

FISCAL FEDERALISM

Congress should

- cut federal aid programs, which give state and local governments hundreds of billions of dollars a year for education, highways, housing, transit, and other activities.

Under the U.S. Constitution, the federal government was assigned specific, limited powers, and most government functions were left to the states. To emphasize the limits on federal power, the nation's Founders added the 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 amendment embodies federalism, the idea that federal and state governments have separate policy areas and that federal activities are "few and defined," as James Madison noted in *Federalist no. 45*.

The federal government generally kept out of state and local fiscal affairs until the mid-20th century. But since then, Congress has increasingly intervened with "grant-in-aid" programs, which are subsidies to the states coupled with top-down regulations. Today, there are more than 1,300 federal aid programs for education, housing, health care, highways, transit, and many other activities.

Federal aid to the states totaled \$721 billion in 2019. Then Congress boosted aid enormously during the pandemic to \$829 billion in 2020, \$1.25 trillion in 2021, and an estimated \$1.23 trillion in 2022. These are fiscal years. As it turned out, most of this aid was not needed because state and local tax revenues have grown strongly the past two years, providing governments the resources to handle the crisis.

The states have become far too dependent on federal aid. State governments are not regional subdivisions of the federal government. The aid system generates excessive spending, creates costly bureaucracy, reduces political accountability, stifles diversity, and undermines local democratic control. The following discussion explores nine reasons why federal aid should be cut.

Nine Reasons to Cut Federal Aid

1. Aid induces excess spending. Federal aid supporters often talk as if state governments lack resources to fund programs, whereas the federal government seemingly has endlessly deep pockets. The federal government is able to run large deficits, which gives the illusion of deep pockets, but every dollar of federal aid for state programs ultimately comes from taxpayers who live in the states. It is better to fund state activities at the state level because state governments must balance their budgets, limit debt issuance, and be more fiscally prudent than the federal government.

When states fund their own programs, state policymakers balance the benefits of spending with the costs of raising taxes to pay for those programs. But if a program is partly funded with federal aid, both federal and state policymakers claim credit for the spending yet are only partly responsible for the tax cost. In this way, federal aid inflates the ratio of political benefits from spending to the tax costs, which induces excess spending.

A further problem is that many federal aid programs require states to partly match the funding, which stimulates additional spending. When the federal match is open-ended, as with Medicaid, states have an incentive to continually expand programs because it draws additional federal cash. Converting matching programs to fixed block grants would reduce overspending incentives.

2. Aid distorts spending choices. Supporters of aid hope that federal experts can efficiently allocate funds to high-value activities across the nation. But there is no reason to think that federal officials are better able than state officials to target resources for education, housing, transportation, and other activities. Indeed, pork barrel politics and faulty formulas often undermine efficient allocation of federal aid.

With highways, some growing states such as Texas get shortchanged on aid relative to the gas tax dollars that they put into the federal highway fund. With airports, federal aid is tilted toward smaller airports and away from larger airports where it would generate more benefits. Similarly, homeland security aid has been tilted toward rural areas with low terrorism risks.

People may think that federal aid is aimed at less fortunate regions of the country, but that is often not the case. In 2019, the 10 highest-income states received \$2,354 per capita of federal aid, whereas the 10 lowest-income states received \$2,068, based on my calculations. One cause of this situation is that Medicaid's matching formula has encouraged wealthier states to expand the program more than poorer states, so wealthier states end up receiving more matching dollars from Washington.

Federal aid induces states to spend more on federally subsidized activities, and less on other activities that state residents may prefer. For example, federal

transit aid goes mainly for capital costs not operational costs, which has induced dozens of cities to purchase expensive rail systems rather than more efficient bus systems.

Federal aid has prompted the states to make spending decisions that are divorced from the needs of their own citizens. A classic example was the urban renewal or “slum clearing” of the mid-20th century, which used billions of federal aid dollars to bulldoze poor neighborhoods in favor of failed redevelopment schemes. In *The Death and Life of Great American Cities*, Jane Jacobs said of these projects: “This is not the rebuilding of cities. This is the sacking of cities.”

3. Aid generates bureaucracy. Aid programs need legions of administrators, accountants, and lawyers to prepare applications, draft procedures, file reports, submit waivers, audit recipients, litigate disagreements, and comply with regulations. Federal rules for aid programs can run hundreds or even thousands of pages, and just applying for federal aid is a major effort. The Obama administration, for example, handed out \$4.3 billion in Race to the Top school grants to selected states, but states were required to fill out applications for the funding that were generally more than 600 pages in length.

The federal administrative costs of aid programs can consume up to 10 percent of program spending, which is in addition to the state and local administrative costs. For example, the Government Accountability Office (GAO) found that local governments spent an average of 17 percent of Community Development Block Grant funds on administration. Bureaucracy expert Paul Light estimated in his studies on the “true size of government” that millions of state and local government workers are needed to handle federal aid spending and related regulations.

4. Aid creates fraud and abuse. Many federal aid programs suffer from high levels of waste, fraud, and abuse. State administrators have little incentive to reduce such costs because the funds come “free” from Washington. At the same time, members of Congress have little incentive to reduce such waste because all federal spending in their districts is viewed as a political positive.

Consider the largest aid program, Medicaid. The GAO estimates that 21 percent, or \$85 billion, of the program’s spending in 2020 was improper, meaning erroneous or fraudulent. As a matching program, state administrators have less incentive to cut Medicaid waste because they would need to find more than two dollars of waste to save state taxpayers one dollar. Indeed, the states themselves abuse Medicaid with dubious schemes to inflate the matching dollars they receive from Washington.

Federal aid for the School Lunch and School Breakfast programs is also subject to widespread abuse. In 2019, the GAO reported that the improper payment rate was 16 percent for school lunches and 23 percent for school

breakfasts. Local administrators do little verification of recipient eligibility because they have no incentive to. Indeed, administrators have an incentive to inflate the number of children receiving benefits.

Finally, budget overruns plague infrastructure projects funded with federal aid because there is not enough incentive to control costs. Boston's Big Dig highway project more than quadrupled in cost from \$2.6 billion to \$14.6 billion, of which \$8.5 billion came from the federal government. In his 2018 book *Romance of the Rails*, Randal O'Toole found that cost overruns averaged 43 percent on 64 major urban rail projects funded by the federal government.

5. Aid is tied to costly regulations. Since the first aid program in 1862 for land-grant colleges, the federal government has imposed regulations on state and local agencies running the programs. Today, the federal government loads piles of labor, environmental, safety, and other requirements on aid recipients. These regulations raise the costs of projects. For example, Davis-Bacon rules require that workers on federally funded construction projects must generally receive higher union wages, a requirement that increases wage costs on projects by about 20 percent. Federal environmental rules tied to aid also cause project delays. The average time to gain federal environmental approvals for infrastructure projects has risen from 2.2 years in the 1970s to about 6.6 years today.

6. Aid squelches policy diversity. Residents of each state may have different policy preferences for education, highways, transit, taxes, and other items. In America's federal system, state and local governments can maximize value by tailoring policies to the preferences of their residents, and individuals can improve their lives by moving to jurisdictions that better suit them.

Federal aid and related regulations undermine beneficial state policy diversity and local choices. 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 aid. Such one-size-fits-all rules destroy value because they ignore state variations in geography, traditions, and resident values.

In 1987, President Ronald Reagan's Executive Order 12612 on federalism stated: "The nature of our constitutional system encourages a healthy diversity in the public policies adopted by the people of the several States according to their own conditions, needs, and desires. In the search for enlightened public policy, individual States and communities are free to experiment with a variety of approaches to public issues." But the states cannot be free to experiment if Washington is calling the shots through aid programs.

Reagan was a conservative, but policy diversity has also been a social ideal championed by liberals. It was liberal Supreme Court Justice Louis Brandeis who said in 1932 that with federalism each state can "serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country." It is less risky to pursue policy experiments at the state level than

at the federal level because when federal politicians make big mistakes, it harms the whole nation. A good example is the high-rise public housing projects of the mid-20th century, which are now regarded as a policy disaster. Why did many American cities bulldoze neighborhoods and erect unsightly concrete fortresses for the poor? Because the federal government was paying for the projects and promoting them.

7. Aid undermines democracy. With federal aid programs, policy decisions are often made by unelected officials in Washington rather than by elected officials locally. Aid programs move decisions away from the nation's more than 500,000 elected state and local officials to thousands of unknown and inaccessible federal agency employees.

In theory, the 535 elected members of Congress oversee aid programs, but they have delegated much of their power to the federal bureaucracies. If you do not like a policy in your child's public school, you can voice your concern to local officials. But if the policy was imposed by Washington, you will have a hard time making your concerns heard.

Furthermore, the sheer size of the federal government works against democratic involvement. The federal budget is 100 times larger than the average state budget, so federal policymakers have less time to handle citizen concerns about a program than state and local policymakers do. "Citizens are effectively disenfranchised" because of the federal aid system, noted former U.S. Sen. James L. Buckley in his 2014 book, *Saving Congress from Itself: Emancipating the States and Empowering Their People*.

The U.S. Constitution guarantees to each state a "republican form of government," meaning a representative democracy, but that promise is undermined to the extent that the states become subdivisions of the federal government. Federal aid accounts for one-quarter of state and local government budgets, and because of federal regulatory power, that one-quarter is the tail that wags the dog for overall program control.

The George W. Bush administration imposed a slew of top-down mandates on public schools with its No Child Left Behind program. The Barack Obama administration tried to micromanage neighborhoods through control over federal housing dollars. The Donald Trump administration threatened to cut aid to public schools that did not follow its approach to reopening during COVID-19. A better approach in all these cases would have been to repeal the underlying aid programs and allow the states to fund and control their own programs.

8. Aid destroys accountability. Originally, the three levels of American government—federal, state, and local—were like a tidy layer cake with each layer handling separate functions. Citizens knew whom to praise or blame for policy actions. But with the rise of aid, government has become like a marble

cake with responsibilities for policy areas mixed across layers. In his February 1982 budget message to Congress, Reagan complained, “During the past 20 years, what had been a classic division of functions between the Federal Government and the States and localities has become a confused mess.”

The confused mess has made it harder for citizens to hold politicians accountable. When failures occur, politicians point fingers of blame at other levels of government. They blame others for substandard public school results, inadequate responses to disasters, and many other disappointments. When every government has a hand in an activity, no government takes responsibility for failures.

9. Aid crowds out private activities. Federal aid induces the states to displace or “crowd out” the private provision of services. This problem can be seen with infrastructure investment in bridges, transit systems, and airports.

The expansion of federal aid crowded out private highway bridges. Most toll bridges in America used to be privately owned, noted Robert Poole in *Rethinking America’s Highways: A 21st-Century Vision for Better Infrastructure*. But then in the 1930s, federal and state governments began handing out subsidies to government-owned bridges, which put private bridges at a competitive disadvantage, and many of them were taken over by governments.

Urban transit systems in most American cities were privately owned and operated until the 1960s, but then private transit went into decline. The rise of automobiles undermined private transit, but the nail in the coffin was the Urban Mass Transportation Act of 1964, which provided federal aid to government-owned bus and rail systems, which, in turn, encouraged governments to take over the private systems.

A similar thing happened in aviation. About half of U.S. airports were privately owned in the early years of commercial aviation in the 1920s and 1930s, including the main airports in Los Angeles, Miami, Philadelphia, and Washington, D.C. The airports were successful and innovative, but they lost ground from unfair government competition. Government airports could issue tax-exempt bonds and did not have to pay taxes. And then in 1946, the federal government began regular aid payments to government-owned airports, and that placed private commercial airports at a disadvantage and ultimately put them out of business.

In conclusion, the federal aid system is a roundabout and inefficient way to fund state and local activities. The aid system generates overspending and bureaucracy. It undermines policy diversity and democratic control. It is a triumph of expenditure without responsibility, and it should be cut and eventually eliminated altogether.

Suggested Readings

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