NEW FEDERALISM: THE SEARCH FOR NEW BALANCES

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Old Federalism

Before examining New Federalism, it might be a good idea to take a look back at what was "Old Federalism" — a period that extended from the end of the Korean War to 1978. We can use Proposition 13, the tax revolt year, as the end of the era.

Old Federalism was marked by tremendous growth in state and local spending. State and local spending during this period rose at a consistently faster rate than did the economy and federal aid was the fastest growing element within the state-local fiscal structure. (Figure 1 and Table 1)

In fact, our federal aid system grew so fast that some students of federalism likened it to a rogue elephant that would soon trample down all of the traditional barriers that had protected state and local governments from unwarranted federal intrusion. (Table 2) These students documented their concern with several findings that also stand out as significant features of Old Federalism.

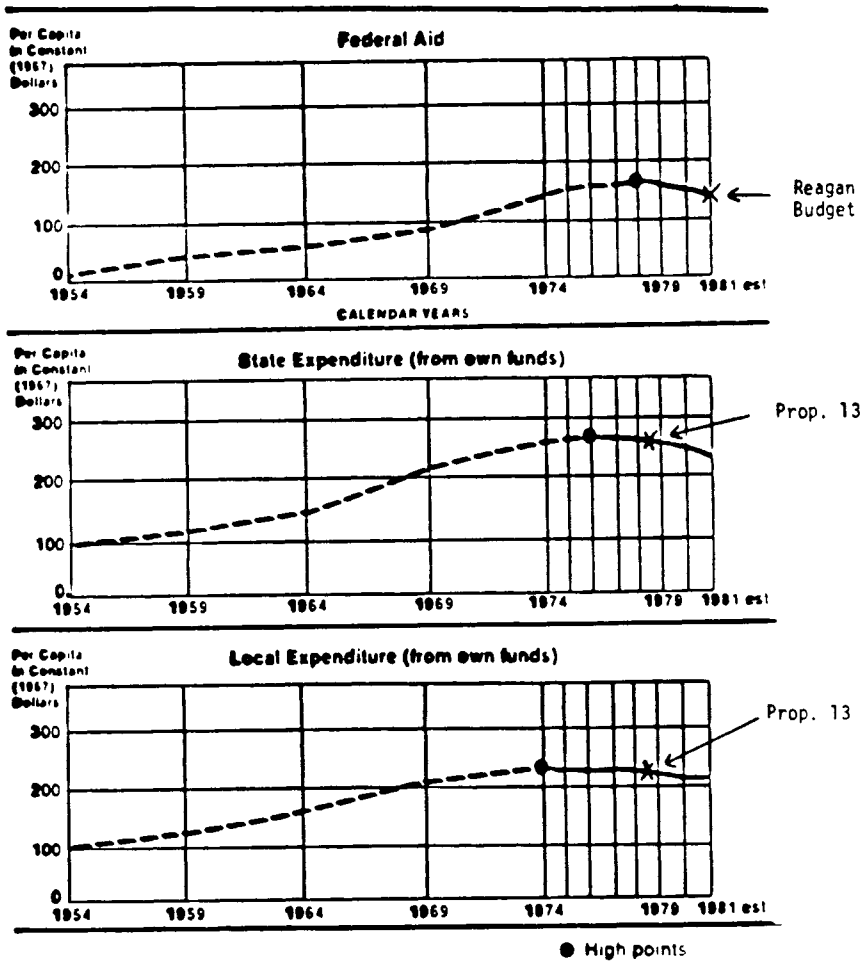
First: There was ever-increasing state-local reliance on federal funds. In 1955 federal aid amounted to only about 10 percent of the revenue the state and local governments were raising on their own; by 1978 it had risen to 32 percent.

Second: There was a tremendous proliferation of these very narrow categorical aids. During the same post-war period the number of separate federal aid programs that were being sent out to state and local governments shot up from about 50 in 1950 to 132 by 1960, and over 500 by 1978. We had federal aid programs for everything — you name it. There was no area of state-local activity that did not have some federal aid counterpart.

There was also the inevitable growing federal intrusion into areas of traditional state-local concern. This rapid and rather disorderly growth of the federal aid system sent federal dollars into all phases of state-local operations. But instead of bringing clear-cut federal control, it

FIGURE 1

THE RISE AND DECLINE OF OLD FEDERALISM
(An Up-From-The-Grass-Roots Phenomenon)



Source: ACIR staff.

resulted in a mish-mashing of federal, state, and local activity with some real loss in accountability, efficiency, and public confidence.

Now, there is also a good side to federal aid — the down side has been emphasized quite a bit recently. That same federal aid system

TABLE 1

THE STATE-LOCAL SECTOR TURNAROUND
(State and Local Government Expenditure,[1] as a Percent of Gross National Product, Selected Years 1949-1981)

Calendar Year	Total State and Local Expenditure	Federal Aid	State-Local Expenditure From Own Funds	
			State[2]	Local[2]
1949	7.8	0.9	3.4	3.5
1959	9.6	1.4	3.8	4.4
1969	12.6	2.2	5.3	5.1
1974	14.3	3.1	6.0	5.2
1975	14.9	3.5	6.2	5.2
1976	14.7	3.6	6.1	5.0
1977	14.0	3.5	5.7	4.8
1978	13.9	3.6	5.6	4.7
1979	13.5	3.3	5.6	4.6
1980	13.5	3.4	5.6	4.5
1981 est.	12.9	3.0	5.5	4.4

[1]National Income and Product Accounts. Includes federal aid.
[2]The National Income and Product Accounts do not report state and local government data separately. The state-local expenditure totals (National Income Accounts) were allocated between levels of government on the basis of ratios computed from data reported by the U.S. Bureau of the Census in the annual governmental finance series.
Source: ACIR staff.

built the world's finest interstate highway system; it provided a lot of aid to poor people and it bolstered the sagging fortunes of central cities. So it is necessary to look at the federal aid system in balance — at the good as well as at the bad.

Federal Aid Cutbacks

Nevertheless, it was against this background of growing federal intrusiveness that President Reagan called for a major streamlining of the federal aid system. Long before Ronald Reagan became President he became convinced that state and local governments could operate much more efficiently if they were relieved of a good share of the federal regulations and controls. He promised if elected to cut back a bloated federal aid system.

> President Reagan's New Federalism has three objectives: First: to decrease sharply state-local reliance on federal aid;
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> Second: to cut back sharply on the number of federal aid programs; and
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> Third: to compensate state and local governments for the loss of this federal aid by returning to them part of the federal excise tax base and by swapping programs.

Well, has that happened?

TABLE 2

FEDERAL GRANTS-IN-AID IN RELATION TO STATE-LOCAL RECEIPTS FROM OWN SOURCES, TOTAL FEDERAL OUTLAYS AND GROSS NATIONAL PRODUCT, 1955-1982
(Dollar Amounts in Billions)

	Federal Grants-in-Aid (Current Dollars)					Exhibits:				
			As a Percentage of—			Federal Grants in Constant Dollars (1972 Dollars)			Grants for Payments to Individuals	
Fiscal Year[1]	Amount	Percent Increase or Decrease (-)	State-Local Receipts From Own Source[2]	Total Federal Outlays	Gross National Product	Amount	Percent Increase or Decrease (-)	Estimated Number of Federal Grant Programs	Amount	Percent of Total Grants
1955	$3.2	4.9	11.8	4.7	0.8	$5.8	5.5	n.a.	$1.6	50.0
1960	7.0	7.7	16.8	7.6	1.4	11.6	8.4	132	2.5	35.7
1965	10.9	7.9	17.7	9.2	1.7	15.8	9.0	n.a.	3.9	35.8
1970	24.0	18.2	22.9	12.2	2.5	26.9	10.2	n.a.	9.0	37.5
1975	49.8	14.7	29.1	15.3	3.4	39.4	3.7	448	17.4	34.9
1976	59.1	18.7	31.1	16.1	3.6	43.4	10.2	n.a.	21.0	35.5
1977	68.4	15.7	31.0	17.0	3.7	46.6	7.4	n.a.	23.9	34.9
1978	77.9	13.9	31.7	17.3	3.7	49.6	6.4	498	26.0	33.4
1979	82.9	6.4	31.3	16.8	3.5	48.3	-2.6	n.a.	28.8	34.7
1980	91.5	10.4	31.7	15.8	3.6	48.4	0.2	n.a.	34.2	37.4
1981 Est.	95.1	3.9	29.5	14.5	3.3	45.7	-5.6	539	40.1	42.2
1982 Est.	88.2	-7.3	24.0	12.7	2.8	39.0	-14.7	395[3]	39.4	44.7
1983 Est.	81.4	-10.7	20.8	10.7	2.4	35.5	-16.7	n.a.	43.8	53.8

n.a.—Not available.

[1]For 1955-1976, years ending June 30; 1977-1982 years ending September 30.

[2]As defined in the national income accounts.

[3]Seventy-nine programs have been folded into nine block grants, and at least another sixty-five programs have not been funded as of August 1, 1982.

Source: ACIR staff computations based on U.S. Office of Management and Budget, *Budget of the United States Government*, annual; *Fiscal Year 1982 Budget Revisions;* and unpublished data; U.S. Department of Commerce, Bureau of Economic Analysis, *The National Income and Product Accounts of the United States, 1929-76, Statistical Tables; Survey of Current Business*, various issues; David B. Walker, *Toward a Functioning Federalism*, Cambridge, MA., Winthrop Publishers, Inc., 1981, p. 79; and ACIR staff estimates.

In the last two or three years we have had one of the most dramatic turn-arounds in the history of our intergovernmental relations. Now there is decreasing state-local reliance on federal aid. Since 1979 federal aid has dropped from about 32 percent of state/local own source revenue down to around 22 percent. Secondly, there has been a very substantial reduction in the number of federal aid programs. Since 1981 the number of federal aid programs has dropped from about 535 to less than 400 — 395 is the last body count.

These actions have caused a real reduction in federal intrusion into state-local affairs. The creation of block grants, the cutbacks, coupled with some progress on the deregulation front, all add up to less federal involvement in state-local affairs.

Actually, this is an amazing record. If someone had told the federal aid watchers three or four years ago that the hard charging federal aid system would be stopped dead in its tracks and then bent backwards, most of them would not have believed it. We thought that the system was out of control, that there was only one way it could go and that was up.

But the sticking point in the New Federalism is this — it is cold turkey. It's "do-it-yourself federalism." The cutbacks are taking place, but state and local governments are not getting compensatory aid in the form of tax turnbacks.

What caused this remarkable trend-break? Looking back (and hindsight's always 20/20), we could have made the prediction that federal aid could not keep expanding. Why? Because by 1981 Congress had lost its four fiscal trump cards thereby insuring a very tight fiscal situation. What were those trump cards that Congress lost?

Defense Card: The first was the defense card. After Korea, defense spending fell from about 13 percent of gross national product to 6 1/2 percent of GNP by 1978. This freed up tremendous amounts of federal revenue — some was earmarked for tax cuts, but most went to finance the growth of federal domestic programs, in general, and new federal aid programs, in particular. In effect, Congress was taking revenue away from the Pentagon and pushing it into the domestic social welfare programs administered in large part by states and localities.

By 1981, there was widespread agreement that the nation had underinvested in defense during the '70s. In fact, after Afghanistan the Carter Administration began to step up defense outlays. As a result, defense spending is now rising as a percent of GNP, and it is placing a tremendous squeeze on all other areas of the federal budget.

Deficit Card: The second congressional advantage was the deficit card. During most of the post World War II period, Congress spent more money than it took in and papered over its revenue shortfalls

with deficits. During most of this period, this easy way out approach was accepted without too much concern.

By 1981 deficit financing had come to be viewed as contributing to inflationary expectations and higher interest rates. It had really become a part of the nation's number one problem, a sluggish inflated economy. The growing demand to balance the budget, or at least to try to keep deficits under control has also started to put a squeeze on all other elements of the budget.

Income Tax Card: The third card Congress had lost by 1981 was the federal income tax card. During the '60s and '70s inflation, as well as real growth, automatically pushed people up into higher and higher tax brackets. The impressive growth performance of the federal income tax actually served as a major argument for federal revenue sharing with states and localities, back in the late '60s, early '70s.

By 1981 there was a strong demand for federal income tax cuts and indexation. These actions designed to take a good share of the inflationary wind out of the income tax sails also build more fiscal discipline into the system.

Social Security Card: Congress also lost the Social Security card. And that might surprise you. What relationship does Social Security have to the rest of the domestic budget? During the late 1960s and the early 1970s, the Social Security financing contributed to an easy federal budget situation because in most years the various trust funds within the social security system were running surpluses that reduced the apparent deficit in the unified federal budget.

By 1981 Social Security financing problems were making a tight budget situation even tighter because the Social Security funds were running deficits in their own accounts, thereby adding to rather than reducing the deficit in the unified federal budget. In addition, there was growing opposition to higher Social Security tax hikes to finance steadily expanding coverage.

The Four Way Squeeze: To sum up, by 1981 there was a four-way squeeze on federal aid — the generals and admirals were moving back into the budgetary arena, the Social Security system was coming in for additional help; the taxpayers were getting tax cuts; and deficit financing was no longer fashionable.

Even if Jimmy Carter had been reelected, the days of federal aid expansion would have been over. In fact, I heard one of President Carter's aides tell the state budget officers shortly before the election, "If Jimmy Carter is reelected, I can promise you one thing. The days of wine and roses are over as far as bigger and better federal aid programs are concerned." He underscored most of the fiscal facts of life that I have just listed.

Closing the Ring — "Austerity Federalism"

The Reagan administration's decision in 1981 to go for a major income tax cut and a much faster defense buildup quickly transformed an already tight budget situation into an extremely tight budget situation. Under such circumstances relatively low priority federal aid programs were the first to be sent to the austerity chopping block.

There is an iron law that governs the expansion and the contraction of federal aid within the federal budget. When times are easy as they were in the '50s and the '60s and the early '70s, federal aid expands. When times get tougher, the rate of federal aid growth slows down. When the budget crunch really gets tight, there is an actual reduction in federal aid flows.

The policy implication is clear — to control the federal aid system it is necessary to keep the Congress on a very short fiscal leash. That is exactly what the Reagan administration did when it went for the big tax cut and at the same time accelerated defense spending.

It should also be noted that there is another reason why we see this remarkable turnaround in federal aid behavior. The Reagan administration used the budget reconciliation process skillfully in 1981 to effect both grant consolidation and federal aid cutbacks. The conservatives have discovered that the budget reconciliation process is a powerful instrument for imposing federal discipline on the Congress and facilitating the down-sizing of the federal aid system.

As a result we have, in effect, New Federalism without the compensation of tax turnbacks. There is a real reduction in federal aid flows, a real reduction in the number of federal grants — it might well be called "austerity federalism."

While this federal aid squeeze has been taking place, the White House has also been negotiating with governors and mayors and other representatives on the President's plan for eliminating many more federal aid programs and compensating state and local governments for the federal aid cuts. (Table 3).

Barriers to New Federalism

It is not surprising that the White House and representatives of state and local governments are taking such a long time agreeing on what the legislative package should look like. They will need the wisdom of a Solomon, the patience of Job, the tenacity of a Winston Churchill, and someone with the political insights of a James Madison.

Why? Because they must come up with a plan that can cope with the tremendous diversity of this federal system of ours. They must reconcile the savagely competing federal, state, and local interests. They must also balance the differing weights that liberals and conservatives assign to such values as efficiency, economy, and equity.

TABLE 3

OUTLINE OF THE REAGAN ADMINISTRATION'S LATEST "NEW FEDERALISM" PROPOSAL
(Administration FY 84 Projected Dollar Levels)

1. States assume full cost of AFDC — $8.1 billion.
2. States lose $30.6 billion to the elimination of categorical aid in 35 program areas. Among the major federal categorical aid programs eliminated are highway aids (except interstate and primary roads) $1.5 billion, mass transit $3.1 billion, CDBG $3.5 billion, waste-water treatment $2.4 billion, general revenue sharing $4.6 billion, child nutrition $3.2 billion, social services block grant $2.4 billion, low income energy assistance $1.9 billion, and CETA $2.9 billion.
3. States gain $18.3 billion as a result of federal assumption of Medicaid costs.
4. States gain $11.6 billion for turnback of certain excise taxes. Federal taxes designated for turnback are tax on alcoholic beverages, tobacco, telephone, cigarettes, (8¢), and motor fuel (2¢).
5. States gain $8.8 billion from federal general revenue turnback. For at least four years, these amounts would be returned to the states via payments from a federal trust fund.

Source: ACIR staff compilation, September 20, 1982.

A few examples will point up the problems that the negotiators face. President Reagan and many of his White House associates believe sincerely that a means-tested public welfare program can be administered far more effectively and with far greater accountability once the states assume complete responsibility for the care of the poor.

In sharp contrast, many state and local officials have contended for years that an equitable distribution of the benefits and the burdens of taking care of poor people can only be achieved if the federal government takes over the welfare task lock, stock, and barrel. They argue that if welfare is turned back to the states, there will be competitive underfinancing of welfare benefits as each state tries to push the poor on to the next state.

Then there is the medicaid dilemma. How can the federal government provide a uniform schedule of medicaid benefits for people across this country without either cutting back on the benefits now provided to beneficiaries in the high benefit states like New York or creating substantial additional program costs for the federal Treasury?

Another issue New Federalists have to hammer out is the role of local government in our federal system. Many federal and state policymakers yearn for the good old days when Washington spoke only to the states, and only the states spoke to their children, the local governments. They claim that we ought to clean up our cluttered intergovernmental system and get our lines of authority straight by having states deal exclusively with local governments. As can be expected, many local officials, (and they have a lot of clout in the House of Representatives), bitterly contest this view and point out that they

have been treated very poorly by their parents in the past and they expect no great change of heart in the future.

If the friends of New Federalism can get over these welfare, medicaid, local government hurdles and agree on a plan for streamlining the federal aid system, then they confront a truly formidable barrier — a hostile Congress. Washington has only one stock in trade and that is power. Committee chairmen, be they Democrats or be they Republicans, will not preside easily over the liquidation of their categorical aid empires. It is one thing for the Congress to retreat grudgingly under massive budgetary pressure; it is an entirely different matter to expect them to meekly turn over part of their revenue domain to state and local governments as unconditional compensation for elimination of federal categorical aids.

The Second Best Approach: Fiscal Discipline

In theory, the new Federalism issue should be characterized by a bracing intellectual discussion as to the best way to sort out program responsibilities between federal, state, and local government. On the basis of rational criteria certain responsibilities would be assigned to the federal government, others to the state and still other tasks to the localities. The federal government would then concentrate its efforts only in those areas of true national concern. Out would go the federal aid programs for jellyfish control, pothole repair, urban gardens, so on and so forth. State and local governments would then work their will in most areas of domestic concern.

Unfortunately, no one appears to possess the magic wand that will create the consensus needed in Washington, at the state level, and at the local level to unscramble our diverse and highly interrelated system.

We may have to settle for New Federalism — austerity federalism. This second best version is to be found in the convincing demonstration that the federal aid system is no longer an irresistible force threatening to overrun state and local governments. It can be harnessed as long as the Congress is forced to operate under powerful fiscal constraints.

Prognosis: What is the prognosis or the evaluation to date? While state and local governments are still in the process of moving from affluent federalism to austerity federalism, it is possible to make certain tentative judgments about equity and accountability and efficiency effects that flow from this transition.

The equity effect appears fairly clear. Because of the cutbacks in social welfare programs, many of the working poor are now finding their lot more difficult than it was in the recent past. While this additional hardship may not prove to be as great as many liberals predict, it is greater than many conservatives would like to admit.

The accountability effect of this great transition from fast growth to slow growth, is also fairly discernable. Even if the Congress does not approve President Reagan's New Federalism proposals for decentralizing our system, the continuing federal budget crunch ensures a diminution of federal involvement in state-local affairs. Fiscal austerity is hurrying political decentralization along and the emergence of a "do-it-yourself federalism" should make it easier for voters to hold their state and local officials accountable.

The jury is still out on the efficiency effects of this great transformation from affluence to austerity. One thing is certain; most state and local officials will no longer be able to do more and more with more and more. Most state and local policymakers will be confronted with three hard efficiency alternatives: do more with less; do about the same with less; or do less with less.

The tone and the quality of American government over the next several years will be determined largely by the way state and local officials answer and respond to these austerity alternatives.