



Make States Compete by Reviving Fiscal Federalism

By Veronique de Rugy and Stefanie Haeffele-Balch

In May 2009, the federal government forced South Carolina Governor Mark Sanford to take his state's share of federal stimulus funds and spend the money on new programs rather than on paying down debt. Many free market advocates claimed this move threatened fiscal federalism. But the truth is that fiscal federalism has been eroded for decades by the growth of the federal government and its ever-increasing number of grants and subsidies to state governments.

WHAT IS FISCAL FEDERALISM?

Fiscal federalism is the idea that, acting under some federal constraints, states should set their own economic policies rather than follow directives from the central government. A limit on federal power, fiscal federalism theoretically produces one main benefit to individuals: It increases competition between states. If states differentiate themselves on the bases of taxes, spending, and regulation, Americans have more freedom to decide the rules under which they live. If citizens are dissatisfied with the state in which they reside, they can register their discontent by voting with their feet and moving to another jurisdiction. This competition for residents helps keep lawmakers in check, giving them an incentive to keep taxes, regulations, and other intrusions modest.

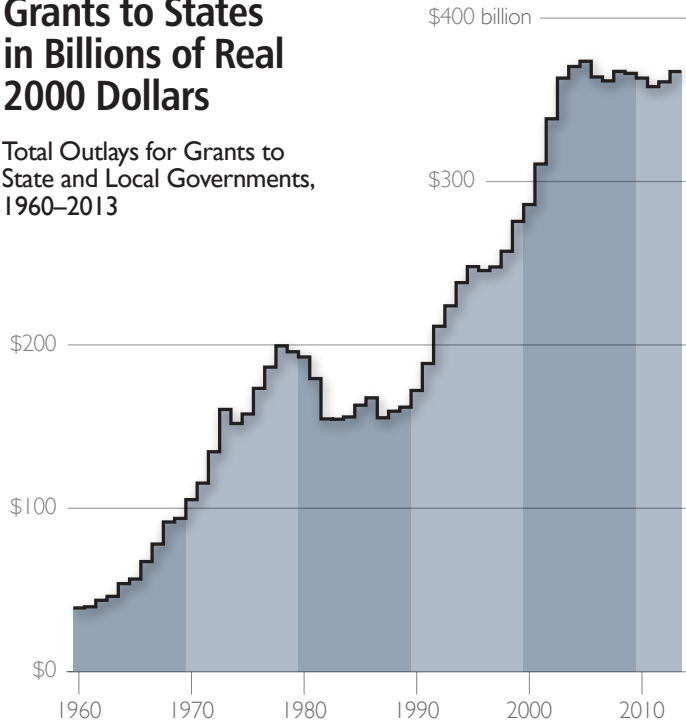
Also, by nature, the policy needs and priorities in the state of Alaska are different than those in the state of Florida. Fiscal federalism involves decentralization of decision making, which allows sovereign states to cater to their constituencies' preferences and provide policies that fit their states rather than impose a one-size-fits-all product.

THE EROSION OF FISCAL FEDERALISM

The precondition for fiscal federalism to work is that taxpayers get a different tax treatment or burden depending on where they live. However, for decades, the federal government has taken over many state functions, essentially eroding federalism by making state policy more homogeneous. This process happened mainly

Grants to States in Billions of Real 2000 Dollars

Total Outlays for Grants to State and Local Governments, 1960–2013



Note: Figures adjusted for inflation into 2000 dollars.

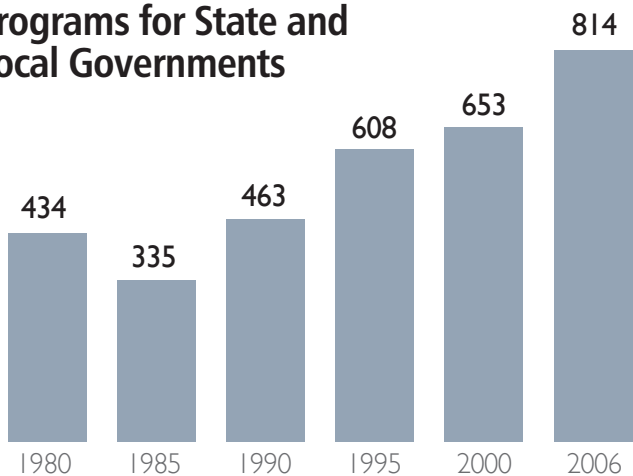
Source: Office of Management and Budget, Historical Tables.

through the federal distribution of grants to state and local governments, also called grants-in-aid. The figure above shows federal grant spending in constant (2000) dollars from 1960 to 2013. Total grant outlays increased from \$285.9 billion in fiscal year 2000 to \$363.3 billion in fiscal year 2010—a 27.1 percent increase. Grants also account for a bigger share of federal spending: 18 percent in 2009, compared to 7.6 percent in 1960. The data show the federal government taking over more and more state activities, such as education.

The same pattern in the takeover of state functions by the federal government is evident when you look at the total number of federal grant programs. (See figure on the next page.) In 1980, according to calculations by Chris Edwards of the Cato Institute, there were 434 federal grant programs for state and local governments. In 2006, there were 814.



Number of Federal Aid Programs for State and Local Governments



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

Edwards notes that the support for grants and for centralization of government power in Washington come from policymakers who favor funding government through the heavily graduated federal income tax system rather than through the more proportional state tax system. Hence, as federal grant programs continue to grow, so does federal taxation.

Federal taxation has grown so much that differences in state tax rates contribute only marginally to a taxpayer's total tax burden. Sixty percent of all government revenues in 2008 came from the federal income tax, making it the dominant tax burden in Americans' lives. (See figure on the next page.) By contrast, in 1930, the federal income tax provided only 30 percent of all government revenues.

All other things being equal, it remains less costly to live or run a business in a low-tax-rate state than in a high-tax-rate one. However, when the federal government imposes an ever-increasing percentage of each taxpayer's total tax burden, differences in state taxes become less important. If your main tax burden is going to be the same wherever you live, why bother moving to another state, especial-

ly if you get to deduct your state taxes from your federal ones? Being able to deduct state taxes from the federal burden obviates any differences between the states.

Federal grants for state and local functions further obviate differences between the states. Such grants come with strings attached, strings that further weaken states' independence. In order to retrieve some of the money that their residents have paid in federal taxes, states must compete with each other

to get money from the federal government instead of more directly competing with each other to gain residents.

This lack of meaningful interstate competition has a negative effect on taxpayers. As programs become more centralized, state authorities must increasingly comply with procedures and regulations set forth by Washington. These homogeneous procedures and regulations often ignore the needs of local taxpayers. In effect, the states and the federal government act as a tax cartel, charging higher taxes for lower quality services that do not address the unique needs of communities.

POLICY IMPLICATIONS

In theory, fiscal federalism is a great tool that holds state and local governments accountable for their policy actions. In practice, it hardly exists. The increasing scope of federal programs and grants has largely eroded its impact on policy decisions by state and local government to the point that tax considerations become almost irrelevant in people's decisions about where to live.

We should mourn the death of fiscal federalism. The fear of losing taxpayers to another

jurisdiction gives policymakers an incentive to keep taxes, regulations, and other intrusions modest; but homogenized, top-down policy diminishes the incentives for states to compete for residents. Instead of competing for residents, states compete for federal funding and privileges. It's a system that rewards the best lobbyists while wasting taxpayers' money.

In order to bring fiscal federalism back to life, the government's power to tax and to spend needs to be decentralized radically. The Reagan administration's policy of "new federalism" attempted to sort out the mess of federal grants by redefining federal and state priorities so that each level of government should have full responsibility for financing its own programs. For example, the Omnibus Budget Reconciliation Act of 1981 eliminated 59

grant programs and consolidated 80 narrowly focused grants into nine block grants, reducing their regulatory burden. Unfortunately, this progress was subsequently reversed.

Today, lawmakers need to revive federalism by transferring many programs back to the states. States are, after all, in a better position than the federal government to determine their needs when it comes to roads or schools.

A first step would be to dramatically cut federal aid to the state governments. Eventually, the federal government would have to abolish the national income tax and cease giving grants to state and local governments. Only such circumstances would expel the authority

of the federal government from state and local functions and force state lawmakers to cater to their constituents for fear of losing them to competing states.

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