

FEDERAL RETRENCHMENT AND STATE MANAGEMENT

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STATE OF CALIFORNIA

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## FEDERAL RETRENCHMENT AND STATE MANAGEMENT

### I. INTRODUCTION

A. Welcome to the panel discussion entitled "Federal Retrenchment and State Management".

B. Our task here this morning is two-fold:

1. First, we want to compile a performance report on the retrenchment process:

a. How is the federal government doing in terms of cutting back?

b. How are the states doing in managing the diminished federal resources?

2. Second, we want to identify the key issues raised by the cutbacks in federal aid, and begin a discussion of these issues.

a. Obviously, we will not come close to completing this part of our task.

b. We'll have accomplished something, however, if we:

(1) Develop some new slants to these issues, and

(2) Encourage a few bright policy analysts to pursue them between now and next year's research conference in New Orleans.

C. The Panel

1. From the looks of things, the panel for this discussion has about 25 to 30 members.

Federal Retrenchment and  
State Management--contd

2. With your indulgence, I'm only going to introduce those panelists seated up here with me.
3. Each of you in the audience is part of the panel as well, but I'll let you introduce yourselves as you take part in the discussion.
4. Introductions
  - a. Robert A. Bittenbender
  - b. John Herbers
  - c. John Shannon
  - d. Bill Hamm

D. Modus Operandi

1. We'll begin the discussion of "federal retrenchment and state management" with John Shannon, followed by John Herbers and Bob Bittenbender;
2. I will then exercise the prerogative of the chair and make some observations of my own;
3. Each of us will speak for 10 minutes or so on the general topic;
4. Then I will open up the discussion to all in attendance.

II. MY OBSERVATIONS ON FEDERAL RETRENCHMENT AND STATE MANAGEMENT

A. Overview

Federal Retrenchment and  
State Management--contd

1. I'd like to share with you four observations on the retrenchment and management process from a more distant perspective than my colleagues have, but I hope a relevant one
  2. I hope they'll be controversial enough to prompt a lively discussion.
- B. Observation #1: The states' management of the retrenchment process--particularly in terms of the transition from categorical to block grants--has been a solid success.
1. This success is evident in a number of ways; for example:
    - a. The states have--almost overnight--put in place fiscal relationships with a number of entities that previously dealt directly with the federal government; in California, these entities include 124 small cities (CDBG), 44 community action agencies, 14 community mental health centers, 47 alcohol research and treatment projects, and a host of others.
    - b. They have integrated the allocation of federal funds with the allocation of state funds, thereby increasing the effectiveness with which these funds are used.
    - c. They have been far more creative than the federal government in devising approaches to containing health care

costs--New York's efforts to set hospital reimbursement rates for all payers, Arizona's prepaid capitated health care program, New Jersey's pioneering diagnosis-related groupings, and California's hospital contracting.

2. I know local governments feel that the state hasn't gone far enough in keeping strings off federal block grants, but even these complaints are fairly muted--at least in California.
3. I think my assessment of the state's performance is supported by the findings of the two principal research efforts focusing on state responses--the Urban Institute's and Princeton's.
4. Even so, I'm not sure the states are getting the credit they deserve.
  - a. This is generally due to the use of evaluation criteria that, in my judgment, are inappropriate.
    - (1) Some commentators, for example, have criticized the states for failing to fill in the funding gaps left by the federal pullback.
    - (2) Others have rapped the states on the knuckles for failing to allocate funds in line with the old federal priorities.
  - b. I don't think either criticism is fair. As the ACIR's ringing indictment of the federal grant-in-aid system makes

clear, the old system is a poor basis indeed on which to evaluate the states' response.

4. The states' success in managing this transition--particularly given the recession that coincided with it--should put to rest once and for all the myth that states are the backwater of the nation's federal system.
  5. It also suggests--to me at least--that it's high time the U.S. Congress relax additional prescriptive requirements which apply to so many of the remaining categorical grants (and some of the new block grants).
  6. I realize, however, that this wouldn't sit well with the single-issue interest groups who were responsible for getting these requirements into the laws in the first place.
- C. Observation #2: The relationship between federal and state tax policies is not what many of us were led to believe.
1. When I began my professional career in the late 1960s, the stock complaint from the public interest groups was that the federal government had "preempted" the nation's tax base, and it needed to pull back so states and localities would have more room to operate.

2. I'm not sure elected officials ever put much stock in the preemption diagnosis, but the literature on state-local fiscal relations makes frequent mention of it.
3. For example, a leading publication on the subject put out by the Brookings Institution in 1969 maintains that "If federal taxes were reduced, the ameliorative effects on state and local finances would be important".
4. When put to the test, I don't think this theory held up.
  - a. The Economic Recovery Tax Act--which is the largest federal pullback that I know of--squeezed, rather than ameliorated, state and local budgets.
  - b. It did so in two ways:
    - (1) First, it cut state revenues directly, since the definition of taxable income used by many states is the federal definition.
    - (2) Second, the restrictive effects of the tax reduction on federal spending fell very hard on grants-in-aid to the states.
5. As it turns out, it probably was the greater accountability of state and local officials to those they represent, rather than federal preemption of the tax base, that in the past checked the growth in state and local revenues.

- D. Observation #3: Faced with the inevitability of federal retrenchment, state governments have done a poor job of articulating what's really important to them and what isn't.
1. For example, one organization representing the states that shall remain nameless has put the states on record as follows. The federal government must move decisively to reduce the deficit in the federal budget, and in doing so:
    - a. It should not raise any taxes that tap the resources relied on by the states (which as near as I can tell rules out everything but tariffs);
    - b. It should "review" existing tax expenditures other than those, such as deductibility of state taxes and exclusion of interest earned on municipal debt, that benefit states;
    - c. It should provide additional funding to states for federally mandated programs;
    - d. It should provide "adequate funding" (meaning increased funding) for programs providing aid to individuals;
    - e. It should provide "inflation adjustments" (meaning funding increases) "for programs of high priority and superior efficiency"; and
    - f. It should control the rapid growth in military spending.



2. Not terribly helpful, if our objective is, as I think it should be, to get the high-employment deficit down to 1 percent of GNP.
3. In one respect, it is not surprising that the states seek to protect everything -- in the budget business, voluntary contributions seldom work to the contributor's advantage.
4. In another respect, however, the states are being shortsighted: In my judgment, their unwillingness even to discuss changes in the tax-exempt borrowing privilege doesn't make any sense.
  - a. If the academic literature on this privilege means anything, and I think it does, the states are drawing their wagons in the wrong circle.
  - b. Much of what is being supported with funds borrowed in the tax-exempt market provides no direct benefit to the states --particularly projects financed with industrial development and mortgage revenue bonds.
  - c. Even where the states are able to milk benefits from tax-exempt borrowing, those benefits are worth only about two-thirds of what it costs the federal government to provide them.
5. I think it's high time the states reassess their unbending commitment to tax-exempt borrowing.

- E. Observation #4: More and more, state management of federal, as well as state, money is being limited by the courts.
1. Court intervention in the budget process is not something that just happened recently, of course.
  2. It has become a much more significant phenomenon, however, since the thrust of budgetary policy has shifted from growth to reduction.
  3. In California, for example, the courts have been asked to rule (and have shown absolutely no reticence in doing so) on every change in program benefits that leave a recipient worse off.
  4. In essence, the courts have come to view program benefits almost as a vested right.
  5. The states' efforts to alter these benefits, even when done pursuant to federal law changes, have been blocked or delayed time and time again.
  6. In one instance, a prominent superior court judge invalidated the state's ability to impose any controls on health care benefits prescribed by a Medicaid recipient's physician, which was tantamount to an increase of \$208 million in Medicaid costs.
  7. The implications of this trend are two-fold --

Federal Retrenchment and  
State Management--contd

- a. Less flexibility for legislatures in setting priorities through the budgetary process; and
  - b. Less accountability to the public for the way in which public monies are spent.
8. In other words, as the federal government is legislating changes that seek to provide states with more flexibility and the public with more accountability, the courts are "legislating" changes that go in the opposite direction.
9. I think we need to rethink the nature of the relationship between the legislative and judicial branches.

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