



## The Rise of the States: U.S. Fiscal Decentralization in the Postwar Period

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### Introduction

One of the most dramatic changes in the fiscal federalism landscape during the postwar period has been the rapid growth in state budgets, which almost tripled as a share of GDP and doubled as a share of government spending between 1952 and 2006. In “The Rise of the States: U.S. Fiscal Decentralization in the Postwar Period” – the working paper this policy brief is based on – we argue that the greater role of states cannot be easily explained by either the Tiebout model, which predicts that individuals sort themselves into jurisdictions based on their preferences for public goods, or demographic or income trends.<sup>1</sup> Rather, we demonstrate that much of the growth in state budgets has been driven by changes in intergovernmental interactions. Restricted federal grants to states have increased, and federal policy and legal constraints have also mandated or heavily incentivized state own-source spending, particularly in the areas of education, health and public welfare. Our results suggest that naïve budgetary accounting may not adequately capture the real distribution of responsibility for spending. Our analysis of the role played by the evolution of intergovernmental interactions sheds new light on the changing patterns of fiscal federalism

that are not easily explained by forces of fiscal competition.

### Historical Trends in Government Spending

The past 50 years have seen notable changes in fiscal decentralization in the United States. Total government spending grew from 27.6 percent of GDP in 1952 to 36 percent in 2006, and the increasing concentration of responsibility at the state level has been particularly pronounced. Between 1952 and 2006, total state spending increased from 4.5 percent to 11.6 percent of GDP, with direct state spending (excluding state grants to localities) growing from 3.1 percent to 8.6 percent as a share of GDP and from 11 percent to 24 percent as a share of government spending (Figure 1). Local direct spending increased from 5.8 percent to 10.6 percent of GDP during this period, with most of this growth occurring before the 1970s. In the last 40 years, state budget growth exceeded local growth both in absolute terms and, more dramatically, relative to its base at the beginning of the period. Indeed, the growth in state budgets accounts for much of the overall growth in government spending since the 1980s. Similar patterns are observed on the revenue side of the budget.

*Taubman Center Policy Briefs are short overviews of new and notable research on key issues by scholars affiliated with the Center. This policy brief is based on a working paper entitled “The Rise of the States: U.S. Fiscal Decentralization in the Postwar Period,” which is forthcoming in the Journal of Public Economics.*

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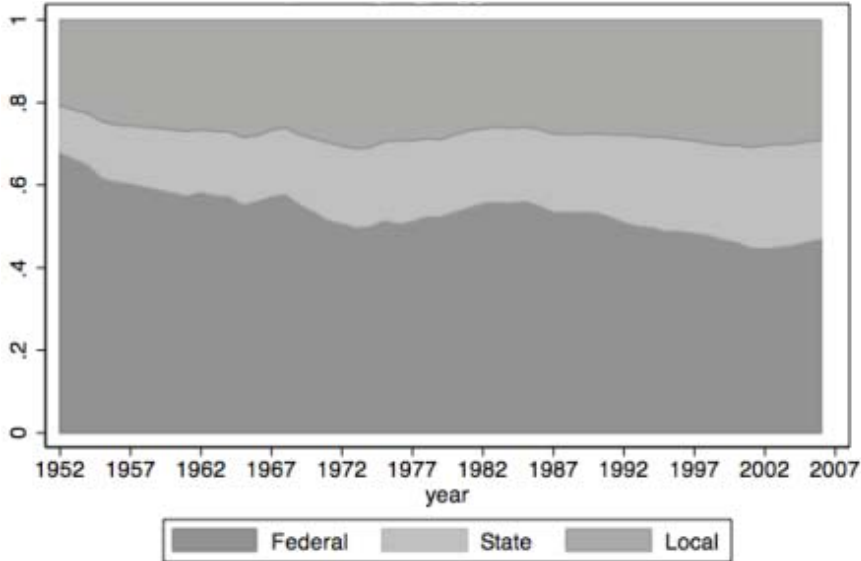
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Figure 1: Direct Spending by Type of Government



We have also observed notable changes in the composition of spending and revenues at different levels of government. The federal government has substantially increased its spending (both as a share of total spending and as a share of GDP) on social insurance programs, particularly after the introduction of Medicare and Medicaid in 1965. However, this increase has been almost entirely offset by declines in defense spending, leaving the total levels of direct federal expenditure remarkably stable. The composition of local spending has remained largely stable as well, with education being the single largest component of local budgets throughout the period. For states, the largest source of expenditure growth has been “public welfare and income maintenance” programs, which importantly includes both their share of the jointly financed Medicaid and cash welfare programs (AFDC/TANF) and the federal share, since federal grants for these programs flow through state budgets in the form of intergovernmental grants (showing up as federal indirect spending, state intergovernmental revenues, and state direct spending). Growth in this category comprises 38 percent of the total growth in state direct expenditure. The other drivers of state direct

expenditure growth are increases in education spending during the early part of the period and a rise in insurance trusts, which include state employee pension plans.

The mechanisms for financing this spending have also changed. On the federal side, the most notable shift in own-source revenues has been a movement away from corporate income taxes and towards payroll taxes. Local governments saw a decline in the use of property taxation prior to the 1980s and some increased reliance on income taxes. State governments are relying less on sales taxes (generally thought to be regressive) and more on individual income taxes (more likely to be proportional or progressive) – although this increase is from a very small base. States are also increasing their use of miscellaneous and general charges.

Perhaps more dramatic has been the increased role of intergovernmental revenues: in 1952 states got 13.8 percent of their revenues from federal intergovernmental grants, while in 2006 that share had risen to 22.5 percent. During this period, federal grants to states and localities rose from 0.8 percent of GDP to 3.3 percent of GDP. The bulk of these grants are

to states, rather than localities, with grants to states rising from 0.8 percent of GDP to 3.1 percent of GDP (Figure 2). This growth contrasts starkly with the slight decline in direct federal spending over the time period. The largest component of this increase in intergovernmental transfers has been income security, including Medicaid.

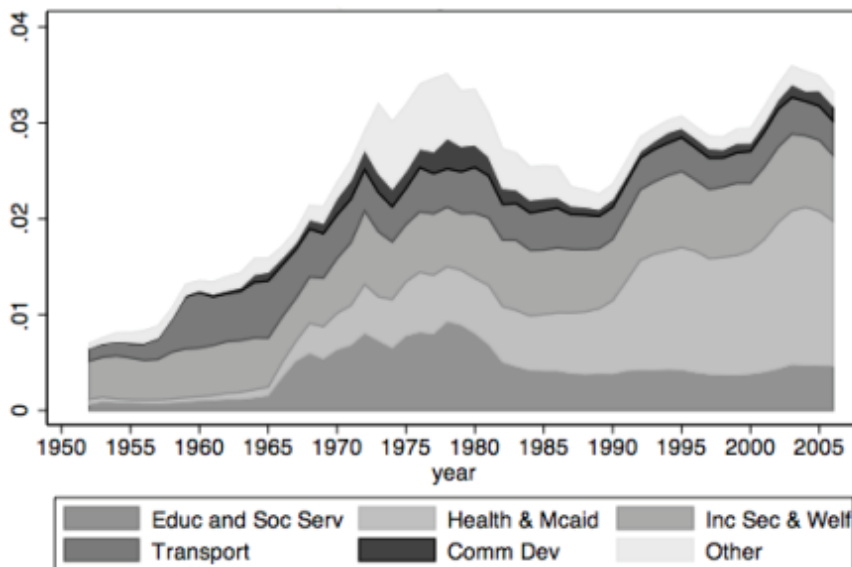
### Changes in Tiebout Forces: Mobility and Voting

We explore various explanations for the observed empirical patterns, first considering those motivated by the classic Tiebout model, which remains the benchmark framework for thinking about the optimal provision of public goods in a federal system. We focus on two key aspects of the Tiebout model: fiscal competition driven by mobility and the aggregation of voter preferences. Several studies find significant spillover effects of one state's spending on its neighbors, particularly in the context of welfare reform and among states with the greatest interstate migration, consistent with models of mobility-induced competition. Changes in mobility over time could thus change household sorting behavior and the constraints faced by different levels

of government. However, despite substantial declines in moving costs, when we analyze data from the U.S. Census and the Current Population Survey, we find that actual mobility has changed little since 1960 and has even declined slightly for many population subgroups. The absence of significant changes in mobility suggests that it can do little to explain observed changes in patterns of federalism.

We explore another important aspect of the Tiebout model by addressing the possibility that the rise in state budgets can be explained by changes in the way preferences are expressed through voting. This may be particularly important when there are mobility costs or other limits to voters' ability to sort into homogeneous communities. Voter turnout is often low, particularly in local elections, and is not representative of the overall population. There are few systematic differences, however, in the demographic characteristics of the voting population for national and local elections and there are no obvious trends in turnout over time. Voting patterns, like patterns in mobility, seem to have little power for explaining observed changes in the landscape of fiscal federalism.

Figure 2: Federal IG Spending as Share of GDP



It is thus difficult to reconcile the observed empirical facts with changes in Tiebout-style forces. In addition, these facts are not explained by developments such as changes in the size of the school-age population or the increases in income inequality and volatility that took place over the last half century. Rather, we argue that much of the growth in state budgets, as well as changes in their composition, can be explained by changes in the nature of intergovernmental interactions over time.

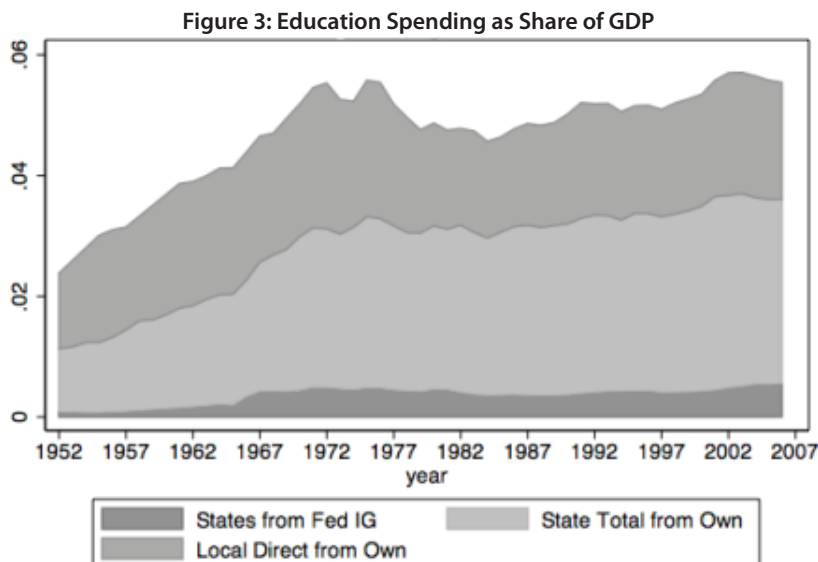
### Intergovernmental Interactions

Tiebout's original work does not directly address the role of multiple levels of local government. In practice, different levels of government not only take on different responsibilities themselves but also enact policies that affect the choices of other jurisdictional levels. A higher level can impose mandates that are not fully-funded (such as the federal government requiring the states to take costly steps to comply with regulatory standards). Similarly, courts can order governments to meet particular standards (as in the case of court-ordered school finance equalizations). Also, higher levels of government can create grants that induce rather than require spending (such as federal matching funds for Medicaid along with

minimum participation requirements). These requirements and matching funds may show up as spending by a unit of government that in reality had little control over its allocation. When the federal government requires state governments to maintain a certain level of spending on welfare, for example, the distributional implications may be the same as if the federal government financed the program itself even though the spending and associated revenues appear in state budgets. A more nuanced understanding of state budgets would account for the fact that they may not be solely the product of residents' preferences, but may be constrained or influenced by external policies. Our exploration of the timing and composition of the changes in state spending suggests that these external forces are quite important. We focus first on growth in state spending on education and public welfare and health, which together account for almost 60 percent of the overall growth in state direct spending.

### State Spending on Education

Total spending on education by federal, state, and local governments rose throughout the 1950s and 1960s, with a sharp increase in state education spending in particular during the 1960s (Figure 3). This was also a period that



saw a rise in federal intergovernmental grants to states. Federal dollars accounted for 23.6 percent of the growth in total state spending during the 1960s and 18.9 percent of the growth over the full time period (1952- 2006). Almost all of this increase occurred between the late 1950s and early 1970s, coinciding with demographic shifts, such as the post-World War II baby boom. However, the increases in spending associated with numbers of students appears less quantitatively important than increases in spending per student.

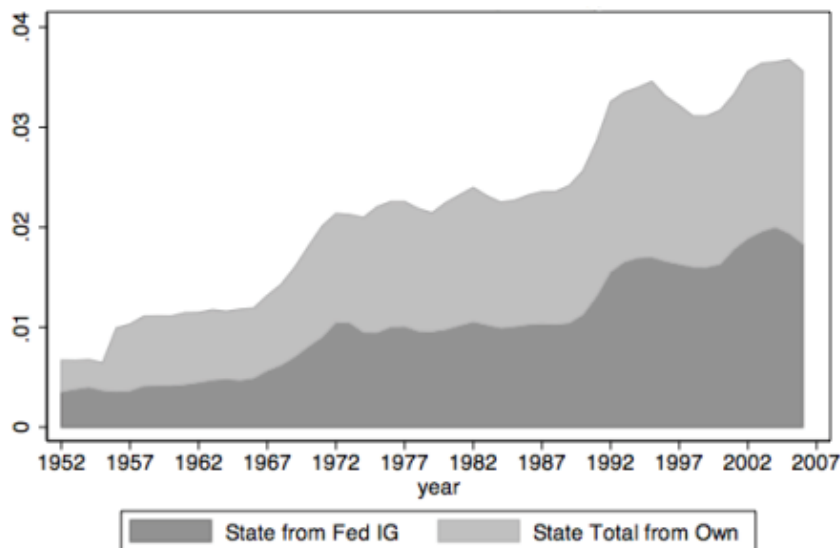
There are several federal policies during this time period that may explain the rise in federal grants to states as well as some of the increases in states' own spending. The sharpest increase in federal grants and additional state spending occurred immediately after 1965, when the Elementary and Secondary Education Act (ESEA) and the Higher Education Act (HEA) were passed. A central component of ESEA was Title I, which provides grants to states for compensatory education programs for low-income households. Maintenance of effort provisions made it more difficult for states to use these funds to supplant their own, and studies suggest that much of the increase in federal dollars did flow directly into increases in state education spending. Compliance with

Title IV (part of the 1964 Civil Rights Act), which prohibited federal aid to schools that practiced racial discrimination, may also have increased states' own spending.

### *State Spending on Health and Welfare*

The largest component of the increase in state spending can be attributed to increases in spending on public welfare and income security programs (including Medicaid), which rose from 0.5 percent to 2.5 percent of GDP (Figure 4). The largest increases occurred in the late 1960s-early 1970s and the late 1980s-early 1990s, following the passage of the jointly-financed Medicaid program in 1965 and the enactment of federal floors for state Medicaid participation in the late 1980s. As with education, federal policy may have been a key driving force in this growth. While states were not required to participate in Medicaid or welfare, federal matching grants made it extremely attractive to do so. Federal program rules incentivized state spending in two ways. First, to be eligible for any federal matching funds, states were required to provide coverage to certain populations. These federal floors moved up in 1989 and 1990, requiring states to cover pregnant women and children higher up the income distribution. Second, both Medicaid and AFDC were jointly financed, with the

Figure 4: State Health and Public Welfare Spending as Share of GDP





federal government providing between 50 and 80 cents of every dollar spent by the state.

A closer look at state spending on health and welfare in light of these program rules is revealing. First, it is important to note that state spending on welfare and Medicaid includes federal matching funds. If we assume that federal dollars translate directly to increases in state spending, increases in federal grants account for 55.5 percent of the increase in total state welfare spending in the 1960s and 51.2 percent of the increase over the full period. Second, the fact that many of the dollars are given in the form of matching grants suggests that they are bundled with a substantial share of the remaining state spending. The timing of the increases suggests the importance of federal policies. The first sharp increase in state spending was between 1965 and 1975, the decade after the enactment of Medicaid, and the second increase was in the early 1990s, immediately after increases in the federal income-eligibility standards.

The structure of federal incentives thus changes the interpretation of observed state spending. Federal floors increase state spending in that the minimum eligibility floor for matching grant will encourage states funding below the floor to increase their funding in order to be eligible for a matching grant. It is also possible that increases in the floor allow states already above the floor to further increase their spending by relaxing constraints associated with fiscal competition across states (as driven by the mobility of taxpayers and program participants). We use an extremely crude proxy for the generosity of state eligibility rules for 1982-2001: the “need standard” that is one of many parameters used to assess families’ eligibility for assistance. The growth in real health and welfare spending by states that were below median in 1985 (measured in real per capita spending) was 132 percent between 1985 and 1995, but the growth for above-

median states was also a substantial 74 percent. The lower base spending of below-median states means that increases in these states accounted for 40 percent of overall growth in health and welfare spending over the period. These results indicate that federal floors may have affected not only states for which the floors were binding, but also states throughout the distribution. Taken together, the findings suggest that the features of federal conditional matching grants were important factors in explaining the large observed rise in state health and welfare spending.

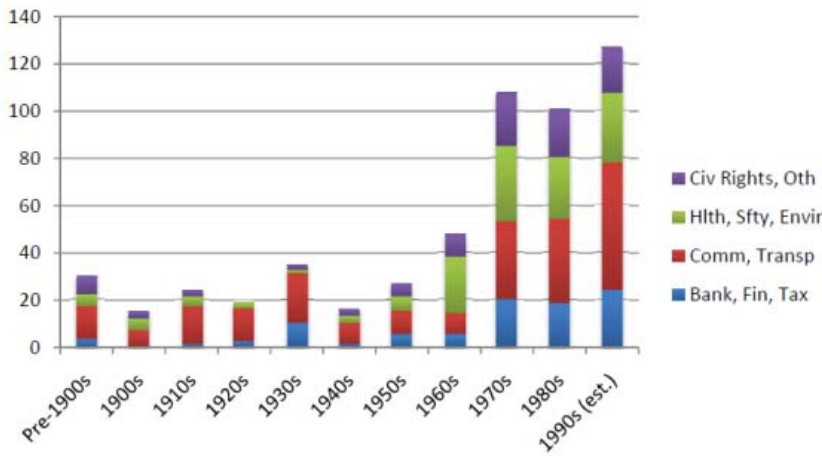
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#### *Regulations and Mandates*

Another way in which federal policy can influence state spending is through the imposition of regulations and mandates. The now-defunct Advisory Commission on Intergovernmental Relations (ACIR) outlines the many ways in which federal actions dictate state spending. For instance, statutory “direct order” mandates require specific spending (such as requiring states to make all voting places accessible to the disabled). Other examples are the requirements that states must meet in order to receive federal aid – including both requirements for matching spending (as in Medicaid) or other conditions (such as having a drinking age of 21 to qualify for federal highway funds); or the statutory preemption of state rights to regulation or action (which may impose indirect costs or preclude revenue sources).

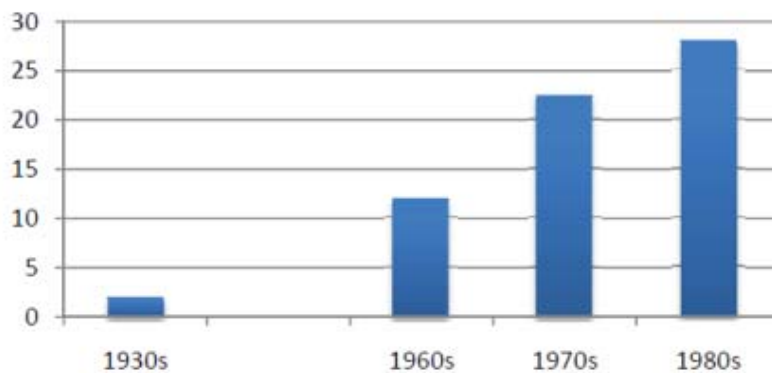
Unfortunately there is limited systematic evidence on the magnitude of this indirect

Figure 5A: Federal Statutory Preemption of State and Local Authority



Source: Reproduced from ACIR.

Figure 5B: Federally-Induced Costs Affecting State and Local Governments



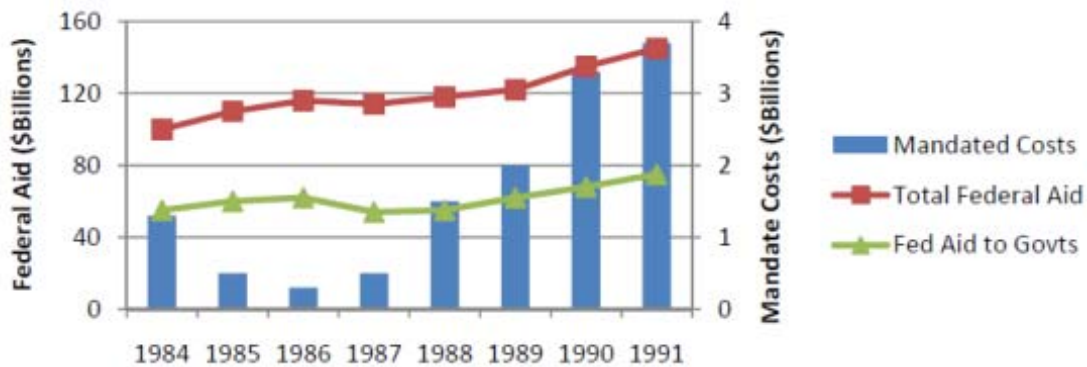
Source: Reproduced from ACIR.

spending generated by federal choices. A series of reports issued by the ACIR examined costs imposed by federal mandates and regulation (Figure 5). It identified 12 mandates enacted in the 1960s, 22 in the 1970s and 27 in the 1980s, many of which imposed substantial financial burdens on lower levels of government. For instance, the EPA estimated that about 25 percent of the \$125 billion cost of environmental mandates imposed in 1995 would be borne by states and localities.

The rate of enactment of federal preemption statutes increased at a similar pace. Mandated

costs grew rapidly in the 1980s (Figure 6), and amid mounting discontent over this burden, Congress enacted the Unfunded Mandate Reform Act (UMRA) in 1995 as part of the Contract With America. UMRA required that the Congressional Budget Office analyze the cost imposed on lower levels of government by proposed legislation. While it is difficult to quantify the effect of these policies on state budgets, it is reasonable to believe that they played at least some role in explaining the rise in remaining state budget categories.

Figure 6: Aid and Mandate Burdens



Source: Reproduced from ACIR.

### *Rationales for Intergovernmental Interventions*

These results demonstrate the important and growing role the federal government has played in explaining the rise of state budgets over the last half-century, which naturally raises the question of why the federal government might intervene to change state behavior. A classic rationale for intergovernmental intervention is the presence of externalities: if there are positive interjurisdictional spillovers, public goods will be underprovided in a decentralized system. To correct this underprovision, higher levels of government can provide the relevant goods or set subsidies to encourage provision. A large share of intergovernmental grants from federal to state governments seem consistent with this rationale, as they are comprised of goods for which we might expect there to be substantial interjurisdictional spillovers (health, education, transportation). Some types of unfunded mandates, such as those in the area of environmental policy, may also be motivated by the desire to correct externalities.

A second potential explanation for observed intergovernmental interventions is redistribution. Many federal Title I provisions explicitly incentivized increased state and

local spending directed toward low income areas and households. Federal Medicaid and welfare policy has almost certainly been driven by a desire to generate a different distribution of transfer benefits than would be seen in the absence of federal intervention.

### **Conclusion**

One of the most salient changes in the landscape of fiscal federalism in the last half-century is the rising prominence of state governments. In our analysis, we find little evidence that changes in “Tiebout-style” forces (voting with one’s feet or voting via the ballot box) can explain the rising prominence of state governments. A closer look at the particular areas in which state budgets have grown – particularly education and health and welfare programs – suggests the importance of intergovernmental forces in determining state spending. Interpretation of state spending thus depends on understanding the extent to which that spending is compelled or incentivized by federal policies. While states still have some choices within those rules, the timing of the increases in state spending and the size of federal intergovernmental grants suggest that the patterns we observe are strongly influenced by these outside forces.



A natural direction for further research would be to better quantify the relative importance of federal incentives and other changes in population characteristics and preferences in explaining the rise of state spending. In addition, these findings raise the important question of why federal interventions have increased so dramatically over the last half-century, and why federal involvement has tended to run through the states rather than through direct federal action alone. The current health reform debate highlights ongoing contention over the roles of federal and state governments in determining the shape and extent of social insurance spending.

What is clear is that these federal interventions – regardless of their underlying cause – have important implications for understanding fiscal federalism in the United States. To the extent that the growth in state budgets is driven by federal requirements, it is not merely the product of state-level decision-making and cannot be undone by interjurisdictional competition. A number of programs that appear on state budgets should actually be thought of as federal programs, at least in part. The last decades have seen increasingly complex maneuvering between governments as the federal government attempts to influence the distribution of resources across states and localities through subsidies, taxation, and regulation. While the welfare consequences of these activities are ambiguous, it is clear that analyses of either fiscal competition or of the landscape of fiscal federalism must account for these intergovernmental forces.

## ENDNOTES

1 Much of this memo is excerpted directly from Baicker, Clemens, and Singhal (2011). For more detail as well as information on data sources and calculations, please see this working paper.

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