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State Fiscal Responses to Welfare Reform during Recessions: Lessons for the Future

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Abstract

This paper addresses two questions. First, in periods of recession or slow economic growth, will state governments be *able* to meet the needs of their low-income residents for public assistance? Second, will states be *willing* to devote adequate resources to programs that provide either cash assistance or social services to their needy populations? We conclude that primarily because of a set of unique circumstances, including the accumulation of large balances of unspent TANF funds, many states were able to weather the first year or so of the current recession without having to cut programs directed toward low-income families. As the fiscal crisis facing most states enters its third year, states have implemented cuts in spending on a wide range of social programs designed to support work efforts by low-income families. These cuts are likely to accelerate the overall rise in welfare caseloads. If the economy remains weak, and spending cuts deepen, then contrary to past predictions, welfare caseloads may begin to climb rapidly. Thus the new fiscal rules of welfare reform, which by and large promoted positive reform during a period of economic prosperity, may be leaving states and their most vulnerable citizens at serious risk as the economic and fiscal slowdown continues. Drawing on our findings, we suggest several elements that we believe should be included in the reauthorized welfare legislation in order to enhance the chances that during future economic downturns state governments will be able to meet the needs of their low-income residents for cash public assistance and related social services.

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INTRODUCTION

The Personal Responsibility and Work Opportunity Reconciliation Act (PRWORA) of 1996 marked a fundamental change in the role state governments play in the financial support of their low-income residents. Under the old welfare system, Aid to Families with Dependent Children (AFDC), all families meeting certain eligibility criteria were *entitled* to cash payments that were jointly financed by the states and the federal government through a system of matching grants. Thus a portion of every dollar that a state government paid to a low-income family came directly from the federal government. The new welfare system, Temporary Assistance for Needy Families (TANF), ended federal entitlement to welfare payments and shifted the responsibility for ensuring the well-being of low-income families to state governments. The role of the federal government was limited to providing each state with a fixed amount of money in the form of a block grant and imposing certain restrictions on eligibility for cash transfers.

Between January 1993 and December 2002, welfare caseloads declined by 59 percent.[1] This dramatic reduction reflects both the strong economy during most of this period and changes in welfare policies at both the national and state levels. Because the amount of each state's TANF block grant allocation has remained largely unchanged since 1996, the falling caseloads have freed up funds for other programs, some designed to assist low-income families—such as child care, housing assistance, and job training—and others less targeted to the needy.

But in much the same way as the federal budgetary situation has shifted very rapidly from large surpluses to growing deficits, state governments' fiscal outlooks have also changed dramatically for the

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[1]Department of Health and Human Services, Agency for Children and Families, "U.S. Welfare Caseload Information," Washington, DC; available from: <http://www.acf.dhhs.gov/news/stats/newstat2.shtml>; accessed 15 April 2003; contains caseload data from January 1993 through September 2002. The December 2002 caseload data are from Elise Richer, Hedieh Rahmanou, and Mark Greenberg, "Welfare Caseloads Increase in Most States in Fourth Quarter," Washington, DC: Center for Law and Social Policy; available from <http://www.clasp.org/DMS/Documents/1049386524.1/view_html>.

worse. In passing their budgets for fiscal year (FY) 2003, states were forced to close budget gaps that totaled $50 billion. At the end of the third quarter of the 2003 fiscal year, slower than anticipated revenue growth and rising costs, especially for Medicaid, have resulted in states facing $25 billion in FY 2003 deficits, plus projected budgetary shortfalls for FY 2004 that may reach $85 billion.[2] Unlike the federal government, state governments are required to enact balanced budgets.[3] In response to these deficits, most states are cutting spending on a wide range of state government programs. The majority of states have already made or are planning substantial cuts in spending on a wide range of public services including Medicaid and K–12 and higher education.[4]

This paper addresses two questions. First, in periods of recession or slow economic growth, will state governments be *able* to meet the needs of their low-income residents for public assistance? Recessions lead to job losses and make it increasingly difficult for those without jobs, especially those with little experience and education, to find new jobs. Thus, a slowing economy not only reduces state tax revenue but also increases the need for fiscal assistance for low-income state residents.

Second, will states be *willing* to devote adequate resources to programs that provide either cash assistance or social services to their needy populations? In periods of fiscal stress, will state governments place a high priority on preventing holes in their "social safety nets" or will they choose instead to satisfy other claims on state resources?

Prior studies of cyclical variations in welfare spending tended to focus on the growth of caseloads during recessions. They generally found that caseload growth was relatively modest during economic

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[2]Liz McNichol, "The State Fiscal Crisis: Extent, Causes, and Responses," Washington, DC: Center on Budget and Policy Priorities, April 24, 2003.

[3]In nearly all states the governor must submit a balanced budget and the legislature must enact a balanced budget. If a revenue shortfall develops after the budget has been passed, however, legislatures in some states are not required to close the budget gap prior to the end of the fiscal year. For a description and analysis of various balanced budget rules see Arik Levinson, "Balanced Budgets and Business Cycles: Evidence from the States," *National Tax Journal* 51, no. 4 (December 1998): 715–732.

[4]National Conference of State Legislatures, *State Budget Update: April 2003*, Denver, Fiscal Affairs Program, 2003.

slowdowns. This finding led to the conclusion that most states could get through an average recession without implementing major cuts in spending on the poor. In this paper, we conclude that primarily because of a set of unique circumstances, including the accumulation of large balances of unspent TANF funds, many states were able to weather the first year or so of the current recession without having to cut programs directed toward low-income families.

In the years following the enactment of TANF, the combination of falling caseloads, a fixed block grant, and maintenance of effort provisions enacted as part of the 1996 welfare reform legislation meant that states diverted a large portion of TANF funding from cash assistance to a set of programs, such as child care, job training, and transportation, that are designed to support work efforts by low-income families. These programs are now seriously at risk. As the fiscal crisis facing most states enters its third year, evidence suggests that while states have not cut cash benefits, they have implemented cuts in spending on a wide range of social programs designed to support work efforts by low-income families. These cuts are likely to accelerate the overall rise in welfare caseloads which began in the fourth quarter of 2002. If the economy remains weak, and spending cuts deepen, then contrary to past predictions, welfare caseloads may begin to climb rapidly. Thus the new fiscal rules of welfare reform, which by and large promoted positive reform during a period of economic prosperity, may be leaving states and their most vulnerable citizens at serious risk as the economic and fiscal slowdown continues.

Having failed to enact new welfare legislation in 2002, Congress has returned to the subject in 2003 and is again deliberating the reauthorization of the TANF legislation. Drawing on our findings, in the final section we suggest several elements that we believe should be included in the reauthorized legislation in order to enhance the chances that during future economic downturns state governments will be able to meet the needs of their low-income residents for cash public assistance and related social services.

THE ECONOMIC SLOWDOWN AND STATE FISCAL HEALTH

To date the economic recovery from the recession that started in early 2001 has been weak and sporadic. As a consequence, revenue collections have been substantially lower than anticipated in the vast majority of states.[5] A recent compilation indicates that in 25 states current budget deficits exceed 10 percent of current state spending, and collectively, state governments are facing a budgetary shortfall for FY 2004 of between $80 and $100 billion.[6] The National Governors Association and the National Association of State Budget Officers have declared that "states face the most dire fiscal situation since World War II."[7]

Although reductions in tax revenue are the primary cause of current state budgetary shortfalls, in many states they are exacerbated by a rapid escalation in Medicaid spending. Over the past two years, despite efforts by nearly all state governments to control Medicaid costs, Medicaid spending has increased by about 25 percent compared to revenue growth over the same period of 5 percent.[8]

Predicting the impact of recessions on state tax revenues is notoriously difficult. The current recession provides a good case in point. Measured by declines in real gross domestic product per capita, the recession that started in spring 2001 is quite mild compared with the past few economic downturns. Nevertheless, real state tax revenue per capita has declined much more than it did in the previous two recessions. When we adjust for modest legislated tax increases, real (inflation-adjusted) per capita state

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[5]National Governors Association, *The State Fiscal Crisis*, (Washington, DC: Published by the National Governors Association and the National Association of State Budget Officers, 2003); available from: <http://www.nga.org/nga/legislativeUpdate/1,1169,C_ISSUE_BRIEF^D_5080,00.html>; accessed 2 May 2003.

[6]Stateline.org, "State Budget Gaps: How Does Your State Rank?" (February 11, 2003); available from: <http://www.stateline.org/story.do?storId=287750>; accessed 26 February 2003.

[7]National Governors Association, "State Budget Outlook Remains Bleak," Press Release, Washington, DC, November 25, 2002.

[8]National Governors Association. *The Fiscal Survey of the States: May 2002,* Washington, DC. Published by the National Governors Association and the National Association of State Budget Officers; available from: <http://www.nga.org/cda/files/MAY2002FISCALSURVEY.pdf>; accessed 10 March 2003.

tax revenue fell by 7.4 percent in FY 2002.[9] This decline continued in the first quarter of FY 2003, when real per capita revenue adjusted for tax law changes was reduced an additional 2 percent.[10]

Simple rules which suggest that tax revenues are more sensitive to economic performance in states that rely more heavily on personal and corporate income taxes than on sales and excise taxes often lead to incorrect predictions. In a state that excludes most necessities from its sales tax base, the sales tax may be highly sensitive to economic fluctuations, whereas in a state with a flat-rate income tax that excludes capital gains, income tax revenue may be fairly stable during an economic downturn. In this recession, however, most of the states experiencing the largest percentage reductions in per capita state tax revenues are states with progressive income taxes. The rapid rise in state income tax revenues in the late 1990s was driven to a large extent by a sharp increase in revenues from the taxation of capital gains. Not surprisingly, the collapse of the dot.com bubble and the broad-based decline in the stock market contributed to sharp drops in income tax revenue in states, such as New York, Connecticut, Massachusetts, California, and Oregon, that rely heavily on the income tax and where many taxpayers were paying taxes on capital gains. Cuts in income tax rates through the 1990s have exacerbated the current budgetary shortfalls.

Predicting the magnitude of budget deficits in individual states is also complicated by factors affecting single states or regions of the country. Despite the promise of substantial amounts of federal aid, New York State's fiscal situation has been deeply affected by the terrorist attacks on the World Trade Center. California, which was particularly hard hit by the collapse of the dot.com industry, faces a budget deficit in FY 2004 of nearly $35 billion.

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[9]Donald J. Boyd and Nicholas W. Jenny, "State Fiscal Crisis Far Worse than Economy Would Suggest," *The Rockefeller Institute State Fiscal News* 3, no. 4 (May 2003), Albany, NY: Nelson A. Rockefeller Institute of Government; available from <http://stateandlocalgateway.rockinst.org/fiscal_pub/state_news/sn_reports/SFN_3-4.pdf>; accessed 6 May 2003.

[10]Nicholas W. Jenny, "Sluggish State Revenue Performance Continues," *State Revenue Report*, No. 51 (April 2003), Albany, NY: Nelson A. Rockefeller Institute of Government; available from <http://stateandlocalgateway.rockinst.org/fiscal_pub/state_rev/sr_reports/RR_51.pdf>; accessed 4 May 2003.

In past recessions, there has been a great variation across states in the way state governments responded to budgetary shortfalls.[11] In general, state governments tend to respond to mild economic slowdowns by cutting state government spending. Only when revenue declines become more severe do states consider tax increases. This time around (at least so far), states are relying more heavily than usual on spending cuts. During the first year of the current recession, political leaders in many states relied on spending cuts, one-time sources of funds, and existing "rainy day" fund balances, as opposed to tax increases, to close their growing fiscal deficits.[12] Although most FY 2004 budgets have yet to be finalized, it appears that balancing the FY 2003 and FY 2004 budgets will result in aggregate cuts in spending in excess of $50 billion. In contrast, state governments enacted tax changes that will increase tax revenues by only about $8 billion in FY 2003.[13] This amounts to a modest 1.4 percent increase in state tax revenue. To balance their FY 2004 budgets, a number of states are considering additional tax increases. However, in a substantial number of other states there appears to be very strong political resistance to raising taxes.

Two factors that will help determine whether the current economic slowdown will result in large cuts in spending on social welfare programs are the existence of state rainy day or stabilization funds, and substantial balances of unobligated TANF funds.

Rainy Day Funds

In FY 2000, the year before the current recession began, 47 states had budget stabilization or rainy day funds. The total amount in these funds equaled 5.8 percent of state general fund spending in that year. When combined with general fund ending balances, state governments had an aggregate cushion

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[11] Howard Chernick and Andrew Reschovsky, "The Distributional Politics of Fiscal Adjustment: A Case Study of Four Northeastern States," *Public Budgeting & Finance* (Fall 1990): 6–23.

[12] National Conference of State Legislatures, *State Fiscal Update for FY 2002,* (Denver: Fiscal Affairs Program, April 16, 2003).

[13] Nicholas W. Jenny, "2002 Tax and Budget Review and 2003 Budget Preview," *State Fiscal Brief*, No. 66 (March 2003), Albany, NY: Fiscal Studies Program, Nelson A. Rockefeller Institute of Government.

equal to nearly 13 percent of FY 2000 general fund expenditures.[14] By historical standards, most states entered the recession that began in spring 2001 in relatively strong positions. It should be emphasized, however, that there was a great variation in the size of rainy day funds. Whereas the average state rainy day fund equaled $95 per capita in FY 2001, two states had fund balances under $2 per capita, an additional five states had balances of less than $20 per capita, and ten more states had balances under $50 per capita. Although many states were initially able to use their accumulated balances to protect state programs, including welfare, from significant cuts, the magnitude of states' budgetary shortfalls clearly overwhelmed state rainy day funds. According to surveys conducted by the National Association of State Budget Officers, the aggregate amount of money in state budget stabilization funds declined from $27.4 billion in FY 2000 to $8.9 billion in FY 2002.[15] Thus, most states face the prospect of balancing their FY 2004 budgets without much, if any, help from their rainy day funds.

Unobligated TANF Funds

The 1996 welfare reform legislation included a provision that the unspent portion of each state's annual TANF allocation would be held by the federal government in a special fund that each state could access in future years. One way in which state governments can ensure that they have more TANF funds to spend if an economic downturn significantly increases need is to treat unspent TANF funds as a rainy day fund; the actual funds remain with the federal treasury until they are needed. At the end of the first half of federal FY 2001, there were $8.3 billion dollars of unspent TANF funds for all 50 states plus the

[14] Christian Gonzalez and Arik Levinson, "State Rainy Day Funds and the State Budget Crisis of 2002–?." Paper presented at the State Fiscal Crises conference held at the Urban Institute, Washington, DC, April 3, 2003; available from <http://www.taxpolicycenter.org/sfc2003/pdf/Levinson_Gonzalez_final.pdf>; accessed 5 May 2003.

[15] National Governors Association and National Association of State Budget Officers, *The Fiscal Survey of States*, Washington, DC, December 2001 and November, 2002; available from <http://www.nasbo.org/Publications.php>; accessed 25 April 2003.

District of Columbia, equal to 11 percent of total TANF grants from the beginning of the program through the first half of FY 2001, and 48 percent of the FY 2001 TANF allocation.[16]

One measure of the ability of states to continue to provide fiscal assistance and services to their low-income populations in an economic downturn is the sum of their general purpose budget stabilization fund and their unspent TANF balances. On the whole, states with large unspent TANF balances also tend to have large stabilization fund balances. In FY 2001, the per capita value of the sum of the two funds ranged from $2.40 in Oregon to $279 in Massachusetts.[17] Among the seven states with the largest number of TANF recipients (55 percent of the nationwide total), Texas and Illinois had total per capita balances in the two funds of under $20, New York had a below-average balance of $104, and California, Ohio, Pennsylvania, and Michigan had above-average per capita balances.

Those states with relatively large TANF fund balances were able to use these funds during FY 2002 and, in some states, during FY 2003 to prevent or minimize cuts in TANF spending. However, because of the magnitude and the duration of state budgetary problems, by the end of FY 2003 unspent TANF balances have almost completely disappeared. Until recently many states used unspent TANF balances to help fund a wide variety of programs to assist low-income individuals. As their TANF balances declined, many states have been withdrawing TANF funds from these programs. As a result, as states enter FY 2004, substantial cuts in TANF-funded programs are widespread.

Shifting Federal TANF Funds to Child Care and Social Service Block Grants

Since the passage of PRWORA in 1996, states have reallocated substantial amounts of funds from cash assistance to services to recipients and the working poor. This shift reflects the general reorientation of the welfare system toward work, and the provision of services to support work. States'

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[16]Zoe Neuberger and Ed Lazere, "Analysis of TANF Spending Through the Middle of Federal FY 2001," Washington, DC: Center on Budget and Policy Priorities, September 2001; available from <http://www.cbpp.org/9-28-01wel.htm>.

[17]We exclude Alaska; because of its oil revenues it has a stabilization fund balance of over $4,500 per capita, an amount that exceeds the size of its general fund budget.

ability and willingness to finance this shift have been due to three factors: rapidly declining caseloads, the existence of a large surplus of relatively unrestricted federal funds which could be used for a wide variety of services to the poor, and a maintenance of effort requirement which has forced states to spend their savings from reduced cash outlays within the social services area.

In general, states have become quite dependent on the TANF surplus to fund the increase in social services. As the TANF surplus has diminished, states are facing a difficult fiscal choice between cash assistance and social services. Evidence to date suggests that many states and cities are responding to fiscal pressures by cutting social services, rather than cash assistance.[18] In FY 2002, $3.5 billion of TANF funds were allocated to child care for low-income families. Because a relatively large portion of TANF funding is devoted to child care, child care subsidies are now particularly vulnerable to cuts. Given the importance of child care in enabling mothers to work, these cuts are likely to accelerate the return of former welfare recipients to the rolls.[19]

<u>By How Much Will Demand for Public Assistance Rise during a Recession?</u>

There seems little doubt that a recession will limit the employment opportunities available to recent welfare recipients, although we do not know how much employment will decline.[20] The fiscal impact of rising unemployment rates and falling incomes depends in part on how many newly unemployed workers will qualify for unemployment insurance (UI), the duration of unemployment benefits, and the extent to which benefits replace lost wages.

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[18]Kenneth Finegold, Stephanie Schardin, and Rebecca Steinbach, “How Are States Responding to Fiscal Stress?” *New Federalism*, Series A, No. A-58, Washington, DC, Urban Institute, March 2003. Available from: <http://www.urban.org/Template.cfm?Section=ByAuthor&NavMenuID=63&template=/TaggedContent/ViewPublication.cfm&PublicationID=8335>; accessed 5 May 2003.

[19]Margy Waller, “Welfare, Working Families, and Reauthorization: Mayors View,” Washington, DC, Brookings Institution, May 2003; available from: <http://www.brook.edu/es/urban/publications/wallermayors.htm>; accessed 5 May 2003.

[20]Harry Holzer J., “Unemployment Insurance and Welfare Recipients: What Happens When the Recession Comes?,” *New Federalism; Issues and Options for States*, Series A, No. A-46, Washington, DC: Urban Institute, December 2000.

During past recessions, insufficient work experience, low levels of earnings, and unavailability for full-time work because of family responsibilities disqualified most low-income workers from eligibility for UI. During the next (or current) recession, eligibility for UI among low-income workers should be higher than during past recessions, in part because the long period of economic growth means that many former welfare recipients have gained more than sufficient work experience to qualify for UI. Nevertheless, Holzer estimates that during the next recession it is unlikely that more than 40 percent of all unemployed former welfare recipients will receive unemployment compensation. Moreover, entering the 2001 recession the UI replacement rate for lost wages was quite low, averaging only 33.1 percent in 1999.[21] If these estimates are even approximately correct, the number of families in need of public assistance is likely to grow substantially during an economic downturn.

We now address the issue of how state governments are likely to respond to these increased demands?

STATE GOVERNMENT FISCAL RESPONSES TO INCREASED NEEDS

One of the major advantages of the pre-1996 system of matching grants for AFDC was that federal payments to the states automatically increased if more people became eligible for cash assistance. Matching grants also reduced the *tax price* of welfare spending relative to other forms of state spending. Thus one dollar of increased spending on a state university generally cost state taxpayers a full dollar, whereas one dollar of increased spending on welfare cost less than one dollar of state tax revenues.

The conversion of federal spending on cash assistance into block grants requires that state governments bear a much greater share of the incremental costs of maintaining an economic and social safety net for their citizens. State governments must now bear 100 percent of the additional costs of

[21]Economic Policy Institute, "Unemployment Insurance Benefits State by State," Washington, DC: Press Release, October 3, 2001. In New York and California, the two states with the largest welfare caseload, the replacement rate is even less than the average.

running the TANF program in a recession, although the federal government continues to finance 100 percent of the cost of the Food Stamp Program and partially finances health care and housing assistance to the needy.

How state governments respond to this changed fiscal environment depends on the severity of any recession and the extent to which program eligibility increases. In the past, the full effects of an increase in the unemployment rate have not shown up in welfare caseloads until at least two years after an initial increase in unemployment. Hence, the duration of any recession is crucial to estimating the increased spending needs of states.

Estimates by Blank and Wallace suggest that an increase in the unemployment rate of 1 percentage point would increase TANF caseloads by 4 to 6 percent.[22] Similar magnitudes are estimated by Figlio and Ziliak.[23] Levine estimates that three years into a downturn recession marked by a rise of one percent in the unemployment rate, annual welfare expenditures would have increased by 4.75 percent.[24] The most recent data show a national increase in TANF caseloads of 1.2 percent for the fourth quarter of 2002, but a small decline for the entire year.[25] Thus at this point in the current economic slowdown, the increase in TANF caseloads appears to be smaller than in previous downturns.

The similarity of the caseload and expenditure estimates suggests that, by and large, in past recessions states have not chosen to respond to higher caseloads by reducing benefit levels. This

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[22]Rebecca M. Blank and Geoffrey Wallace, “What Goes Up Must Come Down,” in *Economic Conditions and Welfare Reform*, edited by Sheldon Danziger, Kalamazoo, MI: W.E. Upjohn Institute for Employment Research, 1999, pp. 49–90.

[23]David N. Figlio and James P. Ziliak, “Welfare Reform, the Business Cycle, and the Decline in AFDC Caseloads,” in *Economic Conditions and Welfare Reform*, edited by Sheldon Danziger, (Kalamazoo, MI: W.E. Upjohn Institute for Employment Research, 1999, pp. 17–48.

[24]Phillip B. Levine, “Cyclical Welfare Costs in the Post-Reform Era,” in *Economic Conditions and Welfare Reform*, edited by Sheldon Danziger, Kalamazoo, MI: W.E. Upjohn Institute for Employment Research, 1999, pp. 249–274.

[25]Elise Richer, Hedieh Rahmonaou, and Mark Greenberg, “Welfare Caseloads Increase in Most States in Fourth Quarter,” Washington, DC: Center for Law and Social Policy, April 29, 2003; available from: <http://www.clasp.org/DMS/Documents/1049386524.1/view_html>; accessed 7 May 2003.

conclusion is supported by the findings of Dye and McGuire that state welfare spending is countercyclical, rising during recessions.[26] In the past, however, there has been considerable variation across states. For example, in the last recession, both California and Michigan cut their benefit levels substantially. California had a big caseload increase (37 percent) whereas Michigan's caseload was largely unchanged. New York and Texas mirrored the national trend in that both had big caseload increases but did not change their benefit levels. The change in a state's caseload is not solely a function of a state's economy, but may also depend on politics. Blank and Wallace find that states with Democratic governors have significantly higher caseloads than states with Republican governors, suggesting that in a downturn some states may erect higher barriers to qualifying for public assistance than other states do. In FY 2003, 43 states left their cash benefits levels unchanged, while seven states actually increased benefits by amounts ranging from 2.5 to 6 percent.[27]

Previous estimates of the unemployment-caseload linkage suggest that it would take a substantial and prolonged recession to raise public assistance costs substantially. A sustained increase in unemployment of 2 percentage points would lead to an 8 to 12 percent increase in annual TANF-related state social welfare expenditures (about $1 billion per year, at current levels) and a 7.8 percent increase in Medicaid enrollment, implying an increase of about a $2.3 billion per year in state Medicaid expenditures.[28]

The calculus of increased costs appears, however, to have changed substantially in the aftermath of TANF. While the unemployment rate has risen from a low of 3.9 percent in October 2000 to 6.0

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[26]Richard F. Dye and Therese J. McGuire, "State Fiscal Systems and Business Cycles: Implications for State Welfare Spending When the Next Recession Occurs," Discussion Paper 99-04, Washington, DC: Urban Institute, June 1999; available from: <http://www.urban.org/UploadedPDF/discussion99-04.pdf>; accessed on 5 May 2003.

[27]National Governors Association and National Association of State Budget Officers, *The Fiscal Survey of States*, November 2002, p. 4.

[28]John Holahan and Bowen Garrett, "Rising Unemployment and Medicaid," *Health Policy Online*, No. 1, Washington, DC: Urban Institute, October 16, 2001. Available from: <http://www.urban.org/UploadedPDF/410306_HPOnline_1.pdf>; accessed 25 April 2002.

percent in April 2003, the caseload response, at least to date, has been substantially smaller than in previous recessions. Given the size of the TANF surplus, the much smaller baseline of caseloads as the recession began, and the role of time limits and work requirements in slowing the rate of entry onto the rolls, the cost of providing cash assistance to additional eligible individuals and families should be manageable for most states. As noted above, however, fiscal pressure on state governments, both on the revenue side and the expenditure side from the increase in Medicaid costs greatly exceeds recent experience. Hence, even if the extra costs of cash assistance are not excessive, should unemployment rates remain at current levels or increase over the next few years, the overall social service budgets of states are likely to be targets for cuts. The longer the fiscal crisis lasts, the more likely that these cuts will spill over into the cash assistance portion of the state budget.

The TANF Contingency Fund

The TANF legislation established a special contingency fund of $2 billion, to be allocated to states in dire economic circumstances. The usefulness to states of this fund, which expired in September 2001, is unclear. The rules for the contingency fund required that to qualify for payments, a state's welfare spending had to equal 100 percent of its 1994 levels. The federal maintenance of effort [MOE] provision under PRWORA requires states to maintain a level of spending on social welfare that is at least 75 percent of pre-TANF expenditures. However, many states are currently spending at or close to the minimum level mandated by federal regulation. If the contingency fund were to be reauthorized under the same rules, states would have to increase their outlays on TANF-eligible families by close to one-third to receive money from the fund. Since the contingency fund is only available on a matching basis, states would actually have to increase their spending by more than a third to access a significant amount of funds from the contingency fund.

Uncertainty of Estimates

There is much more uncertainty than in the past about the increase in fiscal needs which might attend the next recession. The small estimated effects of the unemployment rate on caseloads imply that the robust economy can explain only a small portion of the rapid decline in caseloads from 1996 to the present.[29] If state policies have played an important role in the decline, then one unknown is the extent to which states will reverse their policies, and admit or readmit to the TANF caseload families that might have been diverted or removed in the late 1990s. A second unknown is the level of support states will choose to offer those recipients who have exhausted their TANF eligibility but are still in need of assistance.[30] Furthermore, the flexibility of the block grant and the caseload decline have allowed states to reallocate a substantial portion of TANF funds from direct cash assistance to social services. If, as a result of the recession, more resources are needed for cash assistance, it may prove politically difficult to reduce these social service expenditures in order to free up funds to finance cash assistance for newly eligible recipients.

Changes in Medicaid costs are also more uncertain than in the past. Until recently Medicaid enrollment has declined, but total spending has been growing rapidly because of rising medical costs. The federal government pays a share of all Medicaid spending with the federal share ranging from 50 percent in the nation's 13 richest states to 77 percent in the poorest state.[31] Given that states are more likely to

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[29]Blank concludes that "the economy seems to have mattered less in the post-1996 period, and welfare policy has mattered more in reducing caseloads than it did in the earlier period." Rebecca M. Blank, "Declining Caseloads/Increased Work: What Can We Conclude About the Effects of Welfare Reform?," in Conference Proceedings: Welfare Reform Four Years Later: Progress and Prospects, *Federal Reserve Bank of New York Economic Policy Review* 7 (September 2001), pp. 25–36.

[30]In New York State, which is governed by a constitutional provision requiring care for the needy, many families who are no longer eligible for TANF can enroll in New York's Safety Net Assistance program. As a result, while the TANF caseload declined by 46.5 percent from February 2001 to February 2003, the overall public assistance caseload declined by only 16.6 percent.

[31]For a list of the Medicaid matching rates for FY 2004 see Department of Health and Human Services, "Federal Medical Assistance Percentages," *Federal Register 67*, No. 221 (November 15, 2002), 69223–69225; available from: <http://http://aspe.hhs.gov/health/fmap04.htm>.

trade off expenditures within the social service budget than between social services and other state spending, rising Medicaid outlays could have a significant crowding-out effect on cash assistance.[32]

The potential increase in Medicaid caseloads depends not only on the economy but also on current participation in Medicaid, which declined after PRWORA decoupled eligibility for cash assistance and Medicaid.[33] If an increase in welfare receipt brings with it an increase in Medicaid participation, than the growth in overall state Medicaid costs is likely to be greater than previous estimates. Evidence from New York and Wisconsin suggests that many of those no longer on public assistance have in fact retained their Medicaid coverage. For example, starting in 2000, Medicaid rolls in New York City began a sharp increase, rising by 570,000 people by April 2003.[34] In a recent study of multiple program receipt in New York City, Chernick and Reimers find that between 1994–95 and 1997–99, among households most at risk of needing public assistance, the rate of Medicaid receipt has not declined, even though receipt of cash assistance is substantially lower.[35] A similar result has been found by Cancian, Meyer, and Wu for former welfare recipients in Wisconsin.[36] FY 2002 Medicaid data from Wisconsin indicate that the largest reason for the growth of Medicaid spending is increases in the caseload, and most of the recent caseload growth is for coverage for low-income families.[37]

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[32]Katherine Baicker, "Government Decision Making and the Incidence of Federal Mandates," *Journal of Public Economics* 82 (November 2001): 147–194.

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[36]Maria Cancian, Daniel R. Meyer and Chi-Fang Wu, "Program Participation of Mothers on W-2." in Daniel R. Meyer and Maria Cancian, *Child Support Demonstration Evaluation Phase 1 Final Report*, Institute for Research on Poverty, University of Wisconsin–Madison, 2001.

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STATE FISCAL INCENTIVES

Decisions by state governments about how much to spend on cash assistance are influenced by two different concepts of the *price* of welfare. The first concept, which we call the *marginal price of recipiency*, indicates the amount of state fiscal resources needed to provide cash assistance to one additional welfare recipient. This price is equal to a state's share of the total cost per recipient times the average welfare benefit level per recipient. In symbols, the marginal price of recipiency equals $(1-m_i)*B_i$, where B_i is the average welfare benefit level in state i and m_i is the share of each dollar of benefit coming from federal funds. Under AFDC, the states' share of assistance varied from 13 to 50 percent; in the average state it was 40 percent. With the enactment of TANF and the replacement of matching aid with a block grant, the marginal price of recipiency increased from an average of 40 cents to a full dollar, times the average benefit level. National average benefits per family were about $400 in 2001. Thus the cost of enrolling an additional family for a year has increased from $1920 to $4800.

What effect will this increase in the marginal price of recipiency have on state willingness to provide benefits to those newly eligible? Economic theory predicts that a block grant of equal magnitude to the grant that a state receives under a matching regime should over time lead the state to reduce spending on cash assistance, though the size of the expected reduction has been the subject of some debate. Reduced spending could come through smaller caseloads, lower benefit levels per caseload, or some combination of the two. The most significant aspect of the post-welfare reform period has been the sharp drop in caseloads. Some of this drop can be attributed to the change in fiscal incentives, although the precise share is difficult to quantify,. The fixed size of the TANF block grant will undoubtedly reduce the willingness of states to actually enroll those families that are newly eligible for assistance. How much of a barrier to welfare participation states will erect is unknown. The fact that TANF caseloads continued to fall over most of 2002, even as the economy slowed substantially and unemployment rates rose, suggests that de facto states have continued to discourage participation in public assistance programs.

An alternative measure of the price of welfare is the per capita cost to a state of raising benefits by one dollar for all welfare recipients. We call this measure the *marginal cost of benefits*. Because an increase in income automatically reduces the amount of food stamps for which a low-income household is eligible, and because welfare payments are included in income, state governments must spend more than $1 of state funds to increase total benefits by $1. Our estimates suggest that in 1996, prior to the enactment of TANF, an increase of $100 in the cash benefit for each welfare recipient would have required, on average, a $3.07 per capita increase in state welfare funding.[38] By 2001, we estimate that in the average state, the marginal cost of increasing benefits by $100 per recipient rose by $1.84 per capita, a 60 percent increase. This net increase in marginal cost reflects both the replacement of AFDC matching aid with TANF block grants, and the decline in welfare caseloads.[39]

The increase in the marginal cost of welfare benefits leads one to expect that state governments would respond by reducing benefit levels. However, the latest studies suggest that states will be unwilling to cut benefits very much, even if faced with a substantial increase in caseloads.[40] In fact, between 1996

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[38]The marginal cost of benefits in state i in year t (MCB_{it}) can be written as $(1-m_i)*(Recip/Pop)_{it}*FS_{price}$, where m_i is the share of each dollar of benefit coming from federal funds in state i, $(Recip/Pop)_{it}$ is the number of recipients of cash assistance divided by the state's population, and FS_{price} is the extra cost to a state of increasing benefits by one dollar after taking account of reduced food stamps (and federal housing benefits) as cash assistance is increased. In 1996, m was equal to 0.6 in the average state, FS_{price} was equal to 1.6 (Howard Chernick, "State Fiscal Substitution between the Federal Food Stamp Program and AFDC, Medicaid, and SSI," Working Paper 123, Joint Center for Policy Research, Northwestern University, October 1999; available from: <http://www.jcpr.org/wpfiles/Chernick_WP.pdf>; accessed 30 April 2003.), and the average recipient to population ratio was .0479. With these values, MCB_{it} in the average state had a value of 0.0307, implying a marginal cost of benefits of $3.07 per capita for each $100 increase in cash benefits.

[39]As FS_{price} did not change between 1996 and 2001, the change in MCB_{it} between 1996 and 2001 is due entirely to the change in the average federal matching rate, which went from 0.6 to zero, and changes in the welfare recipient to population ratio that were independent of changes in state welfare policies. Based on one recent review of the literature (Stephen H. Bell, "Why Are Welfare Caseloads Falling?" Discussion Paper 01-02, Urban Institute, March 2001; available from: <http://www.urban.org/UploadedPDF/discussion01-02.pdf>; accessed on 25 April 2003), we make the conservative assumption that 60 percent of the approximately 60 percent decline in the caseload between 1996 and 2001 was unrelated to state welfare policies. Using these numbers in the formula in the previous endnote allows us to calculate the change in the average value of MCB between 1996 and 2001. If caseloads had not declined dramatically in the period following the enactment of TANF, our calculations suggest that the MCB in the average state would have increased by 150 percent.

[40]Howard Chernick, "Federal Grants and Social Welfare Spending: Do State Responses Matter?," *National Tax Journal* 53 (March 2000): 143–152.

and 2000, 20 states increased and three states decreased their maximum TANF benefit levels; in the remaining states, benefit levels remained unchanged.[41] Although the value of benefits in many states has been eroded by inflation, the sharp drop in benefit levels (known as the "race to the bottom") that some predicted has not occurred.[42] However, the real test of whether states will resist the incentive to lower benefit levels will come if and when there is a significant increase in welfare caseloads. But we would also expect that any benefit cut that does occur is most likely to happen during a recession, when fiscal pressures are heightened.

Maintenance of Effort (MOE) Requirements

The federal MOE requirements are but one example of the many and complicated incentives built into the TANF law. If states fail to meet the MOE requirements, they lose TANF funds dollar-for-dollar, and must make up for the spending deficit by the next fiscal year. If state spending is increasing over time because of rising population and income, then the MOE becomes a smaller and smaller percentage of what states would have spent anyway, and it has a diminishing effect on state budgeting decisions. However, because of the sharp and continuous drop in caseloads from 1996 onward, rather than diminishing in effect, the MOE requirement has become increasingly important. If states had kept their benefit levels per recipient the same as they were from 1992 to 1994, and paid the same share of benefits as they did under the AFDC matching rate regime, they would now be spending only 38 percent of what they spent in 1994: at least 37 percent below the MOE requirement. Hence, the MOE requirements have been an extremely important factor in preventing states from reducing their own spending for welfare.

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[41]Gretchen Rowe and Tracy Roberts, *Welfare Rules Databook: State TANF Policies as of July 2000,* Urban Institute, November 2001.

[42]Some states may have allowed the real value of cash benefits to decline because the federal Food Stamp Program continues to impose a high implicit tax on cash benefits. Food stamp benefits are reduced by about 38 cents for every dollar increase in cash assistance, so states have a strong incentive to substitute food stamps for cash assistance.

How have states responded to this increasingly tight constraint on their fiscal decisions? An initial response was to spend state dollars first, "banking" unused TANF funds for future spending without penalty. This, coupled with the uncertainty over what actually constituted allowed TANF expenditures, explains why initially many states built up large TANF balances. The latest data indicate that most states are now fully obligating their annual TANF allocation, and that most states have used up a large portion of their past balances.

In FY 2000, 22 states spent just enough to satisfy the MOE requirement, and many other states were only a few percentage points above.[43] Thus the MOE level has been closer to a ceiling on spending than a floor. States can satisfy their MOE requirement by providing either cash or a set of services. If states tighten their TANF eligibility standards too severely, causing the caseload to decline very rapidly, then they must put more and more funds into social services to meet the MOE requirement. This constraining effect of the MOE on caseloads must be set against the fact that under PRWORA a decline in caseloads counts in terms of satisfying the work requirements of the act.

The MOE requirement was included to limit the opportunity for states to substitute federal for state dollars. Nonetheless, over time such substitution could still occur. For example, if states do not raise benefit levels as much as they would have under the matching grant, federal funds would gradually wind up providing a higher share of total cash assistance than under the AFDC program. States could also use TANF funds for other social services and allow their own contributions to these services to erode.

The state of New York provides an example of fiscal substitution. In fiscal year 1998, the state used $200 million of TANF funds to replace state funds for cash assistance.[44] New York also chose to put a portion of its TANF funds into child care and the state Earned Income Tax Credit. At least some of these funds probably substituted for the state's own spending on these programs. Substitution becomes

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[43]Ed Lazere, "Unspent TANF Funds at the End of Federal Fiscal Year 2000," Washington, DC, Center on Budget and Policy Priorities, February 23, 2001.

[44]New York City Independent Budget Office, "New York's Increasing Dependence on the Welfare Surplus," *Fiscal Brief*, August 2001.

easier the more states are allowed to count spending on any low-income program toward their MOE requirement. For example, New Jersey has been allowed to designate "the post-1996 portion of court-ordered spending on select low-income school districts toward its TANF MOE."[45]

The rules of the program allow states to spend TANF funds directly on services such as child care and child welfare services, but states are also allowed to move a portion of the TANF funds into the child care and development fund (CCDF) block grant and the social services block grant (SSBG). At most 10 percent of the annual TANF grant can be transferred to SSBG, and 30 percent to the two block grants together. States have an incentive to transfer TANF funds to the other block grants because client services paid under these funding streams are not subject to the TANF time limits and work requirements. Many states have chosen to move funds to the block grants in this way. In FY 2002, for the nation as a whole, 12 percent of TANF funds were transferred to the two block grants.[46]

States face a variety of incentives and constraints under PRWORA which make the determination of fiscal substitution complicated. For example, the child care block grant has both a fixed and a matching component. The matching component (at the state's federal Medicaid matching rate) provides an incentive for states to maintain their prior level of expenditures. Econometric studies which carefully model these various incentives have not yet been done, but are clearly necessary to be able to assess the extent to which PRWORA has induced fiscal substitution on the part of states.

CONCLUSIONS AND RECOMMENDATIONS FOR WELFARE REAUTHORIZATION

In this paper, we have explored the question of whether state governments, when facing an economic slowdown, will be willing and able to meet the rising needs of their low-income residents for

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[45]Feingold, Schardin, and Steinbach, p. 6.

[46]U.S. Department of Health and Human Services, Administration for Children and Families, "Fiscal Year 2002 TANF Financial Data; Table A: Combined Federal Funds Spent in FY 2002 through the Fourth Quarter," Washington, DC, February 2003; available from: <http://www.acf.dhhs.gov/programs/ofs/data/tanf_2002.html>; accessed 9 May 2003.

cash public assistance and for various social services. It is difficult to predict the magnitude of the increase in costs that states will face in order to maintain services for their low-income populations. The first question is, How much are welfare caseloads likely to increase during a recession? The much smaller base of recipients as we enter a period of economic slowdown, and the greater barriers that states have erected to receiving public assistance, should help to slow the initial rise in eligibility relative to prior recessions. As the duration of the recession lengthens, however, the increase in eligibility and cost of public assistance will depend on four factors:

- What impact will an economic slowdown have on the unemployment rate of low-income, low-skill workers; will a large number of former welfare clients face unemployment?
- What proportion of the newly unemployed workers will be covered by unemployment compensation, for how long, and what share of their after-tax wages will be covered?
- By how much will rising unemployment and falling incomes increase Medicaid eligibility and state government costs?
- To what extent will falling incomes lead to increases in state government costs for subsidized social services, such as child care?

We conclude that if the TANF block grant is large enough to allow states to build up a cushion of unspent TANF funds during periods of economic prosperity, then states should be able to get through a relatively mild recession without having to substantially reduce the access of their low-income residents to public assistance.

Nevertheless, as the current fiscal condition of state governments clearly demonstrates, balances accumulated in prosperous times can quickly be eroded. As we explained previously, the unique circumstances associated with the transition to a new fiscal regime for welfare, combined with a boom economy in the late 1990s, provided state governments with fund balances of a size that is unlikely to be repeated in the future. Thus, to prevent cuts in programs that support low-income families during future recessions, it is essential that the reauthorized TANF program include a large and easily accessible contingency fund.

There is certainly no guarantee that even states in relatively strong fiscal health will choose to meet the rising demands of their low-income populations. The behavior of states during recessions in the 1980s and early 1990s provides little help in predicting how states will behave in future recessions, because the 1996 welfare reform has so fundamentally changed the "rules of the game." Likewise, the welfare-related decisions states have made since 1996 provide us with limited information about how they will behave during a recession. The combination of a fixed block grant, a very strong economy, large drops in welfare caseloads, and quite stringent MOE provisions made it possible for most states to expand programs directed toward their low-income populations.

As of this writing, it is very much in doubt whether states facing large budgetary shortfalls will be willing to maintain the funding of programs for their low-income populations. Despite the fact that growth in the TANF caseload has been relatively modest compared to previous slowdowns, the pressure on social services and work-support programs, where spending now greatly exceeds cash assistance, has sharply intensified.

In light of our discussion, we offer the following suggestions to be considered in the reauthorization debate.

<u>Capacity to Build TANF Rainy Day Balances</u>

The interaction of four unrelated events created a large, unanticipated fiscal cushion of unspent TANF balances that forestalled large cuts in public assistance to the neediest state residents:

- To gain sufficient political support for the passage of PRWORA, the block grants to states were set at levels equal to federal AFDC allocations in the early 1990s, a period with relatively high caseloads.
- The rapid economic growth that lasted throughout the second half of the 1990s contributed to rapidly falling welfare caseloads.
- The falling caseloads, which helped to make the MOE minimum spending requirements binding for states, and the work requirement rules in the 1996 legislation induced states to substantially increase the amount of state money they devoted to each welfare recipient.

- The long period before issuance of federal regulations for spending TANF dollars led to state uncertainty and delay in the spending of federal TANF funds.

The lesson we draw from this piece of history is that Congress, in reauthorizing welfare legislation, should explicitly authorize sufficient funds so that in periods of economic prosperity state governments will have the resources to build up balances of unspent TANF dollars that they can hold for use in times when the economy slows and demand for welfare increases.

Retention of the MOE Provision

Without this provision, state governments would almost certainly have shifted more resources out of poverty-related activities, and would have been much less likely to "bank" some of their TANF grant allocations for future use. Thus, in reauthorizing TANF, state governments should be given a strong incentive to maintain their existing spending on programs that benefit their low-income populations. The creation of an effective "work-based system" that will, over time, lift former welfare clients out of dependence and poverty requires a substantial investment in ancillary services such as child care, transportation, and skills training. These programs are likely to see a substantial drop in fiscal support from states, especially during times of sluggish economic growth, unless federal welfare legislation prevents state governments from shifting funds to other uses.

After the passage of PRWORA, states' incentives to shift funds away from support for the poor has been enhanced by the elimination of the matching provisions under AFDC. If states are spending more than the MOE requirement, then for every dollar of reduction in state spending, they now realize a full dollar in savings. The role of the MOE requirement will tend to be eroded over time, as it becomes more difficult to distinguish TANF-related spending from spending states would have done without TANF, and as overall population and public assistance spending rise. To prevent the MOE from losing its effectiveness, it should be set in inflation-adjusted terms.

Establishment of an Adequate Contingency Fund

The original TANF legislation established a relatively small contingency fund that was, in our opinion, seriously flawed. The TANF legislation made access to contingency funds extremely difficult, meaning that any state was unlikely to avail itself of the fund.

In reauthorizing the welfare legislation, Congress should recognize that state governments will need additional funds when recessions occur. The block grant shifts the fiscal risk of recession to the states. After a certain point in any recessionary cycle, the federal government should intervene to bear some portion of the additional costs. To do this, Congress should renew the contingency fund, but with a rule that access to the fund is triggered by some indicator of economic activity that is independent of state government actions, such as a specified increase in the state unemployment rate.

More Ample Fiscal Reporting Requirements

The premise underlying the welfare reform act of 1996 was that allowing states greater freedom in program design would lead to more effective social welfare programs and long-run self-sufficiency. The risk is that in converting the federal program from a matching to a block grant, states might reduce their own fiscal commitment to the poor, particularly in times of fiscal stress. To address this fundamental question, the design of reporting requirements for a reauthorized welfare bill should allow the federal government to trace as clearly as possible the impact of welfare reform on state spending for low-income persons. It is important to be able to gather data that allow one to determine the extent to which states are able to substitute TANF funds for their own spending on cash assistance. For example, such data would help to determine whether TANF funds become part of state rainy day funds, or whether states cut taxes more than they otherwise would have because of the availability of the TANF surplus.

To be able to better track TANF spending, funding shifts, and fiscal substitution, we need consistent data across all states on total state spending on the various categories of social services. One helpful step would be for the U.S. Census Bureau to refine the broad category of spending now called "social welfare" with the goal of providing uniform definitions for spending on specific services, such as child care and child welfare services.