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21st Century Federalism: Proposals for Reform

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INTRODUCTION

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From the beginning, federalism has been a defining feature of our constitutional order. As our country has changed, our federal system has evolved significantly as the national government has assumed added responsibilities for economic stabilization, income and health security, and functions such as criminal justice and education that were previously understood as falling within the states' "police powers."

Today's pressures—an aging population, increasing health care costs, and challenging fiscal prospects—are straining government capacities at every level. Political factors have compounded the problem. Polarization has led to inaction at the federal level, putting pressure on states and metropolitan areas to fill the policy void. Many have responded admirably, a prospect that the Brookings Metropolitan Policy Program has assisted and chronicled. Polarization has also led states to resist federal programs that don't align with the ideological positions of their majority party (Obamacare is exhibit A). And ideologically driven political parties often override the preferences of local majorities, weakening ties between the national government and the rest of the federal system.

These trends call for a systematic review and updating of relations among different levels of government. The purpose of this policy brief is to lay out the current operating structure of the inter-governmental system and to propose reforms that would ameliorate its worst ills. Unfortunately, the dismantling of key institutions at the federal level that once would have driven such a review has diminished the focus on these issues. Because states and localities have responded far more flexibly to shifting circumstances and needs, our recommendations will focus on institutional and policy changes needed within the federal government.

INTERGOVERNMENTAL GRANTS: THE BASICS

While fiscal ties between the federal government and the states are only part of a complex relationship, they offer the best point of departure for our analysis. The federal government provides states substantial funding across a broad range of activities. In 2011, the last year for which detailed data are available, federal grants to the states—more than 200 programs administered by 30 federal departments and individual agencies—totaled $607 billion. Of this, $293 billion went for health, $114 billion for income security, $89 billion for education, and $61 billion for transportation. All other functions constituted the remaining $50 billion. Federal tax credits and deductions subsidized states and localities by an additional $97 billion.[1]

In the aggregate over the past three decades, these grants have moved within a relatively narrow range. From 15 percent of federal outlays in Fiscal Year 1980, they fell to 11 percent in FY 1990 and then rose to nearly 18 percent in FY 2003 before falling back to 15 percent in FY 2009. (They now stand at about 17 percent). As a share of Gross Domestic Product, intergovernmental grants have varied even less, from a bit less than 3 percent to a bit more than 4 percent.[2]

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Beneath the surface of aggregate stability, the composition of federal funds flowing to the states has changed significantly since 1980. Reflecting the surge in Medicaid enrollment and per capita costs, federal grants for health care rose seven-fold during this period—*after* correcting for inflation. (The actual dollar amounts rose by even more). At the same time, grants for education and income security increased much more modestly, and funding for transportation barely budged.[3]

While these figures appear modest from a national standpoint, matters look different from the vantage-point of the states. Between 2000 and 2010, federal grants accounted for an average of 30 percent of total state revenues, rising to about 35 percent in 2010 as the American Recovery and Reinvestment Act kicked in and state revenues declined. Since then, the percentage has fallen, a trend that the sequester is accelerating. About 18 percent of total federal grant funds to the states are subject to sequestration, which resulted in cuts of about $7.5 billion between January and September of 2013. As a share of each state's revenues, federal grants subject to the sequester vary between 5 and 10 percent, averaging 6.6 percent nationally.[4]

Although the recent bipartisan budget deal will take the edge off the sequester during the next two years, sequestration's impact on states will be profound. Federal discretionary spending—

funds subject to the annual appropriations process—flowing to the states has averaged about 1.4 percent of GDP during the past three decades. Under current law, this will fall to less than 0.9 percent by 2021. This would mean significant cuts in federal support for education and most other domestic functions for which funds must be appropriated each year.[5]

WHY DOES THE FEDERAL GOVERNMENT GIVE GRANTS TO THE STATES?

The Congressional Budget Office offers a lucid summary of the rationales for intergovernmental grants:

- "Such programs can increase economic efficiency in instances when state and local governments have localized knowledge that would allow them to implement a program more efficiently and effectively than the federal government could, but they lack an incentive or funding to provide as much of the good or service as would be desirable from a national perspective;
- The federal government is better able to redistribute resources in the economy;
- The federal government can borrow money more readily than most state or local governments so it has greater ability to stabilize a weak economy;
- Intergovernmental grants can be used as a tool to influence the policy priorities of state and local governments; and
- Intergovernmental grants can encourage state and local governments to innovate or experiment with new programs and activities."[6]

To the extent that federal grants represent free money, states and localities are tempted to game the system to maximize their draw on the federal treasury.

Some of these rationales are more controversial than others. Most economists would agree that the individual states and localities would tend to undersupply public goods whose benefits spill over into other jurisdictions. Keynesians would endorse the proposition that federal borrowing in times of economic weakness can shelter states from at least some of the pro-cyclical budget cuts they would otherwise be forced to make, reducing the intensity and duration of economic downturns. To the extent that a particular activity (for example, emergency preparedness) is regarded as an essential government function, it makes sense for the federal government to help poorer states that cannot fund the activity adequately out of their own resources. Whether it is a good thing to use federal funds to influence policy priorities and innovation at the state and local level is a contestable political judgment, as the debate over the Obama administration's "Race to the Top" competitive grant program for educational innovation illustrates.

A standard argument against intergovernmental grants is that they separate programmatic accountability from fiscal responsibility. The federal government bears the political burden of raising revenues for programs that the states and localities administer and for which they receive public credit. And to the extent that federal grants represent free money, states and localities are tempted to game the system to maximize their draw on the federal treasury. Decades of experience suggests that this dynamic is driving rising expenditures in the Medicaid program. No doubt there are other, less significant instances.

But there is an overlooked argument in favor of intergovernmental grants—namely, that states and localities enjoy significantly more public confidence than does the federal government and are therefore in a better position to administer public programs. A recent study by the Pew Research Center found that while favorable views of the federal government have fallen to a record low of 28 percent, public opinion about state and local government remains stable at much higher levels: 57 percent of Americans have a favorable view of their state government, and even more—63 percent—look with favor on their local government.[7] If the federal government were to administer directly more public programs than it now does, public confidence might fall even farther. No doubt the problem-plagued rollout of HealthCare.gov has intensified these doubts.

INFLUENCING THE STATES

The federal government seeks to influence state conduct in various ways. The Advisory Commission on Intergovernmental Relations classified such tactics as follows: conditions on federal grants; mandates included in federal legislation; federal preemption of state laws; federal tax policies which affect state and local tax bases; regulatory actions taken by federal agencies; and federal exposure of state and local governments to liability lawsuits.[8] Some mechanisms force the states to take action while others curtail or prevent action. Almost all are costly to lower-level governments and centralize power in Washington.

Conditions on federal grants to the states

The federal government is not in the business of giving out money with no strings attached. Different kinds of grants come with different requirements and limitations. Block grants leave maximum flexibility to states and localities and are paid to the states in lump sums regardless of fluctuations in services or recipients. Perhaps the most notable current block grant is Temporary Assistance to Needy Families (TANF). In the case of TANF, states may use the funds to achieve very broad goals—to assist needy families with dependent children, promote work, reduce the incidence of out-of-wedlock pregnancies, and encourage two parent families—and they can do this through cash assistance, service provision, or other means. States can also set their own eligibility and benefit levels. (This is a good example of federal dollars encouraging state and local governments to innovate or experiment with new programs). While block grants provide states with a large degree of flexibility, Congress watches carefully to be sure the states are not undermining its agenda[9], and it tends to restrict flexibility over time. The 2005 reauthorization of TANF, for example, narrowed the definitions of work activities and instituted new requirements for the monitoring of such activities, forcing the states to change their programs significantly.[10]

Formula grants, typically allocated to qualifying jurisdictions on the basis of a fixed formula, restrict the kinds of projects on which federal funds can be spent. Federal support for state infrastructure projects through the Highway Trust Fund (HTF) is an example. The federal government collects revenue (mainly through the fuel tax) and redistributes it to the states based on certain variables—miles of highway, fuel usage, distances driven. (The HTF is a good example of a case where state and local governments have localized knowledge to implement projects but lack the revenue source to do so). While states have broad leeway to use the funds on the projects of their choice, the federal government sets requirements and minimum standards which, if not met, could mean a reduction in funding or more oversight in fund allocation. The most recent reauthorization of the HTF prioritized the condition of our nation's infrastructure and focused funds on highway and bridge maintenance.[11]

Project grants are the most prescriptive. Project grants tend to have clearly stated goals, targeted service areas and recipients, and restrictive rules and regulations. Unlike block or formula grants, project grants can be awarded to non-governmental organizations. Compliance with such grants is often onerous and costly, and many are duplicative, but because they allow Congress to put funding toward specific activities or recipients and articulate explicit goals, such grants continue to be authorized.

Regardless of type, all federal grants come with conditions.

Regardless of type, all federal grants come with conditions. Title VI of the Civil Rights Act of 1964 conditioned federal funds on compliance with antidiscrimination regulations, and once the courts affirmed that this was an appropriate use of federal power, this practice spread to many other areas, ranging from wages to environmental assessments to restrictions on purchases of goods not made in the United States. Some programs (Medicaid and highway grants are leading examples) require state or local matches equaling a specified percentage of the federal contribution. Many federally funded education and welfare programs, such as TANF, come with "maintenance of effort" requirements: states and localities may use federal funds to supplement but not substitute for their own appropriations.

One might imagine that the administrative costs of federal grants would impose substantial additional burdens on the states. According to the CBO, however, this does not appear to be a large problem. In the first place, many federal grant programs authorize reimbursements to the states for a share of their administrative expenses—in the case of Medicaid, more than half. And because federal and state administrative responsibilities are distinct, the amount of wasteful duplication is surprisingly small.[12] Otherwise put, the administrative burden on the states probably does not exceed by very much the cost of running comparable programs that the states fund themselves. So the question the states face is whether the activities that federal grants make possible are worth doing, not whether the administrative costs of doing them are excessive.

There is a point at which incentives cross the line into compulstion.

As a result of the Supreme Court's decision on President Obama's Affordable Care Act (ACA), we now know the limits of the federal government's ability to impose conditions on the states' receipt of federal funds. It has long been a settled principle of law that the "Federal Government may not compel the States to enact or administer a federal…program." This principle has led the Court to strike down federal legislation that "commandeers a State's legislative or administrative apparatus for federal purposes." Congress, the Court says, may use its spending power to create "incentives" for States to act in accordance with federal policies. But there is a point at which incentives cross the line into compulsion—when the federal government makes the states an offer they can't refuse. And the Medicaid expansion under ACA was deemed to have crossed that line.

As enacted, the health care law required states to expand their Medicaid program by 2014 to cover all individuals under the age of 65 with incomes below 133 percent of the federal poverty line. Instead of simply refusing to grant new funds to states that rejected the new conditions, Congress threatened to withhold those states' existing Medicaid funds. Given the states' enormous dependence on the federal government for the bulk of the funds needed to provide health care to low-income people, no state was free to make a choice that would lead to the outright loss of the funds. In this case, the Court concluded, the condition Congress imposed was much more than an encouragement or incentive; it was a "gun to the head" that had the effect of commandeering state governments for federal purposes—a consequence the Constitution prohibits.[13] So the Court struck down that portion of the ACA and, in so doing, helped define in operational terms the sphere of sovereign authority the Constitution reserves to the states. It will be some time, one suspects, before the federal government knowingly tests that limit.

Federal mandates, preemptions & regulations

Federal mandates, which order states to take some form of action, often impose uncompensated costs, which the states understandably resist. States are also frequently forced to put resources toward upgrades or overhauls in order to comply with the rules and regulations issued by federal agencies, the costs of which are only sometimes offset by federal funding.

After the Republican takeover of the House of Representatives in 1994, Congress enacted the Unfunded Mandates Reform Act (UMRA), which attempted to reverse or slow the growth of mandates. The act requires CBO to prepare "mandate statements" on proposed legislation and agency rules, and to determine whether the direct costs of mandates exceed the statutory thresholds UMRA established ($73 million for intergovernmental mandates in 2012).

UMRA has helped monitor the use of direct federal mandates and may have discouraged their use somewhat. Between 2008 and 2012, CBO issued intergovernmental mandate statements on 2,834 bills. Only 315 (11 percent) of these statements identified any mandates whatever. Only 17 (0.6 percent) found mandates whose costs would exceed the statutory threshold. Another 29 statements could not determine whether the costs would exceed the threshold. And many of these proposals never became law.[14]

UMRA is limited in scope, however. It does not apply to legislation that addresses broad policy areas, such as national security, conditions on federal grants, or preemptions of state and local law. And even when the mandate point of order is triggered, lawmakers are still able to maneuver around it.

The limits of UMRA have allowed the federal government to continue to impose considerable costs on state and local governments. No Child Left Behind is an oft cited case. Because it was couched as a condition on a federal grant—most significantly, Title I grants, which in FY 2013 totaled $13.8 billion—it was not subject to UMRA review. Nevertheless, states had to spend considerable sums to meet the strict standards and complex reporting requirements.

Federal preemption of state authority to collect taxes on certain online services and electronic commerce has been a point of contention. Despite a CBO estimate (triggered by UMRA) that the revenue states would lose would total more than $80 million annually[15], exceeding the statutory threshold, lawmakers passed a law preempting states' ability to collect such taxes.[16] The ongoing fluctuation in federal estate taxes has also led to significant losses in state revenues. Because state estate taxes are linked directly to the federal regime, the decreases in federal estate and inheritance taxes mean that state revenue also falls.[17]

In addition to federally legislated mandates, federal agencies can also pass rules that require states to take actions or comply with standards that may be costly. While UMRA was intended to address this issue as well, GAO found that "agencies' rules seldom triggered UMRA."[18] Paul Posner argues that "the relatively narrow definition embraced in UMRA has served to limit not only our understanding of the implications of national policy decisions for our federal system but also the potential effectiveness of this reform in influencing these policy decisions." States have had some success in pushing back against federal mandates, however. The Real ID Act, which was included as a rider on a military spending bill in 2005, created national standards for state driver's licenses and I.D. cards and introduced demanding verification and security requirements. A coalition of state associations estimated that states would have to spend $11 billion over the first five years to implement the act.[19] State resistance was so fierce (15 states passed legislation against the law and an additional 10 states passed resolutions opposing it[20]) that numerous extensions have been passed. To date, enforcement mechanisms are not yet in effect.[21]

Each generation of policymakers has found it necessary to reform the relationship between the federal government and the states to solve emerging problems.

NON-GRANT FEDERAL SPENDING

The federal government influences the economies and budget of the states, not only through grants, but also through direct spending on its own programs. In FY 2010, total federal spending on procurement, salaries, and wages as a share of state GDP varied from just over 1 percent for the least affected state to about 20 percent for the most affected. (It averaged a bit over 5 percent nationally.) Defense is by far the largest component of this spending, ranging from 1 to 15 percent of state GDP and accounting for more than 3.5 percent of the total GDP of the states.[22] The large cuts in defense spending required by the budget sequester over the next decade will exert significant downward pressure on state economic activity, employment, and revenues.

SOME PRESSING PROBLEMS

Each generation of policymakers has found it necessary to reform the relationship between the federal government and the states to solve emerging problems. In the current cycle, four such problems are central. First, the national government's institutional capacity to monitor its relationships with other levels of the federal system has been dismantled. Second, the national government's ability to execute effective macroeconomic policies is weakened by limited state fiscal capacities in times of stress. Third, Medicaid's rapid growth is imposing unsustainable burdens on states and is distorting their fiscal relationship with the federal government. And finally, the terms of the fiscal partnership between the federal government and the states are outdated. The four reforms sketched below are designed to address these problems.

RECOMMENDATION 1: REBUILD THE FEDERAL GOVERNMENT'S INSTITUTIONAL CAPACITY

As Timothy Conlan and Paul Posner have observed, during the past generation, the federal government's capacity to monitor and assess intergovernmental trends has been dismantled. The Senate and the House once had subcommittees dedicated to intergovernmental affairs;

they no longer do. Unsurprisingly, congressional attention to issues of intergovernmental management has drastically dwindled. But changes within the executive branch have been even more striking. In the White House, the Office of Intergovernmental Affairs has lost influence, and the Office of Management and Budget's intergovernmental relations office has disappeared altogether. Similarly, the Treasury Department's Office of State and Local Finance (an important function of which was to aid in tax coordination among the levels of government) was also eliminated.

But the largest nail in the intergovernmental coffin was the abolition of the Advisory Commission on Intergovernmental Relations (ACIR). Formed during the Eisenhower administration, the ACIR was a critical source of data, policy analysis, and intergovernmental management expertise. The 104th Congress, eager to shrink the size of government, eliminated the office, "with little recognition or thought given to the implications for the effective functioning of the intergovernmental system."[23] Today, only the General Accountability Office and the Congressional Budget Office retain any analytical capacity in this area.[24]

The objective should be to rebuild capacity as cost-effectively as possible while minimizing institutional changes that are bound to be controversial. The obvious solution is to create one center of analysis and monitoring within the executive branch and one in the Congress. In the former, we suggest restoring and rebuilding OMB's intergovernmental relations office. OMB's mission is to monitor and assess the fiscal and policy dimensions of government programs, and intergovernmental relations would be a natural extension of that mission.

The Great Recession offered a preview of the necessity and effectiveness of such an office. The Obama administration insisted that state and local governments spend stimulus funds quickly, but also transparently and without mistakes. This mixed message "induced an early sense of paralysis" among the states. OMB took two steps that allowed recovery funds to be spent "expeditiously on activities that were beyond reproach." First, they quickly issued rules and guidelines to federal agencies. Second, OMB staff and state and local representatives held weekly conference calls to answer questions, resolve conflicts, and expedite implementation.[25] While this degree of collaboration is unnecessary outside of extraordinary conditions, a permanent center within OMB would go a long way toward restoring the executive branch's analytic and cooperative capabilities on matters of intergovernmental relations.

On the legislative side, we are resisting the temptation to recommend the restoration of House and Senate subcommittees: the congressional committee structure needs to be streamlined, not made even more complex and fragmented. Instead, we believe, the focus should be on key analytical institutions—the Congressional Budget Office and General Accountability Office. The CBO's State and Local Government Cost Estimates Unit produces real-time cost estimates of proposed mandates for Congress as well as annual reports on overall trends in intergovernmental relations. The GAO's intergovernmental relations group produces reports on issues as diverse as grant distribution and management, state and local fiscal outlooks, third-party governance, and Medicaid formulas. We suggest enhancing CBO and GAO's capacity to assess existing inter-governmental programs and conduct forward-looking analyses of new policy options.

In the same vein, we endorse the recommendations of the State Budget Crisis Task Force to enhance the federal government's capacity to assess the impact of its policies on other levels of the federal system. As the Task Force puts it,

> There should be a permanent national-level body to consider the ways in which federal deficit reduction or major changes in the federal tax system will affect states and localities. Such a body, with purposes similar to those of the former Advisory Commission on Intergovernmental Relations, should conduct careful, ongoing examination of the relationship between federal and state governments. Even before such a body is established, Congress should require the Congressional Budget Office to prepare analyses of the ways in which major legislative proposals … are likely to affect the fiscal situation of state and local governments.[26]

RECOMMENDATION 2: CREATE A NEW FEDERAL LOAN WINDOW FOR STATES TO USE DURING ECONOMIC DOWNTURNS

During the Great Recession that began in December 2007, state revenues took a hit larger than any other since World War II. In 2010, when the slump finally bottomed out, revenues were 12 percent below their 2007 level. By contrast, state revenue loss during the 2001 recession peaked at 6 percent, and in the two prior recessions (1981-1982 and 1990-1991), it barely exceeded 1 percent.[27]

Even though states had entered the Great Recession with rainy day funds averaging about 11 percent of their annual budgets, the recession's depth and duration quickly drained them, and most states were forced to slash spending.[28] In FY 2009, states cut spending by 3.8 percent, and then by another 5.7 percent in FY 2010, the first consecutive declines since monitoring of these statistics began.[29]

These cuts inflicted significant damage on vital state functions. In the 2012-13 school year, for example, 35 states were funding K-12 education below 2007-2008 levels after adjusting for inflation. Higher education was hit even harder. Nationally, states cut inflation-adjusted spending per college student by more than 28 percent, making college less affordable while forcing students and their families to incur higher student loan debt.[30]

These cuts also impaired the federal government's effort to counteract the recession through macroeconomic policy. Since the 1930s, government often has used spending increases and tax cuts "counter-cyclically," to boost demand during periods when the private sector was lagging. President Obama's nearly $800 billion stimulus bill, enacted in February 2009, was larger than previous efforts but constructed on similar principles. But because the states' ability to borrow is limited by both fiscal capacity and law, the massive revenue losses they experienced forced many of them to increase taxes while cutting spending—the reverse of what the economy needed. While the federal government was hitting the gas pedal, the states were stepping on the brakes, diluting the stimulative impact of fiscal policy.

The State Budget Crisis Task Force has recently recommended that the states should strengthen their rainy days funds—by saving larger amounts automatically and by allowing enough time to replenish these funds once a fiscal emergency ends. Although we endorse these recommendations, recent experience suggests that more prudent state planning may not be enough to counteract the impact of severe economic downturns. To avoid future conflicts between federal macroeconomic policy and state fiscal constraints, we believe that it is necessary to build in an additional level of protection.

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Although federal/state Unemployment Insurance (UI) is in many respects a flawed program, it does offer a useful template for improving the coordination between state and federal budgeting. States are encouraged to forward-fund their share of UI by building up trust fund reserves during good economic times. The federal government recognizes, however, that rising unemployment during recessions can drain state reserves. To maintain the flow of benefits to covered workers, UI permits the states to borrow from the federal government and repay the loans in later years, allowing the states to keep spending without raising taxes during economic downturns. If a state fails to repay during the prescribed period, the federal government is required to raise federal UI taxes on the state's employers.

In 1976, the federal government instituted a program of counter-cyclical revenue sharing. When economic downturns reduced state revenue, the federal government would transfer revenues to states. Although this approach may be optimal theoretically, it would be difficult to reinstitute today. Given today's fiscal realities—especially long-term deficits and debt at the federal level—renewing anything like the Ford/Carter-era program is unrealistic. In any event, intense political opposition would almost certainly doom this approach to failure in Congress. Likewise, the massive aid to the states in the 2009 Recovery Act came in the midst of the worst economic crisis since the Great Depression and isn't likely to be a model for less extreme cyclical downturns.

It would be possible, however, for the federal government to structure temporary assistance to the states as loans rather than grants. A state's access to the federal loan window could be triggered by a decline in economic output (or an increase in unemployment) above a certain threshold. Participating states would be required to repay their loans, with interest, within a fixed period.

As Iris Lav has pointed out, this approach would encounter a number of obstacles.

- The constitutions of 5 states prohibit public debt altogether, and at least 16 others would require voter approval for debt backed by general revenues.
- States have already been compelled to borrow from the federal unemployment insurance trust fund and are on the hook for up to $90 billion in repayments to the federal government.
- State rainy day funds have been depleted and need to be rebuilt during the recovery.
- States will have to repay the money they've borrowed from their pension funds.
- And finally, states will need the additional revenues the recovery will generate to begin restoring the funding slashed from vital services such as education during the Great Recession.[31]

These are very real practical objections to a federal lending window. But it is not clear that they are dispositive. Bluntly, if the choice is not between a loan program and counter-cyclical grants but rather between loans and nothing at all, the program we are suggesting looks better than the status quo. In any event, each state could make this decision for itself based on its own conditions and calculus.

The obvious objection is that the creation of such a program would diminish pressure on the states to pursue sustainable fiscal policies, a goal enshrined in nearly all state constitutions through balanced budget requirements. There may be some truth to this. But the more significant consequence would be smoother patterns of state spending over business cycles: the highs would be lower, and the lows higher.

Indeed, the loan program could be drafted so as to encourage and reward prudent fiscal policy—for example, through a system of tiered interest rates linked to the size of each state's pre-recessionary rainy day fund as a percentage of state economic output. The objective would be to find the sweet spot—incentives large enough to encourage prudent planning but not so large as to discourage states from borrowing during downturns, which would undercut the point of the program. Experience would indicate the adjustments needed to achieve these goals.

RECOMMENDATION 3: LIGHTEN THE BURDEN MEDICAID IMPOSES ON THE STATES

Health care is the major driver of mounting state fiscal burden. A recent GAO study found that as a share of GDP, state health care expenditures will rise from 3.8 percent in 2013 to 7.2 percent in 2060. During that same period, state outlays unrelated to health care are expected to fall from 10.5 to 7.7 percent of GDP. Within the next two generations, the states will be shelling out as much for health care as for all the other functions of government combined.[32]

The rising burden of health care is already reflected in the intergovernmental programs administered by the federal government. In FY 2011, the most recent year for which detailed data are available, the federal government provided state and local governments a total of $607 billion in grants, of which $293 billion (48 percent) was for health programs. Adjusted for inflation, federal health grants to states and localities rose seven-fold between 1980 and 2011, while grants for other functions remained flat (transportation) or rose only modestly (education and income security).[33]

Medicaid, which is jointly funded by the federal government and the states, accounted for the lion's share of the increase in federal health grants. Over the past three decades, enrollment in Medicaid rose from about 20 million to about 53 million, while federal spending per beneficiary (adjusted for inflation) tripled from $1700 to $5200 per year. As of 2011, the federal government's expenditures for Medicaid amounted to $275 billion, while the states spent $157 billion on Medicaid that year.[34]

Medicaid expenses fall into two broad categories—acute care for poor and near-poor beneficiaries, and long-term services and supports (LTSS) for the elderly and disabled. While the size of the former category will be determined by economic growth and income distribution, the latter will be driven by inexorable demographic trends. By 2050, one fifth of the U.S. population will be 65 or older, up from 12 percent in 2000 and 8 percent in 1950. The number of Americans age 85 and older (the principal consumers of LTSS) will rise even faster. As of now, LTSS consumes about one-third of total Medicaid spending, a share that may well rise in coming decades. And because the states provide about 40 percent of Medicaid spending, the burden on their budgets will rise as well.[35]

While no one can repeal demography, the federal government can act to reduce the burden of Medicaid on state budgets (and on its own as well). Specifically, the government should remove most long-term care expenses from the program and institute two new programs to fund these expenses. One would be a social insurance program with contributions set at the level needed to assure actuarial soundness over time. To keep costs affordable for contributors during their working lives, the government should also create a catastrophic insurance program that would pay nursing or home care expenses after three years of social insurance funding. In effect, contributors would be buying a standardized long-term care package whose coverage would last for three years.[36]

RECOMMENDATION 4: RETHINK FEDERAL AND STATE ROLES IN 21ST CENTURY FEDERALISM

Academics and policy experts long have called for a major reallocation of categorical responsibilities between the federal government and the states. In 1992, for example, Alice Rivlin proposed a complete federal takeover of health care, in return for which the federal government would turn over full responsibility to the states in areas such as elementary and secondary education, job training, economic and community development, most highways and transportation, social services, and some pollution control programs.[37]

This hasn't happened, nor is it likely to. The reasons go beyond conflicts over finances and turf. In just about every programmatic category, it turns out, there are legitimate national as well as state and local concerns. The difficulty is not that the federal government is involved, but rather that it is often involved in the wrong way.

Even though top-down changes have been hard to come by, the respective roles of the federal government and the states have continued to evolve. As the Brookings Metropolitan Policy Program has argued, metropolitan areas have moved aggressively to fill the void federal gridlock has created, and there are steps the federal government has already begun to take to generate a more cooperative and creative relationship with states and localities.[38]

Metropolitan areas have moved aggressively to fill the void federal gridlock has created.

But much more remains to be done. Among the many areas that cry out for a reformed federalism, two stand out—education and infrastructure.

Education.

In the wake of two decades of rising concern about the condition of elementary and secondary education, the law known as No Child Left Behind (NCLB) was enacted with bipartisan support. NCLB reflected the national interest in a more internationally competitive system of public education—and with disparities of educational attainment among different groups of students. To promote these interests, NCLB required the testing of all 4th and 8th grade students in core subjects and the publication of the results, broken down by groups. But the law went further, laying down a timetable by which all students should achieve competence in core subjects, defining adequately yearly progress toward this goal, and prescribing remedies—some quite intrusive—in cases of sustained under-performance. Not surprisingly, these enforcement mechanisms produced resistance from state and local officials.

The federal government can help steer the ship, but state and local governments must do the rowing.

The reauthorization of NCLB, long overdue, is mired in controversy. But there is a way forward that reflects a more appropriate division of responsibility between the federal government and other jurisdictions. Because there is a national interest in better educational performance, because many students cross state lines, and because mathematics is the same in Massachusetts and Mississippi, Washington should continue to insist on strong state standards and regular tests to assess student progress toward meeting them. And because public information shows where improvements are needed and helps catalyze citizens' involvement in local reform efforts, the federal government should continue to require annual reporting, broken out by groups. On the other hand, it should eliminate binding timetables, prescriptive definitions of adequate progress, and mandatory enforcement mechanisms, all of which exceed Washington's administrative and political capacities.

In the end, state and local governments, which provide the lion's share of funding and administration for elementary and secondary education, will have to take the lead in making desired educational improvements a reality. The only coherent alternative—a centralized system along European lines—goes against the grain of our history and institutional arrangements and is entirely infeasible. The federal government can help steer the ship, but state and local governments must do the rowing.

Infrastructure.
The federal government now offers a bewildering variety of grant and loan options—especially for transportation—to states and localities contemplating infrastructure projects. The rationale for a measure of federal involvement is clear: some worthwhile projects cross jurisdictional boundaries, impeding local agreements on funding. State and local governments often have difficulty raising necessary revenue and have limited ability to borrow. Some infrastructure projects provide benefits to the country as a whole—public goods that individual jurisdictions cannot fully capture, leading to an undersupply of these goods. Only the federal government could have built the Interstate Highway System or maintained the Mississippi River as a major interior thoroughfare that facilitates commerce among the states. Only an international agreement between the governments of Canada and the United States could have funded and managed the St. Lawrence Seaway. Major seaports provide regional and national benefits. At

a time when the rapid expansion of exports is deemed a national priority, cutbacks in federal funding for dredging as well as for roads and railways connecting the interior to coastal parts is hard to justify.

In the case of projects whose costs and benefits are predominantly local, the presumption shifts toward state and local funding, and federal participation must discharge a burden of justification. Redistribution is one possible rationale, in cases where jurisdictions lack the resources for essential infrastructure and the states are unable or unwilling to help out. But if redistribution is not a central concern, it makes little sense for the federal government to collect revenues, deduct a piece of the proceeds for administrative expenses, and then send the remainder back to the states and localities on either a formula or project basis.

This argument suggests that the federal government should reshape its relationship with states and localities, funding infrastructure of national or regional significance while pulling back from more localized projects. As we have detailed in a previous paper, the federal government could make scarce public dollars for these purposes go farther by establishing a national infrastructure bank that could attract significant sums of private capital.[39]

Since the mid-1990s, more than 30 states have established their own infrastructure banks.[40] While the general argument for banks is as valid at the state level as it is for the federal government, it is not clear why it was appropriate for the federal government to provide the initial seed capital to the states. To be sure, federal law simply allowed the states to divert a portion of their federal transportation allocation for this purpose. But this implies that at least that percentage of the federal funds was not needed for projects of regional or national significance and was in effect supplanting funds that states should have raised by themselves for their own purposes.

As a general matter, few jurisdictions will expend political capital to raise funds available from outside sources, especially in the form of grants that need not be repaid. But over time, shifting responsibility for the unpopular activity of revenue-raising from states and localities to the national level has exacerbated the mistrust citizens now feel for the federal government. While states and localities reap the reward of providing more services than they are prepared to fund, the federal government bears the onus of raising taxes and incurring debt exceeding the benefits citizens experience from its activities. The lack of trust and confidence at the national level makes it harder for the federal government to carry out its distinct and unique responsibilities.

The counterargument is that most states are legally and constitutionally debarred from going into debt, even when they could use the proceeds for productive investments. But these restraints are less limiting than they appear. For example, although states are not allowed to borrow for general fund expenses, they are allowed to do so within trust funds. (That's why they can go into debt to the federal government to keep unemployment insurance checks flowing when their own funds for this purpose are exhausted.) Moreover, the availability of federal grants and loans enables states to maintain the appearance of fiscal virtue without reducing popular services. Downsizing the federal fiscal hammock would give the states long-overdue incentives to take responsibility for the matters that fall squarely within their purview.

CONCLUSION

The Hippocratic Oath binds doctors to do no harm. This is a sensible maxim for public policy as well. Federal legislators and regulators should pay attention to the impact of their decisions on other levels of the federal system. Although we take no position in this policy brief on contested issues such as the taxation of internet sales, we urge national policymakers to think twice before depriving the states of the ability to broaden the base of their revenue systems. And although it is legitimate for the federal government to condition its grants on state policies and reporting requirements, there is a point at which such conditions become unreasonably demanding—indeed, onerous. Policymakers should do their best to stay on the right side of that line, which cannot happen without a regular and robust dialogue between state and federal officials. When all is said and done, that dialogue is at the heart of a healthy system of federalism.

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