

Cato Handbook for Policymakers

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5. Fiscal Federalism

Congress should

- begin terminating the more than 800 federal grant programs that provide state and local governments with about \$500 billion annually in subsidies for education, housing, community development, and other nonfederal activities;
- convert Medicaid from an open-ended matching grant to a block grant, as a first step toward downsizing this massive health subsidy program; and
- end federal highway and transit funding and repeal the federal gasoline tax that finances these programs.

Under the 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 Framers 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 were "few and defined," as James Madison noted. Historically, federalism acted as a safeguard of American freedoms. Indeed, President Ronald Reagan noted in a 1987 executive order, "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 courts have mainly discarded federalism in recent decades. Congress has undertaken many activities that were traditionally reserved to the states and the private sector. Grants-in-aid are a primary mechanism that the federal government has used to extend its power into state and local affairs. Grants are subsidy programs that are

combined with federal regulatory controls to micromanage state and local activities.

The Growth in Aid

Federal granting began during the late 19th century, expanded during the early 20th century, and exploded during the 1960s. Under President Lyndon B. Johnson, aid programs were added for housing, urban renewal, education, health care, and many other activities. President Johnson called his policies “creative federalism,” but his activism dealt a severe blow to the federalism of the nation’s Founders.

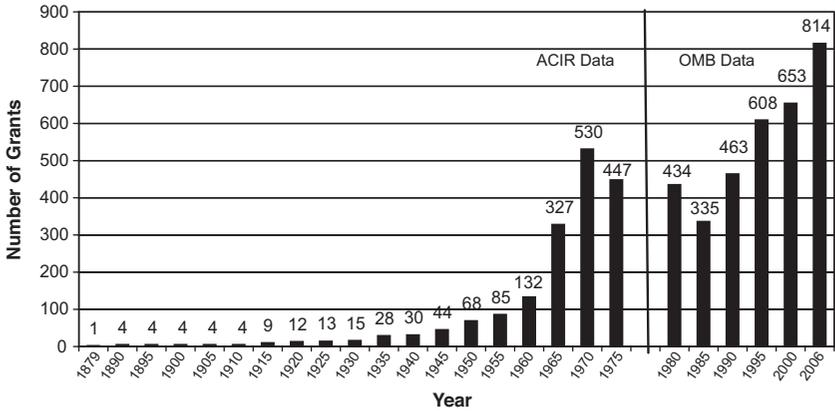
The unchallenged optimism of the 1960s about the federal government’s ability to solve local problems through grants did not last. In the early 1970s, President Richard M. Nixon argued that federal aid was a “terrible tangle” of overlap and inefficiency. In his 1971 State of the Union address, he lambasted “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.

Ronald Reagan had more success at sorting out the “confused mess” of federal grants, as he called it. In a 1981 budget law, dozens of grant programs were eliminated, and many others were consolidated into broader block grants. Reagan’s “new federalism” attempted to re-sort federal and state priorities so that each level of government would have responsibility for financing its own programs. However, these efforts to trim the federal aid empire were reversed in subsequent years, although the Republican Congress of the mid-1990s did succeed in turning the federal welfare program into a block grant.

Figure 5.1 shows that there are more than 800 state and local aid programs today, based on my count of programs in the *Catalog of Federal Domestic Assistance*. They range from the giant \$225 billion Medicaid program to hundreds of programs that most taxpayers have probably never heard of, such as a \$15 million program for “Nursing Workforce Diversity,” a \$120 million program for “Boating Safety Financial Assistance,” and a \$150 million program for “Healthy Marriages.”

Total federal grant spending in fiscal 2008 was \$467 billion. Figure 5.2 shows that real spending on nonhealth grants rose rapidly during the 1960s and 1970s, fell during the 1980s, and soared in the early 2000s.

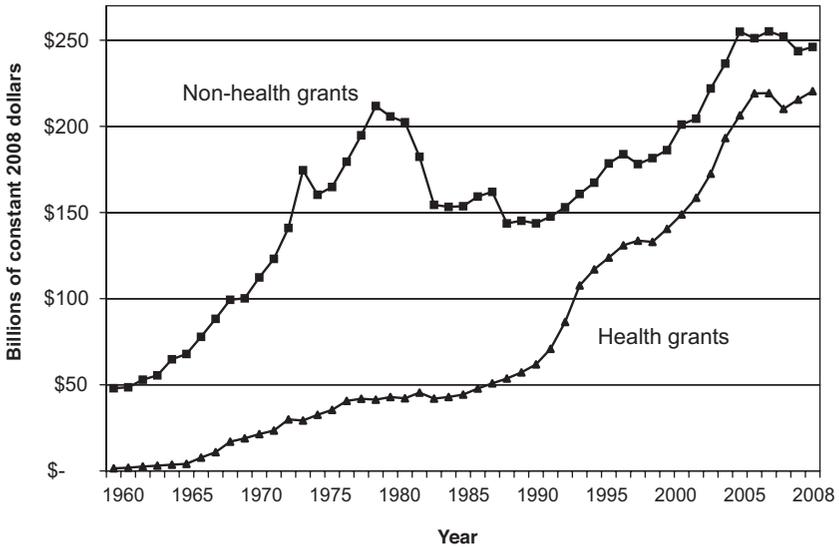
Figure 5.1
Number of Federal Grant Programs for State and Local Governments, 1879–2006



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

NOTE: ACIR = Advisory Commission on Intergovernmental Relations; OMB = Office of Management and Budget.

Figure 5.2
Real Federal Grants to State and Local Governments, 1960–2008



SOURCE: Author's calculations based on *Budget of the U.S. Government, FY2009, Analytical Perspectives*, p. 120. Fiscal years.

Real spending on health care grants has more than quadrupled since 1985, but in recent years spending has been flat. However, that flatness is partly illusory because the new federal prescription drug benefit has shifted billions of dollars of spending from the Medicaid program to Medicare, which is not a grant-in-aid program.

Federal Aid: Theory vs. Reality

The theory behind aid to the states is that the federal government can operate 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 based on a rational plan designed in Washington.

The federal aid system does not work that way in practice. Most federal politicians are not inclined to pursue broad, national goals, but are consumed by the competitive scramble to secure subsidies for their states. At the same time, federal aid stimulates overspending by state governments and creates a web of complex federal regulations that destroys state innovation. At all levels of the aid system, the focus is on regulatory compliance and the amounts spent, not on delivering quality services. The following are seven reasons why Congress should begin cutting federal grants-in-aid.

1. **Grants spur wasteful spending.** The basic incentive structure of aid programs encourages overspending by federal, state, and local politicians. The system allows politicians at each level to claim credit for spending on a program, while relying on another level of government to collect part of the tax bill.

Federal politicians design aid regulations that prompt states to increase their own funding of programs. For example, Congress often includes “matching” provisions in programs, which means that the costs of expansion are split between federal and state taxpayers. Under a 50–50 arrangement, for every \$2 million a state spends on a program, the federal government chips in \$1 million. Matching reduces the “price” to state officials’ added spending, thus prompting them to expand programs. Two-thirds of federal aid spending is on grant programs that have matching requirements.

The open-ended federal match under Medicaid, for example, has prompted state governments to continuously expand health benefits and the number of eligible beneficiaries. Indeed, many states have designed

complex schemes to artificially raise federal matching payments under Medicaid and to fleece federal taxpayers.

One way to limit the gold rush response of state politicians to matching grants is to convert them 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, an open-ended matching grant, into Temporary Assistance for Needy Families, a lump-sum block grant. Similar block grant reforms should be pursued for Medicaid and other programs. Converting programs to block grants would reduce incentives to overspend and would make it easier for reformers to cut and eliminate programs in the future.

2. Aid allocation is haphazard. The theorists favoring federal grants assume that aid can be rationally distributed to those activities and states with the greatest needs. But in the real world, the aid system has never worked that way. A 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.” A June 1981 report by the Advisory Commission on Intergovernmental Relations concluded, “Regarding national purpose, the record indicates that federal grant-in-aid programs have never reflected any consistent or coherent interpretation of national needs.”

Today, for example, states receive varying amounts of highway funding for each dollar of gasoline taxes sent to Washington. While some congested and fast-growing states that need new highways lose out, some slow-growing states get “highways to nowhere” because they have skilled politicians representing them. A major highway law in 2005 included 6,371 “earmarks” directing spending to particular projects that were chosen by individual politicians, not by transportation experts on the basis of merit.

Even if a program could be operated in a rational way, outside of politics, the states can often nullify the policy choices of federal officials. The Department of Education’s \$15 billion Title I program, for example, is supposed to target aid to the poorest school districts. But evidence indicates that state and local governments use Title I funds to displace their own funding of poor schools, thus putting poor schools no further ahead than without the federal program. In such cases, there is no reason

to federalize an activity to begin with, even if one believes in the theory behind federal aid.

3. Grants reduce state policy diversity. Federal grants reduce state innovation because federal money comes with regulations that limit policy flexibility. Grants put the states in a straitjacket of federal rules. Medicaid has perhaps the most complicated top-down rules of any grant program. The 2005 federal budget noted, 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 that defied common sense was the 55-mile-per-hour national speed limit. The limit was enforced between 1974 and 1995 by federal threats of withdrawing state highway grant money. It never made sense that the same speed should be imposed in the wide-open western states and the crowded eastern states, and Congress finally listened to motorists and repealed the law.

However, federal regulations tied to grants are increasing in other areas, such as education. Federal education spending has exploded, and so have federal regulatory controls. The No Child Left Behind law of 2002, for example, mandates that all teachers be “highly qualified,” that Spanish-language versions of tests be administered, and that certain children be tutored after school. State officials have complained bitterly about these new federal rules, and 30 state legislatures have passed resolutions attacking NCLB for undermining states’ rights.

4. Grant regulations breed bureaucracy. Federal aid is not a costless injection of funding to the states. Its direct cost is paid by federal taxpayers who live in the 50 states. In addition, the system generates an enormous amount of bureaucracy at all three levels of government. Each level of government consumes grant program funding with proposal writing, funding allocations, review, reporting, regulatory compliance, litigation, and many other bureaucratic activities.

State and local agencies must comply with long lists of complex federal regulations, which is one reason why the nation employs an army of 16 million state and local government workers. There are three types of federal aid regulations. The first are the specific rules for each program. Each program may come with hundreds or thousands of pages of rules for grantees to follow. The second are “crosscutting requirements,” which are general provisions that apply across aid programs, such as labor market

rules. The third are “crossover sanctions,” which are the various penalties imposed on the states if certain federal regulatory requirements are not met.

What makes matters worse is that the more than 800 federal grants have overlapping mandates, and each program has unique rules. For example, state and local governments deal with 16 different federal programs that fund first responders, such as firefighters. That complicated federal intrusion has led to fragmented disaster response planning and to much first-responder funding going to projects of little value and to regions with little risk of terrorism.

5. Grants cause policymaking overload. A serious problem caused by the huge scope of federal grant activity is that federal politicians spend their time dealing with local issues, such as public schooling, rather than crucial national issues. The huge array of grant programs generates endless opportunities for federal politicians to earmark projects for their home districts, in a chase for funding that consumes much of their time.

Each new aid program has stretched thinner the ability of policymakers to deal with truly national problems because local spending issues divert their attention. Grants have helped create an “overload” on federal decisionmaking capability. It is hard to quantify this problem, but it is clear that most federal policymakers ignore important national problems, such as they did the increasing threat of terrorism before 9/11. Even after 9/11, a number of investigations have revealed that most members of the House and Senate intelligence committees do not bother, or do not have time, to read crucial intelligence reports. President Calvin Coolidge was right in 1925 when he argued 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.

6. Grants make government responsibilities unclear. The three layers of government in the United States no longer resemble the tidy layer cake that existed in the 19th century. Instead, they are like a jumbled marble cake with responsibilities fragmented across multiple layers. Federal aid has made it difficult for citizens to figure out which level of government is responsible for particular policy outcomes. All three levels of government play big roles in such areas as transportation and education, thus making accountability difficult. Politicians have become skilled at pointing fingers of blame at other levels of government, as was evident in the aftermath of Hurricane Katrina. When every government is responsible for an activity, no government is responsible.

7. Common problems are not always national priorities. Over the decades, policymakers have argued that various state, local, and private activities needed federal intervention because they had become “national priorities.” A June 2005 fact sheet from the secretary of education begins: “The responsibility for K–12 education rests with the states under the Constitution. There is also a compelling national interest in the quality of the nation’s public schools. Therefore, the federal government . . . provides assistance to the states and schools in an effort to supplement, not supplant, state support.”

Education is, of course, a priority of many people, but that does not mean that the federal government has to get involved. Indeed, there are few activities that the federal government performs that are not also priorities of individuals, businesses, and state and local governments. The states are certainly free to share their policy experiences in areas such as education, but there is no need for top-down control from Washington.

In a 1987 executive order, President Ronald Reagan observed:

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).

The confusion between problems that are national in scope and those that are merely common to the states even extends to areas such as homeland security. Much “homeland security” funding goes toward items that should be funded locally, such as bulletproof vests for police officers and radio systems for first responders. Federalizing such spending only creates bureaucracy and a tug of war between the states over funding. By contrast, when funding and spending decisions are made together at the state or local levels, policy tradeoffs will better reflect the preferences of citizens within each jurisdiction.

Conclusion

The federal aid system is a roundabout funding system for state and local activities that serves no important economic purpose. During the 1970s and 1980s, government auditors and official commissions pushed for fundamental reforms to the aid system, but those reforms were never made. Ronald Reagan put the system on a diet for a few years, but the core pathologies were not addressed. Since then, hundreds more grant

programs have been added, the costs are higher, and the parochial battles over aid are bigger than ever.

The failings of federal aid have long been recognized, but the system has spawned a web of interlocking interests that block reform. Those interests include elected officials in the three levels of government, the hundreds of trade associations representing the recipients of aid, and a large portion of the 16 million state and local workers who depend on federal funding.

The aid system thrives not because it creates good governance, but because it maximizes benefits to politicians. Politicians at each level of government can get involved in spending on a diverse range of programs, while blaming other levels of government for poor service quality and high tax burdens. The federal aid system has been called a “triumph of expenditure without responsibility.”

Yet the system desperately needs to be scaled back. With today’s large federal budget deficit and the massive cost increases that face entitlement programs, there is little room in the federal budget for state and local activities. Policymakers need to revive federalism and begin to terminate grant programs. If the aid system were shut down, state governments and the private sector would step in and fund those activities that they thought were worthwhile. But by federalizing state and local activities, we are asking Congress to do the impossible—to efficiently plan for the competing needs of a diverse country of more than 300 million people.

Suggested Readings

Advisory Commission on Intergovernmental Relations. From the 1970s to the 1990s, ACIR produced many detailed critiques of federal-state fiscal relations. ACIR reports are available at www.library.unt.edu/gpo/acir/browsetitles.htm.

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.
Edwards, Chris. *Downsizing the Federal Government*. Washington: Cato Institute, 2005.

_____. “Federal Aid to the States: Historical Cause of Government Growth and Bureaucracy.” Cato Institute Policy Analysis no. 593, May 22, 2007. This study has citations for many of the facts in this chapter.

Office of Management and Budget, “Aid to State and Local Governments.” *Budget of the United States Government, Fiscal Year 2009, Analytical Perspectives*. Washington: Government Printing Office, 2008.

Ronald Reagan, Executive Order 12612, October 26, 1987. www.reagan.utexas.edu/archives/speeches/1987/102687d.htm.

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