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The rise of the states: U.S. fiscal decentralization in the postwar period

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ABSTRACT

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. We argue that the greater role of states cannot be easily explained by changes in Tiebout forces of fiscal competition, such as mobility and voting patterns, and are not accounted for by demographic or income trends. 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. These outside pressures moderate the forces of fiscal competition and must be taken into account when assessing the implications of observed revenue and spending patterns.

1. Introduction

The past 50 years have seen notable changes in fiscal decentralization in the United States. The increasing concentration of responsibility at the state level has been particularly pronounced: between 1952 and 2006, total state spending increased from 4.5% to 11.6% of GDP, with direct state spending (excluding state grants to localities) growing from 3.1% to 8.6% as a share of GDP and from 11% to 24% as a share of government spending. Tax and expenditure programs at the state level also appear to have become more redistributive over time. The fastest growing component of state expenditure is public welfare, and state revenue raising has shifted away from sales taxes and toward income taxes. In this paper, we explore the reasons for the rapid growth in state budgets as well as the change in composition of these budgets.

We first consider explanations motivated by the classic Tiebout model, which remains the benchmark framework for thinking about the optimal provision of public goods in a federal system (Tiebout, 1956). Although Tiebout does not speak directly to state actions, we draw broad lessons from the model through which to interpret state budget patterns. For example, one of the core features of the model, the idea that households can "vote with their feet" leading to jurisdictional competition, has been enormously influential in the subsequent fiscal federalism literature and has been applied to states as well as localities.

We focus on potential explanations associated with two key aspects of the Tiebout model: 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.[3] 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 (Rhode and Strumpf, 2003), we show 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 also consider 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

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[3] See Wildasin (1988) for a model of competition comparing competition in price (taxes) versus quantity (services). Hoyt (1993) shows that the results of this model are sensitive to the degree of mobility. Brueckner reviews the mixed evidence on interstate competition (1998) and the potentially harmful effects of tax competition (2004). See Case et al. (1993) for an example of empirical evidence of spillovers, which Baicker (2005) uses to show that interstate mobility is the best predictor of state "neighborliness."

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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 to explain observed changes in the landscape of fiscal federalism.

It is thus difficult to reconcile the observed empirical facts with changes in Tiebout-style forces. Nor do they seem primarily 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.

There are several mechanisms through which one unit of government can influence the budget of another. First, 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). Last, 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. Close to 60% of the overall increase in state direct spending is attributable to two expenditure categories. First, 20% of the increase comes from increases in state educational expenditures, which rose from 0.4% to 1.6% of GDP between 1952 and 2006. Almost all of this increase occurred between the late 1950s and early 1970s, coinciding with demographic shifts but also with the enactment of federal provisions to increase education spending. Second, 38% of the increase can be attributed to increases in state spending on public welfare and income security programs (including Medicaid), which rose from 0.5% to 2.5% of GDP. 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.[4] Furthermore, there has been substantial proliferation of unfunded mandates over the postwar period. Our analysis suggests that these federal forces accounted for a substantial share of the increase in state spending, although it is difficult to perform a rigorous decomposition, especially given the matching nature of several key programs.

Together, these results suggest that naïve budgetary accounting may not adequately capture the real distribution of responsibility for spending — just as who nominally pays a tax does not necessarily show who bears the incidence. An 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.

2. Empirical trends: fiscal federalism and the rise of the states

We begin by documenting patterns and trends in government spending and revenues. We start with the size of government budgets and then delve into their composition. We distinguish between two types of government spending: direct spending (going to individuals, programs, providers, vendors, or other non-governmental entities, such as state payments to a doctor providing care to a patient covered by a state insurance program) and indirect spending (where one governmental entity gives funds to another, such as federal matching funds for Medicaid that flow to state governments themselves after the states pay medical vendors). Similarly, total revenues can be divided between own-source revenues and indirect revenues from intergovernmental grants. Total government spending and revenues are thus the sum of federal, state, and local direct spending and own source revenues, respectively. These distinctions are important for understanding the net resources available for different uses (avoiding “double counting” funds that flow through several government entities) and for understanding the intergovernmental relationships that may influence total budgets.

2.1. The size of federal, state, and local governments

Total government spending grew from 27.6% of GDP in 1952 to 36% in 2006 (Fig. 1a).[5] The growth of state governments has been particularly pronounced. Federal direct spending (excluding intergovernmental grants) actually declined slightly over this period, from its Korean War build-up level of 18.7% of GDP in 1952 to 17.0% in 2006.[6] Local direct spending increased from 5.8% to 10.6% of GDP during this period, with most of this growth occurring before the 1970s. In contrast, state direct spending increased steadily over this period, rising almost three-fold from 3.1% of GDP in 1952 to 8.6% in 2006. As a share of government spending, state direct spending doubled over this period, from 11% of total government spending to almost 24% (Fig. 1b). Total state spending, including intergovernmental grants to localities, increased from 4.5% to 11.6% of GDP over the period. The size of government can also be gauged on the revenue side. The increases in own-source revenues are quite similar to those seen in direct spending (Fig. 1c). Between 1952 and 2006, federal own-source revenues declined as a share of GDP from 19.0% to 18.4%, local own source revenues increased from 4.0% to 7.1%, and state own-source revenues more than doubled, going from 4.1% to 10.4%.[7] State-raised revenues increased from 15% of total government revenue to 29%.

As these figures demonstrate, the U.S. has seen substantial fiscal decentralization to states during the postwar period. The growth in state and local budgets has outpaced growth in federal budgets. While local budgets did grow from the 1950s to the mid-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.

2.2. The Composition of federal, state, and local government budgets

We next turn to an examination of the mechanisms through which funds are raised and the programs on which they are spent. 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

[4] A third important category has been the rise of insurance trusts, discussed in more detail below, which account for 16% of the overall increase; the remaining quarter of the increase is spread over the residual spending categories, with no striking patterns.

[5] Data for these analyses come from the *Census of Governments* (conducted by the Census Bureau in years ending in 2 and 7, but not yet available for 2007) and the *Annual Survey of Governments* (conducted annually, but without comprehensive coverage of individual local governments). Note that we focus throughout on the postwar period, and that our data series end before the financial crisis of the late 2000s.

[6] Federal spending was 14.8% of GDP in 1950, prior to the war.

[7] The figure shows a dramatic drop in revenues in 2002, which is largely due to an anomalous drop in insurance trust revenues, described in the notes to Fig. 3.