July 15, 1986

STATES AND CITIES PAY A HIGH PRICE FOR THEIR FEDERAL AID

INTRODUCTION

Powerful mayors and governors have been descending on Washington. Their goal is to spare from the federal budget cutters all of the $105 billion in federal aid now received by the nation's cities and states. Without every last penny of this aid, they argue angrily, their localities may not be able to survive.

Their concern is as understandable as it is predictable. Their anger, however, is misdirected, for the federal aid that they have been receiving may be more a curse than a blessing. Federal aid, for example, tends to prompt state and local tax hikes, encourages highly uneconomical projects, and widens the income disparities between the states. In short, the current federal aid structure causes the rich states to get richer and the poor states poorer.

Federal aid to the states may serve appropriate national policy objectives in two cases. First, channeling federal funds to the states can be justified when the payments supplement state spending on projects of national significance. Federal grants to assist the states in operating and maintaining the interstate highway system may be legitimate because the spending benefits residents of all states. Conversely, local roads ought to be built with state and local tax dollars since community residents enjoy most of the benefits. Second, federal aid to the states may be necessary to ensure that all states, even the poorest, are able to deliver a nationally defined minimum level of a carefully restricted list of services in such areas as education, police and fire protection, and health. At most, 20 states would qualify for federal aid under such a criterion.

The tragedy of federal aid, however, is that, despite more than $100 billion in outlays each year, no coherent national policy objective has been achieved. Clearly the current structure of federal aid needs overhaul. To replace the 300 fragmented grants-in-aid programs, Washington should establish a program of Fiscal Equity Grants to the states, similar to a proposal last fall by the Committee on Federalism and National Purpose--a private bipartisan Commission chaired by Senator Daniel J. Evans, the Washington Republican, and former Virginia Governor, Democrat Charles S. Robb. Under such a system, only those states with tax capacities below the national average would receive federal assistance. The idea rests upon the premise that areas with an ample tax base to pay for services and projects themselves should not receive tax dollars from residents of other states.

By basing grant payments solely on need, the income disparities between the states would be lessened, while the poorest states would be assured of receiving adequate federal payments to provide residents necessary services. The Fiscal Equity Grants thus would reduce total federal spending while assuring assistance to the most deserving states.

Most important, state and local governments must be cured of their addiction to federal aid. This aid has only expanded spending at all levels of government, while transferring decisionmaking responsibility on local issues from the hands of community residents where it belongs into the hands of Washington bureaucrats. Worst of all, by accepting billions of dollars of federal aid each year, local governments have subjected themselves to the strangling grip of hundreds of federal regulations. Federal aid is a costly burden, not a benefit, to state and local taxpayers.

THE PROLIFERATION IN FEDERAL AID

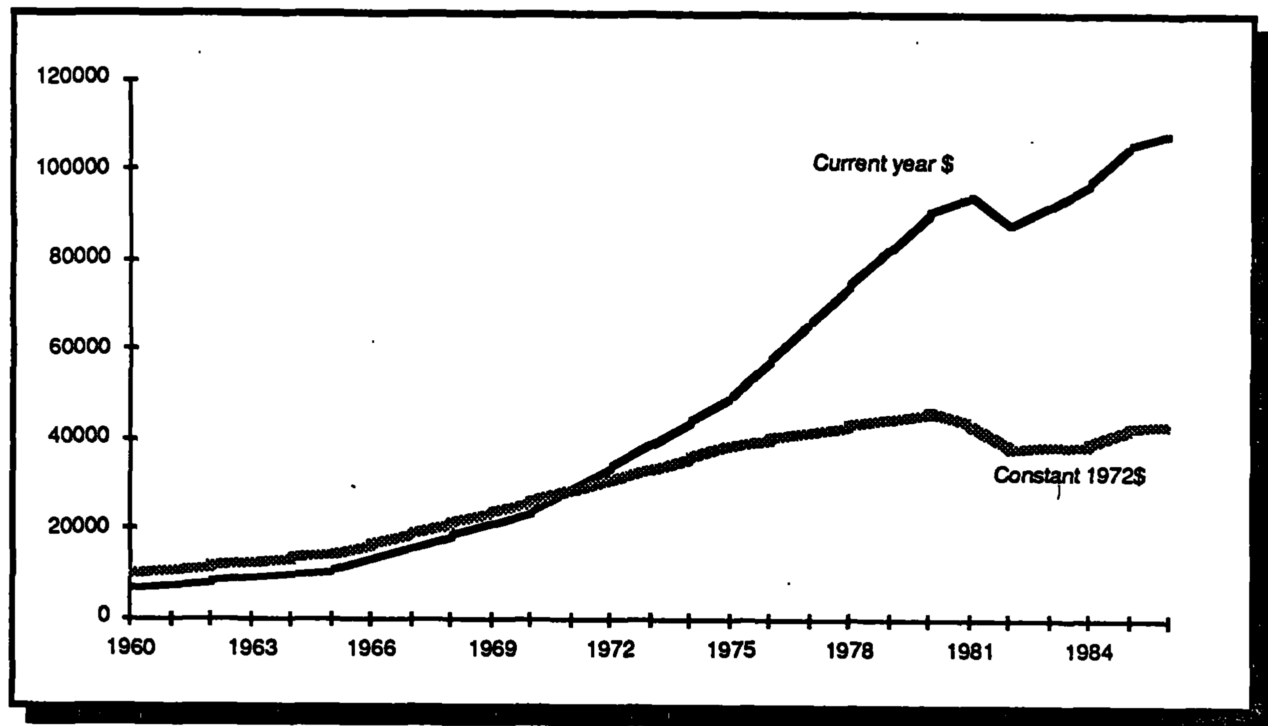
As Figure 1 indicates, after a brief slowdown in 1981 and 1982, federal aid to state and local governments is climbing rapidly again. This federal aid consists not only of direct payments, but also of revenue forgone by the federal government in the form of deductible state and local taxes. In 1985 nearly $50 billion was "lost" in this way, bringing total federal aid to state and local governments to $150 billion for that year. This is an all-time record.

In his comprehensive analysis of the 1981 federal spending cuts, Princeton University political scientist Richard Nathan concludes that

FIGURE 1

Federal Grants To State and Local Governments in Current and Constant Dollars

(Plotted in $ millions for fiscal years)



opponents of the cuts exaggerated the magnitude of the reductions to garner resistance to them.[1] In fact, only 17 states experienced absolute reductions in federal aid. For the remaining states new money for highway construction offset budget cuts.[2]

Ronald Reagan's federalism initiative mainly scaled back the number of grant programs; it has not stemmed the total outflow of federal dollars. When Reagan took office there were an estimated 500 separate federal grants-in-aid programs to states and cities. The Office of Management and Budget reports that there now are just over 300, meaning greater flexibility--and thus efficiency--in the spending of federal aid. Yet duplication remains: this year, for instance, over 25 grant programs will aid the handicapped, eight will provide weatherization assistance, and seven will disburse funds for libraries.

FOUR MYTHS CONCERNING FEDERAL AID

Each of the past three Presidents has strongly endorsed trimming federal aid to state and local governments. Powerful vested interests have thwarted them. The critics of federal cutbacks have advanced four principal arguments for their case. While these claims may have seemed plausible two decades ago, each by now is discredited by the evidence.

Myth 1: Cuts in federal aid force state and local tax hikes.

If this were true, then state and local taxes would be higher in years when federal aid was low, and lower in years when federal aid is high. But just the opposite is the case. In per capita inflation-adjusted dollars, increases in state taxes correspond very closely with increases--not decreases--in federal aid to the states. Similarly, reductions in state taxes are associated with decreases in federal aid to the states. The same relationship has emerged between federal aid to local governments and local tax rates.[3] Admittedly,

---

1. Richard P. Nathan, Philip M. Dearborn, and Clifford A Goldman, "Initial Effects of the Fiscal Year 1982 Reductions in Federal Domestic Spending," in John Ellwood, ed., U.S. Domestic Spending Cuts: How They Affect State and Local Governments (New Brunswick, New Jersey: Transaction Books, 1982), p. 320.

2. "Study Cites Gaps in Federal Spending," The New York Times, June 19, 1985, p. D27.

3. The correlation between per capita own-source state revenue collection (1972 dollars) and per capita federal aid to the states (1972 dollars) over the period 1954-1983 was .98. The correlation between per capita own-source local revenue collection and per capita direct federal aid to local governments was .83.

extraneous factors could be causing these variables to fluctuate together. But at the very least, the evidence contradicts the popular contention that only the billions of dollars of federal aid disbursed by Washington each year have kept down state and local tax rates.

There are, in fact, several reasons why federal aid increases, rather than decreases, state and local tax revenue and spending.[4] The majority of federal grants-in-aid programs impose a matching requirement on the state or local recipient. Thus federal aid is linked to taxes raised by a state or locality. The average matching requirement is one local dollar for every four federal dollars.

This "free" federal money encourages local governments to fund programs that they otherwise could not justify by comparing costs and benefits. One survey of municipal projects receiving partial federal and state assistance, for instance, finds that 51 percent of the projects would not have been undertaken without federal aid.[5]

Another reason state and local taxes rise with federal aid expenditures is that acceptance of federal grants-in-aid money subjects local governments to costly federal regulations. The Advisory Commission on Intergovernmental Relations (ACIR) has tabulated 1,259 federal regulations affecting state and local governments; over 1,000 of these were direct conditions of aid.[6] The costs of these rules can be considerable. An Urban Institute study of the impact of just six of the more burdensome federal regulations on local governments found that they added $24 per capita to the cost of running city hall.[7]

Myth 2: Federal aid reduces fiscal disparities between the states.

The best justification for federal aid to the states and local governments would be that it reduced income disparities among the states sufficiently for all communities to afford essential goods and services. But many of the poorest states, including Florida, Arizona, and Oklahoma, receive less in federal aid than they contribute in

---

4. See Richard B. McKenzie, "How Federal Aid Hikes State and Local Taxes," Heritage Foundation Backgrounder No. 223, October 29, 1982.

5. Catherine H. Lovell, et al., Federal and State Mandating on Local Governments: An Exploration of Issues and Impacts (Riverside, California: University of California, Riverside, 1979).

6. Quoted in: Murray L. Weidenbaum, "Strengthening Our Federal System," Journal of Contemporary Studies, Fall 1981, p. 90.

7. Ibid., p. 91.

taxes. By contrast, such affluent states as California and Alaska continue to walk off with the lion's share of federal funds. With a tax capacity three times the national average, Alaska received four times the average federal aid in 1984. And California received $395 per person more in federal aid than that state's residents paid out in federal taxes, despite having the fourth highest per capita income of any state.

In a comprehensive study of federal aid, former ACIR staffers Albert Davis and Robert Lucke examined the 1980 distribution of per capita federal aid weighted by population.[8] The authors found that "The higher capacity states received more per capita on average than the lower capacity states." This was confirmed when Davis and Lucke looked at 44 programs that supposedly base the size of an area's grant on its relative degree of need for federal funds. Write the two researchers: "The grant system, as a whole, tends to distribute funds in favor of the wealthier states."

This maldistribution of federal aid has had serious effects on low income states. If federal aid had been based simply on a state's population, for example, one study finds that ailing West Virginia would have created 10 percent more jobs in 1984 than it in fact did. Michigan, with a 12 percent unemployment rate in 1984 was found to have lost over 200,000 jobs because of the regressive aid system.[9]

Myth 3: The federal government is in better fiscal shape than the states.

The original justification for many federal aid programs was that Washington's greater revenue raising capacity should be used to help states and local governments. The premise, however, simply is false. Figure 2 compares the financial condition of the federal government with that of the combined states and local governments. Since 1978, state and local governments routinely have been in the black, while the federal government has been hopelessly in the red. The Congressional Budget Office projects that the federal deficit will remain far above $100 billion for the next five years. The states and locals, however, are expected to run annual surpluses of close to $100 billion by 1990.[10]

---

8. Albert Davis and Robert Lucke, "The Rich State-Poor State Problem in a Federal System," National Tax Journal, September 1982, pp. 337-363.

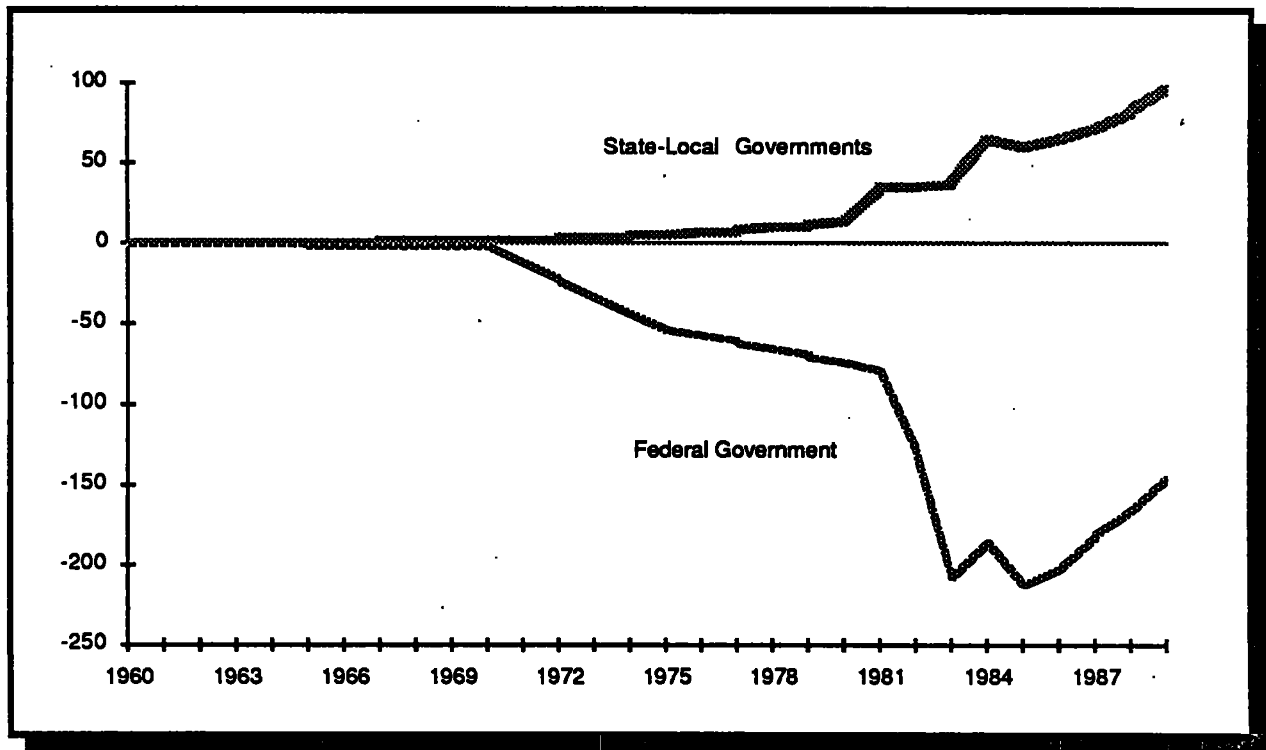
9. Study by State Policy Research, Inc., findings quoted in: The New York Times, "Study Cites Gaps in Federal Spending," June 19, 1985, p. D27.

10. U.S. Department of the Treasury, "Report on Federal Regulations," 1986.

FIGURE 2

Federal and State-Local Annual Budget Surplus/Deficit

(Annual rates plotted in $ billions, current year)



Myth 4: Federal aid is needed because the states are not responsive to the needs of local governments.

The facts refute this. Over the past 20 years, state assistance to localities has risen significantly. Between 1962 and 1982 the level of state aid in constant 1972 dollars rose about threefold--from $12 billion to $35 billion.

State targeting to distressed areas also has improved. A recent study by Texas A&M political scientist John Pelissero concludes that although "state revenue sharing was not targeted to needy cities," during the early 1960s, by 1976, "state revenue sharing was shown to be responsive to all three dimensions--social, economic, and fiscal--of city need."[11]

DIVIDENDS FROM GREATER STATE AND LOCAL SELF-RELIANCE

Cuts in federal aid typically are perceived as harmful to state and local taxpayers. The opposite is more likely true: taxpayers would benefit greatly from less federal involvement in activities primarily local in scope. Reasons for this are:

1) Legal constraints on spending force the states to be more innovative than the federal government.

The constitutions of 47 states require balanced budgets and the vast majority of localities impose balanced budgets on their municipal governments. All but one state grant the governor the line item veto. These restraints force state and local governments to innovate in delivering services at lower cost. Privatization of a number of services, for instance, is now routine in most municipalities. As a result, service delivery costs have been cut by an average of 30 to 40 percent without any diminution in service quality.[12] Los Angeles County recently estimated that it has saved taxpayers $23 million annually through its extensive use of private contractors, which provide, among other things, garbage collection, park maintenance, and street repair.[13]

---

11. John P. Pelissero, "State Revenue Sharing With Large Cities: A Policy Analysis Over Time," Policy Studies Journal, March 1985, pp. 643-652.

12. Privatization in the U.S.: Cities and Counties (Dallas, Texas: National Center for Policy Analysis, 1985), p. 16.

13. Ibid.

Localities also have introduced vouchers for education and medical care, volunteers and nonprofit groups to provide social services, and outside management consultants to cut the cost of data processing, cash management, procurement policy, and debt collection. Indeed, while the federal government responds to fiscal crisis by going deeper into debt, the states and cities respond by administrative belt tightening and privatization.

2) Reduced federal aid encourages efficiency improvements.

Miami recently completed construction of a $1 billion metro rail system. Ridership is so low and expenses so high that by one calculation it would have been cheaper for taxpayers to provide free limousine service for passengers than to build the system. Such white elephants go ahead for one simple reason: they are built primarily with "free" federal Urban Mass Transit funds, and they benefit developers, construction firms, and other powerful political interests. Since the local taxpayers pay a negligible share of the federal taxes that make the grant available, they have little reason to oppose such spending. Understandably, if local taxpayers had to foot the bill, such projects rarely would be considered.

Understandably also, studies show that when local projects are purchased with local rather than federal tax dollars, there is far greater efficiency. Example: A Congressional Budget Office study of local spending patterns under the federally financed wastewater treatment program found "strong statistical evidence that higher cost shares are associated with increased investment efficiency."[14] The Office of Management and Budget found that the availability of federal dollars for capital improvements encourages a deterioration of capital infrastructure. The reason: local governments often neglect basic upkeep for which they receive no federal funds, but because federal construction grants are available, wait until it is necessary to replace deteriorating infrastructure. The study noted that public facilities decayed most rapidly in the 1970s, when federal funds for public works peaked.[15]

3) Decentralization empowers local taxpayers.

Citizen participation in government decision making, notes the Advisory Commission on Intergovernmental Relations, is "most direct and most frequent at the local level." Taxpayers have far greater influence on local budgets than they do at the federal level. Over 70

---

14. Congressional Budget Office, Efficient Investment in Wastewater Treatment Plants, 1985, p. 21.

15. Office of Management and Budget, "Budgeting for Capital Infrastructure: Which Level of Government," 1982.

percent of the states, for instance, require municipalities to hold open hearings on the budget, allowing taxpayers a voice in budget proceedings.[16]

Greater taxpayer influence at the local level permits communities to tailor public expenditures to their own needs and priorities, and to balance costs and benefits more exactly than they can by lobbying Congress. Many governors and mayors now lobbying Congress for more aid, of course, complain that taxpayer resistance makes it difficult for them to replace federal projects with state and local spending. But this is simply an admission that taxpayers have calculated that the costs are not worth the benefits, or that the objective of the project can be achieved with a more economical approach. Rather than a legitimate objection to decentralization, this is a virtue.

THE 1981 CUTS IN FEDERAL AID

Supporters of Reagan's 1981-1982 aid cuts maintained that federal spending reductions would spur greater economies and innovation in local service delivery without impairing service quality. Subsequent evidence supports this. Only minimal local and state tax increases generally were enacted to replace lost federal revenue. Princeton political scientist Richard Nathan examined the responses of 14 states and 14 large cities to reduced federal funds.[17] He found that the vast majority of the states used revenue hikes to replace less than 10 cents for every dollar in federal program cuts. Replacement rates at the local level were even lower.

Thus the Reagan federalism reforms did not lead to an acceleration in state taxing and spending. As Table 1 indicates, during the 1980-1982 period, when federal aid was slowing, the annual rate of increase in state taxes fell significantly.

And state taxes continued to fall during the post-1982 economic expansion. By 1984, Illinois, Wisconsin, Pennsylvania, Minnesota, Ohio, and other states were planning or had enacted major tax rollbacks.

---

16. For a detailed analysis of this issue, see: Advisory Commission on Intergovernmental Relations, Citizen Participation in the American Federal System, 1979.

17. Nathan, et al., pp. 189-204.

TABLE 1

ANNUAL RATE OF INCREASE IN STATE OWN-SOURCE TAX REVENUE AND FEDERAL AID RECEIPTS--1970-1982

Revenue Source	Annual Rate of Increase		
	1970-1975	1975-1980	1980-1982
Total Federal Aid	13.4%	11.4%	1.1%
Total Own-Source Taxes	10.8%	11.3%	8.8%

Source: Table adapted from: Stephen D. Gold, "Recent Development in State Finances," in New Federalism: Its Impact to Date, Hearings Before the Joint Economic Committee, Congress of the United States, 1983, p. 235.

To be sure, there were declines in the growth of state spending, including welfare programs. But it would be incorrect to conclude that welfare spending was significantly curtailed. According to a 1985 assessment of the Reagan block grant reforms by the General Accounting Office, for instance, "program continuity was rarely disrupted....Overall program areas that had been funded under the categorical programs continued to receive support under the block grants."[18]

One key reason was that the cutbacks coincided with the consolidation of dozens of categorical programs into nine block grants. This gave increased flexibility to the states, enabling them to improve efficiency and thus blunt the impact of the cuts. States were generally able to hold down tax rates, absorb federal aid cuts, and at the same time retain service levels without disrupting service quality through a combination of steps. Chief among these are:

Cuts in administrative costs. The block grant consolidations and relaxed program auditing and reporting requirements allow state and local paperwork requirements to be cut an estimated 5 to 6 million man hours annually.[19] Over 30 states, moreover, merged and simplified state programs into local block grants, cutting local costs. By combining the Handicapped Children's program with the Maternal Child Health Block Grant, for instance, Montana was able to

18. General Accounting Office, Block Grants Brought Funding Changes and Adjustments To Program Priorities, 1985.

19. Edgar E. Vash, Testimony before the Joint Economic Committee, New Federalism: Its Impact to Date, 1983, p. 481.

reduce administrative costs sufficiently to expand program access to 11 percent more recipients.[20] And California cut administrative salaries and overhead by $9 million by collapsing nine public health programs into one state public health block grant.[21]

Priorities in spending. The states quickly put their own imprint on spending levels for programs within block grants. Under the Social Services Block Grant--a Reagan Administration creation which combined about a dozen categorical programs--most of the states give high priority to such programs as child and adult protective services, education, training, adoption, and foster care programs, while trimming state spending on family planning and day care services.[22] Other programs, including the community action agencies, were eliminated by many states.[23]

The substitution of state spending priorities for federal priorities was perhaps the most significant achievement of the Reagan federalism reforms. According to detailed analysis of the state response to federal aid cuts by George Peterson, Director of the Urban Institute's Public Finance Center: "The states' budget adjustments seemed to show that, as the administration intended, if forced to become reliant on their own resources, states would select very different budget priorities than those coaxed from them by federal aid."[24]

More stringent needs-based criteria for social program eligibility. The General Accounting Office found in their survey of thirteen states that nine introduced new criteria for distributing funds under the Community Services Block Grant. The result of these new criteria is that poverty-based factors play a more prominent role in spending. The states therefore have not turned their backs on the poor, as many social service organizations feared. Indeed the Coalition on Block Grants and Human Needs, an umbrella organization of over 100 groups that represent the poor and handicapped, acknowledges: "The states were far more progressive than we expected...on many social issues."[25]

---

20. Ibid., 477.

21. Ibid., p. 482.

22. General Accounting Office, op. cit., p. v.

23. George E. Peterson, "Federalism and the States," in John L. Palmer and Isabel V. Sawhill, eds., The Reagan Record, (Washington, D.C.: Urban Institute, 1984), p. 244.

24. Ibid., p. 238.

25. The New York Times, op. cit., p. 32.

Privatization. Contracting with private companies to provide public services was a novelty in the 1970s. It now is routine. The National Center for Policy Analysis surveys of local governments discovered that reliance on private firms for service delivery increased by over 1,000 percent for a wide range of municipal services between 1973 and 1982.[26] Cost savings averaged 30 to 40 percent.

REFORMING THE FEDERAL AID SYSTEM

Since the enactment of the Reagan block grant reforms of 1981-1982, there has been little serious discussion of fundamentally restructuring federal aid to states and localities. The Reagan reforms changed the nature of federalism, but they scarcely dented the colossal aid budget Reagan inherited. To do so would require a number of reforms. Among them:

1) Establish a Fiscal Equity Grant for States.

The current federal aid system gives wealthy states too much and poor states too little. The U.S. intergovernmental grant structure should resemble more closely those of Australia, Canada, and West Germany, where the sole objective of federal payments to subnational units is to redress income disparities among these areas. Under such a Fiscal Equity Grant concept, state eligibility and the size of annual payments would be based exclusively on economic need. The Advisory Commission on Intergovernmental Relations computes annually a "Tax Capacity Index" for each state. Those states with tax capacities above the national average would not qualify for federal funds; those with capacities below the average would receive grant payments sufficient to maintain service levels at national minimum standards.

There is no compelling reason why the federal government should provide revenue to a state that has an adequate tax base, but simply chooses not to tax its residents to provide necessary services.[27]

---

26. National Center for Policy Analysis, op. cit., p. 3.

27. To make the proposal politically feasible, reduction in federal aid must be accompanied by expanding the state and local tax base through reductions in federal taxes. The ACIR has compiled a scheme whereby spending reductions of $20 billion could be combined with revenue turnbacks of an equal magnitude. The plan has been devised in such a way that no state loses or gains benefits of more than 10 percent. The patterns of gains and losses, however, match the state's level of fiscal need. For details, see: Advisory Commission on Intergovernmental Relations, Devolving Federal Program Responsibilities and Revenue Sources to State and Local Governments, March 1986.

2) Continue to consolidate federal aid programs through block grants.

A necessary step toward the Fiscal Equity Grants would be to collapse the over 300 existing federal grant programs into about twelve "Super-Block Grants."[28] Rather than having over 30 Department of Transportation grant programs, for instance, there should be one payment to state and local governments for transportation. This would give communities an incentive to spend those federal funds more efficiently, and permit them to take advantage of block grant flexibility to tailor municipal programs in the interests of the community.

3) Terminate most development assistance grants.

Dozens of federal programs provide general development assistance to state and local governments, including General Revenue Sharing, Urban Development Action Grants, and Community Development Block Grants. Though each was designed to create employment in distressed areas, money actually tends to flow to affluent or politically powerful states and jurisdictions. These grants, moreover, help developers rather than development.[29] It makes little sense for the federal government, with its $200 billion deficit, to aid states and localities that are running healthy annual budget surpluses.

4) Discontinue direct federal assistance to local governments.

If it is the federal government's role to reduce excessive disparities among the states, then it is the states' responsibility to remove such disparities between localities within their borders. The states have greatly expanded the fiscal assistance they provide to their localities--and targeting to needy areas has similarly improved. The states have the capacity and experience to take a larger role in community assistance. They should do so.

CONCLUSION

The framers of the Constitution conceived federalism as a device for cooperation and as a barrier to prevent intrusion by one level of government into the affairs of another. In recent decades, the

---

28. The concept of "Super Block Grants" was proposed by the Reagan Administration in 1982, but was stalled and forgotten before it received a thorough public hearing.

29. For example, see "Urban Grant Program Is on the Defensive," The Washington Post, February 20, 1985, p. A4. See also Peter Ferrara, "Time to End Wasteful Urban Development Grants," Heritage Foundation Backgrounder No. 419, March 26, 1985.

federal government has become involved in activities that traditionally have been reserved to the states and local communities.

Because political considerations are the deciding factor in determining which states receive how much, federal aid has failed to promote any clearly defined national objective. Wealthy states receive larger shares of the federal assistance pie than the relatively poorer states, and states and localities are routinely discovered spending federal tax dollars on uneconomical projects, since passing up "free" federal dollars would be unthinkable. Moreover, instead of federal aid helping to trim taxes on the state and local level, increases in federal assistance invariably have been matched with increases in own-source local spending.

The Reagan Administration has made useful changes in the grants structure. But so far the reforms have been at the margin. What is needed now is a commitment to terminate the potpourri of assistance programs, and replace them with a Fiscal Equity Grant based on the financial capacities of states to meet clearly defined needs. This would benefit poorer areas to a far greater extent than the present aid structure, and it would be a decisive victory in the campaign to control federal spending.

Stephen Moore
Policy Analyst

FIGURE 1

Federal Grants To State and Local Governments in Current and Constant Dollars

(Plotted in $ millions for fiscal years)

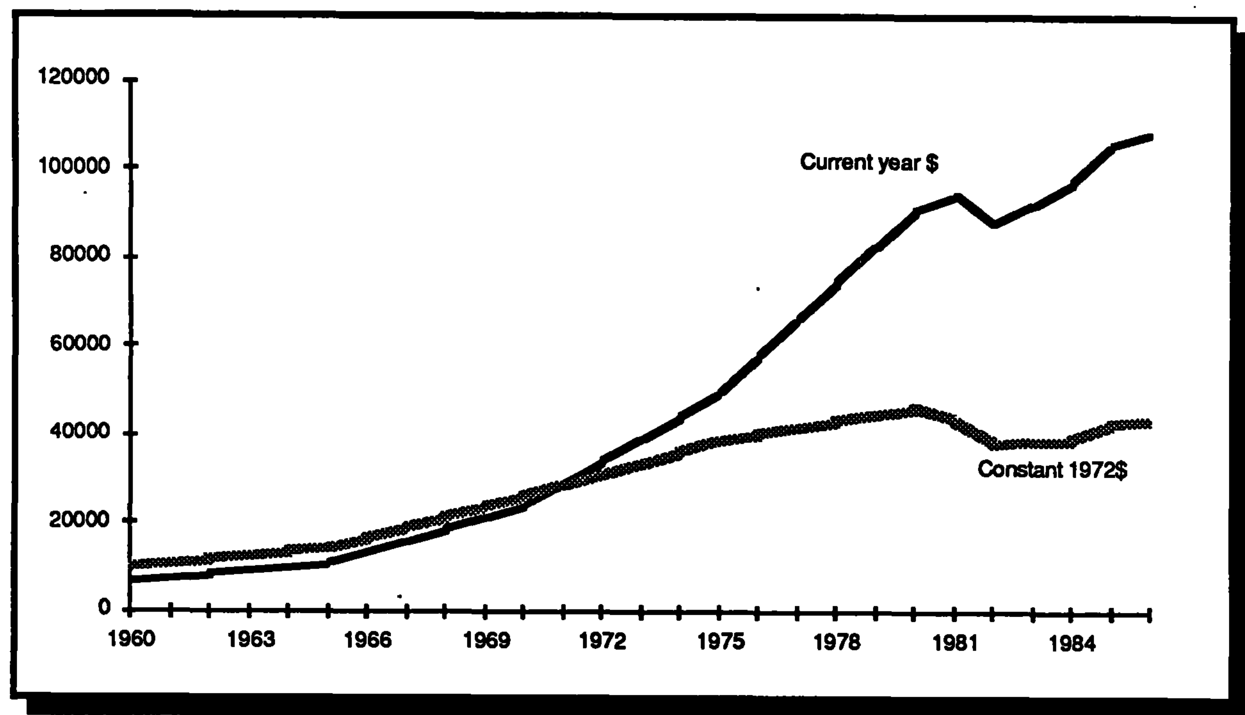


FIGURE 2

Federal and State-Local Annual Budget Surplus/Deficit

(Annual rates plotted in $ billions, current year)