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How America's "Devolution Revolution" Reshaped its Federalism

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Abstract. Instead of representing a static division of authority between the national and state governments, American federalism is constantly in flux. The "devolution revolution" of the mid-1990s gave states tremendous power to rewrite the rules of their welfare programs, changed the fiscal incentives that states face, and initiated a massive health insurance expansion funded primarily the federal government but implemented, with great latitude, by states. How did states react? How did this change the social safety net in the United States, and how did it reshape the nation's distinct brand of federalism? This essay explores these questions, both through a close focus how devolution played out in California and through a broader look at trends across the states.

For the first few minutes after the Supreme Court issued its opinion in the case challenging President Obama's universal healthcare law – a constitutional battle fought over whether the federal government could order individuals to buy health insurance, launched by state governments that opposed such mandates – America's leading media outlets got the news wrong. Fox News and CNN incorrectly reported that the health care mandate had been overturned, misleading even the president himself.[1] Reading the first few pages of the opinion, in which the Court took the side of the states in sharply limiting the power of the federal government to regulate commerce, reporters first believed that the healthcare law had been overturned. Reading further, they saw that Court upheld most parts of the law, interpreting the health care mandate as a "tax" which Congress was free to levy. When they read further still, reporters discovered that the opinion struck down the requirement that states dramatically expand the healthcare program (known as Medicaid) that provides care for the poor and elderly or lose all federal funding for these services. This returned to governors and state legislatures the power to decide how wide their social safety nets should be cast.

The frantic, confused news cycle on the morning of June 28, 2012 serves as a microcosm of the shifting story of American federalism. Exactly which powers belong to the federal government and which are reserved to the states has been fought out in constitutional conventions, in courtrooms, and on battlegrounds. Victories have never been complete and resolutions are never final, but the impacts of these fights have always had a profound effect on vital policies governing millions

[1] Neetzan Zimmerman, "President Obama Thought SCOTUS Struck Down Individual Mandate Because CNN and Fox News Said So." June 28, 2012. *Gawker*.

of Americans. This essay focuses on one critical episode in the evolution of American federalism and how it has shaped health care and social service policy.

I. American Federalism in Flux

Throughout its development as a nation, the United States has seen its formal governing structures and informal lines of authority redrawn over and over again through the constantly contested evolution of American federalism. Conflicts over which powers should belong to the national government and which belong to the states are as American as apple pie, the Star Spangled Banner, and Levi's jeans. America's failed first government under the Articles of Confederation collapsed in large part because the federal government was not given enough authority. The debates over the new Constitution in Philadelphia in 1787 often focused on the key question of federalism, with the Founders constructing patchwork solutions such as state-based representation in the US Senate and the population-based House to bring states large and small into agreement. Since then, two of the nation's most profound and bloodiest internal conflicts – the Civil War from 1861-65 and the civil rights movement nearly a century later – have been fought over the intersecting issues of race and states' rights. Because the national government and states often take opposing positions in areas as fundamental as slavery, civil rights, abortion rights, and the scope of government, shifting authority from one level to another shifts policy in profound ways. "From the start," one scholar of the history of American federalism notes, "political opponents have fought about federalism because it affects who wins and who loses a particular fight (Robertson 2012, p. 8)."

In recent decades, battles over federalism have shifted into less hostile but still critically important venues. The federal courts are the final arbiter of what is and what is not a state right, and also serve as the final arbiter in the disputes between the fifty sovereign states that are inevitable in America's "horizontal federalism" (Zimmerman 2011). Recent landmark cases have shifted power in different directions. In the 2010 *McDonald v. Chicago* case, the US Supreme Court struck down a Chicago, Illinois handgun ban, ruling that the Constitution's 2nd Amendment right to bear arms constrained state gun control legislation. Yet the national government does not always win in federal courts. The Supreme Court's June 28, 2012 decision in the *National Federation of Independent Business v. Sebelius* case, while upholding much of President Obama's healthcare law, was nonetheless a victory for states because it so sharply circumscribed what the federal government could do to regulate commerce and to compel states to expand programs like Medicaid that are jointly funded by states and by the national government.

The back and forth of modern federalism has played out most clearly in an area of government that is central to both the budgets of federal, state, and local governments and to the lives of tens of millions of Americans: the social safety net. Power over the design and funding of welfare and healthcare programs has been in constant and consequential flux over the past generation. These social services were first provided by individual states with some federal assistance, then standardized into the joint federal-state programs of Franklin D. Roosevelt's "New Deal" and Lyndon B. Johnson's "Great Society" legislation, and more recently have come to be shaped more and more by state forces.

These changes have over and again rewritten the rules of federalism. One longtime observer of and participant in these battles, who served as an intergovernmental affairs advisor to President Richard Nixon, titled a recent essay, "There Will Always Be a New Federalism." (Nathan 2006) The newest federalism was created in the mid 1990s through the "devolution revolution," which gave states tremendous power to rewrite the rules of their welfare programs, changed the fiscal incentives that states face, and initiated a massive health insurance expansion funded primarily the federal government but implemented, with great latitude, by states.

In this essay, I ask how the devolution revolution has reshaped federalism in the United States. My focus is on social services because its stakes are so high – with joint federal and state expenditures totaling $405 billion dollars in 2009[2] – and because it is in this realm that policy choices and implementation by the two levels of government are most deeply intertwined. I look at how the newest "new federalism" -- including the devolution of authority over welfare and the children's health insurance program, as well as new intergovernmental fiscal incentives -- has altered both state policy and the federal-state relationship. I begin by explaining how federalism now works in the realm of social service policy, describing how federal laws shape the level of state flexibility and the variation in policy choices across states. To illustrate how abstract regulations affect concrete political decisions, I turn a close focus to how the devolution revolution played out in the nation's largest state, California. I then draw upon recent data from all states in order to two central theses:

[2] In 2009, joint state and federal expenditures on social services included $374 billion for Medicaid, $11 billion for the Children's Health Insurance Program, and $20 billion in Temporary Aid to Needy Families (Bureau of the Census 2012, Tables 135 and 540).

1. The way that federal aid to states is structured has profound fiscal and political effects, determining how fast the social service safety net will expand. When Washington, DC began funding state welfare programs through block grant, this shift in the structure of aid predictably caused growth in state spending on welfare to slow dramatically. By contrast, generous matching grants for Medicaid and children's health insurance have put states on a fiscal escalator that has been hard to get off even during recessions.

2. Shifts in which level of government funds a social service program have a profound effect on which types of Americans pay its bills. When the federal government supports a program, the highly progressive structure of federal taxation ensures that more affluent Americans provide most of the funding for redistribution. When states pay more, the burden of welfare funding falls more heavily on middle- and low-income residents because state taxes in the US are generally regressive.

After demonstrating these points, I conclude by putting my findings in the broader context of the literature on federalism and on political representation, and by speculating about the lessons they hold for future policy devolution.

II. The Devolution Revolution in Social Services

The construction of America's social safety net – the healthcare, welfare, and pensions provided to the aged, the needy, and the disabled – is a complex story of federal and state policymakers working together to provide services that are funded both by government and by the private sector (see Hacker's 2002 *The Divided Welfare State*) and delivered both through bureaucracies and through private actors (see Morgan and Campbell's 2011 *The Delegated Welfare State*). Any brief summary of its history necessarily omits important details. Still, I begin this section by outlining how the development of America's welfare state interacts with federalism, and then devote the rest of the section to a close look at one critical period: the "devolution revolution" in social services that took place during the 1990s. I discuss the political

bargains that led lawmakers in Washington, DC to give state leaders more authority over their safety nets and to change the funding formulas that structure intergovernmental aid. I then analyze how those formulas shape the incentives of state policymakers. To illustrate the ways in which the new authority and new incentives affected state policy choices, I provide a case study that focuses on how the devolution revolution led to the expansion of one program but the contraction of another in California.

The American welfare state has its roots in the pensions provided for veterans of the nation's Civil War during the late nineteenth century and in the payments granted to impoverished single women with children in the early twentieth century (Skocpol 1992). The veterans' pensions were federally funded, but state governments played an important cooperative role in the early development of social service programs (Johnson 2007). For instance, California's 1941 budget included $38 million in federal assistance payments to the aged, blind and children, matched by $22 million in state funds. The two landmark expansions of these joint state-federal social services came with the "New Deal" policies passed under President Franklin D. Roosevelt in the 1930s and the "Great Society" policies passed by President Lyndon B. Johnson in the 1960s. The New Deal established pensions for the elderly and systematized welfare payments to the poor through what became known as the Aid to Families with Dependent Children (AFDC) program. The Great Society created, among other programs, the Medicaid program to fund health care for the poor, the elderly in nursing homes, and the disabled. Both Medicaid and AFDC would be administered by the states, with the federal government paying at least half of the cost through "matching grants" (and more than half of the cost in

the less affluent states). Throughout the 1970s and 1980s, Democrats in Congress passed new laws giving states the opportunity to expand their safety nets (Congressional Research Service 1993, Coughlin, Ku, and Holahan 1994). Because the matching grants offered them such a good deal, which I detail below, most states took advantage of this opportunity and widened their safety nets. Then, in the devolution revolution of the 1990s, lawmakers in Washington, DC changed the funding relationship between the federal and state governments, giving states more autonomy but at the same time halting the growth of one of these social service programs.

II A. Roots of the Revolution

In the mid 1990s, the roots of this revolution were planted by two trends, one economic and one political. First, a national recession put tremendous fiscal pressure on states, especially in the area of social services. Though the recession lasted only from July 1990 through March 1991,[3] the slow recovery created major deficits in state budgets for years to follow. Twenty-nine states were forced to cut their budgets in 1991, and thirty-five states made budget cuts totaling $4.5 billion in 1992.[4] California's budget did not pass until months past the constitutional deadline in 1993, and even as late as 1995, eight states, including New York, were still forced to make cuts.[5]

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[3] National Bureau of Economic Research, NBER Business Cycle Dating Committee Determines that Recession Ended in March 1991". Accessed in October 2011.
[4] National Association of State Budget Officers, *The Fiscal Survey of the States: October 1992*, Washington, DC: National Governors Association.
[5] National Association of State Budget Officers, *The Fiscal Survey of the States: October 1995*, Washington, DC: National Governors Association.

Why did the recession hit states so hard? One reason is that nearly all American states have strict balanced budget requirements,[6] a rule that is notably lacking at the federal level. Presidents and Congress can react to deficits by increasing spending and cutting taxes, as President Obama and the Democratic Congress did with the 2009 stimulus package. States, by contrast, must balance their books through painful cuts and tax increases. A second reason is that because states administer so many of the nation's safety net services, any financial downturn has a two-sided effect on their budgets. The supply of tax revenues goes down, but the demand for social services like Medicaid and welfare rises.

A contemporary report by the National Association of Budget Officers at the time demonstrated how these supply and demand dynamics threw state budgets out of balance: "Both the modest budget growth and the midyear budget adjustments reflect the tepid economy as well as pressures from double-digit growth in Medicaid spending and increased welfare caseloads."[7] The statements of state leaders testify to how they saw these trends. Medicaid was called the "Pac-man" of state budgets, a reference to the video game character who ate up everything around him, and Georgia governor Zell Miller compared it to the state's quick-spreading kudzu plant (Weissert 1992). State officials chafed at what they perceived as a lack of flexibility to make major Medicaid and welfare cuts, and called upon Washington, DC to give states great power over these increasingly expensive programs.

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[6] For full detail on the nature of these requirements, see National Conference of State Legislatures, *NCSL Fiscal Brief: State Balance Budget Provisions*, Denver, CO: National Conference of State Legislatures, October 2010.

[7] Quoted from page 7 of National Association of State Budget Officers, *The Fiscal Survey of the States: October 1992*, Washington, DC: National Governors Association.

After the 1994 elections, Congress became much more receptive to such demands. The Newt Gingrich-led "Republican Revolution," in which the GOP took control of the House of Representatives for the first time in a generation, set the stage for the devolution revolution. This shift in party control came in the midst of the growing political polarization between the two parties in America (see McCarty, Poole, and Rosenthal 2006). Whether the sharp disagreement between Democrats and Republicans on issues such as the optimal size of the safety net was due more to shifts among elected leaders (Fiorina 2005) or among voters, it was clear during the 1994 elections that the partisan divide was vast. After winning those elections, Gringrich and many other Republicans pushed for a switch from federal matching grants for social services to "block grants," a proposal that had also been made by Ronald Reagan. This was a proposal as much about ideology as it was about federalism, since all sides expected that block grants would lead to smaller government. "Block grants aim to provide greater federal budget certainty and a stronger state incentive to contain program costs," according to Lambrew (2005, p. 1). They do so by giving states both a fixed annual sum from the federal government to run a social service program (increasing predictability) and by making states responsible for any and all funding above that sum (providing them with the incentive to cut costs). In 1995, Speaker Gingrich pushed to switch the Medicaid program into a block grant to states, but lost in a political battle that revived the electoral fortunes of President Bill Clinton.

The Democratic president had steadfastly opposed major changes in Medicaid, but throughout his career had called for "an end to welfare as we have

come to know it."[8] He vetoed two early welfare reform bills pushed by Republicans, but as the 1996 election approached, Clinton took a centrist position by cutting a deal with Gingrich on a major welfare reform package in August of that year. The new law transformed the Aid to Families with Dependent Children program, renaming it Temporary Assistance for Needy Families, proposing a five-year lifetime limit on benefits, requiring that welfare recipients go back to work after two years on the rolls, and providing more child care for working recipients.[9] The law also changed federalism by making welfare a block grant, and giving states tremendous control over how to spend the grant. No longer did states receive matching dollars from the federal government, giving them the greater incentives to cut costs that Gingrich had favored for Medicaid. States were also given great freedom to craft their new programs; they could make their lifetime limits either shorter or longer than the federal baseline of a five-year limit, they could set the length of the workweek required of welfare recipients, and could create other limits or extensions. Whether states wished to build a program that was more conservative or more liberal that the federal guidelines, they had the flexibility to do so (Kousser 2005, Ch. 7).

Another major deal cut between Clinton and Gingrich the next year completed the devolution revolution. The creation of the state Children's Health Insurance Program (CHIP) as part of a budget deal in 1997 put states in charge of building a new healthcare program for the children of the working poor and, at state discretion, their parents. Reaching families with incomes too high to qualify for Medicaid but too low to purchase private insurance, the program could be offered

[8] Bill Clinton, "The New Covenant: Responsibility and Rebuilding the American Community. Remarks to Students at Georgetown University," October 23, 1991.
[9] CNN All Politics, "Clinton Signs Welfare Reform Bill, Angers Liberals," *CNN All Politics*, August 22, 1996.

through Medicaid, through the plan that covered state employees, or through a new program that met specific benchmarks (Health Care Financing Administration 1998). State legislatures and governors were left to decide. In this way, the CHIP program gave states another great source of authority. However, in its funding structure, it resembled Medicaid, with matching rates giving the federal government the ability to influence state decisions.

While the move in the mid 1990s to shift policy and fiscal control of social services to the states may have been an incomplete victory for the advocates of states rights, it still constituted a revolution. Though Medicaid remained generally unchanged, the new CHIP program gave states policy control of a program with fiscal incentives still managed by the federal government, and the TANF program transformed welfare into a system with policies and purse strings firmly under state control.

In the battles over each of these programs, Democratic and Republican leaders in Washington, DC clearly understood that the major policy dimension that polarizes American parties – the battle over whether to expand or to shrink government – was at stake in the debate over whether to devolve authority and restructure grants. Federalism, to paraphrase Robertson's (2012) words, would determine who won and who lost the fight over health care costs and welfare generosity. Republican support for decentralization of social policy, as Béland and de Chantal (2003) have observed, was driven primarily by ideological opposition to big government. To understand completely the link between devolution and the size of the safety net, it is necessary to look close at how federal funding formulas can influence state decisions.

II B. How Federal Funding Formulas Reshape State Incentives

In the joint federal-state programs that compose America's healthcare and welfare programs, the national government has used both regulations and inducements to motivate states to broaden their safety nets. The regulations have come in the requirement that states dramatically expand their welfare (beginning in the 1930s) and healthcare programs (starting in the 1960s) to meet new nationwide standards. The inducements have been the federal dollars sent to pay much of the cost of these new mandates, structured in a way that gave states a clear incentive to meet and often to go beyond the national baseline. Federal grants were intentionally designed to push states toward more generous services than they might otherwise provide. If Washington, DC had sent states block grants of a fixed amount, most states would spent all of the federal money while trying hard to minimize state costs paid in addition to the block grant. Instead, federal lawmakers designed matching rates that required states to spend their own dollars in order to bring in federal money. The more a state spent of its own, the more money it would bring in from Washington, DC, a formula for growth in social service provision.

The rationale for this system, from economic theories of fiscal federalism, is that matching grants should "be employed where the provision of local services generates benefits for residents of other jurisdictions (Oates 1999, p. 1127)." That is, because the advantages of providing for the welfare and healthcare of residents in one state spill over into other states and the nation as a whole, those benefits should be internalized into the decision calculus of lawmakers in each state. It did not hurt that Democrats in Congress at the time favored higher social service spending, and

realized that matching grants would create a powerful incentive for states, even ones that had traditionally been frugal, to move in this direction. Importantly, the federal matching rate varied across states, and always provided at least one federal dollar for each state dollar spent. Table 1 shows the matching rates that an illustrative sample of states receives today in Medicaid and in the CHIP program. It shows that poorer states like Mississippi and New Mexico received a higher match than rich states such as California and New York, a deliberate feature of the funding formula designed to give state lawmakers in states with tight budgets the ability to provide generous services.

Table 1. Federal Matching Rates for Social Service Programs

State	Medicaid	CHIP
Arkansas	$4.31	$4.25
California	$1.60	$1.86
Kansas	$2.30	$2.61
Mississippi	$5.61	$4.87
Montana	$3.54	$3.38
New York	$1.60	$1.86
New Mexico	$4.13	$3.99
Texas	$2.44	$2.46

Notes: Entries indicate how many dollars will be transferred by the federal government to match one dollar of state spending, by program and by state. Medicaid and CHIP figures are from the 2010 fiscal year, both taken from Kaiser Family Foundation (2011) and Families USA (2011).

Consider the effects of this grant structure on the decision calculus of governors and state legislators writing their budgets. For a program like the Children's Health Insurance Program, in New York the nearly two-to-one match means that in good times, the state can increase its budget by $100 million dollars and deliver, thanks to the federal grant, an additional $286 million in healthcare

services to poor families. When the state budget is flush, this acts like an escalator, providing a great incentive to spend a surplus on the CHIP program because lawmakers get so much "bang for the buck" in this program area. But just as the federal match makes it easy to increase spending in this area during good times, it also makes it hard to cut healthcare spending in bad times. When New York is in deficit, in order to reduce its state deficit by $100 million, lawmakers must eliminate $286 million worth of services. This effectively sends $186 million back to the federal government, never an attractive option to state policymakers. This makes cutting healthcare to working families much more difficult, in both political and policy terms, than cutting other areas of government like higher education, prisons, or primary education that are almost entirely state funded. Because matching grants push states to increase healthcare provision in good times and make it hard to cut in bad times, they should be thought of – whether one favors or opposes generous social services – as a lever of federal control over state decisions that reduces state autonomy.

In a poor state such as Mississippi, the federal matching rate is even higher. This gives the state an even better fiscal deal, at the same time that it makes the federal lever of control even stronger. For $100 million in new state spending, Mississippi lawmakers can secure and extra $487 in federal CHIP funds, but of course they would have to sacrifice that much in order to trim their state budget by $100 million. Washington, DC structured grants this way during times when Democrats controlled government, knowing that the arrangement would lead to social service expansion, while Newt Gingrich and other Republicans sought to change the formulas in order to shrink government.

Yet sometimes lost in this debate about the overall size of government is the important redistribution of federal tax dollars across states accomplished by the varying matching rates detailed in Table 1. Pointing out the disparities in these matching grants rates paints of portrait of an "equalizing" federalism that is at odds with the conventional idea that America's national government treats all states uniformly. "In all other federal systems," Robertson (2012, p. 2) writes, "the national government deliberately equalizes regional resources by redistributing more financial aid to the poorest regions. The United States is the only federal system that does not equalize state resources in this way" (see also Watts, 2006). In Medicaid, a massive program in which the federal government distributes $318 billion in aid across the states annually (Bureau of the Census 2012, Table 152), the aid is spread out unequally, with the most generous grants going to the poorest states. At least in this realm, American federalism is not exceptional; it redistributes money from rich to poor states just as federalism does in other nations.

II C. Implementing the Devolution Revolution in California

Leaders in each state capitol had little time to ponder such distributional concerns in the late 1990s, because the devolution revolution gave them important decisions to make. Every state's autonomous control over its welfare programs dramatically increased after the federal passage of welfare reform in 1996. While the freedom granted by this devolution sent states in different directions, the experience of one state can teach general lessons about how the shift in power and the new fiscal relationship played out in state capitols around the country. The nation's

largest state, California, has often been a policy leader whose choices, especially in social services, have diffused across the rest of the nation (Walker 1969, Gray 1973). The state's government at the time was split between the nation's two political parties, with a Republican governor negotiating policy with a legislature controlled by Democrats. Like the rest of America, the Golden State was just coming out of the deep recession, giving policymakers some money to spend on expanding social services but leaving them cautious about how such generosity would threaten the state budget when lean years returned. Though never a "typical state," California's political and fiscal conditions at this time were reflective of what was occurring in many other states.

In California, 1997 was the year of welfare reform, with Washington DC's actions the previous year putting this issue at the top of the agenda for state officials at the state's capitol in Sacramento. Governor Pete Wilson, a moderate Republican who had been elected on a platform of expanding "preventive" social services like child care and prenatal health, but who had been forced by the state's struggling economy to push for budget cuts in these and other areas, saw this as a chance to leave a major policy legacy. The Democrats who controlled the two houses of the state's legislature worried that any welfare reform meant welfare cuts to the constituents whom many Democrats represented. Yet while legislators have a monopoly over the power to introduce bills in California, as in all American legislatures, they felt pressured to respond to the federal mandate for reform as well as to the way that block grants changed state fiscal incentives. As the following account shows, this led to one of the paradoxical patterns of federalism: While

devolution gives states freedom, it also forces decisions upon them and allows the federal government to dictate state policy agendas.

When California's legislature convened for the beginning of its session in January, 1997, one influential newspaper columnist wrote that the capitol's hallways were filled with talk of many issues, but that, "There was, however, one topic that overshadowed all others in terms of magnitude, uncertainty and urgency: welfare reform. Under new federal welfare - reform legislation, Republican Gov. Pete Wilson and the Democrat-controlled Legislature have six months to develop an overhaul of the system that consumes nearly a fifth of the state budget and supports nearly 5 million Californians, about 20 percent of the nation's welfare burden."[10] The extent to which state action was forced by federal devolution was illustrated by another columnist's quote: "The challenge the state faces to come up with a new welfare system is enormous, dictated by the federal welfare reform bill President Clinton signed last summer."[11]

Does this mean that devolution pushed the state in a direction that it's leaders did not want to go? In the legislature's case, it certainly did. Prominent leaders like Senate Health and Human Services Committee Chair Diane Watson, a Democrat representing an inner city Los Angeles district with many welfare recipients, certainly would have preferred not to change the existing system. But Gov. Wilson clearly did want change, and seized the political opportunity created by federal action. In the spring of 1997, he gave speeches across the state in support of his reform plan, which went beyond the federal guidelines by putting a one-year limit on welfare enrollment, cutting the size of monthly checks to recipients, and requiring

[10] Dan Walters, "The Welfare Unknown," *Sacramento Bee*, January 8, 1997, p. 6B.
[11] John Jacobs, "Movement on Welfare Reform," *Sacramento Bee*, March 25, 1997, p. 6B.

them to work 35 hours a week in job training or education programs to receive the checks.[12]

Democratic legislative leaders, quite predictably, pushed back against the governor's proposal. When the bills containing them, authored by Republican legislators, reached the Assembly Human Services Committee, the Democratic majority on the committee stripped out their key provisions – the one-year time limit, the grant reductions, and the 35-hour workweek – on votes that broke down along party lines. "I would suggest that's gutting the bill to almost nothing," said Republican Assemblyman Keith Olberg, author of one of the bills.[13] Yet legislators knew that the governor possessed the key power of the veto, giving him the power to kill any welfare deal that the Democrats themselves reached and thus assuring that the state's reaction to federal devolution would be a compromise between what California Democrats and Republican Gov. Pete Wilson wanted. Dion Aroner, the state Assembly's Human Services Chair, spoke about welfare reform in a tone that was at once resigned to the fact that federal action worked against her policy preferences but also optimistic that it opened up new opportunities for positive state innovations. "We will do significant damage to lots of families and seniors and kids who will be hurt by what the federal government did." Aroner said. "We can't fix that… But if the system becomes more focused on helping people get off welfare and finding them jobs, … that will be historic reform."[14]

In order to craft a compromise that might garner both legislative approval and the governor's signature, top leaders created a conference committee that

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[12] John Jacobs, "Movement on Welfare Reform," *Sacramento Bee*, March 25, 1997, p. 6B.
[13] Dana Wilkie, "Democrats gut Wilson proposal to cut welfare Assembly panel leaves only shell, but it's not dead yet," *San Diego Union-Tribune*, April 2, 1997, p. A3.
[14] Quoted in John Jacobs, "Movement on Welfare Reform," *Sacramento Bee*, March 25, 1997, p. 6B.

brought together 18 members of the Assembly and Senate, many of whom were political moderates not closely tied to either side of the issue. After liberals on the committee pushed for a plan that "went as far as it legally could to maintain the status quo… Speaker Cruz Bustamante intervened, and he and Senate President Pro Tem Bill Lockyer directed Democratic members of a welfare conference committee to tone down their plan and make it at least marginally acceptable to moderates."[15]

After Gov. Wilson vetoed the first set of welfare bills sent to him at the beginning of the summer, in August he signed a compromise package crafted in the conference committee. Passed on votes of 65-11 in the Assembly and 33-5 in the Senate, with liberal Democrats objecting, the plan included an 18-month time limit and a 20-hour work requirement, splitting the difference between the governor's plan and the legislature's proposals.[16] Just as importantly for the state, it slowed the growth of welfare spending, with all of the savings going to other California programs because the funding was sent through a block grant. The devolution of power from the federal government had spurred state action, but the new policy bore the imprint of both branches of state government and put all of the savings back into California's budget.

Welfare was not the only power passed along to the states by Clinton and the Republican in Congress. In late 1997, after the welfare reform debate was resolved in California, state lawmakers were given authority over a newly created program to provide health insurance for the children of the working poor through the Children's Health Insurance Program. Unlike welfare reform, this program was a clear expansion of the social safety net, a concession that President Clinton won from

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[15] Dan Walters, "Demos' Welfare Plan Backfires," *Sacramento Bee*, June 30, 1997, p. A

[16] Brad Hayward and Dan Smith, "Wilson Gets Landmark Welfare Bill," *Sacramento Bee*, p. A1.

Newt Gingrich that thrilled Democrats in state capitols across the country and calmed the fears of fiscal conservatives with its generous federal matching rate. Because every dollar of California spending was matched with nearly two federal dollars, Republican Governor Wilson and legislative Democrats both agreed on expanding coverage.

While they could have done so through Medicaid or the government employees' healthcare program, California lawmakers took advantage of the federal option to craft a completely new program which they called "Healthy Families." The privately administered, publicly funded insurance program would be available to 580,000 children whose parents paid a premium of about $27 per month, costing the state $478 million and the federal government $875 million.[17] The governor proposed a plan that Democratic leaders immediately embraced. While a handful of conservative lawmakers criticized the plan as too costly for the state and some Democrats worried that the premiums charged would be too expensive for the poor, it passed within weeks with overwhelming bipartisan support.[18]

The lessons of this California case study are clear, and confirm the strategies that Gingrich and Clinton pursued in Washington, DC. Giving states more autonomy through block grants in welfare led California to contract its welfare services and spending, even though the federal law did not strictly mandate such retrenchment. In the Children's Health Insurance Program, by contrast, the generous matching grants combined with state autonomy was a gift that California's Republican governor and Democratic legislators eagerly accepted. They designed a

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[17] John Maurelius, "Wilson Optimistic on Kids' Health Coverage," August 28, 1997, *San Diego Union Tribune*, p. A3.

[18] Bill Ainsworth, "Kids Health Plan Could Get OK Today," *San Diego Union Tribune*, September 12, 1997," p. A1.

new program, putting a Californian imprint on the national idea, but happily took Washington's money to expand their health coverage of the working poor. Devolving power through different funding structures caused the healthcare safety net to widen while the welfare safety net shrunk.

III. The Long-Term Effects of the Devolution Revolution

While every state's reaction to the devolution revolution differed in its details, the broad spending trends in health care and welfare across the states mirror California's pattern. This section examines broad spending patterns to show that healthcare expenditures rose consistently after the devolution revolution, while welfare spending has often been flat. This illustrates the argument that grant structures help to shape the size of government. After looking at how much is spent, I then ask which citizens pay for safety net spending when more responsibility is sent to the states. Looking at tax distributions at different levels of government supports the thesis that devolutions to the states quietly shift the fiscal burden of supporting the safety net towards lower- and middle-income Americans.

III A. State Spending Patterns Since the 1990s

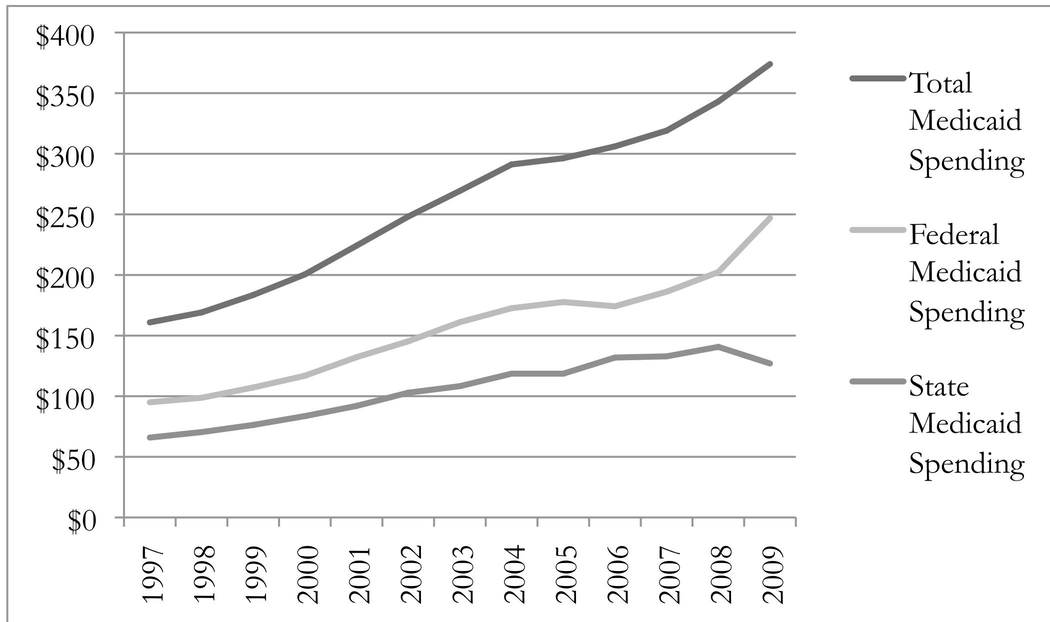
Just as California's response to powers devolved from the national government was shaped by the state's partisan configuration, policy needs, and fiscal capacity, other states took the devolved responsibilities in different directions. Their governments crafted policies that "fit their states," in the term often used by advocates of devolution, or at least reflected contemporary demands and the preferences of state leaders at the time. To structure their CHIP plans, 13 states

chose to expand Medicaid coverage, two offered a program based on the plan offered to state employees, but 35 did what California did: they created their own new systems, verified as "equivalent" to the benchmark but with state-specific details (Kousser 2005, Ch. 7). When it came to reforming their state welfare systems, 36 states adopted the federal default of a five-year lifetime limit on benefits, but nine states adopted shorter limits and five states enacted longer limits. In both policy areas, states picked policies that generally fit the preferences of the parties holding their governorships and state legislatures. States with more "professional" legislatures – those paying full-time salaries, meeting year-round, and employing large staffs – were more likely to move beyond the default options and craft innovative programs (Kousser 2005, Ch. 7).

At the same time that the devolution revolution changed the shape of state social safety nets, it also changed their scope. State spending on healthcare and welfare both shifted. Importantly, they went in different directions, a divergence that can be explained by the differing funding formulas chosen for each policy area. In health care, where generous federal matching grants created an incentive for states to spend a bit more of their own money to capture many federal dollars, spending rose sharply. By definition, CHIP spending rose as the new program came into being.

But Figure 1 shows just how much the Medicaid matching rates, preserved in the 1995 budget battle that fended off the transition to a block grant, gave states both the motivation and the means to spend ever-larger sums on health care for the poor, aged, blind, and disabled. Medicaid spending was already high in the early 1990s, but since the mid 1990s it rose sharply as medical costs soared and as states

Figure 1. Growth in Federal, State, and Total Medicaid Spending Since "Devolution Revolution" (in billions)

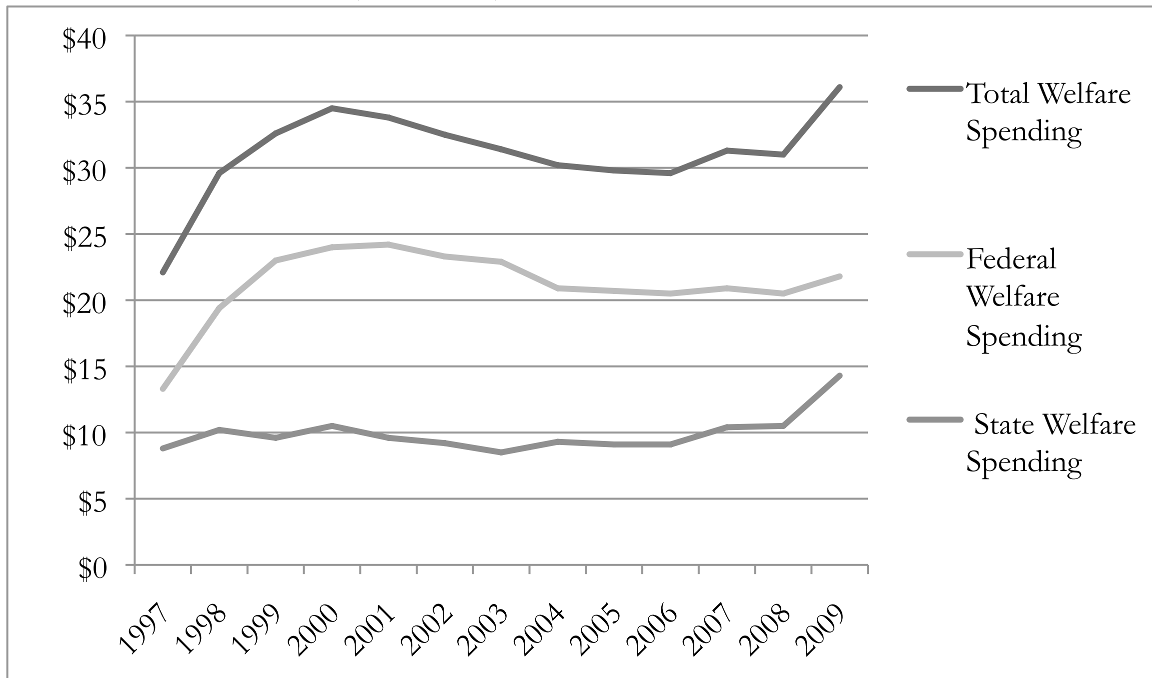


Notes: Medicaid data taken from Table 3 of the Centers for Medicare and Medicaid Services' National Health Expenditures Web Tables, accessed at https://www.cms.gov/NationalHealthExpendData/downloads/tables.pdf in November, 2011.

frequently added recipients and services to their programs. This growth generally slowed when a stronger economy meant that fewer Americans qualified to receive health care coverage, but grew nonetheless. Total state and federal Medicaid spending more than doubled from $161 billion in 1997 to $374 billion in 2009.

By contrast, the rise in welfare spending was sharply curtailed through the welfare reforms of 1996. As Figure 2 shows, after an initial increase in federal expenditures to provide services such as child care and job training in the immediate aftermath of welfare reform, spending on this safety net program has been flat or decreasing over the past decade. Since the numbers reported for both Medicaid and welfare here are not adjusted for inflation, they indicate a clear retrenchment in this

Figure 2. Growth in Federal, State, and Total Welfare Spending Since "Devolution Revolution" (in billions)



Notes: "Welfare" spending defined as Temporary Aid to Needy Family (TANF) total federal and total state maintenance of effort spending. Welfare data taken from appropriate tables in the US Department of Health and Human Services' TANF Financial Data Archives, accessed at http://www.acf.hhs.gov/programs/ofs/data/archives.html in November, 2011.

portion of the American safety net. This is a function of two trends. First, the default guidelines passed down from the federal government to the states tightened up welfare eligibility through policies such as weekly work requirements and, most importantly, the lifetime limit on benefits. Although the federal welfare reform did also encourage more spending in areas such as child care, and the federal legislation did not dictate any reduction in monthly benefit checks, but many states were able to contain their costs by trimming their welfare roles once recipients had reached their lifetime benefit limits. The second factor at work here was the shift to a block grant funding structure. When states cut welfare after 1997, they could (subject to

"maintenance of effort" requirements[19]) keep much of the savings, and this no doubt played a role in the many benefit cuts that have come during tough fiscal times over the past decade.

Overall, the devolution revolution has been a tale of two programs. Once Newt Gingrich's proposal to block grant Medicaid was defeated, the program saw no major policy or funding formula changes. As a result, this program continued to grow through state and primarily federal funds, and was augmented by the Children's Health Insurance Program with its generous matching grants. In welfare, both policy reforms and a shift to block grant funding set the program on a path to retrenchment. Though one could still debate whether the compromise reached by Speaker Gingrich and President Clinton led to "an end to welfare as we have come to know it," both the state and national governments have been able to curtail the growth of welfare spending. States have been able to shape the program's new rules to the policy preferences of their elected officials, and as many states meet the bare minimum spending requirements, the federal government has paid an increasingly large role in funding welfare.

III B. Changing "Who Decides?" Changes "Who Pays?"

The shares of funding for a program that is paid by the federal government and by the states is important for those concerned with redistribution. One fact of federalism that is seldom discussed but which deserves serious contemplation is that shifting the responsibility for funding programs to the states also shifts the burden of

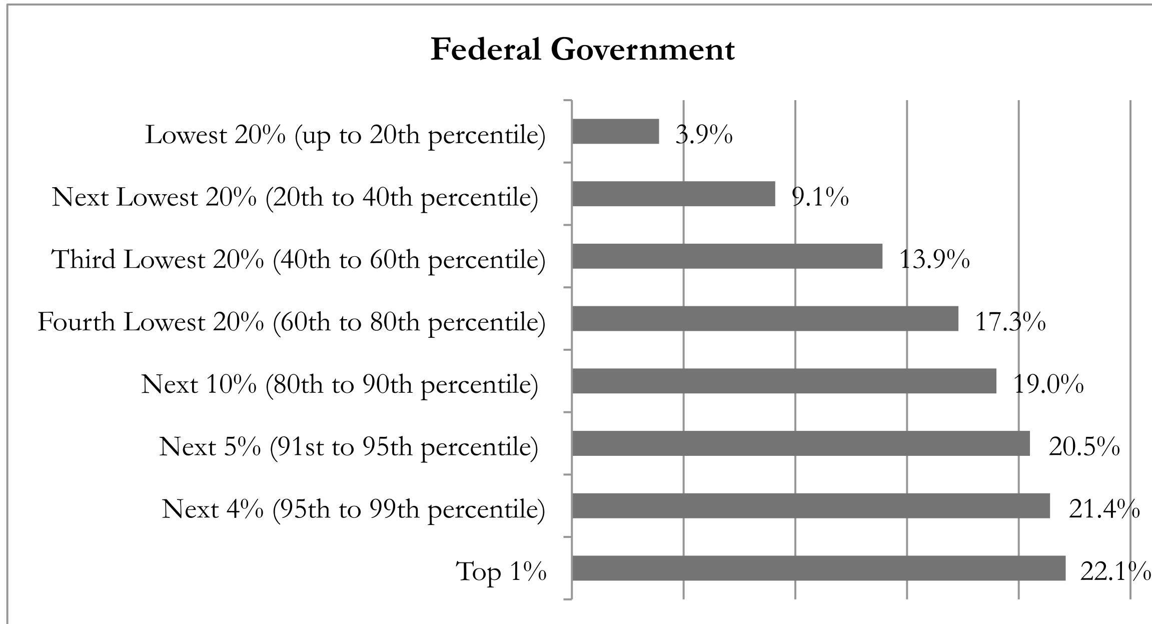
[19] See Mark Greenberg, "The TANF Maintenance of Effort Requirement," Center for Law and Social Policy, accessed at http://www.policyarchive.org/handle/10207/bitstreams/14041.pdf in November, 2011.

paying for them to less affluent Americans. This is a result of the way that tax structures differ across different levels of government. The federal government relies primarily on a progressive income tax and other payroll taxes to fund its programs.[20] Because money is raised this way, higher income Americans generally pay a larger share of their incomes in federal taxes than middle and low income Americans do. States vary dramatically in the sources of their funding. Legislators, governors, and direct democracy voters have set up fiscal systems that rely in different measures on income taxes, sales taxes, and property taxes. There is no single state tax structure. What is generally true, though, is that state taxes all across the country are less progressive than federal taxes.

A "progressive" tax system is one in which higher income households pay a higher tax rate. By contrast, the less affluent must pay a larger portion of their incomes in taxes than the rich in a "regressive" system. Analyses of the tax rates paid by Americans in different income groups show that federal taxes are strongly progressive, while nearly every state has, instead, a regressive tax system. Figure 3, below, reports the tax rates paid by different income groups, beginning with the poorest 20% of Americans at the top and continuing through to the richest 1% at the bottom. Moving down the chart, we see that Americans who make more money pay higher tax rates. The least affluent income groups pay 3.9% and 9.1% of their incomes in federal taxes, because the tax rates on their incomes are so low and

[20] In 2010, 90% of the federal government's $2.163 trillion budget came from these sources: $899 billion from personal income taxes, $191 billion from corporate income taxes, and $857 billion from Medicare, Social Security, and unemployment insurance taxes (which are not structured in the progressive way that income taxes are structured but which are still less regressive than state sales taxes). See Table S3 from the Summary Tables of the Budget of the United States Government, Fiscal Year 2012, accessed at http://www.whitehouse.gov/sites/default/files/omb/budget/fy2012/assets/tables.pdf in October, 2011.

Figure 3. Fraction of Income Paid in Federal Taxes, by income group



Source: Citizens for Tax Justice, *America's Tax System is Not as Progressive as You Think*, April 2011. Based on the Institute on Taxation and Economic Policy Tax Model.

because many qualify for the earned income tax credit (EITC), a rebate given to those with low incomes to make up for the fact that Social Security taxes are withheld from their monthly paychecks. As incomes rise, eligibility for the EITC goes away and those in the third group, the middle class, pay 13.9% of their income in taxes. The upper middle class pays 17.3% and the richest Americans pay tax rates of about 20%, with the rate edging up at every income level. Overall, taxes paid to the federal government take much more from the rich than from the poor.

The pattern in the states is radically different. As Figure 4 shows, state and local[21] tax rates are highest on the least affluent. States rely on three general types of taxes. First, many raise money from personal and corporate income taxes, but state

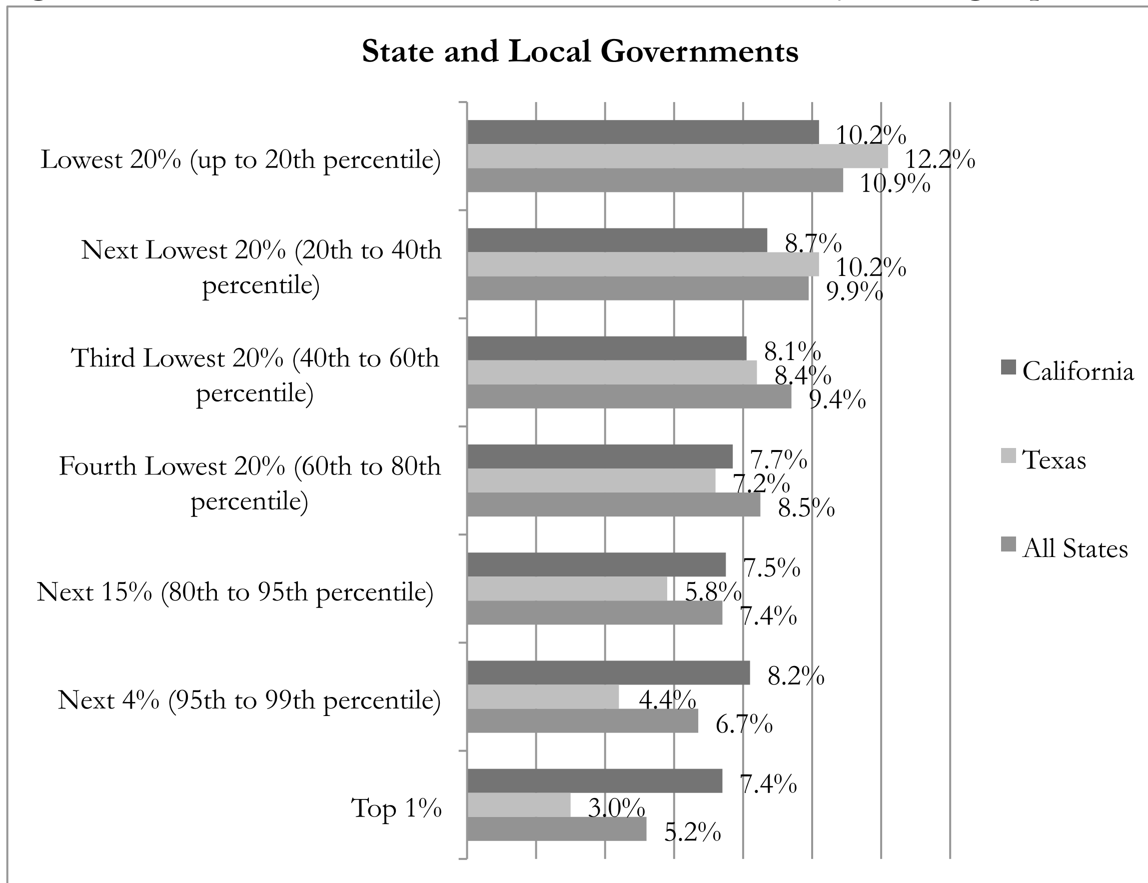
[21] Fiscal analyses that compare states frequently combine state and local receipts because, while some states collect more money at the local level than others and some states administer more programs than others at the local level, the combined receipts and programs of these two closely interconnected levels of government represent the full package of taxes and policies that make states comparable to each other.

income tax rates are generally less progressive than federal rates and some states, such as Texas and Florida, have no personal income tax at all. Second, most states[22] fill their coffers with sales taxes, which charge a flat rate on the purchase of products. Since poorer Americans spend more of their incomes on these purchases than rich Americans, who are generally able to save more money, sales taxes hit the poor especially hard. Finally, states charge property taxes, paid by homeowners and passed along, by market forces, to renters. These rates – which range from 0.40 in Hawaii to 2.57 in Texas[23] – are flat across property values, and thus generally hit lower income earners harder than the affluent. Although states vary widely in which of these three areas they rely most upon for their tax revenues, the cumulative effect is that states charge higher rates to poorer residents, acting like the folklore character Robin Hood in reverse.

Figure 4 reports tax rates by income group for Texas (a relatively low-tax, strongly regressive state), California (a high tax, less regressive state) and for the average across all states. In each case, state residents in the lowest income group pay the highest rate: 10.2% in California, 12.2% in Texas, and 10.9% across all states. By contrast, the top 1% of earners only pay 7.4% of their income in state taxes in California, a mere 3.0% in Texas, and 5.2% nationally. Averaging across all states, tax rates go down as income levels rise, just the opposite of the pattern for federal taxes. Why is this the case? In Texas, taxes are so clearly regressive because the state imposes no personal income tax and instead taxes the sales and housing expenses

[22] Again, some states – Alaska Delaware, New Hampshire, Montana, and Oregon -- do not charge sales taxes at all. See Federation of Tax Administrators, "State Sales Tax Rates," February 2011, accessed at http://www.taxadmin.org/fta/rate/sales.pdf in October 2011.
[23] See *New York Times*, State-by-State Property-Tax Rates, April 10, 2011, accessed at http://www.nytimes.com/2007/04/10/business/11leonhardt-avgproptaxrates.html in October 2011.

Figure 4. Fraction of Income Paid in State and Local Taxes, by income group



Source: Institute on Taxation and Economic Policy, *Who Pays? A Distributional Analysis of the Tax Systems of All 50 States*, 3rd Edition, November 2009. Percentages reflect net payments by non-elderly families in 2007 after federal deductibility of some state taxes in calculating federal income taxes.

that cost the poor so much of their incomes. California does impose an income tax, which explains why it is less regressive than Texas and the state average. Yet because the Golden State's famous Proposition 13 dramatically reduced property tax receipts, it relies on a steep sales tax that taxes the poor heavily.

Overall, federal taxes take the most from the wealthiest, while state tax policies give some of this redistribution back. The implications for federalism are clear. Any shift in program responsibility from the federal to state governments shifts the burden of paying for these programs increasing to the less affluent.

Devolution, in this respect, works against redistribution. By contrast, federal "bailouts" of the states are paid for much more by high-income earners than tax increases enacted at the state level. Recognizing this does not imply a normative judgment about such shifts – there have been strenuous arguments made in favor of both progressive and regressive tax structures. What is hard to debate, however, is that changing who decides on a policy by shifting control of it from one level of government to another also changes who pays for it.

III. Conclusion: Perspectives on Devolution

While modern America may have been created through a war against England, its national structure has been formed and reshaped not through fights with external powers but by internal conflicts among states and between states and the federal government. The battles to define American federalism were once carried out in a war and in lunch counter sit-ins, but have now shifted to the courts and to federal funding formulas. These venues may be less dramatic, but they are no less important. As Théret (1992) makes clear, federal systems need not be static, with the actual *practice* of federalism – including whether or not the central government equalizes resources across subnational units – determining whether the *form* of the federation will endure, centralize, or dissolve. Though a bloodless revolution, the "devolution revolution" nonetheless changed the structure of the federal-state relationship and the scope of the social service safety net.

Were these changes for the better? The fiscal federalism literature has long argued for an increased role for states in fitting policies to local needs and demands. "In our 'ideal' model," declared influential economist Wallace Oates, "the central

government provides the efficient out-put of the national public good, while numerous local governments offer individuals a wide variety of output of the local public good. (Oates 1968, 54)" The devolution revolution clearly gave states more authority over their welfare programs, and provided the opportunity to create new health care programs and much of the money to fund them.

Did this give Americans the structure of government that they wanted? A recent survey asking respondents about what level of government should address specific policy challenges found that voters wanted to see the federal government address health care, but that state and local governments should assist the poor (Schneider et al 2010, 9). Because the devolutions of the 1990s provided the most latitude to states in the welfare realm, both in the freedom to craft policy and through the funding mechanism of block grants, this move appears consistent with public opinion.

Does devolution give residents of each state the programs and policies that they desire? While much research has shown the impact that the preferences of state elected officials has on policy choices, a new study based on a breakthrough in the ability to measure state public opinion shows that these choices do not always reflect voter demands. Not all states respond equally to public demands, and some do such a poor job matching policy with public opinion that there is a potential "democratic deficit" in the states (Lax and Phillips 2011). Combined with Wlezien and Soroka's (2010) recent research showing the challenges that Canadian federalism poses for public responsiveness, this recent stream of research raises questions about whether giving more authority to states truly brings government closer to the people.

Looking toward the future of federalism in America, how do the lessons of this essay combine to tell us anything about what might happen if more control over the safety net is devolved to the states? Just as Newt Gingrich pushed to create Medicaid block grants in 1995, Republican candidate Mitt Romney called for block grants during the 2012 presidential campaign.[24] If this new round of devolution comes to pass, how will states react? The lessons of the devolution revolution suggest that growth in Medicaid spending will slow dramatically if states have to pay all of the costs of program expansion and are allowed to keep all of the savings of program cuts. Medicaid expenditures may flatten out in the way that welfare spending has evened out since over the past decade. This pattern will not be uniform across states, of course. Because the two parties take clearly different positions on this issue, statehouses controlled by Republicans will be much more likely to use their newfound autonomy to cut Medicaid than Democratic-led states.

The analysis in this essay, put in the context of recent findings from the cross-national study of welfare states, also suggests that the distribution of tax burdens could also shape how state policy might shift. Kato (2003) shows that, during the economic downturns of the 1980s, nations with generous social services turned to consumption taxes – a regressive yet stable source of income – in order to retain funding for their welfare states. In the American states, taxes are already much more regressive than they are at the federal level. If the next round of devolution forces states to provide more of the funding for social services, health care and welfare programs might be preserved only by raising regressive taxes such as the sales tax. If the United States thus follows the European path, social service

[24] Sam Baker, "Romney plan calls for Medicaid block grants, repeal of Obama health law," *The Hill*, September 6, 2011.

programs will be funded through taxes that burden poor and middle class taxpayers most heavily (as a proportion of their incomes). The redistributive impact of Medicaid and welfare would be counterbalanced by a more regressive funding, all because of a quirk of American federalism.

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