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THE NEW FISCAL FEDERALISM AND THE SOCIAL SAFETY NET
A VIEW FROM CALIFORNIA

James Hosek, Robert Levine, editors

RAND
The purpose of the RAND Conference on Fiscal Federalism, held in Santa Monica on May 1–2, 1996, was to consider the opportunities and risks of a proposed shift to block grants in key areas of the nation's safety net—welfare, Medicaid, and job training. The conference brought together many California state, county, and local officials, as well as officials from other states and the federal government, in order to gain a practical grasp of the objectives and issues behind the current round of devolution, and to anticipate the consequences for program implementation and the populations served. The essays in this volume were prepared for the conference and incorporate a number of observations made during the sessions.

Fiscal federalism is the central focus of the Contract with America, the legislative agenda set forth by the Republican majority in the House of Representatives of the 104th Congress. The political basis for the new thrust is a public perception that existing federal programs have gone out of fiscal control, and that welfare and allied programs have become permanent props for their recipients rather than temporary assistance on their way to self-support.

This new philosophy contrasts with an older one adapted to the 1990s by the Clinton Administration. The Administration favors continued major responsibility for the federal government, slower movement toward a balanced budget, welfare reform stressing positive incentives to work and eschewing some of the negative strictures of the Republican plans, and broad latitude for the states to experiment within these structures—but retention of at least part of the en-
itlement system, albeit with a lifetime eligibility cap similar to that proposed by the Republicans.

The American debate over the proper balances between government and private activities and among the various governmental entities in a federal system goes back to the Articles of Confederation. In a democracy, such choices are properly made by the political process, and that has been the rule for the United States. The public/private balance and the federal/state balance have swung back and forth throughout our history; the 1994 election has been viewed as one more swing in this continuing process, a turn away from government in general and the federal government in particular. By returning Republican majorities in both Houses of Congress, the American people apparently chose the new premises of the Contract and endorsed fiscal federalism. The original purpose of the RAND conference was thus to assist the states upon which the new fiscal federalism would place so many new responsibilities and opportunities.

By the time the conference took place in the spring of 1996, however, it had become far less clear what policy and political choices were going to be made by the legislative process that included the Democratic Administration as well as the Republican Congress. The drive toward a balanced budget continued, and it seemed probable that, one way or another, federal expenditures on these programs would be cut—18 to 20 percent was the estimate of one conference participant. Beyond that, however, it now seems unlikely that such choices will be made before the elections of November 1996; the structure of current programs will remain in place by default. Some funding levels have been reduced, but entitlements remain entitlements, with full funding available under current law.

The RAND conference thus had a more difficult but more interesting task than had originally been conceived. Rather than exploring the options available to states and localities under an already-determined set of federal programs, the task was to explore the state and local options available, given a still-wide range of federal options. In doing so, much of the conference discussion was inevitably devoted to the implications of the alternative federal options.
The papers in this volume formed the basis of the conference; they are analytical, as were the conference discussions. But it should be stated frankly that most participants were inclined to question many of the premises underlying the new federalism, although most were also critical of some older premises and programs as well.
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WHAT IS THE NEW FISCAL FEDERALISM?

Answered narrowly, the new fiscal federalism consists of federal legislation to restructure the funding mechanism of domestic programs in areas such as health care, welfare, and training. The changes would provide block grants to the states—specific federal appropriations giving the states funds to use at their discretion, within broad guidelines, in the areas of Aid to Families with Dependent Children (AFDC), the central and most controversial component of welfare; Medicaid; and job training. This would represent a dramatic change for AFDC and Medicaid, which today are entitlement programs in which federal law allows any person meeting low-income and other criteria to receive assistance. The change in job training would be more modest, since federal training efforts have for many years been composed of categorical grant programs. The block grants would contain new guidelines for states—in some cases giving them more freedom of action, in others imposing federal goals. Block grant funding would be at levels below the projected amounts for the programs in their current form.

More broadly, the new fiscal federalism is the latest wave in a movement to shift more power and authority from the federal government to the states. In 1971, Richard Nixon proposed special revenue sharing in an attempt to shift program control to the states and thereby side-step congressional politics that targeted categorical grants at specific constituencies. In 1981, Ronald Reagan proposed a sweeping program of categorical grant program consolidation, even-...
tually gaining passage of legislation that brought together 57 categorical grants into nine block grants. Nixon proposed general revenue sharing as well, and its passage returned unrestricted federal revenues to the states. Like the most recent initiative, the Nixon and Reagan block grant initiatives anticipated various efficiency gains to be achieved by pruning back the bureaucracies required to administer the many categorical grants, by cutting federal restrictions and paperwork, and through greater local control.

The Reagan block grants turned out to have several positive effects. Three years after their passage, the grants had led to greater state flexibility in program design, lower administrative costs, little funding reduction in areas in which states already had significant spending, little redistribution of benefits away from the poor to the middle and upper income classes, and evidence of state capacity for efficient administration. Some income eligibility requirements were tightened, although changes in other criteria largely offset the resulting effects. These outcomes were basically the reverse of what critics had expected and occurred despite the fact that block granting was accompanied by a funding cut of 13 percent relative to the 1981 baseline.¹

Several additional elements fuel the new federalism. Although present in the Nixon and Reagan rounds, they are more prominent now and include the states’ rights movement, the bipartisan efforts to reduce the federal deficit, and states’ desires to gain more control over their budgets. The states’ rights movement points to the 10th Amendment of the Constitution, which states that “The powers not delegated to the United States by the Constitution, nor prohibited by it to the states, are reserved to the states respectively, or to the people.” States are concerned that their power to set policy and fund it has been sapped over time by the expansion of federal policymaking and taxing authority. Whereas in the 1960s public debate considered how to ensure equal treatment across states, leading to support for a prominent federal role in social program design and funding, today

¹This paragraph draws on George Peterson et al., The Reagan Block Grants: What Have We Learned? The Urban Institute Press, Washington, D.C., 1986, pp. 21–27. Because the assessment relied primarily on administrative data, little could be done to detect whether subtle adverse changes such as a decline in the quality of services had occurred.
states are concerned with efficiency and their authority to adapt programs to local conditions and preferences.

Federal deficit control, perennially acknowledged but postponed, now appears to be moving toward a credible bipartisan consensus. As both sides of Congress agree, deficit reduction will require significant cuts—upwards of 15 percent—in domestic programs. In view of the program pressures that will result, and the possible backlash from program constituencies, Congress is willing to provide greater authority to states to design and implement programs in exchange for states taking on the responsibility of doing so under reduced budgets. Finally, states seek to gain more control over their budgets. Control has been ebbing because of the imposition of unfunded federal mandates, which states and localities must pay for, and because of the growth in entitlement program costs. AFDC and Medicaid require states to match federal funds, and Medicaid costs have grown rapidly. The burden of unfunded mandates and matching requirements comes at a time when many states’ revenues are growing slowly and other needs are pressing, such as education and infrastructure. Block grants eliminate matching requirements and, once enacted, may be less subject to additional unfunded mandates.

Both states and the federal government foresee potential gains from block grants. States can gain greater policy autonomy and budget control. Even though block grants will come with federal guidance and at reduced funding, states will nevertheless have greater freedom to change eligibility requirements, devise programs that recognize the heterogeneity of program clientele (treat different groups differently), and influence the coordination of activities across agencies. For its part, the federal government should be able to make progress toward deficit reduction. Block grants will be funded at levels below the anticipated spending levels, and further, because block grants are fixed, the federal government will be relieved of responsibility to cover cost increases if states should broaden their program eligibility, increase benefits, or otherwise experience increased program participation and cost. Politically, federal legislators may deflect backlash from spending cuts by shifting program responsibility to states, and state legislators may gain strength by constructing programs better suited to the state’s economy and population.
In addition to the cost-cutting and decentralization aims, the proposed changes, particularly those in AFDC and Medicaid, have been motivated by social concerns related to deficiencies in program design. Advocates of change believe that AFDC provides weak incentives to work and encourages out-of-wedlock birth, marital dissolution, and welfare dependence. Medicaid has resulted in runaway cost growth and has been a major source of unfunded mandates through expansions. (In the 1980s Medicaid coverage was extended to disadvantaged pregnant women, children, and immigrants.) In addition, Medicaid has become a prominent indirect means of covering the health costs of the uninsured, and Medicaid contains weak incentives for providers to control cost. Training encompasses a large number of categorical programs that overlap in scope and clientele, and many training programs have not proven to be cost-effective. On net, this critique paints an image of programs that are too costly and, in the case of welfare-related programs, offer little incentive for personal responsibility and self-reliance.2

Much of the proposed new structure is controversial. Apparent political consensus exists on the desirability of federal expenditure reduction and program decentralization, and on the failure of current AFDC and Medicaid programs, but the size of reductions, the abandonment of national entitlements, and the proposed new program structures have by no means been agreed to.

The central fear of opponents is that the end of national entitlements will tear holes in the safety net through which many people in need, particularly children, will fall. Under current programs, the federal government guarantees some level of welfare and medical support to all who fall within defined categories of need. The block grant proposals turn over to the states decisions on who will be supported: Some states may continue or even expand entitlements similar to the current ones; others may drop them. The incentives for dropping or severe cutting are strong; federal funding will be cut, so that maintenance of standards in the face of rising caseloads or growing costs

will increasingly be born by state and local taxpayers. The incentives in any state will be to decrease benefits in the hope that recipients will perhaps move to a more generous locale, or—perhaps more likely—not be attracted from other states.

Additionally, the central objective of the proposed new welfare system, in conjunction with proposed changes in job training, is to get people off welfare and into work. This represents a striking shift from the original rationale of the federal welfare system—to allow mothers to stay home and take care of their children. Although today's goal of moving welfare recipients into work is now widely accepted, opponents doubt whether the new programs will achieve it any better than the old ones. Existing and past training programs have been at best marginally effective; reduced federal funding under the proposed programs will make more difficult the one support that many believe to be central to the transition from welfare to work: child care. Under these conditions, the effectiveness of the work incentives in the proposed welfare block grants is not clear.

Other criticisms of the block grant proposals are that they make little provision for cyclical and other changes over time that may increase overall needs and shift the allocation of needs among the states, and that they impose their own new federal rules on the states—for example, the proposal that a single mother under 18 be required to live with her parents and enroll in school or job training.

The next two sections of this chapter take up the proposals in more detail and describe some challenges the states will face if major provisions are eventually passed and implemented. The chapter then examines several specific issues for California and concludes with comments on the tension between devolution by means of block grants and protecting the safety net.

THE BLOCK GRANT PROPOSALS

The essays in this volume describe the AFDC, child care, child protection, Medicaid, and training block grants proposed by Congress in fall 1995 and discuss their consequences. We examine the proposals briefly here to show the flexibility they allow and the restrictions they impose, and to introduce some of the implications. The value of these proposals lies in illustrating the elements of the policy debate.
These elements are likely to reappear as the debate continues, though not in the exact form initially proposed.

The welfare block grant proposals include AFDC, child care, and child protection, and would replace a variety of current programs. AFDC is a federally supported entitlement program making available support to all children in qualifying female-headed families and families with two unemployed parents; support levels are determined by the state. Child care and child protection include a wide variety of entitlement programs such as school lunches.

Main features of the proposed block grants include

- two years' cash assistance while eligible for AFDC plus three more if working, for a lifetime limit of five years,
- a goal of 50 percent of single-parent family heads working by 2002, and 90 percent of two-parent family heads working sooner (by about 2000),
- no benefits for additional children born to welfare recipients,
- state can borrow from a federal contingency fund but must repay loan,
- food stamp eligibility and benefits can be changed by states so as to mesh better with AFDC changes,
- child protection, child and family services, and child care combined into block grants, whereas foster care remains an entitlement program, and
- nutrition programs combined into a block grant.

Medicaid currently provides federal funds for an entitlement program available to all those on AFDC and other low-income people. The House-proposed MediGrant block grant

- bases the grant amount on recent historical allocations,
- offers states increased flexibility to determine eligibility, benefits, and financing,
- allows experimentation with vouchers, fee-for-service, managed care, utilization controls, and the like, and
allows states to charge premiums and to impose deductibles and co-insurance (except for AFDC families below the poverty line).

Soon after this proposal was introduced, the National Governors’ Association suggested a modified version allowing some growth in grant size from year to year.

The proposed training block grants substitute not for entitlements but for a miscellany of narrowly categorical federally supported programs. The proposed block grants would:

- consolidate job training and vocational education programs,
- eliminate categorical eligibility on the basis of unemployment or disadvantaged status,
- require states to create “one-stop” career centers and maintain the Employment Service,
- emphasize accountability and performance standards, and
- allow some use of vouchers for training.

Compared with the House bill, the Senate bill offers considerable latitude to move funds between job training and vocational education. The Senate bill allows 25 percent for workforce employment activities, 25 percent for workforce training, and 50 percent for a flex account allocable by the governor.

**Welfare**

Many states have already begun to reform their AFDC programs through waivers that allow for the introduction of experimental changes for the purpose of evaluation. However, waivers offer only a temporary exemption from federal rules. Block grants allow states greater scope for change, and the successful changes can be kept at the state’s discretion. California, Missouri, Michigan, and Wisconsin are among the states seeking a vast restructuring of their AFDC systems, and the goals and provisions of the block grants are consistent with their ongoing activities.

Nevertheless, the loss of entitlement status, funding reduction, and work requirements pose difficult challenges. Meeting the 50 percent
and 90 percent working requirements will be hard because jobs may not be available, and although public sector jobs can be created, it will be costly.\textsuperscript{3} Job training programs have a history of limited success and can be expected to produce only small increases in wage and employability. If the goals are not met, states face the financial penalty of a 5 percent cut in their block grant. Thus, the inherent question facing states is whether the incremental cost of attaining the goals is less than or greater than the penalty—if the goal cost is too high, states will opt for the penalty. Even if they do, however, that would not necessarily slow down the existing efforts within many states to changes the terms of welfare, replacing an ongoing entitlement to those eligible with a reciprocal obligation involving public support in exchange for progress toward economic self-reliance.

Whether or not such self-reliance is achieved, the five-year lifetime limit means that the federal government would no longer be obligated to share in the cost of public support of children and other members of families with adults who, though able-bodied, have long-term dependency needs. Many of these families would transition onto General Assistance, the residual welfare program for those who do not fit into AFDC or other welfare categories. Since General Assistance receives no federal funds, the cost burden would shift to states and localities.

A shift from AFDC to block grants will thus create serious risks for the welfare population, foremost being the end of entitlements. Although General Assistance provides a secondary safety net, its benefit levels are often considerably lower. Children, in particular, may be severely disadvantaged. Nor is there any requirement that states and localities fully fund General Assistance. If they cannot or do not, it is not clear what the sources will be for final support to these family heads and their children.

\textsuperscript{3}About 50 percent of these family heads are on AFDC, and of them, about 15 percent are employed. Thus the work goal requires raising the percentage working from 15 percent to 50 percent. Among the 50 percent off AFDC, about 85 percent are employed. Robert Moffitt, "Incentive Effects of the U.S. Welfare System: A Review," \textit{The Journal of Economic Literature}, Vol. 30, No. 1, March 1992, pp. 11–14.
The preferred outcome of achieving self-reliance through employment, toward which the new programs aim, raises its own tough questions: Will additional education and training sufficiently increase skills and instill better work habits? Will child care and transportation be available? Will child care, Medicaid, and food stamps extend beyond welfare?\(^4\) Wisconsin, for instance, has determined that in its welfare reform, child care and Medicaid must be extended to all working poor, in part to maintain welfare family heads' incentive to transition to work; many other states have not yet developed an integrated perspective, thereby leaving welfare recipients to wonder about such bridge support. Further, child care funding will be reduced under block grants, but AFDC work requirements will increase the demand for child care. This leads some to wonder whether the quality of child care will diminish—and with it the positive effects of child care on children's development. Funding for family protective services will also be reduced under block grants, raising the possibility that cases of child abuse and neglect will more often be handled by removing the child from the family and opting for foster care, which remains an entitlement.

**Medicaid**

Like AFDC, the proposed Medicaid block grant proposal will reinforce efforts already under way to reform policy. As Medicaid costs have spiraled upward, states have sought ways to control cost growth. The Medicaid block grant provides states with the authority to employ tools such as utilization review, premiums, and deductibles and copayments that can be effective in controlling costs. In addition, the move toward managed care may accelerate, which would reduce the amount of indigent care given in costly hospital emergency rooms and outpatient clinics, and potentially offer more routine and preventive health care and better medical record management. Still, because of the fixed nature of block grants, states would assume the financial responsibility to cover cost increases, which in turn could create pressure to reduce the range of benefits and tighten eligibility. Tighter eligibility, depending on how it is im-

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plemented, could rub against the need to expand Medicaid coverage to include workers who transition from welfare into jobs that do not include health insurance. Another factor is that under the Medicaid entitlement program, Medicaid helps cover the health costs of the many uninsured who receive care at public hospitals, which perform a last-resort function for health care similar to that of General Assistance for welfare. Medicaid support for the uninsured would be eliminated under the proposed block grant.

Training

The gains to training from block grants may be small because the training reforms in 1973 and 1982 already consolidated many categorical training programs and decentralized their control to the local level. As part of those actions, private industry councils were created to develop training programs that coordinated training with employer needs. The fact that block grants will combine job training and vocational education may lead to little tangible difference, not only because past efforts have tried to link these two areas, but because training and vocational education serve different clientele and provide different services. Still, the Senate bill—with its 50 percent flex account—creates an opportunity for greater statewide coordination of job training, although without sacrificing the high degree of local control that now exists. This opens the possibility of meeting an employer’s needs by training provided in other communities, provided workers are willing to move to where the jobs are. The flex account should also make it easier to use training funds for the welfare-to-work transition.

IMPLEMENTATION CHALLENGES

To realize the potential of block grants, states and communities must work together on a host of activities. These include establishing and administering new or modified programs, allocating block grant and state funds across localities, evaluating policy options to determine the best policy approach, monitoring effectiveness and determining further improvements, sharing information to learn from one another, and—underpinning all of this—creating integrated data sys-
tems. All of this will take time to do, as is true of any large organizational change. State actions will have to lie within federal guidelines and goals (e.g., the work goals and time limit for welfare), and it is possible that by the time block grant legislation is finally approved, it will contain additional restrictions that make it seem more categorical in nature. States and localities will need to invest in their governance capacity, including planning and evaluation, personnel training, and data systems, and the funds for this investment will have to be found.

States must devise funding and financing strategies to cope with the end of entitlements. Once set, block grants do not adjust with changes in population, demographics, or economic conditions, all of which can vary across states and within states. Either the states and localities cover the added costs of contingencies or they reduce coverage, benefits, and quality of service. The situation is complicated by the slow growth of state revenues, the pressing needs for other uses of state funds—for example, investment in infrastructure and education, seen as essential to economic development—and the constraint of balanced budget requirements. All states but Vermont require an ex ante balancing of a state’s budget, thereby prohibiting, even during recessions, budgets intentionally based on deficit funding.

Block grants bring state/local relations to the fore. Block grants provide new opportunities to integrate programs and rethink social service delivery, and states will have to provide strategic thinking as well as incentives for cooperation and integration, or else the existing stovepipe structure of social programs will remain. However, block grants come to the states, and their political incentive may be to re-

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5Nathan urges states to provide common access to social services and develop integrated data systems. "If states really linked up their data systems for welfare, jobs, social services, and health by requiring state agencies to share data for these programs, the new world of social program management would never be the same again. Instead of top-down coordination that agencies and interest groups fight and defeat, put the data together to create one-stop systems for social services." Richard Nathan, Hard Road Ahead: Block Grants and the "Devolution Revolution," The Nelson A. Rockefeller Institute of Government, Albany, New York, 1995, pp. 21–22.

6Block grant formulas could be devised to adjust for these factors, but even with adjustments block grants are unlikely to vary closely with the size of the eligible population or its costs.
tain control of funds but push down responsibility for implementation. This could thwart local innovation and remove a potential gain from devolution, namely, making greater use of local knowledge for structuring and administering local programs.

Indeed, local agencies are wary of more responsibility without more resources. States could impede local efforts by adding new restrictions and accountability requirements, finding ways to divert block grant funds to other uses and reducing state safety net spending. Block grants remove state matching requirements for AFDC and Medicaid, and the proposed maintenance of effort requirements are fairly weak; that is, they give states latitude to shift state dollars to other uses. State balanced budget amendments, too, raise the specter of cuts in funding to localities.

State concerns about block grants are to some extent related to the cuts in federal funding they will bring. If block grants brought states new flexibility without funding cuts, the potential adverse consequences would abate, although not disappear. Similarly, the opportunities for successful and rapid implementation would potentially increase.

CALIFORNIA

Over the last two decades, California voters have used the initiative/referendum process to make it more difficult for the state and its localities to raise revenues by taxation. In particular, Proposition 13, passed in 1978, limited both state and local taxing powers. Ten years later, Proposition 98 constrained the governor's and legislature's ability to allocate state spending among functions. As a consequence of these enactments and some older peculiarities of state/local governance, the block grant proposals will present California with some special difficulties.

- A common principle of governance is that authority and resources be placed at the same level. In California, Proposition 13 has shifted revenue-raising power away from localities and to the

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7 However, as mentioned, there was little evidence of reduced state funding under the Reagan block grants. See Peterson et al., pp. 21–27.
state. The proposition limited property tax to 1 percent of property value (sale price) plus a growth factor not to exceed 2 percent per year. In addition, it required two-thirds legislative or referendum majorities to increase taxes at state and local levels, respectively. These provisions sharply reduced California localities' ability to raise revenues.

- For almost 15 years after the 1978 passage of Proposition 13, the state budget included substantial compensatory fund transfers to the counties as well as other localities. With the passage in 1988 of Proposition 98, which dedicated a fixed percentage of state general revenues to K–14 education, however, state subsidies to local governments became more difficult. In the early 1990s, California had a fiscal crunch, caused in large measure by the national recession and the deep spending cuts in defense aerospace. Operating in conjunction with Proposition 98, the crunch led the state to reverse course, abruptly reducing fund transfers to the counties and cities and causing major crises in several of them, including Los Angeles. In particular, in 1992–1993 and 1993–1994, $3.9 billion of property tax was shifted to schools and away from counties, cities, redevelopment agencies, and special districts.\(^8\) Localities' limited fund-raising ability and the end of state compensatory funding have created extremely tight fiscal straits for them. This heightens their concern that under the new fiscal federalism they not be left with more responsibility and fewer resources, and further, that some means of contingency funding be established for downside risks. Such risks could come from unexpected population growth, widespread recession, local recession, epidemics, and so on. Benefit coverage for immigrants, documented and undocumented, remains another factor for localities to watch (and is also part of the continuing federal debate about program reforms).

- Given the political near-impossibility of rescinding Proposition 13, California has increasingly turned to special districts to fund public services. In particular, nonenterprise special districts rely upon tax and assessment revenues to finance service delivery in

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\(^8\) CAL FACTS, Legislative Analyst's Office; January 1996, p. 23.
fire protection, flood control, air pollution control, and many other functions. Today, nearly one-fourth of all state revenues come from special revenue funds. California may need to investigate the possibility of creating special districts to fund social services, viewing the latter as serving the community at large. (The Jarvis Gann group, which fostered the passage of Proposition 13, is now seeking to qualify a ballot measure for the November 1996 elections to require a vote of the electorate for any new assessments, including those that would fund special districts.) In a related vein, California might also consider outsourcing service delivery as a possible means of reducing administrative cost and increasing efficiency, as suggested at the Conference.

- In California, General Assistance is financed by the county, unlike most states. The General Assistance caseload could swell because of the AFDC five-year limit and add greatly to counties’ fiscal burden. In effect, this would constitute a shift of responsibility to the county but without the resources; AFDC agencies would have the incentive to devote their efforts to the most employable and allow the least employable to exhaust their five-year limit and become wards of the county. To avoid this, state and local officials at the Conference suggested that General Assistance become a state responsibility, thereby integrating this program and its funding burden with that of AFDC.

- California has relied on Medicaid to pay a significant portion of caring for the uninsured population, more than other states. As a result, California will be especially hard hit if and when this funding is ended under a Medicaid block grant. California will need to develop an alternative strategy and funding source for the uninsured.

- Relative to other states, California’s cost per Medicaid enrollee is quite low. However, California could be heavily penalized for its success in controlling costs if the Medicaid block grant is based strictly on recent historical expenditures. For this reason, California has reason to follow closely the debate over the Medicaid block grant allocation formula.

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9 CAL. FACTS, pp. 26–27.
The property tax limitations of Proposition 13 remain highly popular in California, apparently even among those who have purchased property since its passage and are thus liable for much higher taxes than their long-resident neighbors. These limitations are therefore considered politically untouchable, although some advocates of more fiscal flexibility believe that the supermajority requirements for increasing other taxes might be relaxed. It is not clear whether the state’s constitutional revision commission will recommend this, even in the context of an overhaul of California’s basic law, which has been laid down over an 80-year period under the initiative/referendum process introduced by reform governor Hiram Johnson.

LOOKING AHEAD

The debate over the new fiscal federalism has delineated the tension between devolving greater authority to the states by means of block grants and maintaining the strength and resiliency of the safety net by means of the entitlement concept. Block grants can help the federal government reduce cost growth and thereby lower the deficit, but the end of entitlements spells the end of federally underwritten, open-ended support available to all eligible persons among the nation’s disadvantaged.

Compromise between these positions, should it occur, might take the form of constrained entitlements, that is, maintaining the federal entitlement concept but with changes in program structure that control usage and limit cost growth. There is seemingly much common ground in welfare and Medicaid. President Clinton, having vetoed the congressional welfare reform bill, nevertheless shares much of the Republican position, agreeing that AFDC should have a lifetime limit, emphasize work and economic self-reliance, and promote strong families and personal responsibility. Similarly, both the Administration and the Congress favor limiting the cost growth of Medicaid. The agreements in welfare represent possible steps toward overall compromise; the interest among federal legislators in Medicaid demand- and cost-limiting measures such as managed care, utilization review, and premiums also indicates room to compromise. Limiting individual entitlements to welfare does not fix a cap on total welfare expenditures, meaning that federal funds would
be available to support expanded caseloads during a recession. And the Medicaid measures do not eliminate the entitlement concept but rather constrain its cost.

However, maintaining the entitlement concept, even with constraints, is at odds with devolving authority to the states. Entitlements require the federal government to bear major funding liability, rather than capping it as block grants would, and history suggests that so long as it bears the brunt of the funding liability, the federal government will want to retain considerable control. Thus, the preservation of entitlements may be tantamount to retaining federal control over the AFDC and Medicaid programs, which is contrary to what states’ righters seek. States then would neither be able to achieve the full decisionmaking authority and budget control they would like nor correct the structural flaws they see in these programs.

Additional flexibility might be gained by maintaining entitlements, but rewriting the rules of AFDC and Medicaid to allow greater state autonomy in program design and execution, perhaps with periodic federal review and a mechanism to assess program effectiveness and cost. That would allow states to explore alternative program structures; and if done under broad federal rules and the continuation of entitlements (albeit constrained), the interests of the disadvantaged would be protected. States would have more opportunity to tailor programs as they see fit and not be constrained by the temporary nature of waivers; waiver periods might be made longer. By keeping the entitlement concept and requiring evaluation, this approach also alleviates concern about the untried nature of state programs. Although states want more control, it is nevertheless true that it has not been made clear how they will handle contingencies not under their control that increase the demand for safety net support; retaining entitlements helps alleviate this concern. Further, as with any significant change in program goals or operation, uncertainty exists about how effective the state programs will be in moving people off welfare and not jeopardizing child well-being; again, entitlements provide assurance that an increase in the number disadvantaged families will not result in their being underserved by the new system.

Lacking such a compromise on constrained entitlements, advocates of block grants need to devote more effort to clarifying how they will
handle contingencies and how their programs will maintain a strong safety net even with reduced federal funding. Building this case should help them gain support for passage of the devolution agenda, whereas not building it may weaken their cause. Additionally, with regard to Medicaid and child care, the states and the federal government must consider whether to extend these benefits to all working poor—eliminating the abrupt benefit loss when leaving welfare and extending health coverage to the uninsured—and how to pay the added costs of doing so. This is an important complication because of its intimate relation to the prospects for moving people off welfare and into work.

Finally, local governments, agencies, and institutions have so far been the state’s quiet partners in the new fiscal federalism, but their role is critical to its success. Their challenges will include contributing to the development of new program goals, procedures, and incentives, ensuring that resources accompany responsibility, and investing in governance capacity including integrated data systems. The debate over federalism should be enlarged to ask what authority localities will have to innovate in program design and integration, and to allay concern that localities will find themselves hampered by new state regulations.
Although reform legislation has not been finalized, it is clear that the 104th Congress intended to consolidate separate federal programs within a variety of broad domestic policy areas, including welfare, Medicaid, transportation, and job training. The elimination of categorical programs and increasing reliance on block grants pose significant challenges to state and local governments, which will need to develop new capabilities to establish and administer programs, allocate funds, evaluate policy options, and demonstrate program effectiveness. For example, in some versions of welfare reform, administrative burdens and associated costs might be shifted to states and communities at the same time that overall funding levels for programs are reduced. Longer-term budgetary pressures would increase further if the revision of "entitlements" provisions means that federal funding levels become less responsive to increased needs of the local populations. For example, legal noncitizen populations in the United States less than five years would not be eligible for certain welfare payments, or overall funding levels may not adjust on the basis of changes in the numbers of eligible populations. As a result, states will wish to adopt programs that do not induce relocation of individuals seeking higher benefit levels. Finally, if state budgets are fixed in the short run and the demand for assistance increases, states will need to ration limited funding by lowering benefits, limiting the duration of program eligibility for individual families, or denying benefits to some population segments.
Despite these challenges, the devolution of government and the emphasis on local control over the design and execution of social programs create a unique opportunity to reinvent the manner in which such services are provided. In particular, states and communities have an opportunity to restructure and coordinate the current array of aid programs to make them more consistent and effective in serving the needs of families. If they become less encumbered by federal restrictions, states will be able to tailor social service efforts, make policy tradeoffs that are based on cost-benefit criteria, and approach regional and local problems in a strategic rather than piecemeal fashion.

For this to happen, state and community leaders will have to think about social services in a whole new way. They will have to abandon "stove-pipe" approaches to policymaking, restructure social service agencies, and collaborate across traditional policy domains in order to make sound decisions. In addition, they will have to develop institutional mechanisms for creating and sharing information, establishing oversight, and evaluating alternative policy options. The greatest challenge, however, may come from the need to define overall strategic goals, without which an integrated strategy cannot be designed and implemented effectively.

In this paper, we first provide a brief description of the existing welfare program as well as other social services that have administrative links (for example, via eligibility requirements) or otherwise serve the same or overlapping populations. We then review the most recent versions of legislation and describe the key programmatic attributes that are likely to emerge. Next, we identify some of the most important issues that states and communities will have to address in response. We conclude with a discussion of some of the more interesting options already adopted by some states and review the available evidence concerning the likely efficacy of alternative approaches to welfare reform.

CURRENT SYSTEM OF ASSISTANCE

Established in 1935, Aid to Families with Dependent Children (AFDC) provides cash grants to needy children under the age of 18 whose families cannot meet their basic needs. When AFDC was established, assistance was meant primarily for single mothers who
had been widowed or whose husbands had abandoned them. At that
time, it was expected that a mother’s primary responsibility was to
work in the home, including raising her children, and the AFDC cash
grant allowed a single mother to do just that. Today, the norms and
expectations are quite different. While only 25 percent of working-
age women were employed outside the home in 1930, current levels
of labor force participation are about 70 percent (Bureau of Labor
Statistics, 1996). Moreover, today over 50 percent of mothers partici-
piate in the formal labor market within six months of childbirth
(Klerman and Leibowitz, 1993). Perhaps more important, the pre-
vailing wisdom is that rising caseloads and long average duration of
welfare dependence are directly the result of incorrect personal in-
centives that stem from the design of social programs. Thus, it is
widely believed that single mothers (or both parents in two-parent
households) should not be perennially insulated from the need to
support their family via cash assistance, but instead be encouraged
to work outside the household and take responsibility for their own
well-being.

Families qualify for AFDC under one of two categories: AFDC-FG
(i.e., Family Group), which consists of single-parent families, and
AFDC-U (i.e., Unemployed Parent), which consists of two-parent
households in which at least one parent is unemployed. Currently,
in California, only about 15 percent of the AFDC caseload qualifies
for assistance under the AFDC-U category. However, cash grants are
typically higher to those in the AFDC-U category because these fami-
lies are larger and therefore have greater need. As a result, assistance
to AFDC-U households accounts for about 25 percent of all cash
grants made through the AFDC program. In total, approximately
907,000 households, or 2,660,000 individuals, received AFDC assist-
ance in California in August 1995, which is 8.3 percent of the state’s
population (California Department of Social Services, 1995a).

Eligibility and the amount of assistance received under AFDC is
determined by a number of factors that are set by each state. In
California, the amount of assistance increases by roughly $100 per
month for each additional child in the family, and the benefits de-
crease (on a dollar-for-dollar basis) with the amount of labor market
income earned by the mother. Applicants are not eligible if they hold
assets of more than $1000 (excluding their home and the value of
their car up to $1500), and many children are not eligible if both the mother and father live with the child.

In California, the maximum benefit for a mother with two children is $607 per month in cash assistance plus an additional grant of about $214 in food stamps, totaling approximately $9852 annually. Although these combined benefits still leave the family’s income about 15 percent below the poverty line, they are higher than the benefits in all but three states. The median maximum combined AFDC and food stamp payments across all states is $7932 annually. However, California is a state with a relatively high cost of living. Compared with New York, a state that probably has a similar cost of living, California’s benefits are about the same.\(^1\) It is worth noting, however, that while in the average state the maximum benefit has decreased by 47 percent (in real terms) over the past 25 years, California’s benefits have eroded by only 13 percent, which is the lowest decline registered among all states. However, between 1989–1990 and 1995–1996, the maximum benefit fell by 26 percent, so that changes in benefits in the last five years have been distinct from the changes in the earlier period (U.S. House of Representatives, 1995).

In California, the federal, state, and local governments all play a role in the AFDC program. The federal government prescribes overall rules regarding eligibility, benefit standards, and administrative requirements for the program. The state provides additional administrative guidelines, sets benefit levels, and allocates state and federal money to counties. California is one of a minority of states in which local governments also play a significant role in welfare delivery, with counties being responsible for implementing and delivering the services to applicants.

The cost of the program in California is shared by all three levels of government. In California, the federal government pays 50 percent of the costs of the benefit payments and administration of the program.\(^2\) California’s 50 percent contribution is the highest in the na-

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1. Unfortunately there is no accurate measure of state-level cost-of-living differences that would allow us to make reliable adjustments across states.

2. Administrative expenses represent about 8 percent of all AFDC-related costs in California. This compares with the U.S. average of just over 11 percent, primarily reflecting California’s higher level of benefits per capita.
tion, with other states averaging 46 percent. States with the lowest per-capita income receive as much as 80 percent of the benefit costs from the federal government. Out of expenditures not reimbursed by the federal government, counties contribute 5 percent of benefit payments (primarily for special assistance) and 30 percent of local administrative costs. The state pays for 100 percent of the administrative expenses incurred at the state level that are not reimbursed by the federal government. In total, government expenditures on AFDC in California were about $6.7 billion in 1995, with about 50 percent, 46 percent, and four percent derived from federal, state, and local funds, respectively (U.S. House of Representatives, 1995).

The AFDC program serves a wide array of people in different predicaments. About 75 percent of all new episodes of welfare dependence were precipitated by a personal “event” such as the birth of a child (30 percent) or the loss of a spouse (45 percent were the result of a divorce or separation). The average age of single mothers on AFDC in California is 31, and only 3.3 percent of the mothers are currently teenagers. However, national estimates suggest that almost one-half of all AFDC recipients had a teen birth (Maynard, 1994). Forty-one percent of current participants have just one child, and only 11.2 percent have more than three children, which is counter to the myth that AFDC recipients have unusually large numbers of children (California Department of Social Services, 1995b). About one-half of AFDC recipients nationally have less than a high school degree, and 40 percent did not work at all in the previous two years (Ellwood, 1986).

One-quarter of California’s population is foreign-born and about 17 percent are not U.S. citizens, which has unique ramifications for the state’s AFDC program. About 10 percent of persons in the AFDC-FG assistance units are not U.S. citizens, while among AFDC-U assistance units the share is 31.2 percent. In addition, approximately 30 percent of recipients do not speak English as their primary language. Thirty percent of recipients are (non-Hispanic) white, while 37 percent are Hispanic, 18 percent are black, and the remainder come from a variety of other ethnic backgrounds (California Department of Social Services, 1995b).

AFDC is the primary source of cash income for most participants, with only 17 percent of California recipients reporting cash income
from other sources (California Department of Social Services, 1995b). Some mothers physically cannot work—an estimated 19 percent report that a disability limits their ability to work (Ellwood, 1986). This is an important factor when considering that the proposed federal legislation requires that at least 50 percent of AFDC-FG recipients work, and that many of these families may not be eligible for aid after receiving assistance for five years in total over their lifetimes. At the same time, about one-half of AFDC recipients use the program for more than five years during their lifetimes, and 30 percent are on for eight or more. Just 30 percent of all recipients are enrolled for less than two years over their lifetimes (Ellwood, 1986). In addition, counter to popular belief, although caseloads have increased nationally, the length of time that participants remain enrolled in AFDC has, if anything, decreased between the early 1970s and late 1980s (which is the latest available data), and there is no evidence that the duration of welfare use among long-term users has increased (Hoynes and MaCurdy, 1993).

Most AFDC participants are also affected by other government programs. All states are required to maintain a job opportunities and basic skills program, whose purpose is to facilitate transition off welfare and into the workforce. In California, this program is called Greater Avenues for Independence, and the monthly GAIN caseload in 1995 was estimated at 78,000 (California Department of Social Services, 1996). Families receiving AFDC are automatically eligible for Medi-Cal, which is California's version of Medicaid. Although the bulk (about 75 percent) of the $89 billion cost of Medicaid goes to paying for the long-term care of disabled and elderly populations, this program also provides basic health care for 26 million poor individuals nationally, including all AFDC recipients. Some 85 to 90 percent of California AFDC recipients participate in the federal food stamp program, increasing the basic package of assistance (i.e., cash assistance plus food stamps) by about 30 percent (California Department of Social Services, 1995b). Child care assistance is also available, with the government covering up to 75 percent of the re-

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3 Most versions of welfare reform allow for some percentage of the population (e.g., those with disabilities) to be exempt from the limitations on duration. However, the allowable percentage is likely to be significantly less than 19 percent.
gional market rate for child care (California Department of Social Services, 1996).

Although the federal government sets basic AFDC guidelines, since 1962 the law (Section 115 of the Social Security Act) has given states the option to apply for waivers that have allowed them to experiment with alternative AFDC structures. As a result, welfare reform has been implemented, albeit at a limited level, in a large number of states. California, in particular, has been granted a number of waivers. For example, one waiver increases the asset limit from $1000 to $2000, permits families to own an automobile valued at $4500 instead of just $1500, and allows families to retain up to $5000 in a restricted savings account. Money from the savings account can be withdrawn only for the purchase of a home, education of children in the assistance unit, or to start a new business. Another waiver allows California to reduce benefits for recipients who can be expected to work (e.g., those without disabilities). In addition, to stimulate work the waiver increases the earnings disregard and removes the limitation on two-parent families working more than 100 hours per month. A waiver has also been received that ties benefit levels to schooling performance. Under the Cal-LEARN program, pregnant and parenting teens receive rewards for completing high school and receiving good grades.

IMPENDING CHANGES IN THE WELFARE SYSTEM

As of this writing, the nature of the federal legislation that will finally emerge remains uncertain. However, the House and Senate Conference Committee has agreed to a reform proposal that was passed by the House on December 21 and the Senate on December 22, 1995. Although President Clinton vetoed the bill on January 9, 1996, he has agreed to many of the fundamental aspects of the proposed overhaul. Thus, the system that eventually emerges will probably have many of the characteristics of the Conference Committee agreement. The following are the most important elements.

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4It is worth noting that the political clamor for welfare reform is pervasive at all levels of government. As our earlier discussion suggests, several states have received federal waivers and are initiating the process of change in advance of the federal legislation.
CASH WELFARE ASSISTANCE

Structure of Grants and Eligibility Requirements

- Cash welfare assistance that has historically been distributed through the AFDC program as an entitlement will be turned into a block grant allocation to states, called the Temporary Assistance for Needy Families Block Grant.

- Welfare eligibility, except for a minority of cases (up to 15 percent of caseload) experiencing unusual hardship, will be restricted to a cumulative lifetime total of no more than two years of cash assistance without working. Individuals can receive no more than an additional three years of benefits if they work in either a subsidized private sector job or a public sector job. It is currently estimated that 70 percent of AFDC participants use welfare for more than two years over their lifetimes, and 45 percent are enrolled for more than five years (Ellwood, 1986). Therefore, a large share of recipients are likely to be affected by the time limits.

- Over time, an increasing percentage of welfare recipients in each state will be required to engage in work-related activities. For example, among all families participating in the program, adults in 15 percent of families must be working in 1996, increasing by about 5 percentage points in each year until the year 2002, when 50 percent of single parents receiving cash subsidies must be working. Among two-parent families receiving cash assistance, 90 percent of families must have at least one working family member by 1999. Those states whose caseloads do not satisfy the work requirements will have grants reduced by 5 percent.

- States must deny benefits to single mothers under age 18 unless the mother lives with her parents or in a supervised setting and is enrolled in school or a training program.

Thus, these issues have current relevance even if the welfare reform bills remain bogged down.

5The work requirements will be reduced (on a percentage-for-percentage basis) for states that successfully get families off public assistance. If this were not the case, states would be penalized if the most employable individuals left the welfare roles, thereby making it more difficult to meet federal targets for work participation.
• Cash benefits cannot be increased if a mother has an additional child while receiving welfare, unless the birth is due to rape or incest. However, there is a state “opt-out,” so any state can pass a law overturning this prohibition.

• Applicants who have resided in the state for less than 12 months can be subject to more-stringent eligibility criteria and benefit levels. For example, benefits are likely to be limited to those available in the previous place of residence. Thus, individuals would have less incentive to migrate in search of higher welfare benefits.

• Parents must assist in determining paternity in order to maintain their cash assistance, unless contacting the father may lead to harmful consequences for the mother or child.

**Level of Funding to States, and State Requirements and Opportunities**

• The amount of federal assistance that a state receives will be the higher of the funding levels from 1995, 1994, or the average of 1992–1994.

• Over the first five years of implementation, federal funds for welfare, including AFDC, SSI, and food stamps, can be expected to decline in real terms for many states. This is because there will be no adjustment for inflation or for increases in populations who would have been eligible under previous rules (e.g., noncitizens).

• Higher funding will be awarded to those states that decrease their abortion and illegitimacy rates. If illegitimacy declines by at least 1 percent (2 percent) and the abortion rate declines, then the state will receive an additional 5 percent (10 percent) in welfare block grants.

• Funding allocations will not be very responsive to future changes in local economies and/or populations. In other words, increases in “need” will not be met with equivalent increases in funding. However, if California has population growth higher than the average across all states, or its population grew by 10 percent or more between 1990 and 1994 (which California’s did
not—it grew by 7.2 percent), or its welfare spending per poor person in the state is less than the national average (which it is not), then it will receive an additional 2.5 percent in federal grants.

- States will be able to borrow from a federal contingency fund (for an amount up to 20 percent of total state welfare expenditures) in order to provide welfare services if the state is experiencing financial difficulties; the loan must be repaid with interest. States are also permitted to save an unlimited amount of their block grant funds for use in later years.

- States must establish an electronic data tracking system that will allow them to determine the total lifetime benefits received by all applicants and recipients. This must include information on receipt of benefits in other states and the applicant's immigration status, including the date at which an immigrant became a citizen.

- In general, some program requirements for design and administrative reporting may be eliminated, giving states opportunities to consolidate, avoid redundant administrative costs, and design innovative programs that are more cost-effective and provide target populations with better incentives to reduce their dependence on government subsidies in the short and long run.

**CHANGES IN OTHER SOCIAL SERVICES**

The changes in assistance to the poor are not restricted to modifications of the cash assistance program. For example, eligibility requirements for food stamps are currently the same across all states, but the legislation permits non-uniform standards of eligibility. However, federal costs of any new state food stamp plan must not exceed previous federal costs (after adjusting for changes in the cost of the Thrifty Food Plan). States will also have the option to receive food stamp funds through a block grant, with the requirement that they establish an electronic benefit transfer system. Able-bodied beneficiaries 18 to 50 years old who do not have dependents would have to work to receive assistance.

Various nutrition programs (e.g., the National School Lunch and Breakfast programs and Women Infants and Children program) are
currently provided by the federal government as entitlements to low-income children and adults. States determine the income eligibility guidelines (within federally mandated limits). Much of the assistance is in the form of actual food items or nutritional screening services. The conference agreement makes no cuts in school lunch or school breakfast programs and maintains the Women, Infants, and Children program. However, it does allow as many as seven states to receive their allocations in the form of nutrition block grants.

Supplemental Security Income (SSI) will remain a federal program (with optional state supplementation), but it will undergo change. Individuals who are currently eligible for SSI assistance because of drug or alcohol addiction will no longer receive benefits. The eligibility requirements for children are likely to change, perhaps reducing the number of eligible children. In addition, parents’ resources will not be counted against children in determining their eligibility. Currently, unless a child is institutionalized, the parents’ income is counted against the child, which provides an incentive for parents to move their children into institutionalized care.

Child support enforcement will continue as a matching grant program, with the federal government currently reimbursing each state 66 percent of the costs of administering its Child Support Enforcement program. (Ninety percent of the states’ costs for developing and improving management information systems is reimbursed by the federal government.) The conference agreement will permit states to withhold, suspend, or restrict the use of driver’s licenses, professional or occupational licenses, and recreational licenses of people not abiding by child support laws. Passports will be refused to those owing $5000 or more. The agreement expands the Federal Parent Locator Service to better track down deadbeat parents. In addition, states must establish an Automated Case Registry for each case in which services are provided, including the names, Social Security numbers, and dates of birth of both parents. States would also be required to work with financial institutions to retrieve financial data on delinquent child support payers. A lien may be placed on the assets held by the institution. Those who owe child support will not be eligible for food stamps.

Under child protection services, foster care and adoption maintenance payments remain open-ended entitlement programs receiving
matching funding from the federal government. A Child Protection Block Grant will focus on prevention of abuse and services to abused children. A Child and Family Services Block Grant will be established to replace the Child Abuse Prevention and Treatment Act, the Abandoned Infants Assistance Act, adoption opportunities under the Child Abuse Prevention and Treatment and Adoption Reform Act, family support centers under the McKinney Homeless Assistance Act, and the temporary Child Care and Crisis Nurseries Act. Federal funding for the block grants will increase from $2.047 billion in 1987 to $2.766 billion in 2002. Each state’s share of these resources will be determined by the share they have received historically. Clearly, this will hurt states that experience an increase in eligible populations.

Finally, for child care, a Child Care Block Grant will be established as part of the Child Care and Development Block Grant (CCDBG). As in other block grants, each state will receive a grant equal in size to the amount it currently receives from the total of AFDC Child Care, transitional Child Care, and At-Risk Child Care programs.

Benefits and eligibility for immigrants will be reduced in most social service programs. Legal resident aliens and those arriving after the enactment of the legislation may not receive SSI or food stamps unless they have worked in the United States for 10 years or until they receive citizenship. States will have the option of providing benefits to legal aliens under the Temporary Assistance for Needy Families Block Grant, Medicaid, and Title XX programs. Legal noncitizens arriving in the future will be denied benefits under all federal means-tested programs (except emergency medical services under Medicaid, short-term emergency disaster relief, school lunch, foster care and adoption, and immunization) for five years after their entry into the United States. (Refugees, asylees, veterans, and those working in the United States for at least 10 years are exempted.) Those who remain legal noncitizens after being in the United States five years will continue to be denied SSI and food stamps; states will have the option of providing these immigrants with cash welfare and Medicaid and Title XX services.

As indicated earlier, Medicaid is viewed as an entitlement, providing basic health care coverage to poor children, including all AFDC recipients. However, recent proposals seek to limit Medicaid costs, which have grown over 400 percent since 1985. By giving states
lump-sum block grants, future funding is expected to be limited even though demand for services is likely to grow along with eligible populations of destitute children. Also, as insurance coverage via private sector employment is reduced, many more children of employed parents will require Medicaid. State options to save money include reducing benefits, reducing eligible populations, and mandating (or encouraging) employer-based coverage. In the face of budget pressures, states are more likely to maintain coverage for the very poor, nonworking families. In contrast, the benefits received by poor working families are more vulnerable to reduction or eventual elimination. This could enhance the attractiveness of AFDC relative to employment, thereby working against the reform goals of reducing long-term dependence by encouraging welfare recipients to work.

ISSUES FACING THE STATE AND LOCALITIES

Federal Reform Includes Reduced Funding

These likely elements of change will create several challenges for California. One of the most salient issues is that block grants will go hand-in-hand with significantly lower funding levels in the long run. Although future allocations to states will be set at the highest level of recent years, inflation will quickly erode the purchasing power of these payments and the funding level will not increase, even if the demand for services or the cost of providing them continue to increase in the future. If California agencies maintain “business as usual” at the very least they will have to reduce the amount of services provided, increase revenues, or reallocate funds from other components of their budgets. California’s Legislative Analyst’s Office estimates that, relative to projections under the status quo, the congressional welfare reform legislation would cost the state $8 billion in federal aid for AFDC, SSI, and food stamps over the next five years. This represents about 20 percent of the total budget for these programs.

California and all other states will not have the incentive to supplement cash welfare funding at the same level as they have in the past. In the past, the federal government matched state funding levels. As indicated earlier, the match was between 50 to 80 percent, depending on the income of the state. This match disappears under block
granting, which implicitly increases the state’s price of an additional dollar of welfare spending and might be expected to lead to a decrease in the amount of assistance the state wishes to allocate to welfare. In the past, Governor Wilson has sought decreases in benefits through waivers, and the reduction in federal requirements may provide some opportunity to make these changes. On the other hand, there is currently a requirement that states must spend at least 75 percent of their 1994 level of spending; states that are most successful in moving families off of welfare will be allowed to reduce spending below 75 percent.

**Will the State Plan for “Rainy Days”?**

The amount of future federal funding to states will be based primarily on current funding levels. Except to a limited degree, changes in federal funding streams will not adjust in the face of demographic or economic trends experienced at the state level. As a consequence, states will have to shoulder the burden of planning for contingencies. This could be problematic if, for example, caseloads increase substantially during a recession and if the states do not have the resources or budget flexibility to serve many of those in need. Most of the federal legislative proposals do allow for some adjustment for states experiencing larger-than-average population increases or increases in unemployment. There are also mechanisms (similar to a “loan bank”) for adjusting the funding stream in response to cyclical fluctuations in need. However, under the proposed formulas for adjustment, federal funding will not be as elastic as the potential change in need under plausible scenarios likely to affect many states, and these “loans” must be repaid.

**Will Programs be Integrated?**

It is clear that the new regime will require more comprehensive approaches to both policymaking and service delivery. At the very

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6In theory, the total effect of reform on the level of state-provided funding is uncertain. In the past, states have generally not altered funding levels in response to federal budget cuts. Of course, if the state is truly given more flexibility to design more innovative programs, the resulting gains in effectiveness could lead to increases in supplemental funding.
least, the replacement of categorical programs with more-flexible (albeit lower-level) block grant funding will require states to consider broader cost-benefit tradeoffs and will provide unique opportunities to consider systemic, coordinated approaches to program design. In addition, states will have new incentives to develop overarching strategic plans. Moreover, many of the mandated changes in the structure of particular programs will have important implications that transcend narrow domains or individual agencies. For example, the more optimistic goals regarding time-limitation and work requirements for welfare will be unattainable without coordinated efforts to facilitate the transition to work. To meet federal mandates, effective JOBS (Job Opportunities and Basic Skills) programs, alternative health insurance coverage, daycare options, and transportation to work will have to be available. In addition, many of the proposed program attributes, including work requirements, time limitations, and restrictions on eligibility for immigrants, could leave many populations, especially children, without a safety net. States may wish to design alternative means of providing benefits in such circumstances.

Currently, state agencies are structured and organized to parallel the narrow and restricted funding streams provided by the federal government. State and local agencies are, for the most part, charged with implementing predetermined policies and adhering to a cumbersome set of administrative regulations. State and local officials are mostly concerned with following the rules, avoiding risk, counting the number of families served, and keeping the federal funding flowing. There is little room for innovation, coordinated service delivery, new program design and evaluation, or comprehensive strategic planning across traditional functional domains. However, if states are to meet the new challenges and opportunities posed by block grants, fundamental reform must be made in the way social services are provided. This will require enhanced flows of information, new decision rules, and broader criteria for evaluating policy options. At the very least, California will have to establish new mechanisms for facilitating interactions across programs and make complex decisions based on multiple, often conflicting objectives. It is likely that organizational barriers, bureaucratic inertia, and deeply imbedded cultural resistance will make the requisite changes difficult to accomplish without a complete restructuring of social service
agencies and the way in which they conduct their business. Unfortunately, there are no obvious examples of comprehensive reform of similar organizations that could provide a useful blueprint for implementing such dramatic change.

**What Decisions Will be Passed on to Localities?**

States will have to determine how much of the resources and control will be passed on to local communities and counties. In the past, the design of federal programs left relatively little discretion to the state and local governments. However, increased flexibility over program design, eligibility, and funding allocations will require another level of decisionmaking that could well lead to new conflicts. In particular, state and local communities will need to decide how control over social services will be distributed between Sacramento and local communities. What is the likely regional distribution of welfare money under block grants? Counties and local communities that have political leverage are likely to receive greater resources. If urban perspectives are better represented at the national level, then one might expect that there will be a shifting of resources from cities to rural or suburban areas.

One of the attractions of the legislation is that it moves the decision-making closer to the problem, which will hopefully lead to more innovative and effective policies. However, it is not clear that the state government will be much better in addressing California’s problems. California is a large, diverse state whose needy population has differing problems. Perhaps the decisionmaking needs to be shifted down to a lower level, but it is unlikely that the state legislature will willingly give up control. As a result, tension between California and the federal government may simply be replaced by the tension between Sacramento and the localities.

California is one of a handful of states in which local communities are currently involved in the welfare delivery system, which can be an asset for the state. However, if local agencies currently implement federal policies merely as part of a bureaucracy—a way of doing business that will need to be overhauled, their involvement may be viewed as an additional barrier to effective reform. Whether the state will build on this existing infrastructure to meet its goals remains an open question. Alternatively, perhaps other institutions, such as pri-
vate organizations, would be better suited to contract with the state to deliver welfare services.

**Database Infrastructure Must be Built**

In order to meet new federal requirements and support systemic approaches to policy design and implementation, California will have to invest heavily in new database infrastructure. At the very least, it will become necessary to track individuals over their lifetimes as they enter, leave, and reenter episodes of receiving public assistance. These tracking systems will need to be developed in collaboration with other states since proposed regulations limit the cumulative time on welfare, regardless of location. This is an ambitious and expensive project. However, with some foresight, the data source that is used to track individuals over time may be quite valuable for examining the effectiveness of programs. This will be especially true if the information system is capable of assessing the movement of individuals and family members across multiple social service programs.

**Work Programs Must be Expanded**

The legislation requires that eventually at least 50 percent of the AFDC-FG caseload and 90 percent of the AFDC-U caseload be engaged in work-related activities. Nationally, the General Accounting Office estimates that only about 11 percent of the AFDC caseload is participating in the JOBS program, and in California the rate is under 9 percent. Is California ready to expand the employment-related dimension of assistance? What job-related activities will be provided for participants? How will work be monitored? How much will workers be paid? How will California work with unions to ensure that these government-subsidized workers do not displace other workers? Will there be a training component of the program? Does there exist an infrastructure for managing this dimension of the program? Is California ready and willing to expand the GAIN program to meet these requirements? Or should the state pursue alternative strategies? The fundamental goal of most welfare reform policies is self-sufficiency, which is derived largely through employment.7 As a

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7 Becoming married is another major pathway off of welfare.
result, the work and job training component of welfare reform is fundamental.

Although jobs and training programs may reduce welfare dependency and save money in the long run, some states may be reluctant to pursue these options. Clearly, such programs require an initial investment of tax money, with benefits unlikely to be forthcoming until several years later. The up-front investment is likely to be even greater if the effort is supported by other programs designed to enhance the attractiveness of employment and/or job preparation activities. These include transportation and child care subsidies. Rather than make such an investment, California might prefer the 5-percent penalty on federal funds in the event that it does not achieve federal targets.

Some AFDC recipients cannot work because of physical or mental health problems. What will happen to these individuals when their two-year time limit expires? To what extent are job agencies, with no experience in working with needy populations, equipped to serve these people? Failure of these programs will likely cause enrollment in other programs, such as SSI or homeless assistance, to expand. What will happen to the children of mothers who become ineligible for benefits? There may be a rise in the demand for child care services for the low-income population. If the mother cannot find work, a growing number of children may become wards of the state, entering foster care or institutionalized care, which is often expensive. These cross-program effects are likely to be quite important.

**Be Aware of Consequences of Actions for Related Federal Funds**

State-determined eligibility and benefit requirements for AFDC can indirectly affect other sources of federal funding. If states decide to decrease cash welfare assistance, then the amount of food stamp benefits available to an applicant would increase because cash assistance is counted against food stamps (at least under current law). As another example, if the federal government continues noncapped assistance for foster care and adoption services, then local and state government would have a financial incentive to move children into foster care and adoption services and away from other types of ser-
services that are funded solely out of the state's available funds. Of course, the extent of movement will depend on the cost of outplacement to foster care and adoption services, as well as those services' capacities to expand.

**Incentives to Work May Actually Attract Nonparticipants to AFDC**

To encourage self-sufficiency, welfare reform will include proposals that will make work while on welfare more attractive. For example, child care benefits may increase, AFDC-related job training may expand, and the amount of earnings disregarded may increase. An unintended side effect of such changes is that participating in the program will become more attractive, and, at least in the short run, participation in AFDC may actually increase.

**Realize that Changes in Welfare Benefits May Induce Migration**

The increased state and, potentially, local flexibility in program design could, in theory, create more inter- and intrastate variation in benefit levels or standards of eligibility. If adjoining states or localities within a state offer different programs, they must realize that some individuals may migrate to the areas with more generous benefits. To prevent this, states will be reluctant to increase benefit levels and, instead, may begin a competitive "spiral to the bottom." The current legislation allows states to restrict benefits for new entrants, at least in the short run, thereby reducing migration in search of assistance. Alternatively, states (and jurisdictions within states that are empowered to design programs independently) should collaborate with contiguous government jurisdictions to see that these migration effects and responses geared to reduce migration are not realized.

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8As we note below, there is little solid evidence to support this claim.
Be Prepared to Demonstrate the Usefulness of Federal Funds

Along with devolution and increased flexibility in designing welfare programs comes an increased responsibility to compare policy alternatives and evaluate decisions after the fact. Because the federal government is allocating block grants with (in theory) fewer strings attached, the state should expect to become more accountable for the use of these resources. Specifically, two to three years from now states should be prepared to demonstrate that the money is being spent wisely and that the programs they have established are working. States will need to do more than simply calculate caseloads and comply with regulations. The design of effective policies will require answers to substantive questions such as: Are the programs helping people achieve long-term self-sufficiency? Are they reducing out-of-wedlock and teenage pregnancy? Have they decreased the abortion rate? What elements of program design are critical in achieving observed levels of success? States, as a group, should strive to plan, conduct, and disseminate comparable, high-quality evaluations of their programs. Otherwise there will be no pool of common knowledge upon which to improve program effectiveness or to justify continuing levels of support for the welfare block grants.

LOOKING TOWARD THE FUTURE, BUT LEARNING FROM THE PAST

Under block grants, California will be given greater control over its welfare policy. A variety of policy options will likely be debated, and in fact Governor Wilson's proposal for reform, which anticipates federal action, has been discussed widely. To inform these decisions, it is important to integrate the lessons we have learned from welfare policies of the past.

Some 75 percent of all initial welfare applicants apply following the birth of a child or the break up of a marriage. However, there is little evidence that such events are, in fact, induced by the prospects of receiving welfare. For example, women are eligible for AFDC only if they have a child (or are pregnant), and the amount of the benefit increases with the number of children, providing, in theory, an incentive for women to have children. A number of empirical studies testing this claim with alternative approaches have found no consis-
tent evidence that women have children because of the generosity of welfare benefits. (See reviews of the evidence by Moffitt, 1992, and Robbins and Fronstein, 1993, and new evidence from Jackson and Klerman, 1995). There are several reasons why welfare benefits may not induce women to have children. As summarized by Jackson and Klerman (1995), women (and men), especially teens, may not make childbearing decisions using rational, forward-looking calculations based on the costs and benefits of having a child. Second, the amount of assistance received under welfare may be so small that it does not provide enough of an incentive to have a child. Third, the observed differences in welfare payments across states and over time within states are not large enough to induce changes in childbearing. However, if benefits were altered by a much larger amount (e.g., if they were completely eliminated), then we may observe changes in childbearing.

The AFDC eligibility criteria provide an incentive to remain unmarried, or once married, to divorce. Some of the empirical evidence does find an effect of AFDC on female household headship, but the magnitude of the effect is small. (See Moffitt, 1992, for a review.)

As discussed, policymakers have expressed concerns that differences in generosity might induce women to migrate to states with higher benefits. However, the empirical evidence does not support this claim either (Roan, 1996; Walker, 1994). As is the case with fertility, it may be that there is no effect because the differences in benefits across states are not large enough to offset the costs of moving, which may include losing ties to family members who are important resources. However, welfare-motivated migration may occur in major cities that straddle state lines, where the cost of migrating is lower. California does not have any major metropolitan areas along its borders, which minimizes this problem. However, if the design of programs is eventually left to the discretion of individual counties, this could emerge as a future issue.

In theory, increases in AFDC benefits should reduce labor force participation as well as the hours worked by employed women who receive welfare because earned income merely reduces the level of

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3Of course, there may be work-related benefits and costs that are independent of income. The former may include untaxed fringe benefits or on-the-job human capital
assistance on a dollar-for-dollar basis. On this topic, the evidence in fact suggests that AFDC reduces the number of hours of work. Using the mid-point of the range of estimates reviewed by Danziger et al. (1981), Moffitt (1992) calculates that if AFDC were completely eliminated, the number of hours worked would increase by about 5.4 hours per week.\footnote{Although the complete elimination of AFDC is an unlikely policy scenario, it is clear that certain populations will be entirely cut off after reaching the time limitation on the duration of assistance. The question of what happens to these people (and to their children) is partially addressed by knowing how many of them are likely to be motivated and successful at finding work.} Moreover, the studies find that very few women who would not be eligible for AFDC in the absence of the program change their hours of work enough to become eligible in the presence of the program. Or, as stated by Moffitt (1992, p. 17): “95 percent of those on the AFDC rolls would, if off the program, retain eligibility for benefits.” At the same time, Moffitt (1996) notes that if participation in job training programs is basically voluntary and the programs are valuable, then offering training may increase the welfare caseload. On the other hand, if job training is mandatory, which is the direction in which current proposals are moving, and some potential AFDC participants would rather not have to enroll in job training, then welfare caseloads may decrease when job training is expanded.

California’s job training program, GAIN, currently enrolls about 78,000 participants monthly. The Manpower Demonstration Research Corporation completed an evaluation of the program in 1994, with some encouraging findings (MDRC, 1994). In some counties, GAIN increased participants’ earnings by 49 percent and decreased their welfare payments by 15 percent. And the return on the investment was about $3 for every $1 spent by the government. Although the positive effects in other counties were not as large, they were still substantial in many settings.

With an estimated one-half of all AFDC recipients having had a teen birth, addressing the special problems faced by teenagers provides perhaps the most significant leverage point for increasing self-development. Costs include transportation costs, disutility of time working or absence from the home, or daycare expenses.
sufficiency. Summarizing the work on teenagers, Maynard (1994) finds that employment is the primary avenue out of poverty, and that support services such as child care and transportation are effective in promoting education and employment. At the same time, financial penalties (such as reduced benefits), in conjunction with an outreach effort by case managers to those who have violated the rules, also play an important role in achieving positive results.

SUMMARY

Despite the current impasse on welfare reform, it is clear that the "new federalism" will pose significant challenges for the delivery of social services in California. Regardless of the exact form of the final legislation, several emerging trends are inevitable. First, it is important to recognize that there is a broad consensus that traditional approaches to welfare and related public assistance have not been effective. The categorical programs will be replaced by more-flexible block grants that, at least in theory, will provide a unique opportunity to redesign social programs. However, available funding will be severely constrained, with fiscal pressures surely leading to reduced budgets overall. Perhaps more dramatically, the probable end (or at least reduction) in entitlements will place increasing responsibility on states to address the changing needs of its citizens. Initial projections suggest that prospective federal funding for California under the proposed block grant legislation will eventually be reduced by an amount exceeding 20 percent of the total cost of the programs. Finally, devolution of authority will, in reality, come with many new strings attached. Federal restrictions on eligibility, the duration of benefits, and work participation requirements will have significant effects on overall funding levels, administrative costs, and the design of alternative policy solutions. Unfortunately, there is not much evidence that the new restrictions will make these programs any more effective.

Despite the daunting challenge, the wave of welfare reform can be viewed as a unique opportunity to reinvent the manner in which so-

\[^{11}\] We are not arguing that teen births are necessarily the root cause of subsequent welfare dependency. Indeed, the correlation between such births and the subsequent need for assistance may result from other factors.
cial services are provided. Short of a complete organizational over-
haul (an ultimate outcome that may indeed be desirable), reform
efforts will, at the very least, require the use of information tech-
nologies, common data sets, and mechanisms for enhanced com-
munication across agency boundaries and different levels of influ-
ence, including government, private industry, and the nonprofit
sector. Effective reform will also require a dramatic change in the
values, objectives, and culture of policymakers in state and local gov-
ernment. In the past, the provision of social services has focused
narrowly on expanding budgets, meeting administrative require-
ments, avoiding controversy, and counting the number of program
recipients. In the future, it may be possible to link previously inde-
pendent efforts, plan strategic approaches that span traditional de-
partments, and design more innovative programs that respond and
listen to the populations they are intended to serve.

Clearly, such a complete overhaul will be difficult to accomplish and
there exists no convincing evidence that it will succeed. Thus, as an
intermediate solution between the status quo and instantaneous
systemic change, expansion of the current waiver system should be
considered. Over two-thirds of the states have been granted waivers
that allow them to experiment with alternative program designs.
Recent evaluations of these changes have begun to inform
decisionmakers of the efficacy of a variety of policies. Perhaps an ex-
pansion of the waiver system, including expediting states’ requests
for waivers and lengthening the time for experimentation, would be a
judicious direction for policy. As the federal and state governments
learn from these changes, they can implement on a broader scale the
policies that have been proven to be successful.
REFERENCES


Sweeping demographic changes over the last 20 years have moved child care onto the public policy agenda. As more women with children entered the labor force, the public debated the desirability of publicly subsidizing child care in order to facilitate female labor force participation and ensure adequate developmental opportunities for children. Recent proposed changes in federal and state policies have propelled these issues to a more prominent role in policy discussions. This paper outlines the likely impacts of federal and state policy proposals that are expected to affect child care, with an emphasis on the state of California.

We group the proposed changes into five broad themes. The first is a rejuvenated focus on the transition to work in federal welfare reform discussions. Policymakers have recognized that requiring mothers to work fuels child care demand and hence they have incorporated child care provisions into welfare reform proposals. Second, while Republicans and Democrats alike have lauded investments in child development through child care program expenditures, this interest in school readiness has been overshadowed by interest in the other major goal of child care policy: facilitating maternal work. The result is that lawmakers may be trading one for the other. The third major policy initiative that will affect child care is consolidating the major federal child care programs into child care block grants. Lessons learned in 1981, when many federal child care services were consolidated into the Social Service Block Grant, suggest that such a move
would have only minor pluses for child care programs. Fourth, while the block grants are expected to offer recipients “seamless” child care coverage, lighten administrative burdens, and reduce federal expenditures, they are also likely to decrease federal resources devoted to child care over the next half decade and to yield further quality compromises. Actions at the federal level on the whole tend to weaken child care quality, although many states are strengthening child care quality standards. Although this may have developmental benefits for children, it entails tradeoffs—providing higher-quality care costs more, which leads parents to utilize less care and to reduce mothers’ labor force participation. Finally, the California state legislature is considering reinstating the California child care tax credit after a five-year hiatus. Researchers have found that child care tax credits encourage maternal labor force participation, but that the relief provided by the tax credits accrues primarily to middle- and upper-income families.

In this paper, we first provide the demographic and historic context leading up to the current policies influencing child care. Next, we describe the current status of government involvement in child care. We then outline the proposed federal and state policy changes and summarize their implications for child care in California. In this discussion, we pay particular attention to informing readers of research findings that have implications for the policies being considered. We conclude with a brief summary.

DEMOGRAPHIC AND HISTORIC BACKGROUND

From a historic point of view, the United States is in the midst of a second child care revolution, as more and more children under the age of six are cared for by someone other than their parents (Hernandez, 1993). The first child care revolution began more than 100 years ago and affected children over age five: Through compulsory education law, the government both mandated and paid for universal schooling for all children age six and over for reasons of equity and the “children as a public good” argument.

Over the past few decades, several broad demographic trends have led us to confront the second child care revolution. First, the fraction of working mothers with children below school age more than dou-
bled over the last quarter-century, growing from less than a third in 1967 to 70 percent in 1993. Second, the divorce rate has grown rapidly, from 9 per thousand in 1940 to 20 per thousand in 1990. Coupled with the greater out-of-wedlock birth ratio, this led to one out of every four children living in single-mother families by 1993. Half of these families live under the official poverty line. The net result of these trends is that more children under the age of six are cared for during the day by someone other than their parents, and more children are living in economically disadvantaged households.

The second child care revolution gives rise to a similar question that arose in the first child care revolution: Should child care be provided publicly or mainly by parents? While a full role of the government in child care can be supported either for the well-being of the children and their parents (Blau, 1991) or for society-wide benefits, a consensus has emerged in which child care remains primarily the purview of families, with only limited government involvement—through partial assistance to low-income families for child care through government-sponsored programs and through tax breaks for middle- or high-income families. Questions still remain as to what extent of government involvement is in accordance with the societal benefits from child care.

Federal and state child care programs have been justified using two primary motivations. One justification stresses the potential developmental benefits of child care. Programs in this category are designed to improve child welfare and reduce the costs of government intervention later in the child’s life. These types of programs include government regulation of quality standards such as the health and safety of child care environments, the provision of food for children in daycare, and subsidized or free child care such as Head Start. A second justification focuses on care during maternal employment. The focus of programs with this orientation is to encourage parents to work. These programs are often linked to public assistance programs with the hope that providing child care will help the parents move from welfare to work. Still other government child care programs attempt to satisfy the dual goals of child development and maternal employment. As we discuss below, rather than being complementary, these goals are often in competition with each other.
PORTRAIT OF FEDERAL AND STATE CHILD CARE PROVISION TODAY

Federal and state governments participate in the child care market through a variety of programs that place different amounts of emphasis on maternal employment and child development goals. Here, we briefly review government involvement in the child care market at both the federal and state level.

Federal Child Care Programs

Federal support for child care comes from seven programs, briefly outlined here. Table 1 reports federal and state funding in federal child care programs, and Table 2 summarizes the primary motivation for each program and the state matching-fund requirements.

Child Care Tax Credit. The child and dependent care tax credit accounted for about a quarter of federal funding for child care and early education programs in 1995 (see Table 1). This credit applies to work-related child care expenses of $2400 for one child and $4800 for two or more children. Families with adjusted gross income of less than $10,000 receive a credit of 30 percent. This credit decreases from 30 percent by 1 percent for every $2000 increase in adjusted gross income for families with incomes above $10,000 but below $28,000. Families with incomes over $28,000 receive a 20 percent credit. Since this is a nonrefundable tax credit, which cannot exceed the family’s tax liability, the program primarily benefits middle- and high-income families (Blau, 1991). This tax credit represents the second largest federal expenditure on child care.

Head Start. Despite the consensus that child care remain in the family domain, Head Start is one of the most popular government programs today. This program receives more federal funding than any other child care or early education program, accounting for nearly a third of federal child care outlays (see Table 1). The program, begun as part of the “War on Poverty” in 1964, is designed to permit disadvantaged children to begin schooling with the same skills as their peers. Child care centers funded by Head Start matching grants aim to improve the health, learning skills, and social skills of poor children. At least 90 percent of the children served by a
The Impact of Federal and State Policy Changes on Child Care in California

Table 1

Federal and State Funding of Child Care and Early Education Programs
(Millions of dollars in FY 1995)

<table>
<thead>
<tr>
<th>Program</th>
<th>Federal</th>
<th></th>
<th>State</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Amount</td>
<td>%</td>
<td>Amount</td>
<td>%</td>
</tr>
<tr>
<td>Tax-based</td>
<td>3,475</td>
<td>31.2</td>
<td>265</td>
<td>12.9</td>
</tr>
<tr>
<td>Child and dependent care tax credit</td>
<td>2,800</td>
<td>25.1</td>
<td>265(^a)</td>
<td>12.9</td>
</tr>
<tr>
<td>Dependent care assistance plan</td>
<td>675(^b)</td>
<td>6.1</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Expenditure-based</td>
<td>7,773</td>
<td>68.8</td>
<td>1,793</td>
<td>87.1</td>
</tr>
<tr>
<td>Head Start</td>
<td>3,500</td>
<td>31.4</td>
<td>700(^c)</td>
<td>34.0</td>
</tr>
<tr>
<td>Child and Adult Care</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Food Program</td>
<td>1,568(^d)</td>
<td>14.1</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Child Care and</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Development Block Grant</td>
<td>935</td>
<td>8.4</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>AFDC child care</td>
<td>666</td>
<td>6.0</td>
<td>233(^g)</td>
<td>11.3</td>
</tr>
<tr>
<td>At-risk child care</td>
<td>357</td>
<td>3.2</td>
<td>125(^b)</td>
<td>6.1</td>
</tr>
<tr>
<td>Transitional child care</td>
<td>199</td>
<td>1.8</td>
<td>70(^e)</td>
<td>3.4</td>
</tr>
<tr>
<td>Social Services Block Grant</td>
<td>448(^f)</td>
<td>4.0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Preschool programs</td>
<td>0</td>
<td>0</td>
<td>665</td>
<td>32.3</td>
</tr>
<tr>
<td>Total</td>
<td>11,148</td>
<td>100.0</td>
<td>2,058</td>
<td>100.0</td>
</tr>
</tbody>
</table>


\(^a\) Estimated, for 23 states and D.C.

\(^b\) For FY 1994.

\(^c\) 20-percent state match.

\(^d\) Estimated as 98 percent children.

\(^e\) Estimated, average 35 percent (ranging from 20 percent to 50 percent) state match.

\(^f\) Estimated average 16 percent of SSBG was used for child care in 1990 survey.

Head Start child care center must be below the federal poverty line. Despite increases in funding and population served in the last decade, the Government Accounting Office (GAO) reports that in 1993 Head Start still served less than 30 percent of the eligible population (GAO, 1995). Note that Head Start is primarily a child development program rather than a child care program—it does not require that parents work, and its half-day part-year programs typically do not meet the child care needs of working parents.
Table 2

Primary Motivation and State Matching Requirements, by Program

<table>
<thead>
<tr>
<th>Program</th>
<th>Primary Motivation</th>
<th>State Matching Requirements</th>
</tr>
</thead>
<tbody>
<tr>
<td>Child care tax credit</td>
<td>Encourage maternal LFP&lt;sup&gt;a&lt;/sup&gt;</td>
<td>None</td>
</tr>
<tr>
<td>Head Start</td>
<td>Child development</td>
<td>Local match of 20 percent (may be donated, in-kind, or waived)</td>
</tr>
<tr>
<td>Social Services Block Grant</td>
<td>Encourage maternal LFP, child development</td>
<td>None</td>
</tr>
<tr>
<td>Child Care Food Program</td>
<td>Child development</td>
<td>None</td>
</tr>
<tr>
<td>Family Support Act</td>
<td>Encourage maternal LFP</td>
<td>Required at Medicaid matching rate</td>
</tr>
<tr>
<td>Child Care and Development Block Grant</td>
<td>Encourage maternal LFP, child development</td>
<td>None</td>
</tr>
<tr>
<td>At-risk child care</td>
<td>Encourage maternal LFP</td>
<td>Required at Medicaid matching rate</td>
</tr>
</tbody>
</table>

<sup>a</sup>LFP = labor force participation.

*Child Care Food Program.* The U.S. Department of Agriculture administers this program to provide nutritious meals to children under age 12 enrolled in licensed child care centers, family day care homes, and before- and after-school programs. In FY 1994, this program fed over two million children. The Child Care Food Program represents the third-largest expenditure on child care and early education programs with spending of over $1.5 billion in 1995 (see Table 1).

*Child Care and Development Block Grant.* This grant gives money to the states to expand the supply and improve the quality of child care and to provide child care subsidies to low-income parents who are working or in education or training programs. While 75 percent of CCDBG funds is earmarked for child care subsidies, 18.75 percent is reserved for early childhood development and school-age child care services, and 5 percent goes toward quality enhancement programs. The CCDBG is the only federally funded program that allocates some funds specifically for improving child care quality through such efforts as provider training. One of the requirements of the program is
that subsidized providers (except children's family members), must meet basic health and safety standards. No state match is required for CCDBG funds.

*AFDC Child Care.* The Family Support Act of 1988 included provisions for two child care programs aimed at families on Aid to Families with Dependent Children. The first is child care for AFDC families, which provides child care assistance to parents on AFDC who are working or participating in educational or training programs.

*Transitional Child Care Program.* The second program included in the Family Support Act is the Transitional Child Care program, which offers child care assistance for the first year after working parents have left AFDC because of increased earnings. Like the AFDC Child Care Program, this program aims to support families as they transition from public assistance to self-sufficiency. States must match federal funds going to the two Family Support Act programs at the state Medicaid matching rate or lose the federal money.¹

*At-Risk Child Care Program.* Low-income families "at risk" of going on welfare are eligible for child care subsidies. Since this program is so similar to the CCDBG, some states combine the two into one program. Unlike the CCDBG, which requires no state matching funds, states must contribute matching funds to the At-Risk Child Care Program at the Medicaid matching rate.

*Social Services Block Grant.* The SSBG allocates block grants to states to use for a variety of social services including child care. However, the use of these funds is at the discretion of the states. A 1990 survey of states yielded an estimated average of 16 percent of the SSBG being allocated to child care. Hence, out of $2.8 billion the government allocated to the SSBG, approximately $450 million was used for child care services.

¹Another feature of AFDC that could be considered a child care program is the fact that AFDC provides an income disregard under which earned income spent on child care is not subtracted from AFDC benefits (as earned income normally is).
States’ Role in Child Care

The role of states in child care comes from both state involvement in the federally funded programs and state-initiated programs. The states’ participation in the federally funded programs takes several forms. First, states decide whether or not to match or supplement federal funds for child care programs. For example, because not all states matched federal funds allocated to the At-Risk Child Care Program, in 1994 only 92 percent of the $300 million in federal funds earmarked for the program were spent (Adams and Poersch, 1996). Second, the states determine the eligibility criteria for participation in the federal means-tested child care programs. For example, the states have had the primary responsibility for identifying the income-level eligibility standards and whether parents must be working, enrolled in school, or participating in other programs to qualify.

Third, the states administer most of the federally funded programs including CCDBG, the At-Risk Child Care Program, and the Child Care Food Program, and often determine how to allocate the funds for those programs. Little information is available regarding state variation in administration costs and efficiency, and the potential for gains in this area has pretty much been ignored. A fourth issue relating to federally funded programs is that the state has jurisdiction in setting reimbursement rates to child care providers. Given that child care quality and availability are related to the price of care, this has implications for the supply of care as well as the quality of care in the state. Fifth, states set quality standards that providers must meet to receive state and federal funds. These include health and safety regulations, whether providers are checked for criminal records, educational content requirements, and other dimensions of quality. Sixth, as mentioned above, states must determine what fraction of their SSBG to devote to child care. This allocation varies by state with some states allocating no SSBG funds to child care. California currently does not use any of its SSBG to pay for child care services.

In addition to their participation in the child care market through their role in federally funded child care programs, states may also have a role in child care that is independent of federal programs. This type of state government involvement in child care includes state child care tax credits, subsidies for child care, prekindergarten initiatives, extending elementary school to include after-school child
care, training grants and small business grants to child care providers, child care referral services, and a range of other child care services.

Thirty-two states offered prekindergarten programs during the 1991–1992 school years (Adams and Sandfort, 1994). Over half of these states fund their own prekindergarten programs, while the remainder used the funds to augment Head Start or other federal preschool programs. Most of the state programs targeted children who were likely to need improvements in school readiness. California has been a leader among states in developing prekindergarten programs, being one of only 10 states who have had programs since at least 1980 (Adams and Sandfort, 1994). During the 1991–1992 school year, California served over 35,000 children in prekindergarten programs at a cost of $83 million (Adams and Sandfort, 1994).

Most states have a state child care tax credit that supplements the federal child care tax credit. This is typically a fraction of the federal credit—for example, in 1992, California allowed families to credit 30 percent of their federal dependent care tax credit. California terminated its tax credit after the 1992 tax year, but legislation is pending to renew it.

Every state regulates child care in some form, but the types and level of states' involvement vary dramatically. All states license daycare centers and all states except Louisiana license family daycare homes.2 In addition to controlling quality through licensing, all but a couple of states also control quality through minimum quality standards. The states generally mandate minimum standards for items that are believed to affect children's health, safety, or development. These include requiring immunization records, maximum child-to-staff ratios, minimum educational levels for staff, and a diverse set of additional requirements. In addition to setting these regulations, states must also determine the intensity with which they enforce the regulations, which has been found to affect compliance with regulations and overall child care quality. Thompson and Molynaux (1992) argue that child care standards are meaningless without enforcement and report that inspections and enforcement

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2Well over half of all children are cared for in modes of child care (such as care by relatives) that are typically not subject to licensing.
are meager at best in most states. In sum, state child care regulation exerts an important influence on the child care market, affecting both the quality of care in the state and, because quality comes at a price, the cost of care as well.

A Children’s Defense Fund survey (Adams and Sandfort, 1992) of state expenditures on child care and early childhood development services revealed dramatic disparities across states. State expenditures per child in 1990 ranged from $0.24 per child in Idaho to $70.00 per child in Alaska. California ranked sixth in per-child expenditures, with a total outlay of $343 million.

Now that we have outlined government involvement in the child care market, we will describe proposed changes in this involvement and discuss the implications these changes would have for child care in California. The discussion highlights findings from the academic literature related to the proposed changes.

PROPOSED CHANGES AT THE FEDERAL AND STATE LEVEL: IMPLICATIONS FOR CHILD CARE IN CALIFORNIA

Rather than discussing every proposal that might have implications for child care, we analyze the likely impacts of five general themes that are expected to be important components of upcoming changes at the federal and state level. These are: (1) focus on transition to work in welfare reform, (2) interest in school readiness overshadowed by work emphasis, (3) consolidating federal child care programs into block grants, (4) stricter state-level regulations, and (5) reinstating the California child care tax credit.

Focus on Transition to Work in Welfare Reform

One of the primary drivers of change in child care in California is federal welfare reform. Congress produced three separate proposals last year regarding welfare reform that included provisions for child care. The House passed H.R.4, The Personal Responsibility Act, in March 1995, and in September the Senate passed H.R.4, The Work Opportunity Act. In December both the House and the Senate passed the Conference Agreement bill, which attempted to reconcile the differences between the House and Senate versions, but
President Clinton vetoed this version. It did not have enough votes to override the veto. There is likely to be additional action on welfare reform later this year.

One of the predominant themes in these welfare reform bills has been to encourage mothers receiving public assistance to make the transition to work. This reinforced emphasis on work has been embodied in proposed legislation in two ways. First, proposals require states to increase the percentage of welfare recipients who are working. For example, the Conference Agreement would have required states to have 15 percent of welfare recipients working within two years and up to 50 percent of welfare recipients working within approximately five years. Second, the proposals make the definition of working more stringent. Under the Conference Agreement plan, by the year 2003, mothers must work 35 or more hours instead of the current 20 hours to qualify as working. Moving significant numbers of welfare mothers to the labor force implies a dramatic increase in the child care needs of this population. Lawmakers have recognized this fact and have incorporated child care programs into welfare programs in tandem with the work requirements. For instance, anticipating federal welfare reform, California proposed its own redesign of its welfare system (see California Department of Social Services, 1996a and California Department of Social Services, 1996b). This redesign proposed four employment-oriented programs to replace the existing welfare system and each of these four programs included child care as part of the program.

However, whether these efforts to increase government assistance meet the needs of child care among AFDC clients remains questionable. While federal funding targeted for child care appears to be relatively stable, it has dropped in real terms over last few years (Adams and Poersch, 1996). This funding will be expected to serve a much larger eligible population under congressional proposals. In particular, the reinforced work requirements will substantially raise the demand for child care in the welfare population. In estimates prepared for Congress when members were voting on the Conference Agreement, Department of Health and Human Services (DHHS) and the Congressional Budget Office (CBO) estimated that funding would fall $6 billion and $13.6 billion, respectively, short of paying for all mothers who must now work under the reinforced work requirements (Ebb, 1996).
Research findings in a variety of disciplines including child psychology, economics, sociology, and demography have bearing on the likely implications of this reinforced emphasis on work in welfare programs. To set the stage, first note that the labor force participation rate of public assistance program participants is substantially lower than that of other single mothers and that the labor force participation rates of program participants has fallen over time. Studies have found that young single mothers with infants have a labor force participation (LFP) rate of about 15 percent; rates increase to about 60 percent for mothers of preschoolers or school age children (Hao and Leibowitz, 1995). The LFP rate is much lower among those receiving income support from AFDC and has been falling; the LFP rate of AFDC recipients fell from 16 percent in 1979 to 5 percent in 1984 (Moffitt, 1992), and was about 6 percent in 1991 (U.S. House of Representatives, 1993).

Considerable research documents that child care costs present a major barrier for mothers' participation in the labor force. Higher child care costs are associated with lower levels of women's employment (Hotz and Kilburn, 1995; Ribar, 1992; Blau and Robins, 1988; Leibowitz, Klerman, and Waite, 1992). Hence, public programs that subsidize child care or provide free child care would be expected to boost mothers' LFP. The GAO (1995) estimates that providing a full subsidy to mothers who pay for child care could raise the percentage of poor mothers who work from 29 to 44 percent and that of near-poor mothers who work from 43 to 57 percent.

Other research indicates that child care presents a greater impediment to the LFP of single mothers than it does to the LFP of married mothers. First, single mothers receive less support from the father of the child and his family. Many married mothers depend on child care assistance from their husbands (Presser, 1989) or from an extended family that includes their husband's relatives (Leibowitz, Waite, and Witsberger, 1988; Cochran, Larner, Riley, Gunnarsson, and Henderson, 1990). While single mothers are less able to draw on the resources of the child's father, they are more likely than married mothers to live with relatives and so may receive more low-cost child care from their own relatives (Hogan, Hao, and Parish, 1989; Hofferth, 1984; Parish, Hao, and Hogan, 1991). However, relative care is not licensed and often of lower quality. Second, while research has shown that the child care tax credit promotes the em-
ployment of *married* mothers (Blau and Robins, 1989; Leibowitz et al., 1992), other research finds that child care subsidies have little effect in promoting the employment of *single* mothers (Michalopoulos et al., 1992). The child care tax credit may have little impact on low-income single mothers, since it requires having a tax liability and it is nonrefundable.

Despite a large literature on the effect of child care on women’s work and the effect of AFDC on single women’s labor force participation, only a few studies have examined the impact on maternal LFP of child care programs geared to assist low-income single mothers, such as AFDC disregard for child care costs and public-provided child care places. Berger and Black (1992) find that single mothers who receive child care subsidies from the Child Care and Development Block Grant are more likely to be employed. Kimmel (1995) finds that greater child care subsidies increase the probabilities of labor force participation among single mothers in poverty. Hao and Leibowitz (1995) report that subsidized child care and AFDC child care disregards increase single mothers’ employment and school enrollment. There is little knowledge of how public child care programs affect the amount of child care help received from kin, or how much public programs merely “displace” assistance from families rather than provide additional assistance to families in need.

A novel component of the Conference Agreement was that welfare recipients be allowed to provide unpaid child care to other welfare families to meet work requirements. This proposal is conceived as a co-op between welfare mothers that could raise the productivity of the group as a whole. A counterpoint to this potential benefit of the policy is the concern that it may not provide quality care. The child development literature suggests that care providing cognitive stimuli is particularly important for older preschoolers (see next section). It is well known that welfare recipients have lower human capital on average than the rest of the population, and hence that they may not be in a position to provide the type of care that will encourage optimal development among the children.

In sum, evidence suggests that if lawmakers are serious about moving mothers from welfare to work, they must be prepared to address the concomitant child care needs. By including child care provisions as a component of the welfare reform legislation designed to raise
the labor force participation of welfare mothers, Congress and the President have indicated that they realize the essential relationship between female labor force participation and child care. However, it appears that the proposals do not allocate adequate resources to accommodate the additional child care demand generated by the new work requirements.

Interest in School Readiness Overshadowed by Work Emphasis

Both Republicans and Democrats agree that investments in school readiness are worthwhile public expenditures. One manifestation of this is the overwhelming bipartisan support for increases in funding for Head Start, the primary federal school-readiness program. A hallmark of Head Start is its emphasis on quality child care provision that aims to prepare children for school—that is, child care that has a strong cognitive and socioemotional development component. In contrast to the interest in school readiness is the fact that a byproduct of the work-oriented child care proposals may be a compromise on child care quality. Hence, although lawmakers have an interest in school readiness, it is likely to be overshadowed by the current emphasis on work-related child care programs.

In this section, we review the proposed changes that are likely to have an impact on school readiness. These include changes that directly target school readiness—like increasing Head Start funding—and changes designed to accomplish other goals—like moving mothers from welfare to work—which may indirectly influence school readiness. The proposals we examine are those that emphasize maternal labor force participation in welfare programs, the relaxation of quality standards for federal programs, and increased funding for Head Start.

Emphasis on Maternal Labor Force Participation. As discussed in the last section, one the most salient components of last year’s welfare reform proposals was to encourage mothers receiving public assistance to make the transition to work. A review of research findings indicates that an unintended consequence of this orientation may be tradeoffs in school readiness for the children of welfare recipients. First, the literature on the relationship between maternal employ-
ment and child development finds mixed evidence of the effect of maternal employment on child development. Findings vary, depending on the child’s age at which the mother returned to work, the continuity of the mother’s work during the child’s life, the gender of the child, the family’s income, and other factors. In general, studies report a negative impact of maternal work on infant behavior (Belsky, 1988; Clarke-Stewart, 1989; Belsky and Eggebeen, 1991). However, several studies find positive effects of maternal employment on cognitive and behavioral outcomes for older preschoolers (Blau and Grossberg, 1992, Desai, et al., 1989; and Studer, 1992). Another perspective is that mothers’ work increases family income and household production efficiency, which improves children’s emotional adjustment and reduces behavioral problems for children of all ages (Greenstein, 1993).

A second line of research stresses that it is not only maternal work but also the type of child care that influences child development. Like the findings on the effects of maternal work on child development, the findings on the effects of types of nonmaternal child care on child development vary, often depending on the age of the child, family structure, and other factors. For infant care, some studies report that care from a relative yields the best outcomes (Baydar and Brooks-Gunn, 1991; Furstenberg, 1979; Kellam et al., 1977), especially if the child is unhealthy (Mott, 1991). For older preschoolers, the evidence is mixed (Barnett, 1995), ranging from no differences in outcomes by type of care (Desai et al., 1989), to better outcomes for family daycare (Studer, 1992) to better outcomes in centers (Clarke-Stewart, 1991).

Note that the drive to encourage mothers to work rather than stay home and care for their children and the trend toward using nonmaternal care to promote school readiness is in stark contrast to historic public perceptions that the appropriate role for mothers and the best child care setting for children was maternal child care (see e.g. Spock, 1946). Consistent with the idea that mothers are the best caregivers for their children is the design of the AFDC program, up to the present: it could be considered a subsidy that allows mothers to stay home to care for their children rather than entering the workforce (Leibowitz, forthcoming). While the child care research has examined whether child care in one setting outperforms child care in another setting, the research has ignored the fact that maternal care is
also a child care setting and has not compared the performance of maternal care and other child care settings. Given the substantial body of research that reports that parenting style has important implications for child outcomes (e.g., McLeod and Shanahan, 1993; McLoyd, 1990; Dornbusch, et al., 1985), discussions of attempts to promote school readiness should include parental care as one of the school readiness alternatives and might expand the set of policy options to include child care and parenting training for parents.

As part of the recent welfare reform proposals that encourage maternal work, it has been recommended that welfare mothers with infants be exempt from work requirements. Evidence in the literature suggests that this may be in the best interest of the development of the children. The mixed nature of the findings of the effects of maternal work and child care, however, make it unclear whether maternal work would have positive or negative consequences on child outcomes. Another perspective on the effect of maternal work and child care settings on child outcomes is that it is the quality of the child care setting that dictates the impact of nonmaternal care on children. We address this perspective in the next section.

Relaxing Quality Standards of Federal Programs. A second component of the federal welfare reform proposals that is likely to affect school readiness and child outcomes is the relaxation of quality standards in federal child care programs. Both the House and Senate versions of H.R.4 would have repealed or reduced CCDBG quality set-asides, the only federal funds specifically aimed at child care quality improvement. In addition, the Senate versions expanded the set of family-member caregivers who were exempt from health and safety requirements. The Conference version of the bill completely eliminated the requirement that any providers meet minimum health and safety standards.

Research indicates that some dimensions of child care quality improve the development of children. Studies have reported that among children in day care centers, cognitive skills and emotional development were higher the fewer the children in the group, the lower the child-to-staff ratios, and the more child-oriented training caregivers acquired (see Ruopp et al., 1979; Howes, 1983; Phillips and Howes, 1989; and Studer 1992, for example). These findings suggest that if quality dimensions such as group size, child-to-staff ratio, and
provider education decline as a result of relaxed federal standards, the cognitive and emotional outcomes of children might suffer.

A recent study by Child Trends (forthcoming) finds that welfare homes provide little cognitive stimulation and emotional support to children. One interpretation of these findings is that moving welfare mothers to work and hence moving their children into child care may benefit the children. This argument assumes that the nonmaternal child care the family would utilize is of higher quality than the care available in the child’s home. It is not clear that the child care alternatives to welfare mothers would in fact be of high quality, however. The potential for the “welfare-to-work” initiatives to achieve a second goal of preparing young children for school underscores the role that child care quality standards have in the welfare reform program.

Note, however, that child care quality entails tradeoffs. On one hand, higher quality is desirable since the child development literature suggests that quality care yields enhanced developmental outcomes for children. On the other hand, higher quality care costs more than lower quality care, and since the higher the cost of care the less likely mothers are to work, strict quality requirements might induce women to work less, counter to the goals of the welfare reform. Because of this link between quality and the price of child care, and between the price of child care and work, relaxing quality standards is consistent with the labor force participation goals of welfare reform while being inconsistent with the school readiness policy goals.

Increased Head Start Funding. Head Start is probably one of the most popular public programs in the United States. Both the Republicans and the Democrats have supported modest increases in funding for the program over the last several years. President Clinton proposed an 11 percent increase in Head Start funding for 1996 and encourages developing full-day, full-year services to supplement the current part-day programs. The popularity of this program is likely to be related to the consensus among policymakers and advocates that Head Start is a truly successful program (see, for example, DHHS World Wide Web site).

In contrast to this perception regarding the efficacy of Head Start are the research findings. A review of the literature in psychology,
economics, and sociology indicates that the results of Head Start are mixed at best. In their recent *American Economic Review* paper on Head Start, Currie and Thomas (1995) write: “despite literally hundreds of studies, the jury is still out on the question of whether participation in Head Start has any lasting beneficial effects” (p. 343). Studies of the effects of Head Start on IQ find that while Head Start participants experience initial IQ gains greater than their contemporaries, these gains fade over time, disappearing by the third grade. Furthermore, most of the studies suffer from design flaws such as not including representative samples of Head Start children and attrition bias. Other claims in support of Head Start are that the program lowers teen pregnancy, reduces high school drop-out rates, and depresses grade repetition. These claims are based on studies from model preschool programs, the most famous of which is the Perry Preschool Project. These studies suffer from shortcomings, including small sample sizes and the fact that the model programs typically devoted more funding per child and had better-trained caregivers than typical Head Start programs. In their own study, Currie and Thomas find that Head Start is associated with large and significant gains in test scores among both whites and African-Americans, but that the gains are quickly lost among the African-Americans. They also find that Head Start substantially reduces the likelihood that white students repeat a grade but that the program has no effects of grade repetition for African-American students. They report that all students from Head Start gain better access to preventive health care services.

Considering the evidence on the relationship between child care quality and child outcomes, it is probable that like any child care program, Head Start centers are most effective when they achieve high quality. Hence, the mixed findings on the effect of Head Start may be less a condemnation of Head Start than a call for greater attention to quality in Head Start programs. Furthermore, the evidence suggests that Head Start is not a child care panacea, and that for all public child care programs, the quality of the child care setting is likely to be crucial to success in promoting school readiness. In addition, the ambiguity of results in investigations of the impact of Head Start programs and child care quality on children’s outcomes suggests that more research in these areas is warranted.
Federal lawmakers claim to make school readiness a priority, but other than raising funding for Head Start, their actions seem to value other objectives more than school readiness. For example, while moving more welfare mothers to employment achieves welfare reform goals, it is questionable whether this will enhance or debase school readiness. Furthermore, relaxing quality standards promotes the labor force participation of low-income mothers by reducing child care costs, but this is likely to come at the cost of compromising children’s developmental outcomes.

**Consolidating Federal Child Care Programs into Block Grants**

As part of the welfare reform, lawmakers have recommended consolidating At-Risk, AFDC, Transitional Child Care, CCDBG, and several other smaller child care programs for low-income populations into one child care safety net for working or nonworking program participants. Part of the impetus behind this recommendation is that mothers will not have to change from one child care program to another as their labor force participation status or income changes. It is also hoped that this change will reduce administrative costs for both program administrators and program participants.

Like many block grant proposals, this one also appears to be linked to federal spending cuts. The new block grant would be capped at a funding level of $2.1 billion a year over the FY 1996–2000 period. While this is $150 million above the FY 1994 funding allocated to the four programs that will be subsumed by the block grant, the Congressional Budget Office estimates that because of expected increases in price levels, the net result will be a reduction in real expenditures of about $1 billion or 9 percent over the five-year period (Clark and Long, 1995).

Currently, the AFDC, Transitional Child Care, and At-Risk programs all require state matching funds, while the CCDBG does not. Under the proposed block grant, states would not have to provide matching funds. Another change between the current program characteristics and the proposed block grant is that the AFDC and Transitional Child Care programs are entitlement programs, meaning that provision is guaranteed to anyone who meets the eligibility requirements and funding was provided to serve all participants. The block grant is a capped dollar allotment, implying that if the size of the needy popu-
loration grew, either block grant dollars would have to be stretched over more recipients or some families would go unserved, although there are provisions for a federal "Rainy Day Fund" from which states could borrow during recessionary periods. Since more welfare mothers would be required to work under the welfare reform proposals, it is expected that the number of families needing child care services would grow.

A final issue related to the block grant consolidation is the possibility that more needy families would go without child care or early childhood development programs. This possibility arises as a result of maternal work becoming a condition for more child care programs and because of proposed welfare receipt time limits. For example, the Conference Agreement stipulated that no family can stay on welfare for more than two years without working and that the total time a family can spend on welfare is five years. Considerable disagreement exists about whether welfare recipients will be successful in finding jobs before their time limits run out (see Danziger and Danziger, 1995; and Ellwood, 1988, for example). If benefits to a child's family were terminated because of time limits, not only would the child be subject to poverty without income support, but that child would also become ineligible for many federally sponsored child care programs. To the extent that these child care programs provided subsidized meals as well as developmentally appropriate settings, the children who were most disadvantaged could receive the fewest benefits from child care services.

This would not be the first time that child care programs were consolidated into block grants from categorical entitlement programs. In 1981, President Reagan consolidated more than 90 categorical programs into a handful of block grants, one of which was the Social Services Block Grant. Federal social services funding was cut by nearly 20 percent as part of the consolidation. Lessons learned from this experience are likely to be informative in evaluating the potential impacts of another consolidation of child care programs into a block grant. First, in the 1981 grant consolidation experience, states replaced most but not all of the lost federal funds and replaced funds in some but not all programs. States made up the lost funding through a combination of increasing state expenditures and shifting part of
the burden to local governments. Second, creation of the Social Services Block Grant suggests the order of magnitude of the administration savings that consolidation should be expected to yield. While the consolidation of programs did yield administrative savings, contrary to claims made by some consolidation proponents, these savings did not completely offset the 1981 budget cuts (Peterson, 1986). Program administrators claim that the administrative savings rarely exceeded 5 percent (Peterson, 1995).

Third, prior experience with the consolidation of programs into block grants showed that state programmatic standards are typically more lax than the federal standards they replace. This is perhaps most aptly illustrated by child care regulations. In 1980, Congress approved Federal Interagency Day Care Requirements (or FIDCR), a set of regulations to which caregivers receiving federal funds would have to adhere. These federal regulations were slated to take effect in 1982, but upon the approval of the Title XX block grant in 1981, the federal regulations were withdrawn and states were free to set their own standards for block grant child care providers. Only one state—Massachusetts—met the FIDCR staff-to-child ratio for both infants and toddlers, and only three states had infant staffing requirements as high as federal standards. This may be less of an issue in California, where policymakers have been more willing to impose tougher standards on the child care market.

Our experience with the creation of the Social Services Block Grant in 1981 provides a portent of what might result from the consolidation of the major child care programs into a block grant today. While the block grant proposal has the benefits of potentially providing families with “one-stop” child care services, helps control federal spending, and is likely to reduce the costs of administration, the proposal also has several drawbacks. One is that the block grant programs are capped at slightly more than current funding in nominal terms, and given inflation and expected pressures on child care demand from other welfare reform proposals, the potential for growing unmet child care demand is very real. Second, as the states control more child care services, child care quality requirements are likely to suffer, reducing the possibility that public child care is developmentally enriching.
Stricter State-Level Regulations

As just discussed, the tough federal child care regulations authorized under FIDCR never went into effect and were replaced instead by less stringent state regulations. Under proposed federal welfare reform measures, regulations covering federally-supported child care spaces would also be relaxed. At the same time that the federal government is relaxing child care quality standards, states are taking actions that strengthen child care quality standards. While this is typically justified on the grounds that it improves child well-being, there is reason to believe the regulations may not have their intended effects.

The rationale for imposing, tightening, and/or enforcing minimum quality standards for child care is that it will enhance child development or ensure child safety. Consistent with this argument are findings in the child development literature (discussed above) that indicate that lowering child-to-staff ratios or increasing the use of more educated providers appears to improve the rate of child development. Whether regulating child care in a market environment improves child outcomes is an open question, however, for at least two reasons. One is that child care quality standards may not be effective in altering the characteristics of care consumed—for example, providers could retreat to the underground economy to avoid regulation or regulation might be ineffective because it lacks effective enforcement. Second, parents may respond to the regulations and alter their child care choices, labor force participation, and other time and income allocation choices. For example, while the National Research Council Panel on Child Care Policy (Hayes, 1990) advocated the development of national quality standards, it acknowledged that:

> just how costly [such standards would be] is difficult to estimate precisely since it will depend not only on the particular public and private policies and programs that are adopted, but also on how parents respond to them and other future changes in the economy and society, in their choices regarding childbearing, labor force participation, and child care arrangements. (p. 292)

Few studies have investigated the impact of child care regulations on parental choice of child care arrangements, the cost of such care,
and, ultimately, on the child developmental process. Rose-Ackerman (1983) reports that stringent regulations may have the unintended consequences of curtailing the supply of child care, increasing racial segregation, and promoting large subsidized for-profit firms as child care providers. Gormley (1991) investigates the effects of state child care regulations on the number of providers of different types and finds that the effects depend on the costliness, intrusiveness, and enforceability of the regulations and that unenforceable regulations have no effect on the market at all. Waite et al. (1991) find that parents are not willing to pay higher child care prices to obtain child care with regulations associated with better child outcomes. Hoth and Kilburn (1994) find that child care regulations that improve the quality of care raise the price of the care, leading to a drop in the quantity of the care demanded. However, they also find that the regulations induce an increase in the quantity of care demanded independent of the price effect, consistent with a quality assurance effect. They find that the price effect dominates the quality assurance effect for a net decline in the utilization of care after the imposition of regulations. Finally, a recent study by Chipty and Witte (1995) investigates the impacts of state child care regulations on various measures of the quality of child care services parents select. They find evidence of parental substitution away from higher quality care in states that more stringently regulate such care and show that this substitution arises because more stringent regulations increase the cost of providing child care.

California ranks among the toughest states in terms of child care regulations. California is among the one-third of states that regulate family daycare homes serving as few as three children. The state also provides few exemptions from state licensing requirements, such as programs operated by public schools or religious institutions. In addition, California mandates unqualified parental visitation rights to child care sites and has low child-to-staff ratio regulations.

To summarize, although the evidence suggests that higher child care quality is associated with superior child outcomes, mandating child care quality is not necessarily a desirable policy. Higher-quality care is more expensive, inducing families to substitute away from higher-quality care. Furthermore, strengthening regulations could have the unintended effect of reducing maternal labor force participation,
since stricter regulations raise child care costs and, as discussed earlier, higher child care prices discourage mothers from working.

Reinstating the California Child Care Tax Credit

Although the child care tax credit is the second-largest federal government outlay for child care, California currently has no state child care tax credit. In 1992, California repealed its dependent care tax credit, which was 30 percent of the federal credit. This may change depending on the outcome of a bill to reinstate this child care credit, submitted in February. This bill is in the Assembly Revenue and Taxation Committee.

The impact of a California state child care tax credit is likely to be similar to the impact of the federal child care tax credit. Research shows that a child care tax credit acts much like a reduction in the price of child care, raising the probability that a mother is employed (Blau and Robins, 1989; Leibowitz et al., 1992; Michalopoulou et al., 1992). Like the federal child care tax credit, the state child care tax credit will primarily benefit middle- and high-income families, with less benefit to lower-income families. For example, in 1988 one-third of working families with incomes over $25,000 per year claimed the federal credit. In contrast, only 12 percent of working families with incomes below the poverty line claimed the federal credit. The regressivity of this tax credit—the fact that it benefits higher-income individuals more than low-income individuals—is due to the fact that the policy is a nonrefundable tax credit and therefore is limited to the amount of the individual’s tax liability. Although child care tax credits promote employment in a general population of women, this policy is likely to play a minor role in promoting disadvantaged mothers’ employment and school enrollment.

The cost of the California child care and dependent tax credit in terms of forgone taxes is likely to be a large fraction of the state’s total expenditure on child care. In an era of limited resources for child care programs, the utility of a program that subsidizes primarily middle- and high-income families is highly suspect.
SUMMARY

In this paper we have described the major federal and state policy proposals that are likely to affect child care in the state of California. We conclude with a brief summary of our discussion of the five major themes into which we grouped these changes.

Focus on Transition to Work in Welfare Reform

One of the major themes of welfare reform has been to encourage welfare recipients to make the transition to work. Policymakers have recognized that moving mothers to the workplace implies a need for child care and have incorporated child care provisions into proposals that include work requirements. Indeed, the consensus among researchers is that child care assistance is a great boon to female labor force participation. However, federal funding remains at roughly the same level as last year, making it likely that child care funds would fall short of meeting the surge in child care demand that is expected to result from the work requirements.

Interest in School Readiness Overshadowed by Work Emphasis

Child care programs often serve dual purposes: to facilitate maternal labor force participation and to contribute to child development. Contrary to public and policymaker opinion, the research results are far from conclusive on the point of whether child care programs—even the popular Head Start program—enhance child development. The most encouraging potential for child care to improve school readiness appears to be in full-day programs with high quality that serve older preschoolers from disadvantaged families. Such programs are expensive, however, leading to a direct conflict between the child development goals and labor force participation goals of child care programs: The best programs for kids may be the most expensive programs, the cost of which discoures mothers’ labor force participation. In an era of retracted government funding
and at a time when lawmakers are enamored of programs that encourage maternal work, school readiness may become a casualty.

**Consolidating Federal Child Care Programs into Block Grants**

Block grants have several potential benefits: They provide child care recipients with “seamless” benefits, reduce administrative costs, and help the federal government manage financial difficulties. Moving federal child care provision to block grants is also likely to have unfavorable consequences for child care recipients. One is that child care is no longer an entitlement but rather becomes subject to state allocation of an ever-shrinking pot of fixed federal resources. Another is that states have been less likely to maintain quality standards, which could compromise the ability of government child care programs to fulfill the mission of enhancing child development.

**Stricter State-Level Regulations**

At the same time that federal child care quality requirements seem to have gone into remission, states are tightening their quality standards. The justification for minimum quality regulations is typically that higher-quality care yields healthier, safer, and more developmentally appropriate child care. Researchers have found associations between higher-quality care and better child outcomes. Nevertheless, stricter state-level regulations may not have their intended effect because of the vexing relationship between quality and price: Raising quality standards raises the price of care, and the higher the price of care, the less likely families are to use care and the less likely mothers are to work.

**Reinstating the California Child Care Tax Credit**

After a five-year hiatus, the California state legislature is considering reinstating the California child care tax credit. Tax credits have been shown to promote mothers’ labor force participation and ease the burden of child care costs, but they do so primarily for middle- and high-income families, providing little assistance to families with lower incomes. Given the paucity of funding available for child care and other programs to help lower-income families, the appeal of this program is limited.


Although much attention in ongoing debates over welfare reform has focused on Aid to Families with Dependent Children (AFDC), these reforms will affect many other social service programs. This paper explores the implications of welfare reform for child protective services, with special consideration to the situation in California. We first describe key features of the current child protective system, then summarize the ways legislation currently being considered by Congress would change existing federal programs and consider the direct and indirect effects of welfare reform on the delivery of child protective services. Finally, we suggest likely short- and long-term effects of these reforms on California’s child protective system, and discuss ways that the state and counties might prepare for these changes.

CHILD PROTECTIVE SYSTEM

Services

The child protective “system” encompasses a vast and complex array of services, delivered by state or local authorities that are organizationally and programmatically diverse. In spite of much regional diversity, these agencies have similar broad mandates to accept and document reports of child abuse or neglect, to investigate these reports, and to protect and care for children who have been endangered. Most of the services delivered by these agencies fall into the following program areas:
• **Child abuse/neglect reporting**: Reports of child abuse or neglect are generally filed with hotlines operated at state or local levels. Whether filed by a professional who is mandated to do so when evidence is discovered (e.g., a physician, psychologist, teacher, or social worker) or by other individuals, reports are subject to a preliminary screening to determine appropriate responses (Zellman and Antler, 1990). Potential responses include undertaking no further inquiry, referral to another service agency, setting up in-person evaluations of the child and family, or sending immediate emergency response services if the child is deemed to be in imminent danger.

• **Child protective services**: If a report requires further evaluation, a child protective service (CPS) caseworker is dispatched to visit and interview family members and others associated with the case. Workers have three charges: to evaluate whether the allegation of abuse or neglect is substantiated, to determine whether the child is at continued risk, and to decide what additional services are most appropriate given the presenting needs of the child and family.

• **Family maintenance and preplacement preventive services**: Ongoing support services can be provided to children and their families if a CPS worker determines that such services will allow the child to remain safely at home. Typical services include counseling, in-home caretakers, parenting classes, and assistance in accessing other support programs (e.g., AFDC). These services are generally short term.

• **Out-of-home placement**: When a CPS investigation determines that a child cannot safely remain at home, workers will place the children in the least-restrictive out-of-home setting available. Substitute care settings include placement with relatives, traditional foster homes, group homes, and institutions. Service providers are required to prepare detailed case plans for each child in care, and to offer necessary services and support to best ensure that children can be reunited with their parents as quickly as possible (Pecora et al., 1992).

• **Permanent placement**: Inevitably, reunification with parents is not possible for many children. In these cases, child protective service agencies are charged to find a stable, nurturing home
environment for children. Although adoption is generally the first preference in developing such permanency plans, other options include placing the child with a legal guardian or in a long-term foster home. Finally, for children who will "age out" of care, agencies offer independent living services that may provide counseling, life-skills training, transitional housing, and/or work experience.

Federal Role

Because new welfare legislation being contemplated shifts greater responsibility from federal to state government, it is important to have a contextual understanding of the federal role to date. Over the past three decades, Congress has taken an active role in establishing many of the specific policies that make up the core of child protective services today. Although the issue of child abuse and neglect gained national attention as early as the late 1890s, little federal action directly addressed child protective services until the early 1960s, when federal funding was made available for child protective services (Pelton, 1987). Federal leadership in this policy arena really emerged, however, with passage of two landmark pieces of legislation: the 1974 Child Abuse Prevention and Treatment Act and the Adoption Assistance and Child Welfare Act of 1980. Combined with amendments to these and other existing social welfare laws, these initiatives provided significant federal financial support for a broad range of child protective services—including development of reporting systems, investigation of maltreatment reports, family preservation and reunification services, foster care, adoption assistance, and independent living programs for emancipated youth. The initiatives also stimulated basic improvements in case practice, including mandates that child care professionals register all allegations of child abuse/neglect with authorities, mandates to create information systems on children in foster care, and requirements that all foster children receive case planning services with appropriate oversight by judicial bodies. New standards for foster care children were developed, requiring that these children be placed in the least-restrictive available setting, that plans for permanent placement be developed, and that appropriate efforts be made to reunite children with their parents or other relatives (Pecora et al., 1992).
Many other changes in child protective services have been driven by court action at both federal and state levels, and by state legislative bodies. While these reforms generally only directly affect case practice and programs within individual jurisdictions, their cumulative effects are often much broader—advocates, legislators, social welfare professionals, and child protective service system administrators are well aware of developments in other localities, and will often act to change practice in their community in response to changes in other areas. While many positive programmatic benefits have derived from such judicial mandates and case law, court-driven program reforms by nature unfold as a disconnected series of decisions, which compound the complexity of administration, decisionmaking, and service delivery in these systems, and pose significant barriers to improving system efficiency.

**Growth in Child Protective Service Caseloads**

New welfare legislation regarding child protective services must be viewed in the context of an overall trend of increasing demand for these services. This upward trend in the number of children requiring child protective services over the past decade is dramatically clear. As can be seen in Table 1, the increase is evident in both reports of maltreatment and in placements in substitute care settings, and holds for California as well as the nation as a whole.

The reasons for these increases are not fully understood. Some of the growth is undoubtedly due to improved reporting of child abuse and neglect, but increases in substance abuse and poverty are commonly implicated as factors fueling real increases in incidence of maltreatment. It is believed that up to two-thirds of children seen by child protective workers in recent years come from families in which alcohol or drug abuse is a serious problem (Curtis and McCullough, 1993). Nationally, more than one-third of substantiated cases of child abuse were directly linked to parental substance abuse (American Humane Association, 1995). In addition, children in the child protective system are overwhelmingly from families living in poverty or marginal economic circumstances. Among families with incomes below $7000 per year, the incidence of abuse and neglect is 10 times higher than in families with incomes of $25,000 or more (Pecora et al., 1992). Three-quarters of children receiving child pro-
Table 1

Increases in Child Maltreatment and Children in Substitute Care

<table>
<thead>
<tr>
<th>Location</th>
<th>1994 Level</th>
<th>Rate per 1000 Children</th>
<th>Change (%) from 1988</th>
</tr>
</thead>
<tbody>
<tr>
<td>United States</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Children reported for maltreatment</td>
<td>3,140,000</td>
<td>46.2</td>
<td>39%</td>
</tr>
<tr>
<td>Children in substitute care</td>
<td>462,000</td>
<td>6.8</td>
<td>36%</td>
</tr>
<tr>
<td>California</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Children reported for maltreatment</td>
<td>664,294</td>
<td>76.6</td>
<td>256%</td>
</tr>
<tr>
<td>Children in substitute care</td>
<td>87,367</td>
<td>10.1</td>
<td>53%</td>
</tr>
<tr>
<td>Los Angeles</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Children reported for maltreatment</td>
<td>164,716</td>
<td>68.8</td>
<td>291%</td>
</tr>
<tr>
<td>Children in substitute care</td>
<td>41,291</td>
<td>17.3</td>
<td>87%</td>
</tr>
</tbody>
</table>

SOURCES: 1995 Statistical Abstract of the United States; Performance Indicators, Los Angeles County Department of Children and Family Services; Public Welfare in California, California Department of Social Services.

..lle services in Los Angeles County were determined to be AFDC-eligible in 1994–1995.¹

While such characteristics as parental substance abuse, family poverty, or child health status have clear associations with risk for child abuse and neglect, the actual pathways through which any allegations are ultimately substantiated are quite complex and inherently subjective. For example, the percentage of cases in which allegations of child abuse and neglect are substantiated ranges from 11 to 83 percent across states (American Humane Association, 1995). Further, the types of maltreatment suffered by children can vary considerably across jurisdictions. As can be seen in Table 2, Los Angeles and the state of California attribute a relatively larger share of substantiated cases of maltreatment to abuse rather than neglect than is found in the nation as a whole. These patterns reflect important differences not only in the nature of risks facing children in different communities, but important differences in case practice and in definitions of behavior considered abusive or neglectful.

¹Another risk factor that should be considered is the personal health of at-risk children—60 percent of maltreated children in the United States suffer from mental health disorders, while 40 percent have health problems (Helfon, 1994).
Table 2
Type of Maltreatment in Substantiated Child Abuse/Neglect Cases (in percentages)

<table>
<thead>
<tr>
<th>Location</th>
<th>Neglect</th>
<th>Sexual Abuse</th>
<th>Physical Abuse</th>
<th>Emotional Abuse</th>
<th>Other</th>
</tr>
</thead>
<tbody>
<tr>
<td>United States</td>
<td>49</td>
<td>11</td>
<td>21</td>
<td>3</td>
<td>16</td>
</tr>
<tr>
<td>California</td>
<td>38</td>
<td>17</td>
<td>32</td>
<td>4</td>
<td>9</td>
</tr>
<tr>
<td>Los Angeles</td>
<td>33</td>
<td>15</td>
<td>37</td>
<td>4</td>
<td>11</td>
</tr>
</tbody>
</table>


Finally, the types of programs offered by child protective agencies may themselves have fueled increases in the population served. One striking example of this is the rapid growth in “kinship” foster care, a development that has contributed significantly to the growing number of children in child protective services over the past decade. Kinship care refers to the practice of preferentially placing foster children in the home of a relative. The number of such placements has skyrocketed in many states, following a series of court orders requiring that kinship caregivers receive financial support approximately equal to that given nonrelated foster parents. With the rise in kinship placements, California (like other states) has experienced a large increase in foster care caseloads, in part because children placed with relatives tend to stay longer in foster care (see Table 3). Thus, although kinship care is valued for the stability, continuity, and family ties it provides for foster care children, it appears to have contributed to growth in demand for child protective services.

FEDERAL LEGISLATION REGARDING CHILD PROTECTIVE SERVICES

As part of the sweeping welfare reform effort of the 104th Congress, legislation has been proposed that, if signed by the President, would constitute significant changes in the ways that federal funds for child

2 These cases include the 1979 Supreme Court case *Miller v. Youakim* based in Illinois, and the *Eugene F. Consent Decree* in New York.
protective services would be provided to states. In this section, we summarize key features of the House and Senate Conference Committee agreement on H.R. 4, the Personal Responsibility and Work Opportunity Act, that concern child protection services, and how these differ from current legislation. As it currently stands, the agreement proposes three funding programs that are described in further detail below: open-ended entitlements for foster care and adoption assistance, a block grant for child protection services, and a block grant for child and family services.

**Foster Care and Adoption Assistance Entitlements**

Currently, federal payments for foster care and adoption maintenance are an uncapped entitlement provided to states under Title IV-E of the Social Security Act. These cash payments go to foster (including kinship) and adoptive families to support children who have been removed from their homes because of abuse and neglect. Only those children who are eligible for the state’s AFDC program are also eligible for the foster care entitlement; children who have defined “special needs” are eligible for adoption assistance payments. For the country as a whole, some 40 percent of children removed from their homes by the child protective system are eligible for Title IV-E foster care or adoption assistance payments. States are required
to match the Title IV-E foster care payments they receive at their Medicaid matching rate (which averages 57 percent) and to match their Title IV-E adoption assistance payments at 50 percent.

Limited federal funds are also available for non-AFDC children. This funding stream is currently a discretionary appropriation under Title IV-B (subpart 1) of the Social Security Act. States must match their Title IV-B federal funds at 25 percent. States generally provide additional foster care and adoption assistance to non-AFDC children using state and local revenues and a portion of their flexible Title XX Social Services Block Grant funds. In 1993, federal spending under Title IV-E was about $1.4 billion for foster care maintenance payments and about $235 million for adoption assistance. It is estimated that this uncapped entitlement covers only about 18 percent of states’ total spending on foster care maintenance and adoption assistance payments. State and local revenues have been used to support some 68 percent of these payments, Title XX Social Service Block Grant funds have been allocated to cover another 12 percent, and Title IV-B funds have supported less than 2 percent.3

The conference committee agreement retains payments for foster care maintenance and adoption assistance as open-ended entitlements. Like the current Title IV-E programs, payments would be limited to children who are AFDC-eligible (for foster care) and to certain categories of “special needs” children (for adoption assistance). The Congressional Budget Office estimated the cost of these programs at $2 billion in 1996, with costs increasing to $3.7 billion by 2002.

**Child Protection Block Grant**

The conference committee agreement creates a new Child Protection Block Grant. This block grant would combine several currently existing funding streams. One of these is an uncapped entitlement (part of Title IV-E), supporting child protection administrative and training costs. Essentially, this entitlement funds staff who investigate, arrange for placement, and protect abused and neglected children.

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and also provides funds to support the training of child protective workers and foster or adoptive parents. States are required to match federal funds for placement services and administration at 50 percent, and for training at 25 percent. In 1993, the federal government spent nearly $1.3 billion under this uncapped funding stream. The other funding stream that would be combined into this block grant is a capped entitlement, now administered under Title IV-B (subpart 2) and Title IV-E (Independent Living), that is intended to promote stable and permanent living arrangements for abused and neglected children. These services include preplacement, family preservation, and family reunification services that are intended to avoid unnecessary removal of and return of children to the family of origin; child welfare services for placing children as quickly as possible in permanent adoptive homes; and independent living services to assist teens in their transition from foster care or group homes to independent living. Total federal money available for Title IV-B Child Welfare services (including subparts 1 and 2) was $295 million in 1993. In addition, $70 million was available for Independent Living services under Title IV-E in 1993.

The new Child Protection Block Grant would include two streams of funding—one a capped entitlement that would be $1.936 billion in 1996 and rise to $2.593 billion in 2002, the other a discretionary appropriation of up to $32.5 million. To receive maximum allowable federal funds from this block grant, a state must have in place a number of child protection procedures and standards that represent a maintenance of current standards. In addition, states must maintain their own spending on this program at 100 percent of their 1995 level in 1996 and 1997 and maintain their spending at a 75 percent level in 1998 through 2002.

**Child and Family Services Block Grant**

This block grant would provide flexible funds to support a broad range of services to promote child protection and improve the child protection system, including improving risk assessment, training, developing family support programs, and facilitating the delivery of services to children. This block grant represents a reformed version of the Child Abuse Prevention and Treatment Act (CAPTA) passed in 1974, which provided funds to states to develop programs to prevent,
identify, and treat child abuse and neglect. This proposed block grant requires states to have in place the same procedures and standards as required for the Child Protection Block Grant.

The conference agreement reauthorizes the reformed CAPTA, with a discretionary funding stream of up $230 million set for 1996 and "such sums as needed" in 1997 through 2002. Of each year's total appropriation, 12 percent is to be set aside for the Secretary of Health and Human Services to use for research and demonstration projects.

**IMPLICATIONS OF FEDERAL REFORMS ON CHILD PROTECTIVE SERVICES**

**Federal Role Little Changed; Some Funds More Constrained**

In many respects, the proposed welfare reform legislation as reflected in the conference agreement leaves in place current federal support and requirements for states' child protection systems. Two aspects of a continuing policy commitment are especially noteworthy. First, the uncapped entitlement status of payments to foster families for AFDC-eligible children and to families who adopt children with special needs is retained. Second, requirements for states to have various child protection laws and procedural safeguards and to maintain certain standards of care for abused and neglected children have essentially been left intact from the landmark child protective laws of 1974 (the Child Abuse Prevention and Treatment Act) and 1980 (the Adoption Assistance and Child Welfare Act). These features of the reformed child protection legislation maintain the federal government's role in ensuring that basic safety needs of abused and neglected children be met, in providing cash support for children who must be taken into state custody, and in insisting that reasonable efforts be made to permanently place children who enter the child protective system.

In the past decade, as the demand for child protection services has increased, federal support for basic foster care maintenance and adoption assistance support has kept pace—both for payments to families and for increases in child protection staff and training to administer these services (Figure 1 shows growth in IV-E Foster Care Maintenance and Adoption Assistance). In the seven years between 1987 and 1993, federal payments to families for foster care and

Figure 1—Federal Spending on Child Protective Services, 1983–1995
adoption assistance increased by nearly 200 percent, closely matching the 212 percent growth in the number of children served by these programs over the same period. The new conference agreement legislation would allow payments to foster and adoptive families to continue to expand or decline with need.

A significant departure from the past, however, is that under new legislation, federal support for child protective services such as abuse/neglect investigation, preventive services, professional development, foster parent training, and recruitment and administration would be capped and allowed to increase by only 34 percent over seven years. In contrast, between 1987 and 1993 federal support for child protection staff and their training grew by 289 percent (see Figure 1). If the incidence of reported child maltreatment and resulting demand for child protective services continue the recent upward trend, states will face shrinking federal support for many core child protection services. A leveling-off of growth in caseloads, on the other hand, will give states a stable federal contribution to the child protective system. Because both federal mandates to meet high standards of child protection and local judicial mandates for child protective services will continue to exist, it will fall to the states to fill the gap created by potential future increased demand for services, or to challenge their child protection systems to do more with existing resources. The investigative capacity of many child protective systems is already tightly stretched or inadequate (Zellman and Antler, 1990). While increased demand without increased resources may result in increased system efficiency, it is more likely to result in a poorer-functioning child protective system (e.g., higher rates of inadequate investigation and more misjudgments regarding risks to children).

As in the past, the conference agreement budget continues to provide discretionary and capped funds for other child welfare services. Historically, discretionary funds for these services (including services to rehabilitate families with the goals of preventing out-of-home placement and returning children to the family, and to promote the permanent placement of children and assist teens' transition to independent living) have not kept pace with the increase in the number of children requiring assistance from child protective systems. As shown in Figure 1, federal funds available under Title IV-B Child Welfare Services increased only 32 percent in seven years between
1987 and 1993 (from $223 million to $295 million), and Title IV-E Independent Living Services, originally funded in 1987, increased 55 percent (from $45 million to $70 million). As a result, over the past decade states have had declining federal support to provide these types of services to a growing caseload. Unless the incidence of child maltreatment flattens, this trend is likely to continue.

It could be argued that one advantage of the new legislation funding these supportive child welfare services is that it combines a number of existing programs into a single funding stream, providing states with broad flexibility in how to spend these funds. Relative to current legislation, however, little additional flexibility will be gained, for two reasons. First, state flexibility will continue to be limited, both in program design and disposition of individual cases, by legal precedent and local court orders that have had an important role in shaping the delivery of supportive services independently of congressional legislation. Second, states have had considerable flexibility within current federal programs to design specific services to be provided; welfare reforms do relatively little to expand this flexibility.

**Indirect Impact of Welfare Reform on Incidence of Child Maltreatment**

In addition to the direct impact of new legislation on child protection services, it is likely that other aspects of welfare reform will have an indirect effect on child protective services, particularly the extent to which reductions in cash welfare assistance to families through the AFDC program may increase the incidence of child abuse and neglect.

How would features of the congressional conference agreement increase child abuse and neglect? Many low-income families and children will have fewer resources to lift them out of poverty. Limits on the number of years that families can receive AFDC and restrictions pertaining to teen mothers, families who have additional children, and legal immigrants are intended shrink the size of the AFDC population from what it is under existing eligibility criteria. In addition, new pressures for welfare mothers to work are likely to increase the stress experienced by these families, particularly when child care resources and options are limited. Such financial stresses are likely to
exacerbate the pressures already facing these families, increasing the likelihood that abusive or neglectful behavior might take place, while simultaneously making it more difficult for children already served by the child protection system to be reunified with their parents.

The Office of Management and Budget (OMB) has estimated that full implementation of Senate welfare reform provisions affecting benefit levels and taxes would result in an addition 1.2 million children falling into poverty.\footnote{The same report estimated that the House welfare reform proposal would increase child poverty by 2.1 million. The report was issued before the compromise proposal emerged from the conference committee, so similar projections for this proposal are not available.} Using 1994 population data, this represents an increase from 10 to 11.2 million children in poverty, raising the poverty rate among children from 14.4 percent to 16.2 percent. Beyond its impact on families near the threshold of the poverty line, the broader impact of the congressional budget plan on low-income families was also estimated. For families with incomes less than $30,000 a year, reductions in benefits (including cash, in-kind, and health coverage) would average $252 per family, while tax burdens would increase by an average of $53 per family. Although the assumptions underlying these projections are open to argument,\footnote{OMB projections are sensitive to assumptions made for expected program growth rates in the absence of welfare reform and for the expected number of AFDC recipients who, upon reaching the proposed time limits for benefits, will find employment. In addition, they do not take into account changes in overall economic growth or levels of unemployment, changes in out-of-wedlock birth rates, or changes in state funding for welfare programs.} the estimates are not overly dour predictions of the likely impact of welfare reform on increases in poverty, at least in the short term; in some cases they may be quite optimistic. For example, the projections assume that 40 percent of parents reaching the AFDC benefit time limit will find employment. In addition, they do not appear to take into account new restrictions on assistance to legal and illegal immigrants, which may have a particularly dramatic effect on reducing eligibility for welfare benefits among poor families in California—in 1994, approximately 15 percent of California families receiving AFDC were noncitizens (California Department of Social Services, 1995). Finally, they assume that states will maintain their current level of effort in funding welfare programs.
Although in the immediate future welfare reform is likely to lead to a substantial deepening of poverty for families, longer-term effects are more difficult to predict. These will be influenced by broader trends in economic growth, supply of jobs in low-skilled occupations, and out-of-wedlock birthrates among poor women. Over time, some features of welfare reform may contribute to reductions in poverty by providing stronger work incentives and services to assist the transition to work, and by discouraging births among teens and poor families. However, existing literature on the ability of government programs to change the earning capacity of poor families and decrease single motherhood suggests that these goals will not easily be attained (Edin and Jencks, 1992).

Given the long-recognized association between poverty and child maltreatment, welfare reform will almost certainly place upward pressure on the incidence of child abuse and neglect in California and the nation. Unfortunately, there has been insufficient research to predict the magnitude of this effect. Whatever its size, however, this effect will be overlaid upon a long-term upward trend in demand for child protection services. In the best of all worlds, positive trends such as economic recovery in California could cancel out or minimize the impact of welfare cutbacks on the incidence of child maltreatment. More realistically, the effects of welfare cutbacks will heighten recent trends of steady annual increases in child protective cases.

**Federal Funding Streams Favor Substitute Care**

Should the demand for child protective services grow, there appear to be incentives in the conference proposal that could lead states to increase their substitute care populations while reducing efforts to prevent out-of-home placement and return children to their families. Federal funds for foster care and adoption assistance will remain an uncapped entitlement, while federal funds for all other child protective services (including child protective staff and family support services) will be limited and capped. In addition, with fewer families eligible for AFDC cash assistance, it will become more difficult to provide natural families with the assistance they need to properly care for their children. Thus, out-of-home placement may occur more often when maltreatment cases are investigated, and longer
stays in foster care may be required, especially given the likely continuing growth in kinship placements.

Kinship placements may also be stimulated as AFDC eligibility limits tighten and benefits are reduced. Some families currently caring for children of relatives in informal arrangements may seek to become approved relative caregivers as a means of gaining access to a restricted welfare benefit. Other families may respond to reduced AFDC access by attempting to have their children removed from their care and placed with relatives who then receive foster care benefits.

Shifting child protection resources from family support services to maintaining children in substitute care is a false economy when viewed from a total cost perspective. It costs considerably more in cash payments to support a child in substitute care (in California, $1100/month) than to support a child who remains with an AFDC-eligible family ($250/month). Furthermore, costs for foster care are the same for each additional child added to the foster home, while AFDC payments decrease with additional children. The added costs of increasing the size of the population that is maintained in foster care will be borne not only by the federal government as part of the continuing uncapped entitlement for these services, but also by states, which must match these expenditures to qualify for the entitlement. The high costs of substitute care, then, may justify a sizable investment in time-limited supportive services (such as mental health counseling and drug treatment) that could prevent out-of-home placement or hasten children’s return to their natural parents, even when such investments are not federally supported.

PREPARING FOR WELFARE REFORM EFFECTS ON CHILD PROTECTIVE SERVICES

What Effects Can Be Anticipated?

Short-term (1–2 years). New restrictions on eligibility for AFDC would begin to take effect immediately.⁶ These restrictions include

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⁶If recipients are given some “grace period” for time limits to take effect (for example, the time-limit clock starts after the legislation is passed), then some of the impact will be delayed.
Time limits (after two years, recipients must participate in some work activity, after five years, assistance is discontinued), requirements for teen mothers to live with family or in a supervised setting and to attend school to receive benefits, family caps (denial of benefits for additional children born to mothers receiving assistance), and prohibitions for legal immigrants (who are barred from receiving benefits for their first five years in the United States). These restrictions would immediately tighten eligibility for cash welfare assistance for California families. As noted previously, this is likely to result in a noticeable increase in the incidence of child maltreatment (particularly neglect) cases, and to lead to a significant upturn in the demand for child protective services within the first year.

The direct fiscal impact of welfare reform on the capabilities of the child protective system to deliver services is unlikely to be great in the first year or two, since block grant funding levels will be based on the level of recent federal expenditures. Only over a longer period will federal contributions to child protective services under block grants be expected to fall considerably short of the federal share under current legislation. In the first year or two, therefore, the state should anticipate some increased demand for services and stabilized levels of federal support to provide these services.

Intermediate (2–5 years). The congressional legislation on child protection would keep growth in block grant caps low for the next five years. Growth of block grant funds is not likely to keep pace with growth in demand for child protective services if the trends of the last decade continue in subsequent years. The absence of federal dollars will be most acutely felt in the resources available for child protective service staff. States and counties may step in to fill the gaps—in deed, the state will have flexibility to transfer up to 30 percent of their block grant for cash welfare assistance to child protection. However, cash welfare and other social service programs may also be strained and may compete heavily for discretionary state and federal dollars.

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7 In California, the governor’s proposed budget for the upcoming fiscal year allocates an additional $31.5 million to partially backfill for a reduction in federal aid. The total impact on the state was estimated by the governor’s office to be $45 million; county and local governments would have to assume responsibility for any gap between reduced federal aid and the increase in state backfill funds.
Unless child protective services compete effectively for funds commensurate with growing caseloads, the ability of the child protective system to prevent out-of-home placement, triage children into least-restrictive settings, and arrange for permanent placements will decline. Although the child protective system will in principle have flexibility to spend resources on family support services, in reality little flexibility will exist when resources are severely constrained. Priorities will be driven by court mandates to protect the safety of children and by specific court rulings determining the disposition of individual cases.

Severely constrained resources will undoubtedly affect the quality of services provided to maltreated children—the time that staff spend investigating reports of abuse and neglect and managing the cases that are founded will be spread across a larger number of cases. Although court mandates and local oversight of child protective services may pressure the system to operate at maximal level, requirements for the state to be accountable to a federal authority will be reduced. This reduced accountability may additionally contribute to a decline in the quality of child protective services, increasing the risk of harm for some children. Such decline may also lead caseworkers to favor removal of children from their homes as a quick way to ensure the safety of a child when risk is uncertain. Finally, decline in quality is likely to lengthen periods of out-of-home placement, given reduced resources for reunification efforts and permanency planning.

** Longer-term.** The long-term outlook for child protective services under welfare reform will depend on the success of the reform in changing work and fertility behavior among poor families and on broader economic and social trends unrelated to welfare per se. The new welfare legislation endeavors to create greater incentives for families to work, and to encourage families either to assume the financial burden of raising their children or to defer child-bearing. The long-term effectiveness of these legislative incentives, and the effectiveness of specific programs that the state will undertake to achieve such goals, are major unknowns. Past evaluations suggest that it is no easy matter, even when AFDC recipients work, to raise their wages sufficiently to lift a family out of poverty, and costs of living in major urban areas such as Los Angeles and San Francisco are an added challenge to transitioning welfare families to jobs that
can provide them with living wages (Edin and Jencks, 1992). Only time will tell, then, whether dramatic changes in welfare program incentives and innovations in work and child care programs will have their intended effects.

The effects of any new welfare incentives and work programs will be laid upon broader economic and social trends. These broader trends may be much more important than welfare incentives for promoting work and decreasing single-parent families. Factors that will be important include the availability of jobs and wages for unskilled workers, overall levels of poverty, educational attainment, fertility and marriage patterns in young cohorts, the size and characteristics of the immigrant population, and patterns of drug abuse. While it is unlikely that welfare reform will have considerable influence on these broader trends, its success will undoubtedly depend upon them.

Whether or not the child protection system fares well under welfare reform will depend on long-term trends in the incidence of child maltreatment. Maltreatment incidence will be fueled by deepening poverty and unemployment, greater homelessness, escalating drug abuse, and higher rates of unwanted births. Thus, the same economic and social factors that could make welfare reform successful will also ameliorate demand on child protective systems.

**What Steps Should Be Taken to Prepare for These Changes?**

*Monitor changes in demand for and quality of child protective services.* As the foregoing suggests, much depends on how welfare reform and broader economic and social conditions will converge to influence the incidence of child maltreatment. Under federal welfare reform, the child protective system will be less able to respond to growth in incidence of maltreatment without additional state and local resources. The state and counties would benefit from closely monitoring trends in incidence of child maltreatment reports, founded cases, the size of the substitute-care population, and child protective worker caseloads, so that they can respond appropriately to problems of inadequate child protective services before these reach crisis proportions.
The reforms also raise important questions regarding the quality of care offered to maltreated children and their families, and the systems of accountability currently in place to ensure that adequate services are provided. The federal government currently provides oversight of child protective agencies through performance audits and other monitoring systems. As this oversight diminishes with the transfer of greater authority for child protective services to the states, the states should consider whether current oversight mechanisms are sufficient. Particularly when agencies are required to serve more children with fewer resources, early warning of unacceptable compromises in the quality of care provided to children and families is needed.

*Evaluate the mix of services needed to protect children and promote their well-being.* Child protective systems walk a delicate balance between protecting children from risks imposed by their natural families and ensuring that children will be transitioned to a safe, nurturing, and permanent family situation (either the original or an adoptive family) as soon as possible. Decisions to leave children in their homes or take them into custody, where to temporarily place them, and what type of permanent family arrangements should be sought for them are seldom straightforward. Over time, agencies have developed and increased their range of services, to better balance their mandate to protect children with a preventive mission that supports families in adequately caring for their children. These supportive services include family preservation and reunification programs that target the natural family, kinship programs that provide extended family options, training and services for foster and adoptive families to improve their effectiveness as parents, and independent living programs to assist teens’ transition from substitute care to independence. Collectively, these services provide child protective systems with options to deal with the various shades of gray that exist between the extremes of ignoring a report of child maltreatment and stranding a child for years in temporary substitute care arrangements.

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8A recent audit revealed substantial problems in the quality of child protective services offered in many states (Pear, 1996).
When child protective agencies have severely constrained resources, family support services will suffer as resources become increasingly devoted to core protective services. As we argued earlier, this imbalance may actually cost more in total since it is more expensive to support children in foster care and group homes than to support them with their natural families. In addition, the overall welfare of children may suffer with too great a shift in favor of protective over supportive services.

It will be important, then, for California and its counties to consider what the ideal mix of core child protective and family support services should be, both to keep substitute care costs from becoming excessive and to optimize the quality of care provided to maltreated children. Maintaining an ideal balance of protective and family support services may require an increased investment of state and local discretionary funding to expand family support services. Greater reliance on family support services can in some cases avoid the higher cost of cash payments to families for foster care and adoption assistance.

*Consider the implications of the state welfare program on child maltreatment.* As the state takes the reins of the welfare program for families and designs specific eligibility criteria, cash assistance levels, in-kind contributions, work programs, and child care programs for needy families, it should consider the consequences of alternative designs on the incidence of child abuse and neglect. More generous benefit design in some aspects of the child welfare program (for example, child care for working parents) may translate into savings in child protection costs if it results in less child neglect. Research to investigate the impact on children of welfare changes (such as time limitations, denial of benefits to later-born children, and child care programs), and specifically to what extent these changes increase the risk of child maltreatment, would greatly inform the design of the state’s welfare program and suggest ways that the welfare and child protective systems could be more effectively integrated. Integration could be facilitated by linking information systems on services pro-
vided to families by a diverse range of health and human service providers.⁹

⁹See Wulczyn, 1992. This program has recently been substantially expanded in New York.


RESTRUCTURING THE MEDICAID PROGRAM

Arleen Leibowitz and Helen DuPlessis

Medicaid is a jointly funded federal-state entitlement program that finances the majority of medical and long-term care services for America's low-income and disabled population. Recent surges in Medicaid expenditures, attributable in large part to increases in the numbers of Medicaid recipients, have caused lawmakers to consider restructuring proposals that address both the entitlement character of the program—which mandates benefits to anyone meeting eligibility criteria—and the overall expenditures. This paper discusses recent trends in Medicaid financing and explores the implications of restructuring proposals for the nation's health care delivery system with special emphasis on the implications for California.

MEDICAID TODAY: A FEDERAL/STATE PROGRAM

Established in 1965 by Title XIX of the Social Security Act, Medicaid is jointly funded by the federal and state governments but administered by the states. Federal regulations mandate minimum standards for eligibility and coverage of benefits, but grant considerable discretion to states in a number of program areas, including (1) expansion of eligibility to groups above the minimum required by the federal government, (2) expansion of health care services above the minimum, and (3) establishment of provisions for reimbursement to providers. Under current law, federal funds pay for at least 50 percent of allowable Medicaid costs in every state. However, the federal government pays a larger share of the cost in low-income states. Currently the federal share ranges from 50 to 80 percent of Medicaid expenditures in a state.
The number of Medicaid beneficiaries has risen rapidly since the inception of the program. After a period of relative stability during the 1980s, the total number of Medicaid recipients expanded substantially from 21.8 million in 1988 to 33.5 million in 1994 (HCFA Review, 1995; Kaiser Commission, 1995). This recent growth resulted primarily from the expansion of Medicaid coverage to low-income pregnant women and young children who are not enrolled in income support programs, such as Aid to Families with Dependent Children (AFDC). Adults under 65 and children account for approximately 73 percent of the beneficiaries, while the elderly, blind, and disabled account for 27 percent. Despite the disproportionate growth in the numbers of adult and child Medicaid beneficiaries, these two groups, adults and children, contributed less to the growth in overall expenditures than did the aged, blind, and disabled beneficiary groups. Children and non-aged adults account for approximately 27 percent of Medicaid spending compared with nearly 60 percent of expenditures funding services for the aged, blind, and disabled (Figure 1).

The period from 1988 to 1993 also saw dramatic growth in expenditures for the Medicaid program. Total spending (federal and state contributions) increased from $51 billion in 1988 to $125 billion by 1993, with the Congressional Budget Office projecting expenditures to reach $158 billion for fiscal year 1995. The expansion in eligibility and spending for Medicaid increased state expenditures as well. State contributions almost tripled from $19 billion in 1988 to nearly $56 billion in 1993. Medicaid is seen as a prime example of an "unfunded mandate" in which the states are obligated to share in the cost of the program that the federal government has decided to expand.

Medicaid spending covers a variety of mandated services including inpatient and outpatient acute care services, long-term care for the elderly and mentally ill, Medicare (Part B) premiums for elderly persons in poverty and Disproportionate Share Hospital (DSH) payments. Despite recent increases in acute outpatient spending, long-term care services account for more than one-third of all Medicaid costs (35 percent). Hospital reimbursements account for 34 percent of all costs (including 14 percent spent on DSH); outpatient services account for 26 percent; and payments of Medicare premiums for impoverished elderly account for 5 percent of Medicaid spending.
Some explanation of DSH payments is in order, since these expenditures accounted for much of the increase in overall Medicaid expenditures in the early 1990s. The Omnibus Budget Reconciliation Act (OBRA) of 1987 authorized these payments to supplement the financing of hospitals that cared for a large volume of Medicaid or other low income/uninsured patients. DSH payments are made as a supplemental adjustment to the qualifying hospital's Medicaid rate and are distributed as a function of the number of Medicaid inpatient days. Federal Medicaid reimbursements to states rose sharply in 1989, when DSH payments to states were first implemented. DSH payments accounted for much of the 28 percent increase in Medicaid expenditures between 1990 and 1991.¹ (Winterbottom et al., 1995, p. 127). By 1993, DSH payments amounted to $16.9 billion, or 13.5 percent of total Medicaid expenditures.

¹Without DSH payments, expenditures would have risen by only 18.9 percent.
The factors contributing to increased Medicaid spending have shifted somewhat in recent years. While DSH payments accounted for much of the increase between 1990 and 1991, their contribution was actually negative from 1991 to 1992 (following federal legislation aimed at limiting states’ reliance on DSH funding). Growth in eligibility accounted for two-thirds of the increase in Medicaid expenditures between 1991 and 1992. Additional causes of increased Medicaid spending were an inflation rate in medical costs that exceeded the Consumer Price Index, increases in the number of eligibles resulting from increased immigration, and the continuing loss of job-related health insurance, which was exacerbated by the recession that began in 1990.

The next section describes how these emerging Medicaid trends have affected California. The following sections describe the proposed solutions to California’s health care problems—block grants, Medicaid managed care, and changes in the Disproportionate Share program. The final section discusses the likely interactions among these reforms.

**CALIFORNIA’S MEDICAID PROGRAM**

The California Medicaid program, known as Medi-Cal, has been more generous with eligibility than have other states’ programs. California has high per-capita enrollment rates compared with the national average (200/1000 in California versus 144/1000 in 1992). Thirty-seven percent of children receive Medi-Cal, in contrast to 28.6 percent nationally. Higher percentages of non-elderly adults also receive Medi-Cal than in other states—9.2 percent of persons under 65 versus 5.5 percent nationwide (Table 1). Although children account for more than half of the 6.1 million Medi-Cal enrollees (3.1 million), and their mothers and other non-aged adults account for another 1.7 million recipients, the program also covers many elderly (0.6 million) and blind and disabled (0.7 million). Following the national trend, the number of Medi-Cal beneficiaries grew 12.5 percent a year from 1990 to 1993.

Spending for mandated services in California was distributed somewhat differently than was typical in other states, perhaps owing to the disproportionately large number of children and non-elderly adults covered by the program (Figure 2). The largest portion of the
Table 1
Medicaid Enrollees and Enrollment Rates: United States and California, 1992

<table>
<thead>
<tr>
<th></th>
<th>United States</th>
<th></th>
<th>California</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Enrollees</td>
<td>Per 1000</td>
<td>Enrollees</td>
<td>Per 1000</td>
</tr>
<tr>
<td></td>
<td>(in 1000s)</td>
<td>Population</td>
<td>(in 1000s)</td>
<td>Population</td>
</tr>
<tr>
<td>Total</td>
<td>35,313</td>
<td>144</td>
<td>6,060</td>
<td>200</td>
</tr>
<tr>
<td>Children</td>
<td>18,376</td>
<td>129</td>
<td>3,065</td>
<td>374</td>
</tr>
<tr>
<td>Non-elderly adults</td>
<td>8,271</td>
<td>55</td>
<td>1,724</td>
<td>92</td>
</tr>
<tr>
<td>Elderly</td>
<td>3,778</td>
<td>126</td>
<td>551</td>
<td>171</td>
</tr>
<tr>
<td>Blind and disabled</td>
<td>4,887</td>
<td>20</td>
<td>720</td>
<td>24</td>
</tr>
</tbody>
</table>


Figure 2—California Medi-Cal Spending by Service, 1993

Medi-Cal dollar was spent on hospital services (47 percent), including 19 percent on DSH, with the remainder being distributed as follows: 29 percent on outpatient services; 17 percent on long-term care, and 8 percent on Medicare premiums. California’s heavy
reliance on DSH payments to cover the cost of inpatient care for the uninsured contributed in part to the funding crisis in Los Angeles County and will be discussed in further detail below.

California has relatively low per-enrollee costs compared with other states and has experienced lower-than-average increases in expenditures. Reimbursement rates that are well below the national average (Winterbottom et al., 1995, p. 126) allow Medi-Cal to maintain a relatively low average per-enrollee cost, despite the fact that Medi-Cal covers many services in addition to those mandated by federal regulations.  

A relatively low Medicaid reimbursement schedule has also allowed California to control the growth of Medi-Cal expenditures. Average annual growth in expenditures from 1990 to 1993 was below the national average—11.8 percent, excluding DSH payments, and 24.9 percent including DSH payments (Winterbottom et al., 1995, p. 127).

The State of California is attempting to streamline Medicaid and control costs by promoting the use of managed care. Historically, California has led other states in the enrollment of Medicaid beneficiaries in managed care. In 1993, 5.3 percent of California’s Medicaid payments went to HMOs, compared with 3.1 percent nationally. Current plans call for mandatory enrollment in HMOs for all AFDC-related Medicaid beneficiaries in 19 California counties, beginning in 1996.

The Medicaid reform proposals that call for ending the entitlement aspect of Medicaid and changing the program into one with a fixed budget also will certainly affect California, with its large and growing Medicaid population. The next section discusses the implications for California, and particularly Los Angeles County, of the three proposed policy changes.

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2California’s per-enrollee expenditures for children averaged $601 in 1993, or 62.9 percent of the national average. Expenditures per adult enrollee averaged $1422, or 82.8 percent of the national average (Winterbottom et al., 1995, p. 126).
PROPOSALS FOR RESTRUCTURING THE MEDICAID PROGRAM

The MediGrant Proposal

Federally mandated expansions in Medicaid eligibility have driven the inexorable rise in both federal and state Medicaid expenditures. A proposal introduced in the fall of 1995 in the U.S. House of Representatives would fundamentally change the “entitlement” characteristic of the Medicaid program, which mandates the provision of services to all persons meeting eligibility criteria for the program. The House MediGrant proposal would replace the current Medicaid program with block grants to states. Block grants would allow increased flexibility (with approval from the Secretary of Health and Human Services [HHS]) in the determination of eligibility standards, scope of benefits, and financing with regard to the provision of medical assistance to low-income individuals and families. The amount of money received as a block grant would be based on historical allocations, and would not increase or decrease with the numbers of persons eligible.3

The bill explicitly eliminates the entitlement characteristic of the program, thus eliminating current federal regulations regarding categorical eligibility, duration of eligibility, and financial standards. Instead, states could set their own eligibility standards. However, states would be required to devote specified minimum shares of total Medicaid spending for each of three groups: low-income families with a pregnant woman or child (below 185 percent of the federal poverty line), low-income elderly, and low-income disabled. The share for each of these beneficiary groups would have to reach at least 85 percent of the average share of the spending mandated for that group by federal law during FY 1992 through FY 1994. Requirements for coverage of particular services would be removed; thus states could develop their own scope of benefits (with the exception of requirements regarding immunization).

Additionally, states would be free to determine the organization and financing of health services delivery methods. Such flexibility in the

3DSH payments and payments for services to illegal aliens would not be included in computing the base-period spending percentages.
organization of delivery systems would eliminate the need for a federal waiver of “statewideness” or freedom of choice of providers before experimenting with alternative delivery models in all or part of the state. Flexibility in financing health care would permit experimentation with a variety of arrangements such as the use of vouchers, fee-for-service, managed care arrangements, or utilization controls. The bill also would allow states to charge premiums for Medicaid coverage (except for AFDC families below 100 percent of the poverty level) and to impose coinsurance and deductibles for medical services without securing special federal waivers.

The National Governors’ Association Proposal

In February 1996, the National Governors’ Association (NGA) put forward a Medicaid reform proposal that modifies the MediGrant plan to allow the continuation of some of the elements of an entitlement program. At the same time, the NGA plan allows states greater freedom than under the current Medicaid program to determine eligibility standards and benefits. Federal financing would be fixed in any year, but would depend partly on growth of the eligible population.

The NGA proposal guarantees eligibility for persons and families who are eligible for AFDC. Whatever the AFDC standards, states would be required to provide Medicaid for pregnant women and children up to age 6 with incomes up to 133 percent of poverty; children aged 6 to 12 with family incomes up to 100 percent of poverty; elderly persons eligible for SSI; and persons with disabilities. This list does not include several groups whose Medicaid coverage is currently mandated by the federal government: poor children aged 13 to 18, low-income elderly also covered by Medicare, and elderly nursing home residents whose incomes are above the SSI income standard. At their option, states could cover other groups with family incomes below 275 percent of poverty.

Unlike the MediGrant bill, the NGA plan allows the federal Medicaid contribution to depend on factors other than historical Medicaid payments. The NGA proposal would require states to contribute toward Medicaid reimbursements to obtain the federal allocation, but would reduce the state’s matching contribution from the current
level of 50 percent to a maximum of 40 percent. The amount of the federal contribution would depend on (1) the base Medicaid allocation in FY 93, FY 94, or FY 95, (2) expected growth in Medicaid expenditures resulting from increase in caseloads and medical price inflation, (3) special grants to cover illegal aliens and Native Americans, and (4) an insurance umbrella designed to provide coverage (at a fixed level) for unanticipated growth in the number of eligibles whose coverage is guaranteed under the plan.

The NGA plan would guarantee most benefits for the populations whose coverage is mandated, but states would have increased flexibility in defining the amount, duration, and scope of these services. States would be freed of statutory provisions (such as the Boren Amendment) that require states to pay “reasonable and adequate” reimbursements to providers. Thus, states could set all health plan and provider reimbursement rates without approval of the federal government or threat of legal action by the plan or provider.

**Implications for California of Medicaid Restructuring**

The MediGrant and NGA proposals represent two different approaches for restructuring the Medicaid program. Although neither may be adopted exactly as proposed, they provide a blueprint for two different options. Table 2 presents the principal features of the current Medicaid program and the two “prototype” reforms proposed.

Historically, California has had low Medicaid reimbursement rates and high rates of growth in eligible Medicaid populations, as compared to other states. These two factors imply that block grants will severely disadvantage the California Medi-Cal program.

Because of low levels of provider reimbursements and the state’s leadership in the use of managed care, California has relatively low levels of Medicaid expenditures per beneficiary compared with other states. The MediGrant proposal, which bases the block grant on historical spending patterns, seems to punish states like California that have been aggressive in controlling Medicaid costs. One analysis found that under block grants based on historical spending patterns, high-reimbursement states like New York would receive federal contributions averaging $2000 per person under 150 percent of poverty;
Table 2
Characteristics of Current, Block Grant, and Restructured Entitlement Proposals for Medicaid

<table>
<thead>
<tr>
<th></th>
<th>Current</th>
<th>Block Grant (MediGrant)</th>
<th>Restructured Entitlement (National Governors' Association)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Financing</strong></td>
<td>50–79% federal share, based on state per-capita income</td>
<td>Fixed dollar amount: formula allocation based on base year (including DSH) and fixed growth rate (7–9%)</td>
<td>Maximum federal allocation with growth and inflation factors</td>
</tr>
<tr>
<td></td>
<td>– maximum state match 50%</td>
<td>– cost-sharing flexibility without waiver (preventive care and very-low-income families excepted)</td>
<td>– umbrella fund for unanticipated growth in caseload</td>
</tr>
<tr>
<td></td>
<td>– Disproportionate Share Hospital (DSH) funding</td>
<td>– DSH optional</td>
<td>– maximum state match 40%</td>
</tr>
<tr>
<td></td>
<td>offsets cost of uncompensated care</td>
<td></td>
<td>– cost-sharing restrictions eliminated</td>
</tr>
<tr>
<td></td>
<td>– cost sharing limits (Title IX)</td>
<td></td>
<td>– DSH rules unclear</td>
</tr>
<tr>
<td><strong>Benefits</strong></td>
<td>Mandatory Services guaranteed to categorically eligible (aged, blind, disabled, AFDC) and optional groups</td>
<td>Mandatory benefits repealed (Immunization and family planning excepted)</td>
<td>Mandatory services maintained but with levels at states' discretion</td>
</tr>
<tr>
<td></td>
<td></td>
<td>– prohibits abortion spending</td>
<td>– eliminates current rules on amount, duration, and scope</td>
</tr>
<tr>
<td></td>
<td></td>
<td>– eliminates state wideness (allows different levels of coverage, payment &amp; provider mix for different populations and regions)</td>
<td>– eliminates treatment mandate for EPSDT (Early and Periodic Screening, Diagnosis and Treatment program)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>– Rural health centers and federally qualified health centers to be maintained at 85% of expenditure (1992–1994)</td>
<td>– mandatory benefit package for optional beneficiaries</td>
</tr>
<tr>
<td>Eligibility</td>
<td>Current</td>
<td>Block Grant (MediGrant)</td>
<td>Restructured Entitlement (National Governors' Association)</td>
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<td>---------------------------------------------------------</td>
</tr>
<tr>
<td></td>
<td>Guaranteed eligibility categories (age, blind, disabled, AFDC)</td>
<td>Most mandatory features repealed</td>
<td>Maintains entitlement (for basic services) for:</td>
</tr>
<tr>
<td></td>
<td>- optional groups (medically needy children eligible under Ribicoff provision, etc.)</td>
<td>- covers pregnant women, children (&lt;12 years) up to poverty level</td>
<td>- pregnant women, and children &lt;6 years (to 133% poverty level)</td>
</tr>
<tr>
<td></td>
<td>- EPSDT services being phased in for all children &lt;19 years</td>
<td>- set-aside amounts for low-income families, aged disabled (85% of 1992-1994 base year)</td>
<td>- children 6–12 years (to 100% poverty level)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- Medicare premium @90% of 1993–1995 base year expenditure</td>
<td>- elderly/SSI</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- optional coverage for families below 275% poverty level</td>
<td>- Medicare beneficiary copayments limited to 80% allowable costs (for beneficiaries to 100% poverty level)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- prohibits funding of care for undocumented persons (prohibits funding of care for legal immigrants for 5 years)</td>
<td>- older than 12 yrs optional</td>
</tr>
<tr>
<td>Other</td>
<td>Beneficiary and provider due process allows fair hearing, state and federal court appeals.</td>
<td>Due process includes fair hearing (eliminates any court appeals).</td>
<td>Set-asides for “disabled” (90% or 1995 base year)</td>
</tr>
<tr>
<td></td>
<td>Extensive regulatory requirements for nursing homes.</td>
<td>Modifies federal nursing home regulations (states’ discretion)</td>
<td>- definition of “disabled” at states’ discretion</td>
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however, the federal contribution to California’s Medicaid program would average only $800 per poor person.4

The NGA proposal would moderate the impact of a fixed Medicaid budget on California by providing more support for states in which medical costs generally are rising faster than the national average. In the future, other states may achieve lower rates of medical cost inflation than California because California will start with low reimbursement rates and has already used managed care to control expenditures. In contrast, other states may be able to achieve greater savings by cutting "fat" from their system and moving more beneficiaries into managed care. Under the NGA plan, California’s allocation would rise if its rate of increase in Medicaid costs exceeded that in other states.

The treatment of increases in caseload under the NGA proposal would also be more favorable for California than the MediGrant bill. California has had a larger share of its population covered by Medicaid than other states, partly because of more-generous eligibility standards, and partly because of the characteristics of the California population. It is likely that Medi-Cal caseloads will continue to grow at a faster rate in California than elsewhere because of increases in the share of the elderly population and increases in the number of citizen children of undocumented immigrants. An inflexible block grant, such as that in the MediGrant proposal, makes no allowance for differential growth rates in numbers of persons in need across the states. California would fare better under the NGA proposal, which bases the block grant partially on a growth factor.

Financing the medical care of the uninsured is a critical concern in California. Despite a high level of per-capita income, California has an uninsured rate of that is matched only in the poorest states. Twenty-three percent of Californians have no health insurance, compared with 18 percent nationally. The uninsured rate in Los Angeles County is 31 percent—nearly twice the national average.

(Cousineau et al., 1994). Most of these uninsured persons have low incomes, yet many do not qualify for full-scope Medi-Cal because they are not citizens (46 percent of Latinos living in L.A. County have no health insurance [Cousineau et al., 1994]). Currently, the state relies on DSH payments and general funds to cover the cost of the uninsured.

Both the MediGrant and NGA proposals would alter DSH payments to hospitals. This may impose a large burden on California, which is heavily invested in this approach to financing the medical care for residents who lack health insurance. DSH payments are based on the total number of Medicaid funded inpatient days; thus, the greater the number of days that Medicaid beneficiaries are hospitalized, the greater the DSH payments. Currently, there is little incentive to move toward policies that reduce hospital use in order to limit Medicaid expenditures.

There is no requirement for private inpatient facilities to care for the uninsured. These facilities can provide services only to Medicaid beneficiaries, for whom they can garner better DSH supplemental payment, leaving the burden of care for the more expensive uninsured patient to public facilities. Although federal legislation in 1991 and 1993 placed significant restrictions on DSH payments, these restrictions were specifically aimed at abuses of DSH payments and are unlikely to affect the degree to which California relies on this mechanism for reimbursing the cost of care to Medi-Cal and uninsured patients.

The MediGrant proposal would particularly disadvantage California because it builds in no alternative provision for financing the medical care of the uninsured. The NGA proposal allows for the allocation of special grant funds, with no matching requirement, to cover illegal aliens and Native Americans. The NGA proposal also protects the state in the event of business cycle downturns that result in growth in the Medicaid-eligible population. It would therefore help to finance otherwise uncompensated care, and would build in protection against growth in the numbers of persons without health insurance.
MEDICAID MANAGED CARE

Mandating Managed Care in California Counties

Many states are seeking to enroll their Medicaid beneficiaries in managed care plans in order to contain Medicaid outlays and reduce the uncertainty surrounding Medicaid expenditures. Prepaid health plans may provide health care at a lower cost than fee-for-service plans through the use of delivery system characteristics such as utilization management and care coordination, and financing innovations such as monthly capitation rates that are independent of the amount of care the beneficiary actually uses.

After engaging in a series of problematic prepaid health experiments in the early 1970s, the State of California resumed prepaid Medi-Cal activities in 1982, when the Department of Health Services was granted authority to establish managed health care delivery systems for the Medi-Cal population in Santa Barbara and San Mateo counties. These demonstration projects, while established as County Organized Health Systems (with responsibility for securing but not directly providing health services to Medi-Cal beneficiaries in all program aid categories), operate much like traditional health maintenance organizations. Reimbursement for health services employs a capitated model, and the primary care provider assumes responsibility for care coordination.

Since that time, the state has encouraged the development of other managed care systems, including a limited-risk gatekeeper model known as Primary Care Case Management (PCCM) and a Geographic Managed Care (GMC) model. Under GMC, the state contracts with a sufficient number of commercial prepaid health plans to cover the entire Medi-Cal population in a given county. Sacramento County undertook the development of a GMC demonstration in 1992, the implementation of which has been quite problematic.

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5 Access, quality, and marketing abuses in the 1970s resulted in the passage of two key pieces of legislation that eliminated most existing Medi-Cal contracting by prepaid health plans. The Waxman-Duffy Prepaid Health Plan Act established contracting authority and organizational standards for Medi-Cal prepaid health plans, and the Knox-Keene Health Care Service Plan Act designated the State Department of Corporations as the regulatory agency for all prepaid health plans.
In 1993, the California State Department of Health Services disseminated its plan for expanding the role of managed health care delivery systems for the Medi-Cal population by developing a fourth, so-called two-plan model. This model allows Medi-Cal beneficiaries in counties designated for expansion to choose between a locally-developed managed care plan composed largely of traditional providers of Medi-Cal services (the Local Initiative) and a commercial health maintenance organization with which the state will contract.

At the time of this writing, the California State Department of Health Services anticipates that 12 counties will proceed with the two-plan model, five as County Organized Health Systems (COHS), and two as Geographic Managed Care sites. The Primary Care Case Management model, which was intended as a transitional model allowing individual providers to gain experience with managed care, will be phased out. If implemented as proposed, the plan would increase the number of Medi-Cal beneficiaries enrolled in prepaid health plans from approximately 600,000 (as of March 1993) to over 2 million by 1997, focusing primarily on beneficiaries who are categorically eligible as AFDC recipients.

Projected Effects of Managed Care for Medi-Cal

Access to Care. Access to medical care historically has been difficult for many Medi-Cal beneficiaries, owing to the limited number of providers who would accept the relatively low reimbursement rates offered by Medi-Cal for their treatment. Many Medi-Cal beneficiaries who cannot find private providers who accept Medi-Cal payment seek care in county hospital emergency rooms and outpatient departments. County hospitals provide the services because they are required by law to treat all persons in need of care. Much of this care is for routine health problems, which could be treated in less-
expensive settings than outpatient departments and emergency rooms.

Managed care has the potential to improve the quality of care for Medi-Cal beneficiaries by encouraging access to primary care for routine health problems. Under Medi-Cal managed care, each beneficiary would be enrolled in a plan with a contractual obligation to provide necessary Medi-Cal services. Medical case managers may be able to provide the type of comprehensive, ongoing care that has been lacking for the beneficiaries who seek treatment in outpatient departments and emergency rooms.

On the other hand, prepaid plans create incentives for providers to limit the amount of care delivered. The conflict between plan incentives and state mandates may limit, rather than expand, access to care in the short term. This is of particular concern because the monthly capitation rate negotiated for the most recent managed Medi-Cal expansion is much lower than capitation rates under previous managed Medi-Cal demonstrations, and consequently is very low relative to what plans receive for their commercial enrollees. In recent years, Medi-Cal capitation rates have approximated the capitation rates that managed care plans charge their commercial subscribers (about $105/month/enrollee). However, the capitation rate for Los Angeles’ Medi-Cal beneficiaries is currently projected at $75/month/enrollee, which is about two-thirds of commercial and earlier Medi-Cal capitation rates. Further, because prepaid plans do not file claims itemizing the services they deliver, it will be difficult for the state to monitor whether the beneficiaries actually receive the full range of services to which they are entitled.

**Changes in Medi-Cal Providers.** The competition among providers for Medi-Cal beneficiaries and dollars may dramatically alter the nature and types of Medi-Cal providers. Providers who are newly assuming responsibility for the medical care of Medi-Cal beneficiaries will have much to learn about the spectrum of diseases, utilization patterns, and health-related needs of their new patients. For example, Medicaid children are more likely than children from higher-income families to have complications in routine childhood illnesses, use emergency rooms as their primary source of care, and require psychosocial and other support services (Starfield, 1992). Moreover, because many Medi-Cal beneficiaries have relied on
county hospitals and clinics for their care, they may continue to seek care at those sites even after they have been required to enroll in a managed care plan.

This latter phenomenon may be a double-edged sword for traditional Medi-Cal providers. It would work to their advantage if beneficiaries chose to enroll with traditional providers who are participating with the Local Initiative (rather than having to provide unauthorized care to unenrolled patients who return to these providers out of habit). However, if the Local Initiative enrolls a large share of the chronically ill, it will be in the position of paying for the care of the sickest patients, while receiving only an average level of capitation. This type of selection would threaten the financial viability of the Local Initiative.

**Role of Public Health and School-Linked Health Services.** Under Medi-Cal managed care, the state may allocate funds that previously would have supported traditional public health functions to private managed care plans. This “privatization” of state health resources may undermine traditional public health functions such as communicable disease control/prevention (e.g., sexually transmitted diseases, tuberculosis, vaccine-preventable disease), population-based health services (e.g., vital statistics, disease-specific investigations/analyses), and even the assurance and policy-development functions outlined by the Institute of Medicine (1988). At the same time, the demand for these services may rise. A recent study of immunization rates in low-income areas in Los Angeles suggests that some commercial managed care plans reduce their own costs by referring their enrollees to public health clinics for such routine care as immunizations (Wood, Halfon, et al., 1994).

The increasing role of schools as a locus for health care may be reversed by Medi-Cal managed care. Initial plans call for the maintenance of screening services designated under the Local Education Agency (LEA) legislation, but these services will be maintained only for those children receiving special education services. Schools have served as an important model for expanded access to preventive and acute care services for all children with the establishment of school-based clinics (Healthy Start, 1991). Much of the financing for this care has come from billing Medi-Cal for eligible children. However, if financing for all Medi-Cal children is allocated directly to health
care plans, school-based clinics will have difficulty getting reimbursed for their services. If several plans serve each area, there will be little incentive for any one plan to allocate some of its funding to provide these school-based services.

REORGANIZING THE LOS ANGELES COUNTY HEALTH DELIVERY SYSTEM

In the spring of 1995, the Los Angeles County Department of Health Services (LA DHS) predicted a budget deficit in excess of $655 million for fiscal year 1995–1996. This projected shortfall represented the most severe deficit among many the department has faced in the past decade, and necessitated a temporary reduction in services of county hospitals. These fiscal difficulties are best interpreted in light of the organizational structure of the health care delivery system and the trends in financing strategies.

Before October 1995, the LA DHS operated six hospitals, 39 health centers, and six comprehensive health centers. These facilities provided 85 percent of uncompensated inpatient care and 60 percent of trauma care for the entire county. In recent years, the number of both inpatient and outpatient services delivered at these facilities has declined dramatically, while the organization of this public health delivery system essentially remained unchanged. During this same time period, the private health care market shifted the delivery of care from costly inpatient and emergency services to more-efficient (capitated) outpatient primary and preventive services.

At the same time, funding sources for county medical services have changed. Legislative changes in the State of California over the past 25 years have resulted in a decline in revenues for indigent care available directly from state and county revenues, and a shift to federal revenues. The 1994–1995 LA DHS budget contributions were distributed as follows: 6 percent from the county, 27 percent from the state, 58 percent from the federal government, 9 percent other. It

8) Despite Proposition 13, which allowed shifting of county tax revenues to the state, during the 1980s responsibilities continued to be shifted from the state back to the counties. For example, the Medically Indigent Adult program (MIA), which was funded through Medi-Cal, became a county responsibility in the mid 1980s.
is important to note that historical trends in federal and state financing for indigent care have been disproportionately oriented toward inpatient and emergency (trauma) services, thereby supporting and even encouraging the heavy emphasis on inpatient services by county health systems like the LA DHS. For example, DSH and SB 1255 funding, which together account for almost 40 percent of the $2 billion budget of the LA DHS, are critically dependent upon the number of inpatient Medi-Cal days. OBRA/IIRCA payments are likewise aimed largely at inpatient and emergency services (for undocumented aliens). Although the LA DHS currently provides about 3 million outpatient visits each year, similar spending increases for outpatient (Medi-Cal) services have not occurred.

This most recent fiscal crisis occurred in the face of proposals for dramatic restructuring of the nation’s Medicaid program that threaten to curtail the availability of federal dollars to state and local governments. Recognizing that LA DHS could not make a rapid transition from its heavy emphasis on hospital-based health care delivery, and consequently its dependence on inpatient revenues, local and federal officials requested a waiver of Federal Medi-Cal regulations. The federal (§ 1115) waiver was designed to facilitate a transformation of the LA DHS, while preserving its critical contribution to the health care safety net. The main provisions of the waiver are as follows:

- Expand access to primary care in outpatient settings through public-private partnerships.
- Federal Medicaid matching payments will be made available for outpatient services.
- State and county governments must develop an interagency agreement regarding the funding of indigent inpatient care.
- Payments to county hospitals will be restructured to encourage the provision of care in outpatient settings.
- Growth in LA DHS Medicaid spending must be limited to base spending for 1994–1995 plus an inflation factor.
- Los Angeles County must fund the (50 percent) match (the state will not fund the waiver).
Assuming the county will be able to fund the match, the waiver provides a unique opportunity for the LA DHS to begin a restructuring process into a public sector health system that provides services in the most-appropriate and least-costly setting. This sort of planning process is one that all state and local governments will have to undertake to weather future reforms with the least amount of difficulty.

**WHAT STEPS SHOULD BE TAKEN TO PREPARE FOR MEDICAID RESTRUCTURING?**

Developments at the federal, state, and county level point to extensive changes in California’s Medicaid program in the near future. Federal policymakers may fundamentally change the nature of Medicaid, transforming an entitlement program into a block grant. Whether or not the federal funding changes, Medi-Cal must transform itself into a more-efficient, rational program. That change has already begun at the state level, with the mandatory enrollment of Medi-Cal beneficiaries in managed care in the largest California counties. In Los Angeles County, the attempt to move the county health system away from inpatient services and into enhanced outpatient services is another, parallel effort to increase the efficiency and reduce the cost of delivering health care to county residents who are unable to pay the full cost of their care.

Uncertainty about changes to the federal Medicaid program makes it difficult to plan for state and local restructuring of Medi-Cal. However, it is clear that whether or not the federal program changes, the state and counties must deal with a number of crucial issues: financing care for the uninsured, interfacing with changes to AFDC, providing incentives for cost-efficient health care delivery, and ensuring that Medi-Cal delivers quality care for its beneficiaries.

**Financing Uncompensated Care**

In addition to their role in paying a share of Medicaid costs, states (and counties) have responsibilities as “providers of last resort” to pay for the medical care of poor persons who do not meet the categorical requirements for Medicaid eligibility. Indeed, many Medicaid beneficiaries lose eligibility and become uninsured only to regain eligibility at a later date. This drift between Medicaid and
uninsured status provides a rationale for offsetting the cost of uncompensated care with Medicaid funding. The demands on state and local government to pay for such care have been growing with increases in the numbers of people who lack health insurance and with the growth in numbers of undocumented immigrants (who are not eligible for Medicaid).

To date, California has relied on revenues tied to the federal Medicaid program to cover much of the cost of treating the uninsured. Under MediGrant, coverage for the uninsured is left to the state’s option. The NGA proposal would also fundamentally change the manner in which the county receives payments to cover the uninsured and immigrants.

The problem of paying for the uninsured is exacerbated by the state’s transfer of Medi-Cal beneficiaries into managed care. The state may realize a greater efficiency in caring for Medi-Cal beneficiaries, but separating the providers for Medicaid and uninsured patients reduces opportunities to use Medi-Cal revenues to fund services for the uninsured. If the state allocates its Medicaid funding to health plans that treat a defined population on a prepaid basis, there is little possibility of using Medi-Cal revenues to fund services for the uninsured.

The current method of financing care for the uninsured with DSH payments has contributed to the inefficiency in Los Angeles County’s health system by emphasizing inpatient care. The loss of these transfers will leave Los Angeles County hard-pressed to pay for medical care for the poor. With only limited powers to raise revenue, the counties must look to national and state governments as well as private entities to help shoulder the cost of the uninsured.

To the extent that undocumented immigrants account for a significant share of these costs, state and local governments bear the burden of yet another “unfunded federal mandate.” There is an argument that the federal government has an obligation to contribute toward the cost of medical care for the undocumented, since the number of immigrants in California depends on actions and rules at the federal level.

The counties will continue to seek health funding from state government, which has much greater power to collect revenue. In addi-
tion, the state will have the power to allocate federal health funds under block-grant reforms. Yet neither the MediGrant nor the NGA proposal requires states to pay for the uninsured.

Private medical providers are currently able to evade the costs of paying for the uninsured. As discussed above, even the DSH payments allow private facilities to ignore uninsured patients in favor of Medi-Cal patients for whom they receive larger supplemental payments. By encouraging public-private partnerships, particularly among facilities that do not have a history of providing care to Medicaid or uninsured patients, the county could facilitate cost-shifting from commercial populations to the uninsured. Licensure requirements or "sick taxes" imposed on either hospitals or capitated plans that contract to care for Medi-Cal beneficiaries provide another mechanism to distribute the costs of paying for the uninsured more evenly across providers.

Interfacing with Welfare Reform

State decisions about welfare reform will affect the numbers of uninsured that counties must provide for. If California succeeds in moving large numbers of families off of AFDC and into work, the numbers of uninsured may increase. All AFDC recipients are guaranteed Medicaid coverage. However, persons leaving AFDC for employment are unlikely to be offered employer-paid health insurance in the types of low-paying jobs often available to them. Thus, unless California mandates extended Medicaid coverage for families leaving AFDC, the numbers of uninsured who look to the county for health care will certainly grow. Clearly, the state can make employment a more attractive option for AFDC eligibles by ensuring health insurance for low-income workers whose jobs do not provide it. To ease the transition from welfare, the state might encourage the development of low-premium commercial insurance that is affordable by those individuals moving off of welfare or currently covered under Medicaid expansions. Subsidies could be graduated and required of state/local governments, private sector providers, and employers, thus unhinging the provider of care from the responsibility of financing the care.
Provide Incentives for Cost-Efficient Health Care Delivery

Disproportionate Share Hospital payments, OBRA/IRCA, and other such financing mechanisms support perverse incentives to provide care in expensive settings like hospitals and emergency rooms. The federal §1115 waiver gives Los Angeles County the opportunity to reverse its reliance on inpatient care while still receiving support for the uninsured. However, the county's ability to receive these DSH payments depends on federal restructuring and the evolution of Medi-Cal managed care.

Maintaining Quality Assurance and Monitoring Capacity

None of the restructuring proposals advanced to date maintains rigorous standards for the quality and organization of the health care delivered under the new systems. In fact, most proposals unencumber states from federal standards aimed at securing the most basic assurances of quality. Medicaid HEDIS, an adaptation of a private sector tool, has been proposed as the means of monitoring the care delivered by managed care organizations to Medicaid recipients. However, it will provide only the most basic utilization information, and will not adequately handle the needs of children and individuals with significant acute or chronic health care needs. The large changes in both eligibility and covered services that may result from block grants may bring about equally large changes in health. The state has a proper role in monitoring the effects on health of these massive changes in health policy.
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JOB TRAINING: THE IMPACT ON CALIFORNIA OF FURTHER CONSOLIDATION AND DEVOLUTION

Robert T. Reville and Jacob Alex Klerman

Since federal involvement in job training began in the early 1960s, great expectations have been attached to job training as a policy that can reduce poverty and unemployment at minimal cost to the government. It has been a policy that has failed to reach its anticipated potential. This paper attempts to assess the impact of pending legislation on job training in California. Can the increased discretion provided under the proposed legislation lead to more effective job training, so that job training becomes a significant policy to alleviate poverty and unemployment?

Legislation to overhaul the job training system passed both houses of Congress this fall and is currently in conference committee. The stated purpose of the legislation that passed the House of Representatives is to transform the current system of “fragmented and duplicative categorical programs” into a “Federal workforce development and literacy system that is designed to meet the education, employment, and training needs of the workforce and the competitiveness needs of employers of the United States, both today and in the future.” (HR 1617, title I, section 3b). Both bills provide block

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1 We have benefited from discussions with Norton Grubb, Jim Hosek, Joe Hotz, Robert Moffitt, Bob Schoeni, and the participants in the RAND Fiscal Federalism Conference. Helpful comments were received from Barbara Williams, Cathy Stasz, and Ron Komers.

2 The focus of this paper is on job training provided or subsidized by the federal government. See Lynch (1994) for a collection of papers on employer-provided job training.
grants for training, consolidate vocational education and job training programs, and transfer most authority for training policy and administration to local and state governments. Therefore, the bill reflects the federal vision that meeting the education, employment, and training needs of the workforce is largely a local responsibility, though with federal financial support. The financial support will be substantially reduced in both of the bills.

Since 1973, the federal job training system has been transformed by continual consolidation and devolution. The result is a system that is locally designed and administered. Therefore, the first question is whether further decentralization will have any impact. To answer this, the next section reviews the history of job training; the following section describes the decentralized structure of the current job training system. Despite previous reform legislation in 1973 and 1982, the current job training system has been heavily criticized, which has led to calls for further reform. The third section reviews the critique of the General Accounting Office (GAO) and its suggestions for further consolidation. The fourth section reviews the critique from the job training program-evaluation literature. This critique has not been directly influential in shaping legislation, but it will help inform California in its reaction to proposed legislation. The fifth section describes the bills for job training reform now in conference committee. The final section concludes with predictions on the effect of the legislation on job training and presents recommendations.

A HISTORY OF THE DEVOLUTION OF JOB TRAINING

Federal job training assistance is targeted primarily at four groups: disadvantaged adults voluntarily seeking employment services, disadvantaged youth, dislocated workers, and welfare recipients. These groups are not mutually exclusive, which has led to a tension in job training policy between ending the provision of duplicative services and focusing on the unique needs of each group. Since the goal of job training policy is employment, ideally at earnings above poverty level, another policy tension arises from the roles of the fed-

3 There are also job training programs for veterans, disabled persons, older workers, and inmates, although these programs are relatively small.
eral and local government. While the former provides the funding, the latter is arguably more sensitive to the skill demands of employers. Therefore, the history of federal job training programs has been a history of consolidation and devolution. In this section, the history of job training is reviewed to provide context for the current proposed changes.

The first major training program was the Manpower Development and Training Act (MDTA) in 1962.\(^4\) The MDTA was intended to retrain workers displaced by technological change and to improve the earnings capacity of disadvantaged workers. It was a federally funded and administered training program. The Economic Opportunity Act of 1964 initiated another major job training program: the Job Corps. The Job Corps offers training and counseling in a residential environment to highly disadvantaged youth. A third major job training program arose in reaction to the increase in the Aid to Families with Dependent Children (AFDC) caseload over the 1960s. The federal government determined that training would allow AFDC recipients to find work and leave welfare. As a result, the Work Incentive Program (WIN) was established in 1967 to provide training to welfare recipients (O’Neill, 1973).

In addition to MDTA, Job Corps, and WIN, a number of other job training programs and public employment programs were created in the 1960s, including Neighborhood Youth Corps, Operation Mainstream, New Careers, Concentrated Employment Program, Older Americans, Model Cities, and Foster Grandparents (Bassi and Ashenfelter, 1986). In response to the increasing complexity of the job training system, Congress passed the Comprehensive Employment and Training Act (CETA) in December 1973. Title I of CETA consolidated the various programs and turned the administration and operation of the programs to local officials. It replaced the “categorical” system of funding the programs, whereby each program is targeted at a particular population and federal administrators determined the amount of money allocated to each, with “revenue sharing,” whereby state and local governments would receive a manpower training grant, allocated by formula, which was to

\(^4\)The first federal program was part of the Area Redevelopment Act in the late 1950s (O’Neill, 1973).
be spent at their discretion on various job training programs for the disadvantaged\(^5\) (O’Neill, 1973). This change was intended to rationalize the administration of workforce development and at the same time increase local control, allowing the programs to be responsive to local conditions.\(^6\)

The federal role in job training, dramatically reduced by CETA, was further reduced in 1982, when Title I of CETA was replaced by Title II of the Job Training Partnership Act (JTPA).\(^7\) While CETA delegated the responsibility of administration to local officials, local administration was subject to federal oversight in the form of regulations and plan approval as well as designation of the local entities to receive funds. States were largely left out of the process. JTPA placed primary responsibility for oversight with the states. The private sector, too, was not directly involved in the federal job training system under CETA. In 1978, Private Industry Councils (PICs) were established, but their role was purely advisory. JTPA included a direct role for PICs in the formulation of job training programs at the local level. A further criticism of the job training system under CETA was that it was not sufficiently coordinated with other related educational and social programs. JTPA made states responsible for promoting coordination, and funds were directly allocated to the governors for this purpose (Levitan and Gallo, 1988). Finally, JTPA reduced the federal expenditure on job training.\(^8\) In 1981, $4.4 billion was spent on job

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\(^5\)Job Corps continued under federal administration. The WIN program was not part of CETA.

\(^6\)CETA is best known as a public employment program. In 1973, CETA included a modest public employment program that was intended to be implemented whenever unemployment rates were above a certain level. At the same time, the OPEC oil embargo struck, and unemployment rates increased from 5 percent in early 1974 to over 7 percent by the end of 1974. In response, President Ford agreed to a large increase in the public sector employment component, transforming CETA from a job training act to a job creation act. Under President Carter, the number employed by CETA was more than doubled. CETA’s public sector jobs were eliminated in 1981 (Levitan and Gallo, 1988).

\(^7\)The Job Corps continued as a federally administered job training program under Title IV of the JTPA.

\(^8\)Another significant change from CETA to JTPA was that stipends paid to trainees were eliminated. The Reagan Administration argued that since a substantial portion of training funds were used for stipends, job training was just another form of welfare (Levitan and Gallo, 1988).
training for the disadvantaged. After reductions throughout the 1980s, this amount had fallen to $2.4 billion by 1994 (Lalonde, 1995).

A similar pattern of decentralization characterizes the history of welfare-to-work programs. While welfare programs themselves continue to have considerable federal oversight and administration, training programs established under the programs are designed and administered by states. In 1981, the Social Security Act was amended to permit WIN demonstration programs (WIN Demos). These programs gave states the option to assume responsibility for the administration and oversight of the WIN program for their state. By 1988, 29 states had established WIN Demos (Barnow and Aron, 1989). In 1988, Congress passed the Family Support Act, which replaced the WIN program with the Job Opportunities and Basic Skills (JOBS) program. JOBS provided federal matching funds for states to design their own welfare-to-work programs. Like JTPA, it specified service options and included performance standards, but allowed states the discretion to determine how to meet them (Gueron and Pauly, 1991).

In 1985, the Food Security Act established the Food Stamps Employment and Training (E&T) Program, which funds training programs for recipients of food stamps. This program, too, provides states a great deal of flexibility in designing and administering the training services provided (Barnow and Aron, 1989).

The growth of welfare-to-work programs like JOBS and Food Stamps E&T and the expansion of programs for dislocated workers over the 1980s have led to renewed calls for consolidation of the job training system. However, compared with the system that existed prior to the passage of CETA, twenty-five years of federal job training reform has created a system in which federal administration and oversight are virtually nonexistent, local infrastructure for designing and administering the programs is already in place, the funding for these programs is largely in block grants allocated by formula to the states, and private sector participation is substantial.

**THE CURRENT JOB TRAINING SYSTEM**

The largest federal job training program is the Job Training Partnership Act (JTPA). The JTPA is a highly decentralized block grant program administered by local communities with minimal federal regulation and oversight. There are a number of other programs
with overlapping clientele and similar purposes, but there is also an extensive set of incentives for coordination among programs.

The JTPA is the primary source of job training funds for California. Total federal funding received by California for 1994–1995 was $542 million (Bugarin, 1995). Title II of the JTPA provides training services to disadvantaged workers,9 and Title III, referred to as the Economic Dislocation and Worker Adjustment Assistance (EDWAA) Act since being amended in 1988, provides training to dislocated workers.10 The "partnership" envisioned is between state and local governments, and the local business community.

Under the JTPA, training block grants are allocated to states by a formula based on the unemployment rate and the number of disadvantaged individuals in the state. Within each state, the governor has designated Service Delivery Areas (SDAs) to which 78 percent of the funds are allocated by the same formula11 (Barnow and Aron, 1989). In California, there are 52 Service Delivery Areas (Bugarin, 1995). Within each SDA, the chief elected official will appoint the members of the Private Industry Council. At least 51 percent of the PIC must be from the business community. The PICs, in combination with local elected officials, are responsible for formulating the job training plan for the SDA, which includes procedures for selecting training providers and recipients, and details of the administration of the program (Barnow and Aron, 1989). The active involvement of the business community, the ultimate provider of employment for trainees, is intended to ensure that the training provided is of sufficient quality and relevant content.

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9 According to U.S. House of Representatives, Committee on Ways and Means (1995), disadvantaged is defined as "being a member of a family whose total income for the 6-month period prior to application (exclusive of unemployment compensation, child support payments, and welfare payments) does not exceed the higher of the poverty line or 70 percent of the Bureau of Labor Statistics' lower living standard. Members of families receiving Aid to Families With Dependent Children (AFDC) or other cash welfare payments and those eligible for food stamps are also defined as economically disadvantaged."

10 Dislocated is defined as "Workers who have lost their jobs and are unlikely to return to their previous industries or occupations." (U.S. Department of Labor, 1996b)

11 As will be discussed further below, an additional 8 percent is allocated to state education and coordination grants, and 6 percent for incentive grants and technical assistance. The remaining 8 percent is allocated for training programs for older workers (3 percent), and administration (5 percent) (Barnow and Aron, 1989).
In response to criticism of CETA that performance was measured by the number served rather than the quality of the service, JTPA included performance standards and incentives to meet them. Six percent of JTPA funds are allocated to provide incentives for SDAs to meet a set of performance standards designed by the Secretary of Labor. The governor can modify and extend the standards. SDAs that exceed the standard can receive a portion of the incentive funds. Those that do not meet the standards can receive technical assistance from the 6-percent set-aside, but if they do not meet the standards for two consecutive years, the SDA can be dissolved and reorganized. Standards include the percentage placed in employment and the wage received (Barnow and Aron, 1989).

Training is available to dislocated workers both through JTPA Title III and through the Trade Adjustment Assistance (TAA) program. The TAA program provides assistance to workers displaced by foreign trade. Because of the overlap among Title II, Title III, and the TAA programs, legislation since 1982 has attempted to increase coordination among them. In 1982, JTPA Title III did not require states to pass funds down to local areas, and as a result Title III programs were not administered by SDAs. In 1988, the Economic Dislocation and Worker Adjustment Assistance (EDWAA) Act amended JTPA Title III to, among other things, require states to pass down at least 60 percent of the funds to local areas. This increased coordination among Title II and Title III training programs. At the same time, the Trade Act of 1974, which authorizes TAA, was amended to require training for workers who receive TAA cash assistance, and to encourage extensive coordination between JTPA and TAA (National Commission for Employment Policy, 1991).

JTPA also directed the states to coordinate job training with vocational education, the Employment Service, and welfare. This was intended to avoid duplication of administrative functions, as well as facilitate ease of referral among agencies. Eight percent of JTPA funds were set aside for “coordination grants.” In addition, the gov-

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12 The incentives provided by this system are complex. On the one hand, SDAs are encouraged to establish a training program that meets the needs of local employers so that the standards can be met. On the other hand, contrary to the JTPA’s goal of providing training to the most needy, SDAs may attempt to meet the goals by selecting trainees who are easier to place in high quality jobs (Barnow and Constantine, 1986).
errors were directed to create State Job Training Coordinating Councils (SJTCs) composed of local government, state government, and the business community, as well as other groups such as organized labor and community organizations. The SJTC has the responsibility of preparing a plan for coordinating the various educational and social welfare agencies of the state, and of reviewing the SDA plans for consistency with the state plan (Levitan and Gallo, 1988).

Coordination with the Employment Service avoids duplication with the job placement function of the JTPA. The Employment Service was created in 1933 under the Wagner-Peyser Act. It provides job search assistance from listings of job openings to resume-writing workshops. It is primarily funded from the Unemployment Insurance Tax. Prior to 1982, the Employment Service was largely a federal program, with the Department of Labor determining office locations and staff size. In 1982, the Wagner-Peyser Act was amended to give states the authority to administer the Employment Service, to encourage greater responsiveness to local conditions. After the 1982 amendments, the Department of Labor provided technical assistance and program oversight (GAO, 1991). The 1982 Wagner-Peyser Amendments allow 10 percent of Employment Service funds to be used by states for coordination with JTPA (Levitan and Gallo, 1988). The 1988 amendments to the Trade Act of 1974 also encourage coordination between TAA and the Employment Service (National Commission for Employment Policy).

In 1984, Congress passed the Carl D. Perkins Vocational Education Act, continuing federal support for vocational education that began in 1917 with the Smith-Hughes Act. Separate federal support for job training and vocational education arose from the belief that the vocational educational system had failed in training the disadvantaged and in retraining adults. The Perkins Act, however, emphasizes increasing vocational training for populations, such as adults and the disadvantaged. Therefore the potential for efficiency gains from coordination and costs from duplication became greater than ever (Roberts and Petrossian, 1987). The 8 percent of JTPA funds set aside for coordination grants is intended to provide encouragement for states to realize these efficiency gains. In addition, both JTPA and Perkins require that state and local plans discuss methods of coordi-
nation between vocational education and job training (Grubb, et al., 1990).

The vocational education system is largely financed by state and local governments, and federal support is a small percentage of the total expenditure. Therefore, like JTPA and the Employment Service, Perkins funds are allocated in block grants. The block grant formula is based upon the age distribution of the state, and the state’s relative median per-capita income (with poorer states receiving a larger grant). The funds are then distributed to public secondary and post-secondary schools by a different formula based upon the school’s share of the state’s total enrollment of disadvantaged and handicapped students (Roberts and Petrossian, 1987).

Gains to coordination have also been perceived in welfare-to-work programs. The Family Support Act, which established the Job Opportunities and Basic Skills program, required state plans for JOBS to be coordinated with JTPA. States are allowed to use the 8 percent education coordination grant to fund JOBS. In California, half of the 8 percent is used to fund the JOBS program GAIN (Greater Avenues for Independence). In practice, GAIN participants use JTPA programs extensively (Grubb et al., 1990).

In 1992, Congress amended the JTPA to encourage states to form Human Resource Investment Councils (HRICs) that would unify in one council the various administrative and advisory bodies involved in employment, training, and education. The HRIC would be involved in formulating a comprehensive human capital investment policy, and then would monitor the implementation of that policy. An HRIC has not been formed in California (Bugarin, 1995).

The most recent federal innovation to encourage increased coordination in education, employment, and job training services is the development of the concept of “one-stop career centers.” In late 1994, the Department of Labor began to award grants to states to develop “centers”13 to unify access to job training, employment, and edu-

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13A distinction is sometimes made between one-stop “centers” and one-stop “systems.” The term “center” usually connotes services provided at a particular physical location, whereas a one-stop “system” refers to electronic access to information about available services.
cation for all population groups. The concept envisions recipients of training as "customers" and emphasizes accountability of service providers to maximize "customer satisfaction." Development of a center, according to the Department of Labor, requires integration of the administration of the various employment-related programs at both the state and local level (U.S. Department of Labor, 1996a).

THE CRITIQUE, PART I: THE GAO

Criticism of the current job training system has many dimensions. In this section and the next, criticism of the system from two sources will be reviewed. The first critique, from the General Accounting Office, has been influential in shaping legislation for reform of the system. The second critique, from the academic literature and the research organizations responsible for evaluating training programs, has not directly influenced legislation, but should be considered by California and other states when deciding how to exercise the increased discretion that block grants are expected to provide.

In a series of reports in the last few years, the General Accounting Office has reviewed the current job training system and found that it is fragmented and inefficient. In 1995, it identified 163 separate programs administered by different agencies, often offering identical services to overlapping clientele. With the current popularity of welfare-to-work programs and job training programs, this number has been increasing rapidly. In 1991, the GAO identified 125 programs. By 1994, that number had increased to 154 (U.S. GAO, 1995a).

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14 The "one-stop center" concept was foreshadowed by the "skill center" concept in job training policy in the 1960s. The services initially delivered by MDTA were classes in particular occupational skills taught at public vocational education schools. This approach was criticized because the occupational classes and times available to workers were limited. In response, the "skill center" concept was developed. A "skill center" is a single facility where a broad array of employment and training services are provided to all types of trainees on a continuous basis. In 1968, the MDTA was amended to promote the skill center as the preferred service delivery method, but the amendment was not implemented (O'Neill, 1973).

15 California received a grant of $400,000 from the Department of Labor to develop a One-Stop Career Center System.

16 The GAO has issued a number of studies. The studies are referenced and summarized in U.S. GAO, 1995a. That study also includes the recommendations for policy below.
According to Bugarin (1995), California has 22 labor and employment programs located in 13 administering departments.\textsuperscript{17} The GAO has argued that to administer these programs, parallel structures have been created in different departments at both the federal and state levels. Often, separate programs provide services to the same population. Bugarin (1995) found a comparable situation in California. For instance, 12 programs in California target welfare recipients. This duplication increases administrative cost, reducing the amount of money available for training workers (U.S. GAO, 1995a).

Furthermore, the system, according to the GAO, is confusing to clients, discouraging individuals seeking assistance. Since it is not linked to economic development programs (local programs that seek to attract or retain businesses), it is difficult for employers to meet their employment needs. Administrators, too, face conflicting regulations\textsuperscript{18} and different planning cycles. Finally, according to the GAO, most programs do not have accurate information on the effectiveness of their programs (U.S. GAO, 1995a).

The GAO made four recommendations:

- The number of programs needs to be reduced, and the ease of access to the remaining programs needs to be increased.
- Conflicting federal requirements and duplicative administrative procedures need to be eliminated.
- A wide array of employment training services needs to be offered, with the programs developed in partnership with employers to ensure relevance to labor market needs.

\textsuperscript{17}The number is smaller in California because the GAO study counts all programs operated under a particular law, such as the JTPA, separately, whereas Bugarin does not. JTPA alone, in the GAO study, contributes 20 programs. For instance, the GAO counts the 3 percent of JTPA funds set aside for older-worker grants, the 8 percent set aside for state education and coordination grants, and the 6 percent set aside for incentive grants as separate programs.

\textsuperscript{18}For example, there are different definitions of “low income,” or “household” depending upon the program involved, which leads to confusion and difficulties of coordination (GAO, 1995a).
• Program administrators need to be held accountable, while at the same time states and local agencies need to have the flexibility to design the program to be responsive to local conditions, which requires “clearly defined goals and performance standards.”

The GAO critique is familiar. Congress has been trying to implement the four recommendations above since 1973. It is not clear whether they have not yet gone far enough, have reversed themselves in the intervening years, or have failed to diagnose the problem correctly.

THE CRITIQUE, PART II: THE EVALUATION LITERATURE

Another criticism of the job training system emerges from a review of the training program evaluation literature. This critique is arguably more fundamental, because the source of the problem is not the administration of the system, but the programs themselves. According to this critique, the modest, short-term job training programs offered by the federal government are largely ineffective. For some demographic groups, they produce small gains in employment and yearly earnings (but almost never in wages—amount earned per hour), while for others they have no effect.

A review of which programs are effective and what groups should be served will assist California in its priorities for funding job training programs. According to a GAO study of the experience with block grants in the Omnibus Budget Reconciliation Act (OBRA) of 1981, two important lessons are that funding priorities tend to change when states have more discretion, and the need to offset reductions in federal funding tends to lead to increased state expenditure on the block-granted programs. California’s imprint on programs ought to reflect what is known about job training from these evaluation studies.

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¹⁹The extent of increase varied depending upon the block grant and the state. The overall increase in state expenditure on the programs in the Preventive Health and Health Services Block Grant was 9 percent. The increase in state expenditure on the Maternal and Child Health Block Grant was 24 percent. Some other block grants, however, saw no increase in state expenditure.
Nonexperimental evaluations of the impact of early job training programs were not very reliable. In response, a large number of experimental evaluations of job training programs have been conducted since the 1980s. An experimental evaluation includes a control group which does not receive the programs provided to the experimental group, and the outcomes for the two groups are compared. These experiments have provided a large amount of information about the effectiveness of various training strategies, and about the returns to training for various demographic groups. Several recent studies (U.S. Department of Labor, 1995; Lalonde, 1986; Grubb, 1995) have summarized the literature on job training evaluations, and concluded the following:

- Job training programs, by themselves, cannot eliminate poverty. Even the most-effective programs are not able to raise the participants out of poverty. However, certain programs have been able to increase the earnings, and reduce the welfare participation, of particular groups.

- Modest programs for disadvantaged youth are generally the least effective. Short-term training, classroom training, and summer youth programs have generally been shown to have no long-term benefits. The participants in the programs do not have higher rates of school completion, employment, or wages than the control groups. Programs targeted at young single mothers have not significantly reduced their welfare receipt or poverty. On the

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20See Bassi and Ashenfelter (1986) for a discussion of the early nonexperimental estimates and the need for experimental evaluation of job training programs.

21These evaluations are expensive, and the vast majority of job training programs have not been evaluated in this manner. The enormous value of the information from these evaluations for the formulation of policy suggests that one use of funds that should not be sacrificed under block grants is the rigorous experimental evaluation of training programs.

22Though job training is often suggested as a solution to the increasing inequality in earnings, Heckman (1994), using optimistic assumptions, notes that the amount that would be required to reverse these trends is prohibitive. For instance, to restore average earnings for high school dropouts to their 1979 levels would require spending $214 billion on job training.

23Some programs, such as summer employment, may be effective in reducing crime, but should not be viewed as investment in the human capital of the participants. See Heckman (1994).
other hand, intensive (and expensive) programs such as Job Corps have been effective.\footnote{24While Job Corps is generally viewed as a successful program, there is also some controversy. Lalonde (1995) discusses the difficulties in measuring the benefits attributed to the program. Young single mothers have not been shown to be helped by Job Corps (Department of Labor, 1995). Another intensive, though nonresidential youth training program called Quantum Opportunities Project has also been shown to be beneficial (Department of Labor, 1985).}

- The most promising results have been achieved for disadvantaged adult women. Earnings gains from both voluntary programs (like JTPA) and welfare-to-work programs (like JOBS), while still leaving the participants in poverty, have been shown to last for several years. For example, the difference between the experimental and control group in annual earnings in the second year after participation in JTPA is $900 for women, a difference of 15 percent (U.S. Department of Labor, 1995). The evidence from welfare-to-work programs for adult women is that they can reduce welfare participation rates, and they are cost-effective insofar as the reduction in welfare payments outweighs the cost of the programs (see Gueron and Pauly, 1991).\footnote{25It is possible, however, that if welfare-to-work programs substantially increased the skills of welfare recipients, and that if they were available to a large fraction of the caseload, welfare participation would actually increase (Moffitt, 1996).} For example, AFDC payments to experimental group members in California’s GAIN program were an average of $350 per year lower than the control group in the three years after program participation (U.S. Department of Labor, 1995).

- The evidence is not as conclusive for other groups. In particular, disadvantaged adult males have been helped by some programs, including JTPA (though to a lesser extent than women),\footnote{26The earnings increase for men participating in JTPA is $900, or 10 percent higher than the control group.} and not by others. Training for displaced workers has also been shown to have mixed results. However, results for both of these groups, in particular displaced workers, are tentative because of a relative scarcity of studies.

It is difficult to summarize the evidence with regard to the effectiveness of various services provided by job training programs, and the
Conclusion of Grubb (1995) and U.S. Department of Labor (1995) is that offering a wide variety of services is the best strategy. Job search assistance, the least expensive program, has been able to increase earnings for all groups by reducing the duration of unemployment. However, it tends to raise only earnings and not wages, and the effect does not last.\textsuperscript{27} Short-term classroom training of basic skills is generally ineffective for all groups.

The modest successes for displaced workers may even be less significant than reported, because the benefit of training programs to the worker (and to society) ought to be counted against the value of time spent out of the workforce and in training. Displaced workers tend to be of prime working age and the value of this time is not insignificant, even if the wages they would receive are lower than what they received on their previous jobs. Unlike with disadvantaged youth, there are unlikely to be benefits from reduced crime, or, unlike with disadvantaged women, from reduced welfare participation (Lalonde, 1995).

Despite this somewhat bleak picture of the success of job training programs, it should be noted that certain programs have been extremely successful, and the benefits to replicating these programs may be very high indeed. Two examples of successful programs are located in California. The Center for Employment and Training (CET) in San Jose has been successful in training two groups that have seen poor results elsewhere: young female single parents and young high school dropouts. For example, CET was evaluated as part of a program called Jobstart for disadvantaged youth. The program at most other locations was unsuccessful, but at the CET program participants had 40 percent higher earnings than the control group, an annual earnings increase of $3000 (U.S. Department of Labor, 1995). The success of this program has been attributed to (among other things) the close connections between the center and local

\textsuperscript{27}For this reason, Lalonde (1995) notes that the earnings gains from job search assistance, more than any other service, may be at the expense of another disadvantaged worker not receiving assistance, who does not get the job because the assisted worker does. If this is the case, widespread implementation of job search assistance may be ineffective. The extent of this problem cannot be measured by experimental evaluations.
businesses, and to an innovative training program that integrates basic skills with vocational training. Another successful program is the Riverside County welfare-to-work program (part of the Greater Avenues for Independence (GAIN) demonstration). At this site, an emphasis on job search and job placement has proven very effective. The Riverside GAIN participants had annual earnings $1000 higher than the control group (U.S. Department of Labor, 1995). Grubb (1995) argues that the success of the CET and the Riverside GAIN program derives more from the fact that both provide comprehensive and interrelated employment services than from the quality of any particular services offered by them. The CET, in particular, with a broad array of training programs, is a prototype “one-stop shop.”

While the GAO critique has figured prominently in the plans for federal job training reform, the difficult questions posed by the evaluation literature critique have been delegated to the states. In designing a job training system for California, the evaluation literature has shown that inexpensive short-term job training programs may lead to modest increases in earnings and employment, but they do not reduce poverty on their own. For some demographic groups, they do not even increase earnings. Given reduced federal funding for job training, California should consider targeting job training on groups for which the training is effective. Training for disadvantaged adults, and particularly women, is the most effective. Resources for training youth need to be directed toward expanding intensive job training programs like Job Corps, and toward experimenting with innovative programs like those offered by CET. Continued experimentation,

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28According to Department of Labor (1995), “CET staff have extensive knowledge of local labor markets, which they use to determine which technical skills will be taught in their courses. In each new community CET enters, an industrial advisory board is set up to assist in skill selection and curricular review. CET courses are taught by experienced technicians from industry. Many area employers are also on the board.” (p. 18)

29As noted by the Department of Labor (1995), even this successful program had only 23 percent of participants still employed and off AFDC three years after participation in the program.

30According to Bugarin (1995), the following are available: “JTPA, JOBS (GAIN), Food Stamps Employment Training, adult basic education, GED certification, alternative high school, skills training, labor market information, vocational assessment, foster care independent living skills, infant day care, and job placement services for employers.” (p. 41)
carefully evaluated, should be funded by California as well, since if training is to be a useful poverty alleviation measure, new methods need to be developed.

CAREERS AND THE WORKFORCE DEVELOPMENT ACT\textsuperscript{31}

Federal job training support is about to enter a new era. On October 11, 1995, the Senate passed by a vote of 97-2 the Workforce Development Act, which provides block grants for job training, adult education, and vocational education. A month earlier, the CAREERS (Consolidated and Reformed Education, Employment and Rehabilitation Systems) Act passed the House of Representatives by a vote of 345-79. The two bills are currently in a House-Senate conference committee where differences are being resolved (Havemann, 1995).

The House CAREERS Act consolidates JTPA and Perkins, as well as the Adult Education Act and the School-to-Work Act, into three block grants. The first block grant consolidates youth programs into the Youth Development and Career Preparation Consolidation Grant ($2.325 billion for 1997). The second consolidates adult programs into the Adult Employment and Training Consolidation Grant ($2.183 billion). The third is the Adult Education and Family Literacy Consolidation Grant ($280 million). States would be permitted to transfer up to 10 percent between the youth training grant and the adult training grant.

The Senate Workforce Development Act would also consolidate vocational education and job training, using one block grant instead of three. The block grant would be allocated 25 percent for workforce employment activities,\textsuperscript{32} 25 percent for workforce education activi-

\textsuperscript{31}Concise summaries of the two bills are available from Savner (1996b, 1996c). These summaries, together with the text of the bills and documentation received from the Department of Labor, were used in writing this section.

\textsuperscript{32}The total allocation to the state would include the amount allocated for the Employment Service under the Wagner-Peyser Act. The quarter of the block grant allocated to workforce employment activities would include the amount from the Wagner-Peyser Act, and Wagner-Peyser requirements would be paid for from this block grant. In eight states (though not in California), the current Wagner-Peyser allocation exceeds the amount allocated for workforce employment activities, leaving no money for training activities unless flex fund dollars are used.
ties, and 50 percent for a "flex account" that is allocated to employment or education by the governor. The flex account money can also be spent on welfare-to-work job training programs.

Several provisions are common to both bills, and are therefore likely to be retained in the version that emerges from the conference committee. Both bills

- allow states considerable flexibility in the allocation of funds between vocational education and job training for adults,
- eliminate eligibility on the basis of unemployed or disadvantaged status,33
- emphasize accountability and the use of performance standards,
- require that states make information on available services easily accessible ("one-stop career systems") and maintain a labor market information service (Wagner-Peyser Employment Service),
- allow for the use of vouchers so that adults can choose among providers,34 and
- include provisions for the use of block grant money for economic development, such as firm retraining of incumbent workers.35

There are also several key provisions included in one bill but not in the other. The Senate bill restricts training to individuals who have received a high school diploma or the GED, unless currently enrolled in a course to obtain one. The House bill restricts training to individuals who cannot find employment through job search assistance. The House bill requires states administer training through a system similar to JTPA's Private Industry Councils, but the Senate bill makes this system optional.

33The House bill gives priority to the unemployed or disadvantaged but does not specifically target these groups.
34Vouchers are mandatory in the House bill, provided a sufficient number of certified providers are available. In the Senate bill, vouchers are optional.
35The Senate bill permits up to half of the worker employment grant be used for economic development, or 25 percent of the entire block grant. The House bill is more restrictive.
As noted above, in addition to seeking increased coordination with vocational education and the Employment Service, Congress has sought to increase coordination between JTPA and displaced worker programs, and between JTPA and welfare-to-work programs. However, the JOBS program and the Food Stamps Employment and Training program were not included in either of the block grants. Both bills retain the Job Corps as a federally administered program and exclude the Trade Adjustment Assistance program from the block grants.

THE IMPLICATIONS FOR JOB TRAINING IN CALIFORNIA

CETA consolidated federally administered programs into a block grant and delegated authority to design and administer those programs to local areas. CAREERS and the Workforce Development Act consolidate several block grants into larger block grants. The programs are locally administered and designed, and there is an extensive set of mechanisms and incentives in place to encourage coordination among them. CETA did not revolutionize job training. It is hard to imagine that the new legislation will either. In this section, some of the potential implications of the workforce legislation for California will be reviewed.

According to the GAO, there are numerous potential gains from block grants (GAO, 1995b). They include

- savings through the elimination of duplicative administrative activities,
- promotion of interdepartmental coordination at both the federal and state level,
- decentralization of decisionmaking, so that problems are identified and solved at the source,
- encouragement of innovation, and
- better targeting of resources, since distributing funds by formula reduces the power of federal administrators to control grants.

36 Welfare-to-work programs can be funded through the Flex Fund provided in the Senate act.
The first and second gains are related to consolidation. If the new legislation leads to consolidation of job training and vocational education in California, these gains may be realized. However, there is reason to expect that this will be difficult, given the incentives already in place for consolidation. Unlike consolidating two job training programs for the disadvantaged that are administered by two different agencies, job training and vocational education often have different clientele and offer different services (for example, on-the-job training by JTPA)\(^{37}\) (Grubb et al., 1990). The third and fourth gains are related to decentralization. Since job training and vocational education are already highly decentralized, it does not seem likely that the new legislation will lead to further gains in these areas. Finally, the fifth gain is related to administering a block grant program, but since both JTPA and Perkins are block grants, this gain has already been realized.

Since the block grant and federalism provisions of the job training legislation do not hold the potential to create a job training system significantly different from the current one, it is likely that the criticism in the evaluation literature will still be relevant. There are, however, several provisions in the current legislation that could potentially lead to a very different job training system—one that might be significantly improved. These are the provision of job training through one-stop shops, the potential for increased statewide coordination of job training programs, the ability to combine job training with economic development, and the potential for innovation and efficiency through the use of vouchers.

**One-Stop Shops**

Both versions of the legislation emphasize service delivery through one-stop shops. The conclusion of the evaluation literature is that access to a wide variety of services, as in one-stop shops like the center for Employment and Training (CET), is the most effective way...

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\(^{37}\) An example from California can illustrate the difficulties of coordination of job training and vocational education. According to Bugarin (1995), in March 1993, the State Council on Vocational Education and the State Job Training Coordination Committee attempted to jointly contract for a study of the coordination of job training and vocational education in California but were unable to agree to the terms of the contract (p. 35).
to provide training. Unfortunately, there are two potential problems with the one-stop shop provisions that may outweigh the benefits associated with creating them. The first is that the legislation may not provide enough money to implement one-stop shops effectively. The second is that to eliminate administrative barriers to one-stop shops, both versions of the legislation eliminated criteria for eligibility such as welfare status or low income, which may lead to a job training system that neglects the disadvantaged.

It is unclear whether the benefits from access to a wide variety of services require the services to be provided at a single location, or only that information on a wide variety of services be available. As envisioned by the Clinton Administration, one-stop centers with services provided at a particular physical location are likely to be expensive, and, if only a limited number can be constructed in a service delivery area, the need to travel considerable distances may actually reduce access to services for many individuals. Both the Senate and House bills have emphasized one-stop systems, rather than centers, with the implication that it is access to information about services, rather than the services themselves, that is provided at one stop. While this would certainly be cheaper, there is no evidence that it would lead to more effective job training.

One barrier to one-stop shops in the current job training system is the complex set of eligibility criteria, each created under separate legislation. Both of the bills in conference committee eliminate eligibility criteria, which presumably will reduce the cost of providing job training through one-stop shops. However, at current funding levels, only a very small fraction of the eligible populations can be served by existing job training programs, which are carefully targeted. Without targeting, the beneficiaries of one-stop systems with improved services may not be the targeted population. California should be careful to ensure that the disadvantaged continue to be served.

**Increased Statewide Coordination of Job Training Programs**

Given the size of California, there may be an advantage to reconsidering a fundamental assumption of block grants: the advantages of local control. At least in the Senate version of the legislation, California would have the option of constructing a system
with more statewide coordination than the current 52 Service Delivery Areas (SDAs). The advantage of local control is that the training can be oriented toward the needs of local employers. This advantage may be even more significant in the future if job training programs are coordinated with economic development programs, as current legislation permits. However, since devolution to the local level has led to a reduction in statewide coordination, rethinking this devolution could lead to improvements in the job training system.

The simplest advantage of greater statewide coordination is that the current system leads to wasteful administrative difficulties. For example, a large employer in Long Beach had to spend several months negotiating an arrangement with the Long Beach and Riverside SDAs whereby the firm’s employees living in Riverside could receive training near home. The problem was that it was not clear which SDA would be allowed to receive credit for the training. The job training system in California should, at a minimum, have sufficient coordination to ensure that individuals eligible for training in one SDA should be able to receive training in any SDA. A second advantage to increased statewide coordination is that a statewide system can provide a larger market for trainees and a larger range of occupations for which to train. For example, the national scope of Job Corps is considered one of its advantages, since trainees can choose from different training programs in centers across the country, and graduates are placed in a national market.38 A third advantage of increased statewide coordination is that in a local area with a troubled economy, it may be impractical to expect the local industry to hire the graduates of training programs while other parts of the state are in need of skilled workers. Finally, a statewide program might provide standardization in training for particular occupations. With standardization, the program is recognized in other areas, so that completion of a job training course can be a credential, and the skills can be portable.

38Barbara Boxer, in a speech defending the Job Corps from consolidation in the Workforce Development Act, noted that “Even if California agrees to continue to operate these centers under a State program, the centers would still lose if the national program is eliminated. Job Corps trains students to get jobs in the national market, not just the region. Enrollees can choose centers across the country that best match their career plans.” (Congressional Record, October 11, 1995)
Increased Coordination Between Economic Development and Job Training Programs

Given the evidence on the ineffectiveness of job training programs, particularly for dislocated workers and for disadvantaged youth, the best way to serve these groups may not necessarily be by providing job training courses. An alternative method may be available through the Senate provision that allows Flex Fund money to be spent on economic development job training. Use of Flex Fund money for programs to attract employers who provide jobs to the disadvantaged may be a better way to serve the disadvantaged.

California’s Employment Training Panel (ETP) is an example of an economic development job training program that could potentially be expanded with Flex Fund dollars. ETP provides money to businesses to retrain workers while they are still employed. It may be that using flex fund money to expand ETP is a better way to assist dislocated workers than training them after they become unemployed.39

Ventura County has initiated programs that combine economic development with job training by attempting to assess the needs of small businesses and placing disadvantaged individuals in employment in these businesses. These programs are based on the idea that most jobs are created by small businesses, but small businesses are not served by JTPA and other government job training programs (including ETP). A common criticism of federal job training assistance is that the jobs provided to trainees are simply displacing other job seekers, and that businesses are using government assistance to train workers they would have trained without assistance. Ventura County has argued that this criticism is more likely to be true for large businesses, and less likely to be true for small businesses who are underserved by the current federal job training system.

Whether programs like ETP and the small business development programs in Ventura County are more likely to reduce unemploy-

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39While innovative, ETP is regarded with hostility by many employers. It is considered overly bureaucratic and its regulations overly burdensome. Furthermore, ETP is considered to be poorly targeted, funding job training for firms that are not likely to lay off workers. An expansion of ETP should be coupled with an evaluation and reforms.
ment and poverty than the current job training system is unknown. In fact, it should be emphasized that these programs should be rigorously evaluated and not assumed to be better simply because they are different. However, if after evaluating these programs, they are found to be more effective than the current system, the pending job training legislation is likely to provide the ability to expand them using federal money.

Vouchers

The creation of a voucher system for job training is perhaps the most promising provision in the new legislation. Through the use of vouchers, individuals can choose the service provider that offers the training best suited to their abilities and goals. Since training is most effective when a wide array of services is available, this could be provided by the market through the use of vouchers. However, voucher programs for job training have not been rigorously evaluated. Therefore, this discussion is necessarily speculative and subject to the qualification that the program should be evaluated when implemented.

One objection to vouchers is that to be effective, the customers must have sufficient information to make a well-informed choice among service providers. Since job training is not likely to be a frequently purchased commodity, experience is not likely to provide the information needed. To address the information problem, the House bill requires that training providers report extensive performance-based information and that they be eligible to receive funds under the

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40 The first federal job training program that contained elements of a voucher system was the "Individual Referral" program of MDTA. Under this program, an individual was permitted to choose a vocational program provided by the private sector, and the Employment Service would enter into a contract with the vocational program to provide the service. The Individual Referral program was not widely implemented. In addition, CETA directed the Department of Labor to develop and evaluate voucher programs for job training (O’Neill, 1977).

41 O’Neill (1977) examined vocational-technical training taken by disadvantaged individuals eligible for the GI Bill, a program analogous to a voucher program, and compared their earnings outcomes with those of MDTA and CETA recipients. He concluded that the GI Bill vocational training led to significantly better results than the MDTA and CETA training programs. However, even disadvantaged GI Bill recipients are likely to differ from MDTA or CETA recipients, so the comparison may not be valid.
Higher Education Act or have met acceptable levels of performance set by the governor. Performance standards under JTPA have a somewhat different purpose—to ensure that SDAs provide high-quality training with federal funding. They have been criticized for leading to “creaming,” or the selection of the most trainable instead of the most in need. The combination of vouchers and performance standards available at the service provider level may allow better targeting of training resources.

Another advantage of vouchers is that they may lead to innovative new training programs provided by the private sector. New ideas need to be developed if job training is going to be an effective poverty alleviation measure. Finally, vouchers may help resolve the tension between local, state, and national job training. If vouchers are portable across service delivery areas, individuals eligible for training in one SDA would be eligible in others. Since vouchers will be paid for with federal taxes, this could be true not only within California but across states as well. Furthermore, with vouchers, national private training firms could compete with local training firms to attract workers in need of training, and workers could be placed where their skills are most in need (and their wages the highest).
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THE IMPACT OF A FEDERAL BALANCED BUDGET ON
CALIFORNIA'S BUDGET

Stephen Carroll and Eugene Bryton

INTRODUCTION

The new fiscal federalism arises in the context of seeking to balance the federal budget. Both the Republican majority in Congress and the Democratic president have agreed, in principle, to eliminate the federal deficit by FY 2002. While any number of factors might inhibit efforts to balance the budget, doing so will entail significantly lower federal expenditures than would otherwise be the case. Significant reductions in federal expenditures could dramatically affect state government finances. This paper explores the potential consequences of eliminating the federal deficit for state government finances in California. Although we don't know whether the federal government will actually balance the budget, we will assume an extreme case: that the federal government will make little progress balancing the budget before FY 2002 and will reach balance suddenly in that year.

Balancing the federal budget without changing taxes in FY 2002 will require that the federal government cut its spending by $228 billion, about 11 percent, that year.1 Because the aggregate number of federal dollars flowing into California will be less (than if the deficit is allowed to continue), state tax revenues would be reduced about $2.7 billion. The impact on the state's budget will also depend on

1Tax cuts, as the Republicans have proposed, would entail larger spending reductions.
whether federal grants to the state are decreased. California now receives about $46 billion in federal support for programs operated by the state, and any reduction in federal spending is likely to include some cuts in support for the state’s programs.

How the federal government goes about eliminating its deficit—where federal spending is cut and whether mandates are relaxed in the process—will determine the range of state spending options. Without relief from federal mandates, these decreases will force the California state government to sharply reduce spending on higher education and on other government services. With mandate relief, the state would still face difficult tradeoffs between cuts in spending on various areas, but state decisionmakers would have more options if they could partially close its budget gap by cutting spending on health and welfare.

We review current federal and state spending in California. We then estimate state revenues and expenditures, by spending category, in FY 2002, assuming present trends and patterns in federal taxes and spending. Next, we review the cuts in federal spending that would be required to balance the federal budget by FY 2002 and estimate the implications of those cuts for federal spending in California. Because the extent to which power will be devolved to the states is not now clear, we consider the impact of cuts in federal spending on broad categories of state spending under alternative assumptions of state decisionmakers’ flexibility in responding to decreases in federal spending. We develop several scenarios regarding how the state is affected by, and responds to, those cuts. In each scenario, we estimate state revenues and expenditures by category and compare the expenditure estimates to our baseline estimates of what expenditures would be if present trends in federal spending continue. Finally, we identify the implications of alternative federal deficit reduction policies, and alternative state responses, for state revenues and spending.

This analysis focuses on the short-term effects of federal spending cuts on the California state budget. Eliminating the federal deficit could have a dramatic effect on the California economy. A balanced

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2Because cuts in federal taxes are still under debate, we only consider the spending cuts needed to balance the federal budget given current federal tax policies.
budget might stimulate lower real interest rates and more-robust economic growth, and improve the balance of trade. These effects, in turn, could generate significant increases in state tax revenues. Conversely, significant spending cuts could plunge the economy into a recession and result in significant decreases in state tax revenues. However, the effects of balancing the budget on aggregate economic activity, positive or negative, are likely to be realized over time. In the short term, cuts in federal spending would reduce the resources available to state decisionmakers. We examine the potential dimensions of that problem here.

We neglect other federal policy initiatives under discussion that could affect state finances. Reducing unfunded or partially funded mandates on states and easing the restrictions on the implementation of programs could dramatically affect state spending patterns. Because the state’s income tax structure is based on the federal system, major changes in the federal tax laws—for example, moves toward a flat tax or a consumption-based tax—could affect California state revenues and, consequently, expenditures. Assessing the effects of these proposals is beyond the scope of this study.

CURRENT FEDERAL AND STATE SPENDING IN CALIFORNIA

Federal Spending in California

In FY 1994, the most recent year for which complete data are available, the federal government spent about $155 billion in the state of California, roughly 12 percent of total federal outlays.\(^3\) Federal spending accounted for 22.7 percent of California’s $683 billion in personal income\(^4\) that year. Table 1 details federal spending in California in FY 1994.

California State Spending

California’s state budget includes three distinct types of funds, aggregating to over $84 billion in expenditures in FY 1994. The state


Table 1

Federal Spending in California FY 1994
($ billions)

<table>
<thead>
<tr>
<th>Category</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Grants to State and Local Government</td>
<td></td>
</tr>
<tr>
<td>Medicaid</td>
<td>8</td>
</tr>
<tr>
<td>Aid to Families with Dependent Children (AFDC)</td>
<td>4</td>
</tr>
<tr>
<td>Housing and Urban Development (HUD)</td>
<td>2</td>
</tr>
<tr>
<td>Department of Transportation</td>
<td>3</td>
</tr>
<tr>
<td>Federal Emergency Management Agency (FEMA)</td>
<td>1</td>
</tr>
<tr>
<td>Department of Labor</td>
<td>1</td>
</tr>
<tr>
<td>Other grants to state and local governments</td>
<td>7</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>26</strong></td>
</tr>
<tr>
<td>Wages and Salaries</td>
<td></td>
</tr>
<tr>
<td>Department of Defense</td>
<td>10</td>
</tr>
<tr>
<td>U.S. Postal Service</td>
<td>5</td>
</tr>
<tr>
<td>Veterans Administration</td>
<td>1</td>
</tr>
<tr>
<td>Other wages and salaries</td>
<td>3</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>19</strong></td>
</tr>
<tr>
<td>Direct Payments to Individuals</td>
<td></td>
</tr>
<tr>
<td>Social Security</td>
<td>33</td>
</tr>
<tr>
<td>Medicare</td>
<td>21</td>
</tr>
<tr>
<td>Federal military and civilian retirement</td>
<td>7</td>
</tr>
<tr>
<td>Unemployment compensation</td>
<td>4</td>
</tr>
<tr>
<td>Food stamps</td>
<td>2</td>
</tr>
<tr>
<td>Earned income tax credit</td>
<td>2</td>
</tr>
<tr>
<td>Other direct payments</td>
<td>5</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>75</strong></td>
</tr>
<tr>
<td>Procurement</td>
<td></td>
</tr>
<tr>
<td>Department of Defense</td>
<td>23</td>
</tr>
<tr>
<td>Department of Energy</td>
<td>2</td>
</tr>
<tr>
<td>NASA</td>
<td>3</td>
</tr>
<tr>
<td>Other government procurement</td>
<td>3</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>30</strong></td>
</tr>
<tr>
<td>Other programs</td>
<td>4</td>
</tr>
<tr>
<td><strong>Total federal government spending</strong></td>
<td><strong>155</strong></td>
</tr>
</tbody>
</table>


income tax, general sales tax, and business and corporation taxes are paid into the General Fund—the money that the governor and the legislature can budget, debate about, appropriate, and control to some degree. The General Fund accounted for nearly $39 billion in spending in FY 1994. Another $12.7 billion of total state spending
that year was from special funds: money from specific sources that is earmarked for specific purposes and cannot be spent on anything else. For example, the gasoline taxes paid into the highway trust fund can be used only for transportation projects like highway construction and maintenance. The remaining $32.6 billion of total state spending was, in fact, federal spending—federal funds transferred to the state. The state simply passes on most federal funds without influence. Federal funds often have matching requirements the state must meet in return for the federal support.

Table 2 shows the expenditures from each fund in FY 1994. It also shows the local school districts' and community college districts' local property tax revenues.

In all, six spending categories accounted for about 86 percent of state spending in California in FY 1994. Propositions 98 and 111 define state spending for K–14 education—a category combining elementary and secondary education and the community colleges. Hence, the higher education category in Table 2 is primarily the University of California and the California State University systems. Corrections includes both the youth authority and adult corrections. California

Table 2
California State Spending by Source, FY 1994
($ billions)

<table>
<thead>
<tr>
<th>FY 1994</th>
<th>State General Fund</th>
<th>State Special Fund</th>
<th>Federal Funds</th>
<th>K–14 Property Taxes</th>
<th>Percent of Total State Spending</th>
</tr>
</thead>
<tbody>
<tr>
<td>Higher education</td>
<td>3.6</td>
<td>.5</td>
<td>4.0</td>
<td>10</td>
<td></td>
</tr>
<tr>
<td>K–14 education</td>
<td>15.6</td>
<td>(a)</td>
<td>2.3</td>
<td>8.4</td>
<td>21</td>
</tr>
<tr>
<td>Health</td>
<td>7.1</td>
<td>2.7</td>
<td>17.1</td>
<td>32</td>
<td></td>
</tr>
<tr>
<td>Welfare</td>
<td>6.2</td>
<td>(a)</td>
<td>5.4</td>
<td>14</td>
<td></td>
</tr>
<tr>
<td>Corrections</td>
<td>3.4</td>
<td>(a)</td>
<td>0</td>
<td>4</td>
<td></td>
</tr>
<tr>
<td>Transportation</td>
<td>0</td>
<td>2.2</td>
<td>2.0</td>
<td>5</td>
<td></td>
</tr>
<tr>
<td>Other government activities</td>
<td>3.1</td>
<td>7.2</td>
<td>1.8</td>
<td>14</td>
<td></td>
</tr>
<tr>
<td>Total spending</td>
<td>39.0</td>
<td>12.7</td>
<td>32.6</td>
<td>8.4</td>
<td>100</td>
</tr>
</tbody>
</table>


aCategories in which the amount spent is less than 0.1 billion.
spent about 14 percent of its budget on all other state activities combined, including the costs of operating the state’s executive, legislative, and judicial systems. No single activity in this category accounted for more than 2 percent of state spending.

Although the legislature has discretion over General Fund spending, much of that spending is effectively determined before the governor or legislature even begins to consider each year’s budget. Propositions 98 and 111 define a minimum funding level for K–14 education depending on K–12 enrollments, growth in personal income, and prior-year spending. They also require that state support for K–14 education be at least enough to achieve the specified minimum funding level when added to K–14’s local property tax revenues. Given local property tax revenues, Propositions 98 and 111 effectively define minimum state support for public elementary and secondary education and community colleges. Mandated sentencing laws and state and federal court decisions regarding the treatment of prisoners largely determine the amounts the state must spend for prison construction and operation. Federal mandates determine much of California’s spending on health and welfare. The state of California has provided benefits in some programs at levels higher than those required by the federal government. But the courts have rebuffed attempts to scale back the level of state support. Only spending on higher education and other programs, $6.7 billion, about 17 percent of General Fund spending and 8 percent of total state spending, is truly discretionary.

Special fund spending is entirely nondiscretionary in that the uses of the money paid into a special fund are specified in the law that establishes the fund and permits raising the money. If changes in economic conditions or other relevant factors affect the magnitude of special fund collections, spending on the functions they support will change along with them.

The federal funds shown in Table 2 are spending that flows through the state. The table does not include spending that goes directly to

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5The legislature does control the distribution of the Proposition 98/111 guarantee between elementary and secondary districts and community college districts.
private entities either through benefit programs (e.g., Social Security), direct federal employment, or federal contracts. More than half of federal funds in the state budget support federally mandated health and welfare programs. Note that federal funds in the state accounts include all federal dollars flowing through a state agency. For example, the University of California operates the Lawrence Livermore Laboratories under a contract with the Department of Energy. Because the University of California is a state agency, these funds appear in the federal funds accounts in the state budget. The federal accounts (Table 1) place these funds under procurement.

Table 2 also shows property tax revenues to K–14 education, although they are not formally state revenues or expenditures. Because each additional dollar of local property tax paid to a local school district or to a community college district reduces the state’s minimum obligation to the support of K–14 education, local K–14 property taxes are essentially substitutes for state revenues.

STATE SPENDING IN CALIFORNIA IN FY 2002

To establish a baseline for evaluating the effect of balancing the federal budget, we project California’s state budget to FY 2002, assuming that current trends in federal taxes and spending continue. We also project K–14 property taxes.

We estimate that if current trends in state and federal spending continue through FY 2002, the total funds available for functions carried out by the state of California in that year would be about $124 billion, including about $62 billion in General Fund revenues. The state will have to make sharp cuts in discretionary spending: State General Fund spending on higher education and on other government activities will have to fall about 14 percent in nominal dollars. At a 3 percent annual inflation rate, this would imply a 32 percent decline in real expenditures in these areas.
General Fund Revenues

General Fund revenues are primarily generated by personal income taxes, state sales taxes, and corporate income taxes. These sources accounted for over 90 percent of California's General Fund in FY 1994. (See Table 3.)

Each major component of General Fund revenues—personal income taxes, sales taxes, bank and corporation income taxes, and other revenues—generally vary with California state personal income. (See Table 4.) We projected state personal income and then used the personal income projections to separately project each component of General Fund revenues.

We analyzed trends in California personal income over the last twenty years. Inflation, population size, and population age composition were the most important determinants of personal income over that time period. The business cycle and other year-to-year fluctuations had little effect on the long-term trend. We estimated age-specific income factors and applied the estimates to population projections developed by the California Department of Finance. We project real growth of a bit more than 2 percent per year between

<table>
<thead>
<tr>
<th></th>
<th>Total Revenue ($ billions)</th>
<th>Percent of General Fund Revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td>Personal income tax</td>
<td>17.6</td>
<td>44</td>
</tr>
<tr>
<td>Sales tax</td>
<td>13.9</td>
<td>35</td>
</tr>
<tr>
<td>Bank and corporation tax</td>
<td>4.7</td>
<td>12</td>
</tr>
<tr>
<td>Other general revenue and</td>
<td></td>
<td></td>
</tr>
<tr>
<td>transfers from other funds</td>
<td>3.9</td>
<td>10</td>
</tr>
<tr>
<td>Total</td>
<td>40.1</td>
<td>100</td>
</tr>
</tbody>
</table>


7The demographic projections used in this report were produced from a specially run statewide summary table of the Department of Finance's June 1993 projections.
now and FY 2002. Assuming a 3 percent inflation rate for each year, we project that personal income will increase to $1026 billion in FY 2002.

We used the projected income distribution and California’s income tax laws to project the amount of personal income tax that will be collected in 2002. We took into account the expiration of the higher rate on the highest-income taxpayers in the state that went into effect this year, but did not include the governor’s proposed income tax cuts. Sales taxes, bank and corporation taxes, other taxes, and transfers from special funds were also projected using the personal income projections as a base. The revenue projections for 2002 are shown in Table 5.

Table 5
Projected California General Fund Revenues, FY 2002 ($ billions)

<table>
<thead>
<tr>
<th>Revenue Source</th>
<th>Total Revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td>Personal income tax</td>
<td>26.3</td>
</tr>
<tr>
<td>Sales tax</td>
<td>22.2</td>
</tr>
<tr>
<td>Bank and corporation tax</td>
<td>9.0</td>
</tr>
<tr>
<td>Other general revenue and transfers from other funds</td>
<td>4.6</td>
</tr>
<tr>
<td>Total</td>
<td>62.1</td>
</tr>
</tbody>
</table>
General Fund Expenditures for Health and Welfare

The state’s spending for health and welfare programs accounts for about one-third of its general fund. Three programs—Medi-Cal, AFDC, and SSI/SSP—account for most state General Fund spending for health and welfare. If current trends continue, the state will spend about $19.7 billion on Health and Welfare in FY 2002, a 48 percent increase from the FY 1994 level.

Medi-Cal is California’s Medicaid program (labeled “medical assistance program” in the state budget). It provides medical assistance to low-income people, and a substantial portion goes to elderly, low-income people to supplement their Medicare assistance. (The federal Medicare program is for elderly people of all incomes; federal Medicare payments are not reported in California’s budget.) Aid to Families with Dependent Children goes primarily to single-parent households; a small proportion goes to households with two adults who are both unemployed. Supplemental Security Income (SSI) provides assistance to low-income aged, blind, and disabled individuals. California supplements the federal SSI program with an additional State Supplemental Program (SSP) payment. The federal SSI payments are not reported in the California state budget, but the state’s SSP payments, which come from the General Fund, are.

California’s spending on health and welfare programs has been resistant to economic trends. For example, in the last recovery there was no marked decrease in the percentage of Californians on assistance. Accordingly, in projecting future expenditures for each program, we assume that participation rates—the fraction of the population in each age group who will obtain support from the program—will be constant over the next decade. We also assume that benefit levels in each program will keep pace with inflation. In sum, we assume program growth will come from population growth. For each program, we apply the participation rates by age group to the demographic projections and sum over age groups to estimate the numbers of people who will receive benefits from the program. We then multiply the participation estimates by estimated future benefit levels, assuming a 3 percent annual inflation rate.

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Carroll et al. (1995) provides a detailed discussion of the methods and data used to project General Fund expenditures.
We assumed state General Fund spending for all other health and welfare programs and for the operations of the relevant state agencies would grow at the same rate as the sum of state spending for the three major programs discussed above.

FY 1994 actual spending levels and our projections for FY 2002 are shown in Table 6.

**General Fund Expenditures for Corrections**

California spent $3.2 billion on corrections in FY 1994; we project that, that if current trends continue, the cost will increase to $12.1 billion by FY 2002. California approved the “three-strikes” proposition (Proposition 184) in 1994. RAND projections indicate that if “three strikes” is fully implemented, prison populations will triple from 116,000 in 1994 to 349,000 in 2002.\(^3\) Cost increases will be commensurate with those increases. Significant uncertainties remain about whether the three-strikes law will ever really be implemented. For example, bonds for prison construction must be approved. We project corrections costs assuming Proposition 184 is implemented as passed.

### Table 6

<table>
<thead>
<tr>
<th>Health and Welfare Spending: FY 1994 and 2002</th>
<th>($ billions)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>FY 1994</td>
</tr>
<tr>
<td>Medicaid</td>
<td>5.6</td>
</tr>
<tr>
<td>AFDC</td>
<td>2.8</td>
</tr>
<tr>
<td>SSI/SSP</td>
<td>2.1</td>
</tr>
<tr>
<td>Other health and welfare</td>
<td>2.9</td>
</tr>
<tr>
<td>Total</td>
<td>13.3</td>
</tr>
</tbody>
</table>

---

General Fund Expenditures for K–14 Education

If current trends continue, General Fund spending for K–14 education will increase from $14.4 billion in FY 1994 to $22.5 billion in FY 2002.

The state’s share of support for K–14 education is determined by a complex formula that became part of California’s state constitution in 1988 with the passage of Proposition 98; it was altered in 1990 by Proposition 111.\(^\text{10}\) The propositions essentially require that total support for elementary and secondary education and community colleges be the larger of (a) a specified share of the General Fund or (b) the previous year’s level of support, adjusted for changes in per-capita personal income and K–12 enrollments. K–14 education’s local property tax revenues are determined by Proposition 13, which limits the property tax rate, and a series of state laws that determine how the property taxes raised in a county are to be divided among local governments, school districts, community college districts, and special districts. Given the local property revenues provided K–14 education, the state is required to provide at least enough support to bring K–14 funding to the minimum specified by Propositions 98 and 111.

We modeled the formulas specified in Propositions 98 and 111. We used the Department of Finance’s estimates of future K–12 enrollments and our estimates of future personal income per capita to compute the minimum funding requirements for K–14 education.

We assumed that nominal annual growth rates in local property tax revenues will remain at their current low levels for two more years, then, beginning in 1997, increase but still remain below the rates experienced in the 1980s. We assumed the FY 1994 local property tax allocations among local agencies would continue, and we estimated K–14 education’s local property revenues through FY 2002.

Finally, we subtracted our estimates of K–14 local property tax revenues from our estimates of Proposition 98/111 minimum spending

\(^{10}\)If federal budget cuts in 2001 reduce the 2001 state budget below our base case, then the Proposition 98 required minimum—which depends in part on the 2001 spending level—would be somewhat lower, decreasing the required state spending on K–14 in 2002.
requirements to obtain estimates of the minimum level of state spending for K–14 education in FY 2002. We assume that state General Fund spending for other education programs and for the operations of the state Department of Education will grow at the same rate as the Proposition 98/111 funding requirement.

**General Fund Expenditures for Higher Education and Other Activities**

Unless something happens to modify current trends, state spending for higher education and for other government activities will decline over the next seven years, from $6.7 billion in FY 1994 to $5.7 billion in FY 2002. The legislature is not required by statute or federal mandate to provide higher education or other services. Under current law, they must make do with whatever revenues are left over after meeting the spending requirements of programs mandated by either federal law or propositions enacted into the California constitution. Our projections indicate that if state General Fund revenues grow as we expect, fewer nominal dollars would be available for higher education and other government services in FY 2002 than in FY 1994. In projecting the amounts for these functions in FY 2002, we assumed that the amounts for each category would be the same proportion of the available funds as in FY 1994.

**Special and Federal Fund Revenues and Expenditures**

We expect special fund revenues and, consequently, expenditures, to grow in proportion to personal income. We projected federal fund spending by assuming that it would grow as fast as the primary receiver populations and inflation. Table 7 shows how each category was projected.

**The Baseline Budget: State Spending in FY 2002**

Table 8 shows our projected budget for FY 2002, assuming that the current trends in federal and state revenues, economic conditions,
Table 7
Methods for Projecting Federal Spending in the 2001–2002 California Budget

<table>
<thead>
<tr>
<th>Category</th>
<th>Projection Method</th>
</tr>
</thead>
<tbody>
<tr>
<td>Higher education</td>
<td>Population growth for 18–24 age group plus inflation</td>
</tr>
<tr>
<td>K–14 education</td>
<td>Population growth for 5–17 age group plus inflation</td>
</tr>
<tr>
<td>Health and welfare</td>
<td>Growth in the population served by each program plus inflation</td>
</tr>
<tr>
<td>Transportation</td>
<td>Inflation</td>
</tr>
<tr>
<td>Other</td>
<td>Inflation after adjusting for Northridge earthquake-related emergency federal spending (about $1 billion)</td>
</tr>
</tbody>
</table>

Table 8
California State Budget, FY 2002, Baseline Projection ($ billions)

<table>
<thead>
<tr>
<th>FY 2001–2002</th>
<th>State General Fund</th>
<th>State Special Fund</th>
<th>Federal Funds</th>
<th>K–14 Property Taxes</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Higher education</td>
<td>3.1</td>
<td>.8</td>
<td>5.4</td>
<td>12.5</td>
<td>40.3</td>
</tr>
<tr>
<td>K–14 education</td>
<td>24.5</td>
<td>(a)</td>
<td>3.8</td>
<td>12.5</td>
<td>40.8</td>
</tr>
<tr>
<td>Health and welfare</td>
<td>19.8</td>
<td>4.1</td>
<td>33.3</td>
<td>57.1</td>
<td></td>
</tr>
<tr>
<td>Corrections</td>
<td>12.1</td>
<td>(a)</td>
<td>0</td>
<td>12.1</td>
<td></td>
</tr>
<tr>
<td>Transportation</td>
<td>0</td>
<td>3.3</td>
<td>2.5</td>
<td>5.9</td>
<td></td>
</tr>
<tr>
<td>Other government services</td>
<td>2.7</td>
<td>10.8</td>
<td>1.2</td>
<td>14.6</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>62.1</td>
<td>19.1</td>
<td>46.1</td>
<td>12.5</td>
<td>140.0</td>
</tr>
</tbody>
</table>

*Categories in which the amount spent is less than 0.1 billion.

and relevant laws continue through FY 2002. We have assumed price inflation of 3 percent.

The state General Fund total is the projection for total revenues. Spending for the categories of higher education and other government services is restricted to the funds left over after the other functions have spent what is required by state constitutional requirements or current federal mandates. This projection indicates that even without changes in federal programs, real resources dedi-
icated to these functions will decrease about 28 percent from the present level.

What if the federal government relaxed its spending mandates? While there has been considerable interest in the notion of merging federal health and welfare programs into block grants, the debate over federal policy does not appear to contemplate the removal of all constraints on the uses of federal funds. Thus, even if states are given block grants for the support of health and welfare programs, they would likely be constrained to use those funds for health and welfare purposes and not given the right to allocate those monies to, say, transportation. Special funds would still have to be spent in accordance with the laws that established them and the state would still have to meet the requirements imposed by Propositions 98, 111, and 184. Hence, the state would be free to divert some of its General Fund revenues from health and welfare to other spending categories. The line labeled B in Figure 1 shows the range of alternatives open to the state in terms of the allocation of spending between health and welfare, shown on the horizontal axis, and higher education and other government activities, shown on the vertical axis. The point marked x on line B corresponds to the spending allocation shown in Table 8.

![Figure 1](image)

**Figure 1**—Baseline Options for Health and Welfare and Higher Education and Other Spending
Balancing the Federal Budget

Total federal outlays have been between 20 and 25 percent of Gross Domestic Product (GDP) for the last twenty years, averaging 22.6 percent over that period. In FY 1995, federal outlays were over $1.5 trillion, 21.9 percent of GDP. The Congressional Budget Office has estimated that without any policy changes, by FY 2002, federal outlays would be $2.1 trillion and the deficit would be $228 billion.\(^\text{11}\) The Balanced Budget Act passed by Congress would reduce outlays by $265 billion, about 12 percent of total outlays, to reach that goal; the proposal submitted by the President would reduce outlays by $209 billion, a decrease of 10 percent. For either plan, deficit reduction of about $228 billion, not including changes in interest payments, is required to balance the budget. The impact of those plans is shown in Table 9.\(^\text{12}\)

<table>
<thead>
<tr>
<th>Estimates of Federal Government Outlays, Revenues, and the Deficit ($) billions</th>
</tr>
</thead>
<tbody>
<tr>
<td>---------------------</td>
</tr>
<tr>
<td>Current policy</td>
</tr>
<tr>
<td>Outlays</td>
</tr>
<tr>
<td>Revenues</td>
</tr>
<tr>
<td>Deficit</td>
</tr>
<tr>
<td>Republican plan</td>
</tr>
<tr>
<td>Changes</td>
</tr>
<tr>
<td>Outlays</td>
</tr>
<tr>
<td>Revenues</td>
</tr>
<tr>
<td>Deficit</td>
</tr>
<tr>
<td>Democratic plan</td>
</tr>
<tr>
<td>Changes</td>
</tr>
<tr>
<td>Outlays</td>
</tr>
<tr>
<td>Revenues</td>
</tr>
<tr>
<td>Deficit</td>
</tr>
</tbody>
</table>

SOURCE: Congressional Budget Office.

\(^{11}\) Congressional Budget Office, December 1995.

\(^{12}\) If progress is made between 1996 and 2001 in reducing the deficit, the aggregate size of the debt will be less than under the worst case scenario and interest cost will be somewhat less, reducing the magnitude of the required cuts.
According to CBO estimates, federal outlays in 2002 would be 18.5 percent of GDP under the Republican plan and 19.1 percent of GDP under the Democratic plan (Figure 2). In either case, federal outlays would take the lowest share of GDP since the mid 1960s. At least in the short run, this would have a dramatic impact on recipients of federal dollars.

Political realities and pressures may cause us to put off consideration of the deficit as long as possible. This would create the worst case from the state’s perspective, because deficit reduction would occur in 2002 as very large cuts from the 2001 budget.

**FISCAL IMPACT ON CALIFORNIA OF FEDERAL BUDGET BALANCING**

To balance the federal budget, spending on all non-interest portions of the federal budget will have to be cut 11 percent. A cut in federal spending would affect the state budget in three ways: First, regard-

![Graph showing deficit options under different plans]

**SOURCE:** Congressional Budget Office.

**Figure 2—Deficit Under Options Considered by the Federal Government**
less of which particular federal programs are cut, the aggregate number of federal dollars flowing into the state will be less than if the deficit were allowed to continue. In the short term, federal spending cuts would reduce aggregate economic activity and personal incomes in California and, in turn, state tax revenues. Second, the impact on the state's budget will vary depending on whether—and, if so, how much—federal grants to the state are decreased. Third, the impact of changes in federal support will depend on whether federal spending mandates to the state are relaxed.

If the federal government were to balance its budget in FY 2002, we would expect to see about $59.9 billion in California General Fund revenues, compared to the baseline projection of $62.1 billion. Elimination of the federal deficit would reduce special fund revenues from the baseline projection of $16.1 billion to $15.6 billion that year.

Total federal spending in California in 1994 was $155 billion. A decrease of 11 percent would have been $17 billion. If we assume an income multiplier of 1.5, a $17 billion cut in federal spending translates into a $25 billion decrease in personal incomes. Total 1994 California personal income was $683 billion. A $25 billion decrease in personal income would have been about 3.5 percent.

State General Fund revenues have been a relatively constant portion of personal income. We assume that General Fund revenues would fall in proportion to a decrease in personal income. We projected state General Fund revenues of $62.1 billion in FY 2002. A 3.5 percent cut in personal incomes in that year would thus reduce projected FY 2002 General Fund revenues by about $2.2 billion, to $59.9 billion. We assume this level of General Fund revenues in all scenarios.

We assume that special fund revenues will also drop in proportion to decreases in personal incomes. For example, we assume that a 3.5

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13 Over the longer term, balancing the federal budget could stimulate increases in economic activity that would more than compensate for the decrease in federal spending. We assume the economy will react to the elimination of the deficit only over a period of time and, consequently, will not respond during the year that the budget is balanced. If balancing the budget does not stimulate California's economy over the long term, the fiscal picture could become much worse than shown here.
percent reduction in aggregate California personal incomes would result in a 3.5 percent reduction in special funds for higher education, from the baseline projection of $701 million to $677 million—and so on for the special funds in each of the other major budget categories. Overall, special fund spending in FY 2002 would be about $15.6 billion if the federal budget were balanced, compared to $16.1 billion in the baseline. We assume this level of special fund revenues in all scenarios.

We consider several scenarios regarding the nature of federal spending cuts, beginning with two extreme cases: In the first, all cuts in federal spending are in areas other than support for the state. Federal grants to the state for every category of state spending are maintained at the baseline levels. In the second, federal spending cuts are entirely in support for the state. Reductions in expected grants to state governments would be about $17 billion if all of the reductions came from those areas.

Realistically, federal budget cuts are likely to affect all areas of federal spending. If both federal support to the state and all other areas of federal spending were cut proportionately, federal grants to California would be reduced from $46.1 billion to about $41 billion. We consider several scenarios in which federal spending cuts in support for the state are proportional to total reductions in federal spending.

In all the scenarios we initially assume that current health and welfare spending mandates are retained and then consider the effects of relaxing these mandates.

In all cases, we assume that spending for K–14 education and for corrections must satisfy the California constitutional requirements imposed by Propositions 98, 111, and 184. Because the baseline projections assumed that spending in these areas would be no greater that what those laws required, cuts in federal support will not reduce spending for either K–14 education or for corrections below the baseline spending projections. Because property tax collections are slow to respond to changes in personal income, we assume that they will be unchanged in all scenarios.
Scenario 1: No Cuts in Support to the State

At one extreme, the federal government could eliminate its deficit by cutting spending in areas other than support for state government. Of all possible approaches to eliminating the federal deficit, the state budget would be least affected if federal spending reductions were concentrated on federal employment, procurement, and direct payments to individuals, leaving grants to the state untouched. If there were no cuts in support to the state, California General Fund revenues would decrease $2.2 billion and its special fund revenues $0.6 billion, compared to the baseline. If federal mandates on state health and welfare spending are not relaxed, the state would have to reduce its spending in areas that are not protected by state law or federal mandate. Higher education and other government services would have to absorb the entire decrease.

Table 10 shows the state's budget in this scenario, assuming that the required spending cuts are proportionately divided between higher education and other government services.

If the federal mandates on state spending were relaxed, the state would be free to divert General Fund revenues from health and welfare to other areas. Because higher education and other government activities would initially bear the brunt of the federal cuts, it seems

<table>
<thead>
<tr>
<th></th>
<th>State General Fund</th>
<th>State Special Fund</th>
<th>Federal Funds</th>
<th>K-14 Property Taxes</th>
<th>Total</th>
<th>Difference from Base Case</th>
</tr>
</thead>
<tbody>
<tr>
<td>Higher education</td>
<td>1.9</td>
<td>0.8</td>
<td>5.4</td>
<td></td>
<td>8.1</td>
<td>-1.2</td>
</tr>
<tr>
<td>K-14 education</td>
<td>24.5</td>
<td>0.1</td>
<td>3.7</td>
<td>12.5</td>
<td>40.8</td>
<td>-0.0</td>
</tr>
<tr>
<td>Health and welfare</td>
<td>19.8</td>
<td>4.0</td>
<td>33.3</td>
<td></td>
<td>57.0</td>
<td>-0.1</td>
</tr>
<tr>
<td>Corrections</td>
<td>12.1</td>
<td>0.0</td>
<td>0</td>
<td>12.1</td>
<td>0.0</td>
<td></td>
</tr>
<tr>
<td>Transportation</td>
<td>0.0</td>
<td>3.2</td>
<td>2.5</td>
<td></td>
<td>5.7</td>
<td>-0.1</td>
</tr>
<tr>
<td>Other government services</td>
<td>1.7</td>
<td>10.4</td>
<td>1.2</td>
<td></td>
<td>13.2</td>
<td>-1.4</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>59.9</td>
<td>18.5</td>
<td>46.0</td>
<td>12.5</td>
<td>137.0</td>
<td>-2.8</td>
</tr>
</tbody>
</table>
reasonable to suppose that any reallocation of state General Fund revenues would be to these areas. The line labeled 1 in Figure 3 shows the range of spending alternatives open to the state in this scenario if federal mandates were relaxed. The point marked x on line 1 indicates the particular spending allocation shown in Table 10. For reference, line B reproduces the baseline range of alternatives shown earlier in Figure 2.

Scenario 2: All Cuts in Support to the State

At the opposite extreme, the federal government could eliminate its deficit by cutting support to state government. Of all possible approaches to eliminating the federal deficit, the state budget would be most affected if federal spending reductions were concentrated on grants to the state, leaving federal employment, procurement, and direct payments to individuals untouched. Federal support to California would be reduced about $17 billion. And the reduction in economic activity resulting from the cuts in federal spending would still result in reductions of more than $2.7 billion in state General

![Figure 3—Options for California Spending Choices for Health and Welfare and Higher Education and Other Spending](image)
Fund and special fund revenues. Because nearly three-quarters of federal grants to California are for health and welfare programs, a $17 billion cut in federal grants to the state would have to include substantial reductions in support for these programs. For this analysis, we assume cuts in federal support are distributed across all spending categories in proportion to their size. Health and welfare would absorb most of the cuts imposed by eliminating the federal deficit—$12.5 billion of the $17 billion in federal spending reductions.

How state health and welfare spending would be affected in this scenario is highly uncertain because federal support for health and welfare programs would have to be cut substantially. Would the federal government continue to mandate state spending in these areas at the same level despite significant reductions in the federal role? Would there be substantial pressures for the state to step up its support to make up for some of the reductions in federal support?

We initially assume the state maintains its support for health and welfare programs at the baseline level. The federal government might require that the state maintain spending for health and welfare, despite the cuts in federal spending in this area. Or the state might decide that it must continue to meet the needs of those benefited by these programs. In any case, we assume the state neither matches nor attempts to make up for cuts in federal support for health and welfare. Higher education and other government services must absorb the entire $2.7 billion decrease in state revenues. Table 11 shows the state’s budget in this scenario, assuming that the required cuts in state spending are proportionately divided between these two categories.

If the federal- or self-imposed mandates on state spending were relaxed, the state could divert General Fund revenues from health and welfare to other areas. Or it could attempt to make up for some of the cuts in federal health and welfare spending by diverting funds from higher education and other government activities to health and welfare. The line labeled 2 in Figure 3 shows the range of spending alternatives open to the state in this scenario if federal mandates were relaxed. The point marked x on line 2 indicates the spending allocation shown in Table 10.
Table 11
California State Budget, FY 2002, Deficit Eliminated Through
Cuts in Support to the State
($ billions)

<table>
<thead>
<tr>
<th></th>
<th>State General Fund</th>
<th>State Special Fund</th>
<th>Federal Funds</th>
<th>K-14 Property Taxes</th>
<th>Total</th>
<th>Difference from Base Case</th>
</tr>
</thead>
<tbody>
<tr>
<td>Higher education</td>
<td>1.9</td>
<td>0.8</td>
<td>3.4</td>
<td>0.0</td>
<td>6.1</td>
<td>-3.2</td>
</tr>
<tr>
<td>K-14 Education</td>
<td>24.5</td>
<td>0.1</td>
<td>2.3</td>
<td>12.5</td>
<td>39.4</td>
<td>0.0</td>
</tr>
<tr>
<td>Health and Welfare</td>
<td>19.8</td>
<td>4.0</td>
<td>21.0</td>
<td>0.0</td>
<td>44.7</td>
<td>-0.1</td>
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<tr>
<td>Corrections</td>
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<td>0.0</td>
<td>12.1</td>
<td>0.0</td>
</tr>
<tr>
<td>Transportation</td>
<td>0.0</td>
<td>3.2</td>
<td>1.6</td>
<td>0.0</td>
<td>4.8</td>
<td>-1.0</td>
</tr>
<tr>
<td>Other government services</td>
<td>1.7</td>
<td>10.4</td>
<td>0.7</td>
<td>0.0</td>
<td>12.8</td>
<td>-1.8</td>
</tr>
<tr>
<td>Total</td>
<td>59.9</td>
<td>18.5</td>
<td>29.1</td>
<td>12.5</td>
<td>120.0</td>
<td>-19.9</td>
</tr>
</tbody>
</table>

Scenario 3: Proportional Cuts Holding Health and Welfare Harmless

Federal budget cuts are likely to affect all areas of federal spending. If both federal support to the state and all other areas of federal spending were cut proportionately, federal grants to California would be reduced from $46.1 billion to about $41 billion. State tax revenues would fall to about $59.9 billion.

The effects of proportional cuts in the federal budget on the state's spending pattern would depend, in part, on whether federal health and welfare support and spending mandates would be modified as federal grants to the state were cut. Table 12 shows California's budget, assuming that neither federal support for health and welfare nor federal mandates for state spending in this area were changed from the baseline. Although the decrease in total funds available for services that appear in the state budget decreases by less than 8 percent, truly discretionary functions bear the brunt of the change in available resources.

If the federal mandates on state spending were relaxed, the state could divert General Fund revenues from health and welfare to other areas. The line labeled 3 in Figure 3 shows the range of spending al-
alternatives open to the state in this scenario if federal mandates were relaxed. The point marked x on line 3 indicates the particular spending allocation shown in Table 11.

Scenario 4: Proportional Cuts, State Spending Mandates Retained

Suppose the federal government cut health and welfare support as well as support for other state programs but forces in California precluded cuts in state health and welfare spending? Table 13 shows California’s budget, assuming that federal support for Health and Welfare is cut in proportion to the total cuts in federal spending while the state maintains its spending in this area. Specifically, the budget presented in Table 13 is what would happen if the state had to meet the baseline K–14 education, health and welfare, and corrections spending requirements and had to concentrate its spending cuts on higher education and other government services. Under this set of assumptions, total spending on health and welfare programs would be almost $4 billion less than the amounts projected to maintain services at current levels.
Table 13
California State Budget, FY 2002. Proportional Cuts in Federal Spending:
State Spending on Health and Welfare Continues
($ billions)

<table>
<thead>
<tr>
<th></th>
<th>State General Fund</th>
<th>State Special Fund</th>
<th>Federal Funds</th>
<th>K-14 Property Taxes</th>
<th>Total</th>
<th>Difference from Base Case</th>
</tr>
</thead>
<tbody>
<tr>
<td>Higher education</td>
<td>1.9</td>
<td>0.8</td>
<td>4.8</td>
<td>0.0</td>
<td>7.5</td>
<td>1.8</td>
</tr>
<tr>
<td>K-14 education</td>
<td>24.5</td>
<td>0.1</td>
<td>3.3</td>
<td>12.5</td>
<td>40.4</td>
<td>0.4</td>
</tr>
<tr>
<td>Health and welfare</td>
<td>19.8</td>
<td>4.0</td>
<td>2.9</td>
<td>0.0</td>
<td>53.3</td>
<td>3.8</td>
</tr>
<tr>
<td>Corrections</td>
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<td>0.0</td>
<td>0.2</td>
<td>12.1</td>
<td>0.0</td>
</tr>
<tr>
<td>Transportation services</td>
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<td>2.2</td>
<td>0.0</td>
<td>5.5</td>
<td>0.4</td>
</tr>
<tr>
<td>Other government services</td>
<td>1.7</td>
<td>10.4</td>
<td>1.0</td>
<td>0.0</td>
<td>13.1</td>
<td>1.5</td>
</tr>
<tr>
<td>Total</td>
<td>59.9</td>
<td>18.5</td>
<td>41.0</td>
<td>12.5</td>
<td>131.9</td>
<td>7.9</td>
</tr>
</tbody>
</table>

The line labeled 4 in Figure 3 shows the range of spending alternatives open to the state in this scenario if federal mandates were relaxed. The point marked x on line 4 indicates the particular spending allocation shown in Table 12.

Scenario 5: Proportional Cuts, State Makes Up for Federal Health and Welfare Cuts

Finally, we consider a scenario in which the federal government decreased support to California in all areas, including health and welfare, and the state increased its spending on health and welfare to make up for the cuts in federal support. Under this scenario, federal funds would be available for the higher-education research and development laboratories, federally supported elementary, secondary, and community college programs, and federal funding of transportation projects. However, as Table 14 shows, this option is untenable because there are not enough funds remaining in higher education and other government services to make up the additional health and welfare funds.
Table 14

California State Budget, FY 2002, Proportional Cuts in Federal Spending, State Maintains Total Support for Health and Welfare
($ billions)

<table>
<thead>
<tr>
<th></th>
<th>State General Fund</th>
<th>State Special Fund</th>
<th>Federal Funds</th>
<th>Property Taxes</th>
<th>Total</th>
<th>Difference from Base Case</th>
</tr>
</thead>
<tbody>
<tr>
<td>Higher education</td>
<td>-0.1</td>
<td>0.0</td>
<td>4.8</td>
<td>0.0</td>
<td>5.5</td>
<td>-1.8</td>
</tr>
<tr>
<td>K-14 education</td>
<td>24.5</td>
<td>0.1</td>
<td>3.3</td>
<td>12.5</td>
<td>40.4</td>
<td>-0.4</td>
</tr>
<tr>
<td>Health and welfare</td>
<td>23.6</td>
<td>4.0</td>
<td>29.6</td>
<td>0.0</td>
<td>57.1</td>
<td>-3.8</td>
</tr>
<tr>
<td>Corrections</td>
<td>12.1</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>12.1</td>
<td>0.0</td>
</tr>
<tr>
<td>Transportation</td>
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<td>3.2</td>
<td>2.2</td>
<td>0.0</td>
<td>5.5</td>
<td>-0.4</td>
</tr>
<tr>
<td>Other government services</td>
<td>-0.1</td>
<td>10.4</td>
<td>1.9</td>
<td>0.0</td>
<td>11.3</td>
<td>-1.5</td>
</tr>
<tr>
<td>Total</td>
<td>59.9</td>
<td>10.5</td>
<td>41.0</td>
<td>12.5</td>
<td>131.9</td>
<td>-7.9</td>
</tr>
</tbody>
</table>

Conclusions

Balancing the federal budget without changing taxes in FY 2002 will require that the federal government cut its spending by $228 billion, about 11 percent, that year. Because the aggregate number of federal dollars flowing into California will be less (than if the deficit is allowed to continue), state tax revenues would be reduced about $2 billion. The impact on the state’s budget will also depend on whether federal grants to the state are decreased. California now receives about $46 billion in federal support for programs operated by the state, and any reduction in federal spending is likely to include some cuts in support for the state’s programs.

Propositions 98, 111, and 184 impose minimum state spending requirements for K-14 education and for corrections. Thus, the state will have to respond to cuts in its tax revenues by cutting spending in other areas. Moreover, federal mandates now preclude significant cuts in state spending for health and welfare. Unless those mandates are relaxed, the state will have to concentrate its spending cuts in those areas over which it has discretion—higher education and other government services.

In sum, how the federal government goes about eliminating its deficit—where federal spending is cut and whether mandates are relaxed in the process—will determine the range of spending options.
available to the state. Without relief from federal mandates, these decreases will force the California state government to sharply reduce spending on higher education and on other government services. With mandate relief, we would probably still see sharp cuts in state spending in these areas. But they could be somewhat less sharp if the state chose to partially close its budget gap by cutting spending on health and welfare.
REFERENCES


A Key Resource for Informing the National Debate...

As Washington struggles toward a balanced federal budget, a major shift of responsibilities for social services from the federal to the state level seems possible. States may emerge with greater opportunity to develop innovative programs and better service delivery, but with fewer resources. The strength of the nation's social safety net will depend not only on the nature of the resulting changes but on the response to the changes of the state and local social service agencies and the beneficiary populations. How will a shift away from entitlements, for example, be implemented so that it does not result in weakened income security and less protection for the poor during recessions? How will more state control for job training be managed to achieve better coordination across programs, superior training delivery, and greater cost effectiveness? How will states provide health care for the poor and uninsured and yet prevent health expenditures from sapping the state budget?

The New Fiscal Federalism and the Social Safety Net: A View from California is the result of a May 1996 RAND conference attended by key decisionmakers from all levels of government to address these and similar questions. The essays in the collection review the implications of the new fiscal federalism for the states, particularly California, from the perspective of intergovernmental relations, fiscal impact, program administration, and consequences for the public. Also included are ideas for policy change tempered by the observations of state, local, and county officials who participated in the conference.