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THE NEW FEDERALISM:

HOW WOULD IT AFFECT MINNESOTA?

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

Department of Agricultural and Applied Economics

University of Minnesota
Institute of Agriculture, Forestry and Home Economics
St. Paul, Minnesota 55108

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by

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

Under the banner, "New Federalism," President Reagan has called for sweeping changes in federal-state fiscal relations and service-providing responsibilities. What is New Federalism? How would it affect Minnesota residents? This publication answers some of the questions concerning the President's proposal.

1. WHAT IS THE PRESIDENT'S PROPOSAL?

The President has proposed a realignment of federal-state responsibilities for social welfare programs and the eventual elimination of federal funding for more than 40 existing federal programs.

The first part of the plan, known as the "Swap" component, would have states assume full responsibility for administering and funding Food Stamps and Aid to Families with Dependent Children (AFDC). In exchange, the federal government would take over Medicaid.

The second part of the plan, the "Turnback" component, would shift responsibility for 44 other programs from the federal government to the states over a period of years.

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*Members of the Task Force were Wilbur Maki, Glenn Nelson, Thomas Stinson, Arley Waldo, and Carole Yoho. All are members of the faculty of the Department of Agricultural and Applied Economics. Waldo is also Extension Economist, Public Policy; and Yoho is Extension Specialist, Public Policy.

2. WOULD STATES GAIN FROM FEDERAL TAKEOVER OF MEDICAID?

Yes. The financial benefit to state governments would be substantial. At present, Medicaid (which helps finance health care for needy people of all ages) is jointly funded by the federal government and the states. Medicaid is a major budget item and is expected to continue its rapid growth. In FY 1980, the most recent year for which complete data are available, the state and local share of Medicaid spending totaled about $10 billion. This was 21 percent of total state and local public welfare costs ($47 billion) and 3 percent of total state and local expenditures for all states ($369 billion).

From FY 1980 to FY 1982, estimated federal outlays for Medicaid increased nearly 30 percent (from $14 billion to $18 billion). Under existing law, federal outlays are expected to reach $21 billion in FY 1984.

3. HOW MUCH WOULD MINNESOTA GAIN?

Minnesota would save $501 million in FY 1984 (the first year of the program) as a result of federal takeover of Medicaid, according to Administration estimates. Currently, 56 percent of the state's Medicaid costs are paid by the federal government, 40 percent by the state government, and 4 percent by local units. The state and local share of spending for Medicaid in Minnesota was $340 million in FY 1982. This represented a 35 percent increase over FY 1980.

4. HOW MUCH WOULD STATES LOSE BY TAKING OVER FOOD STAMPS AND AFDC?

The Food Stamp program is now federally financed but administered by the states. AFDC is jointly funded by the federal government and the

states. Nationally, federal grants to states for these programs totaled $16 billion in FY 1980. This represented 17 percent of total federal grants to states and localities and 34 percent of state and local outlays for public welfare.

From FY 1980 to FY 1982, estimated federal outlays for AFDC increased about 14 percent (from around $7 billion in FY 1980 to $8 billion in FY 1982). Under existing law, the Administration expects federal outlays for AFDC to drop to $7 billion in FY 1984. Some observers believe this estimate is too optimistic. Estimated Food Stamp outlays increased from $9 billion in FY 1980 to over $11 billion in FY 1982. The Administration expects these outlays to reach nearly $13 billion in FY 1984, under existing law.

5. HOW MUCH WOULD MINNESOTA LOSE?

State takeover of AFDC and Food Stamps would cost Minnesota $202 million in FY 1984, according to Administration estimates. Under existing rules, 54 percent of AFDC costs in Minnesota are paid by the federal government, 38 percent by the state government, and 8 percent by local units. Federal grants for AFDC in Minnesota totaled $98 million in FY 1980 and $116 million in FY 1982. Funding for the Food Stamp program comes entirely from federal sources. Food Stamp payments in Minnesota increased from $60 million in FY 1980 to $85 million in FY 1982.

6. IF THE FEDERAL GOVERNMENT TAKES OVER MEDICAID AND STATES ASSUME RESPONSIBILITY FOR FOOD STAMPS AND AFDC, HOW WOULD MINNESOTA COME OUT ON BALANCE?

The Administration estimates the Swap would provide Minnesota with net savings of $299 million in FY 1984. The savings from the federal

takeover of Medicaid are estimated at $501 million while the cost to the state of absorbing the Food Stamp and AFDC programs would be $202 million. A critical assumption underlying the estimated impact on Minnesota state government is that the federal government will fund Medicaid at a level consistent with current Minnesota benefit levels.

7. WHY IS THE ASSUMPTION ABOUT MEDICAID BENEFITS SO IMPORTANT?

Medicaid benefits in Minnesota are much higher than the national average. For example, Medicaid outlays in Minnesota averaged $1,817 per recipient in 1980. This was 58 percent above the national average of $1,147. (Only one other state, New York, had a higher average outlay per recipient -- $1,985 -- than Minnesota).

If the federal government adopts national benefit levels lower than those prevailing in Minnesota, Medicaid savings to Minnesota residents would be reduced, lessening the net benefit of the Medicaid/Food Stamp-AFDC Swap. The burden of reduced Medicaid benefits would fall either on state and local taxpayers (if the state chose to supplement federal funds in order to maintain benefit levels) or on Medicaid recipients (if there were no state supplement). The potential burden on state and local taxpayers or Medicaid recipients is substantial. In 1980, the gap between average Medicaid benefits in the nation and benefit levels in Minnesota totaled $218 million.

8. WHAT PROGRAMS DOES THE PRESIDENT PROPOSE TO TURN BACK TO THE STATES?

The Turnback component of New Federalism would give states full responsibility for administering and funding 44 existing federal programs.

The Administration has suggested that the Turnback programs come from a variety of areas -- including social services, health and nutrition services, transportation, education and training, community development, income assistance, and revenue sharing. Projected FY 1984 federal expenditures for the Turnback programs total $30.2 billion. Based on 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.

9. HOW ARE STATES EXPECTED TO FINANCE PROGRAMS TURNED BACK TO THEM?

Revenue to support the programs transferred to the states would come from two sources -- the net savings to the states from the federal takeover of Medicaid and from a state takeover of certain federal excise taxes. After a transition period, federal excise taxes on alcohol and tobacco would be phased out completely, and the federal gasoline tax would be cut in half. These taxes, along with the federal telephone excise tax scheduled to expire in 1988, could then be levied by the states without increasing the total (federal and state) tax bill.

10. WHEN WOULD THIS TRANSFER OF RESPONSIBILITIES TAKE PLACE?

Since the Turnback program represents a major realignment of responsibilities between federal and state government, a transition period is proposed in order to ease the change. During fiscal years 1984 to 1987, all revenues from the federal alcohol, tobacco, and telephone excise taxes; half of the federal gasoline tax; and a major portion of the federal windfall profits tax would go into a Turnback trust fund. These funds would

be distributed among the states according to 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 Medicaid/Food Stamp-AFDC Swap.

11. HOW WOULD THIS WORK FOR MINNESOTA?

White House estimates for FY 1984 indicate that Minnesota would save $501 million from the federal takeover of Medicaid. State takeover of Food Stamps and AFDC would cost Minnesota $202 million, leaving Minnesota a net gain of $299 million. Minnesota's share of the 44 programs to be turned back to the states is estimated to be $535 million. Minnesota's payment from the Turnback trust fund would be $535 million minus the state's net gain of $299 million from the Swap program, or $236 million. During the initial phase of the transition -- the "hold harmless period" -- the trust fund is a balancing device that ensures that no state gains or loses from the Swap program.

12. HOW LONG DOES THE HOLD HARMLESS PERIOD LAST?

The hold harmless period runs from FY 1984 through FY 1987. During this time the trust fund would be fully funded from federal taxes. After FY 1987, states would still share in the trust fund, but the size of the trust fund would decline as federal excise taxes are phased out or reduced over a four-year period. Trust fund revenue from the windfall profits tax would also be reduced during this time. After FY 1991, the trust fund would no longer exist.

13. DURING THE TRANSITION PERIOD, WOULD STATES BE REQUIRED TO CONTINUE FEDERAL PROGRAMS TURNED OVER TO THEM?

No. States could elect to take their share of trust fund revenue in the form of "Super Revenue Sharing." Except for a requirement to pass through certain funds to local governments, states would be free to use the funds in any way they want. States would also have the option of continuing to apply for grants under the 44 Turnback programs, complying with federal administrative regulations just as they had in the past. After FY 1987, the 44 Turnback programs would be eliminated from the federal budget. States would be free to continue, modify, or drop any of the 44 Turnback programs. However, after the trust fund is phased out, there would be no federal funding to help support these activities.

14. WHAT WILL THE OVERALL FISCAL IMPACT OF NEW FEDERALISM BE ON MINNESOTA?

Initially, there would be little gain or loss for Minnesota. After FY 1987, the outcome depends on future funding levels for individual programs, rates of increases for certain expenditures, and the rate of growth of the federal excise tax base freed for use by the states.

Under White House assumptions, Minnesota begins to gain more from the takeover of federal excise taxes and the savings from the Swap program than it would cost to maintain the 44 Turnback programs. The net gain to State government in Minnesota is estimated to increase from $17 million in FY 1988 (the beginning of the trust fund phaseout) to $563 million in FY 1993. Of course, estimates so far in the future are tenuous.

Projections based on other assumptions show less favorable results for Minnesota, however. One indicates that Minnesota would experience a

net loss of $291 million for the period FY 1988 to FY 1990. Even under this scenario, however, Minnesota would have a net gain beginning in FY 1991.

If Medicaid is not funded at a level consistent with current benefits within the state, Minnesota's projected net gain may be largely an illusion. State government costs would increase if it were necessary to supplement federal Medicaid benefits or, if no supplement were provided, Medicaid recipients would lose. It is important to distinguish between the potential impact of New Federalism on state and local governments and its impact on residents of the state.

15. HOW WOULD NEW FEDERALISM AFFECT LOCAL GOVERNMENTS?

New Federalism could create hardships for some local governments. There are two potential difficulties. First, local governments in Minnesota help fund both Medicaid and AFDC. If the state were to take over AFDC, the state legislature could force local governments to increase their share of AFDC costs by more than they would save from the federal takeover of Medicaid.

A second potential problem is that a number of programs to be turned back to the states are programs that send funds directly from the federal government to local units or that channel funds through the state government to localities. The President's proposal requires that states which opt out of programs designed solely for localities must pass the entire amount saved on to local governments. In addition, 15 percent of all trust fund money received by the state is to be passed through to localities. In both cases, the passthrough is based on the federal general revenue sharing

formula. Any distribution of funds based on the revenue sharing formula is likely to be quite different from the current distribution of federal grants. Consequently, some local governments may gain from the passthrough requirements while others lose.

16. IS THE NEW FEDERALISM PROPOSAL LIKELY TO BE ADOPTED BY CONGRESS?

No one expects the President's program to be adopted without change. The Administration is now attempting to forge an agreement with the states concerning the proposal. It appears likely that the Administration will drop its proposal for state takeover of Food Stamps. Many details have yet to be worked out, including what would happen to Medicaid benefits under a federal takeover of that program.

The President's proposal has created widespread discussion and debate. Federal-state fiscal relations are already in a period of significant transformation, and more changes are bound to come. At the heart of the issues raised by New Federalism are some fundamental questions concerning the appropriate division of responsibilities between the federal government and the states. How we answer these questions is apt to have a far-reaching effect on the nation.

A NOTE TO THE READER

Additional information about the potential impact of New Federalism on Minnesota is available from the Department of Agricultural and Applied Economics, University of Minnesota, St. Paul, MN 55108. Ask for The New Federalism: What It Means for Minnesotans (Staff Paper P82-4).