FEDERAL EXPENDITURE AND STATE FUNCTIONS

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In his Williamsburg speech of June 24, President Eisenhower called upon the States to assume financial responsibility for the provision of public services now borne, in whole or in part, by the Federal Government. Following this, in July, he appointed a top-level committee to work with a committee representing the State governors. The preservation of effective political decentralization has been made a subject for serious contemporary discussion.

The President made his views on these matters quite explicit. He recognizes the advantages of genuinely decentralized government. But at the same time, he feels that there exist certain pressing social needs which, if the States do not meet them, must be provided for by the Central Government. In this position, the President is surely reflecting an attitude which is widely shared. And it is this attitude which will possibly provide the motivation for expanded Federal expenditure over the next decade. The Federal Government will probably continue to assume greater and greater financial responsibility for highways, schools, hospitals, resource development, slum clearance, urban redevelopment, flood and natural disaster relief, etc.

"Undeniable" National Needs

In this paper, I want to examine critically this commonly held attitude. Two specific quotations from the President's speech provide a text:

> Every State failure to meet a pressing need has created the opportunity, developed the excuse, and fed the temptation for the National Government to poach on the States' preserve. Year by year, responding to transient popular demands, the Congress has increased Federal functions.
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> Opposed though I am to needless Federal expansion, since 1953 I have found it necessary to urge Federal action in some areas traditionally reserved to the States. In each instance, State inaction, coupled with undeniable national need, has forced emergency Federal intervention.

There is no ambiguity here. The needs exist. Either the States respond to them, or the Federal Government must. On this simple and apparently straightforward logic, the power of the States themselves to determine whether or not there exist needs for services traditionally performed has completely vanished.

Something is wrong here. The mere presence of public or collective needs has become confused with the necessity for satisfying them. The need for more and better highway facilities, for more schoolrooms, for more slum clearance, etc., may be readily admitted. But needs are always relative, never absolute. The existence of "undeniable" need does nothing toward proving that action must be taken to meet it. Paralleling each additional need or desire, be it public or private, there is some cost of meeting it, a cost which can be measured in terms of the goods and services sacrificed or given up. This concept of alternative or opportunity cost is the central principle of economics, and we stand always in danger of overlooking it, especially in discussions of public policy issues. We can collectively satisfy the need for more schoolrooms only by giving up something else—dwelling units, automobiles, or what have you.

Public needs become objectively meaningful only when people indicate a willingness to bear the necessary costs. And there is no objective standard to be utilized at this point. In a democratic society, the genuine collective needs of the people are expressed only through their actions as voters, pressure-group members, legislators, and administrators.

The question at issue concerns the prospects for Federal assumption of financial responsibility for functions traditionally performed by the States and local units of government. The President suggests that the latter units have failed to meet the needs which should be met, presumably on the basis of some objectively determinate standard. But if no objective standard exists, on what basis can such a statement make sense?

Federal Versus Local Decision Making

It might be argued that the social decision-making process represented by the Federal Government is more "rational" than is that represented by State and local units, that is "rational" in the sense that Federal decisions are more closely in correspondence with the genuine desires of the populace. This argument appears from time to time under different forms, but surely it has no basis either in fact or ideal. The philosophical foundation of western civilization embodies the assumption that the individual acting for himself or his family can best express his own wants. Failing this, the individual's desires can be more closely satisfied through decisions made in small, closely associated groups and organizations. How else can we account for the widespread support for such ideas as local option, home rule, self-determination, etc.? The individual's wants are more adequately expressed through the actions of a county or city school board, which is forced to respond directly and continuously to conflicting pressures, than through the action of the National Congress or a Federal administrative agency. At the local levels of government, the needs of individuals are clearly manifest, but (and perhaps here is a key to some of the confusion) so are the costs. And it is precisely because both needs and costs can be more properly weighed that local governments many times seem to the careless observer to be backward and unresponsive in taking positive action. Local school boards do not always decide to build schoolrooms which some educational authorities, thinking only of the need, demand. But this fact in itself is an indication that decisions are being made on a rational basis rather than the opposite.

The best evidence that many of the needs for extra schoolrooms, more roads, more hospitals, and so forth, are not undeniable is provided by the fact that States and local units have not taken measures to satisfy them. Far too often, the Federal Government is called upon to assume additional financial responsibility because the direct connection between benefits and costs tends to become lost in the complex maze of Federal budgetmaking. To the individual recipient of Federal aid, Federal financing gives the illusion of some sort of magic although simple logic must reveal that additional Federal taxation is necessarily present. As a general rule it may be stated that the further removed the individual is from the governmental unit involved the greater the fiscal illusion becomes. This alone should give pause to any extension of Federal financing at the expense of State and local units.

When Is Federal Financing of State Functions Justified?

Fiscal equalization

There are only two legitimate grounds which justify that the Federal or Central Government assume some fiscal responsibility for public services performed by State and local units of government. First, some Federal action is legitimate if the purpose is that of achieving fiscal equalization among the various States. By fiscal equalization I mean the equalizing of the overall fiscal burden among the separate State areas.

This sort of action may become necessary if there exist wide differences in incomes and wealth among the separate States. Here the Federal Government may, in the interest of both efficiency and equity, take action to transfer funds from the richer States to the poorer States. Such transfer is necessary due solely to the fact that average incomes differ among the separate geographical subdivisions, and that these differences impose differential fiscal pressures on individuals. The individual who resides in a low-average-income State must, on the average, be subjected to a heavier fiscal pressure than his equal in a high-average-income State. A fiscal disadvantage is placed on the individual who happens to reside where low income receivers are concentrated. In more concrete terms, the Mississippi resident must pay higher taxes to get the same quality of public services than the New York resident, not due to any inefficiency of the Mississippi fiscal structure, but due solely to the fact that he lives in Mississippi. The equalization of fiscal pressures may be accepted as a proper role of the Central Government.

But, having accepted fiscal equalization as an appropriate Federal function, the next question becomes that of applying this legitimate purpose to the problem of Federal financial aid to States for particular State functions. There are several points to be noted.

First of all, the need for geographical equalization of fiscal pressure is rapidly being eliminated. Average income differentials among the States are narrowing over time. It is not to be expected, nor should it be hoped, that these differences will ever be fully eliminated. Some such differentials must remain as the result of the deliberate choices freely exercised by individuals. But regional income and wealth differentials significant enough to warrant Federal intervention should assume diminishing importance over time.

Secondly, if Federal income transfers to accomplish fiscal equalization are attempted, this does nothing to suggest that particular State functions should be singled out and designated for Federal aid. The equalization argument is a general one, and it should be applied for overall fiscal pressures (taxes and benefits) and not to particular services such as education, highways, and so forth. Ideally, Federal grants-in-aid designed to achieve equalization should be completely unconditional, and the recipient States should be free to dispose of such funds as they wish. Unless this procedure is adopted, State budgets are distorted and spending upon projects of secondary importance may be encouraged. The equalization argument provides no justification for Federal assumption of financial responsibility for specific State and local functions.

Thirdly, if fiscal equalization is the main purpose to be achieved by Federal financial aid, this can be accomplished through Federal grants to the poorer States only. There is no equalization purpose to be served by general Federal financial aid to all States, rich and poor alike.

Federal grants-in-aid, in the past, have not been motivated primarily by the desire for fiscal equalization. The factual record indicates that Federal grants to States have been almost neutral in their equalization effects. The achieving of fiscal equalization has not been the dominant motive behind expanded Federal aid, and there seems no reason to predict that the equalization argument will loom larger in the future. In fact the contrary seems more likely. Federal financial aid in the past has been tied to State performance of particular public functions. This sort of financial aid must be supported on the basis of some argument other than that of equalization.

Spillover or neighborhood effects

The second justification for expanded Federal participation in the financing of public functions traditionally performed by State and local units lies in the possible existence of important spillover effects stemming from independent State action or inaction. If the action taken by a single State with regard to the performance or nonperformance of some public service exerts significant and important effects on citizens of other States, some basis is provided for the interference of the Central Government. It is at once evident that almost any action, public or private, carries with it some spillover effects. The benefits from public expenditures made by individual States rarely fall exclusively upon residents of the spending jurisdiction. And the social costs resulting from a failure to perform certain services are not normally confined to a single political unit. The relevant words become, therefore, significant and important. When do such spillover effects become important enough to warrant Federal intervention? The answer here can only be discussed case by case; there is no clear dividing line which is generally applicable.

We may, first, examine the financing of the highway system. Much of the support for Federal financing of the Interstate System, approved in 1956, was based on the presumed need for a genuinely interstate network of highways. It was argued that full State responsibility would allow portions of the national network to become depreciated to such a degree that effective interstate communication would be disrupted or seriously impaired. No detailed empirical investigation is required to indicate the weakness of this argument. If the separate States were, in fact, characterized by vastly divergent standards of road construction, some additional Federal participation may have been justified. But the road network of the Nation is remarkably uniform, and interstate travel is not difficult. The spill-over effects do not loom as significant or important in any meaningful, relative sense. There appears to have been no legitimate justification for increased Federal participation in financing highway construction. This is not, of course, to deny the existence of benefits to be expected from a single, integrated system of trunk roads. These are real benefits to the Nation as a whole, but they will be secured at the cost of yet another expansion of centralized political power, a cost which can only be indirectly calculated and which tends to be of permanent duration.

As a second currently important case, we may consider the problem of Federal aid for school construction. The existence of spillover or neighborhood effects from State and local expenditure on education cannot be denied. And this is clearly a national interest in seeing that the separate States devote adequate funds to education. The population in any one State at any particular time is made up of individuals educated in many of the separate States. The benefits from educational expenditure are not limited to the citizens of the State which finances. Having said this, the whole question now reduces to one of assessing the significance of the spillover effects and weighing these against the added cost which necessarily accompanies Federal intervention.

In education, these intervention costs are likely to be especially high. Education is not a homogeneous product, and the values of maintaining separate systems are great. We do not know the sort of education which is optimal, and the forcing of all public education into a standardized straitjacket which Federal financing must involve would destroy much helpful experimentation and divergence. It is assumed that Federal financing will involve Federal control, sooner or later. There seems little evidence that such control can possibly be avoided. We may look again at the highway problem for current evidence. Federal intervention was designed to be kept at a minimum. Yet, before the revenue bill was enacted, Davis-Bacon provisions concerning wage setting were imposed, and now, only 1 short year later, active discussion is continuing concerning Federal action to regulate billboard advertising. It is naive to hope that Federal aid to school construction would fare any better. It is realistic to expect that it will fare worse.

We may summarize all this by saying that, when spill-over effects are present, there are real benefits to be gained from the securing of uniform national standards of performance of certain public services. But there are also real costs involved in achieving such uniformity. Far too often, popular discussion overlooks the cost side. The costs are difficult to compute, because they are measurable only in terms of power concentration. It is almost impossible to place dollar equivalents on costs of this nature, but this should not cause them to be neglected. Such costs show up in damage to the whole political power structure represented by a federally organized system. Genuine federalism as a viable political form requires severe limitations on the degree of power concentration in the Central Government. And, in a country so large as the United States, genuine federalism may be essential to the preservation of the free society.

The discussion at this point becomes one of the political philosophy, which is inappropriate in this brief paper. Perhaps a more direct and positive approach is more useful. Let me state that I consider further centralization of political power in the hands of the Central Government to carry with it a real cost; that I consider the benefits to be secured from nationalizing public education, highways, and other similar services insufficient to warrant paying this cost. In making this statement I am not speaking as an economist who has measured such social intangibles as the cost of centralizing power or the benefits of nationalizing education. No accurate measurement can be made. Only those directly responsible for decisions can strike a final balance on the basis of their own attempts at measurement. But, in undertaking this difficult task, political leaders should not allow themselves to be bamboozled into accepting some supposedly objective measures of national need and then cajoled into believing that because the need exists it must be satisfied. The implications of the Eisenhower statements cited at the beginning of the paper must be rejected. The failure of the States and local units to take action in expanding certain public services is no signal for Federal Government action.

Conclusion

I shall conclude by stating that there appears to be no justification for the Federal Government, over the next decade, to assume greater responsibility for financing public functions now financed by States and local units. There are good reasons which suggest that a sizable reduction in Federal aid to States and localities should be carried out. But it would be naive to expect such a reduction, and I am by nature a pessimist. But by waking up, all too late, to the dangers inherent in the continued concentration of power in the Central Government, we can, perhaps, prevent further encroachment.

This study by the Joint Economic Committee is devoted to the general topic, "Federal Expenditure Policy for Economic Growth and Stability." The proper environment for economic growth is a politicoeconomic system characterized by effective decentralization of power. Undue power concentration can only be detrimental to economic progress, whether this concentration be in the form of big business, big labor, or big government.