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State government cash and in-kind benefits: Intergovernmental fiscal transfers and cross-program substitution

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Abstract

US states provide both cash and health insurance benefits for the poor, partially financed by fiscal transfers from the Federal government. The 1996 welfare reform drastically reduces Federal support for cash transfers *at the margin*, lowering the relative price to states of providing benefits to the poor through Medicaid. This paper analyzes the comparative-statics response of state governments to such changes in intergovernmental transfers, showing (in central cases) that they can contribute not only to *reductions* in state expenditures on cash benefits but to *increases* in expenditures on Medicaid, whether or not beneficiary populations are mobile among states.
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1. Introduction

According to a longstanding tradition in the literature of federalism (dating at least to Stigler [16]), subnational governments cannot effectively execute redistributive policies. The openness of such jurisdictions implies that their ability to alter the distribution of (net) income is highly constrained, and attempts to do so will trigger inefficient reallocations of net beneficiaries and

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net contributors. Seen from this viewpoint, US experience, in which state and local governments persistently engage in programs of cash and in-kind redistribution, seems quite anomalous.[1] Notably, through the Medicaid and Temporary Assistance to Needy Families (TANF) programs (previously Aid to Families with Dependent Children, or AFDC), state governments have provided health and cash (welfare) benefits over a period of many decades.

The explanation for this apparent anomaly may lie in the structure of intergovernmental cost-sharing for state health and welfare expenditures, through which the Federal government has absorbed a large portion of state government outlays. On average, the Federal/state financing mix for these expenditures has remained fairly stable over time, with the Federal government paying for about 50–60% of expenditures for both programs during the past quarter century. Nevertheless, the state-Federal relationship has been far from static. Until the passage of the 1996 welfare reform (the Personal Responsibility and Work Opportunity Reconciliation Act of 1996, or PRWORA), Federal assistance to the states took the form of matching grants, with matching rates that were inversely related to state per capita income but that insured that the Federal government would pay at least half and, in some cases, nearly 80%, of state outlays for AFDC and Medicaid benefits.[2] By lowering the relative price of supported activities, matching grants give rise to substitution effects (see, e.g., Wilde [21], Oates [11] for early presentations and discussion of this well-known result) that are expected to increase their amount. Since PRWORA, the Federal government has maintained approximately the same level of overall support for state cash welfare benefits through TANF,[3] but the *structure* of this support has changed: the earlier system of open-ended matching grants has been replaced by one in which grants are lump-sum in nature, so that state expenditures on cash benefits through TANF are no longer subsidized *at the margin*. Continued Federal support for state Medicaid expenditures, however, in the form of open-ended Federal matching grants, was not affected by PRWORA.

A number of analysts have drawn attention to this aspect of PRWORA and to its possible negative impact on welfare spending and caseloads. (See especially Chernick [6,7] and references therein.) An issue that has been relatively neglected in previous studies, however, is how matching grants (or their replacement by lump-sum grants) for *one* type of public expenditures (such as state spending on AFDC/TANF) may affect *other* types of recipient-government spending. AFDC/TANF and Medicaid are both means-tested programs with overlapping (though obviously not identical) beneficiary populations. How do states choose the *mix* of cash and in-kind benefits for their low-income residents, and how is this mix affected by changes in the level of Federal government support for each? Our goal, in the present paper, is to analyze how changes in the structure of intergovernmental transfers can affect the mix or composition of state government expenditures, using Medicaid and AFDC/TANF as our leading cases of grant-assisted programs

[1] There is a large literature (e.g., Ribar and Wilhelm [15] and references therein) that examines the determinants of subnational redistribution. Of course, almost all fiscal policies (e.g., education spending and tax policies (Bahl et al. [1])) have (re)distributional impacts, the subject of several other large branches of literature.

[2] The details of Federal support for and regulation of state health and welfare benefits have of course changed over time. The evolution of national and subnational government involvement in assistance to the poor has long historical antecedents, as discussed in Brown and Oates [3] and, more completely, in Lindert [9]. Modern US experience dates to the New Deal era, as discussed by Wallis [19], who notes (p. 147) that "[a]ll of the [New Deal] relief programs, except the CCC, ... required explicit or implicit matching of federal funds for state and local contributions." The provision of aid to state governments has inevitably come with "strings attached," including requirements as to eligibility and coverage, giving rise to continuous tension between national and state governments over program structure.

[3] There are, to be sure, some non-trivial variations in the levels of TANF funding relative to AFDC levels; see Powers [14].

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