

AIER

American Institute for Economic Research

The Real Achievement of Federalism

Veronique de Rugy

October 16, 2018

Federalism. Great word. Great concept. In theory, it is an important way to balance the powers between the national and state governments. In Federalist 45, James Madison described the role and scope of both levels of government this way:

“The powers delegated by the proposed Constitution to the federal government are few and defined. Those which are to remain in the State governments are numerous and indefinite. The former will be exercised principally on external objects, as war, peace, negotiation and foreign commerce. ... The powers reserved to the several States will extend to all the objects which in the ordinary course of affairs, concern the lives and liberties, and properties of the people, and the internal order, improvement and prosperity of the State.”

Take fiscal issues. Under a pure federalist system, states should set their own economic policies rather than follow directives from Washington. If states can differentiate themselves on the basis of taxes, spending, and regulation, each of us Americans has more leeway to decide which particular rules under which to live. If we're dissatisfied with the policies of the state we live in, we can register our discontent by voting with our feet and moving to another state. This competition for residents – and the tax-dollars they pay – helps keep state officials in check, strengthening their incentives to keep taxes and other intrusions modest.

Sadly, Madison would be horrified to see the extent to which his federalist vision has failed to endure. Fiscal power has become increasingly centralized, with the federal government taking over more and more state functions. One of the ways Washington has inserted itself into the affairs of every state government is through grants to state and local governments, called “grants-in-aid.” A new book published by Wisconsin's Badger Institute called Federal Grant Standing examines the \$750 billion system of federal grants to state and local governments. The findings are distressing.

Total grant outlays increased from \$285 billion in fiscal year 2000 to a whopping \$493 billion in fiscal year 2010—a 73 percent increase. As mentioned, today it totals \$750 billion. Grants also account for a bigger share of federal spending: 17.6 percent today compared to 7.6 percent in 1960. The same pattern is evident when you look at the total number of federal grant programs. According to data computed by the Cato Institute's Chris Edwards, in 1980 there were 434 federal grant programs for state and local governments. In 2006 there were 814. Today there are over 1,100.

These grants seriously blur the lines separating state and federal governments. They also undermine political accountability. According to the Badger Institute, in 2018, \$37.4 billion of state of Wisconsin spending came from federal grants. That's 29 percent of Wisconsin state spending, up from 19.7 percent in 1995. And if you're thinking that this is a great way to get your local spending paid for by national taxpayers, think again. Those federal grants come with strings attached that effectively give the federal government ultimate decision-making power over a large portion of state and local governments' activities.

As the report notes, "The grants-in-aid system has meant a loss of representation at every level of government as our elected officials are hamstrung by regulations they didn't make and their constituents didn't vote for."

The report goes into much more detail than I can here review. It documents the time spent by state employees complying with the federal regulations, the loss of local control (which is especially visible at the school level), the loss of fiscal discipline, and the waste of budgetary resources. It also shows how grants-in-aid reduce innovation, and prompt state and local governments to make bad decisions.

The report also details how the governments of Wisconsin and other states have become administrative arms of the federal government. For instance, we learn that 10,507 of the state's 70,413 employees are actually paid for by the federal government. As the report states, "If Wisconsin, an average-sized state, is typical, there are likely half a million "state employees" throughout American who are actually paid by the federal government."

When it comes to taxes, fiscal federalism has been seriously constrained too. Washington's tax bite has grown so big that differences in state tax rates don't mean as much as they used to. Obviously, other things being equal, it's less costly to run a business in a state with low tax rates than in a state with high tax rates. But that difference becomes less important as the percentage of the total tax bill imposed by Washington grows, especially since you can deduct your state and local tax bill from your taxable income on your federal return. This is why it was a fantastic development that the tax reform passed last December capped the state and local tax deduction at \$10,000.

This lack of meaningful interstate competition is a boon to state and local legislators but bad for taxpayers. The states and the federal government now act as a tax cartel. They are in a position to charge more for their services even when the quality is getting worse.

All this is to say that in theory, fiscal federalism is a great tool for holding our state and local governments in line. But today it's only that: a theory. In practice, federalism has been crushed by the excessive growth of our national government.

To bring federalism back, we must radically decentralize the government's power to tax and to spend. An excellent place to start would be to end federal grants to state and local governments. We can then move to get rid of the income tax as we have it now. Under those circumstances, with the feds expelled from our state and local lives, elected officials would have to fight much harder for our affection for fear of losing us to other states.

AIER Senior Fellow Veronique de Rugy is also a Senior Research Fellow at the Mercatus Center at George Mason University and a nationally syndicated columnist. Her primary research

interests include the US economy, the federal budget, homeland security, taxation, tax competition, and financial privacy.