Staff Papers Series

P82-4

April 1982

THE NEW FEDERALISM:

WHAT IT MEANS FOR MINNESOTANS

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Applied Economics, University of Minnesota

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Staff papers are published without formal review within the Department
of Agricultural and Applied Economics

THE NEW FEDERALISM: WHAT IT MEANS FOR MINNESOTANS

by

A Task Force of the Department of Agricultural and Applied Economics, University of Minnesota *

None of us really understands what's going on with all these numbers.

-- *David A. Stockman*

President Reagan's State of the Union and Budget Messages called for sweeping changes in federal-state fiscal relations and service-providing responsibilities. Under the banner, "New Federalism", the President's proposals continue a dialogue on federal-state relations that goes back to the very roots of our country. The Federalist Papers, written by our revolutionary founding fathers, dealt with this issue, as have innumerable scholarly papers and Presidential commissions since.

Probably no one expects Mr. Reagan's proposals to be adopted without change, and many details have yet to be worked out. Nonetheless, the potential impact of this transformation warrants careful study.

How would Minnesota fare under the New Federalism? The principal objective of this report is to attempt to answer that question. The report focuses on the net fiscal impact of the New Federalism on state finances -- an especially important question in this time of heightened concern over the state's budget problems. A major finding is that one cannot assume that because the program may have a beneficial effect on state government finances, that it will necessarily be beneficial to all Minnesotans.

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* Members of the Task Force were Glenn Nelson (chm.), Wilbur Maki, Thomas Stinson, Arley Waldo, and Carole Yoho. Kim Holschuh provided administrative and secretarial assistance to the Task Force.

- Minnesota state government would benefit substantially from the New Federalism if the Administration's assumptions on relative program costs hold. Simulations of the impact of the Reagan proposal on the state's finances indicate that in 1993 the combination of savings from federal assumption of Medicaid and the additional excise tax revenue made available to the state would total more than $563 million more than the costs of the programs returned to the state for funding.
- Minnesota would not have as large a surplus under alternative assumptions about future spending levels for Medicaid, Food Stamps, AFDC, and the programs returned to the state from the federal level. Under some assumptions Minnesota could actually see negative fiscal impacts -- expected costs greater than savings plus additional excise tax revenues -- of $111 million, $140 million, and $41 million in 1988, 1989, and 1990, respectively. Even under this scenario, however, state government would have a net gain of $201 million in 1993.
- Minnesota's benefits could be largely illusory. Under some assumptions, the President's program could simply shift expenditures away from both the federal and state government and onto local governments and those private citizens currently receiving Medicaid, AFDC, or Food Stamp benefits. The assumption that the federal Medicaid program will maintain the current benefit structure for Minnesotans is crucial. Medicaid benefits per recipient in Minnesota are second highest among the 50 states. Any reduction of Medicaid benefits from existing state levels would reduce Medicaid savings to Minnesota citizens and lessen net benefits. The response of state policymakers to federal reductions in Medicaid payments relative to historical levels in Minnesota would determine who would bear the burden. If the state chooses to supplement federal funds in

order to maintain benefit levels, Minnesota taxpayers will find their tax burden rising above that implicit in the Reagan proposal. If the state chooses not to supplement federal Medicaid funds, letting benefit levels fall, Medicaid recipients will bear the burden. If Minnesota's benefit levels in 1980 would have been reduced to the level of average benefits for all states in 1980, the difference would have been over $200 million.

- New Federalism may create hardships for some local governments. States may force portions of their newly acquired responsibilities onto local governments, without appropriating the funds necessary for implementation. Some funds now passed directly from the federal level to local governments may be given to, and held by, state governments.

THE REAGAN PROPOSAL

The President's plan has two distinct parts. The first, often referred to as the "Swap" component, calls for a trade of social welfare programs. States would assume full responsibility for administering and funding Food Stamps and Aid to Families with Dependent Children (AFDC). In return, the federal government would take over the Medicaid program. The second part of the proposal, the "Turnback" component, would give the states responsibility for 44 programs currently funded by the federal government, while at the same time releasing certain federal excise taxes for state use.

Analyzing the impacts of the President's proposal within this two-part framework is convenient. The two parts are, however, not independent. From 1984 to 1987 the Turnback program and the accompanying trust fund provide the balancing mechanism through which states are compensated for losses

(or penalized for gains) from the Swap. In the absence of a device such as the trust fund, there would be no way to prevent some states from losing and others from gaining from the Swap. Later, after the trust fund is phased out, both the savings from the Swap programs and the additional excise tax revenue are needed if the Turnback programs are to be fully funded. Thus, although the two programs will initially be discussed separately, their fiscal impact will depend on their combined effect.

Medicaid/Public Assistance Swap

The Administration's proposal offers a major financial benefit to the states. The federal government would assume the full cost of Medicaid. This program, which finances health care for needy people of all ages, is a major budget item and is expected to continue its rapid growth. In FY 1980, the most recent year for which complete state and local expenditure data are available, state and local expenditures for Medicaid totaled about $10 billion, equaling 21 percent of their public welfare costs ($47 billion) and 3 percent of their total budgets ($369 billion).[1/] From FY 1980 to FY 1982 estimated federal Medicaid outlays increased nearly 30 percent (from $14 billion to $18 billion).[2/] In Minnesota growth of state and local expenditures for Medicaid was even more rapid, 35 percent, going from $251 million

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1/ State and local budgets - Council of Economic Advisers, Annual Report transmitted with the Economic Report of the President, Washington: Government Printing Office, 1982, p. 323; Medicaid - Office of Management and Budget, Executive Office of the President, Budget of the United States Government, Fiscal Year 1982, Washington: Government Printing Office, 1982, p. 235, and Advisory Commission on Intergovernmental Relations, "Staff Briefing Report on 'New Federalism' Initiatives," photocopy, Washington, D.C., March 1982, p. 3-16.

2/ OMB, Budget, FY 1982, op. cit., p. 235, and Office of Management and Budget, Executive Office of the President, Budget of the United States Government, Fiscal Year, 1983, Washington: Government Printing Office, 1982, p. 5-130.

in FY 1980 to $340 million in FY 1982.[3/] Currently, Medicaid costs in Minnesota are shared by the federal (56 percent), state (40 percent) and local (4 percent) levels of government.[4/]

In return for federal takeover of Medicaid, the President proposed that states would assume, also starting in FY 1984, the full cost of two major public assistance programs, Food Stamps and AFDC. The Food Stamp program is now federally financed but administered by states. The cost of AFDC in Minnesota, as with Medicaid, is currently shared by federal (54 percent), state (38 percent), and local (8 percent) governments.[5/] Nationally, federal FY 1980 grants to states in support of Food Stamp and AFDC programs totaled $16 billion, which represented 17 percent of total federal grants to states and localities and 34 percent of the public welfare costs of states and localities.[6/] The growth from FY 1980 to FY 1982 of federal grants for these two programs is estimated to be 21 percent (from $16.4 billion to $19.8 billion).[7/] State and local expenditures in Minnesota for AFDC (recall that Food Stamps are federally financed) have increased 23 percent, from $79 million in FY 1980 to an estimated $97 million in FY 1982.[8/]

3/ Minnesota Department of Public Welfare, St. Paul, personal communication.

4/ Ibid., FY 1982 estimates.

5/ Ibid.

6/ Food Stamps and AFDC - OMB, Budget, FY 1982, op. cit., pp. 402 and 448; state and local budgets - CEA, op. cit.; federal grants to states and localities - OMB, Budget of the United States Government, Fiscal Year 1983: Special Analysis H, Federal Aid to State and Local Governments, Washington: Government Printing Office, 1982, p. 17.

7/ OMB, Budget, FY 1982, op. cit., pp. 402 and 448; OMB, Budget, FY 1983, op. cit., pp. 8-35 and 8-70.

8/ Minnesota Department of Public Welfare, personal communication.

The Reagan Administration projects that the Swap will be beneficial to states in the aggregate. Administration estimates are for state Medicaid outlays of $19.1 billion and federal Food Stamp and AFDC program costs (to be absorbed by states) of $16.5 billion in FY 1984. Thus, the estimated state savings from the Swap are $2.6 billion.

For Minnesota, the Administration estimates the Swap would lead to net savings of $299 million in FY 1984. The savings from the federal assumption of Medicaid are estimated to be $501 million while costs of absorbing the Food Stamp and AFDC programs are $202 million. Based upon FY 1982 expenditures and recent trends, the Administration's estimates for FY 1984 appear reasonable for Minnesota. A critical assumption underlying the estimate of impacts on Minnesota state government is that the federal government will fund Medicaid at a level consistent with that currently existing in the state.

The projected savings for the states depend heavily upon the Administration's assumptions that the cost of Medicaid will continue to grow at a relatively rapid rate, while funding levels for Food Stamps and AFDC decline. There is general agreement with the Medicaid assumption.[9/] Many question, however, whether the Food Stamp and AFDC programs will diminish. In FY 1982 Food Stamp outlays are projected to be $11.5 billion and AFDC outlays to be $8.3 billion, for a total of $19.8 million.[10/] The total federal outlays for the two programs in FY 1984 are projected to be only $16.5 billion. Thus, the Administration's estimates of the Swap program's

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9/ For example, see National Governor's Association, The Proposed FY 1983 Federal Budget: Impact on the States, Washington, D.C., February 1982, pp. 42-3.

10/ OMB, Budget, FY 1983, op. cit., pp. 8-35 and 8-70.

impact are based on an assumption of a decline of $3.3 billion (17 percent) in outlays in nominal dollars over the next two years. Using the Administration's inflation forecasts of 5.1 percent in 1983 and 4.7 percent in 1984,[11/] the decline in constant 1982 dollars is from $19.8 billion in FY 1982 to $15.0 billion in FY 1984 -- a drop of $4.8 billion or 24 percent. The lack of precedent for such a drop causes some observers to believe that such budget cuts are not politically feasible. The impacts on states of alternative assumptions more consistent with past experience are displayed in Table 1.

Turnback Programs

The New Federalism would also give states full responsibility for administering and funding 44 existing federal programs. A list of the programs the Administration suggested be included is given in Appendix Table A. Projected FY 1984 expenditures for the Turnback programs total $30.2 billion. These expenditures, by functional area, include the following:[12/]

	Turnback Programs	
Functional Area	Total Programs (number)	Projected Expenditures (FY 1984) ($ billion)
Income assistance	1	1.3
Social, health, and nutrition services	18	8.0
Education and training	5	3.3
Transportation	12	6.4
Community development and facilities	6	6.4
Revenue sharing and technical assistance	2	4.8
	44	30.2

11/ Consumer Price Index, fourth quarter over fourth quarter, as stated in OMB, Budget, FY 1983, op. cit., pp. 2-5 and 2-7.

12/ White House, "The President's Federalism Initiative: Basic Framework," Washington, D.C., January 26, 1982, p. 8.

Table 1

Net Impact of the Medicaid/Public Assistance Swap on States as an Aggregate With Alternative Assumptions Regarding Food Stamps and AFDC Outlays, FY 1984.

Assumed Change in Food Stamp and AFDC Outlays, from FY 1982 to FY 1984	Net Impact On States Loss	Gain
	(billions, 1982 dollars)	
Reagan Administration projection (Decline of 24 percent in real dollars)	---	2.4
No change in nominal outlays (Decline of 10 percent in real dollars)	0.6	---
Increase outlays to keep pace with inflation (No change in real dollars)	2.5	---
Maintain FY 1980 - 1982 trend in real terms (Increase of 4 percent in real dollars)	3.3	---

Adjustments for inflation based on the Consumer Price Index, fourth quarter over fourth quarter, as stated in OMB, Budget, FY 1983, op. cit., pp. 2-5 and 2-7.

Based upon Administration projections of total federal grant-in-aid outlays to states and localities of $82 billion in FY 1984, the Turnback programs account for about 37 percent of anticipated intergovernmental grants from the federal level.[13/]

The Turnback program would be phased in gradually, not taking full effect until 1991. States would not be required to continue all federal programs turned back, although some passthrough of funds to local government would be enforced.

Revenues to support the programs transferred to the states would come from two sources -- the savings accruing from the Swap program and from new state taxes replacing existing federal excise taxes. After a transition period, current federal excise taxes on alcohol and tobacco would be phased out, as would $.02 of the existing $.04 per gallon gasoline tax. These taxes, as well as the one percent excise tax on telephone service scheduled to expire in 1988, could be levied by the states without increasing the total (federal and state) tax bill.

Since the Turnback program would produce a major redefinition of responsibilities between federal and state government, a transition period is allowed to ease the change. During fiscal years 1984-1987, all revenues from the federal alcohol, tobacco, and telephone excise taxes; $.02 per gallon of the federal gasoline tax; and a major portion of the windfall profits tax would go to a trust fund. The windfall profits tax is expected to provide almost 60 percent ($16.7 billion) of the trust fund's annual revenues of $28 billion. Gasoline, tobacco, and alcohol excise taxes are expected to contribute $2.2 billion, $2.7 billion, and $6.1 billion, respectively, while

13/ OMB, Budget, FY 1983: Special Analysis H, op. cit., p. 17.

the telephone excise would provide the trust fund with approximately $.3 billion per year. Current federal excise tax rates are given in Appendix Table B; Minnesota's existing excise taxes on alcohol, gasoline and tobacco are shown in Appendix Table C.

The trust fund would be distributed among the states based on their percentage share of receipts from the 44 Turnback programs during 1979-81. Each state's share of the fund would, however, be reduced or increased to balance out any gain or loss due to the AFDC/Food Stamp-Medicaid Swap. White House estimates of trust fund disbursements in 1984 for five Upper Midwest states are shown in Table 2. Minnesota, for example, received about 1.77 percent of the funds from the 44 Turnback programs during the period 1979-81. This translates into an initial trust fund credit of $535 million. However, Minnesota is projected to gain $299 million from the Swap program. As a result, the actual trust fund distribution to Minnesota would be $236 million ($535 million less $299 million net savings from the Swap). Iowa, North Dakota, South Dakota, and Wisconsin would receive $330 million, $83 million, $124 million, and $235 million, respectively, from the trust fund.

South Dakota is unique among the Upper Midwest states in that its trust fund allocation would be increased because the cost of assuming Food Stamps and AFDC would be greater than the savings from federal assumption of Medicaid. Trust fund allocations for the other four states would all be reduced reflecting expected savings from the Swap program. Nationally, 23 states would have their trust fund allocations supplemented to take account of additional costs while 27 states and the District of Columbia would have trust fund revenues cut. New York's cut ($2.3 billion) would be the largest, while Florida ($281 million) would receive the largest supplement.

From 1984 through 1987 the trust fund would be fully funded from federal taxes. Each state could choose to take its share of the trust fund in the

Table 2

Impact of Proposed New Federalism Plan
on Upper Midwest States, 1984.

	SWAP			Turnback Program		
					Financing	
	Medicaid Savings	Public Assistance Cost	Net Difference	Cost	Net From SWAP	Trust Fund
	$ million					
MINNESOTA	501	202	299	535	299	236
Iowa	166	140	26	356	26	330
North Dakota	45	20	24	107	24	83
South Dakota	32	33	-1	123	-1	124
Wisconsin	633	296	337	572	337	235

Source: White House

form of "Super Revenue Sharing" where, aside from a requirement to pass through certain funds to local government, it would be free to use the funds as it sees fit. Or, a state could continue to apply for grants under the 44 Turnback programs, complying with federal administrative regulations just as it had in the past. The grants received would be deducted from the state's share of the trust fund. During this phase of the transition -- the "hold harmless period" -- the trust fund is a balancing device which insures that no state gains or loses from the Swap.

In 1988 the option of using the federal administrative structure would be removed and the 44 aid programs abolished. Any state wishing to offer a particular type of aid to individuals or localities would be free to do so. It would, however, need to establish its own administrative apparatus and obligate its own funds for that activity.

States would still share in the federal trust fund after 1987, but the size of the trust fund would diminish. Tax rates on each of the federal excise taxes would be reduced to zero over four years, and the federal gasoline tax would fall to $.02 per gallon. Contributions from the federal windfall profits tax to the trust fund would also drop accordingly. During this period states could raise their excise taxes to replace the federal tax cuts.

By 1991 the President's program would be fully in place. The 44 Turnback programs would have been removed from the federal budget as would Food Stamps and AFDC. Federal excise taxes on alcohol, telephones, and tobacco would no longer exist, and the federal gasoline tax would be $.02 per gallon. States would no longer have responsibility for Medicaid; and they could, if politically feasible, have increased their excise taxes in an amount equal to the federal tax decrease. Each state would have the freedom to continue AFDC, Food Stamps, and any or all of the Turnback programs using their own funds and management rules.

The Administration estimates that, in the absence of the New Federalism, about $30 billion would be spent by the federal government on the 44 Turnback programs in 1984. This estimate assumes a decline in federal spending for these programs between 1982 and 1984. Funding for the programs, with this assumption, not only would fail to keep up with inflation, it would also decline in absolute terms. Obligations for the Turnback programs in 1982 were estimated at slightly more than $31 billion by the Advisory Commission on Intergovernmental Relations. Our own rough estimates indicate that federal outlays for the same programs in 1980 totaled slightly more than $43 billion.

The magnitude of the expected reduction is more clearly visible when expressed in real (1980) dollars (see Table 3). Between 1980 and 1982 spending on these programs declined by nearly 27 percent in nominal terms and more than 40 percent in real terms. Using the Administration's inflation projections of 5.1 percent for 1982 and 4.7 percent for 1983, expenditures of 30.2 billion in 1984 would reflect a 47 percent decrease in real expenditures for those programs from 1980 to 1984. Fixing the trust fund at projected 1984 expenditure levels causes a continued decline in real expenditures at the federal level. Making a conservative assumption of a 4 percent inflation rate, for illustrative purposes, from 1984 through 1987, the end of the hold harmless period, real revenues to support these programs would have fallen to about 45 percent of their 1980 expenditure levels by 1988, or about three-fourths their 1982 levels. Thus, state programs will be held harmless only in terms of nominal dollars; there will be significant losses in real terms.

NET FISCAL IMPACT ON MINNESOTA

Projecting the impact of the New Federalism on Minnesota state government is difficult. Assumptions about future funding levels for individual programs.

Table 3

Funding Levels for Turnback Programs Assumed in Administration Estimates.

Fiscal Year	Current Dollars	1980 Dollars
	$ billion	
1980 outlays 1/	43.1	43.1
1982 obligations 2/	31.1	25.8
1984 estimates 3/	30.2	22.8
1988 estimates 4/	30.2	19.5

1/ Computed using 1980 federal outlays data.

2/ Advisory Commission on Intergovernmental Relations "Staff Briefing Report on 'New Federalism' Initiatives," pp. 6-7.

3/ Office of Management and Budget, Major Themes and Additional Budget Details, Fiscal Year 1983, p. 21.

4/ Assumes annual inflation rate of 4 percent, 1984-1988.

rates of increase for certain expenditures, and the rate of growth of the federal excise tax base are crucial to any estimates. These are, of course, items over which reasonable people can disagree. As a result, the simulation results discussed below are offered as general indications of the effect of the President's proposal, not estimates of the specific dollar amounts of the state's gain or loss. Projections for 1991 and beyond are particularly tenuous since even slight differences in the assumed growth rates for a particular program, such as Medicaid, can compound over time into a large absolute error. Nonetheless certain impacts of the proposed New Federalism on Minnesota are clear.

Alternative projections of the net fiscal impact of the New Federalism proposal on Minnesota are given in Tables 4 to 6. White House assumptions about 1984 spending levels and the annual growth rates for Medicaid, Food Stamps, AFDC, and Turnback program expenditures are used in Table 4. Congressional Budget Office (CBO) assumptions about growth rates are used in Table 5, while Table 6 uses 1982 authorizations inflated to 1984 levels and CBO assumptions about rates of increase. Impact estimates are provided for the first 10 years of the program in all three simulations.

Minnesota realizes no net gain or loss during the first four years of the New Federalism program under any set of assumptions, consistent with the nature of the hold harmless period. Once the trust fund phase-out begins, however, differences are noticeable. In 1988, under White House assumptions (Table 4), Minnesota begins to gain more from the new excise taxes and the savings from the Swap program than the Administration projects it would cost to maintain the 44 Turnback programs. In 1991, when the trust fund is fully phased out, New Federalism would have a positive fiscal impact on Minnesota's budget of $387 million. From then on, savings to the state continue to increase by an amount equal to the annual increase in Medicaid costs less the increases in Food Stamps and AFDC.

Table 4: Projection of Net Fiscal Impact of Reagan Administration's New Federalism Proposal on Minnesota State Government, Administration's Assumptions (million dollars).

Period	Year	Medicaid Savings	Additional Public Assistance Cost	Net Savings	Turnback Program Base	Net Transfer	Saving + Transfer	Additional Excise Tax	Tax + Saving + Transfer	Net
Hold Harm-less Period	84	501	202	299	535	236	535	0	535	0
	85	548	206	342	535	193	535	0	535	0
	86	600	211	389	535	145	535	0	535	0
	87	657	215	442	535	93	535	0	535	0
Trust Fund Phaseout	88	719	220	499	535	0	499	53	552	17
	89	787	224	563	535	0	563	106	669	134
	90	861	229	632	535	0	632	159	791	256
	91	943	234	709	535	0	709	213	922	387
Long Term	92	1032	239	793	535	0	793	213	1006	471
	93	1129	244	885	535	0	885	213	1098	563

Assumes 1983 budget levels:
a) 9.45% rate of increase for Medicaid.
b) 2.1% rate of increase for Food Stamps and AFDC.
c) 0% rate of increase for Turnbacks.
d) 0% rate of increase for excise tax base. (1981 values for Minnesota).

Table 5: Projection of Net Fiscal Impact of Reagan Administration's New Federalism Proposal on Minnesota State Government, CBO's Assumptions (million dollars).

Period	Year	Medicaid Savings	Additional Public Assistance Cost	Net Savings	Turnback Program Base	Net Transfer	Saving + Transfer	Additional Excise Tax	Tax + Saving + Transfer	Net
Hold Harmless Period	84	501	202	299	535	236	535	0	535	0
	85	558	213	345	551	206	551	0	551	0
	86	621	224	397	568	171	568	0	568	0
	87	691	236	455	585	130	585	0	585	0
Trust Fund Phaseout	88	769	248	521	602	0	521	53	574	-28
	89	856	262	594	620	0	594	106	700	80
	90	952	275	677	639	0	677	159	836	197
	91	1060	289	771	658	0	771	213	984	326
Long Term	92	1179	305	874	678	0	874	213	1087	409
	93	1313	322	991	698	0	991	213	1204	506

Assumes 1983 budget levels:
- a) 11.3% annual increase in Medicaid.
- b) 5.3% annual increase in Food Stamps and AFDC.
- c) 3.0% annual increase in Turnback programs.
- d) no growth in excise tax base. (1981 actual for Minnesota).

Table 6: Projection of Net Fiscal Impact of Reagan Administration's New Federalism Proposal on Minnesota State Government, 1982 Authorization Used as a Base (million dollars).

Period	Year	Medicaid Savings	Additional Public Assistance Cost	Net Savings	Turnback Program Base	Net Transfer	Saving + Transfer	Additional Excise Tax	Tax + Saving + Transfer	Net
Hold Harmless Period	84	421	223	198	583	385	583	0	583	0
	85	469	234	235	600	365	600	0	583	0
	86	522	247	275	618	343	618	0	583	0
	87	580	260	320	637	317	637	0	583	0
Trust Fund Phaseout	88	646	274	372	656	120	492	53	545	-111
	89	719	289	430	676	0	430	106	536	-140
	90	800	304	496	696	0	496	159	655	-41
	91	890	320	570	717	0	570	213	783	66
Long Term	92	991	337	654	738	0	654	213	867	129
	93	1103	355	748	760	0	748	213	961	201

Assumes 1982 budget levels:
- a) 11.3% annual increase in Medicaid.
- b) 5.3% annual increase in Food Stamps and AFDC.
- c) 3.0% annual increase for Turnbacks.
- d) 0% rate of increase for excise tax base. (1981 Minnesota Actual).

By 1993, the tenth year of operation, the sum of the savings from the Swap program and the additional excise collections replacing those formerly levied at the federal level is projected to exceed the added cost of the programs turned back to the state by more than $500 million. Savings accruing to the state from the Swap program would amount to nearly $900 million by 1993 while the additional excise taxes levied would total more than $200 million. The cost of Turnback programs to be assumed by the state was estimated by the White House to be $535 million, leaving a net reduction in revenue needs of $563 million. The additional excise tax revenue by itself, however, is only about 40 percent of the estimated cost of the Turnback programs in 1984.

These results indicate the substantial role of Medicaid savings in the President's program. Without the substantial projected savings from the Food Stamp/AFDC-Medicaid Swap, most states would see negative fiscal impacts once the trust fund was phased out. Minnesota, without those savings, would be short about $325 million even if there were no increase in Turnback program expenditures from 1984 levels.

Simulations of the New Federalism's impact on Minnesota state finances using alternative assumptions about 1984 expenditure levels and growth rates are shown in Table 5. These results support the position that changes in growth rate assumptions are not critical to the long term financial impact of the program on the state's finances. All that is required is that Medicaid costs increase much more rapidly than Food Stamp and AFDC costs.

Results less favorable for Minnesota are obtained when initial levels for Medicaid, Food Stamps, AFDC, and Turnback programs are based on expected 1982 outlays, and then increased at the rates assumed in CBO projections (Table 6). Under these assumptions Minnesota suffers negative fiscal impacts of $111 million, $140 million, and $40 million in 1988, 1989, and 1990,

respectively. Even under this scenario, however, Minnesota would have a positive fiscal impact of $201 million in 1993.

Simulation results indicate that the proposed New Federalism program would benefit Minnesota state government in the long run. Savings available from federal assumption of Medicaid would be large compared to the projected costs of the Food Stamp, AFDC and Turnback programs. These favorable results will not be found in most other states, however.[14/]

Minnesota's benefits may be largely illusory though. They depend heavily on the assumption that the federal Medicaid program will maintain the current benefit structure for Minnesotans. Medicaid outlays in 1980 were $1,817 per recipient in Minnesota--58 percent ($670) above the average of all states of $1,147.[15/] Only one other state, New York, had a higher average outlay per recipient ($1,985). The federal government would probably enact national benefit levels lower than those prevailing in Minnesota. Raising all states to the benefit levels of Minnesota would likely be viewed as prohibitively expensive, especially in a period of great concern over federal budget deficits.

Any reduction of Medicaid benefits from prevailing state levels would reduce Medicaid savings to Minnesota citizens and thereby lessen the net

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14/ The Advisory Commission on Intergovernmental Relations (ACIR), in its preliminary analysis of the Administration's programs ("Staff Briefing Report", *op. cit.*) notes the generally unfavorable outlook for the states saying that "even if the Administration's budget assumptions for AFDC, Food Stamps, and Medicaid prove correct, the Administration's proposal would result in a small shortfall (for states) beginning in 1989 and lasting through 1992. ... If the alternative set of budget assumptions is the basis for the simulation, the prognosis for the states is bleaker. The shortfall would be significantly larger (17.6 billion in 1991) and last longer."

15/ ACIR, "Staff Briefing Report", *op. cit.*, p. 3-16.

benefit of the Swap. The response of state policymakers to federal reductions in Medicaid payments in Minnesota would determine which citizens would bear the burden. If the state chose to supplement federal funds in order to maintain benefit levels, Minnesota taxpayers would find their tax burden rising above that implicit in the Reagan proposal. If the state chose not to supplement federal Medicaid funds, letting benefit levels fall, Medicaid recipients would bear the burden. In that situation the state budget would benefit, but there would be increased costs for certain Minnesota residents, cancelling or offsetting some of the budget savings. Such a transfer of financial responsibilities may improve the welfare of one group of taxpayers, but only at a cost to others. It will not help the state as a whole. If Minnesota's benefit levels in 1980 would have been reduced to the level of average benefits for all states in 1980, the difference would have been about $218 million.

The New Federalism may also create hardships for some local governments. There are two potential difficulties. First, local Minnesota governments help fund both Medicaid and AFDC. The state, in the context of the New Federalism, could force some localities to increase payments for AFDC by more than their Medicaid savings. While local variation in impact would not affect the state government's balance sheet, local fiscal disparities would arise.

The second potential problem for local governments emerges from the fact that a number of the programs to be turned back to the state are programs which send funds directly from the federal government to localities. Other programs channel funds through the state to local governments. There are, of course, obvious financial advantages to state governments if they can abandon such programs as Urban Development Action Grants or mass transit

subsidies, designed to send money directly to localities.

The President's proposal addresses this problem by requiring states which opt out of programs designed solely for localities to pass along the entire amount saved to local governments using the revenue sharing formula. In addition, to compensate for the loss of funds channeled through the states, 15 percent of all trust fund receipts are to be made available to local government using the same revenue sharing formula.

Such provisions will not eliminate inter-local losses and gains. Distributions based on the revenue sharing formula are likely to be quite different from the actual distribution of grant program funds. The first impression is that smaller local governments appear to benefit, while the larger urban centers are likely to receive less. In addition, since the 15 percent passthrough is conditioned on the state's receipts from the trust fund and not on the original base in the trust fund (before deduction of the savings from the Swap program), the amount mandated to go to localities drops quickly. In the absence of state action, there is again the potential for a transfer of financial difficulty from the state to its localities.

THE ECONOMIC AND POLITICAL CONTEXT

The prospects for New Federalism may be usefully assessed from a variety of complementary perspectives. The historical context gives insight into the motives for proposed changes and suggests key issues. Economics provides a more prescriptive perspective, attempting to answer the question, "what should be done?" Political constraints, especially the degree of popular acceptance, determine which alternatives are feasible.

Historical Context

New Federalism may be viewed as a response to a combination of economic, political, and intergovernmental issues and concerns. The growth

of the federal fiscal role in state and local affairs during the 20 year period from 1960 to 1980 is well documented. Reasons most often given to account for the expansion of federal activity include:

- The availability of revenue generated by the federal income tax from an expanding base.
- Willingness of politicians of both parties to use federal revenues and the federal bureaucracy to address social and economic problems seen as inadequately addressed by states or local governments.
- Strong state and local government lobbies in Washington.
- A judicial system which, by a number of key decisions, contributed to a collapse of constraints on federal involvement in matters previously considered state and local concerns.

No matter how long one's list of contributing factors might be or one's choice of which one is key, some reactions to the growing involvement of the federal government in what had traditionally been state and local concerns were becoming apparent well before the Reagan Administration. Federal programs often were perceived as wasteful, inefficient, highly bureaucratized, and simply not working. State and local officials urged removal of federal conditions and regulations, arguing that they were costly, lacking flexibility and burdensome. Many noted that the matching requirements of federal grant-in-aid programs seriously distorted state and local spending patterns and preferences.

At the same time concerns were being expressed about the growth of the federal budget, deficits, and tax burdens in an economy plagued by both inflation and recession. The election of a conservative President, a Republican majority in the U.S. Senate, and a House which, although Democratically controlled, is more conservative in outlook, made it inevitable that intergovernmental relations and a reexamination of the federal role would be on the policy agenda of the 1980's.

During its first year, the Reagan Administration concentrated on tax reductions and budget cuts. Cuts in federal grant-in-aid programs were accompanied by grant consolidations (block grants) in some areas. The New Federalism would make much more sweeping changes in the federal role in providing revenue and services and in its relationships with states and localities.

At this point, New Federalism is only a proposal. It has not been introduced in the Congress in bill form. Given its scope and complexity, the proposal will be subjected to modification (or rejection) at many points along its Congressional journey. Needless to say, there is a high level of apprehension about potential differential impacts of changes in the federal aid system upon states, local governments, regions, and economic groups. This apprehension may make many politicians hesitant to act.

Some observers even question the capacity of Congress to deal with proposed policy changes of this magnitude. They argue that our political process makes incremental change a much more likely possibility. The timing of the President's proposals may also pose a problem. There is a perception that New Federalism is not the most important issue on the political agenda at this time. It is argued that this debate will only detract from consideration of more crucial issues such as federal budget deficits, economic recession, unemployment, shifts in taxpayer burdens, and spending levels for defense and social welfare. Notwithstanding the fate of this particular set of proposals, it seems reasonable to expect some degree of change in intergovernmental relationships.

Initial state and local reactions to the New Federalism tended to be in the form of questions about immediate financial impacts, i.e., do we win or lose relative to our position under the current system? The prospect of getting rid of federal mandates and regulations was attractive, but

how many federal dollars would disappear as a result? The fiscal position of many states (especially those not endowed with energy resources) has been declining rapidly due to inflation, economic downturn, taxpayer revolts, and cuts in federal aids. Many already find themselves in a position of raising taxes and cutting programs. States are very concerned about their ability to cope with federal aid cuts.

Another consideration involves the relationships between state governments and their local units. Under the existing system, the federal government deals directly with local units in many programs. In some cases, new federal block grants directed to the states would change this direct relationship, and local units would find themselves dealing with state governments for a share of these funds. State capitals could rapidly become the only scene of the action for local officials. How would the states respond? Would they attach conditions to their grants as onerous as they felt federal conditions to be? What kinds of criteria would they use in determining which functions should be state and which local? How would they allocate funds?

In most states, the executive branch has had major responsibility for dealing with federal funds. Little discretion was involved. Under the New Federalism, this would change. There would be more opportunity for discretion on the part of the states. What role will state legislatures see for themselves under these conditions?

Economics and the New Federalism

President Reagan's New Federalism proposals are directly related to the rationale for government provision of certain goods and services and for government action to enhance the economy of the nation. Public programs are undertaken with the aim of more nearly achieving three economic goals: (1) growth with stable prices, (2) equity, and (3) efficiency. Growth with stable prices enables an increasing standard of living

for the average citizen. Equity reflects a concern that citizens should have access to goods and services in a manner consistent with the moral standards of society. Efficiency is the means towards greater productivity through the best use of existing resources. Some programs are directed towards a single goal while others contribute to two, or even all three, goals.

Growth with Stable Prices: The pursuit of sustained economic growth with little or no inflation is inherently a national function that requires effective use of monetary and fiscal policy. Monetary policy is controlled by national institutions, primarily the Federal Reserve System and the executive branch of the federal government. An effective fiscal policy requires the flexibility to sustain deficits in periods of economic recession or depression. State and local governments have much less flexibility with regard to deficit spending than does the national government.

An important component of fiscal policy is a set of programs which are designed to be built-in stabilizers. The expenditure levels of these programs tend to rise during periods of economic slowdown and to fall during periods of economic prosperity. Stabilization programs should be financed at the national level since effective implementation depends upon their expansion during periods of economic slowdown. This will often lead to deficit spending, which is consistent with national but not state and local institutions. Unemployment compensation is a major example of a built-in stabilizer. Other transfer programs, such as Food Stamps, also play a role in meeting the needs of the cyclically poor.

State and local attempts to meet the needs of the cyclically poor are frustrated by budget constraints. Their budget receipts are growing most slowly, or even declining, in precisely those periods when the needs of the unemployed are greatest. The frustration is especially acute when the problems

in a state are caused largely by national policies -- for example, a rise in the unemployment of construction workers due to high interest rates caused by national fiscal and monetary policies.

Equity: Programs to enhance equity should be financed at the level of government corresponding most nearly to the scope of the community within which equity is a major concern. For example, shifting Food Stamps from a federally financed program with uniform benefit schedules over the nation to a state program is opposed by those who feel strongly that everyone in the nation should be guaranteed equitable access to food. On the other hand, those who feel equity within their own state is the major concern, leaving citizens of other states to do as they please, should support a program administered at the state level. For example, those who believe AFDC payments should reflect local or state, rather than national, norms of well-being and self-sufficiency are defenders of a decentralized system.

The design of programs to promote equity becomes more complex when migration is considered. Differences in program benefits between areas may lead to migration of beneficiaries from low-benefit to high-benefit jurisdictions. The movement of people will, in turn, lead to a greater burden on the taxpayers of the receiving jurisdiction and a lesser burden on the taxpayers of the sending jurisdiction. Citizens of the sending jurisdiction are "free riders" who experience the benefits of seeing needy people receive aid without paying taxes comparable to taxes elsewhere. Thus, people who are concerned about equity only within their own locality may nevertheless support program implementation at a broader level of government to eliminate the potential of an influx of potential beneficiaries.

Efficiency: To the extent that certain goods and services can be more efficiently provided by the public rather than the private sector, two

factors play a crucial role in determining the efficient allocation of programs between levels of government: (1) regional variations in citizen preferences for public services and (2) the geographic extent of the impact of public programs.

Regional variations in citizen preferences for publicly provided goods and services should be reflected in the number and size of programs. A program should be sufficiently decentralized that citizen groups with marked differences in preferences are not forced to abide by the same policies. The inclusion of Community Education funds in the Turnback program, for example, probably reflects a judgment that communities differ in their desire for this program and that an overall national policy is inappropriate amidst such diversity.

The geographic extent of program impacts is the other critical variable. A program should be structured in such a way that effected citizens have a voice in policy formation and program funding.

The possibility of migration creates a potential for greater efficiency where service levels vary between jurisdictions. Citizens will tend to move into jurisdictions supplying public services at levels they desire. Thus, migration has some tendency to bring about greater homogeneity within jurisdictions as time passes and, consequently, greater efficiency.

The argument concerning migration is valid only for services without significant impacts beyond the jurisdiction in which they are provided. If spillovers or externalities exist, jurisdictions have an incentive to seek "free rider" status. Free riders reduce efficiency and undermine equity goals. Efficiency losses derive from the unwillingness of taxpayers to pay for benefits received by non-paying citizens of other jurisdictions. The result is underfunding of programs with positive spillovers. Similarly,

programs with negative spillovers are overfunded by the jurisdictions making the program decisions.

The existence of spillovers, positive and negative, between jurisdictions provides a rationale for a shared responsibility for programs. To proceed otherwise would lead to efficiency losses. A push to assign all programs uniquely to one level of government as part of "bringing order" to the system would lead to many inappropriate incentives. For example, a project which reduced water pollution in a stream might have the largest impact on the citizens in the county where the pollutant source is located, a smaller impact on other citizens of the state, and a still smaller -- but positive -- impact on other citizens of the nation. The appropriate method of financing the project would be for each governmental level to contribute in proportion to the benefits received by its citizens.

A further complication is introduced by the realities of program implementation. Large, centralized bureaucracies are often plagued by administrative and representational weaknesses. Partial control of professional and bureaucratic interests is sometimes facilitated by decentralization. Comparisons, and even competition, among multiple bureaucracies in different jurisdictions encourages more innovation and experimentation than occurs in one federal program.

Popular Acceptance

Popular acceptance of President Reagan's New Federalism proposal will depend largely on whether it is perceived to be fair. The program's fairness will be judged at a number of levels. A rough balance in the aggregate shifts in costs between federal and state governments will be necessary, as will protection for each state from any significant losses from changes in program responsibility. Large negative impacts for local governments, recipients of

substantial sums from the Turnback program, will not promote popular acceptance, nor will a program which is only superficially fair -- for example, one which is balanced during its early years but which may have costs far in excess of revenues in the future. Finally, if the proposal achieves its objectives at the expense of one or more groups of citizens, particularly if those citizens are among society's disadvantaged, it is not likely to develop the support necessary for Congressional approval.

The Reagan proposal appears to produce no serious financial problems for any level of government if two conditions are met. The first is that interstate differences in Medicaid benefit levels are resolved so that no state is penalized for being either above or below average in its pre-Swap benefits schedule. The second is that Administration projections of the relative rates of growth of expenditures on Medicaid, Food Stamps, AFDC, and the Turnback programs are relatively accurate.

Individual states are protected during the four-year, hold harmless period by the balancing effect of the trust fund distributions. Local governments, while not held harmless individually, are protected by the Administration's requirement that states which choose to opt out of programs designed solely for localities must pass along to local governments the entire amount saved. In addition, to compensate for the loss of funds formerly channeled through the states, 15 percent of all trust fund receipts are also to be made available to local governments. Both mandatory passthroughs are to be made using the general revenue sharing formula.

Such provisions will protect localities as a group through 1987, but they will not eliminate inter-local gains and losses. Distributions based on the revenue sharing formula are likely to be quite different from current receipts of funds from grant programs. Smaller local governments appear likely

to benefit from this shift, while the larger urban centers are likely to lose.

In 1988, when states have full responsibility for the Turnback programs, the distribution of funds is likely to change again. At that time, localities would no longer be guaranteed a share of the state's savings. But they would have had four years to make their needs known to their state legislatures.

There are no built-in surprises for state budgets during the first ten years of the program if White House estimates of growth rates for Food Stamp, AFDC, and Turnback programs are correct. Even increasing the rate at which expenditures on the Turnback programs are assumed to grow from 0 percent (the Reagan assumption) to 3 percent (in nominal dollars) makes little difference to states such as Minnesota.

But the President's proposal offers only partial protection against increases in program costs due to general inflation. Savings from federal assumption of Medicaid are likely to continue to grow, but the tax revenue from assumption of federal excise taxes will not. Excise taxes are levied on a per unit basis and not as a percentage of the value of the item taxed. Consequently, these revenues are expected to remain relatively constant, no matter what happens to inflation. As a result, the New Federalism is not without risk to the states. Inflation -- which forces AFDC, Food Stamp, and Turnback program costs to increase more rapidly than projected -- could create financial hardships.

The fairness of President Reagan's proposal to low income families and the disadvantaged is the most difficult to evaluate. The program's announcement noted that welfare recipients would be protected during the transition from federal to state control of welfare programs, but no specific mechanism was given. Without information about what is actually planned, no conclusions can be reached. The Administration must, however, solve two separate problems,

each of which will require imaginative solutions if the New Federalism is not to take funds away from the less fortunate.

First, some way must be found to insure that states maintain minimum standards for public assistance programs. Cutting program benefits (or simply not increasing them at the rate at which prices increase) could provide significant savings for state government at the expense of public assistance recipients.

The second problem appears even more troublesome -- it is finding a way to resolve interstate differences in Medicaid benefits so that no state, nor any individual in those states, is penalized by the federal takeover of Medicaid. This problem is particularly disquieting since full federal assumption of Medicaid costs is what frees up most of the funds that states are to use to pay for the AFDC, Food Stamp, and Turnback programs. If the Medicaid problem cannot be resolved, the President's New Federalism proposal is not likely to be approved by Congress.

Briefly, the dilemma is this. The federal government can choose to fund Medicaid at a high level (equivalent to the benefit schedule for Minnesota or New York, for example) and deduct the excess given to residents of the states with lower benefit levels from the State's share of the trust fund. This has the effect of forcing the low benefit states to levy additional taxes to fund the Turnback programs. In practice low Medicaid states are also often those with low fiscal capacity. The result is a program which places additional costs on state governments, and thus on taxpayers, in low Medicaid states.

An alternative is to set a low Medicaid payment level. Then states such as Minnesota would be faced with the choice of either instituting a supplementary program and raising taxes to pay for the program level which they had

before, or of letting the burden fall on Medicaid recipients.

Choice of a middle level of benefits reduces the absolute loss for states of either extreme. This does not, however, solve the problem. Instead, both high and low Medicaid states are losers.

There is another alternative under which each state is given credit for its existing level of Medicaid spending and a special federal program, outside the New Federalism proposal, is used to bring low Medicaid states up to some predetermined level. This approach retains the inter-state equity of the New Federalism program, but it adds considerably to the federal budget.

None of these simple alternatives appears to be a satisfactory way of handling the Medicaid problem. If a solution cannot be found, however, it is not likely there will be any enthusiasm among state officials for the program's passage.

"Consider your verdict," the King said to the jury.

"Not yet, not yet!" The Rabbit hastily interrupted. "There's a great deal to come before that!"

-- Alice in Wonderland

APPENDIX TABLE A

Illustrative List of Programs to be Turned Back to States

EDCUATION AND TRAINING

Vocational Rehabilitation:

1. Rehabilitation Services -- Basic Support
2. Rehabilitation Services -- Special Programs
3. Rehabilitation Services -- Innovation and Expansion
4. Rehabilitation Training
5. Centers for Independent Living

Vocational and Adult Education:

1. Vocational Education -- Basic Grants to States
2. Vocational Education -- Consumer and Humanity Education
3. Vocational Education -- Program Input and Support Services
4. Vocational Education -- Program Input Projects
5. Vocational Education -- Special Programs for Disadvantaged
6. Vocational Education -- State Advisory Councils
7. Vocational Education -- Programs for Indian Tribes and Indian Organizations
8. Vocational Education -- State Planning and Evaluation
9. Community Education
10. Adult Education -- State Administrative Programs
11. Adult Education -- Adult Immigrants
12. Emergency Adult Education for Indochina Refugees
13. Adult Indian Education

State Education Block Grant:

CETA:

1. Comprehensive Employment and Training Programs
2. Job Corps
3. Institutional Grant Programs
4. Migrant and Seasonal Farmworkers
5. Employment and Training -- Research and Development Projects
6. Employment and Training -- Indians and Native Americans
7. Special National Programs and Activities for the Disadvantaged

Work Incentive Program (WIN):

INCOME ASSISTANCE

Low Income Home Energy Assistance:

SOCIAL, HEALTH AND NUTRITION SERVICES

Child Nutrition:

1. School Breakfast Program
2. Equipment Assistance for School Food Service Programs
3. Special Milk Program for Children
4. State Administrative Expenses for Child Nutrition

Child Welfare Services -- State Grants:

Adoption Assistance:

Foster Care:

Runaway Youth:

Child Abuse and Neglect -- Prevention and Treatment:

Social Services Block Grant:

Legal Services:

Community Services Block Grant:

Health Prevention Block Grant:

Alcohol, Drug Abuse, and Mental Health Block Grant:

Primary Care Block Grant:

Maternal and Child Health Block Grant:

Primary Care Research and Development:

Special Benefits for Disabled Coal Miners:

Migrant Health Centers Grants:

Family Planning:

Special Supplemental Food Program for Women, Infants and Children (WIC):

TRANSPORTATION

Airports:

1. Airport Development Aid Program
2. Airport Planning Grant Program

Highways:

1. Primary
2. Rural and Small Urban
3. Urbanized Areas
4. Bridge Construction
5. Safety
6. Other
7. Interstate Transfers
8. Appalachian Highways

Urban Mass Transit:

1. Urban Mass Transit -- Capital Improvement Grants
2. Urban Mass Transit -- Operating Assistance, Formula Grants

Water and Sewer:

1. Economic Development Administration -- Grants
2. Economic Development Administration -- Loans
3. EPA Waste Water Treatment Grants

Community Facilities Loans (Farmers Home Administration):

Community Development Block Grants:

1. CDBG
2. State CDBG

Urban Development Action Grants:

REVENUE SHARING AND TECHNICAL ASSISTANCE

Occupational Safety and Health Technical Assistance:

General Revenue Sharing:

Source: ACIR, "Staff Briefing Report," op. cit., pp. 6-6 through 6-10.

APPENDIX TABLE B

Taxes Going to Federalism Trust Fund

Telephone Excise Tax:

rate 1% on all phone service (scheduled to expire in 1984)
Approximate revenue $.3 billion

Alcohol Excise Tax:

rates:

Spirits		$10.50/proof gallon
Beer		$9/barrel
Wine		
	< 14% alcohol	$.17/gallon
	14-21% alcohol	.67/gallon
	21-24% alcohol	2.25/gallon
	champagne	3.40/gallon
	artifically carbonated	2.40/gallon

Approximate revenue $6.1 billion

Tobacco Excise Tax:

rates:

small cigars	$.75¢/1000
large cigars	8-1/2% of sales price but not more than $20/1000
small cigarettes	$4/1000
large cigarettes	$8.40/1000
cigarette papers	1/2¢/50
cigarette tubes	1¢/50

Approximate revenue $2.7 billion

Gasoline Excise Tax

rate: $.04 per gallon
(one-half or $.02 would go to federalism trust fund)

Approximate revenue $2.2 billion

Windfall Profits Tax:

rate: levied at varying percentages of the difference between sales price and recovery price for oil. Tax is required to be phased out between January, 1988 and January, 1991, depending on when the total tax collections exceed $227.3 billion. Recovery price for oil adjusted quarterly to take account of inflation.

Approximate revenue: $16.7 billion

APPENDIX TABLE C

Current Minnesota Excise Taxes on Telephones, Alcohol, Tobacco, and Gasoline.

Telephone Excise: none, telephone bills are subject to state sales tax of 5%

Alcohol Excise Tax:

rates:

Spirits	$4.39/gallon	
Beer	$4/bbl	
Wine		
	< 14% alcohol	$.27/gallon
	14-21% alcohol	.79/gallon
	21-24% alcohol	1.58/gallon
	> 24% alcohol	3.08/gallon
	sparkling wines	1.50/gallon

Tobacco Excise Tax:

rates:

small cigarettes	$9/1000
large cigarettes	$18/1000

Motor Fuels

$.13/gallon of gasoline

APPENDIX TABLE D

Minnesota Revenue Available from Assumption of Federal Excise Taxes.

Telephone Excise	6,000,000
Alcohol Excise	129,000,000
Tobacco Excise	39,000,000
Gasoline Excise	39,000,000
Total New Revenue	$213,000,000
Cost of Turnback programs	$535,000,000
Net long term deficit in funds to State without SWAP program	$322,000,000

Based on 1980 fiscal data from Minnesota.