Fiscal Effects of Block Grants

The 5-year time limit on TANF benefits will eventually force a number of welfare recipients off the TANF welfare program. Unless these former TANF recipients replace lost TANF income with wage income, their net income will decrease and their food stamp allotment will increase. In addition, States are free, subject to some limitations, to directly transfer up to 30 percent of the cash assistance block grant to the child care block grant and are provided the flexibility to develop their own welfare programs. To the extent States replace cash assistance with salary subsidies, child-care vouchers, or other noncash support, measured cash income of food stamp recipients is likely to decrease, making them eligible for larger food stamp allotments. Evidence provided by State assistance plans, required by PRWORA to ensure State funds are spent only on needy families with minor children, reveals a wide variety of expenditure alternatives to simple cash assistance. These alternatives include child care, educational programs, transportation services, contingency funds, wage subsidies, teen-pregnancy prevention, school-to-work programs, and community grants.

Shifting Federal matching funds to a block-grant structure will further the Food Stamp Program's role as a safety net. State welfare programs that shift money away from direct cash assistance increase the pressure on the Food Stamp Program, particularly in economic downturns.[17] Food stamps are a fairly close substitute for cash assistance, are 100 percent financed by the Federal Government, and are closely linked to the cost of living through adjustments to the Thrifty Food Plan. These features provide an incentive for States to allow food stamps to replace TANF cash assistance funds.

We use a State budget constraint model to illustrate the potential implications of block granting welfare. This model maintains that State income determines welfare benefits, the marginal price of cash and in-kind grants, and the preferences of State decisionmakers. In our example, States allocate resources between welfare benefits and other expenditures like schools, prisons, and transportation by choosing a point like O (fig. 9). An open-ended Federal matching grant for welfare expenditures rotates the State's budget constraint from AB to AC by decreasing the price to the State of an additional dollar of benefits.[18] If a State decisionmaker were to move from an original allocation to point 2, all the matching aid is used to increase welfare benefits. At point 1, the matching aid is used to solely purchase schools, prisons, and transportation. In this case, no additional allocations are made to purchase welfare benefits.

We can incorporate food stamps by assuming State decisionmakers view food stamps as fully fungible with cash welfare benefits. The horizontal axis can be redefined to include welfare benefits plus food stamps. The federally financed Food Stamp Program shifts the State budget constraint from AC to ADEF. If the State pays zero cash welfare benefits, welfare beneficiaries (those receiving cash or food assistance) receive a maximum food stamp benefit of AD. Along the line segment DE, additional State expenditures on cash welfare assistance do not decrease food stamp receipts. This cash assistance disregard is captured in the standard deduction of food stamp recipient income. The relationship between cash assistance and food stamps is complicated, however, because for every dollar of cash welfare benefits a family receives above a prespecified base income level, their monthly food stamp benefit is reduced by 30 cents. Holding the number of participants constant, if cash welfare benefits exceed E, then the food stamp program taxes cash welfare benefits at 30 percent. Between E and F, total (State and Federal) welfare benefits must increase by $1/(1-.3)$ or $1.43 to increase total benefits by $1.

What happens to the fiscal incentives facing States under fixed Federal block grants? The shift to block grants increases the implicit price of providing cash welfare benefits. If we exclude food stamps, the effect of fixed block grants is depicted in figure 10.
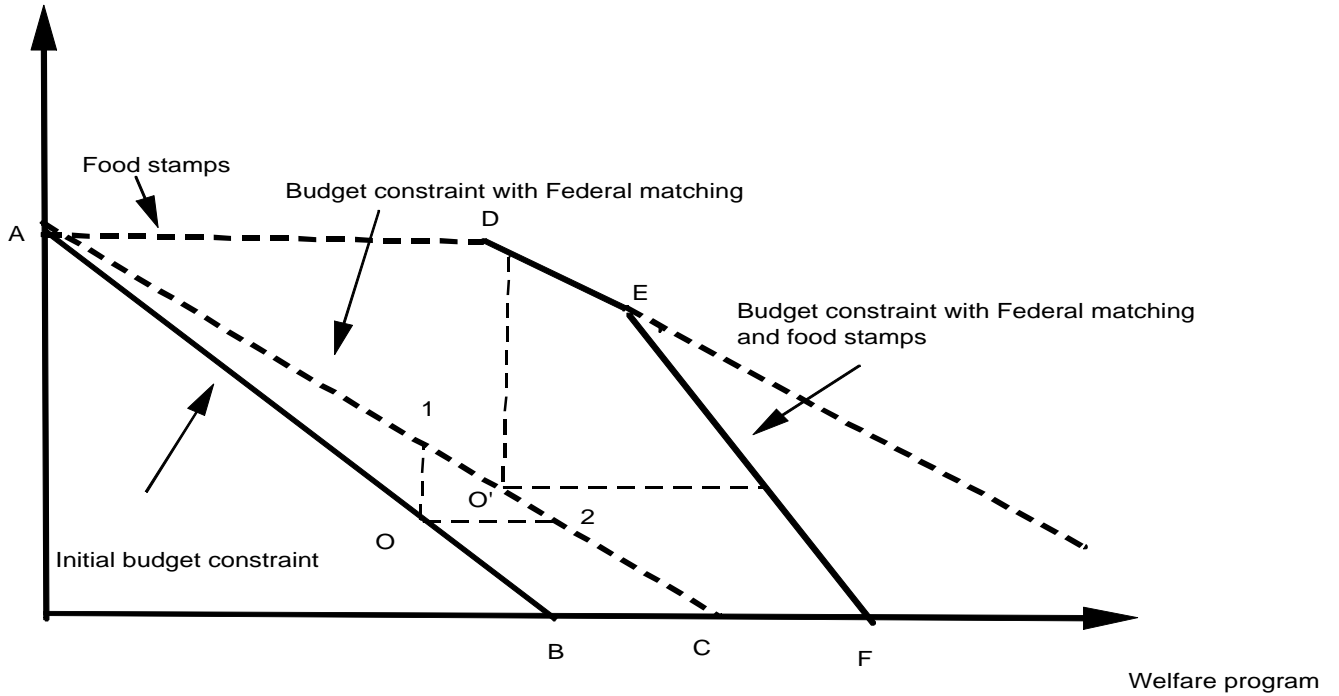
[17]There is a $2-billion contingency fund that States can draw upon during economic downturns and this will alleviate some of the pressure on the Food Stamp Program during a recession. A State is eligible if its unemployment rate for a 3-month period exceeds 6.5 percent and 110 percent of the rate for the corresponding period in either of the two preceding calendar years and its food stamp caseload increases 10 percent over the corresponding fiscal 94-95 level. There is also an $800-million grant fund for States with exceptionally high population growth, benefits lower than 35 percent of the national average, or above average growth and below average benefits.

[18]Tax revenues are assumed constant and fully spent for public goods. If tax revenues are not held constant, it is possible for State decisionmakers, with knowledge of the matching program, to cut taxes and shift the original budget constraint toward the origin. This type of strategic action could mitigate the price effect of the matching grant and leave the original split between welfare expenditures and other State expenditures essentially unchanged.

Figure 9
State budget choices with Federal matching grant

Schools, prisons, transportation

Food stamps

Budget constraint with Federal matching

D

A

E

Budget constraint with Federal matching
and food stamps

1

Initial budget constraint

O'

2

O

B   C   F

Welfare program

Source: Authors' calculations.

Figure 10
State budget choices with Federal block grant

Schools, prisons, transportation

D

Budget constraint with block grant

A   F   Initial budget constraint

G

Budget constraint with matching grant

B   E   C

Welfare program
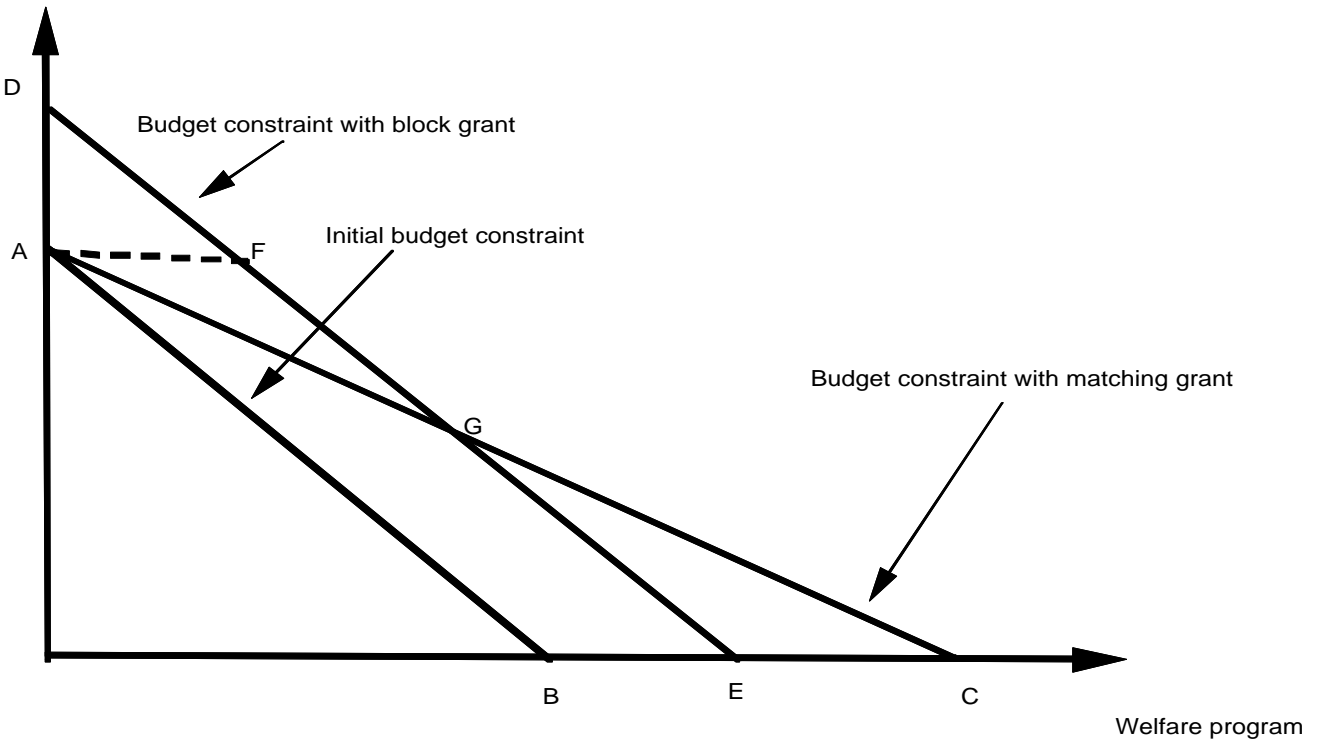
Source: Authors' calculations.

The longrun budget constraint shifts from AC to AFGE. The final mix of public expenditures depends on the slope of the original budget constraint, the preferences of the State decisionmaker, and whether maintenance of effort requirements are binding.

It is possible, without maintenance of effort requirements, for States to reduce their contribution to zero and move to point F. Along the segment DF, States use the Federal block funds for purposes other than welfare. State maintenance of effort requirements suggest States trade off welfare program expenditures against schools, prisons, and transportation. One possibility is that States will move to point G, which reduces State contributions to the minimum allowed by maintenance of effort requirements. Over time, maintenance of effort requirements, even when defined in real terms, lose their constraining power because maintenance of effort requirements are rarely adjusted for inflation, population, or caseload growth (Gramlich, 1982; Chernick, 1982). States would then be unconstrained to select any point along the segment FE.

Figure 11 shows the effect of block grants in the presence of Federal food stamp benefits. With food stamps, the State budget constraint becomes ADEF. Recall, the slope of EF is determined by a 30-cent tax on every dollar of cash welfare benefits a family receives above a prespecified base income level. Because the food stamp program continues to tax cash welfare at a rate of 0.3, and given the mean Federal matching rate in 1996 of 60 percent, the marginal price of increasing cash benefits to the State increases from 57 cents to $1.43 or an additional 86 cents. The increase in price is greater in lower income States, which have historically higher Federal matching rates.

The sharp increase in the implicit price of cash welfare benefits creates a strong incentive for States to substitute away from welfare benefits. Like any demand analysis, the final effect of changing the fiscal incentives faced by States depends on the importance of price and substitution parameters relative to the underlying preferences of State decisionmakers. Estimates of the likely effects of block granting welfare benefits vary considerably. Chernick and Reschovsky (1996) provide an excellent summary of estimates of price and income elasticities associated with State fiscal responses to different incentive structures. Recognizing all the studies are plagued by statistical problems, Chernick and Reschovsky divide the

Figure 11
State budget choices with block grant and food stamps
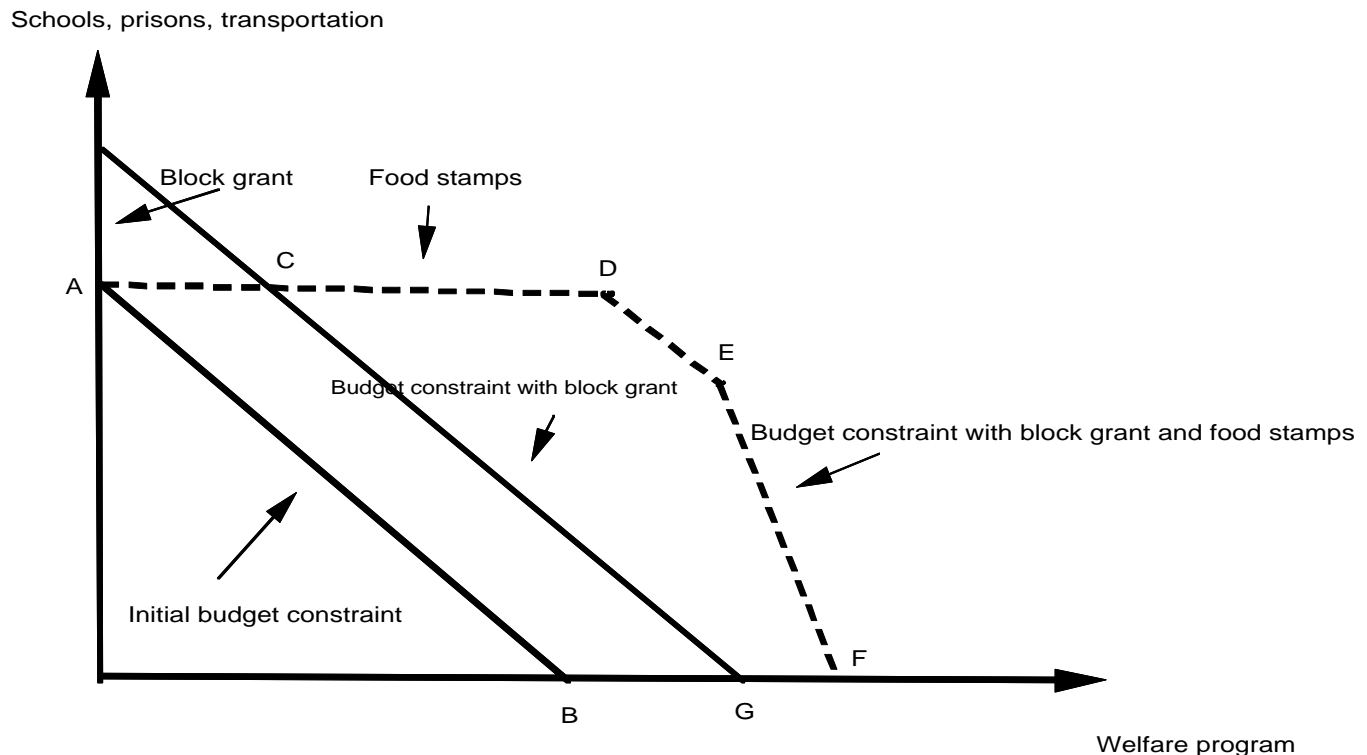
Source: Authors' calculations.

studies into two groups. One group tends to find large State responses to differences in matching rates and relatively little substitution of food stamps for AFDC and the second group indicates total redistributional spending by States is approximately constant, and any decrease in Federal spending will be largely offset by increases in State expenditures.

Studies predicting the largest declines in State welfare expenditures are Gramlich (1982, 1985), Gramlich and Laren (1984), and Craig and Inman (1986). Contrasting these studies are the work of Moffitt (1984, 1990) and Ribar and Wilhelm (1994). Although changes in State welfare expenditures may adjust slowly, perhaps 4 to 5 years, Gramlich and Craig and Inman estimate total reductions in State spending range from 75 to 80 percent.
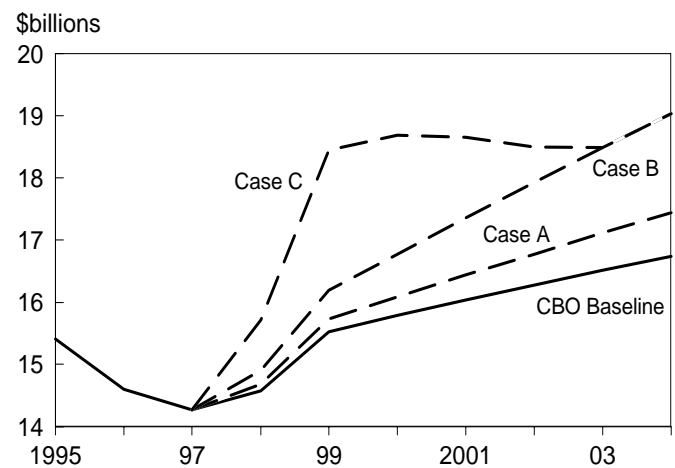
Moffitt's (1990) analysis of the interaction between welfare programs suggests State legislatures have allowed federally financed food stamp benefits and federally subsidized Medicaid benefits to substitute for AFDC. He found declines in real AFDC reflected a substitution of federally funded food stamp benefits. Eliminating matching grants would reduce AFDC benefit levels by about 9 percent, while any reductions in food stamps would in the long run be fully offset by an increase in AFDC benefits.

Given the ambiguous econometric evidence, no definitive estimate of the effect of block grants on State cash welfare expenditures is possible. Any of these studies are likely to provide only a lower bound of changes in State spending on cash welfare benefits because they ignore the effects of current recipients leaving TANF due to time limits and the potential implications of States providing noncash income forms of TANF support. After an extensive review of the literature, however, Chernick and Reschovsky estimate that "on average State governments will reduce overall spending on AFDC (TANF) and Medicaid by approximately 30 percent." In 1994, total Federal and State and local AFDC expenditures were $25.9 billion. If longrun real cash benefits from States were to decline by 9 percent, food stamp benefits would offset 30 percent of this lost income and increase by $700 million over the CBO baseline budget by 2004. More significant declines in cash TANF benefits of 30 percent, as suggested by Chernick and Reschovsky, might mean increases in the food stamp budget of $2.3 billion over the 2004 baseline.

Figure 12 illustrates the implications for the food stamp budget of alternative assumptions about declines in cash TANF benefits by presenting three simulations. The CBO baseline is also presented for comparison. Simulations A and B use the CBO macroeconomic assumptions, but illustrate a different assumption about the share of cash TANF benefits that leak away through time. Simulation A assumes that by 2004, cash TANF benefits will decrease 9 percent; Simulation B illustrates a decrease of 30 percent. Simulation C combines a 30-percent decrease in TANF outlays by 2004 with a mild economic recession. Simulation C converges in the year 2003 to Simulation B because the mild recession is assumed to have run its course.

The results are dramatic. When Chernick and Reschovsky's estimate of a 30-percent decrease in cash TANF benefits is combined with a mild economic downturn, total real food stamp expenditures are simulated to increase to nearly $19 billion by the year 2000. By the year 2004, both Simulations B and C exceed the base by $2.3 billion, but total real outlays on food stamps increase by over $16 billion dollars under Simulation C compared to $9 billion under Simulation B. The more conservative assumption of a cash TANF benefit leakage of 9 percent still results in additional real food stamp expenditures of $2.8 billion greater than the CBO base.

Figure 12

Indirect effects of block grant on food stamp expenditures ($1984)

Source: Authors' calculations.