

12. Fiscal Federalism

Congress should

- begin terminating the 716 federal grant programs that provide state and local governments with more than \$400 billion annually for education, housing, community development, and other nonfederal responsibilities;
- turn Medicaid into a block grant as a first step to cutting the explosive spending growth in this federal-state program; and
- eliminate federal highway and transit funding and repeal the federal gasoline tax that funds these transportation programs.

Introduction

The federal government was designed to have specific limited powers, with most basic government functions left to the states. The Tenth Amendment to the Constitution states this clearly: “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.” But during recent decades, the federal government has undertaken a large number of activities that were traditionally and constitutionally reserved to the states.

The primary mechanism that the federal government has used to extend its power into state affairs is grants to state and local governments (“grants-in-aid”). In FY04 federal grants totaling \$418 billion were to be paid out to lower levels of government for a huge range of activities including health care, transportation, housing, and education. Grants to state and local governments increased from 7.6 percent of total federal outlays in FY60 to 18.0 percent in FY04.

The federal grant structure is massive and complex. One can get a sense of the complexity of the grant-making apparatus by examining the 1,800-

page “Catalog of Federal Domestic Assistance” at www.cfda.gov. The CFDA details 716 different federal grant programs aimed at state and local governments. Grant programs range from the giant \$177 billion Medicaid to hundreds of more obscure programs that most taxpayers have never heard of. The CFDA lists a \$10 million grant program for “Nursing Workforce Diversity” and a \$59 million program for “Boating Safety Financial Assistance.” One Environmental Protection Agency program hands out \$25,000 grants to local governments for projects that “raise awareness” about environmental issues.

Since they were expanded greatly in the 1960s, federal grants to state and local governments have proven to be a terribly wasteful way of providing government services to Americans. Congress should begin large-scale cuts to federal grants.

Grants Are Good Politics but Bad Economics

The increase in federal grants in recent decades has occurred because of political logic, not economic logic. Federal grants have allowed the federal government to sidestep concerns about expansion of its powers over traditional state activities. By using grants, federal politicians can become activists in areas such as education, while overcoming state concerns about encroachment on their power by shoveling cash into state coffers.

Support for grants—and support for centralization of government power in Washington in general—comes from policymakers who favor funding government through the heavily graduated federal income tax system, rather than through the more proportional state tax systems.

Support also comes from those who think that the federal government should redistribute income from rich to poor regions of the country. But such geographic redistributions are neither constitutionally nor economically sound. Besides, politics usually undermines the goal of taking from rich regions and giving to poor regions. Although the initial goal of a grant program may be to aid poor areas, every member of Congress ultimately wants a piece of program spending for his or her district. Grant programs must sprinkle funds broadly to many districts to gain political support, rather than just the areas that really need help.

A good example is the \$6 billion Community Development Block Grant program. The program was created in 1974 to channel federal money to low-income urban areas for key services such as firefighters and police. But today the program spreads taxpayer largesse widely to some of the

wealthiest areas of the country, often for dubious projects. Today all urban areas with 50,000 or more people are eligible for the program, not just the needy ones, and it funds projects such as the installation of traffic lights in wealthy Newton, Massachusetts.

The Department of Education's \$10 billion Title I program provides another example of the difficulty in targeting federal grants to the poor. A 2002 statistical analysis by Nora Gordon of the University of California, San Diego, found that while Title I is supposed to steer money to poor school districts, the actual effect is different. She found that within a few years of a grant being given, state and local governments used the federal funds to displace their own funding of poor schools. Thus, poor schools ended up being no further ahead than they had been without the federal program.

Six Reasons to Cut Grants

The following are six further reasons why grants are wasteful and inefficient—six reasons for Congress to begin cutting the \$418 billion grant empire.

1. Grant Bureaucracy Is Wasteful

The source of federal grant money paid to the states is, of course, the taxpayers who live in the 50 states. Taxpayer money is sent to Washington where it is reallocated by Capitol Hill horse-trading and routed through layers of departmental bureaucracy. The depleted funds are then sent down to state and local agencies coupled with long lists of complex federal regulations with which they must comply.

Taxpayers and the economy lose out from the unproductive activities of the huge bureaucracies that are needed to administer \$418 billion of intergovernmental flows of money. The federal-state grant superstructure is intensely bureaucratic. To take one example, the \$59 million “Weed and Seed” anti-drug program for schools has a 74-page application kit that references 1,300 pages of regulations with which grant recipients must comply.

Many grant programs involve three levels of bureaucracy—federal, state, and local—before funds are disbursed for a project. That is “trickle-down economics” at its worst. For example, the \$441 million Safe and Drug Free Schools program sends money to state education bureaucracies, which in turn use complex procedures to send funds down to local school boards. School boards need expert bureaucrats to apply for the funds and

to follow state and federal rules. After all that, reviews of the program have concluded that schools have tended to spend the money wastefully.

Federal grants for local “first responder” activities were popular in the wake of 9/11, but they too got bogged down in bureaucracy. There are 16 overlapping grant programs that fund first responders, such as firefighters, according to an April 2003 General Accounting Office report. The House Select Committee on Homeland Security reported in April 2004 that \$5.2 billion of \$6.3 billion in first responder grants since 9/11 “remains stuck in the administrative pipeline at the state, county, and city levels.” The committee reported that much of the first responder money went to dubious projects of little value. Indeed, much of the funding went to states on the basis of factors such as population, not terrorism risk.

2. Grants Spur Wasteful State Spending

Federal grants set off a gold-rush response by state and local governments and create irresponsible overspending decisions. States have little incentive to spend grant money efficiently because it comes to them “free.” With federal matching grants, state politicians can spend an added dollar on their constituents while only charging them a fraction of a dollar in state taxes. That makes program expansion very attractive. With Medicaid, for example, state governments have expanded benefits and the number of eligible beneficiaries beyond reasonable levels because of the generous federal match.

Medicaid also illustrates how states can abuse the handouts they receive from Washington. In recent years, numerous states have literally bilked the federal government out of billions of dollars with complex schemes to maximize Medicaid payments. For example, some states imposed taxes on health care providers that were at the same time rebated back to the providers. The effect was to increase reported state Medicaid spending and boost federal matching funds. State gamesmanship to maximize federal grants goes back to at least the 1960s.

One partial solution short of terminating grants is to convert matching grants to block grants. Block grants provide a fixed sum to states and give them flexibility on program design. For example, the 1996 welfare reform law turned Aid to Families with Dependent Children, a traditional open-ended matching grant, into Temporary Assistance for Needy Families, a lump-sum block grant.

Today, a ripe reform target for Congress is to convert Medicaid into a block grant and freeze its overall federal funding. That would help the

federal government to reduce its huge deficit, and it would force the states to cut back on this massively bloated program. For example, if federal Medicaid spending were frozen at its FY05 level, by FY09 it would be saving the federal government \$51 billion annually, which could be used to reduce the deficit.

3. Redistributing Income between the States Is Unfair and Inefficient

The huge federal grant machine has centralized U.S. fiscal power in the hands of the federal government. While utopian grant planners may dream of rationally redistributing money between the states, raw political power ultimately determines spending outcomes, which creates much inefficiency. For example, states receive varying amounts of highway grants for each dollar of gasoline taxes sent to Washington. While some congested and fast-growing states that need new highways lose out, slow-growing states get unneeded “highways to nowhere” if they have champion pork-barrel politicians representing them, such as Sen. Robert Byrd (D-WV) and former representative Bud Shuster (R-PA). It makes far more sense for the states to raise money for their own highways from their own taxpayers since each state has different needs and priorities. For their part, states should move ahead with private highway projects that avoid taxpayer burdens altogether.

4. Grants Reduce State Policy Diversity

Federal grants reduce state government innovation and diversity because federal money comes with regulations that limit policy flexibility. Grants put the states in a costly straitjacket of federal rules. Medicaid has perhaps the most complicated top-down rules of any grant program. The FY05 federal budget notes, for example, that the “complex array of Medicaid laws, regulations, and administrative guidance is confusing, overly burdensome, and serves to stifle state innovation and flexibility.”

The classic one-size-fits-all federal regulation imposed through the grant machinery was the 55 mph national speed limit. The speed limit was enforced between 1974 and 1995 by federal threats to withdraw state highway grant money. It never made any sense that the same speed limit should be imposed in the wide-open western states as the crowded eastern states. Congress finally listened to motorists and repealed the law.

But federal policymakers are increasing their intrusions in other areas, such as education. The cost of federal education grant spending exploded

under President Bush. With higher spending have come complex new mandates under the No Child Left Behind law of 2002, which is a major source of frustration for state and local policymakers.

5. Grants Divert Attention from Crucial National Concerns

A serious problem caused by the huge scope of federal grant activity is that federal politicians end up spending their time dealing with local issues rather than crucial national issues. For example, members of Congress spend much of their time holding hearings and considering legislation on local issues such as K-12 schools. In addition, the 716 federal grant projects generate unending opportunities for members of Congress to steer pork projects to their home districts. The chase for hometown pork consumes much of a typical member's time.

As a consequence, Congress has had little time left over for serious oversight of agencies such as the FBI and CIA, to avert serious failings before they happen, or for considering crucial national issues such as terrorism. The *Washington Post* reported on April 27, 2004, two and a half years after 9/11, that most members on the intelligence committees in the House and Senate had been too busy on other activities to have read crucial terrorism reports or to have held oversight hearings to rectify intelligence agency problems. Congress finally did get around to considering the government failures that led to 9/11 later in 2004, but the federal government is still far too big to oversee adequately.

6. Grants Make Government Responsibilities Unclear

Federal grants create problems for the voting public because it is difficult for citizens to figure out which level of government is responsible for certain policy outcomes. Federal, state, and local governments all play big roles in such areas as transportation and education, thus making accountability very difficult. When the schools fail, which government should parents blame? For their part, politicians have become skilled at pointing fingers at the other levels of government when policies go badly. As Ronald Reagan pointed out in his 1983 budget message, "What had been a classic division of functions between the federal government and the state and localities has become a confused mess."

Cutting Federal Grants

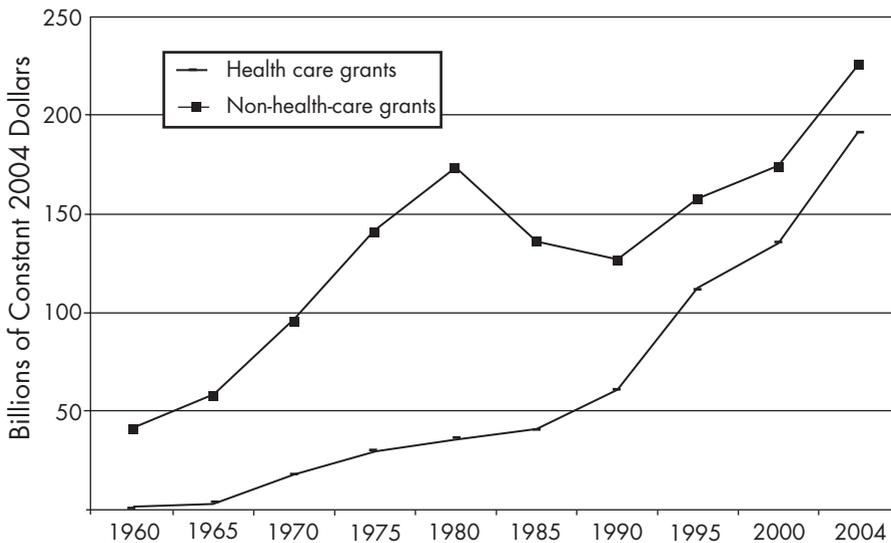
Ronald Reagan tried to sort out the "confused mess" of federal grants. The Reagan administration's policy of "New Federalism" attempted to

re-sort federal and state priorities so that each level of government would have full responsibility for financing its own programs. For example, Reagan proposed that the federal government fully run Medicaid but that welfare and food stamps be fully operated and financed by the states. Reagan sought to terminate spending in areas that were properly state activities: he tried to abolish the Department of Education, calling it “President Carter’s new bureaucratic boondoggle” in the 1980 presidential campaign.

Figure 12.1, which shows federal grant spending in constant 2004 dollars, indicates that Reagan made modest progress in cutting federal grants. Between 1980 and 1985, Reagan cut overall grant spending by 15 percent in constant dollars and nonhealth grants by 21 percent. Unfortunately, the cuts were short-lived, and grant spending has since increased rapidly. Under a Republican Congress, total grant outlays in nominal dollars increased from \$225 billion in FY95 to \$418 billion in FY04. Outlays on the Department of Education soared from \$36 billion in FY01 to \$63 billion in FY04 under President Bush.

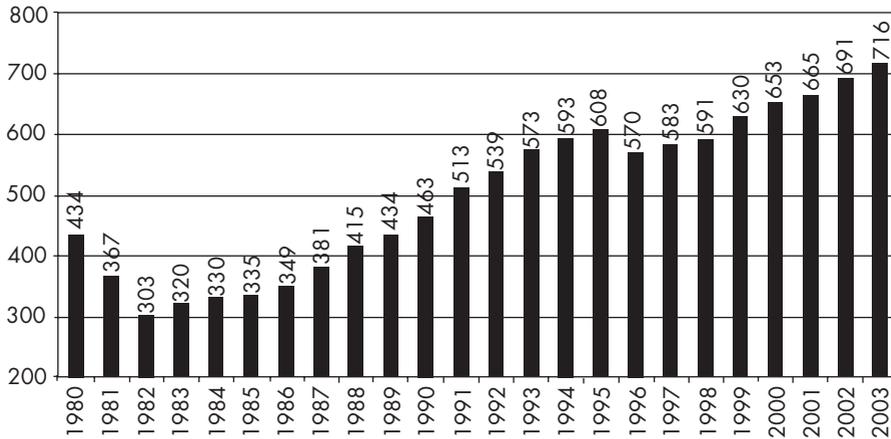
The same pattern is evident when one looks at the total number of federal grant programs, as shown in Figure 12.2. Reagan made some

Figure 12.1
Real Federal Grants to State and Local Governments



SOURCE: Author’s calculations based on *Budget of the U.S. Government, FY2005, Analytical Perspectives*, p. 120. Fiscal years.

Figure 12.2
Number of Federal Grant Programs for State and Local Governments



SOURCE: Office of Management and Budget, based on www.cfda.gov.

progress in cutting the number of programs, but the progress was subsequently reversed. In the Omnibus Budget Reconciliation Act of 1981, 59 grant programs were eliminated, and 80 narrowly focused grants were consolidated into 9 block grants. That consolidation into block grants succeeded in reducing the regulatory burden of those programs.

However, since the mid-1980s the number of grant programs has soared, with only a brief retrenchment in the mid-1990s under the new Republican Congress. The Republicans sought to abolish the Department of Education but were again unsuccessful. They did have success turning welfare into a block grant in 1996. However, President Clinton’s veto pen was a barrier to many reforms, including the Republican budget plan in 1995 that would have turned Medicaid into a block grant and cut the program by \$187 billion over seven years. The number of grant programs increased from 608 in 1995 to 716 by 2003.

With today’s large deficit and the massive cost increases that face the entitlement programs, there is less and less room in the federal budget for state and local activities. Policymakers need to revive federalism and transfer programs back to the states. State and local governments are in a better position to determine whether residents need more roads, schools,

and other items. By federalizing such spending we are asking Congress to do the impossible—to efficiently plan for the competing needs of a diverse country of almost 300 million people.

Suggested Readings

Budget of the U.S. Government, FY2005, Analytical Perspectives, “Aid to State and Local Governments.”

Edwards, Chris. “Downsizing the Federal Government.” Cato Institute Policy Analysis no. 515, June 2, 2004. This report has citations for facts and data used in this chapter.

General Accounting Office. “Federal Assistance: Grant System Continues to Be Highly Fragmented.” GAO-03-718T, April 29, 2003.

Government Printing Office. *Catalog of Federal Domestic Assistance*. www.cfda.gov.

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