Fiscal Federalism and State Budgeting

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The federal government has a large presence in many state policy activities including education, housing, and transportation. That presence is facilitated by "grant-in-aid" programs, which are subsidies to state and local governments accompanied by top-down regulations.

Federal aid spending was $721 billion in 2019, which was distributed through more than 1,300 separate programs.[1] In 2020, aid for the states soared by hundreds of billions of dollars as Congress responded to the Covid-19 crisis and recession.

State and local governments have become heavily dependent on federal aid, but the aid system produces irresponsible policymaking. It encourages excessive and misallocated spending. It reduces accountability for failures while generating costly bureaucracy and regulations. It stifles policy diversity and undermines democratic control of government.

Cutting federal aid would improve the performance of federal, state, and local governments. The idea that federal experts can efficiently solve local problems with rule-laden subsidy programs is misguided. Decades of experience in many policy areas show that federal aid often produces harmful results and it displaces state, local, and private policy solutions.

It is true that the states face fiscal challenges during recessions because they are generally required to balance their budgets. But state governments should plan ahead for downturns by building large rainy day funds and by shifting to more stable tax bases.

This study describes the advantages of cutting federal aid. It discusses 10 reasons why it is better to fund state and local activities with state and local revenues rather than with aid from Washington. Shrinking the aid system would improve American governance along many dimensions. State governments can reform their fiscal systems so as not to be so reliant on Washington for ongoing funding or for bailouts during recessions.

Growth in Federal Aid

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 amendment embodies federalism, the idea that federal and state governments have separate policy areas and that proper federal activities are "few and defined," as James Madison noted in *Federalist 45*.

The federal government generally kept out of state and local affairs for the first century and a half of the nation. But in recent decades, Congress has increasingly intervened in state and local activities with aid, or grant, programs. The number of aid programs rose from 463 in 1990 to 653 in 2000 despite promises by Republicans in 1995 to "return power to our states and our people," as Senate Majority Leader Bob Dole promised, and to "return money, power and responsibility to the states," as House Budget Committee chair John Kasich said.[2] The number of federal aid programs jumped to 967 by 2010 and then to 1,386 by 2018.[3]

Federal aid spending was $721 billion in 2019, and then soared in 2020 as Congress responded to the Covid-19 crisis and recession with large subsidy packages.[4] The largest federal aid program is Medicaid, which accounts for more than half of overall aid. Other large aid programs are for highway funding, school breakfast and lunches, rental housing, and K-12 education.

Federal aid spending is misguided. Experience has shown that federal aid and related regulations are not effective at solving state and local problems. The following 10 sections describe reasons aid programs should be repealed. After that, sections on rainy days funds and state tax bases discuss how state governments can handle economic downturns by themselves, rather than relying on costly federal handouts.

1. Aid Causes Excessive Spending

Supporters of federal aid often talk as if state governments lack resources to fund their programs, while the federal government has endlessly deep pockets. But every dollar of federal aid that supports state and local programs ultimately comes from taxpayers who live in the 50 states. There is no special, costless source of money that funds the federal budget.[5]

It is true that the federal government has a greater ability to run deficits than state governments, which gives the illusion of deep pockets.[6] But the fact that the federal government can run large deficits is an argument against the aid system, not for it. By pushing funding for state activities up to the federal level, the aid system biases American government in favor of imprudent deficit financing. It is better to fund state spending activities at the state level because state governments must generally balance their budgets and limit their debt issuance.[7]

The aid system inflates the political benefits of spending. With a state-funded program, state policymakers must balance the benefit of the spending with the cost of raising taxes to pay for it. But if a program is partly funded with federal aid, both federal and state policymakers can claim credit for the spending yet are only responsible for part of the tax cost. In this way, aid programs increase the ratio of the political benefits of spending to the tax costs, thus inducing excess spending.

Many federal aid programs include a matching feature to stimulate added state funding of an activity. Since the beginning of the aid system a century ago, a common match has been 50-50, meaning that for every dollar the federal government spends on a program recipient states must chip in a dollar of their own. When the federal match is open-ended, states can endlessly expand programs and draw additional federal cash. Matching aid stimulates higher state spending than nonmatching aid.[8] The Medicaid program is a good example of how federal matching aid balloons overall spending and undermines incentives for restraint.

2. Aid Distorts Spending Allocations

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 effectively target resources for education, housing, transportation, and other activities.

For one thing, the allocation formulas used in aid programs are blunt tools that do not measure need very well. Highway aid formulas are biased against states that have larger highway systems and more highway use, and thus biased against states with greater needs.[9] Some states with growing populations consistently get shortchanged. Texas, for example, has accounted for an average of 10 percent of gas taxes paid into the federal highway account over the past decade but has received only 8 percent of the spending from it.[10] One study found that the deadweight or inefficiency losses from federal highway aid misallocation was 40 percent of the value of the spending.[11]

Numerous studies find that politics explains aid allocations, not economics.[12] In theory, aid should be targeted to the neediest states or targeted to fix interstate externalities. But according to an Advisory Commission on Intergovernmental Relations (ACIR) study, “the record indicates that federal aid programs have never consistently transferred income to the poorest jurisdictions or individuals. Neither do most existing grants accord with the prescriptions of 'externality' theory."[13] And the ACIR noted, "the logrolling style…through which most grant programs are adopted frequently precludes any careful 'targeting' of fiscal resources."[14]

One can see this bias with federal aid for airports, which is tilted toward smaller, rural airports and away from the largest airports where it would generate the most benefit.[15] There has been a similar bias in homeland security aid, whereby rural areas with low terrorism risks have received an unduly large share of the grants, which in the years after 9/11 resulted in much low-value spending.[16]

For 2019, the federal budget estimates state-by-state data for $666 billion of federal aid spending.[17] The 10 highest-income states received $2,354 per capita while the 10 lowest-income received $2,068. With Medicaid, its allocation formula is based on state per capita income, so poorer states receive a higher federal match rate. However, the match has encouraged wealthier states to expand Medicaid more than poorer states, so wealthier states end up getting relatively more dollars.[18] There are similar patterns in other programs. A *U.S. News and World Report* investigation into federal school aid found that "billions of dollars end up in districts that are richer on average, while many of the nation's poorest districts receive little Title I funding."[19]

Federal aid induces states to spend more on federally subsidized activities, and less on other activities that state residents may value more. Consider urban transit. Since the 1970s, federal aid for transit has been mainly for capital costs, not for operations and maintenance. That has induced dozens of cities to purchase systems with big up-front costs, which usually means expensive rail systems rather than cheaper bus systems, even though the latter are usually more efficient, flexible, and safer.[20] The number of U.S. cities with rail transit has grown from 8 in 1975 to 42 today, and the construction costs of nearly all these new systems were subsidized with federal aid.[21]

One consequence of the bias toward rail is that many cities, such as New York and Boston, are now getting stung by huge rail maintenance costs years after federal aid induced them to build the systems. U.S. transit systems have deferred maintenance costs of more than $90 billion, and systems across the nation are suffering from breakdowns, delays, and safety hazards.[22]

A recent boondoggle in Albuquerque, New Mexico, illustrates how federal aid induce cities to spend on ill-suited systems. City leaders sprang for an expensive $133 million electric bus system because federal subsidies covered more than half of the costs. But the *Los Angeles Times* reports that the "project resulted in parts of what's now Central Avenue being ripped up to host dedicated lanes for the electric buses, which are currently out of commission and have so many problems that [Mayor] Keller freely calls them 'a bit of a lemon.'"[23]

Residents did not want the buses, local businesses hated them, and dozens of businesses along the dedicated bus route have closed. Federal aid generated problems, not solutions.

Federal aid induces state and local governments to make decisions that are divorced from the actual 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 grand development schemes.[24] A 1963 analysis of these federally driven projects found, "Wholesale clearance of slum areas and pillar-to-post relocation of the families who lived there have generated wide discontent. Members of racial and ethnic minorities who have seen the slum buildings they occupied replaced by luxury apartment houses have grown resentful of city planning that rarely seems to make adequate provision for their needs."[25] At the time, urbanist Jane Jacobs said of these projects: "This is not the rebuilding of cities. This is the sacking of cities."[26]

One infamous federally funded project in the early 1980s was the demolition of the Poletown neighborhood of Detroit. The City of Detroit condemned more than 1,300 homes over 465 acres and removed 4,200 people through eminent domain so that General Motors could build a new plant. The city demolished 143 businesses and 16 churches.[27] Economist William Fischel argues that the Poletown expropriation would not have happened without hundreds of millions of dollars of federal grants and loans as well as state subsidies.[28] Local politicians would be much more cautious before proceeding with grandiose and harmful projects if they had to balance the expected benefits with local tax costs.

3. Aid Generates Bureaucracy

The federal aid system has long generated large government bureaucracies. In 1980, an ACIR report on federalism concluded that the aid system is a "bewildering maze" in which the federal government's role has become "more pervasive, more intrusive, more unmanageable, more ineffective, most costly, and above all, more unaccountable."[29] At the time, there were 434 aid programs; today there are 1,386. More recently, the Government Accountability Office said, "the federal grant system continues to be highly fragmented, potentially resulting in a high degree of duplication and overlap among federal programs."[30]

Aid programs need legions of administrators, accountants, consultants, and lawyers to prepare and review applications, draft program plans and procedures, file reports, submit waivers, audit recipients, litigate disagreements, and comply with regulations. The federal rules for each aid program can run to thousands of pages. The federal administrative costs of aid programs range from a few percent of the value of the aid to more than 10 percent. On top of the federal costs are state and local administrative costs. Bureaucracy expert Paul

Light very roughly estimated that 4.6 million state and local government jobs exist to handle federal regulations—both the rules tied to federal aid programs and direct federal mandates for environmental, labor, and other social policies.[31]

Consider the large bureaucracy for the federal aid program Community Development Block Grants (CDBGs). The GAO found that local governments spent an average of 17 percent of CDBG funds on administration.[32] Or consider federal aid for K-12 schools, which flows from the federal government to state bureaucracies, then to local school agencies, and then to schools. A study for Wisconsin found that state-level administration consumed about 7 percent of the federal aid flowing through to local school agencies.[33]

The Obama administration handed out $4.3 billion in Race-to-the-Top school grants to selected states.[34] The state applications for Race-to-the-Top were generally more than 600 pages long, which needed large teams of state employees to complete.[35] Or consider the federal Assistance for Arts Education Development and Dissemination program. In 2018, it awarded $12 million to school boards in 22 grants out 96 applications received.[36] Each application was more than 50 pages in length.[37] That is a large paperwork effort for a small amount of federal money.

In sum, funding state and local programs from Washington adds a large bureaucratic cost that would be avoided if state and local governments funded their own programs.

4. Aid Creates Waste 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 waste in aid programs because all federal spending in their districts is seen as a political positive.

The largest aid program, Medicaid, has huge amounts of erroneous and fraudulent spending, referred to as "improper payments." The GAO estimates that $37 billion in Medicaid spending in 2017 was improper, which was 10 percent of the program's total cost.[38] As a matching program, the incentive for state administrators to reduce Medicaid waste is low 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.[39]

The school lunch and breakfast programs are subject to widespread abuse as families take benefits they are not eligible for. The improper payment rate for school lunches is 16 percent and for breakfasts is 25 percent.[40]

Local governments do little verification of recipient eligibility because they have no incentive to.[41] Indeed, school administrators have been caught illegally inflating the number of children receiving benefits.[42] When federal auditors have examined applications in detail, they have found that about half of them claim excessive benefits.[43]

Government infrastructure funded by federal aid is plagued by cost overruns. Boston's huge 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.[44] Cost overruns are common on small projects as well. In Arlington, Virginia, the local government built a single bus shelter that cost $1 million, whereas a "typical bus shelter costs between $10,000 and $20,000" noted the *Washington Post*.[45] Arlington chose to build a Taj Mahal bus shelter—which has heated floors—because the federal and state governments were paying 80 percent of the costs.[46]

Urban transit has suffered from bloated costs since the 1960s when private systems were taken over by city governments and the federal government began pouring in subsidies. Construction cost overruns have averaged 43 percent on 64 major rail projects tracked by the federal government since 1990.[47]

The unneeded imposition of federal bureaucracy on local infrastructure projects undermines sound management. The GAO points to the "fragmented approach as five DOT agencies with 6,000 employees administer over 100 separate programs with separate funding streams for highways, transit, rail, and safety functions. This fragmented approach impedes effective decision making."[48] New York's World Trade Center rail station, which was completed in 2015, doubled in cost from $2 billion to $4 billion. A *Wall Street Journal* investigation pointed to bureaucratic delays and complexities: "In public and private clashes," federal, state, and local government agencies "each pushed to include their own ideas, making the site's design ever more complex, former project officials said. These disputes added significant delays and costs to the transit station."[49]

In sum, state administrators do not treat federal money in a frugal manner, and the involvement of multiple levels of governments in projects adds costs, complexity, and delays.

5. Aid Buries the Nation in Regulations

Since the first aid program in 1862 for land-grant colleges, the federal government has imposed on states complex rules for operating programs and for detailed reporting to Washington. The aid system includes regulations that are tied to particular programs, as well as regulations that apply to a broad range of programs, which are called cross-cutting regulations. The latter type greatly increased in the 1960s and 1970s as the federal government imposed dozens of labor, environmental, safety, and other social requirements on aid recipients.[50]

Federalism expert John Kincaid says that during the 1960s and 1970s, the "conditions of aid, mandates, preemptions, and federal court orders experienced unprecedented increases. Consequently, state and local governments took on the mantle of administrative arms of the federal government."[51]

The rules tied to federal aid raise state and local costs. For example, Davis-Bacon labor rules require that workers on federally funded construction projects be paid "prevailing wages," generally meaning higher union wages. These rules increase wage costs on highway projects by an average of 22 percent, while also slowing projects and piling paperwork on contractors.[52]

Federal environmental rules tied to aid push up construction costs and cause delays. A report for the Obama administration found that the average time to complete federal environmental studies for infrastructure projects increased from 2.2 years in the 1970s to 6.6 years more recently.[53] The number of federal environmental laws and executive orders that transportation projects must comply with increased from 26 in 1970 to about 70 today.[54]

Federal aid from the Federal Emergency Management Agency's (FEMA's) raises costs. Federal firefighter assistance grants total more than $600 million a year. A few years ago, San Diego was ready to break ground on two new fire stations funded by local revenues. Then the city heard that they could apply for a federal grant to pay for the buildings. The city eventually received the federal aid, but their new stations were far behind schedule and cost $2.2 million more than otherwise because of aid-related regulations.[55] Aid-tied regulations are a negative for the states and a negative for the U.S. economy.

6. Aid Undermines Diversity

Residents of each state may have different preferences for policies on education, highways, transit, and other items. They may have different views on taxes and spending. In America's federal system, state and local governments can maximize value by tailoring policies to the preferences of their residents.[56] At the same time, individuals can improve their own lives by moving to jurisdictions that suit them best.

Federal aid and related regulations undermine such beneficial state policy diversity. 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 preferences.

President Reagan's 1987 executive order on federalism noted, "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."[57] But the states cannot be free to experiment if Washington is calling the shots.

Reagan was a conservative, but diversity used to be a social ideal championed by liberals. It was liberal Supreme Court Judge Louis Brandeis who said 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."[58] Unfortunately, most policymakers on the left have become strong supporters of the federal aid system even though it undermines diversity and local choice.

Brandeis put his finger onto something important—it is less risky to pursue policy experiments at the state level than at the federal level. Federalism expert Adam Freedman notes, "When states are in charge, policy mistakes are localized," but "when the federal government is in charge, all mistakes are Big Mistakes."[59] By contrast, he writes, with decentralization, "the failures stay local while the successes go national," as states freely copy good ideas from other states.[60]

A good example of a Big Mistake was federal aid for high-rise public housing projects in the mid-20th century. Those projects are now widely regarded as a policy disaster.[61] The projects encouraged crime and social dysfunction, and government housing authorities allowed buildings to deteriorate rapidly. Why did many major American cities bulldoze neighborhoods in "slum-clearing" operations and erect unsightly concrete fortresses for the poor? Because the federal government was paying for it and promoting it.

Another example of a Big Mistake generated by federal aid is light-rail transit. Since the 1970s, federal aid has induced dozens of cites to install these expensive systems even though they are less efficient and flexible than buses. In city after city, aid-backed rail systems have had large construction cost overruns, a fraction of the riders originally promised, and severe maintenance problems.[62] Many cities would not have made the mistake without the subsidies from Washington. Instead, they would have explored less-expensive transportation options better tailored to local circumstances.

7. Aid Reduces Freedom

The structure of American government is based on subsidiarity, meaning that "responsibility rests first with the lowest authority, the individual; then, if necessary, with local, state, and finally national officials."[63] At the nation's founding, that structure "maximized liberty by keeping authority as close to the individual as possible."[64]

In discussing how federalism would restrain government power, James Madison said, "a double security arises to the rights of the people. The different governments will control each other; at the same time that each will be controlled by itself."[65]

More recently, the idea that federalism undergirds our freedoms was articulated in a 1987 executive order by President Ronald Reagan. The order was aimed at restraining federal overreach and stated, "Federalism is rooted in the knowledge that our political liberties are best assured by limiting the size and scope of the national government. …The people of the States are free, subject only to restrictions in the Constitution itself or in constitutionally authorized Acts of Congress, to define the moral, political, and legal character of their lives."[66]

Alas, we have strayed far from the Founders or even Ronald Reagan's vision of a decentralized federation. The federal government has used aid programs to expand into many areas that should be left to states, businesses, charities, and individuals. That expansion is creating a top-down bureaucratic society that is alien to American traditions. Cutting federal aid and related regulations would reverse the tide. It would expand freedom by limiting government power and moving its exercise closer to the people.

8. Aid Weakens Democracy

One of the casualties from the growth in federal aid has been democracy. With 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 known.

Furthermore, the sheer size of the federal government works against democratic involvement. There is empirical evidence that "both citizen influence and effort increase as the size of the government declines."[67] The federal budget is 100 times larger than the average state budget, so federal policymakers only have a fraction of the time to handle any citizen concerns about a particular program than would state policymakers.

The federal government controls a substantial share of state policy. Federal aid accounts for one quarter of state and local government revenues.[68] Another measure of control comes from a study that looked at the share of all state agencies across the nation that receive at least some federal aid. That share increased from one-third in the mid-1960s to four-fifths today.[69]

In the United States, state leaders do not control a substantial part of their own governments anymore. "Citizens are effectively disenfranchised" because of the aid system, noted former U.S. Senator James Buckley.[70] A similar view about aid comes from Richard Epstein and Mario Loyola: "When Americans vote in state and local elections, they think they are voting on state and local policies. But often they are just deciding which local officials get to implement the dictates of distant and insulated federal bureaucrats, whom even Congress can't control."[71]

Many state employees really "work for" the federal government because that is who funds their salary in full or in part. State agencies know that "even if only a small percent of an employee's salary or program resources comes from federal aid, loss of that portion can result in a job loss or program cutback."[72] Federal aid is the tail that wags the dog in terms of program control.

Former Nebraska Governor Ben Nelson expressed his dismay at the limitations of his office: "I honestly wondered if I was actually elected governor or just a branch manager of the state of Nebraska for the federal government."[73] The U.S. Constitution guarantees to each state a "Republican form of government" meaning a representative democracy, but that promise is undermined when the states are just "branch managers."[74] In his book on federalism, Adam Freedman says that the rise of federal aid and related regulations is an "assault on democracy because the point of such measures is to coerce states into doing things that their voters do not want, or at least would not be willing to pay for themselves."[75]

9. Aid Destroys Accountability

Federal aid requirements have spawned the creation and expansion of state and local government agencies. Agencies relying on aid often have substantial autonomy from state elected officials, and so aid has horizontally fragmented state governments.[76]

At the same time, federal aid has jumbled American government vertically. Originally, the three levels of government were like a tidy layer cake with each layer handling separate functions. Citizens knew who to praise or blame for policy actions. But with the rise of aid, American government has become like a marble cake with responsibilities mixed across layers.[77] Federal, state, and local governments play intermixed roles in such areas as education, housing, and transportation.

In his 1983 budget message, Reagan argued, “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.”[78] Reagan was right, and the confused mess has made it harder for citizens to hold politicians accountable. Today’s marble cake structure of government allows politicians to point fingers of blame at other government levels when failures occur. That was clear in the aftermath of Hurricane Katrina in 2005, and it was evident during the water crisis in Flint, Michigan, a few years ago. When every government has a hand in an activity, no government takes responsibility for failures.

Budget expert James Capretta noted, “Medicaid's current federal-state design also undermines political accountability. Neither the federal government nor the states are fully in charge. As a result, each side has tended to blame the other for the program’s shortcomings, and neither believes it has sufficient power to unilaterally impose effective reforms.”[79]

Similarly, the ACIR noted that the aid system “has become too big, too broad, and too deep for effective operation or control. Where all responsibilities are shared, no one is truly responsible. And, if everyone is responsible for everything, none can fulfill their obligations.”[80] Finally, political scientist Steven Teles noted, “The complexity of our grant-in-aid system makes the actual business of governing difficult and wasteful.”[81]

10. Aid Crowds Out State and Private Activities

The federal government often appears to play a crucial role when state and local governments and the private sector are not addressing a public need. But that is the case only because the federal government has displaced or “crowded out” state, local, and private efforts.

For better or worse, the states have usually led the way on expansions in government services over the past century, but then the federal government moves in and displaces them.[82] Modern limited-access highways, for example, were pioneered by the states before the federal government passed the Interstate Highway Act of 1956. The Pennsylvania Turnpike opened in 1940, and its success prompted more than a dozen states to launch their own superhighway programs.[83] The states were already weaving together their highways into a larger national system before the 1956 federal highway law.[84]

Federal efforts displace state efforts, but also federal subsidies also induce the states to displace the private provision of services. For example, the expansion of federal aid crowded out the provision of private highway bridges. A 1932 survey found that nearly two-thirds of 322 toll bridges in the United States were privately owned, notes Robert Poole.[85] But then federal and state governments began handing out subsidies to government-owned bridges during the 1930s, and that put private bridges at a competitive disadvantage. Because private bridge owners did not receive subsidies, many of them succumbed to government takeovers.

Urban transit systems in most American cities were privately owned and operated until the 1960s, but then the private share fell rapidly. Of the systems in the 100 largest U.S. cities, the private share fell from 90 percent in 1960 to just 20 percent by the late 1970s.[86] The rise of automobiles undermined transit; transit firms had difficulty cutting costs because they were unionized; and local governments resisted allowing transit firms to end unprofitable routes. The nail in the coffin for private transit was the Urban Mass Transportation Act of 1964, which provided federal aid to government-owned bus and rail systems. That encouraged state and local governments to take over private systems, and a century of private transit in America came to an end.[87]

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. The main airports in Los Angeles, Miami, Philadelphia, Washington D.C., and other cities were for-profit business ventures. These airports were successful and innovative, but they lost ground from unfair government competition. City governments could issue bonds exempt from federal tax to finance their own airports, giving them a financial edge over private airports. Private airports had to pay taxes while government airports did not. The federal government began handing out aid to government-owned airports during the New Deal, and then the Airport Act of 1946 began regular federal aid funding of government-owned airports. Today, virtually all U.S. commercial airports are in government hands.

Federal aid has encouraged the states to crowd out private provision in other areas. The expansion of Medicaid has crowded out private health care. Estimates vary, but roughly every two persons added to the program has reduced private health coverage by one person.[88] Medicaid long-term care aid has induced many families who would have otherwise paid privately to take advantage of government benefits.[89] Similarly, local public schools have long crowded out private schools, and federal aid has exacerbated the problem.

States Need Large Rainy Day Funds

Economic downturns are a blow to the private sector and to governments. As the sales, profits, and incomes of individuals and businesses fall, government revenues from taxes are undermined. While the federal government can increase borrowing when its tax revenues decline, state governments operate within statutory and constitutional rules that require them to balance their general fund budgets.[90] When a recession hits and tax revenues do not grow as expected, state governments rebalance their budgets by raising taxes or reducing planned spending.

Another option for states during recessions is to tap their rainy day or budget stabilization funds. During boom years, state policymakers should be saving a share of tax revenues in these funds to be available later on during a downturn or crisis. The states use a variety of rules and mechanisms for deposits into, and withdrawals from, their rainy day funds.[91] Large rainy day funds are viewed favorably by bond rating agencies, and thus tend to boost a state's credit rating and reduce borrowing costs.[92]

The National Association of State Budget Officers tracks data on state rainy day funds. Going into the recession in 2020, rainy day fund balances totaled 8.7 percent of annual general fund spending for the states as a whole, up from 4.8 percent going into the last recession in 2008.[93] Rainy day funds are a portion of "total balances," which are the accumulated state funds left over after spending. Total balances are a broader cushion for state budgets, and they averaged 12.1 percent of annual spending going into this recession.

The sizes of rainy day funds varies widely. In 2020, they totaled 10 percent or more of annual spending in 18 states, but they totaled less than 5 percent in 11 states.[94] Among these less-prudent states, New Jersey, Pennsylvania, Illinois, and Kansas had saved virtually nothing in their rainy day funds going into 2020, even after a decade-long economic expansion.

Energy producing states tend to have boom-bust economies, and governments in those states are vulnerable because they often rely on severance taxes (on energy extraction) for revenue. However, many of those states—including Alaska, North Dakota, Texas, and Wyoming—knew their vulnerability to downturns and planned ahead, and they went into 2020 with quite large rainy day funds.

In sum, states that were prudent and built large rainy days going into this recession will have an easier time budgeting over the next year or two. But recent events should be a warning to all state governments to plan ahead and build large rainy day funds because crises and recessions usually happen without warning.

States Should Adopt Stable Tax Bases

State governments raised $1.09 trillion in tax revenues in 2019. Sales taxes were 46 percent of the total, individual income taxes were 38 percent, corporate income taxes were 5 percent, and other taxes were 11 percent.[95] To reduce a boom-bust cycle in their budgets as the economy expands and contracts, state policymakers should move toward sources of tax revenue that are more stable across economic cycles.

Income tax revenues are more volatile than sales tax revenues. During the last recession, state personal income tax revenues fell 12 percent and state corporate income tax revenues fell 18 percent from the peak in 2007 to the trough in 2009.[96] State sales tax revenues fell just 9 percent during that period. An Urban Institute study looking at state revenues found that "the corporate income tax tends to be the most volatile source of tax revenue; the personal income tax, which includes the highly unpredictable capital gains tax, is a close second."[97] A related problem is that forecasts for future income tax revenue are more error-prone than forecasts for sales taxes, which makes state budget planning more difficult.[98]

The Urban Institute study noted that states have become more dependent on volatile revenue sources since the 1970s as the share of revenues from income taxes has risen while the share from sales taxes has fallen.[99] A Federal Reserve study also found that state revenues have become more volatile over time.[100] A chart of annual changes in sales and income tax revenues over the decades clearly shows greater fluctuations in the latter.[101] Within the income tax base, the Federal Reserve study found that investment income (dividends, interest, and capital gains) is far more volatile than wage income.[102]

Progressive personal income taxes that have higher rates on top earners are more volatile than proportional or flat-rate systems. That is because incomes at the top end are heavily weighted by investment and business income, which fluctuate strongly with economic ups and downs. During the last recession, federal adjusted gross income of the top 1 percent fell 34 percent between 2007 and 2009, which compared to just a 6 percent drop in adjusted gross income for the other 99 percent of taxpayers.[103]

The volatility of high-end incomes creates a major budget problem for states that have highly progressive income tax structures, such as New York and California. In New York, the top 1 percent of earners pays about 41 percent of state income taxes, and in California, the top 1 percent pays about 50 percent of state income taxes.[104] In 2019, income taxes accounted for 64 percent of New York's overall tax revenue and 61 percent of California's. When the investment and business income of the top 1 percent drops during a recession in states such as these, it generates a major budget crisis.

During the last recession, California's personal income tax revenues plunged 20 percent in 2009, which compared to just a 9 percent fall in the other 49 states.[105] California's top personal income tax rate of 13.3 percent is the highest in the nation. An analysis by California's legislature found that the state's personal income tax revenues are about five times more volatile than overall personal income because of the income tax system's graduated rate structure and other design features.[106] Within income taxes, capital gains taxes are particularly volatile.[107]

Pew Charitable Trusts examined tax revenue volatility between 1998 and 2017 and found that California had the fifth highest out of the 50 states. The three states with the most volatile revenue systems were the energy producers Alaska, North Dakota, and Wyoming, which rely heavily on severance taxes.[108]

In the Pew analysis, South Dakota has the least revenue volatility among the 50 states. South Dakota does not have a personal income tax and sales taxes account for 83 percent of state tax revenues.[109] During the last recession, South Dakota's total tax revenues did not fall—they were flat for a couple years and then started rising again. Thus, states wanting to be better prepared for the next recession should transition away from income taxes and rely more on sales taxes.

Aside from being a more stable revenue source, sales taxes are less harmful to economic growth than income taxes because they do not tax the return to saving and investment.[110] The Tax Cuts and Jobs Act of 2017 created a further incentive to move away income taxes, particularly systems with progressive structures. The law capped the federal deduction for state and local taxes at $10,000, which had the effect of increasing the tax burden particularly on high earners living in high-tax states. The reform means that millions of middle- and higher-income households have a stronger incentive to move to a lower-tax state.

As explored in a Cato Institute study, state policymakers should rethink their tax codes in today's era of heightened interstate tax competition.[111] High-rate individual income taxes and corporate income taxes make less sense than sales taxes because of the greater harm caused to the economy and the reduced stability for state budgets.[112]

Conclusions

The federal aid system is a roundabout way to fund state and local activities that the deficit-ridden federal government cannot afford. The aid system does not deliver efficient public services, but rather delivers bureaucracy, overspending, and federal micromanagement. It undermines policy diversity and political accountability. With larger rainy day funds and more stable tax bases, the states should be able to handle economic downturns without the gushers of poorly targeted aid from Washington.

It is understandable that federal policymakers are eager to try and fix the nation's ills. But they should appreciate that the states can handle domestic policies by themselves and that federal intervention is usually counterproductive. Americans want more responsive and effective government, and they can get it by devolving power to the states and reviving competitive federalism.

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[1] This is a fiscal year estimate from the *Budget of the U.S. Government, FY2021, Analytical Perspectives* (Washington: Government Printing Office, 2020).
[2] Quoted in Kenneth Jost, "The States and Federalism: Should More Power be Shifted to the States?," *CQ Researcher*, September 13, 1996.
[3] The figure for 2018 is based on my analysis of the Catalog of Federal Domestic Assistance (CFDA), which is available at https://beta.sam.gov (formerly www.cfda.gov). I included programs of type A, B, and C for state, local, and tribal governments, while excluding programs for private-sector recipients. Programs with zero obligations were excluded. The Congressional Research Service provided a count for 2017 of 1,319. See Robert Day Dilger, "Federal Grants to State and Local Governments: A Historical Perspective on Contemporary Issues," Congressional Research Service, R40638, May 7, 2018.
[4] Data for 2019 from *Budget of the U.S. Government, FY2021, Analytical Perspectives* (Washington: Government Printing Office, 2020).
[5] A study by a liberal thinktank arguing against President Trump's proposed aid cuts said, "State and local governments do not have the funds to replace the magnitude of funds that could be lost through cuts." Yet the federal government is running massive deficits and does not "have the funds" either. See Iris J. Lav and Michael Leachman, "At Risk: Federal Grants to State and Local Governments," Center on Budget and Policy Priorities, March 13, 2017.
[6] Federalism expert John Kincaid notes, "Just as grants create the illusion of free money for state and local taxpayers, federal deficit spending encourages state and local officials to try to shift costs to the federal government because it appears to be costless and because state and local officials face comparatively hard budget constraints in the forms of constitutional or statutory tax, expenditure, and borrowing limits." John Kincaid, "The Eclipse of Dual Federalism by One-Way Cooperation Federalism," *Arizona State Law Journal* 49, no. 3 (Fall 2017): 1075. The first book about the new and growing federal aid system published in 1928 captured the political appeal of federal funding: "The voters have clamored loudly for better standards of service—more and better schools, more and better teachers, more and better roads. At the same time they have voiced no less insistently their demand for lower taxes. State legislators … have cast about for new sources of revenue. One the richest finds has been the federal treasury." Austin F. Macdonald, *Federal Aid: A Study of the American Subsidy System* (New York: Thomas Y. Crowell Company, 1928), p. 5.
[7] In addition to legal limits on debt issuance, state budgeting is disciplined by credit ratings on state bond debt. Some states have large unfunded obligations in their worker retirement plans and thus are not fiscal saints. However, state and local debt and unfunded obligations is a smaller problem than federal government debt and unfunded obligations. Also, some states are quite prudent and have very low debt and unfunded obligations.
[8] Shama Gamkhar and Wallace Oates, "Asymmetries in the Response to Increases and Decreases in Intergovernmental Grants: Some Empirical Findings," *National Tax Journal* 49, no. 4 (December 1996): 501-512.
[9] Pengyu Zhu and Jeffrey R. Brown, "Donor States and Donee States: Investigating Geographic Redistribution of the U.S. Federal-Aid Highway Program 1974–2008," *Transportation* 40, no. 1 (January 2013): 203–227.
[10] Author's calculation for 2006 to 2015 of the HTF's highway account. See Federal Highway Administration, "Highway Statistics 2015," August 2016, Table FE-221B.

[11] This is Inman's interpretation of Knight's statistical results. Robert P. Inman, "The Flypaper Effect," National Bureau of Economic Research Working Paper no. 14579, December 2008. Brian Knight, "Parochial Interests and the Centralized Provision of Local Public Goods," National Bureau of Economic Research Working Paper no. 9748, June 2003.

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[13] Advisory Commission on Intergovernmental Relations, "The Federal Role in the Federal System: The Dynamics of Growth," no. A-86, June 1981, p. 94.

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[17] *Budget of the U.S. Government, FY2020, Analytical Perspectives* (Washington: Government Printing Office, 2019), Table 17-4.

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[20] Randal O'Toole, *Romance of the Rails: Why the Passenger Trains We Love Are Not the Transportation We Need*, (Washington: Cato Institute, 2018), Chapter 13.

[21] Randal O'Toole, *Romance of the Rails: Why the Passenger Trains We Love Are Not the Transportation We Need*, (Washington: Cato Institute, 2018), pp. 165, 168, 215.

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