Fiscal Policy

Lessons from Economic Research

edited by Alan J. Auerbach

The MIT Press
Cambridge, Massachusetts
London, England

2

Federalism as a Device for Reducing the Budget of the Central Government

John M. Quigley and
Daniel L. Rubinfeld

The U.S. Constitution incorporates built-in tensions of economic federalism, enumerating certain powers for the central government while reserving others for the state. The historical resolution of these tensions has a complex political and economic history. Given the substantial inertia that is built into the U.S. federalist system, it is not surprising that the current set of economic responsibilities has evolved only slowly during the past two centuries.

The historian Harry Scheiber (1966) has identified four stages in the development of federalism in the United States: (1) a period of dualism (1790–1860) in which the states and the central government had comparable responsibilities; (2) a period of centralizing federalism (1860–1933), when federal responsibilities grew; (3) a time of cooperative federalism (1933–1964), which marked a substantial growth in social programs arising out of the Great Depression; and (4) a period of creative federalism (since 1964) in which the federal government has taken an active role in the problems of state and local governments.

The period of creative federalism was spurred by the support for programs of revenue sharing from the federal government to the states by economists Walter Heller and Joseph Pechman (Perloff and Nathan 1968). In today's environment of large budgetary deficits, it is difficult to imagine that a crucial argument for a broad-based program of unrestricted grants to states was the fear of "fiscal drag"—that the automatic growth of federal revenues under a progressive personal income tax would otherwise lead to excessive fiscal surpluses. The Heller-Pechman plan, substantially modified by Congress and the executive, ultimately became the General Revenue Sharing Program, the heart of President Nixon's New Federalism in 1972.

A decade later, in January 1982, it appeared that a new period in federal relations would begin when the Reagan administration proposed to reverse the trend toward the centralization of financing of government services.

The Reagan proposal sought to return to states and localities all financial responsibility for income redistribution (Aid to Families with Dependent Children, i.e., AFDC, and food stamps) as well as control over more than sixty federal programs targeted to low-income households, including education, community development (e.g., water and sewer programs), transportation, and social services. This was to be accomplished in part by a cut in specific grant programs and in part by the consolidation of other programs into a single block grant program.

Perhaps most important, the Reagan federalism initiatives forced a serious rethinking of the evolutionary path of the public economy, which had moved financial and managerial responsibility for public goods and services steadily up to the national level. Although the core reforms of Reagan's New Federalism proposal never became law, the Reagan budgets significantly curtailed the levels of federal support for state and local governments. This curtailment was bifurcated: federal support for spending on local goods and services declined dramatically, but support for distributional programs, especially those involving health care, increased substantially over the past decade.

The issues that have divided the Clinton administration and the 104th Congress mirror those of the Reagan initiative in many ways. Rather than marking a reversion to the New Federalism of the 1980s, the current debate may well signify the beginning of a new period of retrenchment in American federalism. The debate puts the presumptions of our entire federalist system under scrutiny and asks whether the current structure of responsibilities is appropriate now.

A coherent discussion of the issues that surround the federalism debate requires a well-articulated view of the goals of a federalist economy. Section 2.1 provides an economist's perspective of the essential ingredients. On the basis of economic efficiency, we suggest that governmental functions should be centralized if the decentralized alternative would create substantial spillovers that are unlikely to be remedied through bargains reached among the affected governments. Further, to the extent that externality-creating competition rather than cooperation is the rule, the imposition of national standards can be desirable. Finally, we suggest that a third nonefficiency criterion can be important. When a substantial portion of the population believes that certain fairness principles should apply to all, the imposition of centralized national norms, affecting all citizens, may be appropriate.

Section 2.2 discusses some normative implications of our federalism perspective for intergovernmental fiscal relations. We explain why federalism principles suggest a strong, but not necessarily exclusive, role for the central government in overseeing distributional programs. We believe that the current federalism debates involve two distinct but related features. In section 2.3 we discuss the first issue: the growth of mandates and the opportunity that a change in mandates provides for the federal government to cut its budget. The second issue—the structural changes in intergovernmental grant programs corresponding to a shift in responsibilities from the federal government to the states—is the focus of analysis in section 2.4.

2.1 The Normative Theory of Economic Federalism

The accepted model of federalism, summarized in Wallace Oates's 1972 book *Fiscal Federalism*, gives to the central government responsibility for financial oversight of those public activities distinguished by significant externalities involving spatially dispersed populations, while leaving to local governments responsibility for those public activities for which spatial spillovers are limited or absent. The guiding principle is to internalize all economic externalities at the smallest level of government possible, a principle formalized by Oates in his "decentralization theorem."[1] Decentralization to small collectives is favored since taste differences can best be accounted for by the political process if decision makers most closely represent their constituents. As Oates put it more recently (1994, p. 130), "The tailoring of outputs to local circumstances will, in general, produce higher levels of well-being than a centralized decision to provide some uniform level of output across all jurisdictions.... And such gains do not depend upon any mobility across jurisdictional boundaries."

The consensus at the time of Oates's book was that regulation of markets, national defense, public health, economic stabilization, and redistribution policies are best handled at the centralized, or national, level of government, while education and the maintenance and protection of private and public property are best left to decentralized state or local levels of government. The current political debate questions this view. As a prelude to commenting on this debate, it will be useful to review the underpinnings of the basic theory.

In our multilevel federalist economy, two separate but related efficiency issues arise. The first is interjurisdictional efficiency, involving the appropriate allocation of people and capital among jurisdictions. Interjurisdictional efficiency is achieved when the level of publicly provided goods and services is sufficient to satisfy individuals' demands at minimum cost.

The second is intrajurisdictional efficiency; this is achieved when the choice of government activities in each jurisdiction maximizes the sum of all residents' willingness to pay for those activities net of any cost.

In a federal system, both interjurisdictional and intrajurisdictional inefficiencies can arise, the former because the decisions and actions of individuals within one jurisdiction generate spillovers that affect individuals located in other jurisdictions, and the latter because the political process may not produce wealth-maximizing outcomes within a jurisdiction. In a broad sense, the choice of the appropriate jurisdiction to be responsible for a government activity involves a trade-off: the larger the jurisdiction, the less likely it is that there will be spillovers from one jurisdiction to the next, but the more likely that the political process will lead to a misallocation of resources within the jurisdiction.

The public economy differs importantly from the private economy in that the number of households that benefit from public provision is likely to vary for different activities. In the extreme case of a pure public good, the additional cost of providing the good is zero, so larger communities are more efficient. However, in the more realistic case of a congested public good, the marginal cost of producing the good will increase (after some point) as the number of households in the community increases. When public goods are congested, a jurisdiction reaches its optimal size when the average cost per household of public service provision is equal to the marginal cost of adding another household to the community (Buchanan 1965). Were the average cost higher, the population of the community would be too small; more residents would allow the community to take advantage of economies of scale in producing public goods, and average cost would fall.

The Tiebout model comes closest to making the case for a decentralized system of local governments. In this framework of numerous jurisdictions and a mobile population, each jurisdiction may offer a different tax expenditure and regulation package. By assumption, a sufficient number of jurisdictions will allow each household to choose the one that supplies its desired public sector package. With perfect information and costless mobility, each individual will reveal his or her preference for public services simply by moving into the community of choice. If some other jurisdiction provided a better public service or the same service at a lower cost, there would be nothing to stop the individual from relocating. As a result of this "fiscally motivated" migration, local head taxes would allow competitive governments to allocate public sector packages among individuals in a manner similar to the way in which the competitive private market allocates its goods among individuals. If no community provided the exact bundle of public services that a household wanted, a new community that provided those services at minimum average cost would be established.

In the simplified Tiebout model, there are no spillovers across jurisdictional boundaries. When a government decides to engage in an activity such as primary education, the benefits are obtained only by the residents of the jurisdiction. When benefits and costs do extend beyond the local boundaries, the "optimal" fiscal unit may be a higher (state or federal) level of government. And when governments are deciding how to spend or to regulate, those decisions are determined on the basis of the desires of current residents only.

These spillovers can create competitive incentives that lead to further and more significant inefficiencies. For example, states might be encouraged to relax their environmental controls to encourage business migration. The net result is a race to the bottom, leading to regulatory standards that vary from state to state and that could be significantly more lax than states would prefer if common national standards were set (Revesz 1992).

A further case for a national standard can be made on nonefficiency grounds. To the extent that there is widespread support for a particular national norm, a centralized policy that reflects that viewpoint may be appropriate, whether or not there are significant spillovers. Thus, "fairness" may require that all individuals receive equal access to public services and, more generally, equal treatment under the law. Alternatively, fairness can involve a judgment about the appropriate allocation of entitlements to the nation's output, pointing, for example, to the possibility of an ideal progressive distribution of income or wealth.

It would be wrong to conclude that the presence of spillovers by itself is sufficient to undo the efficiency of a Tiebout economy. For example, in a world with zero transactions costs and full information, a cooperative allocation might emerge from bargaining among governments that are affected by spillovers (Inman and Rubinfeld 1997). Thus, if a public good benefits two or more Tiebout communities (e.g., transportation that requires a large public infrastructure), a Coasian bargain might arise in which joint production internalizes the externality. With costly bargaining, a higher level of government can facilitate and enforce the Coasian bargain (e.g., a county government for water and air quality, a state for roadways, and a national government for defense). The

mechanisms established to internalize these cross-community externalities can involve regulation (e.g., direct provision of the overlapping public good), taxes, or subsidies (e.g., an internally financed matching grant).

Seen from this bargaining perspective, the central government has an important role to play in regulating the activities of local communities. This may involve direct constraints on the provision of services (e.g., minimum levels of provision); it could suggest the use of taxes and subsidies, including matching grants-in-aid; it could involve the monitoring and enforcement of agreements reached among states; and it could involve programs to discourage the competitive race to the bottom. To the extent that spillovers include utility interdependence among households across jurisdictional lines, central government transfers to households—as either lump-sum payments or commodity-specific transfers—are appropriate.

This perspective may be appealing to those who support the Contract with America as well as those who do not. This perspective could form the foundation for a fifth period in our federalism history: one of restrained federalism. In this more limited federalist economy, a primary function for the central government would be to enforce interjurisdictional contracts. Beyond this, the central government's role would be limited to the provision of a few goods or services that are produced nationally by unanimous agreement—for example, military defense and the guarantee of free trade across regions. In the extreme, under a policy of restrained federalism, we could see a minimalist national government responsible for enforcing contracts, ensuring free trade, and providing national defense; a network of ever-changing special districts, state, and county governments controlling specific intercommunity spillovers via regulations, taxes, and transfers, with local communities producing most public goods.

We believe, however, that a more realistic role for the central government would also include the assumption of responsibility for failed Coasian bargains between communities—as an arbitrator of last resort when agreements falter or as the permanent, direct provider when agreements are not reached. Although national provision may not balance benefits and costs perfectly in each locality, communities may still prefer some provision to no agreement at all. Examples include the national supervision of environmental policy, the provision of national parks, or the maintenance of a national highway system.

Perhaps the two most important examples of the failure of Coasian bargaining in a decentralized public economy are the agreement to redistribute income to needy households and the agreement to manage jointly

the overall macroeconomic performance of the economy. Mark Pauly and others have argued that redistributive preferences can have an important geographical dimension. Proximity causes familiarity, and familiarity breeds concern. If so, redistribution policy should allow for regional differences, yet regional agreements, particularly interconnected regional agreements, may not emerge because of strategic bargaining. If so, a national redistribution policy that explicitly grants some degree of local choice may be the second-best compromise. Similarly, strategic bargaining between localities would most certainly prevent the design of a coordinated macroeconomic policy—as it did during the days of the Articles of Confederation. The only recourse, when a voluntary agreement cannot be reached, is a coercive, nationally directed fiscal policy.

Further, we believe that there is a national consensus that poor and elderly U.S. residents should have access to minimum levels of health care. On the basis of this national norm alone, centralized regulation of health care is desirable. Further, however, harmful competition among states could lead to the underprovision of both health and welfare benefits. As a result, there is a presumptive case for minimum national standards for both programs, leaving management and the possibility of program augmentation to the states.

An alternative possibility is for the central government to find constitutionally acceptable mechanisms for allowing states to encourage locational neutrality by requiring new residents to "pay" for some or all of the costs that they impose on current residents when they move into a state. The European Union has residency requirements that restrict new residents' ability to receive the benefit of social programs, but similar requirements were deemed to violate the fundamental "right to travel" as interpreted by the U.S. Supreme Court in *Shapiro v. Thompson*.[2] A state program that allows new residents to receive the benefit levels of their old state for several years may move us closer to locational neutrality within our constitutional confines.[3]

2.2 Implications for Intergovernmental Fiscal Relations

Allocation of Economic Activity

The decentralization theorem suggests that publicly provided programs should be offered by the jurisdiction that covers the smallest area over which benefits are distributed. An examination of expenditure data

Table 2.1
Expenditures by level of government incurring the expenditure, 1992 (millions of dollars)

Category	Federal	State	Local
Intergovernmental expenditure[a]	$ 186,036	$201,314	$ 7,355
Direct expenditure	1,341,275	498,640	647,970
Defense and general expenditure	886,545	409,132	562,842
Education	26,821	86,650	240,120
Elementary and secondary education	12,402	2,221	226,696
Higher education	11,268	70,904	13,424
Public welfare	47,722	125,500	28,734
Health and hospitals	30,679	41,643	46,469
Highways	813	40,266	26,211
Police protection	6,703	4,863	29,682
Fire protection	0	0	14,358
Corrections	2,411	18,306	10,300
Natural resources	51,501	9,022	3,127
Sewerage and sanitation	0	2,235	30,163
Housing and community development	15,482	1,606	15,461
Governmental administration	16,845	19,847	30,488
Parks and recreation	1,984	2,688	13,040
Interest on general debt	199,713	24,622	30,633
Utility and liquor store expenditure	0	9,613	74,748
Insurance trust expenditure	454,730	79,895	10,381
Total	$1,527,311	$699,954	$655,325

Source: U.S. Bureau of the Census, *Government Finances*, Series GF, No. 5, annual. See also *Budget of the United States*, Fiscal Year 1996, Historical Tables, Table 3.2.
[a] Aggregates exclude duplicative transactions between levels of government.

confirms this expectation; programs that are widely dispersed, such as national defense and redistribution, are provided primarily at the national level, while programs with more localized benefits, such as education, police, and fire services, are provided locally. Table 2.1 summarizes government expenditures on various programs by the level of government incurring the expenditure. As the table indicates, expenditures on programs with localized benefits such as education, police, and highways are made disproportionately at the state and local level. Expenditures for the protection of natural resources and social insurance are made disproportionately at the federal level. Despite this, the possibility of Coasian bargains and the potential for political inefficiencies associated with centralized provision raises a question as to whether the decentralization theorem should necessarily apply to all programs with spatially diverse benefits.

Distributional Programs

Although most economists would support the view that distributional programs are best designed centrally, there remains disagreement as to whether certain programs can be more effectively managed at the state or local level. For example, the potential for local redistribution programs to be effective is limited by the possibility of individuals' or households' migrating in response to differential benefit levels.

An alternative view, that of Boadway and Wildasin (1984), provides a rationale that more closely explains U.S. distributional arrangements. Boadway and Wildasin believe that potential donors obtain benefits from redistributional programs that go beyond the boundaries of their jurisdictions but that these donors wish to choose the appropriate level of redistribution. Such a view can be accommodated by a system of federal matching grants, as is currently done in the cases of AFDC and Medicaid.

A third view, supported by Gramlich (1985) among others, argues that a national minimum standard that is higher than the levels of Medicaid or AFDC offered in many states is required. According to his view, allowing states to make redistributional choices ensures that the overall level of distributional effort will be substantially reduced. This position is supported implicitly by Inman (1985, p. 17), who suggests that AFDC and food stamp spending would fall by 70 percent if these programs were transferred to the state and local sector.

Simple productive efficiency may also vary with the level of government actually managing any economic activity. There are many allegations, though not much hard evidence, that nationally run programs stifle the initiative of states and localities. These arguments are made with special force in considering the design and execution of distributional programs.

Intergovernmental Grants

Just as spillovers associated with public programs can create the need for programs that are centrally financed, so can intergovernmental programs be used to overcome inefficiencies and inequities associated with decentralized taxation.[4] In fact, as envisioned by Break (1980) among others, grant programs can be useful in achieving two distinct goals: the reduction in the inequalities among (or the equalization of) tax bases, and the control of tax and benefit competition among states.

Grants can be matching (price reducing) or nonmatching, categorical or general purpose. The latter, which do not alter the price of local spending,

can be used to equalize tax bases and incomes among local and state jurisdictions. Given the empirical findings (Quigley and Smolensky 1992) of a "flypaper effect," these programs can also be used to stimulate spending by state and local governments—governments that would otherwise be restrained by an atmosphere of tax competition. In the alternative competitive environments, governments compete by offering financial incentives to attract new business and keep the old (to stimulate investment and economic growth). The result could be suboptimal levels of state and local spending (Feldstein 1970).[5] Matching categorical programs, on the other hand, can be effective in reducing the inefficiencies described. Matching terms would be set to induce state and local governments to internalize the spillovers provided to other jurisdictions. By far the largest intergovernmental transfers have been categorical matching grants in such areas as transportation, education, community services, and environmental protection.

One particular source of inequity is the disparity in tax bases that result from location-specific resource advantages. As Boadway and Flatters (1982) explain, taxing these resources centrally and distributing them to states and localities is appropriate. When the source of inequity is a local political bias against low-income residents, however, a central grant that penalizes the use of regressive taxes and subsidizes progressive taxes can be beneficial. The U.S. General Revenue Sharing Program, in force between 1972 and 1982, provides a clear example (see Reischauer 1975 for a discussion).

Central government grant policies can also be used to mute the adverse congestion effects from the relocation of economic activity (as when an appealing public program induces migration). The imposition of a charge based on the states whose population creates the congestion, or a subsidy to the states that are adversely affected by the congestion, can be effective. (See Wildasin 1986 and Rivlin 1992, chap. 8.)

While the normative theory of intergovernmental grants is reasonably clear, there is little doubt that government policies have not generally been consistent with these theoretical goals. As Oates (1994) points out, many matching grant programs have very high matching rates—80 to 90 percent. These rates seem inconsistent with the likely fraction of external benefits generated by state and local programs. Further, many of the programs are closed-ended with relatively modest limits, so that the matching terms have no incentive effects on the margin. More generally, Inman (1988) finds that the structure of U.S. direct grants to states does little to control tax spillovers on the margin, nor does it provide appreciably

greater assistance to low-income or resource-poor states. In effect, such programs have become lump-sum transfers to residents (or to the governments serving those residents) financed by national taxes.

2.3 The Growth of Mandates: Opportunities for Federal Budget Cutting?

Federal mandates—directives to state governments—are a built-in feature of America's federal structure. Mandates reflect the constitutional division between the enumerated responsibilities of national government and those reserved to the states by the Bill of Rights (in the Tenth Amendment).

At one level, the appropriate use of mandates encompasses fundamental questions in fiscal federalism. Where in the system of governments should a policy be made? Who should be charged with the execution and implementation of a given policy? How much flexibility in execution should be afforded? Who should bear the costs of compliance?

These philosophical and normative issues once dominated the budgeting policy debate. However, a narrower and more recent focus on "unfunded federal mandates" presupposes answers to these questions and invites the conclusion that central government directives have been used to save federal dollars by imposing expenditure responsibilities on state and local governments.

Federal mandates include a variety of distinct forms, encompassing differing rationales, costs, and levels of direction of state activity by central authorities. One indirect form of federal control, through conditional grants, is considered in section 2.4 below. In this section, we consider other more direct forms.

Direct orders by the federal government to the states can be enforced with civil or criminal penalties, or both. Direct orders are relatively rare. One example is the Equal Employment Opportunity Act of 1972, which bars job discrimination by state and local governments. Other examples are the Asbestos Hazard Emergency Response Act of 1986 and the Fair Labor Standards Act.

More common are the kinds of rules that condition state participation in federal programs. Thus, Congress has passed a series of *crosscutting requirements* that apply to state participation in a range of federally sponsored programs. For example, the Civil Rights Act of 1964 bars specific discriminatory acts in a broad range of federally assisted local programs. The Davis-Bacon Act sets specific requirements for procedures and

standards in all federally assisted construction activities. A variety of laws require that estimates of environmental impacts be made for many classes of federally assisted projects.

Crossover sanctions imposed by the federal government specify that the failure to comply with one federal requirement will result in the loss of funds from a federal program that need not be related to the purpose of the requirement. For example, the federal requirement for a 55 mph speed limit, imposed until November 1995, was accomplished by a national law denying federal highway funding to states not in compliance. The same sanction was used to require that states impose a minimum drinking age of twenty-one years.

Program-specific *matching requirements and grant conditions* include federal rules about the populations served by state programs that are partly financed by the federal government. These also include matching requirements and nonsupplant clauses in federal legislation.

Statutory preemptions involve the assertion by the federal government of full or partial regulatory authority over a particular governmental function. This preemption may be total, as in the case of the Ocean Dumping Ban of 1988, which asserts federal regulatory control over the continental shelf. (This preemption thus prohibits any use of the continental shelf for the deposit of municipal and state wastes.) A more common preemption is partial in nature. The federal government establishes minimum regulatory standards in some program, while permitting states to administer the federal standards or to choose stricter state standards. Many environmental programs are mandated in this way, under, for example, the Clean Air Act, the Clean Water Act, and the Safe Drinking Water Act.

An economic taxonomy of federal government mandates is somewhat elusive. Table 2.2 presents a categorization of mandates by their economic rationale and the type of activity regulated. Objectives for federal mandates include the reduction of spillovers across states, the imposition of national standards, and the reflection of national norms. The first two are clearly efficiency-enhancing rationales: air and water quality standards encourage concerted action by adjoining states on efficiency grounds. The requirement that highway access be provided uniformly for forty-ton trucks ensures a market for these vehicles. The prohibition against automotive fuel economy regulations by the states protects scale economies in auto design. In addition, many federal mandates are imposed on the basis of the third criterion, fairness, to ensure equal treatment of citizens across states (in antidiscrimination mandates or in drinking rules), equal access to

Table 2.2
Economic taxonomy of federal mandates

	Rationale		
Type of state activity	A. To reduce spillovers	B. To impose national standards	C. To reflect national norms
I. Produce some good	Clean air	Highways appropriate for large trucks	Unemployment insurance
II. Produce in a specified way	Specific tests for drinking water		Union wages in construction
III. Regulate firms and consumers (or refrain from regulation)	Handgun waiting period	Refrain from regulating fuel economy	Drinking age at 21

mandated services (unemployment insurance), or other forms of equal treatment (as in the removal of asbestos from schools).[6]

The growth in the number of federal mandates, their complexity, and their costs to state and local governments were pointed out forcefully at the beginning of the Reagan administration (see Koch 1980 for a characteristically sharp statement). In response, much more systematic information about the fiscal dimensions of proposed mandates has been gathered. Beginning in 1983, the State and Local Government Cost Estimate Act required that the Congressional Budget Office (CBO) estimate the intergovernmental fiscal effects of proposed federal legislation. Between 1983 and the end of the decade, the CBO produced cost estimates for state and local governments on over 3,500 proposed pieces of legislation, including estimates for 457 bills that were enacted into law (Gullo 1990).

Increased attention to the existence of mandates and their costs during the 1980s did little, however, to reduce the growth of federal mandates. For example, one count of conservatively defined statutory mandates reported that Congress enacted only one mandate in the 1930s, one in the 1940s, none in the 1950s, nine in the 1960s, and twenty-five in the 1970s. According to this definition, Congress enacted twenty-seven more statutory mandates during the 1980s (U.S. ACIR 1995). Another study reported that more than half of all federal preemption statutes enacted since the founding of the republic had been passed since 1970 (Conlan 1991). Table 2.3 lists some of the most important statutory mandates passed during the 1980s, the so-called era of deregulation.

A comprehensive listing of federal government mandates to the states has been prepared by the National Conference of State Legislatures (1994). The latest compilation from this database lists 192 separate mandates

Table 2.3
Major new statutory mandates affecting state and local governments, 1981–1990

Measure	Public Law	Type
Surface Transportation Assistance Act of 1982	97-424	Crossover
Voting Rights Act Amendments of 1982	97-205	Direct order
Social Security Amendments of 1983	98-21	Direct order
Child Abuse Amendments of 1984	98-457	Crossover
Hazardous and Solid Waste Amendments of 1984	98-616	Partial preemption
Highway Safety Amendments of 1984	98-363	Crossover
Voting Accessibility for the Elderly and Handicapped 1984	98-435	Direct order
Age Discrimination of Employment Act Amendments of 1986	99-592	Direct order
Asbestos Hazard Emergency Response Act of 1986	99-519	Direct order
Commercial Motor Vehicle Safety Act of 1986	99-570	Crossover
Consolidated Omnibus Budget Reconciliation Act 1986	99-272	Direct order
Education of the Handicapped Act Amendments of 1986	99-457	Crossover
Emergency Planning and Community Right-to-Know 1986	99-499	Partial preemption
Handicapped Children's Protection Act of 1986	99-372	Crossover
Safe Drinking Water Act Amendments of 1986	99-339	Partial preemption, direct order
Civil Rights Restoration Act of 1987	100-259	Crosscutting
Water Quality Act of 1987	100-4	Preemption, direct order, crosscutting
Drug-Free Workplace Act of 1988	100-690	Crosscutting
Fair Housing Act Amendments of 1988	100-430	Direct order
Lead Contamination Control Act of 1988	100-572	Direct order
Ocean Dumping Ban Act	100-688	Direct order
Americans with Disabilities Act	101-327	Crosscutting, direct order
Clean Air Act Amendments of 1990	101-549	Partial preemption
Education of the Handicapped Act Amendments of 1990	101-476	Crossover

Sources: See Conlan (1991); Musso and Quigley (1996).

and federal preemptions, 20 of which were passed by the most recent legislature, the 103d Congress. Table 2.4 lists some significant mandates reported by the NCSL that are currently in force. Note that a substantial fraction of these important mandates have been imposed to reflect national norms, not necessarily to increase economic efficiency.

The increase in the number of mandates during the 1980s and 1990s raises the possibility that the federal government has been "saving" money by imposing fiscal burdens on lower levels of government. There is some documentation supporting the second part of the statement, about the increased financial burden on lower levels of government. An early systematic study of mandates (Lovell et al. 1979) concluded that significant costs were shifted. However, the authors refrained from making any cost estimates because available data were not systematic and therefore were quite fragile. A contemporaneous study by Muller and Fix (1980) obtained cost estimates by analyzing intensively a small number of jurisdictions. For the time period studied (the late 1970s), the authors concluded that the cost of federal mandates was roughly an offset to the general revenue-sharing funds received by lower levels of government. Specifically, the authors estimated that the local costs of federal requirements averaged about 19 percent of all federal aid received. The authors also noted that mandates imposed very different costs across jurisdictions.

A more recent study prepared for the U.S. Environmental Protection Agency (EPA) attempted to measure the cumulative costs of regulations imposed during the 1980s (Singh et al. 1988). This research examined the fiscal effects of twenty-two federal environmental regulations on a sample of 270 local governments. The analysis was confined to measuring the effect of environmental regulations at the local level. However, these regulations included many of the more costly provisions, reported in table 2.3, which were enacted by Congress during the 1980s.

The EPA study was intended to analyze directly the combined effects of multiple regulations and to examine the ability of affected jurisdictions to finance their regulatory compliance. The study identified a variety of new requirements that affect local government finances, but it considered the fiscal effects of only a few for which credible cost estimates could be made. Despite these limitations, the cumulative effects of environmental regulations on local governments were estimated to be quite substantial. The authors estimated that local governments would need to generate approximately $22 billion in capital expenditures to comply with pending and previously promulgated rules, along with $2.8 billion in annual expenses for operations and maintenance. To finance these expenditures,

Table 2.4
Some important federal mandates cataloged in 1994

Law	Description	Category[a]
Vehicle Weight Limitations Highway Improvement	Interstate highways must accommodate big trucks	IB
Voting Rights Language Assistance Act	Mandates aid to non–English speaking voters	IA
Anti-Car Theft Act	States must verify cross-state title transfers	IA
Migratory Bird Conservation Act	States must sell land to the federal government	IA
Clean Air Act	States must meet air quality standards	IA
Safe Drinking Water Act	State must take a number of specific actions	IA
AFDC	Welfare mandated; states set level	IC
Education for All Handicapped Children	Education requirements	IC
Welfare Reform Act	Requires job training; expand AFDC & Medicaid	IC
Americans with Disabilities Act	Disabled accessibility	IC
Unemployment Insurance	Mandated; states can choose level	IC
Medicaid and extensions	Medicaid mandated; states set level	IC
Asbestos Hazard Emergency Response Act	Asbestos must be removed from schools	IC
National Environmental Policy Act of 1969	Environmental impact statements for state projects	IIA
Professional and Amateur Sports Protection Act	States may not operate sports lotteries	IIC
Fair Labor Standards Act	Overtime and minimum wage for state employees	IIC
Davis-Bacon Act	Union wages for state construction	IIC
Motor Vehicle Information and Cost Savings Act	States may not regulate fuel efficiency	IIIB
Commercial Motor Vehicle Driver's License	Requires minimum standards and reciprocity	IIIB
Federal National Mortgage Charter Act	States must allow Ginnie/Fannie Mae to operate	IIIB
Interstate Banking Efficiency Act	Restricts state regulation; allows interstate banking	IIIB
United States Grain Standards Act	Imposes federal standards on grain exports	IIIB
Minimum Drinking Age	Minimum age to drink	IIIC
Control of Outdoor Advertising and Junkyards	Highway beautification	IIIA
Brady bill	Handgun waiting period and background check	IIIA
Endangered Species Act of 1973	States must implement conservation programs	IIIA
National Maximum Speed Limit[b]	55, 65 mph	IIIC
National Voter Registration Act	Motor voter; easier registration	IIIC

Source: National Conference of State Legislatures (1994).
[a] Category as defined in table 2.2, I, II, and III refer to the type of state activity; A, B, and C to the rationale for that activity.
[b] Repealed in 1995.

the study concluded that about 15 percent of local jurisdictions would have to double their current fees charged for environmental services. Given the magnitude of these costs, the study estimated that about a fifth of the nation's water and sewer systems could ultimately find it difficult to issue revenue bonds or to obtain bank loans to finance required capital improvements.[7]

The CBO routinely estimates the cost imposed on state and local governments by significant bills that are reported out of congressional committees. These cost estimates are intended to be made available to members of the House and Senate prior to consideration of legislation on the floor, and they are generally included with committee reports. Supporters of this process of provision of fiscal notes on pending legislation believe that a major source of excessive regulatory costs is inadequate information (see Barr 1990).[8]

CBO's own analysis of its costs estimates (Gullo 1990) indicates that the vast majority of the legislation reported from committee imposes no financial costs on state and local governments. Only 382 of the fiscal notes prepared between 1983 and 1988—11 percent of the total—indicated any financial impact on states and localities. The number of bills the CBO estimated would impose substantial costs of $200 million or more was even smaller. By CBO's estimates, only eighty-nine bills would have produced these major financial impacts.

As reported by Gullo and also by Barr (1990), there are a variety of limitations on the accuracy of CBO's cost estimates—limitations that arise from the hurried nature of the legislative process and the opportunity for substantial amendment in floor debate. In addition, CBO cost estimates are not always completed or made available for inclusion in committee reports. For example, no cost estimates were provided for several bills that ultimately proved to be very costly, including the Asbestos Hazard Emergency Response Act of 1986 and the Water Quality Act of 1987.

There have been several recent efforts to increase the salience of federal mandates and to make their costs more transparent. For example, the National Conference of State Legislatures maintains and publicizes a catalog of federal mandates imposed on the states. In addition, recent legislation (the Unfunded Mandates Reform Act of 1995) provides a more carefully constructed definition of those mandates that "impose an enforceable duty" on lower levels of government. This legislation requires CBO to prepare timely cost estimates for mandates expected to cost as little as $50 million.

Several credible cost estimates are available for the most important mandates imposed on state and local governments. EPA has produced

Table 2.5
Cost estimates for major unfunded mandates (thousands of 1994 dollars)

Type	Federal	State and Local	Example
Annual cost			
Air quality	$1,202	$ 1,318	Clean Air Act, Radon Gas
Water quality	8,437	19,974	Clean Water Act, Safe Drinking Water, Marine Protection
Land conservation	1,765	8,226	RCRA, Comprehensive Environmental Response
Chemical requirements	413	125	
Multimedia	1,175	18	
Education of disabled	—	643	
Asbestos	—	164	
Disabilities act	—	664	
Fair labor standards	—	484	
Aggregate cost to cities, 1994–1998			
Underground storage tanks		$ 1,040	
Clean water and wetlands		29,303	
Clean air		3,652	
Resource Recovery and Conservation Act		5,476	
Safe drinking water		8,644	
Asbestos		746	
Lead paint		1,628	
Endangered species		189	
Disabilities act		2,196	
Fair labor standards		1,121	

Sources: Environmental Protection Agency (1991, p. 8-51, Table 8-12A (estimates are for 1988 in 1994 dollars); U.S. Advisory Commission on Intergovernmental Relations (September 1994, pp. 13, 15 (estimates are for 1991 in 1994 dollars); Price Waterhouse (1994, p. 4).

estimates of the magnitude of costs imposed on central and lower-level governments by the most important environmental mandates of the 1980s. These are summarized in table 2.5. Clean air, water, and land conservation, together with chemical requirements and multimedia mandates, impose costs of about $13 billion annually on the federal government and about $31.6 billion on state and local governments. (Other costs to households and private firms, not shown, are estimated to add $76 billion to the bill.)

The ACIR has calculated that mandates relating to the education of the disabled, together with the Americans with Disabilities Act, imposed costs of $1.3 billion annually on state and local governments. The Fair Labor Standards Act is estimated to impose annual costs of slightly less than half a billion dollars. Price Waterhouse has surveyed city governments about the costs imposed by federal mandates. The firm estimated that the ten most important mandates will increase the costs borne by city governments by about $54 billion during the next five years.

These expenditures are certainly substantial, and they may be quite burdensome to the state and local governments required to undertake them. Nevertheless, from the viewpoint of the federal budget process, the numbers are quite small indeed. The cost estimates, $30 billion or more annually, are on the order of 2 percent of federal expenditures. We must conclude that although "mandates" may provide a battle cry for states' rights, they have not provided a substantial opportunity for offloading federal expenditures to the states.

2.4 Reversing the Trend in Intergovernmental Grants: Reform or Budget Cutting?

Federal edicts can require expenditures by state and local governments, which can substitute directly for federal outlays. Consequently, these edicts can be used to reduce the central government deficit. While also making certain stipulations on states and localities as conditions of receipt, federal grants-in-aid involve substantial central government expenditures. As a result, federal deficit reductions can be achieved by enforcing mandates on state spending and cutting grant-in-aid programs. Moreover, if these programs are cut or modified in form, the conditions of receipt will change, as will the incentives of state and local governments to continue the provision of the affected public services.

Even general revenue sharing, in effect between 1972 and 1982, imposed some relatively modest restrictions on recipient governments (Nathan et al. 1975). Most restrictions on grants-in-aid apply explicitly to categories of expenditure by lower-level governments, and many involve matching programs. As a result, these programs stimulate the provision of state and local services.

Reforms in the intergovernmental grant system can therefore have two significant effects. First, changes in regulations governing federal programs may provide ample opportunity for intergovernmental grants to be cut in magnitude and changed in form; the result could be a substantial

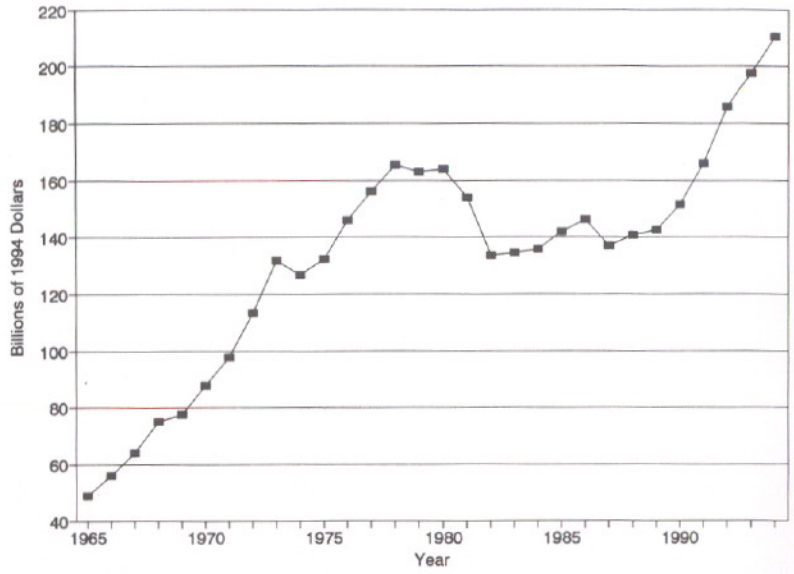

Figure 2.1
Grants to state and local governments. Source: Executive Office of the President, Office of Management and Budget, *Budget of the United States Government*, Fiscal Year 1996, Historical Tables, Tables 10.1, 12.1.

budget reduction by the central government. Second, both cuts and reformulations of grant programs may lead to substantial reductions in state and local spending on programs such as health and welfare. We treat each of these issues in turn.

Reversing the Trend: An Opportunity for Deficit-Reducing Budget Cuts?

Figure 2.1 reports the trend in federal government grant activity during the past three decades. In real terms, federal grants-in-aid quadrupled during the period, from under $50 billion to more than $210 billion (in current dollars). Importantly, more than one-fourth of this substantial increase has been registered in the past five years. Between 1989 and 1994, federal grants-in-aid to state and local governments increased by more than $68 billion.

The pattern of federal grants as a fraction of gross domestic product (GDP) follows this recent trend. Since 1989, grants to states and localities

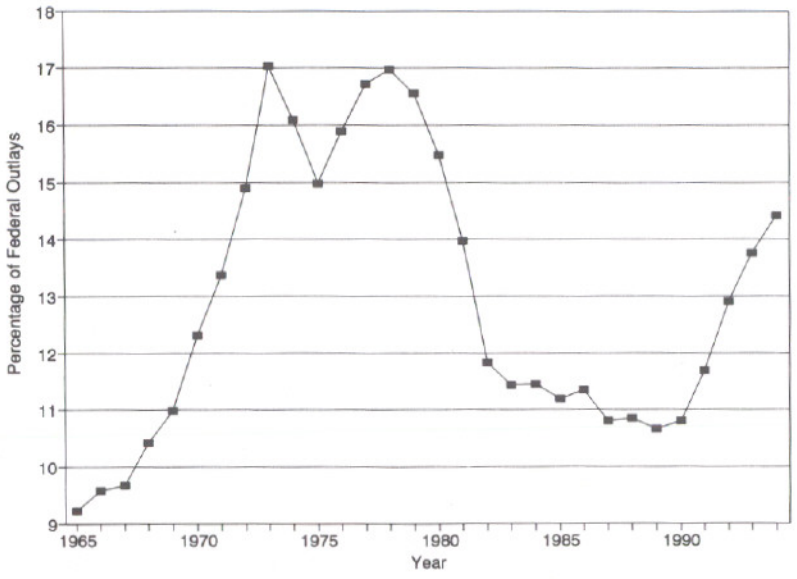

Figure 2.2
Grants as a fraction of federal outlays. Source: *Budget of the United States Government*, Fiscal Year 1996, Historical Tables, Tables 3.1, 12.1.

have increased from about 2.4 percent to 3.2 percent of GDP. Figure 2.2 shows the trend in grants as a fraction of federal government spending. As the figure indicated, spending on grants exceeded 17 percent of federal spending in 1974 and was almost as high in 1979. The Reagan years saw a steady drop in grants as a fraction of federal spending. However, since 1989 grants have climbed from less than 11 percent of federal outlays to about 14.4 percent of outlays.

Figure 2.3 reports trends in grants to state and local governments for the four largest expenditure categories: transportation, education and training, health, and income security.[9] As the figure indicates, there has been little change in the pattern of federal grants for transportation. The pattern of grants for education and training is more complex, but the current level of grant expenditures is substantially lower, in real terms, than it was in the late 1970s. The same cannot be said for federal grants for income security and for health. Grants to state and local governments for income security have risen steadily, from $15.7 billion in 1965 to $38 billion in 1989 (in current dollars). Since 1989, federal grants have risen sharply by $13.5 billion, or by more than one-third.

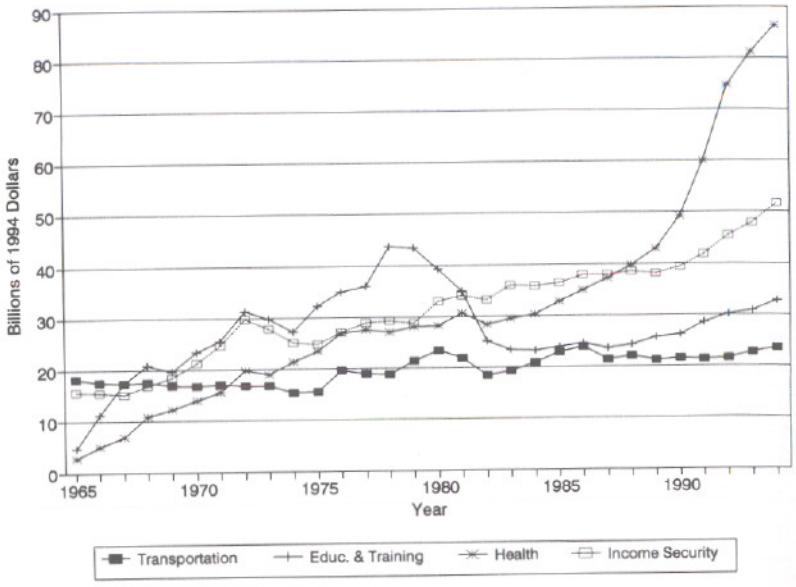

Figure 2.3
Major categories of federal grants. Source: *Budget of the United States Government*, Fiscal Year 1996, Historical Tables, Tables 10.1, 12.2.

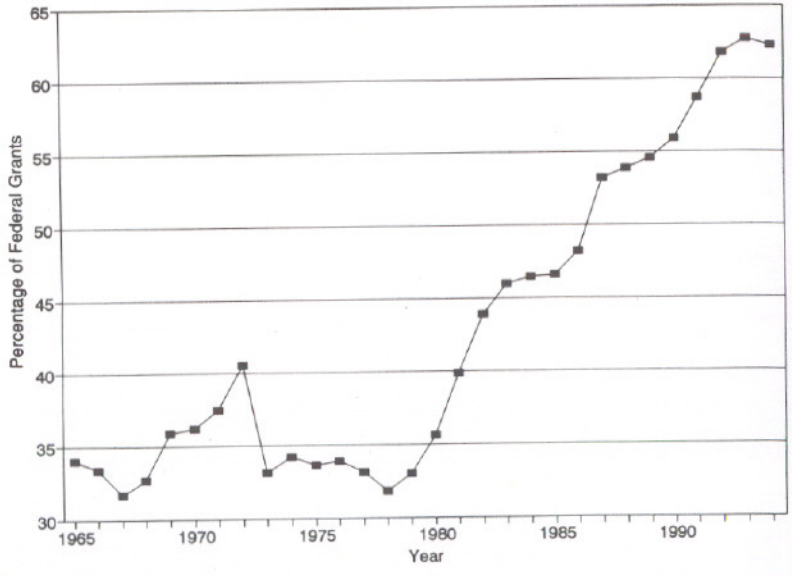

Figure 2.4
Grants to lower-level governments for payments to individuals (as a percentage of all grants). Source: *Budget of the United States Government*, Fiscal Year 1996, Historical Tables, Table 12.1.

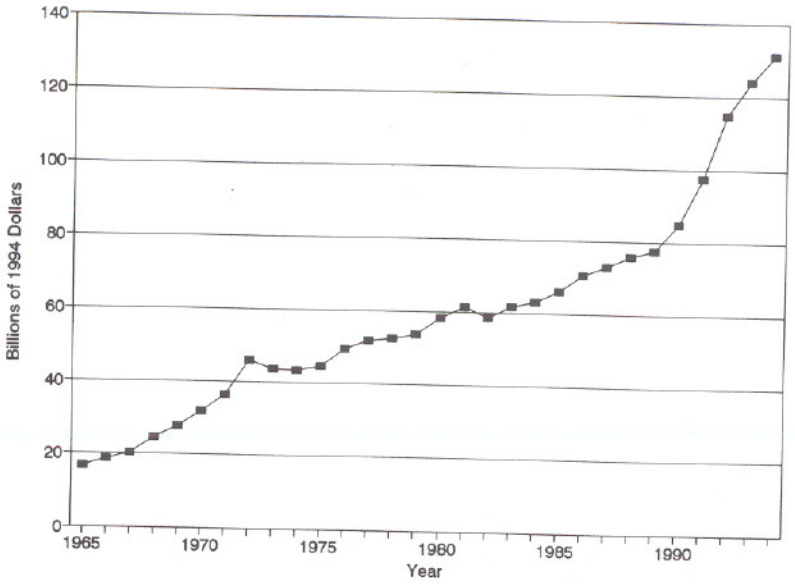

Figure 2.5
Grants to lower-level governments for individuals (billions of dollars). Source: *Budget of the United States Government*, Fiscal Year 1996, Historical Tables, Tables 10.1, 12.1.

The increases in grants for health have been nothing short of explosive. Federal government grants to state and local governments increased from $2.8 billion in 1965 to more than $32.8 billion by 1985 (again, in current dollars). During the past decade, however, grants for health care have almost tripled, to $86.3 billion. The exponential growth of health care grants has continued; health care grants have doubled in the past five years alone.

Figure 2.4 reports the trend in federal grants to local governments for payments to individuals. Chief among these are, in order, medical care (chiefly Medicaid), public assistance (chiefly AFDC), housing assistance, and nutrition programs (not including food stamps). As the figure indicates, the trend between 1965 and 1980 is flat; grants for payments to individuals were something less than 35 percent of the total. The explosion since 1980 has almost doubled the fraction of grants to lower levels of government, which are passed through as payments to individuals.

Figure 2.5 shows the trend in dollar expenditures for grant payments to individuals. Again, there is a steady growth until 1989 and then an

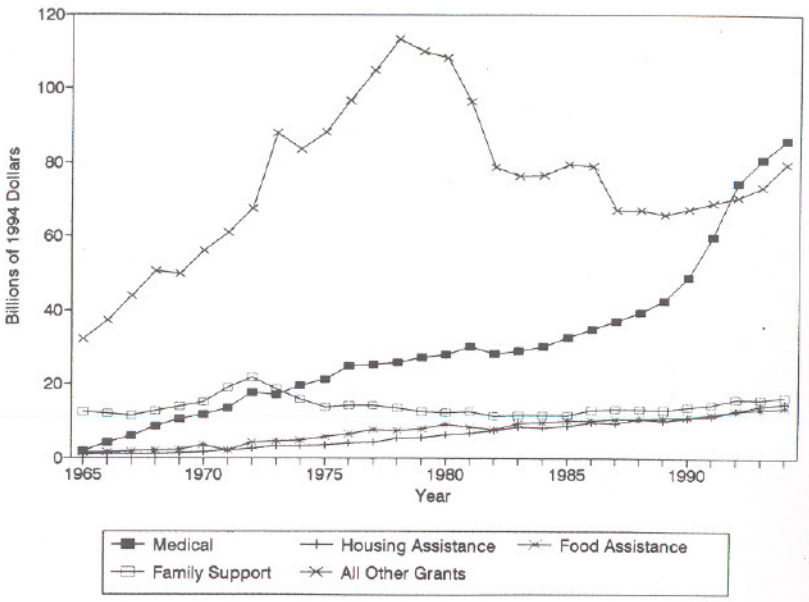

Figure 2.6
Grants to lower-level governments for individuals, by type. Source: *Budget of the United States Government*, Fiscal Year 1996, Historical Tables, Tables 10.1, 11.3, 12.1.

explosive increase. These grants have increased by $53.4 billion in the past five years.

Figure 2.6 compares the trends in federal grants to state and local governments for payments to individuals with other types of grants in aid to lower-level governments. As the figure shows, the trend since the mid-1970s has been a decline in programmatic grants for education, transportation, and the production of local services and an increase in the extent of grants for payments to individuals, principally for medical care. Since 1991, grants for medical care have exceeded all grants for goods and services at the state and local level.

For comparison, figure 2.7 reports direct federal payments to individuals under the largest programs: food stamps and direct housing assistance. Food stamp expenditures by the federal government have increased by more than 25 present since 1989, but current expenditures on this direct federal transfer program are less than $20 billion.

The debate over whether the grant levels of the 1970s or even the 1980s were reasonable and appropriate will certainly continue for many years

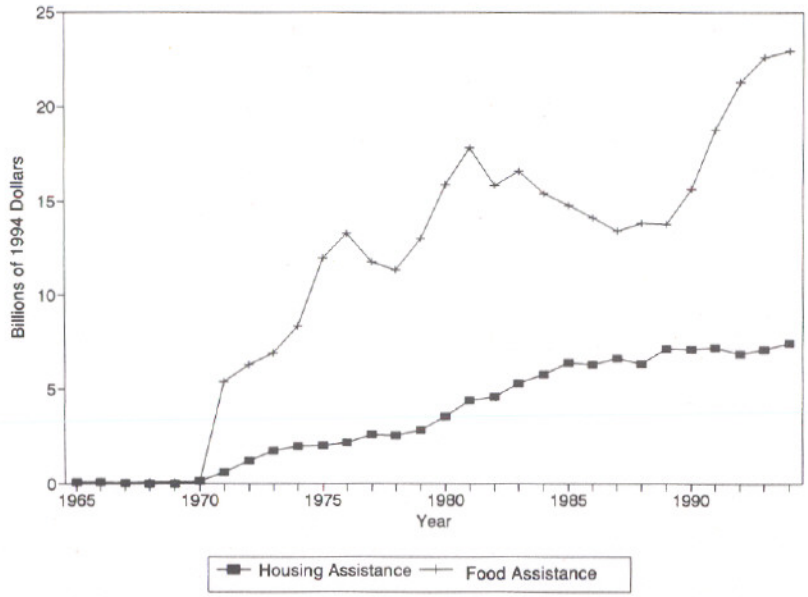

Figure 2.7
Federal direct payments to individuals. Source: *Budget of the United States Government*, Fiscal Year 1996, Historical Tables, Tables 10.1, 11.3.

to come as the specific public programs supported are evaluated and reevaluated. Whatever one's view on the merits of specific programs, a serious commitment to deficit reduction implies some cuts in federal expenditures on these programs. Indeed, much of the current rhetoric for reform of health care and AFDC is explicitly motivated by deficit-reduction efforts. No picture of budgetary reform can be complete, however, without some commentary on the implications for the programs themselves of proposed changes in the federal system of intergovernmental aid. We now turn briefly to the possible effects that changes in grant programs will have on the state and local public sectors.

How Will State and Local Governments Respond?

Most state and local governments operate under balanced budget constraints. It is not surprising, therefore, that the aggregate of state and local budgets is in modest surplus rather than deficit. More to the point, however, the aggregate surplus has generally been declining for a decade.[10]

Seen in this context, we should expect many states would choose not to provide equivalent services when they are given responsibility for health and welfare programs without the funding to support the programs.

At this time, the outcome of budgetary debates between the Republican Congress and the Democratic executive is unclear. It does seem clear, however, that the current health and welfare programs, heavily subsidized by the federal government through a system of open-ended matching grants, will be reformed, or perhaps replaced, by block grants of fixed size. For example, AFDC is currently an open-ended matching program in which the price subsidy varies inversely with state income, ranging from 50 percent to 78.6 percent; Medicaid matches state spending at the same rate as AFDC.[11] Even without any change in federal funding or other regulations, a switch from matching programs with price and income effects to block grants without price effects will lead to a reduction in state and local spending.

The state and local government responses to the policy changes will clearly vary substantially depending on current budgetary pressures and preferences. Depending on the regulations governing program change, it is quite possible that cuts in current programs could be substantial. A review of the evidence on price and income elasticities of demand for transfer programs suggests the reasons; recent work by Chernick (1996) provides some estimates of the responses of state and local governments to a programmatic change in which AFDC and Medicaid were converted to block grants. He suggests that the shift would raise the price of a dollar of AFDC benefits and Medicaid outlays from forty-five cents to one dollar.[12]

The magnitude of the spending response of lower levels of government will depend heavily on the size of the relevant elasticities and the course of reductions in federal spending on block grants. Even if federal budgetary cuts were small initially, they would almost certainly grow over time. Current proposals cap future increases in program expenditures at the federal level. The response magnitude also depends on the extent to which states alter their benefit levels to compete with other states; a decline in one state's benefits could lead (through a race to the bottom) to substantial decreases in benefits offered by other states. At the high end in terms of predicted responses are Gramlich (1985) and Craig and Inman (1986), whose work suggests reductions in AFDC spending of from 70 to 85 percent. At the other extreme are Moffitt (1984, 1990) and Craig (1993), who suggest that substitution effects will reduce AFDC benefit levels by about 9 percent.

A large body of econometric evidence on state welfare spending and state AFDC benefit levels suggests that price elasticities are rather large, income elasticities are relatively small, and there is little substitution of food stamps for other forms of public welfare. Thus, studies by Gramlich (1982, 1985), Gramlich and Laren (1984), and Craig and Inman (1986) all find that the form and level of federal matching programs have substantial effects on the amount of redistribution undertaken by the states. These studies are consistent with declines in benefit levels or state welfare spending of 70 to 85 percent. In contrast, two papers by Moffit (1984, 1990) find smaller price elasticities and somewhat larger income elasticities, both of which would moderate the disastrous effects predicted by the others in moving to block grants.

The views of Gramlich and Laren (1984) and others are based in part on the evidence that states responded to court-mandated increases in beneficiaries (arising from the "right to travel" rulings) by restricting benefits. This suggests that there will be a race to the bottom in the provision of welfare benefits as each state reacts to the cuts in welfare levels proposed in neighboring states by cutting their own benefit levels. To the extent, however, that states are able to create constitutionally acceptable devices for restricting benefit levels of new entrants, or more generally that states do not respond closely to the choices of benefit levels of neighboring states, the race may not be as extreme as suggested by Gramlich and Laren.

There is much less econometric evidence on the determinants of state spending on Medicaid. (An early review is by Inman 1985. Chernick provides a more recent review.) Chernick (1996) concludes that "the small number of studies of Medicaid price responses suggest that the absolute magnitude of the income and price elasticities is greater than for AFDC." If true, these findings imply even larger estimates of the effect of block granting on Medicaid spending and public medical care spending by the state.

This evidence is not conclusive. But given that many states have become more fiscally conservative and given the tightness of their budgets, the conclusion that the effects would be substatial seems appropriate.

From our normative perspective, there is a strong case to be made for centralized control of distribution programs involving health and welfare. Apparently only one factor could mitigate the substantial reductions in aggregate spending on transfer programs that would accompany the termination of current federally supervised matching grants: a large increase in x-efficiency accompanying a shift in control to state governments. Indeed, there are extravagant claims that the states are more creative and

innovative in designing welfare programs, and that they are better managers of these programs. These claims are made more forcefully about transfer programs than about other government activity. There is little doubt that a shift to state-administered block grants will involve less bureaucracy and will give more flexibility to states.[13] Beyond this, there is little or no systematic evidence about creativity or innovation.

Anecdotal evidence is not reassuring. It is reported that efforts to computerize child support and welfare payments in Maryland have been disastrous; the system will be two years late and 67 percent over budget. News accounts have estimated that Florida lost $170 million on food stamp errors, and state officials have acknowledged $28 million in mistakes in the Medicaid program. California's new welfare computer system is now estimated to be $455 million over budget—about 90 percent—and will not accommodate the volume of transactions.

As far as management is concerned, one state secretary of human services suggests that passage of these federalism initiatives will be like "flying blind into a fog."[14]

2.5 Conclusion

It is clearly too early to know with much certainty the direction in which U.S. federalism will move. However, the current budgetary debate suggests strongly that we are entering a new period in fiscal federalism, one marked by restrained federalism. In this more limited federalist economy, the federal government will mandate state responsibilities for a number of public regulatory and spending programs.

This review of the linkages between federal and lower levels of government does suggest three conclusions. First, an increasing burden of federal mandates for expenditures has been placed on the state and local governments by the central government. Despite increasing attention to this issue during the past decade, the level and extent of unfunded mandates continue to grow. However, the evidence also indicates that these mandates provide only limited opportunities for budget reduction at the federal level. Cumulative state and local expenditures engendered by preemptions, direct orders, and crossover mandates are significant and large from the local perspective but rather small in comparison with expenditures from the federal budget.

Second, the rapid rise in federal grants to local governments does provide a significant opportunity to reduce the budget of the central government by appealing to federalist principles. The federalist principles are

bious. They involve the assertion that benefit levels in transfer pro-
ms are better decided locally and that program operations and stan-
ds are better managed locally. We have seen no systematic evidence
gesting a better management capacity by local government. Further,
ough we believe that there are gains to be had from state experi-
ntation with new programs and new ways to administer old programs,
recognize that states already have substantial flexibility to experiment.
he budget opportunity arises from the shift from open-ended match-
grants for substantial programs to block grants of fixed size whose
ease can be controlled centrally. We are persuaded by the evidence
there are moderate price elasticities and small income elasticities at
local level. Given the real possibility of a race to the bottom as well,
suggests that budget savings at the federal level will be achieved by
tically reducing the aggregate size of these programs. This reduction,
d be put off temporarily by the addition of a "hold-harmless" clause
ny new block grant programs; that is, a condition of receipt of a block
t would be that the state maintain nominal benefits at current levels.
hird, since budgetary savings arise from capping the future growth of
e programs, the savings arise in some part from the elimination of
rally imposed rules for eligibility and program participation. It is
ination of the entitlement aspects of the programs that permits them
e devolved to the states. Removal of this "mandate" imposed on
s and localities can generate substantial budgetary savings to the
al government (at the expense of low-income people), but it will
tantially change the nature of federalism in the United States.

es

e grateful to Scott Susin for research assistance. Financial support for this research
en provided by the Fisher Center for Real Estate and Urban Economics, University of
nia, Berkeley.

s theorem is closely related to the concept of "subsidiarity," which appears frequently
current debates over the governmental structure of the European Union. See also
(1965).

U.S. 618 (1969). In this case the state could not, because of the fundamental right to
impose welfare assistance waiting periods on new entrants. The Court did not claim
udgetary considerations were irrelevant; rather, it stated that the specific budgetary
ents made by the state were "utterly devoid of evidence of use of the one-year
ment as a means to predict the number of people who will require assistance in the
year." The Court also struck down a one-year residency requirement for receipt of
its of nonemergency hospitalization and medical care at county expense in *Memorial*
l v. Maricopa County, 415 U.S. 250 (1974).

3. The law is unclear whether a state's attempt to discriminate in any form against new entrants may itself violate *Shapiro v. Thompson*.

4. See Gordon (1983) and Inman and Rubinfeld (1996) for details.

5. Tax competition was essentially the argument that Heller and Pechman had raised in the 1960s.

6. Unfunded mandates have been attacked as inappropriately clouding the link between funding and decision making. See, for example, Rivlin (1992, p. 109). However, they are supported for many of the reasons given above by Dana (1995).

7. EPA research also indicated that the costs of recent environmental regulations are likely to vary widely across jurisdictions.

8. For example, in retrospect, one of the most costly intergovernmental regulations enacted during the 1970s was the Rehabilitation Act of 1973, which prohibited discrimination against disabled persons in federally assisted programs. In public transportation programs alone, the CBO estimated in the late 1970s that this law would require transit authorities to spend $6.8 billion over thirty years to equip buses with wheelchair lifts, install elevators in subway systems, and take other measures to expand access to public transit systems by the physically disabled.

9. These are gross categories. For example, the category "income security" includes substantial expenditures by the Departments of Agriculture and Housing and Urban Development, as well as expenditures by the Department of Health and Human Services.

10. See Gramlich (1991, figure 1). The National Income Accounts Surplus began to decline in 1983, while the operating surplus has generally fallen since 1972.

11. Specifically, the federal matching rate is: $1 - .45(S^2/N^2)$, where S is state per capita income and N is national per capita income. See ACIR (1992) for an extensive discussion.

12. The price would be higher than one dollar if the food stamp program were to continue to tax AFDC benefits.

13. Gold (1995) develops these points.

14. These anecdotes are reported in *Business Week* (1995) and Babington (1995) among other popular sources.

References

Babington, Charles. 1995, October 23–29. "Overloading the States." *Washington Post*, National Weekly Edition.

Barr, Calvaresi. 1990. "Cost Estimation as an Anti-Mandate Strategy." In Michael Fix and Daphne Kenyon, eds., *Coping with Mandates: What Are the Alternatives?* pp. 49–56. Washington, DC: Urban Institute.

Boadway, Robin W., and Frank Flatters. 1982. "Efficiency and Equalization Payments in a Federal System of Government: A Synthesis and Extension of Recent Results." *Canadian Journal of Economics* 15:613–633.

Boadway, Robin W., and David E. Wildasin. 1984. *Public Sector Economics*. Boston: Little, Brown.

Break, George. 1980. *Financing Government in a Federal System*. Washington, DC: Brookings Institution.

Breton, Albert. 1965. "A Theory of Government Grants." *Canadian Journal of Economics and Political Science* 31:175–187.

Buchanan, James. 1965. "An Economic Theory of Clubs." *Economica* 32:1–14.

Business Week. 1995, August 7. "Power to the States: Are They Ready?"

Chernick, Howard. 1996, January. "Fiscal Effects of Block Grants for the Needy: A Review of the Evidence." New York: Department of Economics, Hunter College and Graduate Center, City University of New York.

Conlan, Timothy J. 1991. "And the Beat Goes On: Intergovernmental Mandates and Preemption in an Era of Deregulation." *Publius* 21:43–57.

Craig, Steven G. 1993, September. "Redistribution in a Federalist System: Can the Federal Government Alter State Government Behavior?" Houston: Department of Economics, University of Houston.

Craig, Steven G., and Robert P. Inman. 1986. "Education, Welfare, and the New Federalism: State Budgeting in a Federalist Public Economy." In H. Rosen, ed., *Studies in State and Local Public Finance*. Chicago: Chicago University Press.

Dana, David A. 1995. "The Case for Unfunded Environmental Mandates." *Southern California Law Review* 69:1–45.

Environmental Protection Agency. 1991. *Environmental Investments: The Costs of a Clean Environment*. Washington, DC: Island Press.

Feldstein, Martin. 1970. "Comment on 'An Efficiency Bias for Federal Fiscal Equalization'." In Julius Margolis, ed., *The Analysis of Public Output*, pp. 159–163. New York: National Bureau of Economic Research.

Gold, Steven D. 1995, Summer. "Impacts of the Revolution in Federal Policies on State and Local Governments." *NTA Forum*, no. 22.

Gordon, Roger A. 1983. "An Optimal Taxation Approach to Fiscal Federalism." *Quarterly Journal of Economics* 95:567–586.

Gramlich, Edward M. 1991. "The 1991 State and Local Fiscal Crisis." *Brookings Papers on Economic Activity* 2:249–287.

Gramlich, Edward M. 1987. "Federalism and Federal Deficit Reduction." *National Tax Journal* 40:299–313.

Gramlich, Edward M. 1985. "Reforming U.S. Fiscal Arrangements," In J. M. Quigley and D. L. Rubinfeld, eds., *American Domestic Priorities*, pp. 34–69. Berkeley: University of California Press.

Gramlich, Edward M. 1982. "An Econometric Examination of the New Federalism." *Brookings Papers on Economic Activity* 2:327–360.

Gramlich, Edward M., and Deborah Laren. 1984. "Migration and Income Distribution Responsibilities." *Journal of Human Resources* 19(4):489–511.

Gullo, Theresa A. 1990. "Estimating the Impact of Federal Legislation on State and Local Governments." In Michael Fix and Daphne Kenyon, eds., *Coping with Mandates: What Are the Alternatives?* pp. 41–48. Washington, DC: Urban Institute.

Inman, Robert P. 1988. "Federal Assistance and Local Services in the United States: The Evolution of a New Federalist Fiscal Order." In H. Rosen, ed., *Fiscal Federalism*, pp. 33–74. Chicago: University of Chicago Press.

Inman, Robert P. 1985. "Fiscal Allocations in a Federalist Economy." In J. M. Quigley and D. L. Rubinfeld, eds., *American Domestic Priorities*, pp. 34–69. Berkeley: University of California Press.

Inman, Robert P., and Daniel L. Rubinfeld. 1996. "Designing Tax Policy in Federalist Economies: An Overview." *Journal of Public Economics* 60:307–344.

Inman, Robert P., and Daniel L. Rubinfeld. 1997. "The Political Economy of Federalism." In D. Mueller, ed., *Perspectives on Public Choice*, pp. 73–105. Cambridge: Cambridge University Press.

Koch, Edward I. 1980, Fall. "The Mandate Millstone." *Public Interest*, 42–57.

Lovell, Catherine H., et al. 1979. *Federal and State Mandating on Local Governments: An Exploration of Issues and Impacts*. Riverside, CA: University of California, Riverside.

Moffitt, Robert. 1990, June. "Has State Redistribution Policy Grown More Conservative?" *National Tax Journal* 43(2):123–142.

Moffitt, Robert. 1984. "The Effects of Grants-in-Aid on State and Local Expenditures: The Case of AFDC." *Journal of Public Economics* 23:279–306.

Muller, Thomas, and Michael Fix. 1980. "The Impact of Selected Federal Actions on Municipal Outlays." In U.S. Congress, Joint Economic Committee, *Government Regulation: Achieving Social and Economic Balance*, Vol. 5. Washington, DC: U.S. G.P.O.

Musso, Juliet, and John M. Quigley. 1996. "Intergovernmental Fiscal Relations in California: A Critical Evaluation." In D. Batten, ed., *Infrastructure, Economic Growth, and Regional Development*. New York: Springer Verlag.

Nathan, Richard P., et. al. 1975. *Monitoring Revenue Sharing*. Washington, DC: Brookings Institution.

National Conference of State Legislatures. 1994, December. *1994 Mandate Catalog*. Hall of the States Mandate Monitor Database. Special Edition. Washington, DC: The National Conference of State Legislatures.

Oates, Wallace, E. 1994. "Federalism and Government Finance," In John M. Quigley and Eugene Smolensky, eds., *Modern Public Finance*. Cambridge: Harvard University Press.

Oates, Wallace. 1972. *Fiscal Federalism*. New York: Harcourt Brace Jovanovich.

Pauly, Mark. 1973. "Income Distribution as a Local Public Good." *Journal of Public Economics* 2:35–58.

Perloff, Harvey S., and Richard P. Nathan, eds. 1968. *Revenue Sharing and the City*. Baltimore: Johns Hopkins University Press.

Price Waterhouse. 1994, December. *Impact of Unfunded Federal Mandates on US Cities*. Washington, DC: Price Waterhouse.

Quigley, John M., and Eugene Smolensky. 1992. "Conflicts among Levels of Government in a Federal System." *Public Finance* 47:202–215.

r, Robert 1975. "General Revenue Sharing—The Program's Incentives." In W.
l., *Financing the New Federalism*, pp. 40–87. Baltimore, Maryland: Johns Hopkins
y Press.

Richard. 1992. "Rehabilitating Interstate Competition: Rethinking the 'Race to the
Rationale for Federal Environmental Regulation," *New York University Law Review*

lice. 1992. *Reviving the American Dream*. Washington, DC: Brookings Institution.

Harry N. 1966, October 15. "The Condition of American Federalism: An His-
iew." Subcommittee on Intergovernmental Relations to the Committee on Govern-
perations, U.S. Senate.

binder, et al. 1988, September. *Municipal Sector Study: Impacts of Environmental Reg-
n Municipalities*. Prepared by Policy Planning and Evaluation for the U.S. Environ-
otection Agency. Washington, DC.

visory Commission on Intergovernmental Relations. 1992, June. *Medicaid: Inter-
ntal Trends and Options*. A-119. Washington, DC: ACIR.

visory Commission on Intergovernmental Relations. 1994, September. *Federally
Costs Affecting State and Local Governments*. M-193. Washington, DC: ACIR.

isory Commission on Intergovernmental Relations. 1995, January. *Federal Mandate
State, Local, and Tribal Governments*. A-129. Washington, DC: ACIR.

, David. 1986. *Urban Public Finance*. New York: Harwood.