3	7.0	3.7	1.7	1.1	3.1	3.5	1.2
Kansas	23.6	13.0	6.1	3.6	3.6	2.2	1.7	3.1	1.1
Kentucky	25.8	14.8	6.9	3.3	3.8	1.9	0.6	4.6	2.0
Louisiana	28.5	14.0	6.2	3.3	2.8	4.0	0.8	6.9	4.3
Maine	27.8	14.6	6.6	3.8	3.2	4.2	0.5	5.3	2.5
Maryland	29.4	10.9	4.0	2.6	6.0	6.6	3.0	2.9	1.0
Mass.	22.9	11.4	5.0	3.7	2.0	4.3	1.1	4.0	1.4
Michigan	18.5	12.1	6.0	3.7	1.4	1.2	0.5	3.4	1.4
Minnesota	18.5	9.9	5.1	2.6	1.6	1.8	1.7	3.5	1.4
Miss.	33.4	17.3	7.3	4.0	3.7	5.4	1.0	5.9	2.5
Missouri	29.3	13.7	6.5	3.9	3.1	6.9	2.0	3.7	1.5

Montana	30.4	14.7	7.0	3.4	4.0	1.3	4.4	5.9	1.6
Nebraska	22.0	12.4	6.0	3.4	2.9	1.7	1.8	3.3	1.2
Nevada	17.6	9.8	4.7	1.7	2.2	3.0	0.3	2.3	0.6
N.Hampsh.	17.2	9.8	5.0	2.4	1.6	1.8	0.4	3.6	1.8
N.Jersey	17.0	10.3	4.9	3.1	1.7	1.9	0.2	2.8	1.1
N.Mexico	40.0	14.4	5.9	2.7	5.6	12.8	1.2	6.1	1.9
New York	19.3	11.1	5.0	3.5	1.6	1.3	0.5	4.8	2.4
N.Carolina	20.9	11.9	6.0	2.4	3.5	1.4	0.6	3.5	1.5
N.Dakota	32.9	14.3	6.6	4.6	4.8	1.8	6.1	5.9	1.7
Ohio	20.7	12.7	6.2	3.5	1.9	2.1	0.4	3.6	1.5
Oklahoma	27.4	15.6	7.0	3.8	4.6	2.0	1.1	4.1	1.4
Oregon	20.7	13.1	6.4	3.1	2.2	0.8	0.8	3.7	1.2
Penn.	22.8	14.7	6.7	4.5	2.2	1.7	0.7	3.6	1.5
Rhode Is.	25.0	14.2	6.5	3.7	2.9	2.3	0.6	5.0	2.0
S.Carolina	26.3	13.6	6.5	2.5	3.9	4.2	0.5	4.2	2.0
S.Dakota	26.9	13.1	6.3	3.4	3.8	1.4	3.6	5.1	1.5
Tennessee	24.9	13.4	6.2	3.2	2.7	4.4	0.5	3.9	1.8
Texas	21.9	11.3	4.7	2.8	2.8	3.5	0.8	3.5	1.5
Utah	23.2	10.5	4.9	1.7	4.5	3.6	0.8	3.7	1.2
Vermont	20.7	12.3	6.0	3.0	2.3	0.9	0.5	4.7	1.6
Virginia	31.1	11.6	4.4	2.2	8.2	7.9	1.2	2.2	0.7
Wash.	22.1	11.1	5.0	2.2	3.5	3.4	0.9	3.3	1.2
W.Virginia	30.7	19.3	9.0	4.5	2.5	1.4	0.5	7.0	3.2
Wisconsin	18.5	11.9	6.3	3.3	1.3	1.2	0.9	3.3	1.3
Wyoming	24.2	11.0	5.3	2.3	3.7	1.2	0.8	7.4	1.0
U.S.	22.4	12.1	5.5	3.2	2.8	3.0	0.8	3.7	1.4