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1985 marked year seven for de facto new federalism, the fiscal decentralization process nudged along by strong public support for the Reagan administration's conservative policies and growing fiscal stringency at the federal level. New federalism is most dramatically illustrated by the national government retreat along the entire state-local aid front—a kind of "sorting out"—as an increasing share of the federal budget goes to strictly national government programs. The mounting public concern about massive federal deficits will quicken the federal pullback on the state-local aid front. The only question is whether it will be a ragged retreat or an orderly withdrawal. The tightening fiscal squeeze in Washington is also slowly but surely reversing a fifty-year centralizing trend—the power pendulum is swinging back toward states and localities, thereby creating a better balance within our federal system.

The views expressed are those of the author and do not necessarily reflect the opinion of the members of the Advisory Commission on Intergovernmental Relations.

De facto new federalism is a sorting-out process, but not the nice, neat, orderly one that political scientists and reformers yearn for. Nor has it evolved along the tax turnback and program swap lines advocated in 1982 by the Reagan administration. Rather, this new federalism (which actually started in the latter half of the Carter administration) is most dramatically illustrated by the national government retreat along the entire state-local aid front.

Nevertheless, de facto new federalism clearly represents a "sorting out" of sorts. As more and more federal resources are being earmarked for national government programs—defense, Social Security, Medicare, and payment of the interest on a $1.8 trillion U.S. debt—state and local governments are being forced to fend for themselves.

New De Facto Federalism vs. Old Federalism

The new fiscally austere federalism can best be understood by comparing it to the affluent old federalism, which began at the end of the Korean War and ended in 1978—the year of the Russian invasion of Afghanistan and the California taxpayer revolt.

Old federalism was characterized by steadily growing local dependence on federal aid as the nation increasingly looked to Washington to set the domestic agenda. New

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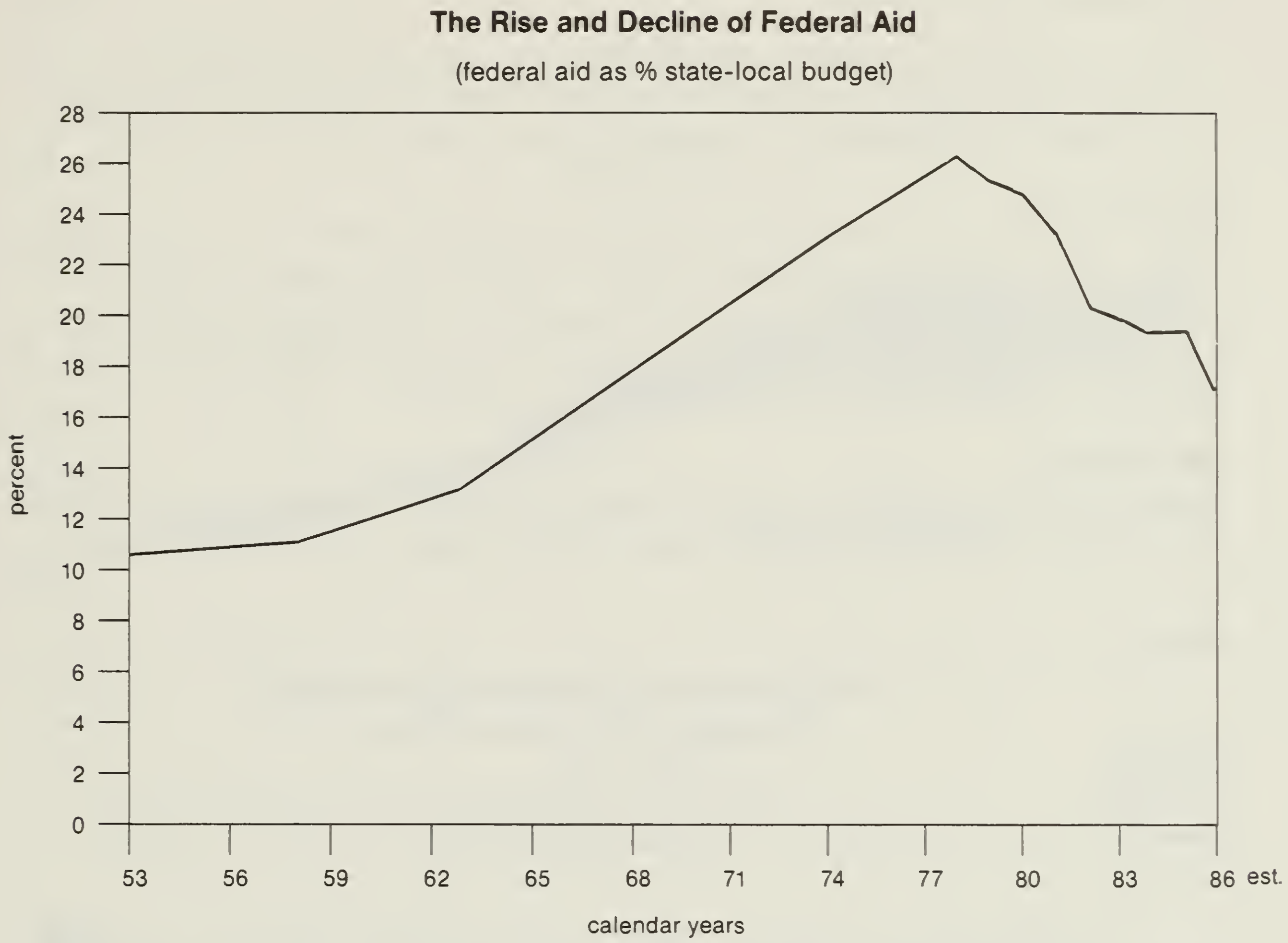
federalism is marked by steadily decreasing state-local reliance on federal-aid dollars as the country increasingly looks first to the localities and then to the states to handle domestic issues (see figure 1).

Figure 1



1986 estimate based on annual growth in state-local general expenditures from 1979 to 1984 (9.3%)
Source: ACIR staff compilation based on federal-aid figures from *U.S. Budget, FY 86, Historical Tables*, table 12.1. State-local general expenditures from U.S. Census government finance series (annual)

Old federalism was intrusive in character—a steadily growing number of federal aid "strings" and conditions were designed to alter state and local budgetary priorities and to race state and local fiscal engines. New federalism is becoming increasingly extrusive in character—the federal government is pulling aid funds and tax resources from state and local governments to strengthen the financing of its own national programs.

Old federalism represented a continuous but unplanned advance of the national government into areas that had heretofore been the exclusive province of state and local governments. New federalism represents a continuous but unplanned retreat from federal positions staked out during the Great Society era.

Old federalism called on Washington to provide extra aid to stabilize state and local finances during periods of economic recession. New federalism calls on the states to help themselves by setting up rainy day funds to cushion their finances from the shock of economic downturns.

Old federalism flourished in a political environment that resolved the political and fiscal doubts in favor of social equity concerns, domestic public-sector growth, and defense contraction. De facto new federalism operates in a political climate that resolves the doubts in favor of economic development, defense expansion, and domestic public-sector containment.

The Gathering Fiscal Storm

Phase I of de facto new federalism (1978–85) evolved against the backdrop of a gathering fiscal storm and produced a remarkable contrast: expenditure acceleration in Washington and expenditure deceleration at the state-local level (see figure 2).

The Three Rs

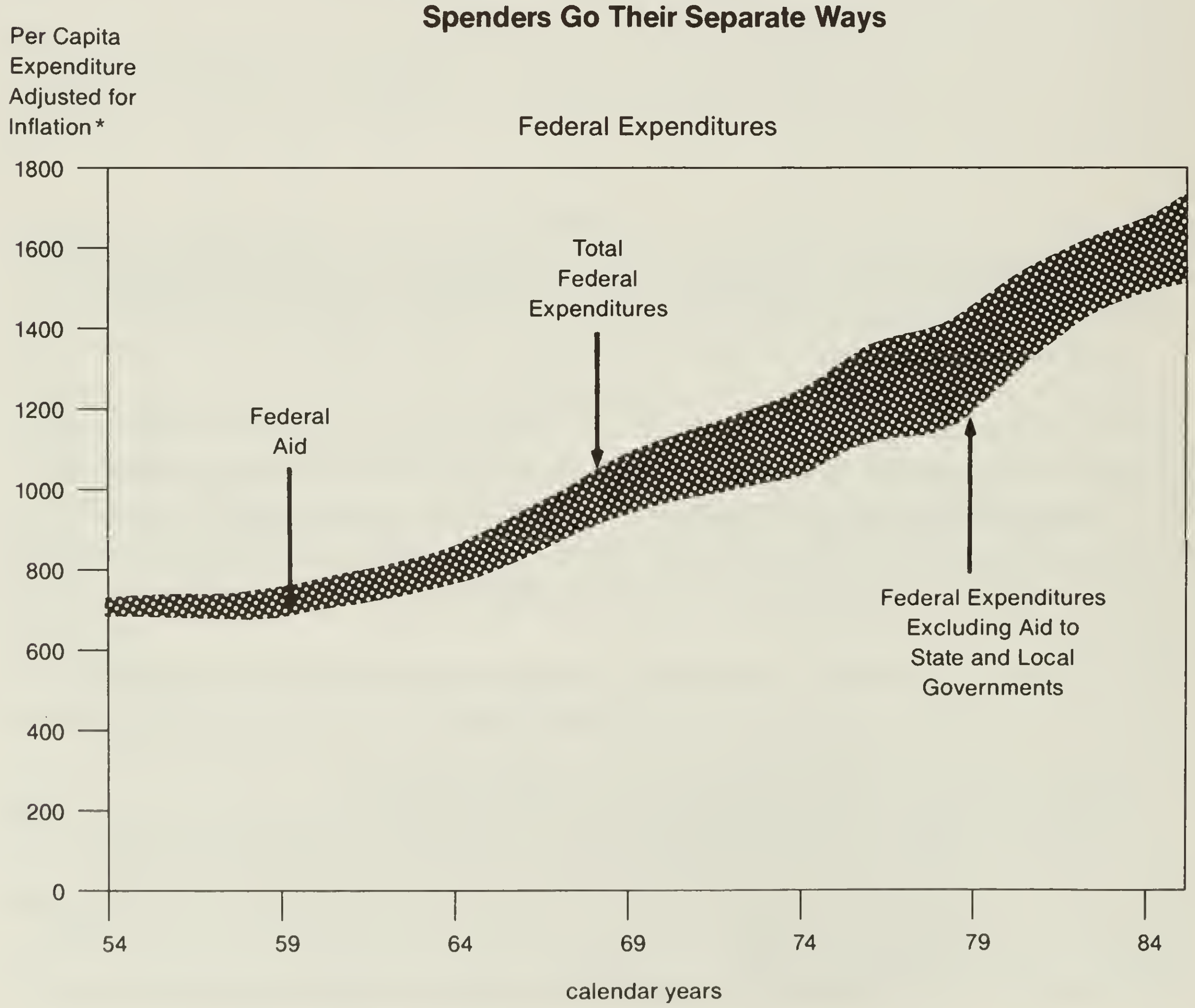
What caused the great slowdown in state-local outlays after 1978? For the first time since the end of World War II, it became much easier for most state and locally elected officials to say no rather than yes to proposals calling for expenditure increases. This newfound fiscal discipline was dictated by the three Rs: revolt of the taxpayers, reductions in federal-aid flows, and the recession.

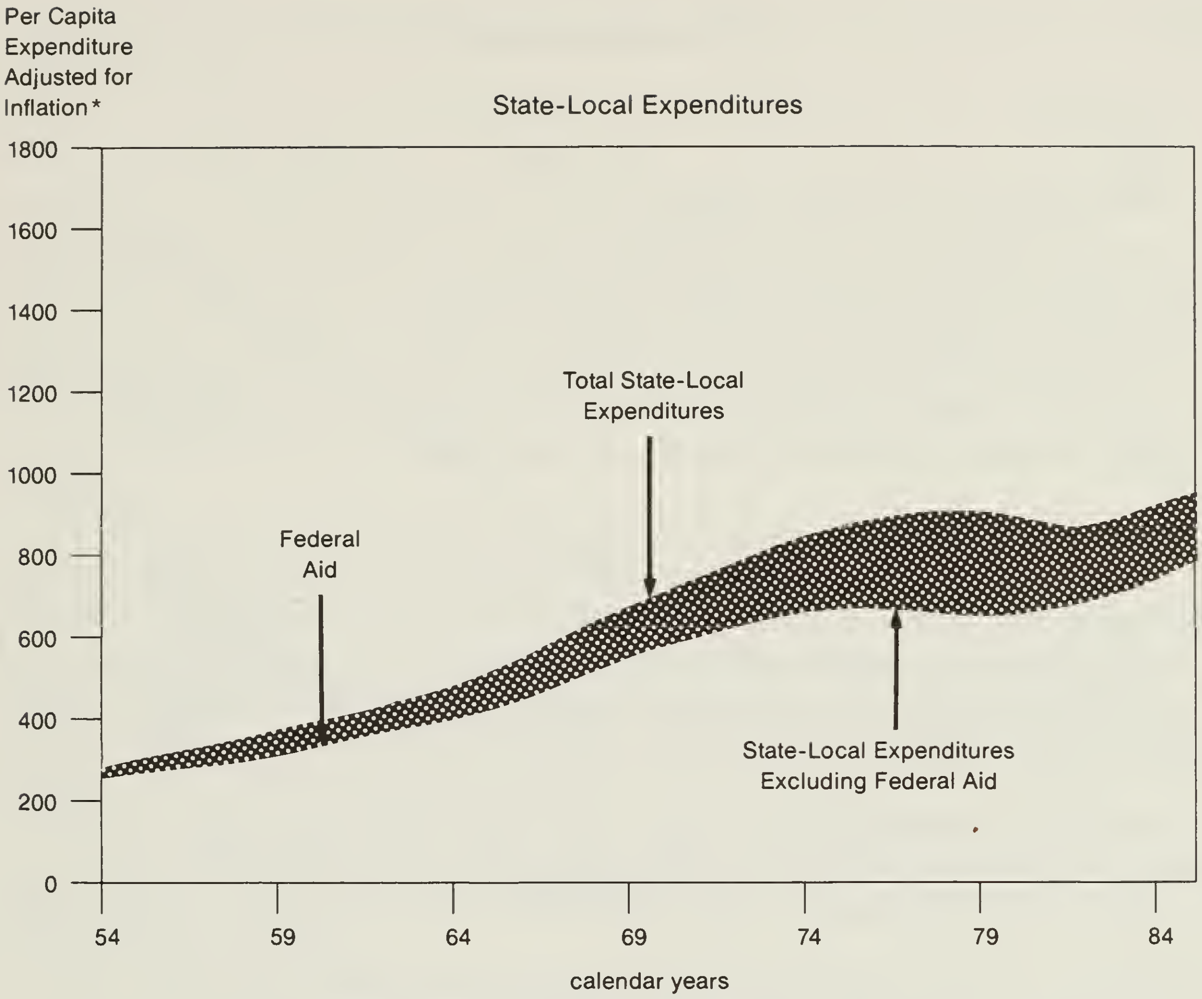
The Three Ds

While state-local expenditures leveled off after the passage of Proposition 13,[1] federal expenditures continued their steady upward climb, rising in constant dollars from

Figure 2

After the Tax Revolt—Federal and State-Local Spenders Go Their Separate Ways





*Inflation adjustment by GNP Implicit Price Deflator, 1972 = 100
Source: ACIR computations based on U.S. Department of Commerce National Income and Product Accounts

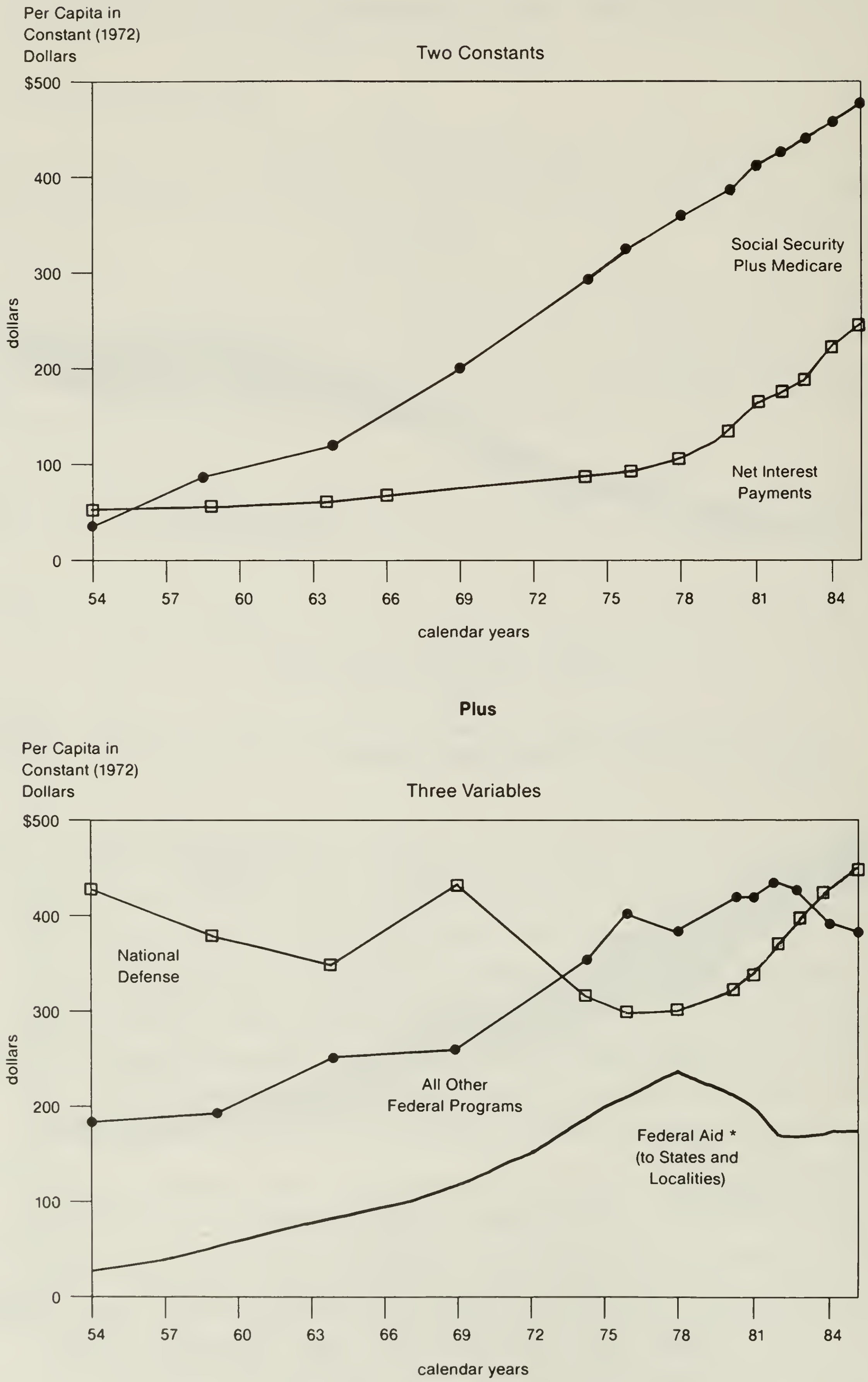
$1,377 per capita in 1978 to $1,700 in 1985. Figure 3 breaks down these federal expenditures into two components: constant and variable expenditures. There are two constants (shown on the top panel); one is Social Security plus Medicare, and the other is net interest payments on the federal debt. Neither constant is susceptible to rapid changes in the near future by either presidential or congressional action. The inexorable rise of expenditures for net interest payments is driven by large federal deficits and the consequent increase in the national debt, combined with continued high interest rates. The equally impressive rise in expenditures for Social Security and Medicare results from our steadily aging population, which means that each year more and more people are entitled to federal retirement benefits and insurance payments for medical care.

Variable expenditures—those which can be more readily changed by executive or congressional action—have been divided into three categories: national defense, federal aid to state and local governments, and all other federal programs. Expenditures for federal aid to state and local governments dropped sharply after 1978 and leveled off after 1981. Expenditures for all the other federal programs began a steady drop in 1981. The other variable, national defense, began to rise after 1978 and accelerated sharply after the Reagan administration took office and started to implement its promise to strengthen the nation's defenses.

Thus, the steady advance in federal expenditures can be traced to the driving force

Figure 3

The Federal Expenditure Equation



*Federal aid includes AFDC and Medicaid payments.
Source: ACIR staff

of the three Ds—deficits, defense, and demographics (shorthand for Social Security and Medicare).

Massive Budget Deficits

There is an iron law that governs the federal budget process: nothing short of a searing crisis can generate the consensus needed for federal policymakers to take unpopular actions such as enacting major tax hikes or making cuts in programs that have strong constituencies. Absent a full-blown crisis, federal officials avoid making these hard budget choices by papering over the budget gap with deficit financing when receipts fall short of steadily rising expenditure demands. Unlike their state and local counterparts, federal officials have not been disciplined by a balanced budget mandate.[2]

In a semicrisis situation, federal authorities can enact modest "revenue enhancements" and slow down the growth of programs that have relatively weak political constituencies. Many of the federal aid programs to states and localities fall into this classification. As a result, federal aid is the first major component of the budget to feel the fiscal squeeze—an early warning signal to the constituencies of more popular federal expenditure programs that there may be serious budget trouble ahead.

From a budgetary standpoint, 1985 was another very bad year for the national government. For the fiscal year ending September 30, 1985, the budget deficit totaled $212 billion[3]—*an amount about equal to the total tax collections for all fifty state governments combined.*

The national government has spent more than it has raised in taxes in twenty-four of the past twenty-five years, but the size of the annual deficit has become progressively greater over the past three decades. In the late 1950s, annual federal budget deficits averaged about 3 percent of total expenditures; by the 1980s, the average had climbed to 17 percent of total federal outlays (see figure 4).

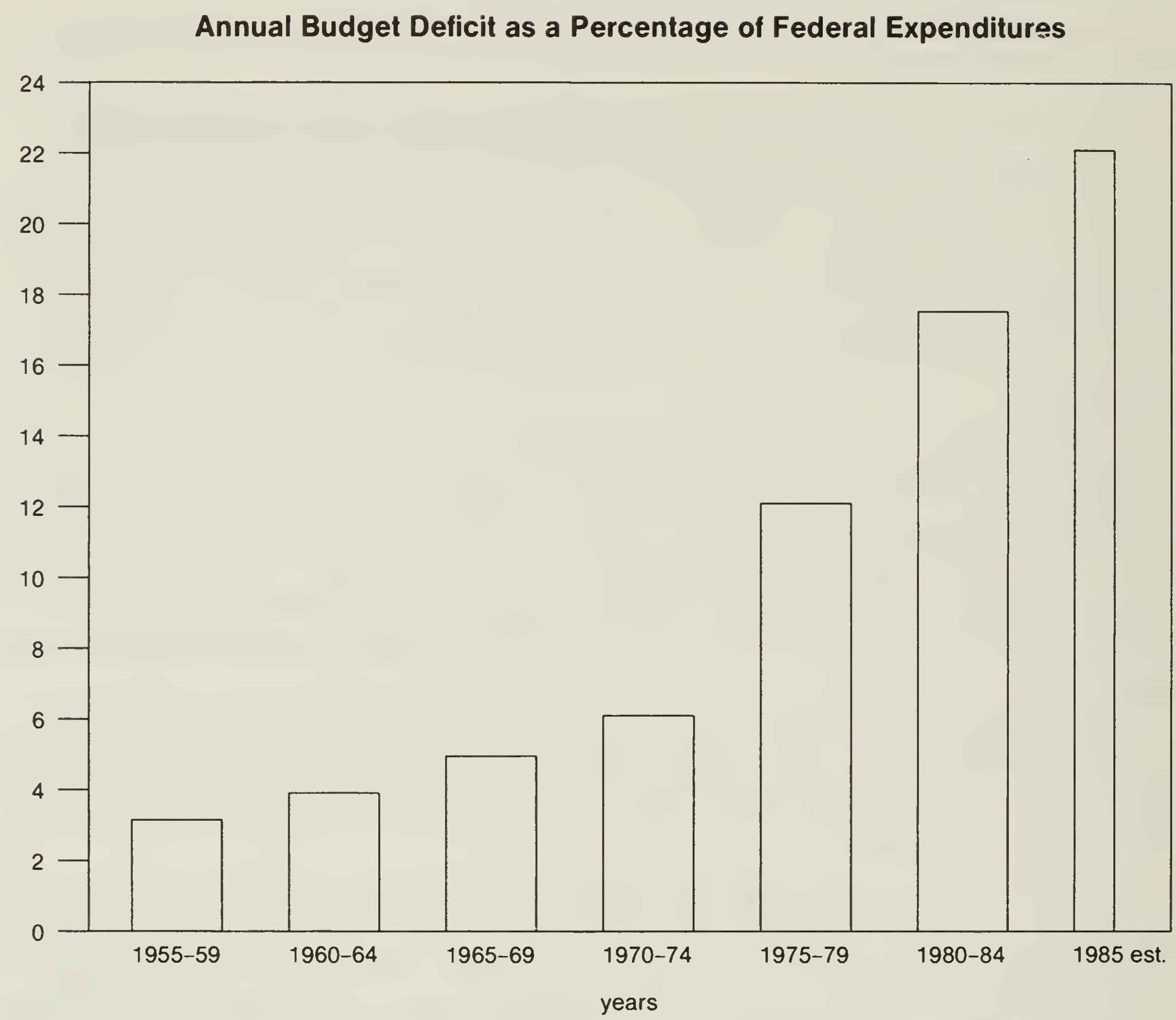
The Watershed Year—1986

Future historians of the American federal system are likely to designate 1986 as a watershed year—the beginning of Phase II of de facto new federalism. Why? Because this long-gathering fiscal storm will probably hit Washington full force in 1986. As a result, in 1986, for the first time since the outbreak of the Korean War, we may see the trend line for federal expenditures (as measured in real per capita terms and adjusted for inflation) begin to flatten out and then remain fairly flat for the next several years. This remarkable change in Washington's fiscal behavior is likely to be produced by the interaction of two powerful factors: the public demand to cut deficits and balance the budget, and the stout opposition of a popular president to a major federal tax increase.

The first factor—growing political demand to cut deficits—certainly proves that quantitative fiscal changes can have qualitative political effects. For years, federal budget deficits attracted remarkably little public attention; now they have reached such massive proportions that they are widely viewed as posing a clear and present danger to the nation's economic health.

Congress will be forced to come to grips with the painful deficit issue more quickly than most Washington watchers would have predicted even a few short months ago.

Figure 4



1985 estimate from OMB Mid-Session Review of Budget, 20 August 1985
Source: U.S. Office of Management and Budget, *The Federal Budget for 1984*, table 24, and ACIR staff computations

Why are we surprised? Because there existed and still exists a widespread and deeply pessimistic belief that Washington is so paralyzed by special-interest politics and partisan conflicts that only a major economic depression or the imposition of a dramatic remedy—a constitutional balanced budget amendment[4]—could force the Congress and the White House to cut the deficit sharply. Most of us overlooked the fiscal crisis opportunity provided by the congressional need to raise its ceiling on the national debt.[5]

Assuming that the Reagan administration continues to block any major federal tax increase, then the road to deficit reduction and balanced budgets will be paved largely with major cuts in domestic programs (excluding Social Security), because expenditure freezes will no longer do the job.

We will enter Phase II of de facto new federalism when the trend line for federal expenditures begins to flatten out and there are actual and substantial cuts in total federal aid flows for several years in a row. In striking contrast, total federal aid flows to states and localities actually grew slowly during most of the years between 1978 and 1985, despite the fact that certain small programs were wiped out and many others were "frozen."

Three Hard Questions

The likely prospect of real and sustained cuts in federal aid flows to states and localities poses three hard questions:

> Will the poorest jurisdictions be at least partially shielded from federal budget cuts?
>
> Will the federal aid programs that help states and localities care for poor people be declared off limits to the budget cutters?
>
> Will states and localities be protected from new federal mandates that come without federal reimbursement?

Special Financial Assistance for Poor Governments

Our federation is unique because it has not dealt directly with the poor government problem. The other major federations—Australia, Canada, and West Germany—provide special fiscal aid to those states with the most anemic revenue sources.

As illustrated by the data in table 1, the states with relatively the lowest fiscal capacity in New England (Vermont and Maine) are likely to be the hardest hit by across-the-board federal aid cuts. A persuasive case can be made for the construction of some form of a special fiscal safety net for the poorest states.[6]

Continued Federal Aid for Poor People

The present federal aid "system" is composed of about four hundred large, medium, and small grants that cut across the entire range of the domestic public sector. In my opinion, such programs as AFDC, Medicaid, and food stamps should not be placed on the budgetary chopping block. The federal government should continue to honor its commitment to help states and localities take care of poor people. The federal government should hold to this commitment even if it means the total elimination of aid programs in areas that have lower national priority.

No New Mandates Without New Federal Money

Many state and local officials fear the worst case scenario—that Congress will become even more inclined to flex its regulatory muscles and impose mandates without money now that it can no longer afford to bribe states and localities with "tied" financial grants.

In its recent *Garcia* decision,[7] the U.S. Supreme Court flashed the greenest of green lights to would-be federal regulators. In that close decision (5–4) the high Court told the states and localities that they could no longer hide behind judicial robes and plead the Tenth Amendment when affronted by an exercise of congressional regulatory power. In effect, the Supreme Court majority announced that it would no longer referee disputes involving state claims for immunity from congressional efforts to regulate interstate commerce. Thus, states and localities will now have to fight their own political battles in the congressional arena.

In the short run, the states and localities need (as an irreducible minimum) legislation requiring the national government to reimburse states and localities for the costs imposed by any *new* federal mandates. In the long run, our federal system may need some form of a constitutional amendment to make sure that the Supreme Court continues to play its historic role as arbiter of power conflicts between the national government and the states.

Table 1

Federal Aid to State and Local Governments for FY84
(Federal Aid Per Capita and as a Percentage of State-Local General Revenue by Geographic Region with National Ranking)

State	Federal Aid (in millions)	Per Capita Federal Aid	Rank	Federal Aid as a % of State-Local Gen. Revenue	Rank	Per Capita Personal Income Calendar Year 1984	Rank
United States	$97,052.4	$411		17.9%		$12,789	
New England	5,699.1	453	3	19.3		14,421	
Connecticut	1,138.0	361	36	14.9	45	16,557	3
Maine	533.6	462	17	22.6	7	10,817	38
Massachusetts	2,904.0	501	10	20.6	13	14,783	5
New Hampshire	331.3	339	41	18.5	27	13,188	16
Rhode Island	487.9	507	9	20.5	15	12,818	18
Vermont	304.2	574	5	24.9	2	10,798	40
Mideast	21,640.6	506	1	18.4		14,004	
Delaware	295.6	482	12	17.6	31	13,675	11
Dist. of Col.	1,253.8	2,013	1	42.5	1	17,108	2
Maryland	1,710.8	393	27	16.3	37	14,464	7
New Jersey	2,790.0	371	32	14.7	46	15,440	4
New York	10,937.7	617	4	18.7	23	14,318	8
Pennsylvania	4,652.7	391	29	18.5	28	12,314	27
Great Lakes	16,679.2	401	5	17.8		12,740	
Illinois	4,796.7	417	22	18.7	25	13,802	10
Indiana	1,775.7	323	47	17.2	32	11,717	32
Michigan	4,340.6	478	13	18.2	30	12,607	21
Ohio	3,745.9	348	39	16.8	35	12,355	26
Wisconsin	2,020.3	424	20	17.2	33	12,475	23
Plains	6,704.9	383	6	17.1		12,555	
Iowa	1,046.8	360	37	16.8	34	12,159	29
Kansas	802.9	329	44	15.0	44	13,249	14
Minnesota	1,928.5	463	16	15.8	40	13,246	15
Missouri	1,630.7	326	46	18.9	22	12,150	30
Nebraska	559.8	349	38	15.8	39	12,430	24
North Dakota	376.1	548	6	20.3	16	12,360	25
South Dakota	360.1	510	8	23.0	6	11,067	36
Southeast	19,779.0	355	7	19.1		11,182	
Alabama	1,540.6	386	30	20.0	17	9,992	47
Arkansas	876.8	373	31	23.1	5	9,805	48
Florida	2,938.1	268	51	14.5	47	12,763	20
Georgia	2,444.4	419	21	20.8	11	11,550	35
Kentucky	1,479.0	397	26	22.5	8	10,300	43
Louisiana	1,798.8	403	25	18.2	29	10,810	39
Mississippi	1,059.8	408	23	23.2	4	8,777	51
North Carolina	2,130.5	346	40	19.7	18	10,850	37
South Carolina	1,109.4	336	42	19.3	20	10,117	45
Tennessee	1,845.6	391	28	23.4	3	10,418	42
Virginia	1,765.6	313	48	16.0	38	13,253	13
West Virginia	790.4	405	24	21.0	9	9,729	50
Southwest	6,994.0	294	8	14.5		12,212	
Arizona	859.0	281	49	13.4	50	11,841	31
New Mexico	653.4	459	19	15.1	43	10,260	44
Oklahoma	1,092.5	331	43	16.3	36	11,655	33
Texas	4,389.1	275	50	14.2	48	12,572	22

Table 1 (cont.)

Federal Aid to State and Local Governments for FY84
(Federal Aid Per Capita and as a Percentage of State-Local General Revenue by Geographic Region with National Ranking)

State	Federal Aid (in millions)	Per Capita Federal Aid	Rank	Federal Aid as a % of State-Local Gen. Revenue	Rank	Per Capita Personal Income Calendar Year 1984	Rank
Rocky Mountain	3,200.6	447	4	18.2		11,878	
Colorado	1,160.2	365	34	15.6	42	13,846	9
Idaho	364.0	364	35	20.6	14	10,089	46
Montana	446.7	542	7	20.9	10	10,546	41
Utah	760.0	460	18	20.6	12	9,730	49
Wyoming	469.7	919	3	18.6	26	12,235	28
Far West*	15,352.0	458	2	18.2		14,007	
California	12,171.5	475	14	18.7	24	14,488	6
Nevada	298.4	328	45	13.8	49	13,317	12
Oregon	1,268.1	474	15	19.2	21	11,613	34
Washington	1,614.0	371	33	15.7	41	12,792	19
Alaska	492.9	986	2	8.2	51	17,478	1
Hawaii	510.3	491	11	19.4	19	13,038	17

*Excluding Alaska and Hawaii
Source: Advisory Commission on Intergovernmental Relations, 6 November 1985

Ragged Retreat or Orderly Withdrawal?

It is now clear that the federal government will be forced by massive and growing fiscal pressure to quicken its retreat along the entire federal aid front. It is to be hoped that the retreating feds will treat the wounded (the poor) as humanely and their allies (state and local governments) as decently as a bad fiscal situation will permit. To put the issue more directly, let us hope that the federal pullback will be conducted in a way that will minimize state and local casualties.

The federal aid issue, however, must be viewed in terms of a larger and harsher reality. While federal aid cuts can sting badly, a return to double-digit inflation followed by a severe and protracted economic recession can do far more damage to most state and local governments. To prevent a serious economic downturn, the federal government must cut deficits substantially.

Ideally, this deficit-reduction strategy will be conducted in a way that avoids placing too heavy a strain on the federal-state-local partnership. But even if it is conducted in a harsh and clumsy fashion, one thing is certain: federal deficit reduction is still in the long-range interest of every state and local government in our federation.

Two Bright Spots

Despite this gloomy assessment of the national government's fiscal plight, there are two bright spots: the remarkable resilience of state and local governments *and* the bracing effect of fiscal decentralization on our federal system.

The fiscal resilience of states and localities is one of the most underrated features of the American federal system. During the past eight years, the state and local sectors have been severely jolted by double-digit inflation, major recessions, the taxpayers' revolt, and a real slowdown in federal-aid flows. Yet most states and localities are now in far better financial shape than most students of public finance would have dared to predict three years ago.

The remarkable change in the expectations of state and local officials stands out as the second bright spot. They no longer look to Washington to finance their new initiatives. In short, we have entered a do-it-yourself era of fiscal federalism.

The tightening fiscal squeeze underscores an old truism: federalism is finance. Budgetary realities are inexorably forcing Washington to devolve more and more responsibility to states and localities.

Notes

1. In 1978, California voters approved Proposition 13, which amended the California constitution to institute a four-point program for sharply cutting back state and local taxes. It mandated that (1) as of July 1, 1978, no property could be taxed at more than 1 percent of its estimated 1975–76 market value; (2) no property tax assessment can be increased in any one year by more than 2 percent unless that property is sold, at which time it can be reassessed on the basis of its market value; (3) no local tax can be increased and no new tax imposed without the approval of two thirds of the qualified voters; and (4) no additional state taxes can be imposed unless approved by at least two thirds of the total membership of both houses of the legislature.

   California's enactment of Proposition 13 prompted similar measures limiting taxes and expenditures in many other states.

2. Congress responded to public demand to cut deficits and balance the budget by shaping and then enacting the Gramm-Rudman-Hollings deficit control measure in December 1985. The Gramm-Rudman-Hollings proposal became PL 99-177 when it was signed by the president on December 12, 1985. This measure put both houses of Congress squarely on record in favor of reducing the deficit to zero in fiscal 1991 by forcing a series of across-the-board cuts in nonexempt programs each year if regular budget and appropriations actions fail to achieve annual goals for reducing the deficit. Only Social Security, interest on the federal budget, and a few veterans' and social programs (such as AFDC) are exempt from automatic cut provisions.

3. U.S. Office of Management and Budget, *Joint Statement of James A. Baker III, Secretary of the Treasury, and James C. Miller III, Director of the Office of Management and Budget, on Budget Results for the Fiscal Year Ending September 30, 1985,* issued 25 October 1985.

4. Gramm-Rudman-Hollings is not a constitutional balanced budget amendment. It is a statutory balanced budget provision that can be altered with relative ease.

5. The architects of Gramm-Rudman-Hollings exploited this opportunity for leverage.

6. It should also be noted that Senators Dan Evans (R-Washington) and David Durenberger (R-Minnesota) proposed legislation to partially shield poor local governments from the losses they would suffer from the complete elimination of the general revenue sharing program.

7. *Garcia* v. *San Antonio Metropolitan Transit Authority* et al., 105 S.Ct. 1005, 1985.