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THE STATE OF THE STATES: TIME FOR A BUSH FEDERALISM POLICY

INTRODUCTION

While Congress and the Bush Administration strive to reduce the federal budget deficit, state and local officials continue to descend on Washington to demand more financial aid. The states want the federal government to spend more money on education, housing, crime prevention, roads and bridges, and other programs demanded by local voters. Governors and mayors say a pull-back in federal aid during the 1980s is straining state budgets already suffering from a decline in revenues.

These arguments play well with the voters back home – who, incidentally, would be paying for the increased federal aid demanded by the state and local politicians – but they paint a false picture of the condition of states, and the causes of budget problems in some states. In fact, federal policy over the past eight years has been very beneficial to states and cities. In particular, they have prospered enormously from the national economic policies of the Reagan Administration, which propelled the economy into a marathon economic expansion now entering its eighth year. The gross national product, adjusted for inflation, has risen by more than 25 percent since Ronald Reagan entered the White House, from $3.19 trillion in 1980 to $3.99 trillion in 1988. Unemployment dropped from 7 percent in 1980 to 5.4 percent in 1988, while annual inflation plummeted from 9 percent to 3.4 percent.[1]

1 Council of Economic Advisors, *Economic Indicators*, December 1988.

Note: Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

Substantial Benefits. Thanks in large part to this national expansion, metropolitan areas have seen enormous economic improvements. Real per capita personal income within the cities rose by 10 percent between 1979 and 1987, and city employment increased by 14 percent between 1983 and 1987.[2] Once troubled Boston now boasts an unemployment rate of 3.1 percent, New York City a jobless rate of 4.7 percent. In short, the states and cities have benefitted substantially from the sustained economic growth triggered by Reagan's fiscal policies.

Many states have built on this underlying economic strength of America by introducing sound budgetary policies. They have adopted measures to limit expenditure growth and tax increases, to return revenue "windfalls" to taxpayers, and to establish budget stabilization or "rainy day" funds for potential future budgetary emergencies. States too have developed innovative, low-cost ways to deliver services. The states with the highest year-end surpluses are those that have resisted tax and spending increases and have relied on creative programs for fiscal soundness.

Spending Surge. Why, then, do governors and mayors come to Washington to urge more federal red ink? The reason is that some politically powerful states have used recent good economic times to unleash a surge of spending. Now these states, concentrated in the Northeast, face a budget crunch and want the federal government to pick up the tab.

Rather than lobbying Washington, these states should follow the lead of Arizona, California, and New Hampshire and introduce measures to encourage fiscal discipline and restraint. The role of the federal government is not to bail out profligate state governments, but to provide a sound national fiscal policy framework that will stimulate economic growth at the state and local level. The federal government thus can best help states by reducing the federal budget deficit, curbing interest rates, eliminating costly mandates and regulations, and replacing the federal grants-in-aid system with a new grant program to channel aid only to those states truly in need.

THE HEALTHY CONDITION OF THE STATES

While the federal government is deeply in the red, America's cities, counties, and states continue to run a healthy combined budget surplus of $54.4 billion – an increase of 56 percent in the past seven years. Even during the economic recession of the early 1980s, the states and localities saw an increase in their budget surpluses of 7 percent between 1981 and 1982.[3]

Part of this budgetary success below the federal level is attributed to state constitutional or statutory measures that require such things as balanced budgets, tax and spending controls, debt limitations, and similar measures

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2 U.S. Department of Housing and Urban Development, *The President's National Urban Policy Report*, 1988. Data based on total employment in 239 Metropolitan Statistical Areas.

3 Office of Management and Budget, *Historical Tables: Budget of the United States Government*, FY 1988.

forcing fiscal discipline. These budget controls have allowed states to maintain a far better budget track record than the federal government. Robert Gleason, Director of Communications and Publications at the federal Advisory Commission on Intergovernmental Relations, reports that while the federal government spent roughly $1.20 for every dollar it received in fiscal 1987, state and local governments took in approximately $1.10 for every dollar they spent.[4]

The governors and mayors now pleading poverty in Washington understandably ignore this underlying budget situation. They also divert attention from another important element in the equation, namely that federal aid to states and localities actually has been increasing, in real terms, since the recession – at the same time state economies have been expanding. While aid is lower than its all-time high of $78 billion in 1978, it has risen steadily in real terms by more than 5 percent since 1983.[5]

THE SPENDING BINGE THAT NOW THREATENS THE STATES

State and local revenues have increased at an average annual rate of 7.3 percent in the past four years, more than twice the rate of inflation. For fiscal 1988 and 1989, most states experienced even faster economic growth than they had anticipated, and revised their revenue estimates upward. For 1989, three out of four states predict that revenue growth for their state will be the same level or higher than for fiscal 1988. These states have pushed the projected aggregate revenue growth rate to 6.5 percent from an original estimate of 5.4 percent.[6]

With general economic growth helping state revenues expand at a rapid clip, it would be reasonable to expect states to forecast a rosy budget future. But many are not, and the reason for their gloom is a huge surge in state spending. Overconfident from the economic expansion, and buoyed by unexpected revenues from the Tax Reform Act of 1986, the states generally have unleashed a spending binge in recent years, especially on health care, education, infrastructure, and corrections. Over the past two years alone, state and local spending has increased in absolute terms by 12 percent – three times the rise in federal spending during the period and almost twice the increase in state and local revenues.[7]

Below the Safety Threshold. On the whole, the states show little inclination to change their excessive spending habits. As many as 34 states expect

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4 Robert Gleason, "Federalism 1986-1987: Signals of a New Era," *Intergovernmental Perspectives*, Winter 1988.

5 Advisory Commission on Intergovernmental Relations, *Significant Features of Fiscal Federalism*, Vol. II, 1988.

6 National Governors' Association/National Association of State Budget Officers, *Fiscal Survey of the States*, March 1989.

7 Office of Management and Budget, *Historical Tables Budget of the U.S. Government*, FY 1990.

expenditures to have risen by at least 5 percent when they close the books for fiscal 1989, and 21 of these states anticipate a rise of more than 10 percent. In fiscal 1988 only six states proposed a spending increase over 10 percent.[8] This surge in spending is eating away the rise in state revenues, shrinking cumulative year-end surpluses from $8 billion in 1985 and $6.8 billion for 1988, to an estimated $5.3 billion for 1989. Measured as a percentage of expenditures, surpluses have declined from 4.3 percent in 1985 to 2.9 percent in 1988, and are slated at 2.1 percent for 1989, well below the National Association of State Budget Officers' advised safety threshold of 5 percent.[9]

State budgets for fiscal 1989 and 1990 indicate that if the states continue spending at their current and projected levels, expenditures will exceed revenues by the end of this fiscal year. While revenues are estimated to rise from $238 billion in 1988 to $253.4 billion in 1989, state expenditures are estimated to rise from $236.2 billion to $255.3 billion, leading to the first cumulative deficit in 13 years. This expenditure-to-revenue ratio is expected to be even larger in 1990; while revenues are projected at $268.2 billion, expenditures are expected to reach $271.5 billion.[10]

HOW SPENDTHRIFT STATES TIP THE BALANCE

These figures, although disturbing, hide two important patterns. The first is that anticipated year-end balances do not reflect surpluses from stabilization or "rainy day" funds established by many states. Some 36 states wisely have established these emergency funds which can be used, often as an alternative to raising taxes in the event of a budget crisis. The second pattern is that the majority of states actually did maintain total balances well above the recommended 5 percent level for 1988. Indeed, thirteen states had balances of over 10 percent. The drop in cumulative year-end balance has been triggered by a few big-spender states which have dragged down the national average.

New England Nightmare. Some important lessons can be learned by comparing these spendthrift states with those that limit spending, adopt "rainy day" funds, and refrain from raising taxes. For instance, Massachusetts is in the midst of a fiscal nightmare, thanks to runaway spending and despite heavy tax increases. Admits the principal state budge official, Edward Lashman, "If the state were a business we'd be insolvent, we'd be eligible for Chapter 11."[11] Governor Michael Dukakis has increased spending at such a pace that the state is expected to post a $1 billion deficit by the end of fiscal 1989. Ironically, Massachusetts and the other New England states propose an average increase in expenditures of 8.9 percent for fiscal 1990. The second

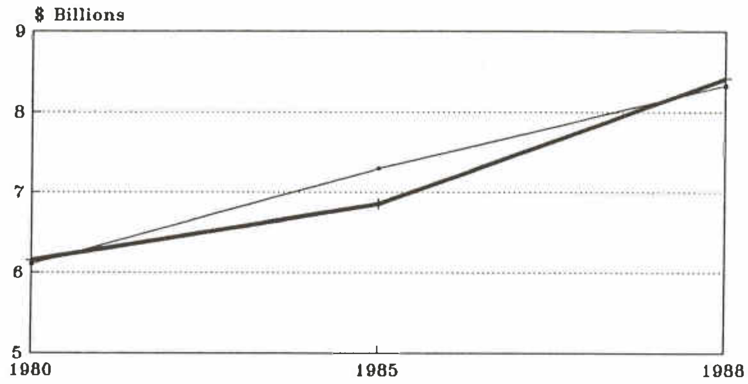
8 NGA/NASBO, *op. cit.*

9 *Ibid.*

10 *Ibid.*

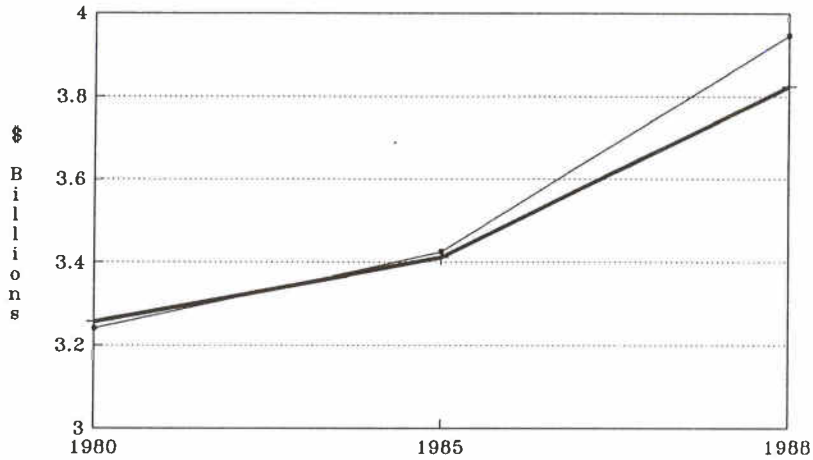
11 Warren Brookes, "Plunging Toward Fiscal Chaos?" *The Washington Times*, May 25, 1989.

Fiscal Overview of the States
(in 1988 constant dollars)



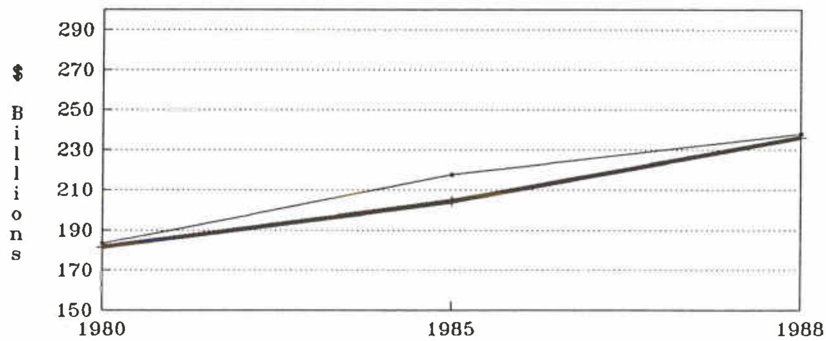
Spendthrift States

Included are Connecticut, Georgia, Kentucky, Massachusetts, New York, and Oregon



Prudent States

Included are Alabama, Illinois, Kansas, Maine, Maryland, and Nevada



All States

Source: National Governors Association/National Association of State Budget Officers.

Heritage InfoChart

highest proposed regional spending increase in the country, the expenditure growth in the Northeast is far above the national average of 6.4 percent.[12]

By contrast, the states now in sound fiscal condition are those that have been taking prudent and often innovative steps to control spending. California, for instance, which had a budget deficit of $1.5 billion just seven years ago, drastically revised its fiscal policies by establishing rainy day reserves and adopting state initiatives to limit spending. The result: a drop in combined state and local spending, relative to personal income, of 3.2 percent between 1981 and 1987.[13] Having maintained a balanced budget from 1981 to 1986, California now holds an accumulated budget surplus of $2.5 billion – without raising taxes.[14]

Fruits of Low Taxes. New Hampshire, with the lowest tax burden in the country, has enjoyed rapid economic growth. From 1975 to 1987, per capita personal income rose by 53.2 percent and general tax revenues rose by 282.8 percent. By contrast, Vermont, whose residents paid roughly 40 percent more of their income in taxes than those in New Hampshire, experienced a rise in per capita personal income of only 30.6 percent and an increase in general revenues of 198.1 percent.[15] A recent study of the two states' fiscal systems by Dartmouth economist Colin Campbell and his wife Rosemary Campbell attributes Vermont's more sluggish economy to heavier taxation at the state level, as well as to government "centralization and its effect on government efficiency."[16]

While Vermont's individual income tax and general sales tax account for a substantial portion of total general revenues – 22 percent in 1987 – New Hampshire's dependence on revenue from these sources is very small. Individual income tax in the state was only 8.7 percent of total revenues in 1987, and New Hampshire does not tax general sales. Instead, the state depends largely on local sources of revenue, like property taxes. New Hampshire collected $2.1 billion in total revenue for the fiscal year; Vermont collected only $1.2 billion.[17]

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12 *Ibid.*

13 Ronald Brownstein, "The Politics of Growth," *National Journal*, June 3, 1989.

14 William Celis III, "California's Unexpected Budget Surplus Proves Frustrating for Legislators to Use," *The Wall Street Journal*, May 19, 1989.

15 Bureau of Economic Analysis, U.S. Department of Commerce, unpublished data.

16 Colin D. and Rosemary G. Campbell, *The Fiscal Systems of New Hampshire and Vermont, An Update, 1975-1987* (Hampton, New Hampshire: The Henley League, Ltd., 1989).

17 *Ibid.*

HOW REAGAN FEDERALISM TRIGGERED STATE INNOVATION

Reagan's federalism strategy often came under fire during his administration. Much of the criticism was from states that had grown accustomed to "free" money from Washington. Yet the principal effect of the overhaul of federal grants was a high degree of policy innovation at the state level.

The Reagan Administration's main federalism goal was to decentralize domestic policy by reducing the amount of federal assistance. To achieve this, Congress cut grants-in-aid from $109.7 billion in 1978 to $88.2 billion in 1982, a decrease in real terms of 24 percent.[18] Through the Omnibus Budget Reconciliation Act of 1981, Congress also consolidated 57 categorical grants into nine new federal block grants.[19] Block grants are a form of government aid designed to provide the states with greater flexibility to make spending decisions. Because federal restrictions are reduced, block grants are often more efficient and less expensive to implement than categorical aid.

Congress also cut federal aid to localities by 33 percent between 1981 and 1986, forcing states to assume a larger financial responsibility for their local governments. In addition, general revenue sharing was eliminated. The Reagan Administration also encouraged state experiments in welfare reform by establishing an interagency board to expedite state requests for exemptions from federal rules to permit demonstration programs.[20]

Leading the Way. Thanks to the stick of modest federal cutbacks and the carrot of increased flexibility, states have begun to provide public services more efficiently and creatively – in most cases without spending more taxpayer dollars on specific services. Indeed, state and cities have become again what they long had been in America: virtual "laboratories of experimentation" and innovation. This creates additional sources of non-tax revenue through lotteries and user fees, privatized municipal services, and creating public-private partnerships to administer and finance economic development projects. Many states have been upgrading their education systems by such measures as mandating tougher requirements for graduation and giving parents greater choice over schools.[21] Similarly, the states led the

18 Advisory Commission on Intergovernmental Relations, *Significant Features of Fiscal Federalism*, Vol. II, 1988.

19 Richard S. Williamson, "A New Federalism: Proposals and Achievements of President Reagan's First Three Years," *Publius: The Journal of Federalism*, Winter 1986.

20 Stuart Butler, "How the White House Spurs Welfare Reform," Heritage Foundation *Backgrounder*, No. 705, May 4, 1989.

21 See Jeanne Allen, "Improving Education: Lessons from the States," Heritage Foundation *State Backgrounder*, No. 670/S, March 1989.

way in welfare reform, such as using their new flexibility to incorporate work and training requirements for welfare recipients to reduce dependency.[22]

ERODING REAGAN FEDERALISM

Although the Reagan reforms triggered the new era of state policy creativity and budget control, Congress gradually has increased state grants and introduced new limitations on state creativity. Example: grant payments to the states and localities rose in real terms from $109 billion in 1982 to $117 billion in 1988.[23] Within just the past year, federal assistance has increased significantly for a multitude of specific purposes, including refugee assistance, student financial aid, mass transit, child support enforcement, and infant nutrition.

Although Reagan succeeded in consolidating many categorical grants into flexible block grants, these block grants comprise less than 12 percent of all federal aid. Categorical grants still account for over 85 percent of all aid. The federal government in 1987 financed 372 state and local programs, up from 170 in 1983.[24] These cost over $170 billion in federal resources.[25]

Congress's Tight Grip. This recent expansion of renewed grants-in-aid comes with strings attached and provides Congress with increased powers to micromanage state and local activity. Three years ago, the National Conference of State Legislatures reported that there were as many as 145 such regulations, the majority of which were imposed in 1972.[26] The 1987 highway reauthorization bill typifies how Congress wields power over the states. The statute established 120 "demonstration" projects that preempted state and local authority by specifying which roads and bridges were to receive funding. As the Advisory Commission on Intergovernmental Relations' Robert Gleason writes, "...this is a new way for members of Congress to get credit for their spending. In any given congressional district,

22 See Kate Walsh O'Beirne, "A State Guide to the New Welfare Law," Heritage Foundation *Backgrounder* No. 681, November 30, 1988.

23 Figures in 1988 dollars. Advisory Commission on Intergovernmental Relations, *op. cit.*.

24 Office of Management and Budget, *FY 1989 Special Analysis H of the U.S. Budget*.

25 Federal Resources include federal outlays for grants-in-aid and foregone revenues for intergovernmental programs. General Accounting Office, *Intergovernmental Relations: Strategic Plan, Fiscal Years 1990-1993*, April 1989.

26 Robert L. McCurley, Jr., "Federally Mandated State Legislation," National Conference of State Legislatures *State-Federal Issue Briefs*, June 1986.

the project becomes not the state's or Governor Smith's road – a subtle distinction of particular importance when it's time to cut the ribbon."[27]

Widening Federal Intrusion. Congress now wants to tighten its grip on the states over health care. One bill pending in the House would require states to expand Medicaid coverage to pregnant women and children whose income is up to 85 percent above the official poverty level. A provision of the House fiscal 1989 budget reconciliation bill, the measure would raise the number of pregnant women and infants eligible for Medicaid to 185 percent of the poverty level – up from 100 percent[28] – and would raise the age for children covered from age 5 to age 6.[29] In addition, the proposal allows the states to include under Medicaid coverage home and community care for the frail elderly and mentally retarded. These "options" would include regulations over the staff and training of such care, and would widely discourage state adoption.

The U.S. Supreme Court has widened the scope for such federal intrusion by declaring that the Constitution gives Congress broad authority to regulate state affairs, both financially and administratively. Reversing the decision in the 1976 *National League of Cities vs. Usery* case, for example, the Supreme Court concluded in the 1985 *Garcia vs. San Antonio Mass Transit Authority* case that Congress could intrude in state and local affairs by requiring that they comply with the Fair Labor Standards Act. And last year, in the *South Carolina vs. Baker* case, the Supreme Court ruled that Congress could refuse to issue tax-exempt bonds to state and local governments. Wrote Justice William Brennan for the majority: "the states must find their protection from congressional regulation through the national process, not through judicially defined spheres of unregulatable activity."[30]

A FEDERALISM AGENDA FOR GEORGE BUSH

The amount of federal aid states receive is not determined by economic need. In practice it depends on the power and influence of state and local politicians and the special interest groups who lobby Washington for tax dollars on behalf of the state. Through this system, aid often is distributed perversely to the most populated and affluent areas. In 1984, reported the American Legislative Exchange Council, a private public policy organization

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27 Advisory Commission of Intergovernmental Relations, *Intergovernmental Perspective*, Winter 1988. Also see Steve Moore, "The Highway Authorization Bill: Inviting a Presidential Veto," Heritage Foundation *Issue Bulletin* No. 127, February 27, 1987.

28 Under the Medicare Catastrophic Act of 1988, Medicaid coverage for pregnant women and infants at 100 percent of the poverty level is to take effect July 1, 1990.

29 Julie Rovner, "Governors' Medicaid Protests Likely to be Swept Aside," *Congressional Quarterly*, August 12, 1989, and Alicia Pelrine, National Governors' Association, unpublished materials.

30 Dick Kirschten, "Leeraged Lobbying," *National Journal*, April 29, 1989.

of state legislators, "Northern states with generally higher per capita incomes were currently receiving comparatively more and faster-growing grant-aid."[31]

If Congress caves in to the demands of powerful spendthrift states, these states will have virtual carte blanche to spend at the federal taxpayers' expense. Furthermore, the system erodes the functional capability of lower-level government. As states become dependent on federal handouts, there is no longer an incentive for states to introduce innovative lower cost programs.

A wise federalism policy, of course, is not one that would ignore state finances. To the contrary. The federal government needs to help states. It can do so best through national policies designed to encourage strong economic growth at the state level, to remove barriers to state policy innovation, and, when necessary, to provide poor states with resources to assure an acceptable level of services for their residents.

There has been little recent discussion of federalism by Washington. George Bush needs to raise the level of debate by introducing a federalism initiative. He should include a number of key principles in such a package. Among these, the federal government should:

1) Promote national economic policies to continue economic growth.

Nothing affects the ability of the states and localities to sustain economic growth more than national economic policy. Reagan's economic policies have led to the longest period of peacetime economic expansion in American history, directly helping the economic performance and budgets of America's states and cities by creating new jobs for American taxpayers, stimulating production and employment growth in all regions of the country, raising personal income, and bringing new sources of revenue to state and local coffers. The most effective "aid" the federal government can give the states and communities is to continue economic policies that reduce the national budget deficit by curbing spending, hold down interest rates, maintain stable prices, limit regulation, and observe the American voters' rejection of new taxes.

2) Avoid becoming a tax gatherer for the states.

Many governors would like to see the federal government raise taxes on their residents and then send the money back to the governors to spend. This would be a mistake. Washington should leave most of the taxing to the state and local governments where the taxpayers can play a more direct role determining how their own dollars are spent. The federal level, far removed from the taxpayer's watchful eyes, is held less accountable for its tax and spending activities than are state and local levels. Moreover, unfamiliar with

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31 Bernard L. Weinstein and Harold T. Gross, *Untying the Federal Knot: An Agenda for State and Local Independence* (Washington, D.C.: American Legislative Exchange Council, 1986).

the specific needs of each state and community, the federal government cannot possibly know what is good for the local taxpayers.

By acting as a tax collector for the states, the federal government only encourages the states to increase spending and adopt bad government policies.[32] Typical are the perverse effects of matching grants. To receive the funds, states and cities must adopt policies designed by Washington, rather than policies that are best for local residents. This forces the states and localities to become increasingly dependent on the federal government for sources of revenue, which in turn restricts their ability to adopt innovative policies. Certain federal programs, moreover, distribute aid directly to the local levels, such as the Community Development Block Grant (CDBG), and this preempts responsibility for designing and funding local programs. The federal government frequently provides handouts for programs already in operation. Explains Richard Nathan of Princeton University's Woodrow Wilson School, "...federal grants, despite their heralded goals and requirements, often end up simply reinforcing state and local programs already in place. State and local officials are not above bending the goals and conditions of federal grant-in-aid programs to fit their purpose. The result is that grants often have much less effect on state programs and activities than is assumed."[33]

3) Encourage policy innovation by state and local governments.

The lower levels of government are "laboratories" of policy innovation. For them to be so to the fullest degree possible, however, they need the federal government's help in removing existing constraints, providing necessary incentives, and revamping the grants-in-aid program.

There are cases where the Administration is already removing red tape holding back the states. The Low Income Opportunity Board was created by Reagan in 1987 to allow states to set up welfare demonstration projects without the usual cumbersome federal regulations. Before the Board was created, states wishing to conduct an experimental welfare reform program had to negotiate with numerous federal agencies in order to obtain suspensions (or "waivers") of regulations to permit an innovative policy experiment. The Board allows the states now to cut through governmental red tape by acting as a "one-stop" interagency clearinghouse for waivers. This speeds the waiver process considerably, and thus gives states a strong incentive to try new ideas. Approximately half the states have proposals before the Board or already received approval for welfare reforms.[34]

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32 See Stephen Moore, "Taxes, Economic Growth, and Budget Deficits: What Washington Can Learn from the States," Heritage Foundation *Backgrounder*, No. 722, July 25, 1989.
33 Robert P. Nathan, "The Role of the States in American Federalism," in Carl E. Van Horn, ed., *The State of the States* (Washington, D.C.: Congressional Quarterly Press, 1989).
34 See Butler, *op. cit.*

Bush could allow the states even wider flexibility over their welfare programs by urging Congress to expand the Board's authority to waive further restrictions. Under current law, for example, states do not have the discretion to require that recipients of certain benefits obtain work.[35] By expanding the Board's waiver authority, states could design more innovative programs while pursuing the intent of the federal legislation providing the funds. Besides providing the states a more direct role in the welfare programs they oversee, such action will encourage further innovation and experimentation in welfare reform.

Enterprise zones are an example of how the federal government can encourage new strategies. Legislation is before Congress to establish a federal enterprise zone program. In these zones, which are depressed neighborhoods in cities, the federal government would reduce some regulation and taxes to stimulate business creation – if the states agree to do the same. Frustrated at the unwillingness of Congress to pass enterprise zone tax legislation early in the 1980s, many states have established their own enterprise zones. Some 36 of them and the District of Columbia have created more than 2,000 zones in over 700 jurisdictions, with such incentives as tax credits and exemptions, technical assistance, and job training. The zones have been very successful. According to the states, the zones have created or retained more than 180,000 jobs since 1982, and have been responsible for approximately $8.8 billion in investment.[36] Yet zones would be even more widespread, and more successful, if the federal government complemented the state incentives with federal tax breaks. Legislation (H.R.6) to provide federal incentives has been introduced by Representative Charles Rangel, the New York Democrat, and a compatible proposal has been sent to Capitol Hill by Housing and Urban Development Secretary Jack Kemp.

4) Adopt a system of Fiscal Capacity Grants to channel federal resources to those states most in need.

In 1985, then-Senator Daniel Evans of Washington and then-Governor Charles Robb of Virginia presented the concept of fiscal capacity grants as a more efficient way to distribute aid to states. Under this arrangement, federal grant assistance would be targeted to states according to their underlying economic condition, and not – as in most cases today – to fund particular programs with only little regard to the states's economic status. "Because too many programs now aid all possible beneficiaries," explained Evans and Robb in a report unveiling their idea, "limited funds are dissipated, and those most in need do not receive enough help. If the goals of programs were more

35 This does not apply to Aid to Families with Dependent Children and Food Stamp programs, which do provide states with the authority to require that recipients work.
36 Robert Guskind, "Zeal for the Zones," *National Journal*, June 3, 1989.

clearly set and more closely focused on the populations or areas of greatest need, intergovernmental programs would have more impact."[37]

Bush should pick up on the Evans-Robb idea and propose a system of fiscal capacity grants that ensures that only poorer states receive aid from the federal government. The Advisory Commission on Intergovernmental Relations has devised an annual "Tax Capacity Index" that calculates how much revenue each state would raise if all states applied a nationally uniform standard of taxation.[38] Congress should use the Commission's index and steer aid only to those states with the most limited ability to generate revenues – specifically, states with a "fiscal capacity" below the national average. With such an index determining assistance, the District of Columbia, with a per capita fiscal capacity 22 percent above the national average, would not have received the largest level of per capita federal aid in 1986. And Alabama, with the second lowest fiscal capacity in 1986, would not have received per capita federal aid at 6 percent below the national average.[39]

CONCLUSION

The debt-laden federal government cannot continue its generous and poorly targeted grants-in-aid program for states. With the exception of a few states, the country is fiscally strong, and states do not need federal aid that, in any case, comes from taxpayers living in the states. Benefitting enormously from the economic policies of the 1980s, state and local economies are stronger today than ever, and revenue continues to grow faster than even state budget officers had anticipated. Federal "assistance" only impedes state and local government action by subjecting aid to costly regulations and unnecessary mandates.

Toward Sounder State Economies. The states and cities are the innovators of new policy ideas. They will have less incentive to be creative, however, if they receive bigger checks from Washington. Rather than campaigning for more federal funds – and greater dependency on Washington – governors and mayors should continue to experiment with more efficient programs and adopt even sounder fiscal policies.

Washington officials, in turn, can aid state and local jurisdictions best by removing costly regulations, holding taxes down to stimulate continued national economic growth, and revamping the grants system. Throwing more money at state houses, paid for by new taxes or more borrowing, would

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37 Daniel J. Evans and Charles S. Robb, *To Form a More Perfect Union*, The National Conference on Social Welfare, December 1985.

38 Advisory Commission on Intergovernmental Relations, *Significant Features of Fiscal Federalism*, *op. cit.*

39 For most recent available data on fiscal capacity, see Advisory Commission on Intergovernmental Relations, *1986 State Fiscal Capacity and Effort*, 1989. For 1986 per capita federal aid to the states, see Bureau of the Census, *Federal Expenditures by State for FY 1986*.

merely allow some states to continue spendthrift policies at federal expense and jeopardize all states by threatening continued strong economic growth.

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