25. Fiscal Federalism

Congress should

- begin terminating the more than 1,100 federal aid programs, which give state and local governments almost $700 billion annually in subsidies for education, highways, housing, transit, and other activities; and
- convert Medicaid from an open-ended matching grant to a block grant to reduce federal costs and encourage efficiency at the state level.

The federal government has developed a complex financial relationship with state and local governments through the grants-in-aid system. The system has grown for more than a century as the federal government has increasingly intervened in state and local activities. Today there are more than 1,100 different federal aid programs for the states. Each program has its own rules and regulations, and the overall system is a complicated mess.

It was not supposed to be this way. Under the U.S. Constitution, the federal government was assigned specific, limited powers, and most government functions were left to the states. To ensure that people understood the limits on federal power, the nation's Founders added the Constitution's Tenth Amendment: "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."

The Tenth Amendment embodies federalism, the idea that federal and state governments have separate areas of activity and that federal responsibilities are "few and defined," as James Madison noted. Historically, federalism acted as a safeguard of American freedoms. President Ronald Reagan noted in Executive Order 12612, "Federalism is rooted in the knowledge that our political liberties are best assured by limiting the size and scope of the national government."

Unfortunately, policymakers and the courts have mainly discarded federalism in recent decades. Congress has undertaken many activities that had been reserved to the states and the people. Grants-in-aid are a key mechanism that the federal government has used to extend its control. Grant programs are subsidies that come bundled with federal regulations to micromanage state and local activities.

The federal government will spend almost $700 billion on aid to the states in 2017, making it the largest item in the federal budget after Social Security. Some of the major federal aid programs are for education, health care, housing, and transportation.

There are few, if any, real advantages of federalizing state and local activities through aid programs, but many disadvantages. The aid system encourages excessive spending and bureaucratic waste, reduces political accountability, and stifles policy diversity and innovation. With the ongoing flood of red ink in Washington, now would be a great time to cut the overgrown grants-in-aid system.

Brief History of Federal Aid

Prior to the Civil War, proposals to subsidize state and local activities were occasionally introduced in Congress, but they were routinely voted down or vetoed by presidents. The resistance to federal funding of state activities started to weaken toward the end of the 19th century. The Morrill Act of 1862 provided grants of federal land to the states for the establishment of colleges that focused on agriculture, mechanical studies, and the military. This was the first grant program with "strings attached." It included detailed rules for recipients to follow and required them to submit regular reports to the federal government.

Federal aid activity increased substantially in the early 20th century. When the income tax was introduced in 1913, it provided the means for policymakers to finance a range of new federal aid programs. There was resistance to the expansion of federal aid, but it was politically difficult for states to opt out of new programs. If they opted out, their residents would still have to pay federal taxes to support federal aid spending in other states.

Various sleights of hand were used to get around constitutional barriers to federal intervention in state and local affairs. For example, a 1916 law that created a broad-based federal program for road subsidies was premised on the constitutional power to fund "post roads," or roads used for mail delivery. Federal aid to schools and airports was originally justified on military grounds.

The number of grant-in-aid programs increased steadily from the 1920s to the 1950s and then exploded during the 1960s. Under President Lyndon Johnson, aid programs were added for housing, urban renewal, education, health care, and many other activities. The number of aid programs quadrupled from 132 in 1960 to 530 by 1970.

Policymakers were optimistic that federal experts and federal money could solve complex local problems such as urban decay. But as the failures of aid began to mount, the optimism faded. President Richard Nixon argued that federal aid was a "terrible tangle" of overlap and inefficiency. In his 1971 State of the Union address, he lambasted "the idea that a bureaucratic elite in Washington knows best what is best for people everywhere," and said that he wanted to "reverse the flow of power and resources from the states and communities to Washington." For his part, President Jimmy Carter proposed a "concentrated attack on red tape and confusion in the federal grant-in-aid system." Unfortunately, Nixon and Carter made little progress on reforms.

President Ronald Reagan had more success at sorting out the "confused mess" of federal aid, as he called it. In a 1981 budget law, dozens of grant programs were eliminated and many others were consolidated. Unfortunately, Reagan's progress at trimming federal aid was reversed after he left office, and there have been few efforts to cut the aid system since then. The number of aid programs has more than tripled from 335 in 1985 to more than 1,100 today.

Eight Reasons to Cut Aid

The theory behind grants-in-aid is that the federal government can create subsidy programs in the national interest to efficiently solve local problems. The belief is that policymakers can dispassionately allocate large sums of money across hundreds of activities according to a rational plan designed in Washington.

The federal aid system does not work that way in practice. Federal politicians do not have the knowledge to design programs that maximize net benefits on a national basis, and they put most of their efforts into grabbing subsidies for their own states. At the state level, federal aid stimulates overspending and creates a web of top-down rules that destroy innovation. Officials at all levels of the aid system focus mainly on spending and regulations, not on delivering quality services.

The following are eight reasons that the federal aid system does not make economic or practical sense and ought to be cut and eventually eliminated.

1. There is no magical source of federal funds. Aid supporters bemoan a "lack of resources" at the state level and believe that Uncle Sam has endlessly deep pockets to help out. But every dollar of federal aid sent to the states is ultimately taken from federal taxpayers who live in the 50 states. It is true that the federal government has a greater ability to run deficits than state governments, but that is an argument against the aid system, not in favor of it. By moving the funding of state activities to the federal level, the aid system has tilted American government toward unsustainable deficit financing.

2. Aid spurs wasteful spending. The basic incentive structure of aid programs encourages overspending by federal and state policymakers. Policymakers at both levels can claim credit for spending on a program, while relying on the other level of government to collect part of the tax bill.

Also, aid programs often include features such as matching that prompt the states to increase spending. A typical match is 50 percent, which means that for every $2 million a state expands a program, the federal government chips in $1 million. Matching reduces the "price" of states' added spending, thus prompting them to expand programs. The largest aid program, Medicaid, is a matching program.

One way to reduce the incentive to spend is to convert open-ended matching grants to block grants. Block grants provide a fixed sum to each state and allow greater program flexibility. An example of such a reform was the 1996 welfare overhaul, which turned Aid to Families with Dependent Children (an open-ended matching grant) into Temporary Assistance for Needy Families (a lump-sum block grant). Similar reforms should be pursued for Medicaid and other programs. Converting programs to block grants would reduce incentives for states to overspend, and it would make it easier for Congress to cut federal spending down the road.

3. Aid allocation does not match need. Supporters of federal grants assume that funding can be optimally distributed to those activities and states with the greatest needs. But even if such redistribution was a good idea, the aid system has never worked that way in practice. A July 1940 article in *Congressional Quarterly* lamented, "The grants-in-aid system in the United States has developed in a haphazard fashion. Particular services have been singled out for subsidy at the behest of pressure groups, and little attention has been given to national and state interests as a whole." And a June 1981 report by the Advisory Commission on Intergovernmental Relations concluded that "federal grant-in-aid programs have never reflected any consistent or coherent interpretation of national needs." The situation remains the same today. With highway aid, for example, some states with greater needs due to growing populations—such as Texas—consistently get the short end of the stick on funding.

4. Aid raises costs and reduces diversity. Federal grants reduce state diversity and innovation because they come with one-size-fits-all mandates. A good example was the 55-mile-per-hour national speed limit, which was enforced between 1974 and 1995 by federal threats of withdrawing highway grant money. It never made sense that the same speed limit should be imposed in uncongested rural states and congested urban areas; Congress finally listened to motorists and repealed the mandate.

The Davis-Bacon labor rules are another example of harmful regulations tied to federal aid. State public works projects that receive federal aid must pay workers "prevailing wages." Since that generally means higher union-level wages, Davis-Bacon rules increase construction costs on government investments, such as highway projects.

5. Aid regulations breed bureaucracy. Federal aid is not a costless injection of funding to the states. Federal taxpayers pay the direct costs of the grants, but taxpayers at all levels of government are burdened by the costly bureaucracy needed to support the system. The aid system engulfs government workers with unproductive activities such as proposal writing, program reporting, regulatory compliance, auditing, and litigation.

Many of the 16 million people employed by state and local governments deal with the complex federal regulations attached to federal aid. There are specific sets of rules—sometimes hundreds of pages in length—for each of the more than 1,100 aid programs. There are also "crosscutting requirements," which are provisions that apply across federal aid programs, such as labor market rules.

6. Aid creates policymaker overload. One consequence of the large aid system is that the time spent by federal politicians on state and local issues takes away from their focus on truly national issues. Past investigations have revealed, for example, that most members of the House and Senate intelligence committees do not bother, or do not have the time, to read crucial intelligence reports. But members and their staff put great amounts of time and effort into steering spending toward their home states on local activities that should not have been federalized to begin with.

The federal involvement in hundreds of nonfederal policy areas overloads Washington's policy agenda. President Calvin Coolidge was right when he argued in 1925 that aid to the states should be cut because it was "encumbering the national government beyond its wisdom to comprehend, or its ability to administer" its proper roles.

7. Aid makes government responsibilities unclear. The three layers of government in the United States no longer resemble a tidy layer cake. Instead, they resemble a jumbled marble cake with responsibilities fragmented across multiple layers. Federal aid has made it difficult for citizens to understand which level of government is responsible for particular policies and activities. All three levels of government play big roles in such areas as transportation and education, which makes accountability difficult. After failures, politicians blame other levels of government, as was evident after Hurricane Katrina in 2005. When every level of government is responsible for a policy area, no level of government is responsible.

8. Common problems are not necessarily national priorities. Policymakers often argue that state, local, and private activities require federal intervention because they are "national priorities." But as President Reagan noted in Executive Order 12612, "It is important to recognize the distinction between problems of national scope (which may justify federal action) and problems that are merely common to the states (which will not justify federal action because individual states, acting individually or together, can effectively deal with them)."

Consider education. It is a high priority of local governments across the country and many millions of people, and thus there is no need for federal involvement. Federal involvement just creates bureaucracy and a national tug of war over funding. By contrast, when spending decisions are made at the local level, cost and benefit tradeoffs better reflect the preferences of people within each jurisdiction.

Conclusions

The federal aid system is a roundabout way of funding state and local activities. By federalizing those activities, we are asking Congress to do the impossible—to efficiently plan for the competing needs of a vast and diverse nation of 320 million people. The system thrives not because it creates good governance, but because it maximizes benefits to politicians. The system allows politicians at each level of government to take credit for spending, while blaming other levels of government for program failures and high tax burdens. The federal aid system is a triumph of expenditure without responsibility. It should be cut and eventually terminated altogether.

Suggested Readings

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—Prepared by Chris Edwards